OIL AND GAS
TAX UPDATE

Allegheny Tax Society
H.Y.P. Club
Pittsburgh, PA
November 17, 2014

Presented by:
Charles L. Potter, Jr.
Shareholder
Buchanan Ingersoll & Rooney PC
301 Grant Street
Pittsburgh, PA 15219-1041
412-562-1561
charles.potter@bipc.com

I. RULES OF THE ROAD

A. Realty Transfer Tax

1. Lease
2. Mineral Rights
3. Rights of Way
4. Retained Royalties
5. Easements
6. Information Notice 2012-4
7. Inheritance Tax Bulletin 2012-01

B. 1031 Exchanges

1. Federal
2. Pennsylvania

C. Pool of Capital Doctrine

D. Section 722 IRC

E. Bona Fide Transfers (*Kimbell*, 371 F.3d 257 (2004)

F. Production Payment

G. Carried Interest

H. Intangible Drilling Cost Deduction

1. Investor Status during drilling period
2. Compositional of Tangibles and Intangibles
3. Timing of IOC deduction, (*Caltex v. Comm.*, 138 T.C. No. 2 (2012)
4. Alternative Minimum Tax
5. Pennsylvania Personal Income Tax Treatment
   a. Before 2014
   b. After 2014

I. Right to Participate

J. Farm Out

II. ENTITY CHOICE

A. Sole Proprietorship

1. Liability
2. No ability to allocate

B. Joint Venture

1. Liability
2. Allocation
3. Place your share of the venture in a limited partnership

C. Corporation

1. IDC Deduction
2. Allocation
3. Distribution of property
4. Profits to invest
5. Transfer relocation
6. S Corporation

D. Partnership

1. Limited or General
2. Property distribution
3. Allocation
4. Control through ownership of general partner
5. Profits interest

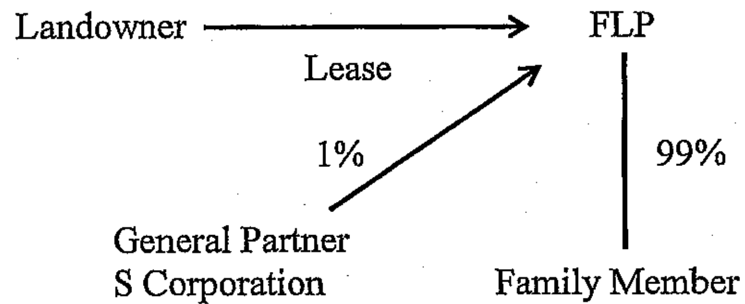
LANDOWNER STRUCTURE

1. Convey leasehold interest to a family partnership.

2. Convey leasehold interest to operator. Retain royalty interest and right to participate.

3. Gift partnership shares to younger family member.

4. File Gift Tax return with appropriate appraisals attached.



Oil and Gas
Partnership Structure

Operator

25%

Outside Investors

75%

Investor Partnership
(leases)

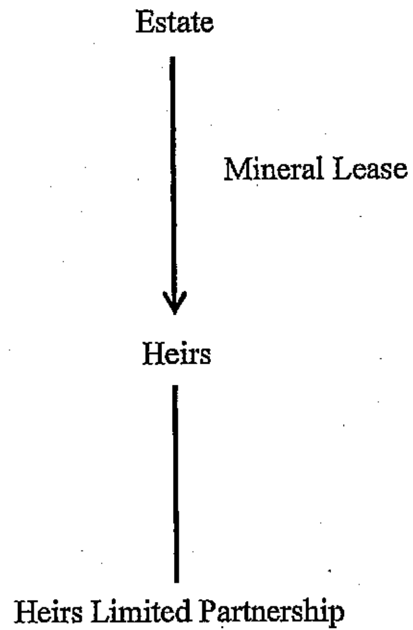
(owned by operator)

Drilling Company

Services Providers

1. Operator contributes the tangibles. Investors contribute cash.
2. At closing, all cash is transferred to the drilling company.
3. The drilling company pays all costs of formation.
4. After drilling is completed, all investor general partners are converted to limited partners.
5. Often, turnkey contracts are used

Transfer from Estate to Heirs



1. The heirs need the limited partnership structure to protect them from liability.
2. Transfer of partnership shares is not exempt from realty transfer tax.

Tax Court & Board of Tax Appeals Reported Decisions

Caltex Oil Venture, et al. v. Commissioner, 138 TC 18, Code Sec(s) 461.

