Oil, Gas & Coal Taxation

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Oil, Gas & Coal Taxation

- The meek shall inherit the earth. But not its minerals.
Outline

- Montana natural resource profile
- Perspectives of mineral owners, developers & investors
- Major tax benefits of oil, gas and coal operations (and their limitations)
- Structuring the transfer of mineral properties
- Details of tax benefits
Montana Oil & Coal Profile

1 percent of US oil production

4.3% of US coal production

Source: EIA
Montana DOR Natural Resource Audit Collections

Natural resource tax audit collections for fiscal year 2015 totaled $5.3 million.

Source: Montana Fiscal Report 2015
We will focus on federal taxes
Mineral developer’s perspective

- The exploration, development, and production of crude oil, natural gas and coal takes enormous amounts of capital.
- To obtain the funds needed, companies sometimes join together and pool their resources to conduct exploration activities.
- Large integrated companies, as well as small companies and individuals, participate in the exploration, development, and production phases of the oil, gas, and coal industries.
Mineral owner’s perspective

- The owner of mineral rights may not have the resources, technology or expertise to explore for minerals.

- An oil and gas or coal company can obtain the rights to explore and drill by purchasing those rights or by entering into mineral leases with the owner of the minerals rights.
  - The lessor (owner) keeps a royalty interest or nonoperating interest in the minerals; &
  - Grants the lessee (driller) a working interest in the land in exchange for the lessee’s promise to explore and drill (a/k/a, an “operating interest”).

Investor’s perspective

- The unique opportunity of Master Limited Partnerships - § 7704(c)
- Exempt from corporate tax treatment commonly imposed on publicly traded partnerships
- Avoids double taxation
- Must meet gross income requirements
  - 90% or more of gross income must be “qualifying”
  - Qualifying income includes: income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource . . . Internal Revenue Code (IRC) § 7704(e)(4)(E)
Generous Tax Treatment

- The tax system provides generous tax treatment for mineral investments
  - Special tax rules permits many investments in oil and gas property to be expensed rather than capitalized and deducted over the income-producing life of the oil or gas property;
  - Percentage depletion reduces the effective tax rate on royalty income;
  - Disposition of coal with a retained economic interest is eligible for capital gains treatment;
  - Passive activity loss rules generally do not apply to working interests in oil & gas.
The Major Tax Benefits

- The Pool of Capital Doctrine
- Percentage Depletion
- Two-year Amortization of Geological & Geophysical Costs (G&G)
- The Election to Deduct Intangible Drilling Costs
- The Deduction for Qualified Tertiary Injectant Expenses
- Capital Gain treatment for coal investments
Structuring the Transfer of Mineral Properties

- Sales
- Leases
- Sharing arrangements
  - The Pool of Capital Doctrine
Sales and Leases

- A landowner typically owns property as a “fee interest,” which may include ownership of both the surface rights and the right to minerals on and beneath the surface.
- The landowner can sell or lease any part of those land or mineral rights.
- Sometimes, however, the mineral rights are held by someone other than landowner.
- Check the deed. Split estates occur when the surface rights are owned by one person and the mineral rights owned by another. Note that different mineral rights under the same parcel of land may be owned by different parties, e.g., one party may have the right to develop the coal, while another party has the right to the oil and gas.
- In any event, when the owner of the land or mineral rights enters into an exploration contract or lease with respect to those mineral rights, the tax consequences of the transaction will turn on the particulars of the contract.
Sales

• The owner of a land interest or mineral rights interest can sell (deed) that interest to a mineral development company.

• In that event, the owner (seller) will recognize a gain, and the company (buyer) will take a cost basis in the interest.
  ◦ IRC § 1031 allows for non-recognition on certain like-kind exchanges of mineral properties.
  ◦ Note: IRC § 1031 is NOT elective – if the transaction qualifies, gain or loss will be deferred.
Leases

- More commonly, the owner of a land interest or mineral rights interest will lease the mineral rights to an oil and gas company.
- The lease agreement usually provides for an up-front cash bonus & a royalty to be paid to the lessor (owner) of the mineral rights.
- Typically, the lessor will get a royalty of 1/8 of production, and the lessee (driller) will take the remaining 7/8.
- The lease will also usually obligate the lessee to pay a delay rental for each year that development is not started.
- The lessee’s interest is typically known as a working or operating interest, while the lessor’s interest is a royalty or nonoperating interest.
A Typical Oil and Gas Lease

