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U.S. FEDERAL TAX ISSUES CONCERNING MINERAL INTERESTS

The following memorandum provides a general summary of the U.S. federal tax considerations with respect to investing in mineral interests.

II. MINERAL INTERESTS IN GENERAL

Mineral Interests are rights carved out from fee simple absolute ownership by grant of a mineral deed or a mineral lease. The normal manner of conveyance of mineral interests is through a mineral lease. A mineral lease GRANTS the lessee the right to extract and produce minerals from the premises, while at the same time requiring the lessee to undertake the costs and burden of developing the resource. A mineral lease generally RESERVES to the lessor an interest in either the minerals or the profits derived from their sale. The mineral leasehold interest may be divided into lesser interests.

There are two different types of rights in respect to mineral interests in real estate. These two types of interests help distinguish the various types of mineral interests that a person may own or transfer. The two types of rights are: (a) the right to enter upon, explore, develop and produce the minerals (executive rights); and (b) the right to the minerals produced (possessory rights).

When mineral interests are involved in a purported Code Section 1031 like-kind exchange, one must determine the nature of the type of mineral interest involved. Generally, under Code Section 1031, all real estate interests are like-kind to all other real estate interests.[1] However, this is not always the case. The rights conveyed by mineral conveyances differ from state to state, though there are many more similarities than differences. State law is not determinative of the status of a property interest as real estate for purposes of Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code"),[2] yet, it remains important to understand the nature of mineral interests to determine their nature for the purposes of Code Section 1031.[3]

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[1] See Treasury Regulation Section 1.1031-(a)-1(a)(1) which provides that the fact that any real estate exchanged is improved or unimproved is immaterial.

[2] See TAM 200424001.

[3] See Crichton v. Commissioner, 122 F. 2d 181 (CA-5 1941), where the court held mineral rights that were real property under Louisiana law could be exchanged for improved Louisiana real property under Code Section 1031. See Journal of Real Estate Taxation, 4th Quarter 2004, "Does Sate Law Really Determine Whether Property is Real Estate For Section 1031 Purposes."

II. TYPES OF MINERAL INTERESTS

A. Operating Interests

An operating interest or "working interest" means an interest that possesses the right to develop the minerals AND has an affirmative obligation of incurring the expense of producing the mineral. The term "leasehold interest," "operating interest," and "working interest" are often synonymous. The leasehold or working interest is often further divided up to secure funds for exploration or to secure financing. The owner of a working interest can create subordinate interests that possess executive rights (operating interests) or non-operating interests that grant an interest in the minerals produced. A working interest is an "economic interest" the cost of which may be recovered by depletion, and which qualifies the owner/operator to expense intangible drilling costs. A working interest is considered a real estate interest for federal income tax purposes. See, Palmer v. Bender, 287 U.S. 551 (1932). All working interests are treated the same, regardless of the lease term. See, Freeman v. CIR, 48 T.C. 96 (1967).

B. Non-Operating Interests

1. Royalty Interests

The term "royalty interest" means a reserved interest in the future mineral production of the entire property, rather than one limited by time or quantity of minerals extracted, AND that is NOT encumbered by the obligation to develop the resource. Royalty interests that have the same term as the mineral lease are "economic interest" qualifying for depletion. There are several types of royalty interests:

- **Underlying Royalty –** An underlying royalty is created when the owner (not the lessee) of the land reserves a fractional interest in all minerals in place. The transfer of the mineral interest in land subject to a reservation of the right to receive a certain percent or fraction of the minerals produced will be considered the creation of a lease and not a sale. Therefore, the consideration received will be treated as an advance royalty payment from the lessee. See Crooks v. Commissioner, 92 T.C. 816 (1989); and Rev. Rul. 73-428, 1973-2 C.B. 303, in which the taxpayer purchased a royalty interest in oil and gas in place from the fee owner of a tract subject to an oil and gas lease. This interest is a fee interest in mineral rights and real property for federal income tax purposes.

- **Overriding Royalty –** An overriding royalty is created when the mineral lessee (rather than the owner) subleases or carves-out and conveys a working interest and retains a royalty. This interest is considered a real estate interest for federal income tax purposes. See Palmer v. Bender, 287 U.S. 551 (1932); and Private Letter Ruling 8434134.

