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Tax Planning for Joint Operations

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Oil and Gas Joint Operations

- Oil and gas joint operations typically involve two or more current or future working interest owners exploring, developing and producing oil and gas properties
- Examples include:
  - Farmout letter agreement trades
  - “1/3 for ¼” drilling fund trades
  - Compulsory and voluntary unitizations
  - “Cash and carry” joint development trades
  - “Drillco” trades – private equity funded development
- Joint operations typically utilize one of the AAPL Model Form 610 – Model Form Operating Agreements

Factors Impacting the Before-Tax Economics of the Joint Operation

- Type of formation
  - Conventional
  - Unconventional shale formation
- Drilling technology and costs
  - Vertical wells
  - Horizontal wells with hydraulic fracturing
- Operator’s competency to drill and complete
- Production technology and costs
- Working interest percentage and associated net revenue interest
- Forward curve for oil and gas prices

Tax Attributes Affecting the After-Tax Economics of Joint Operations

- Intangible drilling and development costs (“IDC”)
  - 100% deductible in year incurred for independents
  - 70% deductible in year incurred for integrated oil companies with 30% amortized over 60 months
- Depreciation deductions for lease and well equipment
  - 7-year MACRS accelerated depreciation
- Depletion deductions for produced oil and gas
  - Limited percentage depletion for independents
  - Cost depletion (based on leasehold cost) for independents and integrated oil companies
- Lease operating expenses deducted in year incurred

Federal Income Tax Objectives <u>for Joint Operations</u>

- No taxable event on the formation of the joint operation by the parties
- IDC deducted by the party who funds the IDC
- Depreciation deducted by the party who funds the depreciable investment
- Lease operating expense (“LOE”) deducted by the party who funds the LOE
- Gross income from production taxed to the party who takes the production in kind and separately disposes of such production

Federal Income Tax Objectives <u>for Joint Operations</u>

- Cost depletion deducted by the party who contributes the oil and gas lease to the joint operation and who takes the production
- Percentage depletion for production deducted by any party who qualifies for percentage depletion
- No taxable event on termination of joint operations
- Distribution of assets in liquidation in accordance with the economic arrangement
- Simplicity in tax reporting – avoid filing a partnership tax return if possible

The Contractual Joint Venture: Base Case for Joint Operations

- Farmout letter agreement containing financial terms and attached joint operating agreement (“JOA”)
  - Farmee drills one well to earn a working interest in Farmor’s lease
  - Farmor retains overriding royalty convertible to working interest at payout
- Not a separate legal entity under state law
- Joint liability disclaimed
- Parties strike Article IX of the JOA
  - Article IX provides that the joint operation intends to elect out of the partnership tax rules in Subchapter K of the Code pursuant to Code section 761
  - Parties must own the oil and gas property as co-owners, reserve the right to take in kind, and not jointly sell services or the property produced, subject to authority delegated to the operator for not more than 1 year
  - Joint selling of gas processing services can be an issue today

The Contractual Joint Venture: Base Case for Joint Operations

- Tax objectives for the transaction
  - Farmor’s assignment of the working interest earned by Farmee is not a taxable event
  - Farmee pays for the costs of drilling the well and deducts the IDC
  - Farmee pays for the costs of lease and well equipment and deducts the tax depreciation computed with respect to that equipment
  - Farmee pays the Lease operating expense (“LOE”) during the payout period and deducts those costs
  - Farmor deducts cost or percentage depletion while Farmee can deduct only percentage depletion (if it qualifies)
  - Parties report the income from production taken in kind on their respective tax returns
  - No taxable event on termination of the joint operation
  - Parties take their working interests in liquidation

Avoiding a Taxable Event on the Formation of the Joint Operation

- Objective: contributions of oil and gas working interests and cash to the joint operation to fund the drilling of wells should not be taxable events
- If the contractual joint venture elects in Article IX to be excluded from the partnership tax rules in subchapter K of the Code, the "Pool of Capital" Doctrine generally provides that these contributions generally are not taxable events

