2022 Oil & Natural Gas Tax Issues

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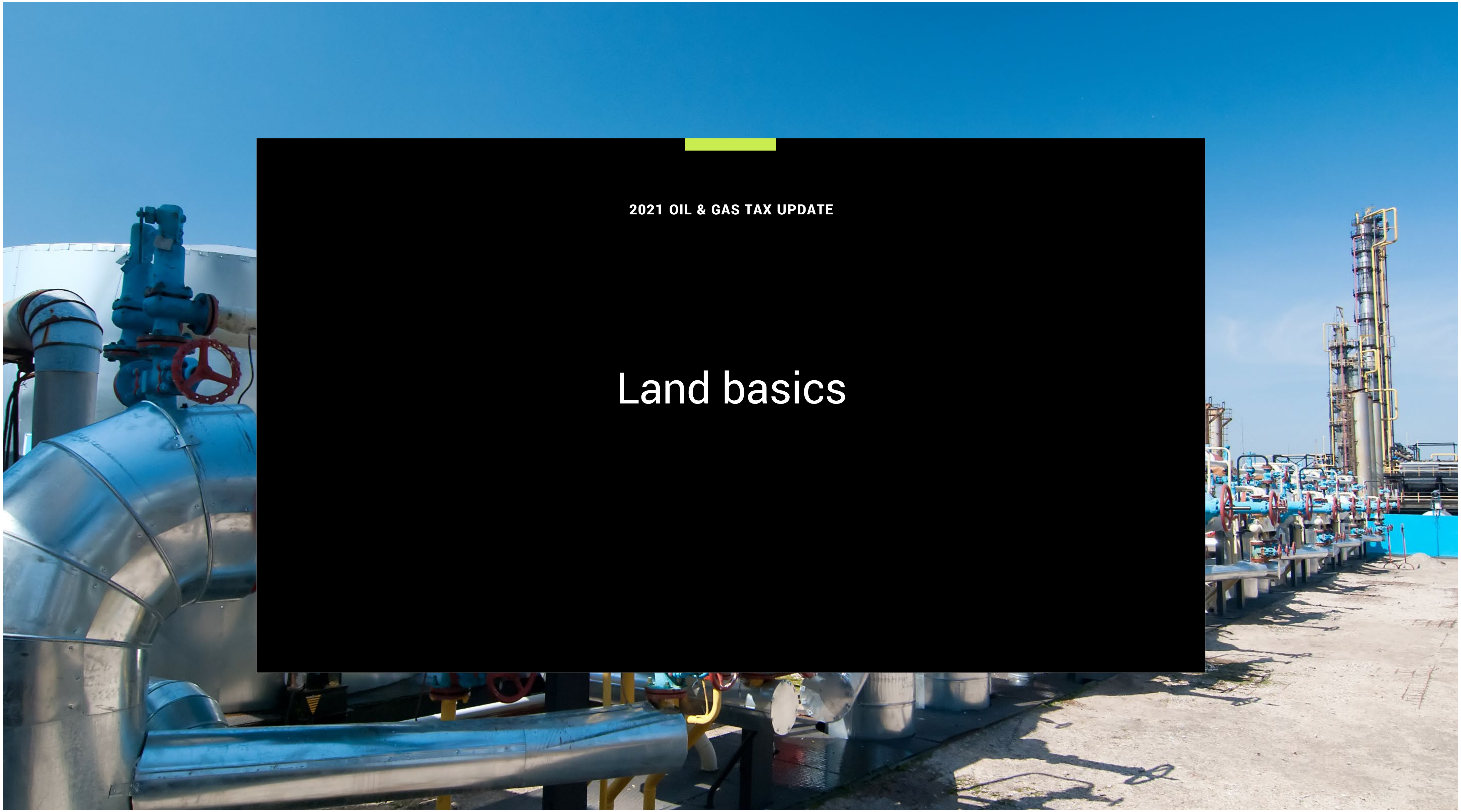
OVERVIEW

Today's agenda

— Land basics
— Tax issues
— Tax updates
— Questions and answers



2021 OIL & GAS TAX UPDATE

Land basics

Identify and define costs

Properly identify and define costs for economic and income tax treatment

– Acquisition, amortization, impairment, disposition

Types of costs incurred

- Lease costs
- Intangible drilling costs (IDC)
- Tangible drilling costs (TDC)
- Lease operating expenses (LOE)
- Delay rentals
- Damages

Lease costs

Includes costs incurred to obtain the lease including the lease bonus, legal costs and other expenses incurred to obtain the lease. These are written off through depletion.

Examples of leasehold costs that should be capitalized

- G&G expenditures leading to acquisition or retention of an oil and gas property
- Lease bonus paid to the landowner or other owner
- Salaries of land department personnel in acquiring leases
- IDC (if there is no election to expense)
- Delay rentals when election is made to capitalize

Intangible drilling costs (IDC)

– Costs incurred on items that in themselves have no salvage value and are necessary for and incident to the drilling of wells and getting them ready for production.

– Includes the costs of drilling, cementing and perforating the casing, logging and fracturing the formation. IDC may be expensed for tax purposes but can be capitalized if desired. IDC can be subject to the alternative minimum tax.

Examples of IDC

– Survey and seismic costs to locate a well site on leased property
– Costs associated with bringing a drilling rig in, setting up and the actual drilling costs including supplies consumed in drilling the well
– Surface damage payments to landowner
– Cementing of casing, but not the casing itself
– Perforating the well casing
– Cost of acidizing, fracturing the formation and other completion costs including swabbing costs to complete the well
– Cost of plugging the well if it is dry

Tangible drilling costs (TDC)

- Includes the equipment and facilities used to produce oil and gas that have a potential salvage value.
- Includes items such as well casing, cost of tanks, separators and production tubing.
- Written off by depreciation for federal income tax purposes. Also qualifies for Section 179 deduction – currently $1,050,000 for 2021 (subject to certain limitations).

Examples of lease and well equipment

— Surface casing
— Cost of well casing
— Transportation of tubing to supply yard, but not from supply yard to well site
— Cost of production tubing
— Cost of well head and “Christmas tree”
— Cost of pumps and motors including transportation
— Cost of tanks, flow lines, treaters, separators, etc., including transportation
— Dirt work for tanks and production equipment
— Roads constructed for operation of the production phase
— Laying pipelines, including dirt work and easements
— Installation costs of tanks and production equipment