- Lois Landowner leases the mineral interest to Doug Driller who will drill the well.
- Lois retains a 1/8 royalty interest but bears none of the cost or responsibility for drilling the well.
  - If the well produces 30,000 barrels a year and each barrel is sold for $50, of the $1.5 M gross income from the well, Lois receives $187,500 annually.
  - Lois may take a 15% depletion deduction of $28,125

- Doug Driller acquires the 7/8 balance of the mineral rights as a working interest that
  - entitles Doug to share in the production
  - in exchange for his obligation to explore and drill

- Doug has gross income of $1.3 M because the payment to Lois is excluded from his gross income. Treas. Reg. § 1.613-2(c)(5)(i)

- Doug can deduct percentage depletion and other expenses
Royalties

• When drilling results in a producing well, royalty payments based on the sales of oil and gas are divided in accordance with the terms of the lease, and those royalties are eligible for percentage depletion.

• A royalty interest entitles its owner to share in the production from a mineral deposit, free of development and operating costs, and extends undiminished over the entire productive life of the property.

• Royalties are included in gross income and can be eligible for percentage depletion.

• Royalty payments made by the lessee to the lessor are excluded from the lessee’s gross income.
Cash Bonuses

- Cash bonuses received by the lessor upon the execution of an oil and gas lease are viewed as advance royalties.
- The lessor may be able to claim cost (but not percentage) depletion. IRC § 613A(d)(5)
  - However, if the lease expires without oil and gas production, the lessor may have to recapture the previously-allowed depletion as ordinary income in the year the lease terminates.
- The payor of a cash bonus (i.e., the lessee) capitalizes the cost into the depletable basis of the lease.
Example of Cash Bonus Tax Treatment: Oil & Gas

- Doug Driller pays Lois Landowner $100,000 as a cash bonus for her signing a 5 year lease on her oil & gas rights, which provides for a 1/8 royalty payment upon production.
- Lois paid $30,000 for the land, $20,000 of which is reasonably allocated to the mineral rights.
- Lois has $100,000 of ordinary income on receipt of the cash bonus.
- Royalties expected to be received are $900,000.
- $20,000 basis × $100,000 bonus/$1,000,000 (bonus + expected royalties)
- = $2,000 cost depletion on the bonus
- The remaining $18,000 will be recovered as depletion as the royalties are received
  - Treas. Reg. § 1.612-3
Example of Cash Bonus Tax Treatment: Coal

- Mike Miner pays Lois Landowner $100,000 as a cash bonus for her signing a 5 year lease on her coal rights, which provides for a 1/8 royalty payment upon production.
- Lois paid $30,000 for the land, $20,000 of which is reasonably allocated to the mineral rights.
- As she has a retained economic interest in the coal deposit, IRC § 631(c) applies.
- Lois has $80,000 of IRC § 1231 gain on the receipt of the cash bonus.
- Percentage depletion does NOT apply.
- Under IRC § 272, Lois may not deduct any of the administrative costs of the lease.
- Lois may continue to subtract a proportionate amount of her basis from future royalty payments and treat the remainder as IRC § 1231 gain.
Minimizing Tax Consequences of Oil & Gas Advance Royalties

- Cash up front is good from a business standpoint.
- However, ordinary income is not good from a tax standpoint.
- Moreover, Doug Driller may not deduct the cost of the bonus, whereas royalties paid to Lois are effectively deductible.

**Solutions**
- Increased royalty share
- Deferred bonus
- Minimum royalty
Delay Rentals

- Oil and gas leases generally require that the lessee begin drilling for oil and gas within one year after the granting of the lease and that if drilling has not begun within that time period, the lease will either expire or the lessee will pay the lessor a sum of money in order for the lessee to retain the lease without developing the property.
- The lessor must treat these so-called “delay rentals” as ordinary income on which no depletion is allowable.
  - Treas. Reg. § 1.612-3(c)(2)
- For the lessee, delay rentals generally must be capitalized into the depletable basis of the lease.
- Also true for coal.
Production Payments

- A production payment is the right to a specified share of the production from minerals in place (if, as, and when produced) or the proceeds from such production.
  - Retained production payments may occur on a sale or sublease of mineral interests
  - Carved-out production payments may occur on a lease of mineral interests

- A production payment is a nonoperating interest, and it must have an economic life that is of shorter duration than the economic life of the mineral property from which it is created.
  - This can be a term interest (number of years), but is more commonly defined as a dollar amount or a sum determined by a formula.