The Pool of Capital Doctrine: A Tool for Achieving the Tax Objectives

- A party may agree to drill a well on an oil and gas property in order to earn an assignment of a working interest in that property
  - Drilling costs incurred to satisfy the earning requirement are economically the same as lease acquisition costs normally capitalized for tax purposes by buyer and accounted for as amounts realized for tax purposes by seller
- Pool of Capital Doctrine (General Counsel Memorandum 22730) allows these drilling costs to be deducted by the assignee rather than capitalized as lease acquisition costs
- Pool of Capital Doctrine also permits the assignor to recognize no gain on the assignment of the working interest to the assignee in consideration for drilling the well

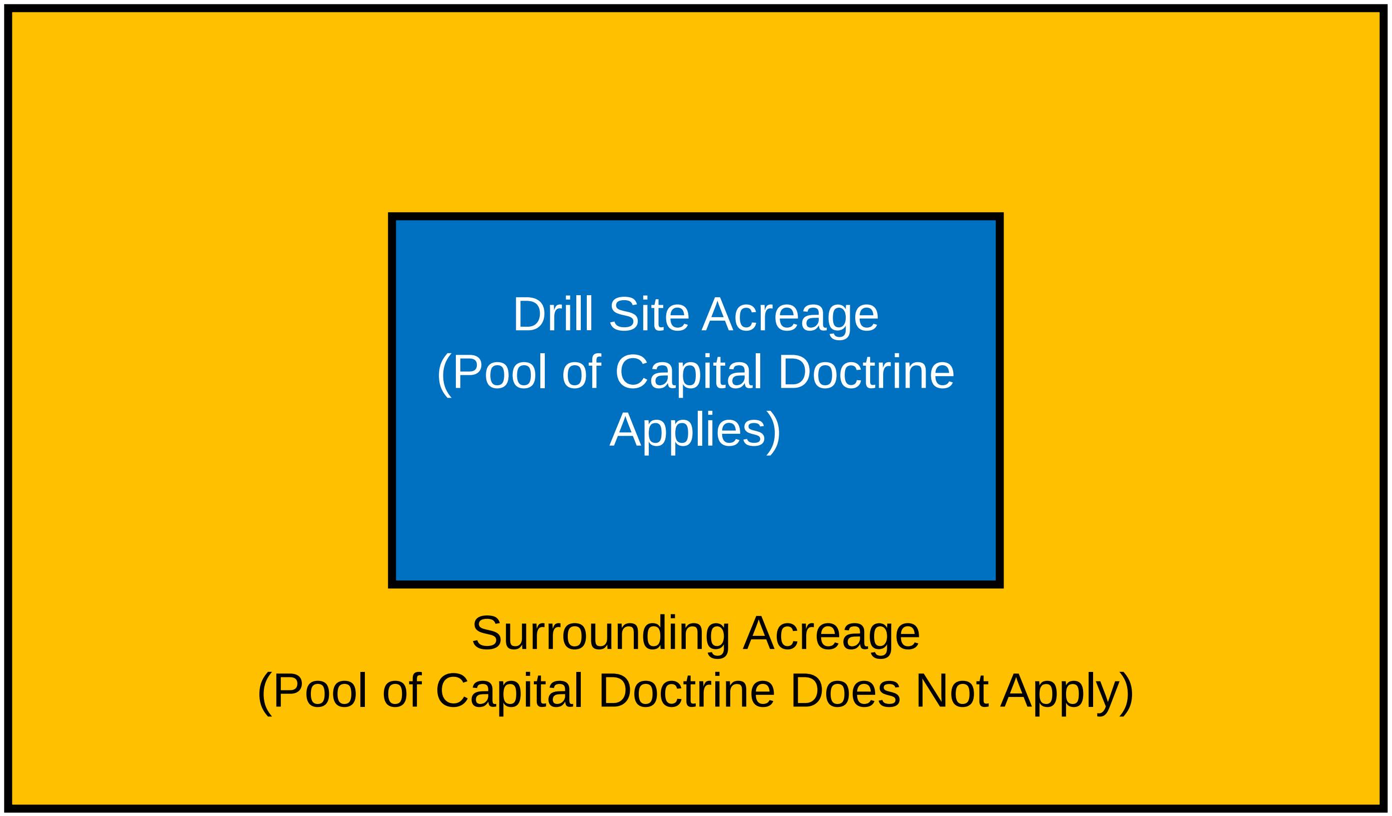
Obstacles Impacting the Tax-Efficient Formation of the Joint Operation