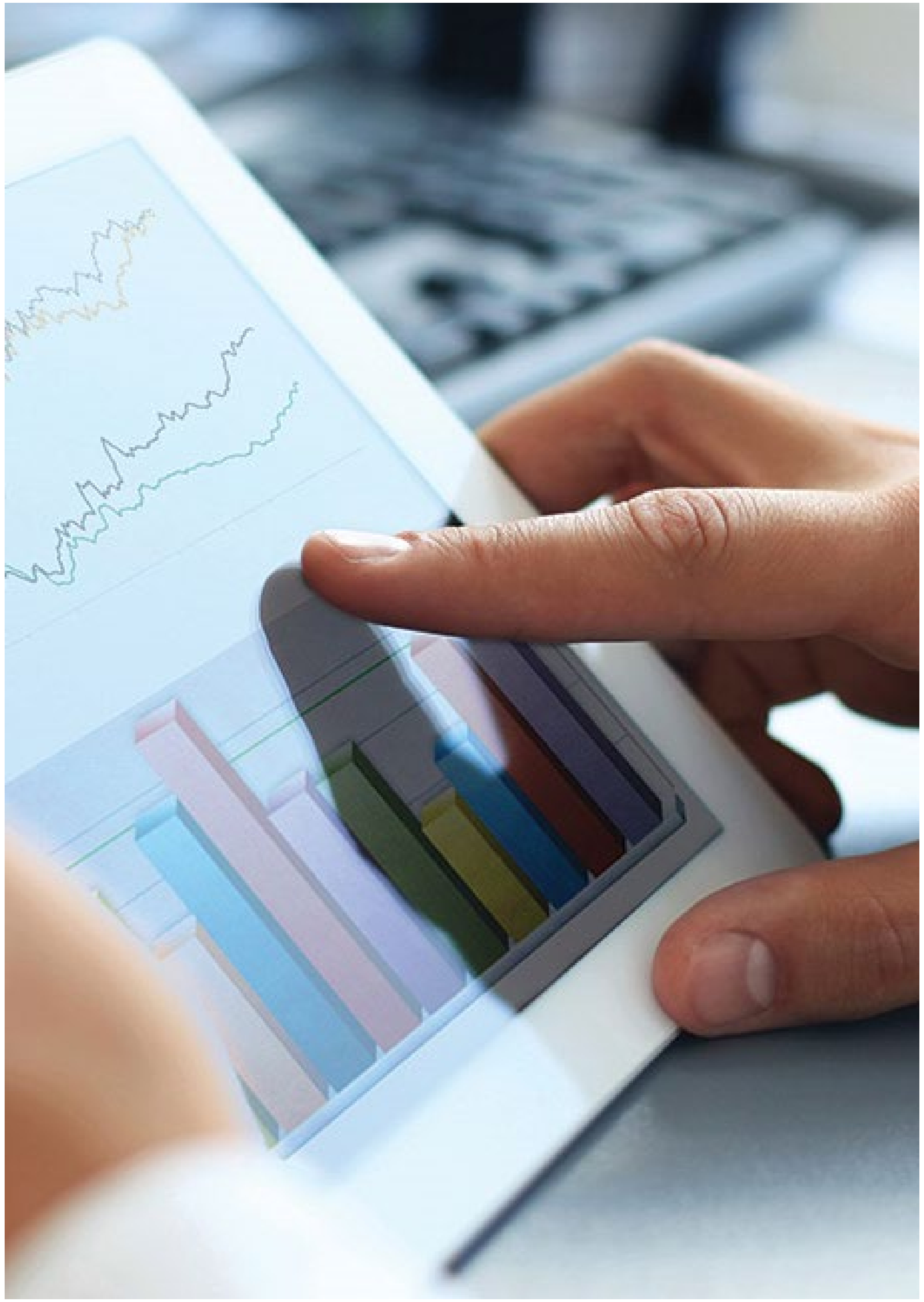
Operating expenses

- Includes expenses incurred to produce the oil and gas after the well is completed
- Expensed in the year incurred

Delay rentals

Operating expenses

These are amounts paid to the lessor for the privilege of deferring the commencement of a well on the lease. Oil and gas lease agreements generally provide a deadline for the lessee to begin drilling of the lease. If the drilling has not begun within this period of time, either the lease agreement will expire, or the lessee must pay a stated sum of money to retain the lease an additional year without developing the property.



Delay rental expense

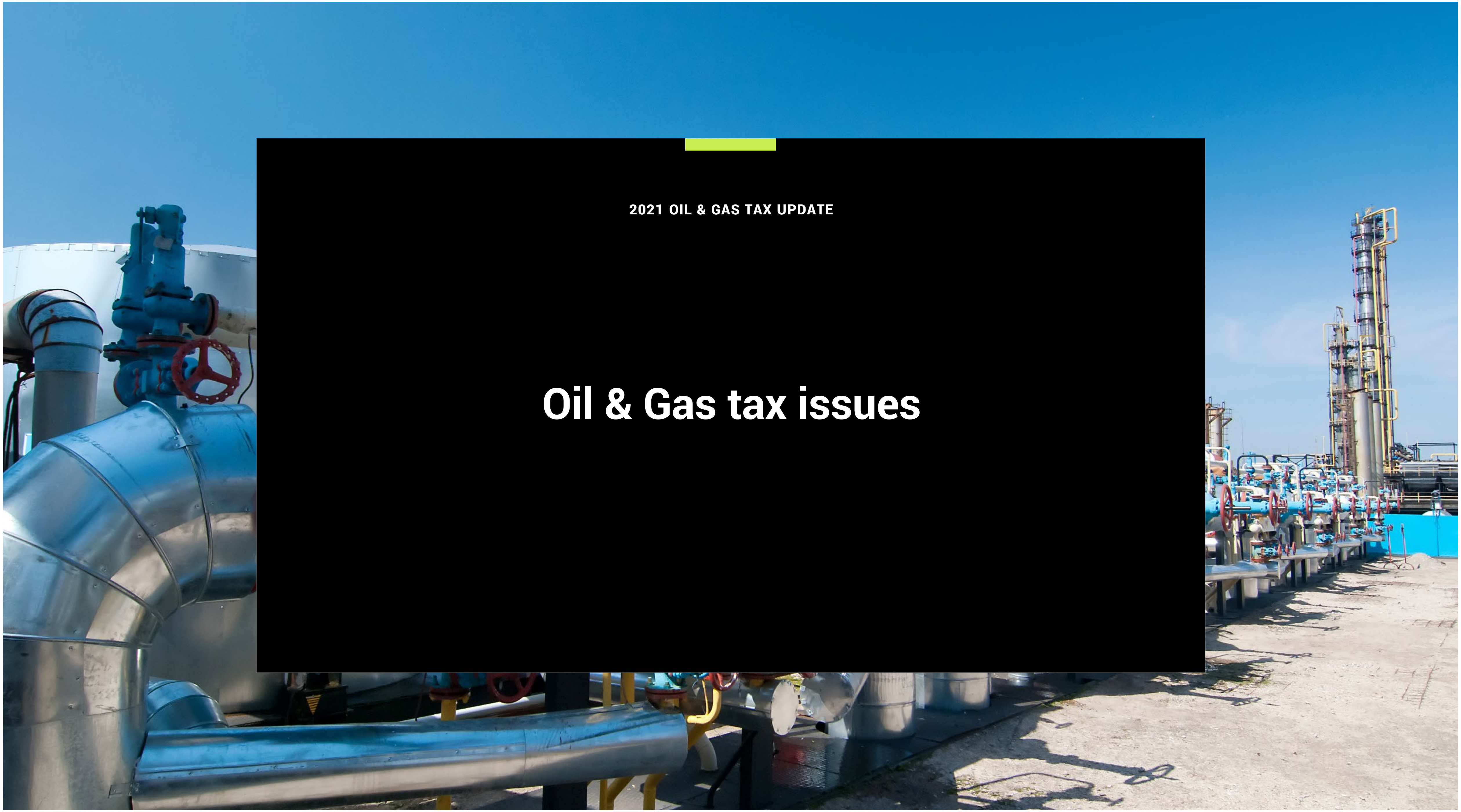
- Official IRS position- capitalize as part of lease
- Tax treatment more crucial with larger payments
- May create cost depletable basis

Damage payments

- Deduct as operating expense
- Tax free to landowner to the extent of their basis in the property

Property definition § 614(a)

— Separate interest
— Separate mineral deposit
— Separate tract
— Different time
— Different assignor
— Not contiguous
— Election important – separate property
— May be more important than ever with sale of Marcellus and Utica acreage



Oil & Gas tax issues

Depletion and ways to compute

What is depletion and what is its significance?

