ISSUES IN OIL AND GAS TAXATION

Allegheny Tax Society
Pittsburgh, PA
November 21, 2011

Presented by:
Charles L. Potter, Jr.
Buchanan Ingersoll & Rooney PC
301 Grant Street
Pittsburgh, PA 15219

I. Federal Issues

A. Intangible Drilling Cost Deduction

1. At Risk
2. Year of Insurance
3. AMT
4. Use of a Captive Drilling Company

II. Pennsylvania Issues

A. Personal Income Tax - IDC deduction

B. Sales & Use Tax - Scope of the Mining Exemption

C. Realty Transfer Tax - Exemptions

D. Proposed Impact Fee Legislation

Potter, Charles L.

From: Potter, Charles L.
Sent: Wednesday, November 02, 2011 3:34 PM
To: 'mbauer@kriebelgas.com'
Subject: PGH1_GENERAL-#7759795-v2-S__Patchin_-_2006__2007__Commonwealth_Ct__Petitions.DOC

per our discussion.

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

STEVEN R. AND LISA PATCHIN	
Petitioners	
v.	**No. _________F.R. 2011**
COMMONWEALTH OF PENNSYLVANIA	
Respondent	

PETITION FOR REVIEW

To the Honorable, the Judges of the Commonwealth Court:

1. This Court has jurisdiction over this matter by reason of (A) Section 235 of the Tax Reform Code of 1971, Act of March 4, 1971, P.L. 6, as amended, 72 P.S. § 7235; (B) Sections 763 and 5105(a) of the Judicial Code, 42 Pa. C.S. § § 763 and 5101(b); and (C) Pa. R.A.P. 1571.

2. The parties seeking review are Steven and Lisa Patchin, husband and wife.

3. The Board of Finance and Revenue made the determination sought to be reviewed.

4. The Order of the Board of Finance and Revenue sought to be reviewed was entered on May 10, 2011 and was mailed on May 13, 2011. The docket number was 1002383. A copy of the Order is attached hereto.

5. The Petitioners are partners in Exotic Oil and Gas LLC (Exotic). Exotic is

engaged in drilling and operating oil and gas wells. The Petitioners deducted their share of intangible drilling costs ("IDCs") in their 2007 Pennsylvania Personal Income Tax Return. Petitioners followed the Federal income tax rules and deducted the IDCs incurred during 2006, 2007 and 2008 in the returns for those years.

6. The Department of Revenue disallowed the deduction and assessed tax and interest and penalties against the Petitioners in the amount of $20,877.00. The Board of Appeals had previously abated the assessed penalties.

7. The Petitioners disagree with the action of the Department of Revenue for the following reasons:

(a) All Intangible Drilling Costs Incurred are Fully Deductible.

(i) Section 303(a.2) of the Tax Reform Code (72 PS 7303(a.2)) provides that a taxpayer may use any depreciation method, recovery method or convention that is also used by the taxpayer in determining Federal net taxable income. The Petitioners believe that the deduction of intangible drilling costs, pursuant to federal law, is a recovery method. Federal law provides several methods for recovery of the costs of drilling wells. Tangible costs, including well casings, production units and piping are recovered over a seven year period commencing when the well is placed in operation. Intangible costs, including site preparation, well drilling, hydro fracking, and cementing can either be deducted in the year of incurrence or amortized over 60 months. Petitioners' deduction of intangible drilling costs in the year that they are incurred clearly falls within the provisions of Section 303(a.2).

(ii) In addition, Section 303(a.3) (72 PS 7303(a.3)) allows the current deduction of asset costs under Internal Revenue Code Section 179 that would normally be capitalized and depreciated over the depreciation period assigned to the asset by the Internal Revenue Code. The Department denies this same type of deduction to intangible drilling costs. This denial is a violation of the Uniformity Clause of the Pennsylvania Constitution. *Commonwealth v. Staley,* 381 A.2d 1280 (1978)).

(iii) The rules of statutory construction require that any ambiguity in the tax law be resolved in favor of the taxpayer. *Commonwealth v. High Welding Company*, 239 A.2d 377 (1968).

(iv) Pennsylvania Tax Reform Code Section 7303(a)(2) provides that net profits are to computed "in accordance with accepted accounting principles and practices". The rules of the accounting profession allow other comprehensive basis of accounting ("OCBOA") as an acceptable method of accounting . The Federal tax basis of accounting is one of the methods of accounting permitted under the OCBOA rules. Under this method of accounting, IDCs are deductible in the year incurred. The Pennsylvania Personal Income Tax Regulations at Section 010.2(61 Pa. Code 101.2) provide that a method of accounting which reflects consistent application of generally accepted accounting principles in a particular trade or business in accordance with prevailing practices, in that trade or business, shall be presumed to clearly reflect income if such method is employed for Federal income tax purposes. The tax basis of accounting clearly meets all of these requirements.

(v) The tax basis of accounting is a permitted method of accounting under Pennsylvania Personal Income Tax law. Accordingly, the Petitioners' IDC deductions, taken pursuant to Federal income tax law, should be allowed for Pennsylvania Personal Income Tax purposes.

(b) Alternative 1 - Petitioners are Entitled to Deduct One-Seventh (1/7) of the Intangible Drilling Costs Each Year.

(i) Petitioners claim the right to recover their costs over the life of the wells contained in the Partnership (See PIT Guide, Chapter 23, page 17). Production data for the type of wells contained in the partnership indicate that a seven year life would be appropriate. Petitioners will provide production data supporting a seven year life.

(ii) Accordingly, Petitioners request that they be allowed a deduction of 1/7 of the disallowed intangible drilling costs deduction in this tax year.

(c) Alternative 2 - the Petitioners are Entitled to Deduct One Tenth (1/10) of the

Intangible Drilling Costs Each Year.

(i) Personal Income Tax Bulletin 2010-4 at Part III e 2 allows the deduction of intangible drilling costs ratably over a 10 year period.

8. The foregoing actions of the Commonwealth violate the due process and Equal Protection clause of the United States Constitution and the Uniformity Clause of the Pennsylvania Constitution, the Pennsylvania Taxpayers Bill of Rights and give rise to the right to attorney's fees pursuant to 42 U.S.C. § 1983.

9. The actions of the Commonwealth and its officials have deprived the Petitioners of property without the process of law in violation of Article I, § § 9, 10 of the Pennsylvania Constitution and the due process clause of Section 1 of the Fourteenth Amendment to the United States Constitution.

10. The administrative decisions further violate Article II, § 1 of the Pennsylvania Constitution which requires that administration actions conform to the statute under which the action is taken and Article 8, § 1 of the Pennsylvania Constitution requiring that all tax be uniform upon the same class of subjects.