CALTEX OIL VENTURE, CALTEX MANAGEMENT CORPORATION, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 18]138 T.C. No. 2

Code Sec(s):	461
Docket:	Dkt. No. 3793-08.
Date Issued:	01/12/2012 .
Judge:	Opinion by Gustafson, *J.*
Tax Year(s):	Year 1999.
Disposition:	Decision for Commissioner in part.

HEADNOTE

1. Accounting methods—time for deductions—accrual method—economic performance—provision of services to taxpayer—services not yet performed—turnkey contracts; oil and gas well drilling; non-productive intangible drilling costs—tax shelters—partnerships—special timing rules and exceptions. In case involving accrual-method oil partnership's claim to fully deduct in contract year nonproductive intangible drilling costs paid via checks and large note pursuant to turnkey well-drilling contract, in respect to which there was only some site preparation but no drilling done during or within 90 days after end of subject year, IRS was granted partial summary judgment that partnership didn't qualify for either Code Sec. 461(i)(2)(A) 's special 90-day "drilling commences" or Reg § 1.461-4(d)(6)

(ii) 's 3 1/2 month "reasonable expectation" rules for deduction. 90-day rule wasn't available because "drilling commences" meant actual drilling/required that drill bit penetrate ground and well be spudded, not mere site preparation as occurred here. And 3 1/2 month rule applied only where taxpayers reasonably expect performance within 3 1/2 months of *all* services called for under undifferentiated, non-severable contract such as turnkey contract involved here; but partnership by its own admission didn't expect that all such services would be provided in stated timeframe. Moreover, 3 1/2 month rule only allowed deduction for payments made in cash or cash equivalents, not amounts paid by note. However, it was possible that partnership might still be entitled to some deduction in stated year under Code Sec. 461(h) 's general economic performance rule.

Reference(s): ¶ 4615.23(25) ; ¶ 4615.23(5) Code Sec. 461

Syllabus

Official Tax Court Syllabus

C, an accrual-basis partnership, entered into a turnkey contract under which it paid $5,172,666 by cash and note in December 1999 for the drilling of two oil and gas wells. Although some site preparation required under the contract occurred in 1999, no drill penetrated the ground for purposes of drilling a well by or on behalf of C within 90 days after the end of 1999. C claimed a full deduction for the $5,172,666 as intangible drilling costs (IDCs) on its 1999 Federal tax return. R issued a notice of final partnership administrative adjustment to P, C's tax matters partner, determining, inter alia, that C was not entitled to deduct the IDCs because the economic performance requirement of I.R.C. sec. 461(h) was not satisfied.

Held: For purposes of I.R.C. sec. 461(i)(2)(A), "drilling of the well commences" when there is actual penetration of the ground surface in the act of drilling for purposes of spudding a well. Mere site preparation is insufficient. Under this special timing rule, C did not satisfy the economic performance requirement of I.R.C. sec. 461(h).

Held, *further*, the 3-1/2-month rule of sec. 1.461-4(d)(6)(ii), Income Tax Regs., does not enable C to treat any of the services due under the contract as having been economically performed in 1999, because, in the case of an undifferentiated, non-severable contract, [pg. 19] the 3-1/2-month rule contemplates that all of the services called for must be provided within 3-1/2 months of payment.

Held, *further*, in the alternative, if C is able to invoke the 3-1/2-month rule and treat some of the services due under the contract as having been economically performed in 1999, then deductions under the 3-1/2-month rule are limited to

payments of cash or cash equivalents and do not include payments made by notes.

Counsel

Bernard Stephen Mark and Richard Stephen Kestenbaum, for petitioner.

Halvor N. Adams III, for respondent.

GUSTAFSON, *Judge*

OPINION

On November 13, 2007, the Internal Revenue Service (IRS) issued a notice of final partnership administrative adjustment (FPAA) for taxable year ending December 31, 1999, to Caltex Management Corp., the tax matters partner (TMP) of Caltex Oil Venture. (It is the latter entity—Caltex Oil Venture—to which we refer herein as "Caltex".) This case is a partnership-level action based on a petition filed by the TMP pursuant to section 6226. [1] The matter is currently before the Court on the IRS's motion for partial summary judgment filed pursuant to Rule 121, which asks us to hold that Caltex is not entitled to deduct the $5,172,666 that it reported in 1999 as nonproductive intangible drilling costs (IDCs). [2] As explained below, we will grant partial summary judgment in the IRS's favor as to most of the issues addressed in its motion, but we find that other issues—e.g., under the general rule of section 461(h), the amount, if any, of IDCs that was incurred in 1999—may remain for trial. [pg. 20]

Background

The following facts are not in dispute and are derived from the pleadings, stipulations of fact, the parties' motion papers, and the supporting exhibits attached thereto.