- Types of depletion
  - Percentage depletion
  - Cost depletion
- Production curve – life of the well

Must have an economic interest

Must have to deduct depletion

- Direct interest in the minerals in place
- Direct economic interest in the income from the production of the minerals
- Palmer vs. Bender - 1933 U.S. Supreme Court

Percent depletion example

Gross income (after royalties)	$30,000
Expenses	$28,000
Net income	$2,000
Percent depletion rate	15%

$30,000 x 15% = $4,500 percent depletion before limitation

Cost depletion example

Cost-original	$10,000
Accumulated depletion at 12/31/19	(2,500)
Reserves at 12/31/20	45,000 mcf
Production in 2021	5,000 mcf

$$\frac{10{,}00-2{,}500}{50{,}000} \times 5{,}000 = \$750$$

Reserves included in cost depletion calculation

- Reserves should include
  - Proven reserves (developed and undeveloped) probable or prospective reserves
- Revenue Procedure 2004-19 provides a safe harbor to avoid IRS challenge
  - Make an election to use 105% of proven reserves
- May become more common with Marcellus and Utica due to bonus payments, lower gas sales prices and increased expenses

Production curve example conventional well

Year	production curve rate percentage
1	15
2	11
3-5	9,8,7
6-10	6,6,5,4,4
11-15	3
16-20	2
Cost of property	$10,000
Year of production	4

$10,000 x 8% = $800 depletion based on production curve

Revising your reserve study?

Is now a good time to consider revising reserve estimates?

Potential income tax consequences

– Increase in cost depletion (lower total reserves)

Potential financial statement consequences

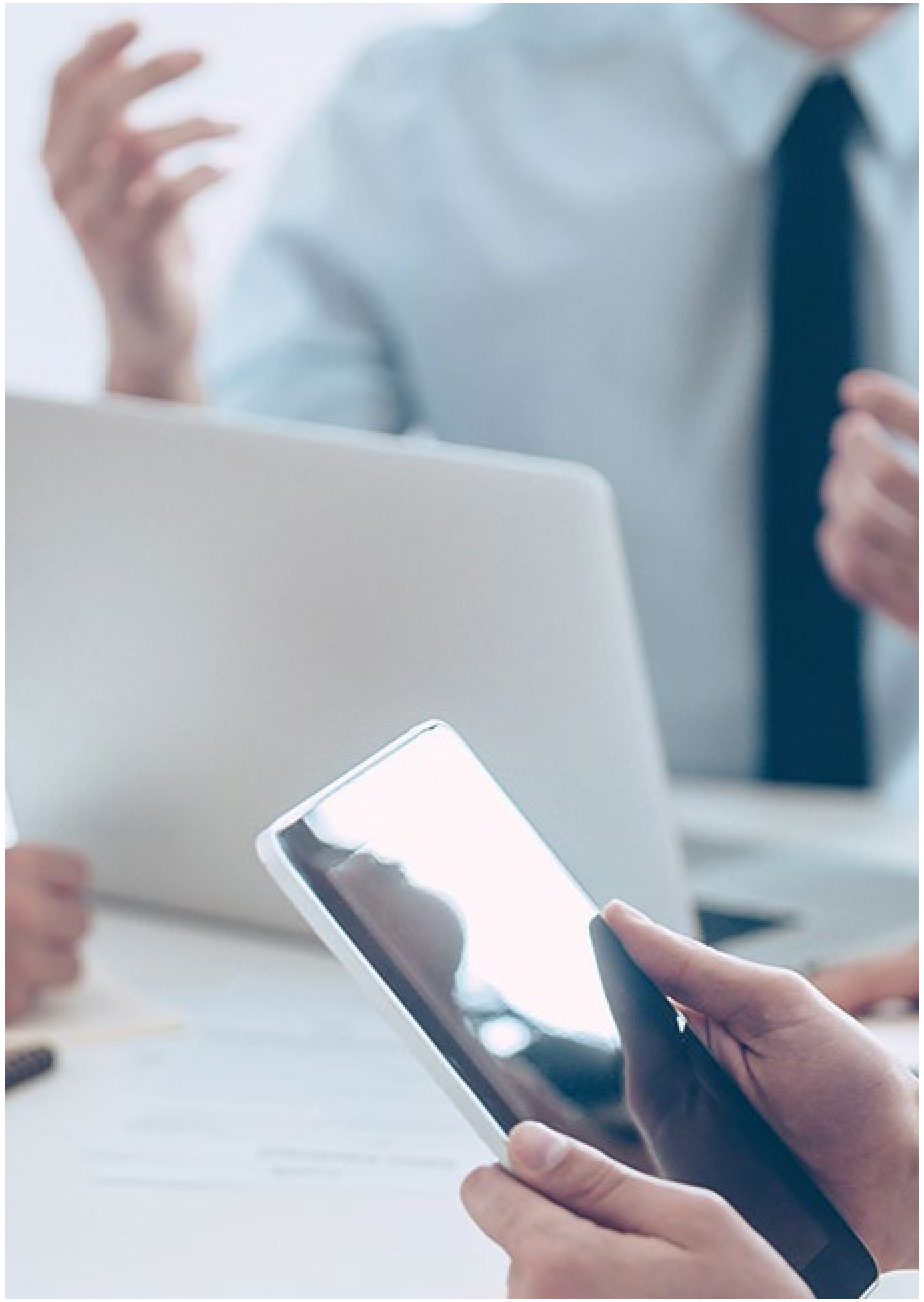
– Lower reserves decreases the value of your company and makes it less likely to receive a loan from a financial institution