2. Production Payments

A production payment involves the purchaser making an up front payment of cash to the producer for the right to receive future consideration based on production ("dollar-denominated"), or the right to receive a certain quantity of the mineral produced from the property for a fixed period of time ("volumetric"). A dollar denominated production payment is not considered an interest in real property. Under Code Section 636, "Production Payments" are considered loans, unless they are pledged for future development of the property, in which case they are considered a contribution to a pool of capital. Certain production payments can be reclassified as royalty interests. See Rev. Rul. 86-119, 1989-2 C.B. 81. The IRS has established ruling guidelines on whether an interest is a production payment. Rev. Proc. 97-55, 1997-2 C.B. 582.

- **Example 1:** Taxpayer owned a production payment and assigned a portion of the production in a sum certain with interest, in exchange for an interest in ranchland. The assignment conveyed an interest in cash derived from production, not the conversion of a capital asset. Therefore, it was not an exchange of like-kind property. Commissioner v. P.G. Lake, Inc. 356 U.S. 260 (1958). (Note that the holding of P.G. Lake, as it pertains to production payments, has been superseded by Code Section 636).

3. Profits Interests

A profits interest is the right to a specified share of the mineral interest profits free of production costs, but contingent on the grantor earning a profit. Most practitioners consider a net profits interest (NPI) to be a type of royalty interest, a non-operating interest like a royalty interest differing in that its payment is subject to the payment of costs of production. "Profits interests" are considered economic interests subject to depletion and are generally considered real property interests for federal income tax law, however, if limited in time or amount, will not be considered real property interests.

III. MINERAL INTERESTS AS REAL PROPERTY FOR CODE SECTION 1031

Generally, Code Section 1031 allows any real estate interest to be exchanged for another real estate interest on the basis that all "real property" is like-kind to all other "real property." Since mineral interests are generally treated under the tax law as a type of real estate interest, it is generally assumed that a fee interest in real estate can be exchanged for a mineral interest, and vice versa, because they are of "like kind."[4] The words "like kind" refer to the nature or character of the property and not its grade or quality.[5] Improved real property may be exchanged for unimproved real property.[6] Leasehold interests of thirty years or more are considered "like

[4] On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act") was signed into law making significant changes to the U.S. tax code. The 2017 Tax Act modified Code Section 1031 by limiting its application to real property that is not held primarily for sale. The House and Senate confirmed in their Joint Explanatory Statement of the Committee of Conference, dated December 18, 2017, that "[i]t is intended that real property eligible for like-kind exchange treatment under present law will continue to be eligible for like-kind exchange treatment." Accordingly, royalty interests in oil and gas in place should continue to be treated as an interest in real property for U.S. federal income tax purposes.

[5] Treas. Reg. § 1.1031(a)-1(b). *See also Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941).

[6] Treas. Reg. § 1.1031(a)-1(b).

kind" to real property.[7]

In oil and gas tax law, the concept of "property" has a different meaning than it does under Code Section 1031, evolving from specialized Code provisions, such as Code Section 614 (definition of property for depletion). These concepts are based on different assumptions than Code Section 1031. There are rulings under Code Section 1031 for some, but not all types of mineral interests. For Code Section 1031, the perpetual nature of an interest in real estate is perhaps the most important factor in determining whether one type of real estate interest can be exchanged for a fee simple interest in another parcel of real property. For mineral interests, the focus has been whether the owner has an interest in the "minerals in place." Palmer v. Bender, 287 U.S. 551 (1932). Therefore, reliance on federal income tax pronouncements on "mineral interests" as real estate should be reviewed carefully in applying them under Code Section 1031.

A. Code Section 1250 Depreciation Recapture

1. General Rule

When real property is exchanged for a mineral interest there are depreciation recapture provisions which might require the transferor of the real property to recognize ordinary income gain. Under Code Section 1250, any real property (other than Code Section 1245 property) which is subject to the allowance for depreciation under Code Section 167 is considered "Section1250 property." If "Section1250 property" is exchanged under Code Section 1031 for like-kind mineral interest property only, "additional depreciation" is recaptured. "Additional depreciation" is all depreciation in the case of property held for one year or less and depreciation taken in excess of straight line depreciation in the case of property held for more than one year. [Note: Most real property placed in service after 1986 is depreciable only by the straight line method and is therefore exempt from recapture unless disposed of within a year of its acquisition.]