11. The Petitioners request relief pursuant to 42 U.S.C. § 1983 and attorney's fees pursuant to 42 U.S.C. § 1988.

12. The actions of the administrative agencies of the Commonwealth are without basis in fact or law and the Petitioners are entitled to fees and expenses pursuant to 72 P.S. § 2031 *et seq.*

WHEREFORE, Petitioners pray that this Court enter judgment reassessing the Order of the Board of Finance and Revenue and granting relief as requested and reimbursing reasonable expenses and attorney's fees.

Charles L. Potter, Jr.
BUCHANAN INGERSOLL & ROONEY PC
One Oxford Centre
301 Grant St., 20th Floor
Pittsburgh, PA 15219-1410
412.562.1561
Attorneys for Petitioners

CERTIFICATE OF SERVICE

I hereby certify that I am this day serving the foregoing Petition for Review upon the persons and in the manner indicated below, which service satisfies the requirements of Pa. R.A.P. 121 and 1514(c) and 1571(d).

Service by *United States Certified Mail,* addressed as follows:

Honorable Linda L. Kelly
Attorney General of Pennsylvania
16th Floor, Strawberry Square
Harrisburg, Pennsylvania 17120

Honorable Jacqueline A. Cook
Secretary
Board of Finance and Revenue
1101 Front Street, Suite 400
Harrisburg, PA 17104-2359

June ______, 2011

Charles L. Potter, Jr.
BUCHANAN INGERSOLL & ROONEY PC
One Oxford Centre
301 Grant St., 20th Floor
Pittsburgh, PA 15219-1410
412.562.1561
Attorneys for Petitioner

pennsylvania
DEPARTMENT OF REVENUE

PERSONAL INCOME TAX BULLETIN 2010-04

Issued: December XX, 2010

Pennsylvania-Qualified Methods of Accounting for Oil & Gas Exploration and Development Costs, Intangible Drilling and Development Costs

PART I. INTRODUCTION

By law, the costs and expenses incurred or paid in the operation of an oil or gas well as a commercial enterprise are to be determined in accordance with those accounting principles and practices that are applicable to the oil and gas industry and acceptable to the accounting profession.

Historically, the Department of Revenue ("department") has permitted the operators of oil and gas wells to amortize exploration and development ("E & D") costs over the life of the wells and to write off the remaining unamortized costs as a loss when the well becomes unproductive and has not allowed current expensing of intangible drilling costs associated with the creation of wells, as permitted in Internal Revenue Code ("IRC") section 59(e)(2) (26 USCS § 59(e)(2)). However, the department has never addressed specifically how E & D costs are to be amortized.

Under Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS"), there are **two acceptable methods of accounting** for oil and gas E & D costs, the **successful effort method** and the **full cost method.** These methods may be used for Pennsylvania Personal Income Tax ("PA PIT") purposes consistent with the requirements of this bulletin.

For taxable years beginning in TY2010, as a convenience, the department will permit taxpayers to elect to use an allowable **default method** described in this bulletin **if they do not use either the successful effort method or full cost method** for financial accounting or regulatory purposes on a regular and consistent basis.

PART II. DEFINITIONS

"*Bottom hole contribution.*" A payment (either in cash or in acreage) that is required by agreement when a test well is drilled to a specified depth regardless of the outcome of the well and that is made in exchange for well and evaluation data.

"*Dry hole contribution.*" A payment (either in cash or in acreage) that is required by agreement only if a test well is unsuccessful and that is made in exchange for well test and evaluation data.

"Exploration and development costs (or E & D costs)." Costs incurred in identifying areas that may warrant examination and in examining specific areas that are considered to have prospects of containing oil and gas reserves, including costs of drilling exploration wells and exploration-type stratigraphic test wells and costs incurred to obtain access to proved reserves and to provide facilities for extracting, treating, gathering and storing the oil and gas. Exploration costs may be incurred both before acquiring the related property (sometimes referred to in part as prospecting costs) and after acquiring the property. Principal types of exploration and development costs, which include depreciation and applicable operating costs of support equipment and facilities and other costs of exploration and development activities, are:

a. Costs of topographical, geographical and geophysical studies, rights of access to properties to conduct those studies, and salaries and other expenses of geologists, geophysical crews, and others conducting those studies. Collectively, these are sometimes referred to as geological and geophysical or "G & G" costs.

b. Costs of carrying and retaining undeveloped properties, such as delay rentals, *ad valorem* taxes on properties, legal costs for title defense, and the maintenance of land and lease records.

c. Dry hole contributions and bottom-hole contributions.

d. Costs of drilling and equipping exploration wells.

e. Costs of drilling exploration-type stratigraphic test wells.

f. Costs of gaining access to and preparing well locations for drilling, including surveying well locations for the purpose of determining specific development drilling sites, clearing ground, draining, road building, and relocating public roads, gas lines, and power lines, to the extent necessary in developing the proved reserves.

g. Costs of drilling and equipping development wells, development-type stratigraphic test wells, and service wells, including the costs of platforms and of well equipment such as casing, tubing, pumping equipment, and the wellhead assembly.

h. Costs of acquiring, constructing, and installing production facilities such as lease flow lines, separators, treaters, heaters, manifolds, measuring devices, and production storage tanks, natural gas cycling and processing plants, and central utility and waste disposal systems.

i. Costs of providing improved recovery systems.

j. Intangible drilling and development costs.

The term does not include the costs of tangible property for which a depreciation deduction is allowable.

"Geological and Geophysical Costs." Costs paid or incurred for surveys of a topographical, geological, and geophysical nature along with other costs incurred to obtain the rights to make these surveys, and salaries and other expenses of the personnel required to carry out the surveys. They are often referred to as "G & G" costs.

"Intangible Drilling and Development Costs." Costs incurred in the development of oil and gas properties that, for federal tax purposes, may, at the option of their operator, be chargeable to capital or to expense pursuant to Treasury Regulation § 1.612-4 (Option with respect to intangible drilling and development costs). Such costs include any expense without a salvage value that a working interest owner necessarily incurs incident to the preparation and drilling of wells for the extractions and production of oil and natural gas, such as expenses incurred in:

a. Drilling, shooting and cleaning of wells.

b. Clearing of ground, draining, road making, and surveying.

c. Construction of derricks, tanks pipelines and other physical structures.

"Working Interest Owner." Someone who holds an interest in subsurface oil or natural gas, which interest grants the right to explore for and develop, extract and produce the oil or natural gas at the holder's sole expense in return for all or a share of the mineral production and sale proceeds.