– Loan covenant violations

– Properties could be impaired

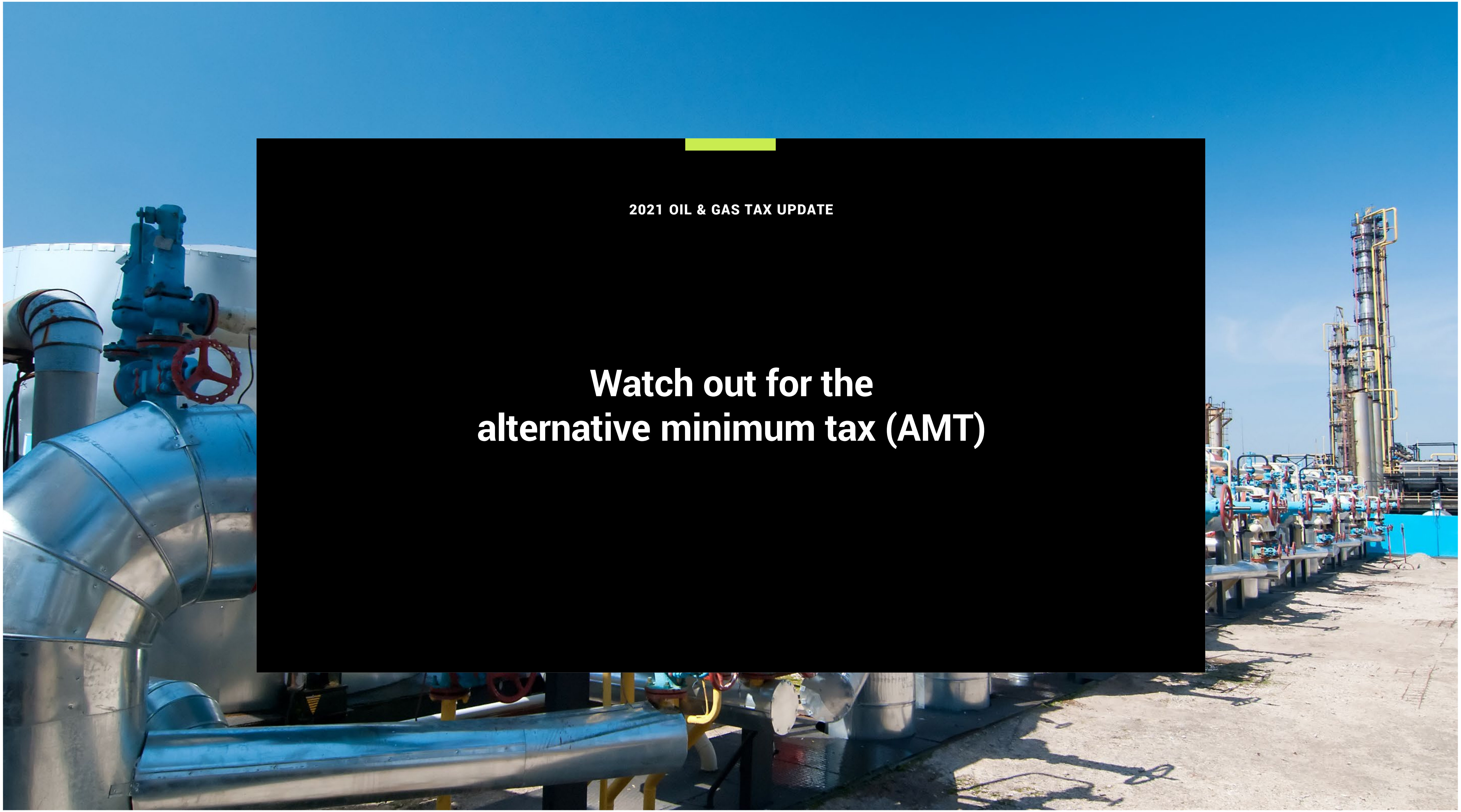
Depletion code sections

- IRC Section 611-Basic Authorization
- IRC Section 612-Cost Depletion
- IRC Section 613-Percentage Depletion



Depletion final thoughts

- Calculate the greater of cost vs. percentage depletion
- Reduce depletable basis by the greater of cost or percentage depletion
- Make a separate property election
- Consider whether it would be beneficial to update your reserve study
- Consider making the 105% safe harbor election
- Must have an economic interest to deduct depletion
- Percentage depletion is limited by net income per property

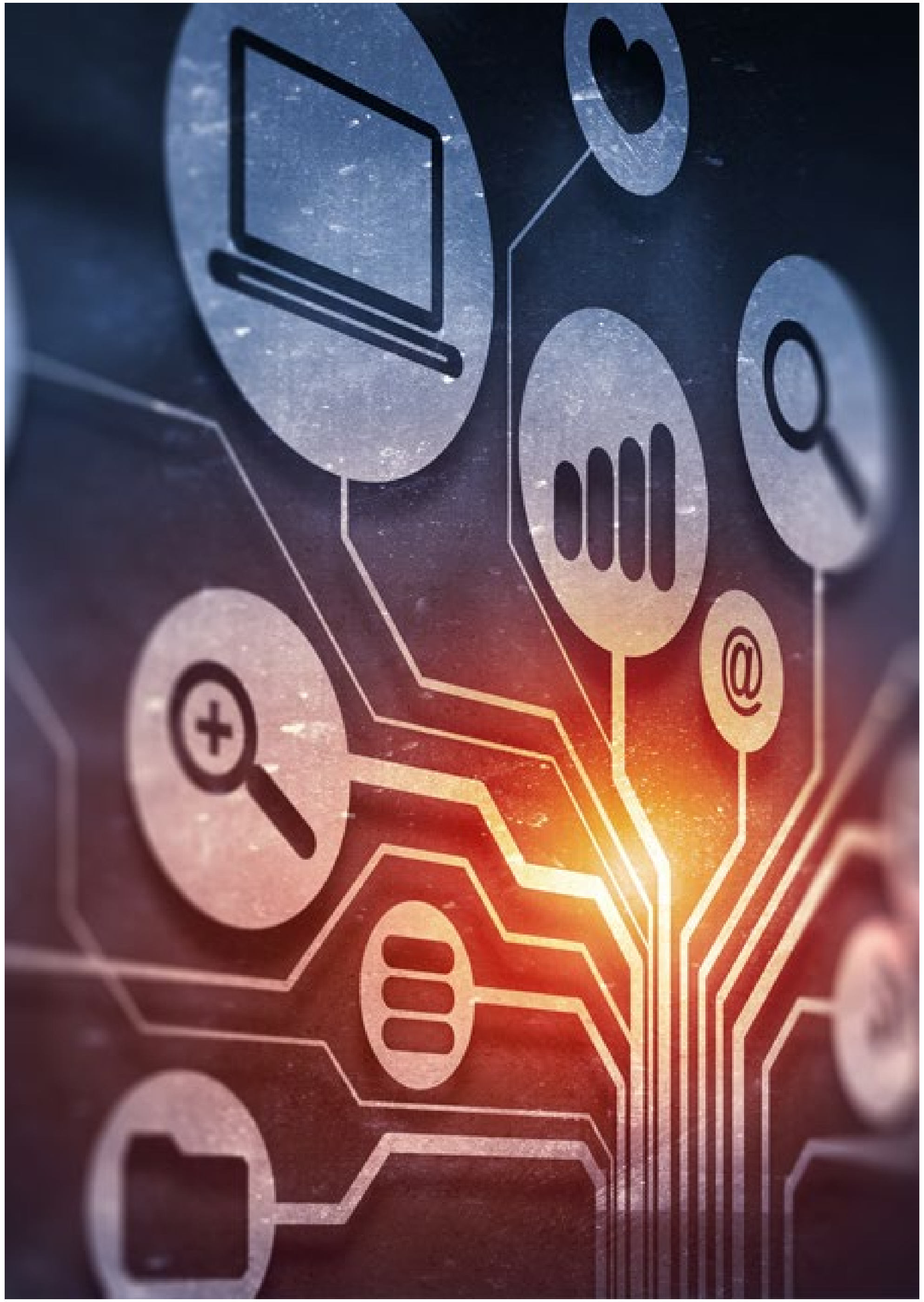


2021 OIL & GAS TAX UPDATE

Watch out for the alternative minimum tax (AMT)

AMT in general (individuals)

- Start with taxable income
- Add back certain items
  - i.e., preference IDC and excess accelerated depreciation
  - taxes deducted on Schedule A
- Less an exemption ($114,600 for 2021)
- Tax at 26 or 28 percent
- Pay if greater than regular tax
- Can generate credits to carryover
- Cannot be reduced by marginal well credits



Excess and tax preference IDC

Gross oil and gas income			**$100,000**
Deductions			
	Royalties	18,750	
	Operating expenses (1)	66,910	
	IDC	152,542	
	Depletion	12,187	
Total deductions			250,389
Net income			(150,389)
Add back – IDC			152,542
Deduct S/L 120-month IDC amortization (2)			(2,542)
Net oil and gas income			(389)
			X 65%
			(252)
Total IDC expensed			152,542
Less S/L 120-month amortization			(2,542)
Excess IDC			150,000
Less 65% of net oil and gas income			0
Preference IDC			$150,000
(1) Including depreciation section 179 deduction or bonus depreciation (2) Well placed into production on October 31			