Code Section 1250 recapture applies only if the amount realized exceeds the property's adjusted basis. If there is a gain, it acts as a ceiling on the deductions subject to recapture

The "additional depreciation" is recaptured at ordinary income rates to the extent of the greater of (i) the taxable boot received and recognized in the 1031 exchange or (ii) the amount of "additional depreciation" taken on the relinquished Section 1250 property reduced by the fair market value of Section 1250 property acquired in the exchange.

2. Special Rule for Corporations

For corporations, the differences between Code Sections 1245 and 1250 are narrowed by Code Section 291(a)(1) . Under this provision, a corporation has ordinary income (or additional ordinary income) on a disposition of Section 1250 property equal to 20 percent of the amount by which (1) the amount that would be ordinary income if the property were Code Section 1245

[7] Treas. Reg. § 1.1031(a)-1(c).

property exceeds (2) the amount that is ordinary income under Code Section 1250.[8] For example, if a corporation sells real property acquired after 1986, no depreciation is recaptured under Code Section 1250, since such property can only be depreciated by the straight line method, but under Code Section 291(a)(1), the corporation has ordinary income equal to 20 percent of the lesser of the gain on the sale or the depreciation adjustments reflected in the corporation's adjusted basis for the property.

- **Example 1**: In a fully qualifying 1031 exchange, Taxpayer (non-corporation) exchanges improved Code Section 1250 (non-mineral interest) depreciable real property which has been depreciated on an accelerated basis (over what would be allowed under straight-line depreciation) for like-kind mineral interests of equal or greater value. (Assume the accelerated depreciation taken was $15,000 and the straight-line depreciation for the same period would have been $10,000, so the "additional depreciation" is $5,000). No boot (cash) is received by the seller on the exchange. Nevertheless, the $5,000 "additional depreciation" amount is subject to 25% tax rate recapture because the $5,000 "additional depreciation" exceeds the amount of 1250 property (depreciable real property) acquired in the exchange ($0 because only mineral interests acquired in exchange).

- **Example 2**: In a fully qualifying 1031 exchange, Taxpayer (non-corporation) exchanges improved "Section1250 property" (FMV: $1,000, basis: $100) which has "additional depreciation" ($400) for like-kind mineral interest (FMV: $600) and other "Section1250 property" (FMV: $400). No boot is received by the seller. The "additional depreciation" will not be recognized because it will be reduced to zero by the FMV of the Section 1250 property received. Since the boot is zero and the "additional depreciation" is reduced to zero by the FMV of the Section 1250 property acquired there is no recognition of gain. The "additional depreciation" in the Code Section 1250 property" received will be increased by $400. Code Section 1250(d)(4)(e).

- **Example 3**: In a fully qualifying 1031 exchange, Taxpayer, a corporation, exchanges improved "Section 1250 property" (FMV: $1000, basis: $100) which has "additional depreciation" ($900 in accelerated depreciation - $500 in straight-line depreciation = $400) for like-kind mineral interest (FMV: $600) and other "Section 1250 property" (FMV: $400). No boot is received in the exchange. Even though under Code Section 1250 alone, no gain would be recognized, under Code Section 291(a)(1) the corporation will recognize 20% of $900 or $180 of gain.

IV. <u>MIXED REAL PROPERTY AND PERSONAL PROPERTY TRANSACTIONS</u>

Working interests can be "producing" (oil or gas is being produced) or non-producing. A sale of a working interest for a producing property will include not only the real estate interest, but also personal property (such as casings, drill rigs, and other personal property used to extract

[8] Note: Under current Treasury Regulations, the special rule for corporations does not apply to the extent that recapture under Code Sec. 1250 is excepted by Code Sec. 1250(d)(exception for Code Section 1250 recapture for transfer by gift, transfer at death, and certain non-recognition transactions).

the oil or gas). Consequently, the sale of a working interest is a multiple asset sale (Treas. Reg. Section 1.1031(j)-1), subject to the like-kind standards for personal property. To the extent that the acquired replacement property does not include sufficient property that is both "like-kind" under Treasury Regulation Section 1.1031(a)-2, and which is Code Section 1245 property, there will be depreciation recapture. See discussion below for other applicable recapture rules. Non-producing property is unlikely to have personal property of any value (there may be exploratory wells).