PART III. DEDUCTIONS FOR EXPLORATION AND DEVELOPMENT COSTS

a. Deductions for exploration and development costs shall be allowed under the rules of this Part III.

b. Except as provided in paragraph c, all E & D costs paid or incurred with respect to an oil or gas well shall initially be capitalized and be accounted for using a Pennsylvania-qualified method. The Pennsylvania-qualified methods of accounting for E & D costs are described in paragraphs c, d, and e of this Part III.

c. Successful effort method

A working interest owner who regularly and consistently uses the successful effort method of accounting for financial or regulatory accounting purposes shall initially capitalize all E & D costs other than geological and geophysical costs, costs of carrying and retaining undeveloped properties, and dry hole and bottom hole contributions, pending the determination of whether the well has found proved reserves.

If proved reserves are found, the capitalized costs shall be amortized on a units of production or units of output method basis. If proved reserves are not found after a reasonably extensive evaluation period has been completed, the capitalized costs shall be charged to the working interest owner's operating expense as of the date of completion of the evaluation period.

Geological and geophysical costs, costs of carrying and retaining undeveloped properties, and dry hole and bottom hole contributions are deductible as expenses in the taxable year incurred or paid.

The accounting unit shall be an individual well, mineral lease, field, concession or production sharing contract; and the determination of proved reserves must be made according to the method current in the industry and in the light of the most accurate and reliable information available.

A redetermination is allowed only if the actual size of the remaining proved reserves is later determined on the basis of more complete exploration studies to be materially greater or less than earlier information indicated and only on a prospective basis. A redetermination is not allowed merely because of a change in current oil or gas prices.

d. Full cost method

A working interest owner who regularly and consistently uses the full cost method described in Security and Exchange Commission Regulation S-X, Article 4, §10 ("S-X Rule 4-10") for financial and regulatory accounting purposes shall use full cost centers or pools established on a country-by-country and state-by-state basis as accounting units and amortize E & D costs on the basis of current gross revenues from production in relation to future gross revenues based on current prices from estimated future production of proved oil and gas reserves using the full cost method of accounting.

e. Default methods

A working interest owner who does not regularly and consistently use either the successful effort method or full cost method for either financial or regulatory accounting purposes may elect to use either the **economic life method** or the **fixed period method** described in this paragraph e. The election shall be irrevocable for the current and succeeding taxable years.

1. Economic life method

A working interest owner may deduct E & D costs ratably over the economic life of the well. The economic life of an oil or gas well or field is determined using its **production decline rate** calculated by a registered professional petroleum engineer, the **price of oil or gas per barrel** on the day the cost is incurred or paid, and the **estimated future annual**

costs to operate the well. Using these **three items,** economic life is equal to the economic limit of a property as a function of the production rate at the time that the operating costs per barrel becomes equal to the gross income per barrel.

For **example,** if the estimated future annual operating costs are $5,000 per year, and the well produces oil that is worth $15.00 on the day the cost is incurred or paid, it will reach its economic limit/life as production declines to 0.9 barrels a day.

Economic life and E & D costs shall be determined on the most well-specific basis available.

2. Fixed period method

(a) A working interest owner of an oil or gas well may deduct E & D costs ratably over the 10-taxable year period beginning with the taxable year in which such costs were paid or incurred.

(b) E & D costs shall be determined on the most well-specific basis available.

PART IV. SPECIAL ISSUES

a. Currently expensed intangible drilling and development costs

1. For Federal tax purposes, a working interest owner may currently deduct intangible drilling and development costs. Such items, however, are subject to recapture as ordinary income on disposition of the oil or gas property under IRC § 1254 (26 USCS § 1254). There is neither provision in the Pennsylvania Personal Income Tax for currently expensing intangible drilling and development costs nor provision corresponding to IRC § 1254. **Accordingly, current expensing of intangible drilling and development costs is <u>not</u> permitted for Pennsylvania Personal Income Tax purposes.** Intangible drilling and development costs must be accounted for in accordance with Part III.

2. When the oil or gas property is disposed of, the lesser of the aggregate amount of deductions with respect to such property that have been currently deducted and should have been capitalized or the amount realized on disposition shall be treated as the net income from the operation of a business.

b. IRC § 263 (26 USCS § 263) election to capitalize certain costs

IRC § 263 which allows working interest owners to elect to capitalize or currently deduct intangible drilling and development costs as to activities inside

the United States is inapplicable for Pennsylvania Personal Income Tax purposes. Intangible drilling and development costs must be accounted for in accordance with Part III.

c. IRC § 263 election to amortize ratably over a fixed period

1. IRC § 263 allows taxpayers to elect to deduct intangible drilling and development costs ratably over a 60-month period in the case of costs incurred within the United States. The Pennsylvania Personal Income Tax has no comparable provisions; and there is no empirical basis for using such period.

2. Taxpayers who elected to amortize intangible drilling and development costs paid or incurred for **tax years prior to TY2010** over a fixed period shall continue to amortize such costs until they are fully amortized or the oil or gas property is disposed of, whichever first occurs. Costs paid or incurred for TY2010 and succeeding taxable years, however, must be accounted for in accordance with Part III.

Pennsylvania Sales and Use Tax Ruling No. SUT-10-003, 09/15/2010

Date Issued: 09/15/2010

Tax Type(s): Sales and Use Tax

Applicability of the Mining Exemption to Fracturing Services

ISSUES

1. Is the equipment used by the Taxpayer in performing cementing, fracturing and acidizing services (collectively "fracturing") tax-exempt under the Pennsylvania mining exemption?
2. Are materials (gases, sand, cement, etc.) used by the Taxpayer in fracturing services subject to tax?
3. Are the Taxpayer's fracturing services and sale of property subject to tax?
4. Does equipment brought into Pennsylvania for use here qualify for the isolated sale exemption?
5. Are vehicles and trailers registered under the International Registration Plan ("IRP") subject to tax?

CONCLUSIONS

1. Yes, equipment predominantly used directly in performance of fracturing services is exempt from tax under the mining exemption.
2. No, materials (gases, sand, cement, etc.) predominantly used directly in fracturing services are exempt from tax under the mining exemption.
3. No, Taxpayer's fracturing services are not subject to tax as these services are directly used in mining. Additionally, the Taxpayer's sale of tangible personal property predominantly used directly in mining are not subject to tax.
4. Yes, equipment to be brought in for use in Pennsylvania qualifies for the isolated sale exemption as long as the sales are infrequent and nonrecurring.

5. Vehicles and trailers registered under the International Registration Plan ("IRP") are subject to tax to the extent that they are required to be registered under 75 Pa. C.S. §§ 101-9909 (the "Vehicle Code").