Caltex was organized in 1999. For Federal income tax purposes, Caltex is a partnership that uses the accrual method of accounting and has a taxable year ending December 31. On December 31, 1999, Caltex entered into a turnkey contract with Red River Exploration, Inc. Under the contract, Red River assigned to Caltex a 74.33-percent interest in a well in Louisiana designated "J.O. Kimbrell 2-8#1" and a 90-percent interest in a well in Oklahoma designated "NW Sulphur #2". Red River agreed to "commence or cause to be commenced" the drilling of wells at the two sites "[a]s soon as practicable after the execution of *** [the contract] but in no event later than March 31, 2000". "[T]hereafter *** [Red River would] continue or cause to be continued the drilling [of the wells] with due diligence and in a workmanlike manner to a depth to adequately test the objective formation." For purposes of the IRS's motion for partial summary judgment, we assume (as Caltex asserts) that "a typical well will take two years to

grow from concept to commencement to production for the purpose of selling hydrocarbons." [3]

The contract called for Caltex to pay to Red River by the close of business on December 31, 1999, $4,123,333 in cash and note "as Turnkey Drilling Costs" and "$1,049,333 for the Intangible Completion Costs", for a total of $5,172,666. Caltex paid Red River with two checks dated December 27, 1999, in the amounts of $308,293.50 for "drilling" and $119,892 for "completion", [4] totaling $428,185.50, and executed a note in favor of Red River for approximately $4.8 million. [5] [pg. 21]

By December 31, 1999, drilling permits were secured for the two well sites identified in the contract, and we assume that in early 2000 Red River engaged in activities to prepare to drill the wells. However, the parties have stipulated that "[n]o drill penetrated the ground for purposes of drilling a well by or on behalf of Caltex Oil Venture during 1999 or 2000."

Caltex timely filed, for 1999, a Form 1065, "U.S. Partnership Return of Income". On the Form 1065, Caltex claimed a deduction of $5,172,666 for nonproductive IDCs.

In November 2007 the IRS issued its FPAA determining that Caltex was not entitled to deduct any portion of the IDCs because, among other things, the economic performance requirement of section 461(h) was not satisfied. The IRS also disallowed $744,241 in other deductions claimed by Caltex on its 1999 return and determined that Caltex was liable for accuracy-related penalties under section 6662(a) and (b)(1) and (2).

On February 12, 2008, Caltex, through its TMP, timely filed a petition pursuant to section 6226 seeking a readjustment of the IRS's determinations in the FPAA. Caltex asserted, among other things, that the IRS erred in determining (i) "that the deduction for non-productive intangible drilling costs in the amount of $5,172,666.00 is improper"; (ii) that economic performance was not met by Caltex under Section 461(h)"; and (iii) that they "are subject to penalties under Section 6662(a), 6662(b)(1) and in 6662(b)(2)." In doing so, Caltex asks us to find that there "are no adjustments to Partnership items for the year in question" and that "no penalties are properly asserted against any investor of Caltex". At the time the petition was filed, the principal place of business for both Caltex and its TMP was Pennsylvania.

On September 18, 2009, the IRS moved for partial summary judgment on the issue of whether the economic performance requirement of section 461(h) was satisfied with respect to the $5,172,666 deduction claimed by Caltex in 1999 for IDCs. In particular, the IRS asks us to narrow the issues of the case by holding that the economic performance requirement of section 461(h), if satisfied at all, limits [pg. 22] Caltex's maximum potential deduction for 1999 for IDCs to amounts paid in 1999 for work actually performed in 1999. [6] Caltex opposes the IRS's motion.

For purposes of deciding this motion, we will consider to what extent, if any, the services attributable to the $5,172,666 in IDCs were economically performed during 1999 or within a time that the Code and regulations allow the services to be treated as if performed in 1999.