V. <u>THE SALE OR EXCHANGE ISSUE</u>

Conveying a mineral interest can result in a sale or exchange under Code Section 1001, creation of a lease/sublease interest, a financing transaction or a pooling of interest in a joint investment.

A. Pooling of Capital

When the grantor transfers an operating interest or a non-operating interest and the consideration is contributed to a pool of capital, then the transaction will not be a taxable sale, but rather a contribution to the pool of capital. GCM 22730, 1941-1 C.B. 214. This GCM's rationale has been reiterated in Rev. Rul. 77-176, 1977-1 C.B. 77. Creating a pool of capital can create a partnership for federal income tax purposes, unless the taxpayers make a proper election out of Subchapter K under Code Section 761.

- **Example 1 – Transfer of Working Interest = No Sale:** A owns an oil and gas leasehold. A and B agree that A will transfer to B the entire working interest in the specified drilling site with A reserving an overriding 1/16 royalty in exchange for B's performance of drilling a well. If successful, B would be required to equip the well for production, and if unsuccessful, would be required to plug and abandon it. The well is successful, and A transfers to B the entire working interest in the site, reserving the underlying royalty. Under the "pooling of capital" principle, A is not considered as having sold a capital interest in the property, but rather given B a right to share in production in consideration of A's investment. Rev. Rul. 77-176, 1977-1 C.B. 77.

- **Example 2 – Transfer of Working Interest = Sale:** A owns two tracts of land, tract 1 and tract 2. A and B agree that A will transfer an undivided 50% working interest in tract 2 in exchange for B's performance of drilling a well on tract 1. If successful, B would be required to equip the well for production, and if unsuccessful, B would be obligated to cap and abandon the well. The well on tract 1 is successful and A transfers to B an undivided 50% working interest in tract 2. Here, A is considered as having sold an interest in tract 2 to B in exchange for B's performance of services, and A is taxed on the fair market value of the working interest. Rev. Rul. 77-176, 1977-1 C.B. 77.

B. Sale or Lease

When the grantor transfers an operating interest and retains a non-operating interest that continues for the entire term of the lease the transaction is a lease, not a sale.

- **Example 1:** Taxpayer owned oil and gas leases, and conveyed a fraction of the working interest in the leases in consideration of a cash bonus, a future payment of up to $1,000,000 out of one half of the production and a 1/8 excess royalty. The taxpayer was considered to have retained an interest in the underlying capital investment. The advance payment reduced its investment and adjusted basis for depletion, but has not severed its investment in the asset. Palmer v. Bender, 287 U.S. 551 (1933).

- **Example 2:** Taxpayer owned a farm and transferred a mineral deed to an oil company in exchange for the fee interest in two other farms, some personal property and retention of a 1/4 interest in the oil and gas to be produced from the farm. Taxpayer claimed that it sold the farm and acquired like-kind property. The Tax Court held that the taxpayer created an oil and gas lease by retaining a 1/4 royalty interest, and consequently, the property received was the payment of an advance lease bonus. Crooks v. Commissioner, 92 T.C. 816 (1989). However, if the grantor transfers an operating interest and the retained interest does not last for the duration of the term the transaction is considered a sale and not a lease. See Treas. Reg. Section 1.636-1(a). The consideration received by the grantor is an advance royalty.

When the grantor transfers a non-operating interest for consideration, the transfer is considered a sale even if the grantor retains an interest. Ratliff v. Commissioner, 36 B.T.A. 762 (1937).

C. Production Payments: Financing Transaction, Sale, or Capital Contribution to Pool

Production payments are one of the most frequently created mineral interests. They are frequently used to raise capital. Ordinarily, under Code Section 636, the creation of a production payment is considered a financing transaction, not a sale or exchange.

- **Example 1:** Taxpayers acquired fee interests, oil production payments and royalty interests in exchange for a cash payment that was to accrue 6% per annum. The seller retained the right to receive 50% of the proceeds derived from the production or sale of the interests. Taxpayers received proceeds from production payments and sale of fee interests and transferred the sellers 50% of what they received. The Court held that the transaction was not a sale, and the taxpayers were responsible for the tax on the payments received, notwithstanding their obligation to pay and subsequent payment of such sums to the seller. Anderson v. Helvering, 310 U.S. 404 (1940).