Repeal of AMT preferences other IDC

	AMT without IDC preference	AMT with IDC preference
Taxable income	$300,000	$200,000
Preference IDC	150,000	150,000
Personal exemption	7,800	7,800
Standard deduction	12,200	12,200
Alternative minimum taxable income (AMTI)	470,000	290,000
Alternative tax		
IDC exclusion (40% AMTI)	(188,000)	(116,000)
AMT IDC tax preference	(-0-)	$34,000

Marginal Well Credit – 45I

- Marginal wells producing < 90 mcf equivalent per day
- 18 mcf per day - 6,570 mcf per year
- 2021 $0.67 per mcf
- Carry back 5 years, then carryforward
- Can only reduce tax to AMT

Basics of basis

- S corporations require cash contributions
- Partnership entities allow loan guarantees
- Percentage depletion deduction in excess of basis allowed unless property has depletable basis within entity

AMT final thoughts

– Plan amount of well investment to avoid preference IDC (40% of income as a guide)

– Capitalize preference IDC under IRC Section 59(e) if necessary

– Use 150% declining balance to depreciate assets to avoid depreciation adjustments

S corporation example

Beginning of year tax basis	$100,000
Net income for the year	$50,000
Tax basis before distributions	$150,000
Distribution to shareholder	(140,000)
Tax basis after distribution	$10,000
percentage depletion available to shareholder	$15,000
- Fully deductible if no depletable basis of assets inside S corporation	

Active vs. passive deductions

- Passive deductions can only be taken against passive income
- Working interest exception still alive Internal Revenue Code §469(c)(3)
- Limited partnership and LLC interests are considered passive
  - Exception for properties previously treated as non-passive, Treasury Reg. §1.469-2(c)(6)
- Important factor given NIIT (net investment income tax) on passive income

Net operating losses

Before TCJA (2017 tax years and earlier)