- Does the trade provide for the earning of an interest in property in addition to a working interest in the drill site acreage?
  - Example: earn a different interest in acreage surrounding the drill site (e.g., 100% BPO/50% APO in drill site but 50% BPO/APO in surrounding acreage)
  - Example: in a continuous drilling program, earn the right to drill additional wells on acreage outside of the drill site
  - Example: in a stacked formation lease, earn a working interest in other productive formations in addition to the target formation
- An IRS rule can cause these trades to result in a taxable event on formation for both parties to the joint operation

Revenue Ruling 77-176 May Impact the Formation of the Joint Operation

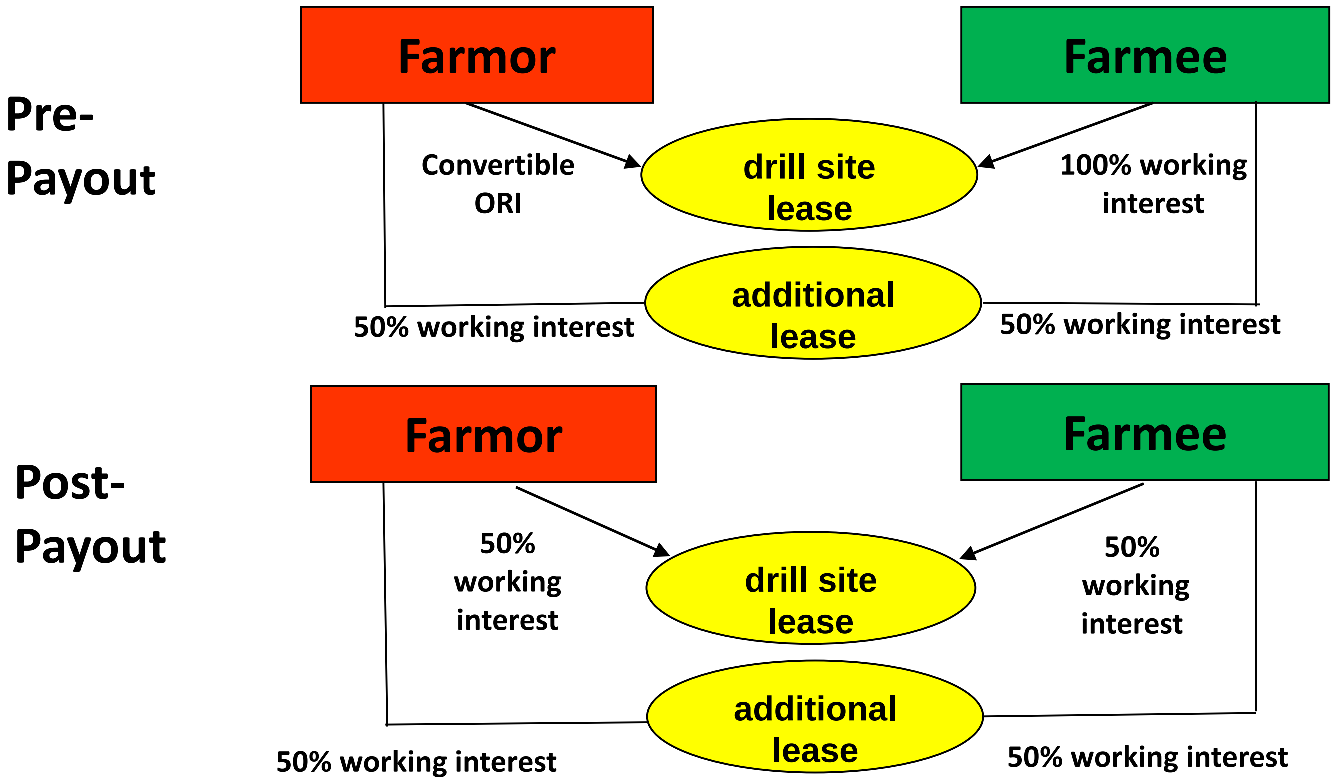
- Farmee in a farmout trade earned an interest in both drill site acreage and acreage surrounding the drill site
- IRS took the position in the ruling that the Pool of Capital Doctrine applied only to the interest earned in the drill site acreage
  - Transfer of interest in the acreage surrounding the drill site caused a taxable event for both the Farmor and the Farmee
  - Taxable event reduced the trade's after-tax economics for both parties