- **Example 2:** Taxpayer owned an oil and gas lease on 311 acres. He transferred his leasehold to Exxon for $54,000 reserving a production payment of $10,000 per acre, payable out of 5% of the production of all the leased property. The leasehold would therefore need to produce over $62,000,000 to pay out the production payment. There was no commercial oil and gas production in the area. Taxpayer claimed a sale occurred, producing long term capital gain. The Court held that the remote possibility of ever satisfying the production payment from the leasehold made the production payment the equivalent of an underlying royalty, applicable to all minerals in place, making the transaction a lease rather than a sale, resulting in ordinary income in the form of an advance royalty payment. Estate of Watnick, 90 T.C. 326 (1988).

However, when a production payment is pledged for use in exploration or development, it will be considered a contribution to the pool of capital and not a financing transaction. Code Section 636(a), Rev. Rul. 92-38, 1992-1 C.B. 197.

When a production payment is considered a financing transaction, the debt obligation created is subject to the original issue discount rules of Code Section 1272 et seq. Therefore, each production payment will be considered part interest, part principal.

VI. SPECIAL RECAPTURE RULES

When a mineral interest is disposed of, there are recapture provisions that can recharacterize the recognized gain as ordinary, and override other non-recognition provisions such as Code Section 1031 and Code Section 1033. Two of the main tax incentives benefiting owners of mineral interests are the ability to deduct intangible drilling and development costs and the ability to recover costs through deductions for depletion of the resource. If either of these benefits have been taken with respect to a mineral interest, the recapture provisions of Code Section 1254 may apply to override Code Section 1031 or Code Section 1033. These recapture rules are in addition to recapture under Code Section 1245, to the extent applicable.

A. Intangible Drilling and Development Costs ("IDC")

To encourage development of mineral resources the owner of a working interest in a mineral lease has the ability to deduct in the current year amounts expended for intangible drilling and development costs of the leasehold. See Code Section 263(c); and Treas. Reg. Section 1.612-4(a).[9] Eligible IDC expenses are those costs expended for drilling or developing a well for production that have no salvage value. Rev. Rul. 70-314, 1970-2 C.B. 132. Salvageable items, such as the pipes, valves and fittings used to control the flow of oil or gas are not IDC and must be capitalized and depreciated.

[9] Note: The amount allowed as a deduction under Code Section 616(a) or 617(a) [or Section 263(c) for an integrated oil company], is reduced by 30% for corporations. Code Section 291(b)(1). The disallowed 30% can be amortized ratably over a 60-month period beginning on the day the costs are paid or incurred. Code Section 291(b)(2). For purposes of Code Section 1254, however, the amortized amount is treated as a deduction allowable under Code Section 263(c), 616(a), or 617(a) (whichever is appropriate). The portion of the adjusted basis which is attributable to the amortizable amount should not be taken into account for purposes of calculating cost depletion under Code Section 611.

B. Depreciation Recapture under Code Section 1254

For properties placed in service after 1986, depletion deductions, to the extent they reduce basis in an oil and gas property, are subject to recapture under the rules of Code Section 1254. Specifically, when a covered mineral interest is sold or otherwise disposed of, both IDC and depletion are subject to recapture under Code Section 1254. Like Code Section 1245, the Code Section 1254 recapture provisions work both as a re-characterization provision and a provision requiring recognition of gain. However, not all dispositions trigger Code Section 1254 recapture. There are exceptions for transfers that are financing transactions, creation of a lease or sublease, establishment of a pooling of capital or expiration of a term interest. There are exceptions to the requirement to recapture for non-productive wells which exception will not apply when the consideration results from foreclosure of a non-recourse debt. Code Section 1254 recapture applies only to "Natural Resource Recapture Property ("NRRP"). For purposes of Code Section 1254, the following definitions apply:

- **"Natural Resource Recapture Property"** means both "Code Section 1254 Property" and "Oil, Gas or Geothermal Property."