- A “carved out” production payment is generally treated as a mortgage loan on the mineral property burdened thereby and not as an economic interest in minerals in place.
Distinguishing Royalties from Production Payments

- Royalty is based on production or proceeds of production over the entire life of the resource.
- Royalty is an economic interest in the mineral in place.
- Royalty payments are eligible for percentage depletion.
- A “retained” production payment is an economic interest in the mineral in place and is treated like a royalty.
- Production payments are based on production over a term shorter than the expected economic life of the resource.
- “Carved-out” production payments are NOT an economic interest in the mineral in place.
- Carved-out production payments are NOT eligible for percentage depletion.
  - Some portion of production payment will be treated as interest
  - Some portion will be treated as repayment of principal
Sharing Arrangements: the Pool of Capital Doctrine

- No taxable event occurs if drillers, equipment suppliers, and investors contribute services and materials to the development of an oil and gas property in exchange for an economic interest in that property.
  - In general, the contributors are not viewed as performing services for compensation or selling property, but as acquiring capital interests in an ongoing pool of capital.
  - Accordingly, they do not have to pay any tax until the well starts to produce.
Economic Interest

- “Economic interest” is an element of the pool of capital doctrine.
- It is also critically important in determining tax consequences of mineral investments.
- Only parties with “economic interests” are entitled to depletion deductions.
- Whether an economic interest exists has been the subject of much litigation.
Economic Interest

- Taxpayer must be *legally* entitled to either
  - A share of the production OR
  - A share in the proceeds from the sale of production
  - The taxpayer does not need legal title to the mineral resource
    - Rev. Rul. 73-470 (taxpayer could recoup investment solely from proceeds of production)
    - Gulf Oil Corp. v. Comm’r., (3d Cir. 1990) (taxpayer held exclusive right to sell minerals)

- If the taxpayer is merely conducting mining or drilling operations as a contractor, there is no economic interest in the minerals in place.
  - Parsons v. Smith, 359 U.S. 215 (1959)
  - Paragon Jewel Coal, Inc. v. Comm’r., 380 U.S. 624 (1965)
Limits on the Pool of Capital Doctrine

- Rev. Rul. 77-176
  - Holding that to come within the pool of capital doctrine, the economic interest acquired must be in the same property to which the materials and services are contributed.

- Rev. Rul. 83-46
  - Holding that an attorney who contributed legal services to a drill site had income when he received a royalty interest in the property in exchange for his services.
Pool of Capital Doctrine: Services

The doctrine applies if all of the following occur:

- The contributor of services must receive a share of production, and the share of production is marked by an assignment of an economic interest in return for the contribution of services;
- The services contributed may not in effect be a substitution of capital;
- The contribution must perform a function necessary to bring the property into production or augment the pool of capital already invested in the oil and gas in place;
- The contribution must be specific to the property in which the economic interest is earned;
- The contribution must be definite and determinable; &
- The contributor must look only to the economic interest for the possibility of profit.

I.R.M. 4.41.1.2.3.1, at paragraph 8.
Depletion

- Depletion is a form of capital cost recovery.
- Depletion deductions are allowed only to the owner of an economic interest in mineral deposits (or standing timber).
  - An economic interest is an interest
    1. acquired by investment in the minerals in place,
    2. that entitles the owner to income derived from the extraction of the minerals, and
    3. to which the owner must look for a return of its capital.
Two Methods of Depletion

- Under the cost depletion method, a taxpayer deducts a ratable share of her adjusted basis in the depletable property as she sells it, but only until she has recovered all of her basis.
- With percentage depletion,
  - Independent oil and gas producers and royalty owners can generally deduct 15% of their gross income from the oil & gas property each year
  - Coal producers and royalty owners can generally deduct 10% of their gross income from mining each year
  - Cumulative depletion deductions can exceed the taxpayer’s basis.
Cost Depletion

To figure cost depletion, a taxpayer must determine:
1. the property's basis for depletion;
2. the total recoverable units of the mineral in the property’s natural deposit; &
3. the number of units of mineral sold during the tax year.

To figure its cost depletion, a taxpayer takes the following steps: 1) divide the property’s basis for depletion by total recoverable units to get the rate per unit; & 2) multiply the rate per unit by units sold during the tax year to get the cost depletion deduction.