Revenue Ruling 77-176 Farmout



Oil and Gas Joint Operations

- Case 1 – Farmor assigns the entire working interest in the drill site lease, subject to a retained convertible overriding royalty after payout, and a working interest in a lease separate from the lease on which the earning well is to be drilled



Planning to Avoid a Taxable Event on the Formation of the Joint Operation

- Traditional planning techniques to mitigate the adverse tax impact of Revenue Ruling 77-176 on contractual joint ventures making the Article IX election out of the partnership tax rules
  - Assign all interests up front to minimize value of assigned interests
  - Assign continuous drilling options rather than working interest in acreage surrounding the drill site acreage to minimize value of assigned interests
- Alternative: Rely on the partnership tax rules providing for nontaxable contributions of property to the partnership rather than electing out of subchapter K in Article IX of the JOA
  - Attach Exhibit G (Tax Partnership Provisions) to the JOA

Using a Tax Partnership for Revenue Ruling 77-176 Trades

- Partnership for tax purposes only
- Working interest in drill site and other acreage are considered transferred to the tax partnership, not to the party providing cash to drill
  - Transfer is non-taxable under partnership tax rules
  - Pool of Capital limitation expressed in Revenue Ruling 77-176 does not apply
- Partnership makes the IDC election and other elections
- Pre-payout and post-payout functional allocations of income, IDC, depreciation, depletion and LOE to the tax partners who take the production and provide the capital for drilling, completing and operating achieve the other tax objectives for joint operations

Optimizing the Deductible IDC <u>and Depreciation for the Joint Operation</u>

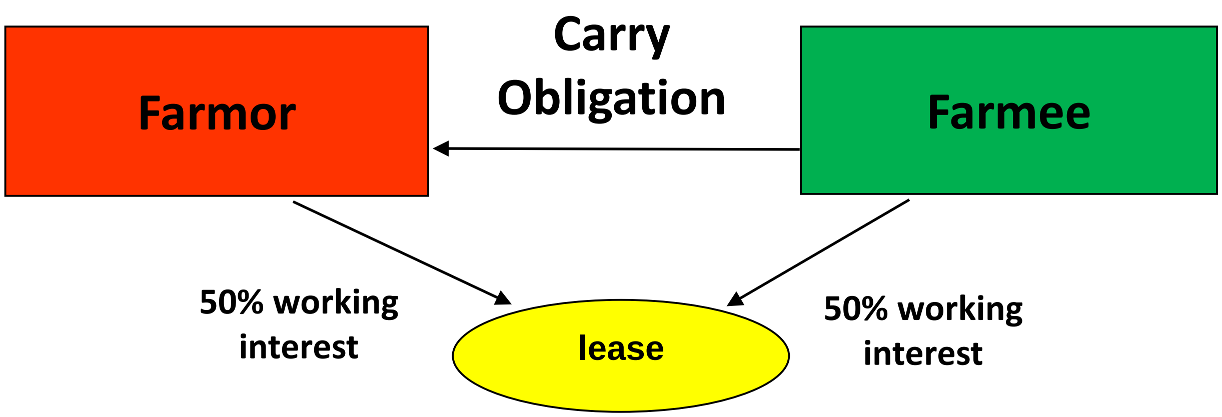
- IRS Fractional Interest Rule limits the deductible IDC and depreciation to the amount attributable to the working interest percentage received in the assignment
  - Party paying 100% of the costs of drilling and completing the well for a 60% working interest generally deducts only 60% of the IDC and depreciation incurred (balance is capitalized and recovered through depletion)
- However, the IRS has ruled that if the trade includes a “complete payout provision”, 100% of the IDC and depreciation can be deducted