FACTS

Taxpayer, an out-of-state business entity, plans to provide fracturing services to mining operators in Pennsylvania in the Marcellus Shale formation. Taxpayer currently does not conduct any business in the Commonwealth but will establish an office in the state when contracts with Pennsylvania clients are finalized. Although Taxpayer also provides other services such as pressure pumping and drilling, services to be offered by Taxpayer in the Commonwealth are currently limited to fracturing services as described below:

Cementing

Cementing involves pumping cement slurry (a blended mixture of dry powder cement, water and various additives) to bond casing or piping to the wall of the bore hole. Taxpayer adjusts the amount and composition of the additives, developed by Taxpayer, from job to job. The cement slurry is blended at Taxpayer's bulk plants or at the well site. Cementing is performed by operators provided by Taxpayers using specialized pumping and related equipment.

Fracturing

Fracturing is a well stimulation process used to improve the natural flow of oil or gas. Fracturing begins with the use of a fluid, a mixture of water and chemicals, to crack the rock formation. Then, proppants such as sand and ceramic materials are injected into the cracks to create open channels through which the gas flows. Once the proppants are in place, the fluid is drained from the well.

Acidizing

Acidizing involves the injection of acid below rock fractures to create flow channels within the rock formation. The acid is specially blended based on a well's bottom temperature, depth, fluid characteristics, and nature of formation. Every acid blend also contains additives such as corrosion inhibitors, surfactants, iron control chelation/reduing agents, mutual solvents, and anti-sludging agents.

Once fracturing is completed, the used chemicals and water will be pumped out of the well bore to be treated and disposed of by the miner using a third party disposal vendor. Taxpayer is not involved in the water/chemicals treatment and disposal process.

In addition to billing for fracturing services, customers are invoiced separately for (1) equipment set up time, (2) equipment standby time, (3) operator time, (4) additional pumping time, and (5) additional chemicals and materials. "Set up time" is time spent on equipment configuration prior to the performance of fracturing services. "Standby time" is the time during which the equipment is on site but not in use. Pumping charges (including a blending charge) are charges for equipment use during fracturing. Charges for additional pumping time and additional chemicals and materials are incurred when actual onsite time or actual usage exceeds that which was originally planned.

Finally, Taxpayer anticipates that equipment purchased outside of the Commonwealth will be used in its operations in Pennsylvania. The equipment was purchased from persons Taxpayer described as non-vendors or vendors who are not vendors of the type of equipment sold.

DISCUSSION

1. Is the equipment used by the Taxpayer in performing fracturing services tax-exempt under the Pennsylvania mining exemption?

The applicability of the mining exemption turns on whether the taxable item is predominantly used directly in mining . 72 P.S. § 7201(k)(8) ; 61 Pa. Code § 32.35(a) . The factors upon which we rely to determine whether a property is directly used are:

(1) physical proximity, (2) temporal proximity, and (3) the existence of an active causal relationship between the use of the property and the mined product. 61 Pa. Code § 32.35(a)(1) .

It is important to note that 61 Pa. Code § 32.35(a)(1)(iii) specifically states, in considering the existence of an active causal relationship, "[t]he fact that particular property may be considered essential to the conduct of the business of mining because its use is required either by law or practical necessity does not, of itself, mean that the property is used directly in mining operations." Additionally, the law limits the mining exemption to "[m]achinery, equipment, parts and foundations therefore, and supplies which are used in the actual mining production, to transport or convey the product or production personnel [other than vehicles required to be registered under the Vehicle Code], or to handle or store the product during the production ." 72 P.S. § 7201(k)(8) ; 61 Pa. Code § 32.35(a)(2)(i) . Moreover, repair parts that are installed and become an integral part of the direct-use property are also exempt. Id.

On the other hand, property such as those that are used, prior to the actual mining operation, to transport personnel or to collect, convey or transport other property, and storage facilities or devices used to store the property prior to actual mining operation are subject to tax. 61 Pa. Code § 32.35(a)(3)(iii)(G) . Furthermore, property used in non-mining activities is subject to tax even if it is used during the mining operation. 61 Pa. Code § 32.35(a)(3)(iii)(H) .

Finally, vehicles required to be registered under 75 Pa. C.S. §§ 101-9909 (the "Vehicle Code") and supplies and repair parts for the same are taxable . 72 P.S. § 7201(k)(8) ; Pa. Code 61 § 32.35(a). Also, no exemption is to be given to maintenance facilities. Id.

Taxpayer, a third party performing mining activities for miners, is entitled to claim the mining exemption for items that are directly used in mining. Commonwealth v. R.G. Johnson Co., 433 A.2d 465 (Pa. 1981). As such, the taxability of the equipment used in the Taxpayer's activities is as follows:

Acid pumper (equipment used to pump specially blended acid)	Exempt

Equipment	Status
Acid transport (a tractor trailer used to move raw or blended acid to well sites)	Taxable
Batch mixer (equipment used at the well site to mix cement slurry)	Exempt
Bulk truck (a truck that transports dry products to the batch mixer)	Taxable
Cargo trailer (a 14-foot enclosed utility trailer that transports testing equipment)	Taxable
Chemical liquid additive unit (a tractor-trailer-mounted unit that transports chemicals to be used at well sites. The unit maintains the temperature of the chemicals in transit)	Taxable
Chemical transfer (a tractor trailer used to transport the chemical liquid additive unit to well sites)	Taxable
Mechanic service truck (self explanatory)	Taxable
Crew bus (self explanatory)	Taxable
Data van (a van used to house remote control equipment) Electronic Van (self explanatory)	Taxable Taxable
Frac iron float (a tractor trailer that transports piping to the well site to connect the manifold and well head)	Taxable
Frac pumps (equipment that injects fluid into a formation)	Exempt
Hydration unit (a tractor trailer hydration unit that mixes and retains fluids on the surface for polymers to hydrate)	Taxable
Manifold trailer (equipment that attaches piping lines to the well head to facilitate the pumping operation)	Exempt
Mobile Data Acquisition & Control Center Van (a van equipped with remote control equipment used to control and operate frac pumps, blenders and liquid additive units during fracturing. The equipment makes automatic	Equipment-Exempt

adjustments to the pumps, blenders, etc. during fracturing but also provides data so that adjustments may be made by an operator of the fracturing equipment. Data collected is used to monitor the depth of drilling, the flow of fluids and chemicals, and the overall effectiveness of the underground operations. Based on the data collected, the van's controls can change the operation of the pumps or the makeup of the liquid additives.)	Van-Taxable
Mobile food trailer (self explanatory)	Taxable
Pick up truck (self explanatory)	Taxable
Pump down acid equipment (a positive placement pump with boost pump for prime up. Positive placement pump is used to expand a cavity. Boost pump is used to increase the system pressure of the operation. The pump down acid equipment is the pumping equipment used to perform the fracturing)	Exempt
Sand conveyor (a trailer-mounted belt used at well site to transport sand from sand storage bins to the blender)	Taxable
Sand storage bins (a mobile trailer storage bin with multiple compartments that delivers sand to the sand belt or directly to the containers for sand)	Taxable
Sand transport (a tractor trailer used to transport sand from the bulk plant to the well site)	Taxable
Twin cement unit (a system located at the well site that mixes cement to be added to the batch mixer)	Exempt

2. Are materials (gases, sand, cement, etc.) used in fracturing services subject to tax?

Gases, sand and cement used by Taxpayer in fracturing services are directly used in mining activities and are thereby exempt.