There is an elective safe harbor for owners of oil and gas property that sets total recoverable units equal to 105% of a property’s proven reserves.
Cost Depletion Example

- Assume that a taxpayer has 100,000 recoverable barrels of oil with a basis of $1,000,000 & this year it sells 5000 of those barrels for $200,000
  - The taxpayer would report $200,000 in gross income; &
  - Take a cost depletion allowance of $50,000
    - $50,000 = $1,000,000/100,000 × 5000.
  - The taxpayer’s basis in the remaining 95,000 recoverable barrels would be $950,000.
Percentage Depletion

- Percentage depletion is available to domestic independent producers and royalty owners
  - but it is not available for integrated producers who are also large retailers or refiners
- To figure percentage depletion, the taxpayer multiplies its gross income from its oil and gas property for the year by 15%.
- All coal investments (i.e., not limited to independent producers) are eligible for percentage depletion on the gross income from mining at a 10% rate, limited to 50% of the taxable income from the property. Treas. Reg. §1.613-5
- Percentage depletion can result in the recovery of more than the capital investment in the property (cumulative depletion deductions can exceed the taxpayer’s basis)
  - But the adjusted basis in the leasehold interest is not reduced below zero.
Limits on Percentage Depletion

- Percentage depletion deductions can exceed the taxpayers’ basis, but there are limits.
- Percentage depletion cannot exceed 100 percent of the taxable income from the property or 65% of the taxpayer’s taxable income for the year.
- For coal, the limit is 50% of taxable income.
- There is also a limit on how much oil can be used for percentage depletion; generally, a taxpayer’s depletable oil quantity is an average of 1000 barrels per day.
  - Related parties are required to allocate the depletable oil quantity among those parties in proportion to their respective production.
Recapture on the Sale of a Lease after Development

• When a lease is sold or exchanged, the taxpayer will realize a gain or loss based on the difference between the selling price and the adjusted basis of the property sold.

• In general, the gain will be taxed as ordinary income to the extent that it relates to basis reductions attributable to depletion or intangible drilling costs (IDCs), but the rest can be capital gain. IRC § 1254
Geological & Geophysical Costs (G&G)

- Geological and geophysical ("G&G") expenditures are the costs incurred by an oil and gas exploration and production company to obtain, accumulate, and evaluate data that it needs to decide about which oil and gas properties it should acquire and retain.

- G&G expenses are usually associated with geologists, seismic surveys, magnetic surveys, or gravity meter surveys.
G&G Expenses—IRC § 167(h)

- For most domestic oil and gas companies, G&G expenses are amortized ratably over 24-months. IRC § 167(h)
  - There is a half-year convention so that the G&G expense is treated as occurring at the midpoint of the year in which the expenses were paid or incurred. IRC §167(h)(2)
  - Accordingly, G&G expense deductions are spread over three tax years.
G&G Example

• Doug Driller spends $10,000 for G&G in Year 1.

• Doug would capitalize those G&G expenditures & he would deduct:
  ◦ $2500 (25%) in Year 1,
  ◦ $5000 (50%) in Year 2, &
  ◦ the last $2500 (25%) in Year 3.
G&G Expenses

- This amortization is the exclusive method of recovering G&G expenses.
  - If the taxpayer abandons the property before the end of the amortization period, amortization continues and no immediate deduction is allowed for remaining amortizable amounts. IRC § 167(h)(4)
- G&G expenses should be allocated to the leases that are acquired and retained.
G&G Expenses

- Major integrated oil companies amortize their G&G expenses over seven years
- Foreign properties are not eligible for favorable amortization treatment
  - Instead, such costs must be capitalized.
Intangible Drilling Costs

- The holder of a working interest in an oil or gas property can elect to either expense or capitalize its domestic intangible drilling and development costs (IDCs). IRC § 263(c)
- IDCs are expenditures that a working interest pays to develop oil and gas property.
  - IDCs include: wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for drilling and equipping of wells for the production of oil and gas.
  - In addition, the costs associated with a nonproductive well, or “dry hole,” may also be deducted as incurred.
  - IDCs do not include expenses for items that have a salvage value, such as pipes and casings—these expenditures are instead depreciated.
Intangible Drilling Costs

• The working interest deducts its IDCs in the taxable year in which they are paid or incurred.
  ◦ On the other hand, for purposes of computing the alternative minimum tax, IDC is a tax preference.
    • There is a limited exception for certain independent producers (as opposed to integrated oil companies).
    • Also, a taxpayer that has elected to deduct its IDCs may make a secondary election to capitalize and amortize its IDCs over a 60-month period, and the IDC expenses so amortized are not treated as tax preference items under the alternative minimum tax.