Obstacles Impacting Deductible IDC and Depreciation for the Joint Operation

- Does the trade include a “complete payout” provision (*e.g.*, the right to 100% of production until the cost of drilling, equipping and operating the well is received)?
  - Tax issue arises if the payout provision is not for “complete payout” or there is no payout provision at all
- If not, the IRS rule can cause the party funding the costs of drilling the earning well to capitalize a portion of the otherwise deductible IDC and recover that capitalized amount through cost depletion over the producing life of the well
  - Net present value cost to the deferred tax deductions grows as the life of the well lengthens and the decline curve flattens

<u>Oil and Gas Joint Operations</u>

- <u>Case 2</u> - Farmor assigns a fraction of its working interest in a single tract of land to Farmee in exchange for Farmee's agreement to pay all of the costs to drill a well on the tract, with no payout provision.



Using a Tax Partnership for Trades With Fractional Interest Rule Issues

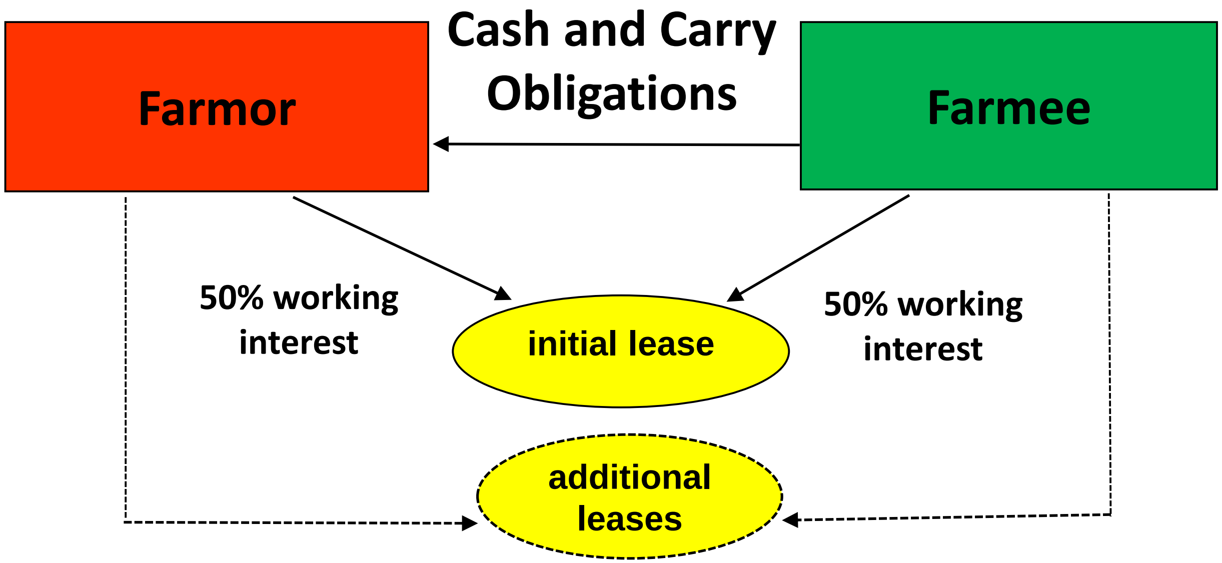
- For trades negotiated with payout provisions that don't satisfy the complete payout period test and for trades with no payout at all
- Strike Article IX and include Exhibit G (Tax Partnership Provisions) to the JOA
- Partnership for tax purposes only
- Working interest in leasehold acreage transferred to the partnership, not to the party providing cash to drill
  - Transfer is non-taxable under partnership tax rules
  - Partnership considered as drilling the well, so no complete payout period test issues
- Partnership makes the IDC election and other elections
- Pre-payout and post-payout functional allocations of income, IDC, depreciation, depletion and LOE to the tax partners who take the production and provide the capital for drilling, completing and operating achieve the other tax objectives for joint operations