3. Are the Taxpayer's fracturing services and sale of property subject to tax?

Generally, mining customers are exempt from tax for services or tangible personal property that is predominantly used directly in mining. 61 Pa. Code § 32.35(a) . Therefore, Taxpayer should

not bill its customers sales tax on the fracturing services or property directly used in fracturing services.

The taxability of the separately stated charges in addition to the fracturing service fees is as follows:

- Set up time—Exempt.
- Standby time—Exempt.
- Additional pumping time (in excess of pumping time originally planned)—Exempt.
- Operator time (operators are supervised by Taxpayer not miners)—Exempt.
- Additional chemicals and materials (in excess of that which was originally planned)— Exempt.

4. Does equipment brought into Pennsylvania for use here qualify for the isolated sale exemption?

The Department's regulation defines an "isolated sale" as the infrequent sale of a nonrecurring nature made by a person not engaged in the business of selling tangible personal property or the infrequent sale of a nonrecurring nature of tangible personal property acquired for use or consumption by the seller and not sold in the regular course of the business of the person. 61 Pa. Code § 32.4(a) . Such sales are limited to no more than three times nor more than a total of seven days in any one calendar year. 61 Pa. Code § 32.1 . The isolated sales exemption is inapplicable to the sale of motor vehicles, trailers, semi-trailers or other similar tangible personal property required to be registered or licensed under Federal or Pennsylvania laws . 72 P.S. § 7204(1) ; 61 Pa. Code § 32.4(b)(7) . Therefore, the equipment as described falls within the isolated sales exemption if the sales are infrequent and nonrecurring and are made by a non-vendor or a vendor who is not a vendor of the type of equipment sold.

5. Are vehicles and trailers registered under the International Registration Plan ("IRP") subject to tax?

The mining exemption does not apply to vehicles required to be registered under the Vehicle Code. 72 P.S. § 7201(k)(8) . Since the International Registration Plan does not change the vehicle registration requirements required by law but merely streamlines the process of registration, Taxpayer's vehicles and trailers are subject to tax regardless of registration under the IRP.

END OF DOCUMENT -

© 2011 Thomson Reuters/RIA. All rights reserved.

pennsylvania
DEPARTMENT OF REVENUE

REALTY TRANSFER TAX BULLETIN 2011-XX
PERSONAL INCOME TAX BULLETIN 2011-XX

Issued: January XX, 2011

Division and Transfer of Interests Related to Oil and Natural Gas

I. PURPOSE

This Bulletin addresses the Pennsylvania Realty Transfer Tax and Personal Income Tax treatment associated with the division and transfer of interests in oil and natural gas.

II. GENERAL PROPERTY LAW RELATED TO OIL AND GAS

A. Types of Estates

Real estate can be divided into three separate and distinct estates: the surface estate, the mineral rights estate, and the support estate.[1] All three estates can be consolidated under one owner or can be severed and held by different owners.

Oil and natural gas interests are derived from ownership of or rights to subsurface minerals of the mineral rights estate.

B. Oil and Gas Leases

Oil and gas companies typically acquire the right to extract and produce subsurface oil and gas through a lease arrangement whereby the lessee is granted what is known as a "working interest" in the oil or gas.

Under an oil or gas lease, the lessor reserves an interest in the minerals extracted and produced, called a royalty.[2] A royalty is a right to a share of the mineral production or income from the mineral production.

A royalty can be taken "in-kind" or in its monetary equivalent.[3]

C. Real Estate vs. Personal Property

Oil and gas in place are themselves considered real estate. However, once oil or gas is physically severed from the land, it becomes personal property.[4]

An oil or gas lease is not a traditional "lease" in the landlord/tenant sense. Rather, it is a conveyance of real estate (the mineral rights estate), which when production is obtained, creates a fee simple determinable interest in the lessee.[5]

The reservation of a royalty under an oil and gas lease creates an estate in land and not a personal property interest.[6]

The royalty payment itself, whether in cash or in-kind, is personal property.

III. REALTY TRANSFER TAX

A. General

Pennsylvania Realty Transfer Tax is imposed upon any "document" that effectuates or evidences the transfer of "title to real estate." 72 P.S. § 8102-C.

1. Title to real estate

Title to real estate is any interest in real estate that is perpetual or endures for an indefinite period or is 30 years or longer, including an estate in fee simple, a life estate, a remainder interest, a leasehold interest, and an easement. 72 P.S. § 8101-C (definition of "title to real estate").

Real estate includes surface estates such as lands and permanent improvements thereon and mineral rights estates in oil, gas and quarries. 72 P.S. § 8101-C (definition of "real estate").

2. Taxable "documents"

A document can be **any** writing that effectuates or evidences the transfer of title to real estate. Consequently, the form or designation of the document is irrelevant.[7] A taxable document can include a formal deed, a lease, an assignment agreement or even a memorandum. As long as the document effectuates or evidences the transfer of title to real estate, it is taxable.

3. Mineral Rights

Documents that effectuate or evidence the transfer of mineral rights are taxable for Pennsylvania Realty Transfer Tax purposes. 61 Pa. Code § 91.169.

Taxable documents are those that transfer interests in a mineral rights estate itself.

Documents that transfer personal property rights associated with the mineral rights estate are not taxable. For example, the assignment of the right to receive income from an oil or gas lease, such as a royalty payment, would not be taxable. However, because the reservation of a royalty creates an interest in real estate, if the royalty itself (that is, if the reservation of the

interest to the oil and gas production reserved by the lessor) is conveyed, the document of conveyance is subject to Realty Transfer Tax.