— Federal – carry back two years and forward 20

— May elect to forgo carry back period

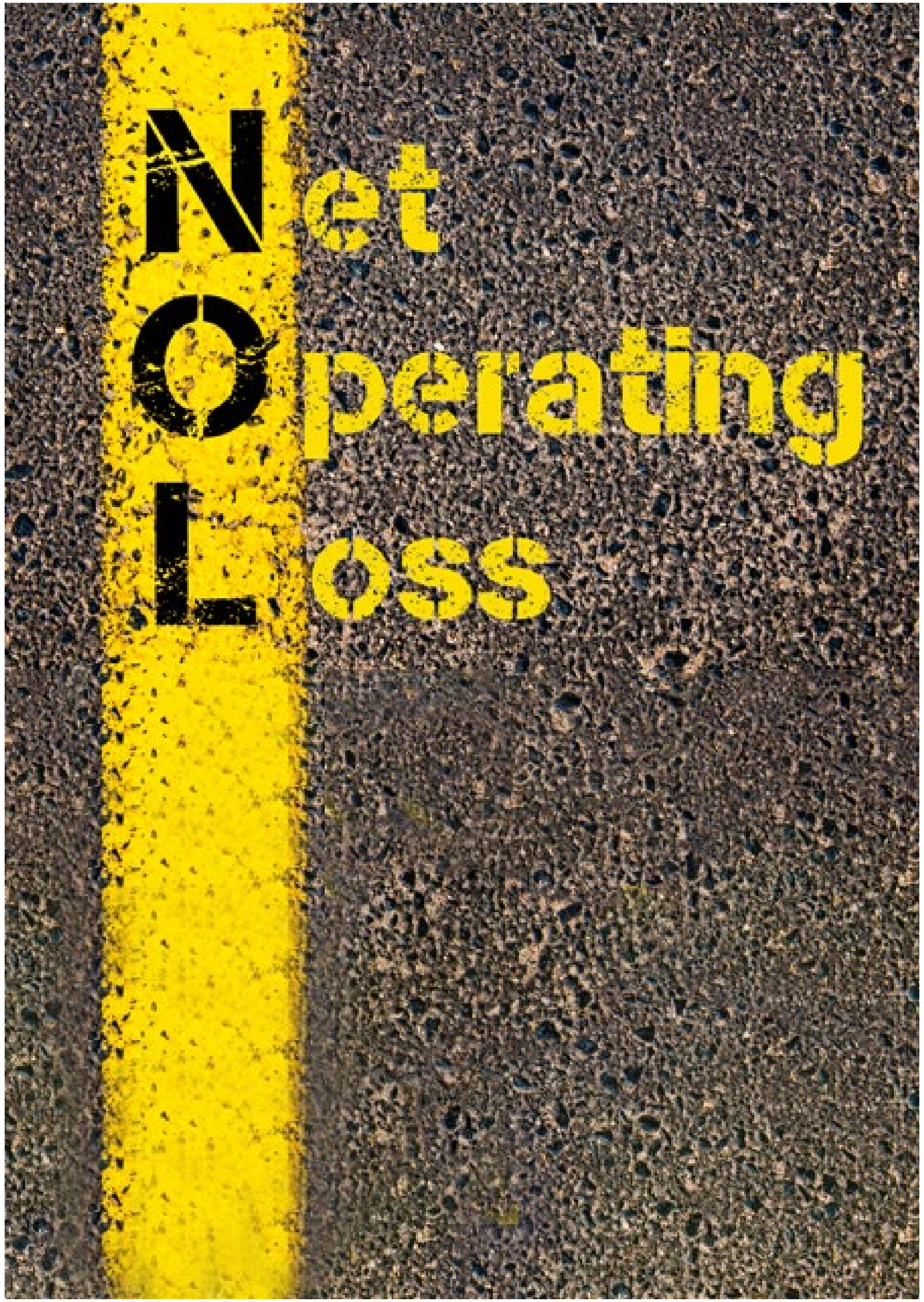
— Corporations – Form 1139

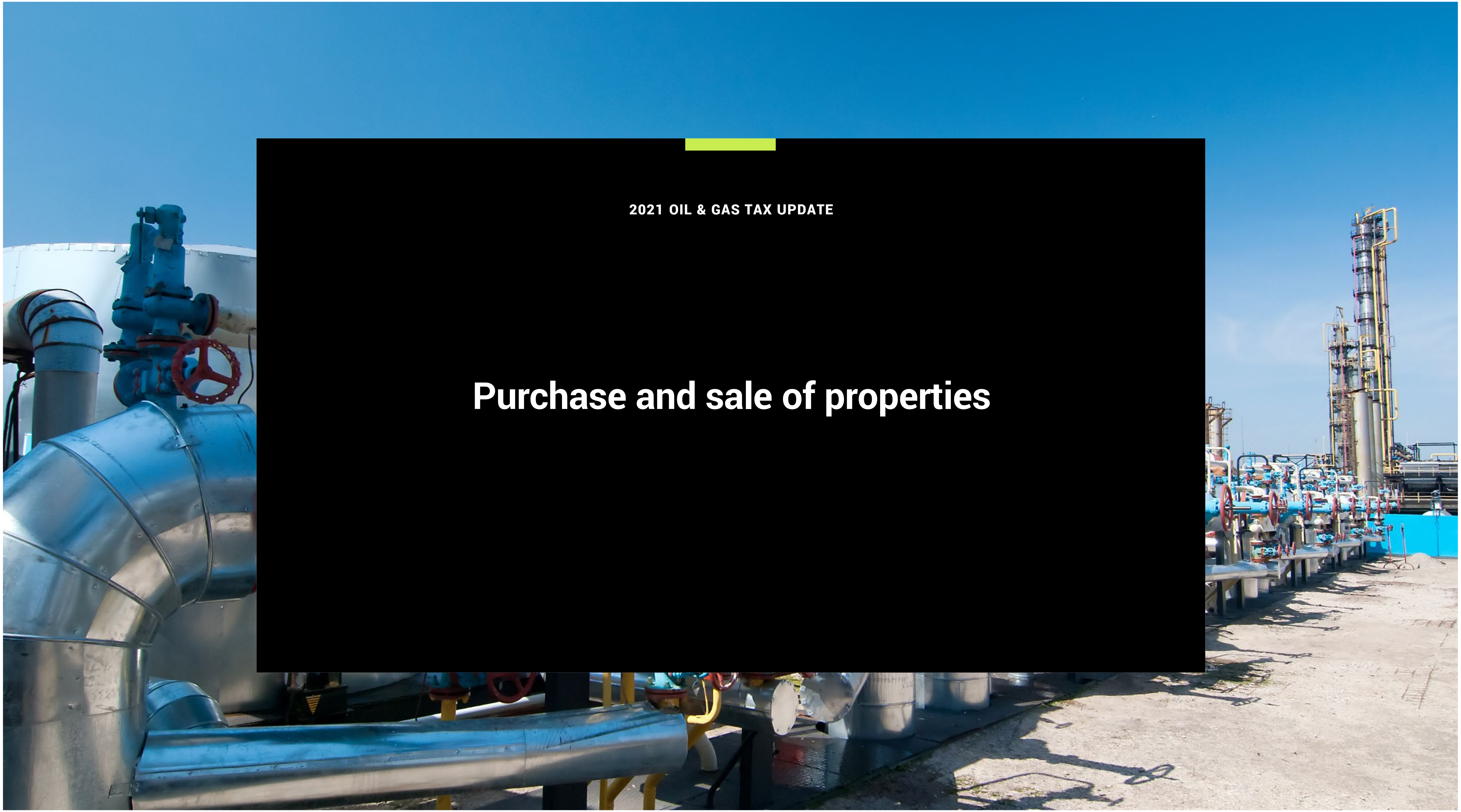
— Individuals – Form 1045

After TCJA (after 2017 tax year)

— No carry back only carry over

Opportunities under the CARES Act for 2018, 2019, 2020, 2021 tax years





2021 OIL & GAS TAX UPDATE

Purchase and sale of properties

Purchase and sale of properties

Understand what you are buying or selling

– Corporation stock

– Partnership or LLC interests

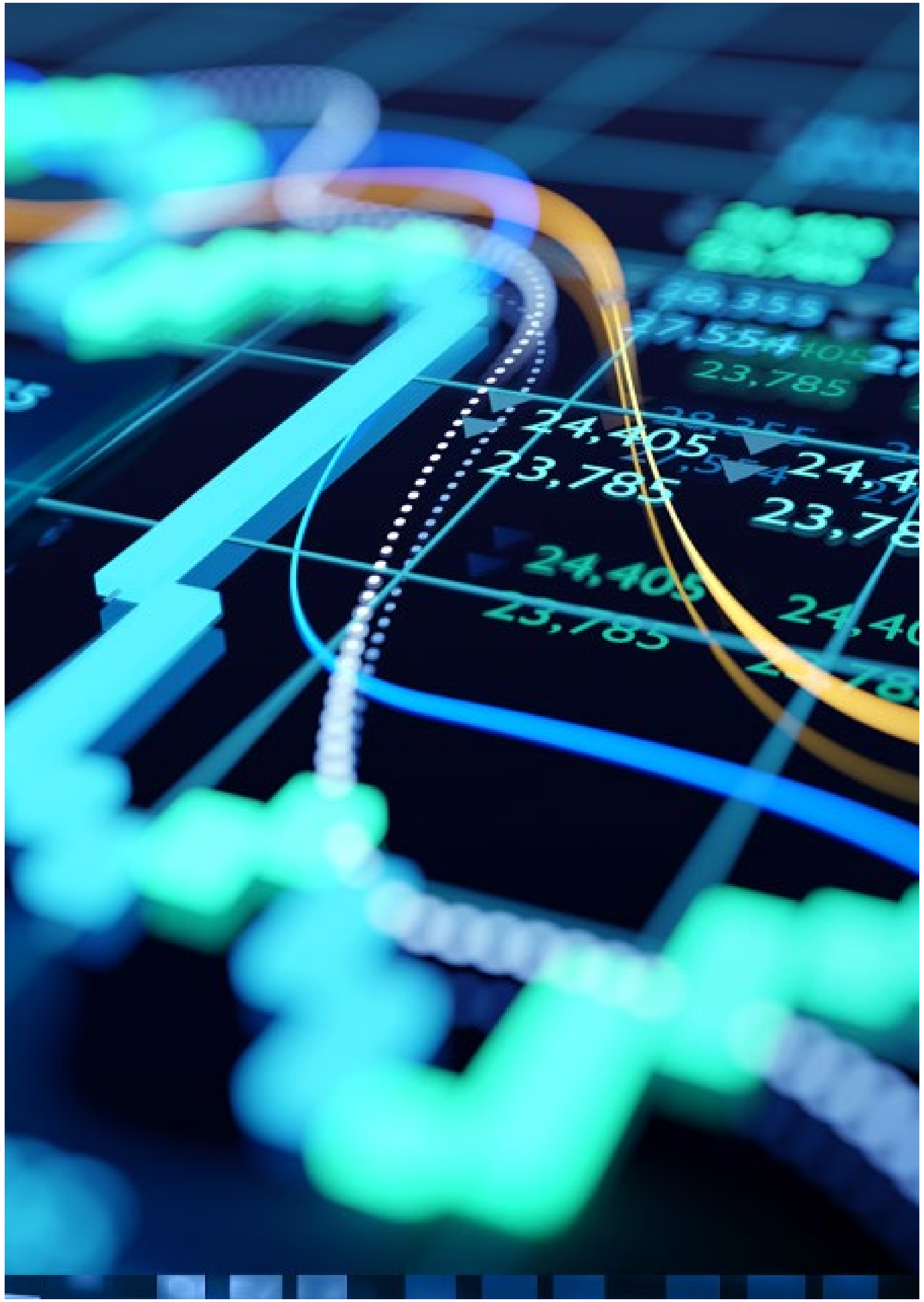
– Assets and other operating rights

– Right-of-way and damage payments

Proper allocation can result in tax savings

– Buyer and seller need to agree on allocation

– The contract should include the allocations



Corporation stock

- Seller – gain taxes at capital gains rates
- Buyer – no step up in basis of underlying assets
- Section 338(h)(10) election

Partnership or LLC interests

- Seller – probably mostly ordinary gain depending on allocation
- Buyer – gets basis step up in assets (if elected) and additional deductions as a result

Assets and other operating rights

Producing wells
- Seller – probably ordinary income
- Buyer – allocate between tangible and reserve value

Deep rights
- Seller – capital gain treatment if structured properly
- Buyer – lease costs written off as wells are drilled or through depletion

Operating rights
- Seller – capital gains treatment
- Buyer – write off over 15 years

Deep rights
- Seller – capital gains treatment
- Buyer – write off through depletion