Discussion

I. *Standard for summary judgment*

Under Rule 121 (the Tax Court's analog to Rule 56 of the Federal Rules of Civil Procedure) the Court may grant full or partial summary judgment where there is no genuine issue of any material fact and a decision may be rendered as a matter of law. The moving party bears the burden of showing that no genuine issue of material fact exists, and the Court will view any factual material and inferences in the light most favorable to the nonmoving party.Dahlstrom v. Commissioner, 85 T.C. 812, 821 (1985); cf. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 255 (1986) (same standard under Fed. R. Civ. P. 56). "The opposing party is to be afforded the benefit of all reasonable doubt, and any inference to be drawn from the underlying facts contained in the record must be viewed in a light most favorable to the party opposing the motion for summary judgment." Espinoza v. Commissioner, 78 T.C. 412, 416 (1982).

The issue presented in the IRS's motion—i.e., whether the economic performance requirement of section 461(h) is satisfied with respect to the $5,172,666 deduction claimed by Caltex in 1999 for IDCs—can be largely resolved on the basis of the undisputed facts. As a result, we will grant the IRS's motion in part.

II. *Statutory and regulatory framework*

The issue before us is an accounting question: What is the proper year for claiming deductions for costs that are related [pg. 23] to the drilling of oil wells? [7] As we will show, Caltex is allowed deductions for 1999 only to the extent that the performance of the drilling-related services was timely under one of several alternative rules.

A. "*All events test*"

Section 461 of the Code and its accompanying regulations provide general rules that govern the timing of deductions. For a taxpayer (like Caltex) that uses the accrual method of accounting, an expense is generally allowed as a deduction for the year the taxpayer incurred the expense, irrespective of the date of payment. Whether a business expense has been "incurred" is determined by the "all events test" as set forth in 26 C.F.R. section 1.461-1(a)(2)(i), Income Tax Regs., which provides:

> Under an accrual method *** a liability *** is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, *and economic performance has occurred with respect to the liability*. *** [Emphasis added.]

See United States v. Gen. Dynamics Corp., 481 U.S. 239, 242-243 [59 AFTR 2d 87-899] (1987). The IRS does not dispute that Caltex satisfied the first two requirements of the "all events test" (i.e., (1) that all the events occurred to establish the liability; and (2) that the amount of the liability was determinable with reasonable accuracy). Rather, the IRS contends that Caltex failed to satisfy the third "all events" requirement, namely, "economic performance". [pg. 24]

B. *Economic performance with respect to services provided to a taxpayer*

1. *General rule: provision of services*

Before the enactment of section 461(h) in the Deficit Reduction Act of 1984 (DEFRA), Pub. L. No. 98-369, sec. 91(a), 98 Stat. at 598, economic performance was not required. With its enactment, section 461(h) expanded the "all events test" by providing that "in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." Sec. 461(h). Section 461(h) applies to any item allowable as a cost, expense, or deduction, unless specifically exempted by an alternative timing rule in the Code. Sec. 461(h)(2).

Generally, if the liability of the taxpayer arises from a third person's providing services to the taxpayer, economic performance occurs as the services are provided. Sec. 461(h)(2)(A)(i); 26 C.F.R. sec. 1.461-4(d)(2), Income Tax Regs. This general rule is applicable in cases of IDCs under a turnkey contract for the drilling of an oil or gas well. See 26 C.F.R. sec. 1.461-4(d)(7), Example (4).

Before the enactment of section 461(h), when an accrual-basis oil or gas enterprise entered into a contract to receive drilling services, under which the taxpayer was to incur IDCs, it was proper under the "all events test" for the taxpayer to claim a deduction in the year in which the obligation for the IDCs became fixed under the contract, whether or not there was in that year any economic performance of services called for by the contract. As compared to a cash-basis taxpayer, this rule placed an accrual-basis taxpayer in a superior position with regard to IDCs, because the cash-basis taxpayer actually had to prepay its IDCs to be allowed the deduction while an accrual-basis taxpayer only had to become obligated to pay in order to be allowed a deduction. However, since the enactment of section 461(h), the Code has not allowed

accrual-basis taxpayers to claim a deduction for IDCs until economic performance of the services under the contract has occurred. Thus, even though the old "all events test" might be met for one tax year because the taxpayer's liability for [pg. 25] payment became fixed and determined in that year, under the rules now applicable to accrual-basis taxpayers, a deduction is allowed for that year only if the economic performance test of section 461(h) is satisfied as well.

As a result, unless an exception to this general rule applies, the IDCs at issue here satisfy the economic performance requirement of section 461(h) for 1999 only to the extent the corresponding services were actually performed in 1999.