The taxable value of mineral rights is determined in the same manner as any other real estate interest. For Realty Transfer Tax purposes, taxable value is the actual monetary worth of the real estate determined either by a *bona fide* sale or, if the conveyance is for no or nominal consideration, computed value.[8] In the event that there is no sale and no computed value, then the taxable value is the real estate's actual monetary worth. 72 P.S. § 8101-C (definition of "value"). Pennsylvania Department of Revenue ("department") regulations provide that actual monetary worth is to be determined by appraisal when the real estate is not subject to a *bona fide* sale or does not have a computed value. 61 Pa. Code § 91.136. In addition to an appraisal, the department may in its discretion accept other credible evidence of the value of mineral rights such as comparable sales. It is the taxpayer's burden to provide the true, full and complete value of real estate, including the value of mineral rights. 72 P.S. § 8109-C.

4. Easements

Easements,[9] because they are interests in land, are subject to Realty Transfer Tax to the extent that they are permanent, indefinite or for a term of thirty years or more.[10] This includes easements associated with oil and gas exploration, extraction and production except as explained in Section III.B., below. Types of easements associated with oil and gas exploration, extraction and production include the following: ingress and egress easements, pipeline easements, water line easements, and fracture ("frac") pond easements.

B. Exclusions and exemptions

1. Public utility easement exclusion

Excluded from the class of taxable documents are those that grant, vest or confirm a public utility easement. 72 P.S. § 8101-C (definition of "document") and 61 Pa. Code § 91.193(b)(28). This exclusion only applies for the transfer of an easement to a person furnishing public utility service and only if the easement is used in, or useful for, furnishing public utility services.

For purposes of this Bulletin, in order to be considered a person furnishing a public utility service, the person must be subject to public utility regulation. Persons that are subject to the jurisdiction of the Pennsylvania Public Utility Commission ("PUC")[11] or the Federal Energy Regulatory Commission ("FERC"),[12] or a similar state or federal agency, are considered a qualifying public utility.

<u>Pipelines</u>: As indicated above, the easement itself must be used in, or useful for, furnishing a public utility service. Consequently, the easement itself must be subject to public utility regulation by entities such as the PUC

and FERC. This is a particularly important issue in determining whether gas pipelines easements are subject to tax.

Generally, there are 4 types of gas pipelines, as follows:

- **Production pipelines** transport gas from the wellhead to a gathering system.
- **Gathering pipelines** are larger pipelines that accept gas from a series of well sites and transport the gas to a transmission facility.
- **Transmission pipelines** are major pipelines of 30" or larger that transport processed gas on an interstate basis for end use.
- **Distribution pipelines** are pipelines that transport oil or gas to residential, commercial and industrial users.

Production and gathering pipelines do not transport oil or gas in interstate commerce or to end users and are not subject to regulation.[13] Therefore, documents that convey easements for such pipelines which easements are permanent, indefinite or for a period of 30 or more years are subject to Realty Transfer Tax.

Transmission and distribution lines, on the other hand, transport oil and gas to end users on an interstate or intrastate basis and are generally subject to regulation. Therefore, documents that transfer easements for such pipelines are not subject to Realty Transfer Tax.

2. Oil and Gas Leases

As referenced above, real estate leases that are perpetual, indefinite or for 30 years or more are subject to Realty Transfer Tax. Generally, oil and gas leases have a fixed term for exploration and provisions for lease extensions after oil or gas is found and as long as they are being produced in paying quantities. Therefore, the term of an oil or gas lease is generally indefinite. As a result, such leases would be taxable. However, there is a statutory exemption for leases for the production of minerals such as coal, oil or natural gas. 72 P.S. § 8102-C.3(22) and 61 Pa. Code § 91.193(b)(22). Consequently, such leases are not subject to tax. The exemption also applies to the assignment of such leases.

C. Assignments of Oil or Gas Leases

An assignment of an oil or gas lease may or may not be subject to Realty Transfer Tax. The determinative factors related to such assignments are the parties making the assignment and the rights being assigned.[14]

As stated in Section III.B.2 above, an assignment of a lease for the production or extraction of coal, oil or natural gas is not subject to Realty Transfer Tax. 72 P.S. § 8102-C.3(22) and 61 Pa. Code § 91.193(b)(22).

A lessee who holds a working interest in oil and gas under an oil and gas lease can assign part or all of his interests to another party (often a subsidiary) without the imposition of Realty Transfer Tax.

A lessor's assignment of an oil or gas lease is more problematic, however. Whenever a lessor "assigns a lease" it is important to determine the rights that are being assigned for Realty Transfer Tax purposes.

A document that assigns a lessor's interest under an oil or gas lease, despite its designation, may intentionally or unintentionally convey title to the entire mineral rights estate. The conveyance of the mineral rights interest is taxable.

Any document that conveys a lessor's reserved real estate interest under the royalty clause of an oil or gas lease is taxable. Even if the document purports to be an assignment of a lease, the tax exemption for oil and gas leases and the assignment thereof is not applicable. The exemption is only applicable to leases for "production or extraction" of oil or gas. The lessor's interest under the lease is a reservation of the oil or gas in place, a real estate interest, as opposed to the interest that the lessor granted to the lessee to extract and produce a portion of the oil or gas in place. Therefore, any document that conveys the reserved interest is subject to tax.

Other documents that only assign duties or personal property rights under the lease are not subject to Realty Transfer Tax. As explained in Section III.A.3. above, a lessor may seek to assign all or a portion of his royalty "income" under the lease. The right to the royalty income is a personal property interest and the document making such assignment is not taxable.

Any document that commingles the assignment of the real estate interests in the mineral rights estate with the assignment of personal property rights or interests under the lease is subject to Realty Transfer Tax to the extent of the conveyance of the real estate interest.

IV. PERSONAL INCOME TAX

A. Rents and royalties

When an owner of a mineral rights estate enters into an oil or gas lease, the lease typically provides for both rental and royalty payments to the owner. The net gains from rental and royalty payments are taxable for Pennsylvania Personal Income Tax purposes and are reportable on Schedule E of the PA-40. 72 P.S. § 7303(a)(4). Calculation of net gains from rents and royalties are beyond the scope of this Bulletin.[15]

B. Conveyance of mineral rights estate

1. Sale

Net income from the disposition of property is subject to Pennsylvania Personal Income Tax. 72 P.S. § 7303(a)(3). If a mineral rights estate owner sells the mineral rights, the consideration less the owner's basis in the mineral rights and other costs associated with the sale is taxable. The gain is reported on Schedule D of the PA-40.

If the owner owns the entire fee simple interest in the real estate, he must allocate a portion of his basis to the mineral rights estate by a fraction, the numerator of which is the fair market value of the mineral rights estate and the denominator is the fair market value of the entire fee simple interest in the real estate. The fair market values shall be determined as of the date of purchase. If the owner did not allocate the basis at the time of purchase and is unable to ascertain the allocable basis of the mineral rights estate, he must use a zero basis.