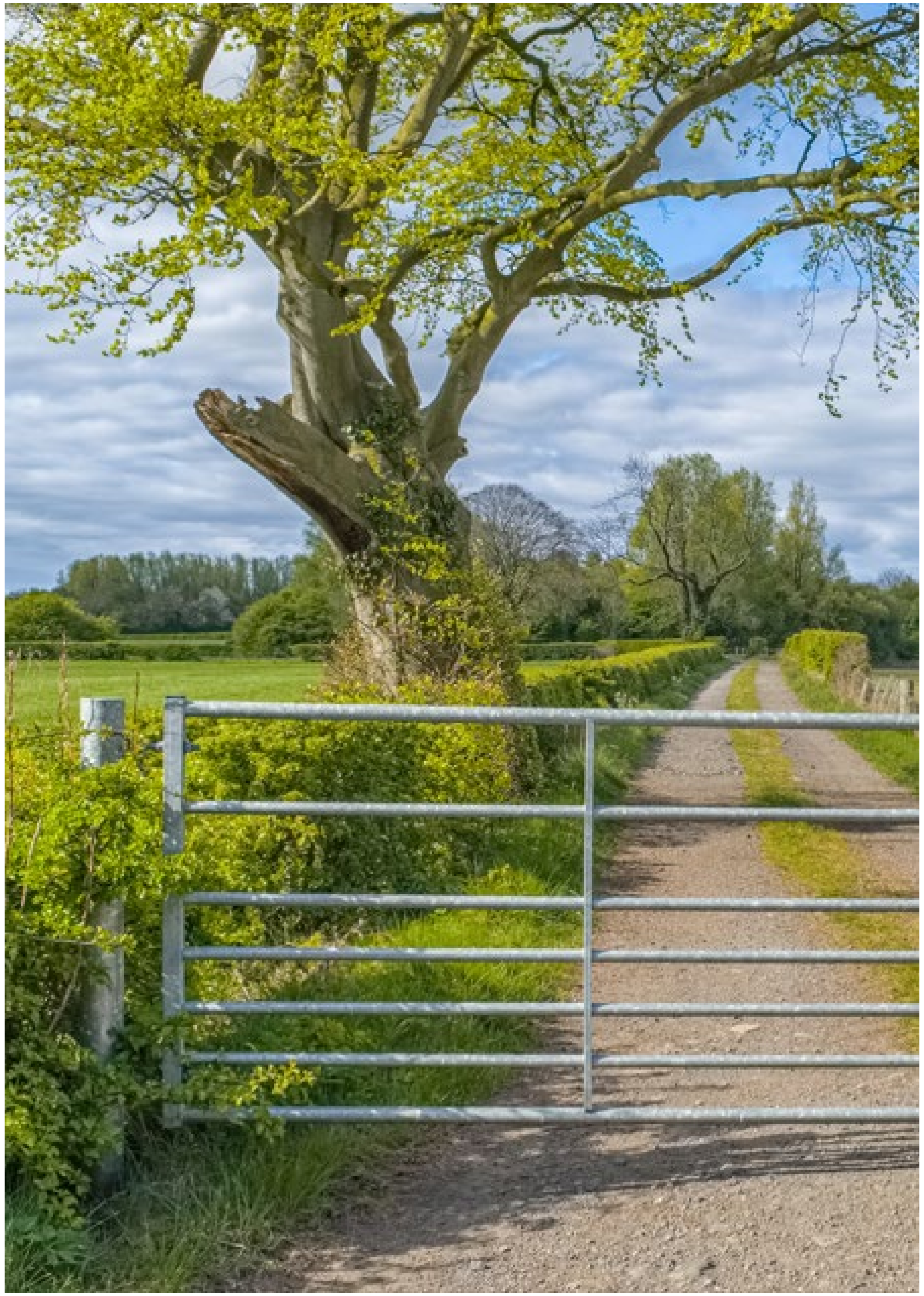
Leases
- Seller – capital gains treatment if structured properly
- Buyer – lease costs written off as wells are drilled or through depletion

Allocation discuss example

- Taxpayer selling of all oil and gas business
- Items being sold
  - Trucks, ATVs and other vehicles – original cost $450,000, undepreciated book value $100,000
  - Various equipment - original cost $300,000, fully depreciated
  - 500 producing wells - IDC expenses, tangible equipment fully depreciated, no basis in lease costs annual net income from WI, $250,000
  - 4,000 acres deep rights all HBP, no wells drilled
  - Royalties and overrides - $100,000 annually
  - Operating contracts - annual net income from operations, $500,000

Right-of-way

- Permanent or well into the future – capital gain treatment, may be able to offset against basis in that portion of the property
- Temporary – ordinary income
- Damages
- Capital gain – may be able to offset against basis in that portion of the property
- Be careful of damage payments received in advance



Allocation of purchased price producing wells

- Tangible equipment – depreciated over seven years, Section 179 deduction or bonus depreciation
- Reserves – written off through depletion
- Try to maximize allocation to equipment based on age of wells purchased

Maximizing depreciation deductions

- Change in depreciation method
  - Changing life of an asset
  - Filing Form 3115
- Beginning depreciation (Rev. Ruling 78-13)
  - Downhole casing must be capitalized
  - Depreciation begins when well is completed and made capable of production

Sale of leases and deep rights

- Lessor treatment of receipts
    - Lease bonus as ordinary income
    - Lease bonus as capital gain
        - Separate property election under §614
        - Dispose of all non-operating interests
        - Sell everything
        - Production payments for 90% or less of expected production

- What not to do – Dudek Case

Like-kind exchange

IRC Section 1031

— Transaction is a sale or exchange

— Property held for productive use in a trade or business or for investment

— Property must be like-kind

— Gain will generally be deferred if requirements are met

— Only applies to real estate after 2017

— Be careful of mixed property

Installment sales

A sale where the sale occurs in one year and one or more payment is received in a future year

- Ordinary income (recapture) is picked up in the year of sale
- Capital gain is deferred until payments are received
- Installment treatment is mandatory unless you elect to report all the gain in the year of sale