2. *The two pertinent exceptions in dispute* [8]

Caltex does not contend that Red River performed more than $5 million in services on the last day of 1999 (i.e., the day the contract was executed). [9] Rather, Caltex claims its deduction is warranted under two possible exceptions to the general rule:

a. *The 90-day rule*

The 90-day rule of section 461(i)(2)(A) allows a taxpayer to deduct IDCs in full prior to economic performance if "drilling of the well commences" within 90 days after the close of the tax year in which the taxpayer prepaid the IDCs and for which the taxpayer is seeking to claim the deduction. The IRS maintains that Caltex is not entitled to the special timing provision of the 90-day rule because no drill penetrated the ground for the purpose of beginning Caltex's wells before the close of the 90th day after the close of 1999 (i.e., by March 30, 2000). In so arguing, the IRS contends that the phrase "drilling of the well commences" as used in section 461(i)(2)(A) requires actual penetration of the ground by a drill bit for purposes of starting the well. [pg. 26]

In contrast, Caltex contends that it is entitled to a full deduction for the IDCs for 1999 because it commenced drilling operations, i.e., by securing drilling permits and beginning site preparation, within 90 days of the close of 1999 in satisfaction of section 461(i)(2)(A). Caltex challenges the IRS's interpretation that the 90-day rule requires that a drill bit actually penetrate the ground. Caltex argues that actual drilling is not necessary and that acts normally required to be done before the commencement of actual drilling are sufficient to constitute the commencement of a well or drilling operations.

b. *The 3-1/2-month rule*

In the alternative, Caltex argues that, even if it is not entitled to a full deduction under the 90-day rule, it is entitled, at least, to a partial deduction of IDCs for 1999 under the 3-1/2-month rule of 26 C.F.R. section 1.461-4(d)(6)(ii), Income Tax Regs., which allows a taxpayer to

treat a liability as having been economically performed at the time of payment if that taxpayer "reasonably expect[ed] the *** [provider of services] to provide the services *** within 3 1/2 months after the date of payment". The IRS maintains that Caltex may not invoke this special timing rule because the 3-1/2-month rule contemplates that, under a non-severable contract, all of the services called for must reasonably be expected to be performed within the required time. Caltex disputes the IRS's interpretation of the regulation and contends that it is entitled to a deduction for the portion of the contracted services that it reasonably expected to be performed within 3-1/2 months of payment.

We now address these disputed issues.

III. *The special 90-day rule for oil and gas tax shelters under section 461(i)(2)(A): "if drilling of the well commences"*

Section 461(i)(2)(A) provides a special rule for economic performance as it relates to the drilling of oil and gas wells. This special rule is limited to "tax shelters" as defined in section 461(i)(3). For purposes of this motion, we will assume (favorably to Caltex) that Caltex is such a tax shelter so that it may invoke section 461(i)(2)(A), which provides: [pg. 27]

> In the case of a tax shelter, economic performance with respect to amounts paid during the taxable year for drilling an oil or gas well shall be treated as having occurred within a taxable year if *drilling of the well commences* before the close of the 90th day after the close of the taxable year. [Emphasis added.]

Thus, accrual-basis oil and gas tax shelters (such as Caltex) may deduct their IDCs in advance of drilling as long as the "drilling of the well commences" within 90 days after the close of the tax year for which the taxpayer is seeking to claim the deduction.

The question that this provision prompts is: When does the "drilling" of a well "commence"?

The IRS maintains that the drilling of a well commences when the well is "spudded", meaning at the beginning of surface drilling (i.e., when the drill bit penetrates the ground), while Caltex argues that drilling is commenced when activities such as site preparation begin.

A. *The plain language of the statute: "drilling *** commences"*

To construe a statute, we consult first the ordinary meaning of its language, see Perrin v. United States, 444 U.S. 37, 42 (1979), and we apply the plain meaning of the words used in a statute unless we find that those words are ambiguous, United States v. James, 478 U.S. 597,