- **"Code Section 1254 Property"** means property that: (i) is placed in service after December 12, 1986; (ii) is property (within the meaning of Code Section 614); and (iii) IDC is properly chargeable to the property, or the basis of the property was adjusted by depletion.[10]

- **"Oil, Gas or Geothermal Property"** means property (within the meaning of Code Section 614) placed in service before January 1, 1987, the basis of which was adjusted by depletion.

C. Interplay between Code Sections 1254 and 1031

If the taxpayer disposes of "Natural Resource Recapture Property" in a Code Section 1031 exchange, then the gain recognized under Code Section 1254 may not exceed the sum of: (i) the gain recognized under Code Section 1031 and (ii) the fair market value of property received that is qualifying property under Code Section 1031, but which is NOT Natural Resource Recovery Property. Treas. Reg. Section 1.1254-2(d).

VII. <u>DEPLETION</u>

Because mineral resources are exhausted during their production, the Code allows economic owners of mineral interests to take a deduction for depletion. An economic interest does not depend on legal title; instead, the only requirements for having an economic interest are:

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[10] Note: The definition of "Code Section 1254 Property" appears to require a property in which the resource has been developed. However, in practice, NRRP is exchanged for non-producing property that is eligible for IDC and/or depletion. In this case, the Code Section 1254 recapture potential carries over to the new property. Therefore, an exchange of a working interest in a developed property for one that is not developed will trigger Code Section 1254 recapture.

(i) that the interest be acquired by investment in the minerals in place; (ii) that the owner must be entitled to derive income from extraction of these minerals; and (iii) that the owner must look to the extraction of the minerals for a return of its capital. Treas. Reg. Section 1.611-1(b)(1). Consequently, the definition of economic interest holder is substantially broad and includes lessors owning overlying royalty interests, lessees owning working interests, sublessors holding overriding royalty interests, holders of net profits interests and owners of production payments to the extent that such payments are not characterized as loans under Code Section 636. All holders of economic interests in minerals in place are entitled to take annual depletion allowances equal to the greater of the allowable cost or percentage depletion.

A. Cost Depletion

Cost depletion is a cost recovery system that entitles an interest holder to a depletion allowance based on the relationship between the amount of minerals sold in a taxable year and the total recoverable mineral reserves. Cost depletion for any year is determined by multiplying the adjusted tax basis of the mineral interest by a cost depletion factor. The cost depletion factor for any given year is computed by dividing the number of mineral units sold (or produced) in a taxable year by the number of mineral units remaining at the beginning of that taxable year. This formula is illustrated below:

$$\textbf{Cost Depletion} = \textbf{Adjusted Tax Basis} \times \frac{\textbf{Units Sold During Tax Year}}{\textbf{Units Remaining at Beginning of Tax Year}}$$

Any cost depletion deductions taken by an interest holder reduce its adjusted basis in the depletable property, but do not reduce such basis below zero. Thus, unlike percentage depletion, the aggregate cost depletion for a mineral interest can never exceed the taxpayer's adjusted basis in such interest.

- **Example 1 – Cost Depletion Calculation:** ABC Corp. has engaged in a like-kind exchange under Code Section 1031. ABC Corp. sold an office building as the relinquished property, which had a fair market value of $1,000,000 and an adjusted tax basis of $200,000. ABC Corp. then purchased a mineral interest as replacement property, which had a fair market value of $1,000,000. In 2012, when ABC Corp. acquired this mineral interest, it had 100,000 recoverable units. During 2012 and the following four taxable years, 3500, 8000, 6500, 10,000 and 13,000 recoverable units were either sold or produced, respectively. The table below illustrates the annual cost depletion allowances available to ABC Corp. in the 2012 through 2016 taxable years.

Cost Depletion Calculation				
Tax Year	**Adjusted Basis**	**Minerals Sold During Year**	**Minerals Remaining at Start of Year**	**Cost Depletion**
2012	$200,000	13,500	100,000	$27,000

2013	$173,000	8000	86,500	$16,000
2014	$157,000	27,000	78,500	$54,000
2015	$103,000	24,500	51,500	$49,000
2016	$54,000	18,000	27,000	$36,000