• If the taxpayer instead elects to capitalize its IDCs, those expenses would be recovered through depletion or depreciation deductions, as appropriate.
Intangible Drilling Costs

- For an integrated oil company that elects to expense its IDCs, only 70% is expensed.
  - The remaining 30% is allowable as a deduction over 60 months.

- IDCs incurred outside of the United States must be capitalized.
Deduction for Qualified Tertiary Injectant Expenses

- Taxpayers engaged in drilling for and producing oil can deduct the cost of qualified tertiary injectants used to recover that oil. IRC § 193.
  - Tertiary injectants are the fluids, gases, and other chemicals that are pumped into oil and gas reservoirs in order to facilitate the extraction of oil that is too viscous to be extracted by conventional methods.
- Taxpayers take the deduction in the later of:
  - the tax year in which the injectant is injected; or
  - the tax year in which the expenses are paid or incurred.
- In short, IRC § 193 allows tertiary injectant costs to be expensed rather than capitalized and deducted over the income-producing life of the oil or gas property.
Capital Gain Treatment for Coal

- Disposing taxpayer must be the owner of the coal property.
- The taxpayer has held the coal property for more than one year.
- The disposition is under a contract whereby the disposing taxpayer retains an economic interest in the coal.
- A sublessee may also obtain capital gain treatment.

- Contract administration expenses are NOT deductible.
- The non-deductible expenses include:
  - Severance taxes
  - Insurance
  - Bookkeeping
  - Legal expenses

§ 631(c); 272
Other Tax Benefits

- When the price of oil is low (below $46.01 in 2016), there is a 15% tax credit for enhanced oil recovery costs. IRC § 43; Notice 2016-44

- The passive activity loss rules generally limit deductions and credits from passive trade or business activities, but these rules do not typically apply to working interests in oil and gas property. IRC § 469(c)(3)
Other Tax Benefits

- Oil and gas producers can use the last-in, first-out ("LIFO") method of accounting
  - When the costs of production are rising—as they usually are—LIFO results in a less income tax liability than first-in, first-out (FIFO).
- Oil and gas producers can also use **accelerated depreciation** to recover costs that are represented by physical property.
  - Many assets used to explore & drill for oil & gas have five-year or seven-year recovery periods.
  - Pipelines generally have a 15-year recovery period.
Other Tax Benefits

- Deduction for Domestic Production Activities, IRC § 199
  - Deduct 6% of qualified production activity income (QPAI)
    - or 6% of taxable income if less than QPAI
    - Also limited to 50% of wages paid
  - QPAI is basically domestic production gross receipts (DPGR) reduced by the cost of goods sold (COGS) and related expenses
  - Deduction is only available for working interests (operating interests that bear the costs of production)
    - not for nonoperating (royalty) interests
Many of the special tax rules for oil and gas development are identified as “tax expenditures” in the tax expenditure budgets prepared annually by the Office of Management and Budget and by the Joint Committee on Taxation.

Policymakers often use these tax expenditure estimates as a rough guide to the cost of these special income tax provisions.

For example, Table 1 reproduces the Office of Management and Budget’s 2017 Federal Budget estimates of the revenue losses attributable to some of the special income tax benefits for oil and gas development.
## Income Tax Expenditures

(millions of dollars)

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<th>Description</th>
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<td>460</td>
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<td>Excess of percentage over cost depletion, fuels</td>
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<td>860</td>
<td>12,700</td>
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<td>Exception from passive loss limitation for working interests in oil &amp; gas properties</td>
<td>40</td>
<td>40</td>
<td>340</td>
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<tr>
<td>Amortize geological &amp; geophysical expenses over 2 years</td>
<td>100</td>
<td>100</td>
<td>960</td>
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The Future of Oil & Gas Tax Breaks

- All in all, these special rules for oil and gas exploration and production are costly tax expenditures, and Congress may eventually curtail them.
  - The Congressional Budget Office often includes repealing the expensing of intangible drilling costs and percentage depletion among its options for reducing the federal deficit.
  - The Obama Administration has repeatedly called for repeal of the expensing of intangible drilling costs; percentage depletion, the deduction for tertiary injectants, the enhanced oil recovery tax credit, and many other oil and gas tax benefits.
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