Tax Obstacles In <u>Cash and Carry Trades</u>

- Cash and carry trades involve a purchaser agreeing to (1) pay cash for a portion of seller's working interest in certain acreage and (2) carry a portion of seller's future development costs on that jointly-owned acreage, without a payout provision
- Purchase and Sale Agreement and Joint Development Agreement (variation of a JOA)
- Fractional Interest Rule issue for purchaser due to lack of payout provision
- Taxable disposition for seller due to receipt of cash

Oil and Gas Joint Operations

- Case 3 - Farmor assigns a fraction of its working interest in a single tract of land to Farmee in exchange for Farmee's agreement to pay (1) a specified amount of cash up front to Farmor and (2) all of the costs to drill a well on the tract, with no payout provision. Agreement also contains a "continuous drilling option" for Farmee to drill on additional leases as each well is drilled.



Case Study – Haynesville Shale
Cash and Carry Transaction

- Deal Description
  - Seller has 100 % working interests in undeveloped 1.5-year old oil and gas leases that will expire unless drilling begins within 6 months
  - Natural gas prices are low, cash flow is down, and credit facility is overdrawn, so Seller doesn't have the cash to drill and preserve the leases
  - Seller needs to raise cash to pay down credit facility due to reduced borrowing base

Case Study – Haynesville Shale
Cash and Carry Transaction

- Deal Description (continued)
  - Seller seeks an industry partner to purchase an interest in the leases and carry out the drilling
  - Buyer agrees to purchase 50% of Seller's 100% working interest with cash, and carry 80% of Seller's drilling obligation until a stated dollar amount has been incurred on Seller's behalf
  - Seller and Buyer execute a Purchase and Sale Agreement and a Joint Development Agreement

Case Study – Haynesville Shale
Cash and Carry Transaction

- Tax results if parties make the Article IX election out of partnership tax rules
  - Seller recognizes taxable gain on sale of 50% working interests to Buyer for cash
  - Buyer capitalizes purchase price to leasehold investment and recovers through depletion
  - Per the Fractional Interest Rule, Buyer deducts the IDC attributable to its acquired 50% working interest, but capitalizes the IDC attributable to Seller’s working interest to leasehold investment and recovers through depletion

Case Study – Haynesville Shale
Cash and Carry Transaction

- Tax results if parties elect partnership treatment
  - Buyer contributes cash to partnership in nontaxable transaction, obtains basis in partnership interest and share of oil and gas lease basis for cost depletion purposes
  - Seller contributes oil and gas leases in a nontaxable transaction but receives a distribution of cash
  - Distribution may qualify in part as nontaxable reimbursement of preformation expenditures incurred within 2 years of transfer of leases to partnership under IRS Regulations (with less tax upfront)
  - Buyer deducts all IDC allocated to it by partnership

The API Model
Tax Partnership Agreement

- Partnership functional allocations for contractual joint ventures
  - Income allocated to the parties who take in kind or who take sales proceeds
  - Deductions of IDC, depreciation, depletion and LOE allocated to the parties who contribute the property or cash used to generate the deductions
  - Gain on disposition or deemed disposition of assets allocated to the parties so as to put capital accounts as close to in balance with proportionate interests under the JOA
  - Allocations of income and deductions impact the capital account balances
  - Liquidation in accordance with positive capital account balances
- The challenge: keeping the capital accounts aligned with the parties’ respective working interests so that the liquidation provisions in the tax partnership agreement do not override the parties’ economic arrangement

The API Model
Tax Partnership Agreement

- 1995 IRS Letter Ruling
  - Farmout letter agreement with API Model Tax Partnership Agreement attached to the JOA as an exhibit
  - Functional allocations of income and deduction to the parties
  - Capital accounts maintained
  - Liquidating distributions made in accordance with positive capital account balances
  - All allocations have "substantial economic effect"

Income Recognition on Gas Sales in Joint Operations Electing Out

- Parties to the JOA leave Article IX in place (no tax partnership)
- Parties to the trade may periodically take and dispose of gas disproportionate to their working interests
- JOA may include a Gas Balancing Agreement that governs the rights of the parties to gas over the life of the reservoir
- How to account for and tax the income from gas sales disproportionate to the parties' interests?