B. Percentage Depletion

Percentage depletion is a statutory allowance based on the amount of income generated annually from a mineral interest, without regard to the amount of minerals that are exploited in any given year. Those who hold economic interests in domestic oil and natural gas are generally entitled to an annual percentage depletion allowance equal to 15% of the gross income generated by the natural resource property;[11] however, such an allowance cannot exceed either 100% of the taxable income from the property (computed without the allowance for depletion, as well as net operating and capital loss carrybacks) or 65% of the interest holder's taxable income in a given taxable year. Moreover, except for certain natural gas production, percentage depletion is generally available only with respect to a limited amount of domestic crude oil or domestic natural gas production of each taxpayer under the so-called independent producer's exception. Under this exception, the first 1000 barrels per day of a taxpayer's domestic oil production or the first 6,000,000 cubic feet per day of a taxpayer's domestic gas production may be eligible for the percentage depletion allowance.

Like cost depletion, percentage depletion reduces the interest holder's basis in the depletable property, but does not reduce this basis below zero. <u>However, unlike cost depletion, a taxpayer can deduct a percentage depletion allowance even if this deduction exceeds the taxpayer's basis in the depletable property</u>. These excess percentage depletion allowances: (i) do not create a negative basis; (ii) are not added onto the amount realized upon subsequent disposition of the property; and (iii) are not subject to the recapture rules under Code Section 1254(a)(1). Based on this ability to take depletion allowances in excess of a property's basis without creating additional gain upon sale of the property, percentage depletion is generally the preferred cost recovery method for holders of oil and gas interests. If percentage depletion exceeds cost depletion, it represents the depletion deduction for the tax year.

- **Example 1 – Percentage Depletion Calculation:** Taxpayer has purchased a $500,000 mineral interest, "Property A," which represents a 20% equity interest in Property A. In 2012 through 2016, Property A produced gross revenues of $360,000, $480,000, $300,000, $740,000 and $920,000, respectively. The table below illustrates the percentage depletion available to Taxpayer in the 2012 through 2016 taxable years.

[11] Only certain "independent producers" and royalty owners are entitled to this 15% percentage depletion on their oil and gas interests. Commercial retailers and refiners cannot take this allowance. In order to qualify as an "independent producer," the taxpayer, either directly or through certain related parties, may not be involved in the refining of more than a daily average of 75,000 barrels of oil (or equivalent of gas) during the taxable year.

Percentage Depletion Calculation				
Tax Year	**Adjusted Basis**	**Gross Revenue**	**Pro-Rate Shares of Gross Revenue**	**Percentage Depletion**
2012	$500,000	$360,000	$72,000	$10,800
2013	$489,200	$480,000	$96,000	$14,400
2014	$474,800	$300,000	$60,000	$9000
2015	$465,800	$740,000	$148,000	$22,200
2016	$443,600	$920,000	$184,000	$27,600

C. Depletion – Tax Preference Item

The advantage of deducting a percentage depletion allowance in excess of the adjusted basis is mitigated for taxpayers subject to the alternative minimum tax ("AMT"). If percentage depletion is taken in determining regular tax, an addition is made to alternative minimum taxable income ("AMTI") equal to any excess of the depletion deduction over the taxpayer's adjusted basis for the depletable property (determined without reduction for current depletion).[12] The effect of this adjustment is that percentage depletion is not an allowable deduction for AMT purposes to the extent it exceeds the adjusted basis of the depletable property. This rule is separately applied to each mineral "property" (as defined in Code Section 614).[13]

VIII. SPECIAL PROBLEMS

A. Forward Exchanges

1. Single or Multiple Exchanges

Oil and gas exchanges raise many of the same issues in other exchanges. One threshold issue is whether a disposition of a number of properties is a single exchange or multiple exchanges. The same strategies can be employed to address this issue.

2. Direct Ownership or Partnership

Many times the property exchanged is a fractional interest owned in common with others who share the cost of production. This arrangement can sometimes constitute a partnership for federal income tax purposes. Also, aside from fractional ownership, many times adjacent or contiguous owners are required by state law to combine their production as a single unit, in order to better extract the minerals. Unitization or pooling arrangements may also be considered tax partnerships. In the natural resource area, there is increased use of the Code Section 761 election

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[12] Section 57(a)(1).

[13] See also Hill v. U.S., 506 U.S. 546 (1993).

out of Subchapter K.