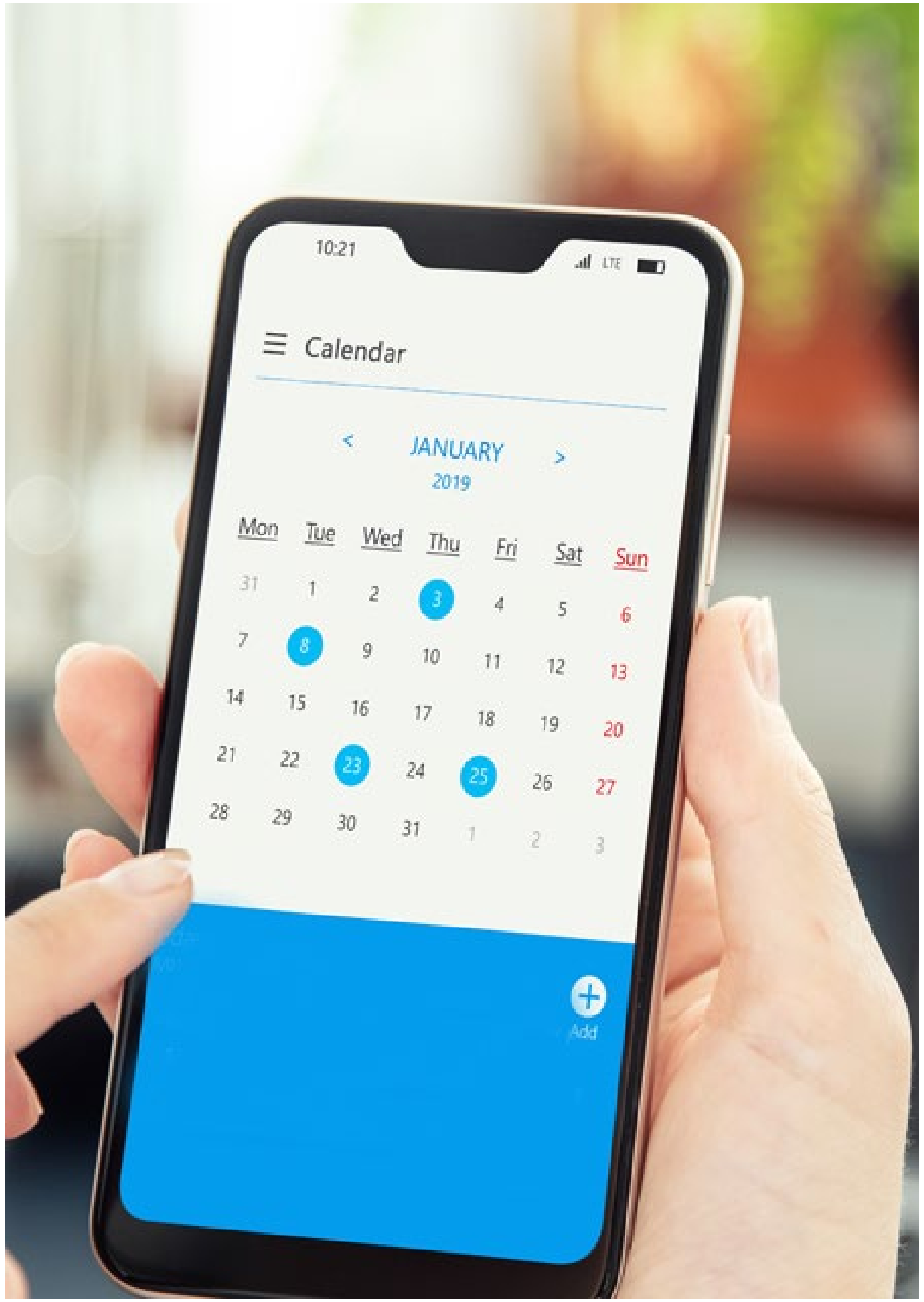
Sale or exchange

Direct exchange/deferred exchange

— 45 and 180-day requirements

— Qualified intermediary

— Multiple party exchange



Purpose of holding property

Trade or business investment

Does not include:

— Property held for personal use

— Inventory property

— Partnership interests

— Securities not included

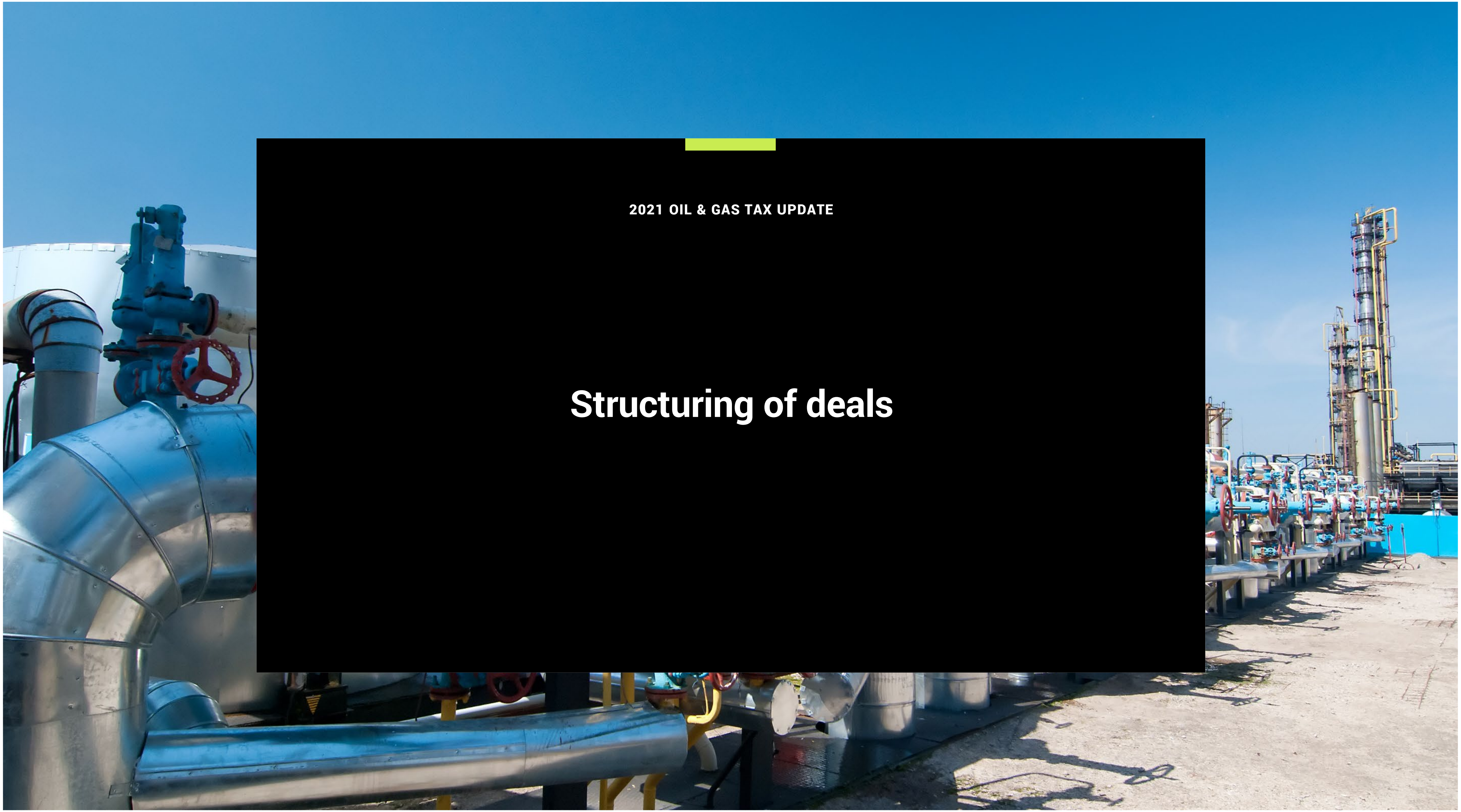
Like-kind

Nature or character of property real estate

– Improved or unimproved

Personal property

– Generally, not available after 2017



2021 OIL & GAS TAX UPDATE

Structuring of deals

Structuring of deals

- Income for services (Revenue Ruling 83-46)
- Receipt of property separate from drill site (Revenue Ruling 77-176)
- Carried interests

Income for services

- A corporation, an attorney and an employee of a corporation receive royalties for performing various services
- Each must include in income the FMV of the override received
- Using a profits interest in a partnership may be one way to avoid immediate income recognition

Receipt of property

Separate from drill site (Rev. Rule 77-176)

- Y (owned lease) entered into an agreement with X to drill a well
- X received entire working interest in the drill site plus an undivided one-half interest in the remaining acreage
- Y received a 1/16th royalty from the well drilled with the option to convert it to a 50% working interest after payout
- Drill site – pooling of interests – not taxable
- Other acreage – each recognized income based on the FMV

Receipt of property

Drill site

Other acreage

Carried interests

– Carrier agrees to drill, complete and equip the well
– Carried party receives a working interest
– Transfer of interest must be after payout

Questions?

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