2. Gift or transfer for no or nominal consideration

Pennsylvania does not impose a tax on gifts. If a mineral rights estate owner makes a gift of the mineral rights (*e.g.*, to family members), the conveyance is not subject to tax. The transferee receives the owner's basis in the mineral rights estate as a carryover basis. 61 Pa. Code § 103.13(c).

If a mineral rights estate owner conveys the estate to a private trust for no or nominal consideration, the same rule applies.

If a mineral rights estate owner conveys the estate to a business entity (such as a limited partnership or limited liability company) in a non-taxable exchange for an ownership interest in the entity, the conveyance is considered a capital contribution and the basis in his ownership interest in the business entity is his basis in the mineral rights estate.

C. Assignment of an oil or gas lease

As explained in Section III.C. above, it is important to ascertain the rights that are being conveyed under an assignment of an oil or gas lease in order to determine the Pennsylvania Personal Income Tax consequences of the assignment. To the extent such an assignment effectuates the conveyance of the mineral rights estate, the provisions of Section IV.B. apply.

If, however, the mineral rights estate owner retains the ownership and control of the mineral rights estate and only assigns income rights under the oil and gas lease, then there is a different tax result as explained below.

1. Sale of production payments

A mineral rights owner who is the lessor under an oil or gas lease may sell and assign his rights to income from future production payments[16] (including royalties) under the lease. For Pennsylvania Personal Income Tax purposes, the sale and assignment are treated as an anticipatory assignment of income.[17]

Assignor: When a mineral rights estate owner sells and assigns his right to income from production payments under an oil and gas lease, he is considered to receive royalty income to the extent of the sale price (which sale price normally represents the present value of the future production payments assigned). The assignor reports the royalty income on Schedule E of the PA-40 in the tax year in which the sale proceeds are received. (The assignor does not receive a subsequent deduction when the production payments are made to the assignee.)

Assignee: The assignee, through his purchase of the income from the production payments, acquires a basis in the future production payments. There are two methods by which the assignee must account for his receipt of the future production payments and his basis therein. The proper accounting method depends upon whether the assignment is part of an open or closed transaction.

The transaction is an **open transaction** if the future production payments to which the assignee is entitled are not readily ascertainable. The transaction is a **closed transaction** if the amount is readily ascertainable. Situations involving open transactions are very rare and are determined on a case by case basis. The presumption is that the transaction is closed. The burden is on the assignee to prove otherwise.

If the purchase of the future production payments is a closed transaction, each future payment is considered a partial non-taxable return of the assignee's basis and the remainder is considered taxable royalty income reportable on Schedule E of the PA-40. The taxable and non-taxable amounts are apportioned based upon the amount of the anticipated future payments and the assignee's basis.

For **example,** a lessor under an oil or gas lease sells and assigns his right to future production payments for the next 25 years. The assignee agrees to pay $35,000 for the future payments. Assignee, therefore, has a basis of $35,000.00 in the future payments. It is anticipated that the total production payments will be $100,000 (1 yearly payment of $4,000 for 25 years). Based upon those numbers, by the time all future payments are made, the assignee will receive a full return of his basis and an additional $65,000 of taxable royalty income. The assignee's basis accounts for thirty-five percent of the future production payments and the taxable royalty income accounts for the remaining sixty-five percent. Consequently, the

assignee must account for thirty-five percent of each production payment as a return of basis ($1,400) and the other sixty-five percent as taxable royalty income ($2,600).

If the purchase of the future production payments is an open transaction, the purchaser/assignee is permitted to use the cost recovery method to account for the taxable amount of each future production payment. Consequently, any future payment will be applied first as a return of the purchaser/assignee's basis. Any payment over and above his basis is royalty income to the purchaser/assignee in the tax year in which it is received. The royalty income is reported on Schedule E of the PA-40.

2. Donative transfers of production payments

Like the sale of production payments, a donative transfer of income from production payments under an oil or gas lease also is an anticipatory assignment of future income. *See* Flewellen v. Commissioner, 32 T.C. 317 (T.C. 1959). When the production payments are made, the assignor is deemed to receive the payment and, in turn transfer the payments to the assignee. Therefore, the production payments remain taxable to the assignor as royalty income. However, the assignor does not report the all of the payments assigned at the time of the assignment. Rather, the assignor reports the payments in the year in which each payment is made.

The conveyance of the payment from the assignor to the assignee is considered a gift to the assignee. There is no tax imposed upon the gift.

Endnotes:

[1] In re Consolidation Coal Sales Co., 932 A.2d 341 (Pa. Commw. Ct. 2007), *citing* Captline v. County of Allegheny, 662 A.2d 691 (Pa. Commw. Ct. 1995).

[2] The lease can create other rights in the lessor for additional payments such as cash signing bonuses (either paid in an up-front lump sum or in deferred installment payments) and delayed rental payments.

[3] *See* Kilmer v. Elexco Land Servs., 990 A.2d 1147 (Pa. 2010). In its decision the Supreme Court conceded that it is "unusual and impractical for natural gas royalties to be taken in-kind," but pointed out that "oil royalties can certainly be so taken." Kilmer, 990 A.2d at 1158.

[4] White v. New York State Natural Gas Corp., 190 F. Supp. 342, 346-347 (W.D. Pa. 1960).

[5] Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 772-773 (W.D. Pa. 2004).

[6] Duquesne Natural Gas Co. v. Fefolt, 203 Pa. Super. 102 (Pa. Super. Ct. 1964).

[7] Determining the nature of a conveyance or grant related to oil and gas instruments can be particularly problematic. As stated by the Pennsylvania Superior Court,

> . . .We remind ourselves the judicial construction of instruments involving oil and gas is particularly troublesome. Pennsylvania case law evidences a long and tortured trail of attempts to make sense of phrases, parts of phrases, and words of art sometimes used in a common sense manner and sometimes used with a precise technical meaning, and all used in documents sometimes drafted with care and sometimes quickly scribbled by the litigants themselves. Many oil and gas titles trace to agreements from the late 19th or early 20th century and may use antiquated terms foreign to us today. A century ago, a farmer's understanding of how the surface of his land would be used to extract the oil and gas lying beneath it would be considerably different from the understanding of the surface owner today who is acutely aware of the increased burdens on the surface imposed by modern extraction technology.
>
> The legal effect of words clearly understood when used in other contexts, therefore, becomes murky when considered in the context of oil and gas instruments. The fact, for example, that an instrument is titled a "lease," "deed," or "agreement" is not determinative. Even the use of the words "grant and convey" does not necessarily create a fee simple estate in the grantee. Applying the literal meaning to words and phrases found in oil and gas documents is fraught with the opportunity for injustice.
>
> As a result, we must be mindful that the object in interpreting instruments relating to oil and gas interests, like any written instrument, "is to ascertain and effectuate the intention of the parties."