3. Identification Issues

The replacement property must be "particularly described" in the identification which must be made and delivered in writing by the exchanger within 45 days of the disposition of the relinquished property. This should require not only that the land be described, but also the interest in the land (type of interest and percentage).[14] The identification time requirement is absolute. There are no good faith or other exceptions to save the exchange if the 45 day identification requirement is not met.[15]

4. Sale/Purchase Procedures

Oil and gas interests are sold at private sale and auction. For auction sales, the assignment and notification procedures must be incorporated into the auction procedure to satisfy the Treasury Regulations' requirements.

5. Replacement Issues

The "mineral interests" replacement property must be received within 180 days after the taxpayer transfers the relinquished property.[16] The receipt of the replacement property time requirement is absolute. There are no good faith or other exceptions to save the exchange if the 180 day replacement requirement is not met.[17]

B. Reverse Exchanges

1. Acquiring "Qualified Indicia of Ownership"

The exchange accommodation titleholder ("EAT") must acquire title to the parked property either directly or through a disregarded entity or by some other method recognized by commercial law. Most oil and gas interests are acquired by recorded instrument. Typically, the EAT or a LLC owned by the EAT will become the titleholder.

2. EAT Ownership of Parked Property for Federal Income Tax Purposes

A mineral interest may generate income and/or expense that is allocated to the owner of the interest. The EAT must be treated as the owner of the parked mineral interest for federal income tax purposes. This arrangement produces issues that both the taxpayer and EAT must address. While there are solutions for these issues, they will require significant cooperation and procedures to incorporate the taxpayer's and EAT's interests into the commercial realities of

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[14] See Code Section 1031(a)(3) and Treas. Reg. Section 1.1031(k)-1(b)(1)(i).

[15] Knight v. Commissioner, T.C. Memo 1998-107.

[16] See Treas. Reg. Section 1.1031(k)-1(b)(2)(ii).

[17] Knight v. Commissioner, T.C. Memo 1998-107.

how income and expenses are paid, collected and reported. Non-producing properties are easier to "park" under Rev. Proc. 2000-37 than producing properties.

VIII. MISCELLANEOUS ISSUES

A. Self Employment Tax

Receipt of royalties from a non-working mineral interest is not included in determining "net earnings from self-employment" under Code Section 1402, for purposes of the self-employment tax. A non-working mineral interest entitles its owner to a specified fraction of the total production from a property, free of expense of development and operation. Consequently, the owner is not deemed to be in the business of producing oil and gas since he has neither the right nor burden of developing and exploiting the property.[18] Only income derived from a "trade or business" is subject to the self-employment tax under Code Section 1402(a). Since an owner of a non-working mineral interest is not deemed to be in the oil and gas business, he will not be subject to the self-employment tax on the income derived from the interest.

In the case of a working interest, the IRS has held in Rev. Rul. 58-166 that income received from a working interest would be included in determining the taxpayer's self-employment tax. Furthermore, in Cokes v. CIR, 91 T.C. 222 (1968) the court held that ownership of a fractional working interest in an oil-producing property was a partnership interest and since the partnership was in a trade or business the inactive partner's distributive share of income was subject to a self-employment tax. It is not clear, however, how authoritative this holding might be, because in a number of other cases the taxpayer's ownership of a fractional working interest was not held to be a trade or business.[19]

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Please review the foregoing and contact us to discuss

[18] Rev. Rul. 69-355

[19] See Hendrickson v. Commissioner, 54 T.C. Memo 1079 (1987); Di Portonova v. U.S., 690 F.2d 169 (1982).

EXHIBIT A

MINERAL INTERESTS AS REAL ESTATE FOR CODE SECTION 1031

The following chart illustrates most oil and gas interests, and their status as real estate for federal income tax purposes with respect to exchanges:

Type of Interest	Real Estate (Y/N)	Authority
Working Interest	Yes	Rev. Rul. 68-226, 1968-1 C.B. 362, Rev. Rul. 68-331, 1968-1 C.B. 352
Underlying Royalty	Yes	Palmer v. Bender, Rev. Rul. 73-428, 1973-2 C.B. 303
Overriding Royalty	Yes	Rev. Rul. 73-428, 1973-2 C.B. 303
Production Payment	No	Code Section 636
Profits Interest	Depends	Rev. Rul. 73-541, 1973-2 C.B. 206 (net profits interest is considered a royalty interest for depletion).