Historical Gas Balancing Accounting Methods for Elect Out Joint Operations

- Taxpayers electing out of partnership tax rules in subchapter K used two different methods to recognize income
  - "Sales" method recognized income on gas sold
  - "Entitlements" method recognized income on percentage interest in gas sold, regardless of which party disposed of the gas
- IRS recognized opportunity for whipsaw, where party selling the entire gas stream used entitlements method (reporting only its percentage interest) and the other party used the sales method (reporting no income)
  - IRS ruled that the entitlements method was the correct method

IRS Regulations and the 2015 JOA <u>Now Control Recognition of Income</u>

- Taxpayers today must use the “cumulative” method unless IRS grants permission to use the “annual” method
- Cumulative method treats each party as owning its proportional share of the gas in the reservoir
  - Party taking and disposing of gas treated as owning all such gas and recognizes income on disposition, eliminating whipsaw
  - Balancing payments, if any, taxed in year made
- AAPL Model Form 610 – 2015 Model Form Operating Agreement now provides in Article IX that: “For federal income tax purposes the parties agree that any gas imbalances will be reported under the cumulative gas balancing method….”

IRS Regulations and the 2015 JOA <u>Now Control Recognition of Income</u>

- Parties intending to use the "annual" method must obtain IRS approval
  - Parties must agree to make annual balancing payments in cash, gas or other property
  - Used where a producer expects difficulty in marketing its gas or otherwise prefers annual balancing payments for tax purposes
  - If approval obtained, the new tax language in Article IX of the AAPL Form 610 - 2015 Model Operating Agreement must be deleted
- Use of cumulative method provides flexibility on timing of balancing payments while meeting objective of recognizing income only on production taken in kind or production proceeds received
- Note that if the JOA strikes Article IX and elects to be classified as a partnership, income from gas sales is allocated to the parties who receive the gas sales proceeds

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Historical Tax Perspective on <u>Oil and Gas Joint Operations</u>

- I.T. 2749 (1934), I.T. 2785 (1934)
  - IRS rules that co-ownership of a lease and joint development can create a partnership for tax purposes
- I.T. 3930 (1948), I.T. 3948 (1949)
  - IRS rules on whether the joint operation is classified as a corporation or partnership
    - Take-in-kind provisions are key
- *Bentex Oil* (1953)
  - Tax Court on the facts holds that co-ownership of a lease and joint development thereof can create a partnership for tax purposes

Historical Tax Perspective on <u>Oil and Gas Joint Operations</u>

- *Kintner* “Four Corporate Characteristics” regulations (1960)
  - Majority of centralized management, limited liability, continuity of life and free transferability of interests results in classification as a corporation
    - Many joint operations arguably had centralized management (an operator) and continuity of life (bankruptcy did not terminate the JOA) but did not have limited liability (unlimited several liability)
    - Key was avoiding free transferability (add right of first refusal)
- “Check-the-Box entity classification regulations (1997) replace the *Kintner* regulations
  - Joint operations classified as a partnership unless a corporate election is made (no need to take in kind)
- Code Section 704(b) regulations (1985)
  - Liquidation in accordance with capital account balances required for special allocations of income and deductions

Role of the Tax Planner

- Review the proposed structure for the joint operation to identify obstacles to achieving the tax objectives for joint operations
- Work with the business team to adjust the structure, if necessary, so that it achieves the tax objectives for joint operations
- Minimize tax complexity and reporting when possible, without adversely affecting the after-tax economics of the joint operation