Szymanowski v. Brace, 987 A.2d 717, 719 (Pa. Super. Ct. 2009) (citations omitted).

Consequently, it is extremely important to review the instruments to determine the nature of the rights affected by the instrument.

[8] Computed Value is the actual monetary worth of the real estate determined by adjusting the assessed value of the real estate for local real estate tax purposes for the common level ratio of assessed values to market values of the taxing district as establish by the State Tax Equalization Board. 72 P.S. § 8101-C (definition #2 of "value").

[9] "'An easement is a liberty, privilege or advantage which one may have in the lands of another without profit. . . . It may be merely negative . . . and may be created by a covenant or agreement not to use land in a certain way. . . . But it cannot be an estate or interest in the land itself, or a right to any part of it.' 'An easement is a right in the owner of one parcel of land by reason of such ownership to use the land of another for a special purpose not inconsistent with a general property in the owner.'" Clements v. Sannuti, 51 A.2d 697, 698 (Pa. 1947). Although not an estate in land, an easement is an "interest in land" that "must be created and transferred by deed, by prescription which presupposes a grant, by an agreement for a conveyance which may be enforced in equity, or by a sale of property with reference to an existing convenience which entitled the grantee to its continued enjoyment. In order to establish an easement the dominant and servient estates must be owned by different persons. . . . The easement may be created by conveyance of the right when transferring property in favor of which it is to exist, or it may be reserved in favor of the grantor." Riefler & Sons v. Wayne Storage Water Power Co., 81 A. 300, 302-303 (Pa. 1911).

[10] The Realty Transfer Tax statute contemplates the taxation of easements as evidenced by the definition of value, which provides that the taxable value of real estate shall be its actual monetary worth "in the case of easements or other interests in real estate the value of which is not determinable . . . ." 72 P.S. § 8101-C (definition #3 of "value") (emphasis added).

[11] The PUC has the "administrative power and authority to supervise and regulate all public utilities doing business" within Pennsylvania. 66 Pa.C.S. § 501. A "public utility" includes a person or corporation that owns or operates equipment or facilities in Pennsylvania for producing, generating, transmitting, distributing or furnishing natural or artificial gas to or for the public for compensation. It does not include a producer of natural gas not engaged in distributing such natural or artificial gas directly to the public for compensation. 66 Pa.C.S. § 102

[12] FERC is an independent agency that regulates the interstate transmission of electricity, natural gas, and oil. Federal Energy Regulatory Commission, *What FERC Does*, http://www.ferc.gov/about/ferc-does.asp (last visited October 25, 2010).

[13] The United States Supreme Court "has stated that 'production' and 'gathering' 'are terms narrowly confined to the physical acts of drawing the gas from the earth and preparing it for the first stages of distribution.' For purposes of the NGA [(the Natural Gas Act of 1938)], gathering is the activity that occurs between the production of the gas and delivery to a facility for transportation in interstate commerce." 4-84 Energy Law and Transactions § 84.02

[14] Generally speaking, a lease is an encumbrance. Berger v. Weinstein, 63 Pa. Super. 153 (Pa. Super. Ct. 1916) ("Familiar illustrations are mortgages, judgments and other liens, leases, executory contracts of sale and taxes assessed."); *see also*, Reimann v. United States, 196 F.

Supp. 134 (D. Idaho 1961); Clark v. Fisher, 54 Kan. 403 (Kan. 1894); Westerlund v. Black Bear Mining Co., 203 F. 599 (8th Cir. Colo. 1913).

"An encumbrance has been defined as 'every right or interest in the land which may subsist in third persons to the diminution of the value of the land, but consistent with the passing of the fee by the conveyance.' It may be such as affects the title, or only the physical condition of the property. Illustrations of the first class are found in mortgages or other liens of record, claims for taxes, assessable benefits, outstanding articles of agreement to sell, or the inchoate rights of dower. As affecting the free enjoyment of the land, easements, such as the existence of a railroad right-of-way, though merely an adopted location, or for private use, unless apparent and notorious, are encumbrances. The same is true as to restrictions on the use of the property, so long as the value of the land may be diminished; though the contrary is held where the existing claim works no injury." Ritter v. Hill, 282 Pa. 115, 118 (Pa. 1925)

In the case real estate lease, a lease encumbers the real estate being leased. In the case of an oil or gas lease, the lease is an encumbrance over the mineral rights estate. As an encumbrance, the lease itself cannot be severed from the real estate interest. In fact, as explained by the Duquesne and Jacobs Courts (as cited above), an oil and gas lease is more than just a lease. It is a defeasible deed. It doesn't just encumber the mineral rights. It effectuates a conveyance and a reservation. There is a conveyance of the mineral rights to the lessee and a partial reservation of the mineral rights to the lessor in the nature of the royalty interest. Consequently, when the lessor attempts to convey his interest in the lease, it is important to determine what interest is being conveyed.

[15] *See* 61 Pa. Code § 125.51 for rules related to cost depletion, and *PERSONAL INCOME TAX BULLETIN 2011-XX* for rules related to intangible drilling costs. *See also CHAPTER 23 (NATURAL RESOURCES)* of the department's on-line *PENNSYLVANIA PERSONAL INCOME TAX GUIDE*.

[16] Treasury Regulation § 1.636-3 defines a "production payment" generally as "a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production." 26 CFR § 1.636-3(a).

[17] Historically, for Federal Income Tax purposes, such sales were treated as an anticipatory assignment of income rather than the sale of a capital asset. *See* Commissioner of Internal Revenue et al. v. P. G. Lake, Inc., *et al.*, 356 U.S. 260 (1958). As the Supreme Court explained:

> The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

Lake, 356 U.S. at 266. Consequently, the assignor is considered to receive taxable ordinary income when the purchase price for the production payment is paid to him by the assignee.

The rule in the Lake case was superseded by amendments to the Internal Revenue Code in 1969. Now, IRC § 636 and applicable Treasury Regulations provide the rules for the assignment of mineral production payments. Under those rules, the purchase price for the assignment of a

production payment is considered a loan from the assignee to the assignor. The production payments when made are considered income to the assignor. Such payments are then paid over to the assignee, as a principal and interest payment, in repayment of the loan.

Pennsylvania Personal Income Tax law does not contain a similar provision to IRC § 636. Instead, Pennsylvania applies rules similar to those established by the Supreme Court in Lake.