University of Texas
2021 Oil and Gas Tax Bootcamp
Part Three - Session 1

Basic Oil and Gas Transaction Structures

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Agenda - Session 1

- Distinguishing Sales of Oil and Gas Properties from Leases
- Key Tax Provisions in Oil and Gas Property Purchase and Sale Agreements

Oil and Gas Property
Purchase and Sale and Leasing Transactions

- Why are these transactions entered into?
  - Seller/Lessor
    - Expected property development costs exceed debt and equity capital available
    - Unfavorable view of the geology
    - Unfavorable future commodity price expectations
    - Distressed financial condition requires the sale or lease
    - Generate Section 1231 gain and ordinary income to absorb net operating losses
    - ESG considerations
  - Purchaser/Lessee
    - Favorable future commodity price expectations
    - Debt and equity capital available to finance development
    - Favorable view of the geology
    - Favorable balance sheet allows the purchase or lease

What is a "Sale" for Tax Purposes?

- Transfer of all or a portion of an oil and gas property in which no continuing, nonoperating interest is retained
  - Transfer of 100 percent of working interest in Tract A
  - Transfer of 50 percent of 100 percent working interest in Tract A
  - Transfer of 100 percent of overriding royalty interest in Tract A
  - Transfer of 100 percent of working interest in Tract A subject to a retained volumetric production payment
    - The VPP is a noncontinuing interest – by definition its life is shorter than the life of the lease

What is Not a "Sale" for Tax Purposes?

- Transfer of all or a portion of an oil and gas property in which a continuing, nonoperating interest is retained
  - Mineral fee owner's assignment of working interest in Tract A subject to a retained landowner's royalty interest
  - Working interest owner's assignment of working interest in Tract A subject to a retained overriding royalty interest
- These transfers instead are "leasing" transactions
  - Any cash bonus or other consideration received by transferor is ordinary income in the hands of transferor
  - Transferor claims a cost depletion deduction
  - Leasing transactions with a partnership/lessee do no qualify for tax deferral under Code section 721

Why Does It Matter Whether the Transaction is a Sale or a Lease?

- "Sale" means that the difference between the "amount realized" for the asset and the asset's "adjusted tax basis" is a gain or loss that can be subject to the capital gain tax rates
- "Lease" means that the cash bonus received is taxed at the ordinary income tax rates, with a cost depletion deduction as computed
- The after-tax results may differ significantly between the two transactions, although the before-tax economics may be substantially similar
  - Tax rate differential for non-corporate taxpayers
  - Capital gain available to absorb capital loss carry forwards
  - Full tax basis recovery versus a cost depletion deduction