

Oil and Gas Taxation: Partnerships and Joint Ventures

November 2021

Agenda

- ✚ Economic interest
- ✚ Leasing
- ✚ Joint operating agreements
- ✚ Complete payout vs. incomplete payout (fractional interest)
- ✚ Rev. Rul. 77-176 and multi-property issues
- ✚ Reimbursements of capital expenditures
- ✚ Tax partnerships
- ✚ Juridical partnerships
- ✚ Publicly traded partnerships (MLPs)

Economic interest

- ✚ Treas. Reg. § 1.611-1(b). An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. See also *Palmer v. Bender*, 287 U.S. 551 (1933).
- ✚ Importance of having an economic interest – intangible drilling and development cost (“IDC”) deductions and depletion.
- ✚ No requirement that the holder possess legal title to the minerals in place.
- ✚ Economic interests are generally real property assets.

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Leasing

- ✚ A “lease” is the most common method of transferring oil and gas interests, and the proper characterization of the lease is important for a variety of tax reasons.
- ✚ Lessee generally has the right and obligation to drill wells, develop and produce oil and gas from a specified location; whereas the Lessor is compensated for granting that right.
- ✚ Lease will have a specified term that can often be extended if certain conditions are met (leases often state when commencement of drilling activity must occur). Subsequently, the lease is generally held by production.
- ✚ A transfer of a working or operating interest constitutes a lease if the transferor retains a cost-free economic interest that will endure for the life of the transferred property.

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Leasing (cont.)

- ✚ The holder of the economic interest is the tax owner (generally the Lessee).
 - Holder is taxed on its share of production and is entitled to depletion
 - The working interest owner (the owner of an operating interest) can generally deduct its pro rata share of IDCs
- ✚ Pool of Capital Doctrine
 - Transfer of an economic interest is generally not taxable if the transferor retains an economic interest and the transferee commits funds or efforts to develop the underlying mineral interest.

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Joint operating agreements

- ✚ The joint operating agreement ("JOA") or mineral partnership is the most commonly used agreement for joint development of oil and gas properties.
- ✚ Where more than one working or operating interest holder exists, a JOA is generally necessary.
- ✚ The mere co-ownership of working interests generally results in the arrangement being treated as a partnership for U.S. federal income tax purposes (however, as parties may elect out of partnership tax treatment in certain circumstances).
- ✚ One party generally serves as the operator, and costs are shared amongst the parties based on agreed upon deal terms.

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