606 (1986). Since the 90-day rule was added to the Code in 1984, see DEFRA sec. 91(a), and has remained relatively unchanged, these are not antiquated words or terms that would need special interpretation. According to Webster's Third New International Dictionary 690 (2002), to "drill" means "to make (a rounded hole or cavity in a solid) by removing bits with a rotating drill", while to "commence" means "to begin".Id. at 456. Giving effect to the plain meaning of these words, we find it unambiguous that "drilling of the well commences" when the boring of a hole for the well begins. Therefore, we find that the plain language of section 461 (i)(2)(A) dictates that, as a matter of law, "drilling of the well commences" when the drill bit penetrates the ground to start the hole for the well. Our interpretive task could stop there, with our conclusion based on the plain language of section 461(i)(2)(A). [pg. 28]

B. *The title of section 461(i)(2): "spudding"*

However, we need not look far to see strong corroboration of this interpretation—or, if the language were thought ambiguous, resolution of that ambiguity. The title of section 461(i)(2) —"Special rule for spudding of oil or gas wells" (emphasis added)—shows the intended meaning of the term "drilling of the well commences". While the title of an act will not limit the plain meaning of the text, see Strathearn S.S. Co. v. Dillon, 252 U.S. 348, 354 (1920); Caminetti v. United States, 242 U.S. 470, 490 (1917), it may be of aid in resolving an ambiguity, Fla. Dept. of Revenue v. Piccadilly Cafeterias, Inc, 554 U.S. 33, 47 (2008). [10] In the case of section 461(i), the heading is not at any variance with the text. This is an instance in which the heading is "of some use for interpretative purposes", [11] Wallace v. Commissioner, 128 T.C. 132, 140-141 (2007), and it confirms our reading of the text of the statute:

To "spud" means "to begin to drill (an oil well) by alternately raising and releasing a spudding bit with the drilling rig". Webster's Third New International Dictionary 2212 (2002). [12] As a result, we find that a well is "spudded" when [pg. 29] the drill bit penetrates the ground for purposes of drilling an oil or gas well. That being the case, the title that Congress gave to this subparagraph—"Special rule for spudding"—indicates that when Congress said that the special rule would apply "if drilling of the well commences", it meant that the rule would apply if a spudding bit had been raised and released to begin the actual drilling.

C. *Giving effect to every word in the statute*

In support of its contrary position, Caltex cites several State court opinions that interpret similar language in oil and gas leases but hold that actual drilling is not required. However, in most of the cases Caltex cites, the language and the contexts are different from section 461. [13] Caltex cites one case with language sufficiently close to section 461 to warrant discussion: Jones v. Moore, 338 P.2d 872 (Okla. 1959), which interprets a contract term that required a lessee to "commence to drill a well" and holds that the contract was satisfied even without actual drilling. [14] In Jones the Supreme Court of Oklahoma held that the "well was commenced" by certain preparatory acts, e.g., staking the location, digging a slush pit

preparatory to drilling, and ordering a machine out to drill the well. Id. at 874-876. In doing so, the court seems to have ascribed no significance to the presence of the word "drill" in the lease term at issue ("commence to drill a well" (emphasis added)), and Caltex would evidently [pg. 30] have us do the same here. However, we do not face the question whether, under Oklahoma law, lease terms of this nature are understood not to require actual penetration of the ground, despite language literally calling for "drill[ing]" Instead, we interpret a statute (not a lease), and we construe it as a provision of Federal law (not under State law).

In so doing, we follow the "elementary rule of construction that effect must be given, if possible, to every word, clause and sentence of a statute." Vetco Inc. & Subs. v. Commissioner, 95 T.C. 579, 592 (1990) (quoting 2A Sutherland Statutory Construction sec. 46.06 (1986)). As a result, we will not ignore or minimize the word "drilling" in section 461(i)(2)(A). To do so would be at odds with the heading of the section (discussed above at III.B.) and its intended purpose (see supra note 11). Therefore, we do not find the cases cited by Caltex to be persuasive in aiding our interpretation of section 461.

D. *Application to Caltex*

Caltex has stipulated that "[n]o drill penetrated the ground for purposes of drilling a well by or on behalf of Caltex Oil Venture during 1999 or 2000." Given that fact, Caltex is not entitled to the special timing rule of section 461(i)(2)(A).

IV. *The 3-1/2-month rule of 26 C.F.R. section 1.461-4 (d)(6)(ii)*

As we have shown, the general "economic performance" rule of section 461(h)(2)(A)(i) provides that economic performance occurs as services are provided to the taxpayer; but section 461(h)(2) conferred on the Secretary the authority to promulgate regulations that would provide alternative timing. Acting under this authority, the Secretary promulgated 26 C.F.R. section 1.461-4(d)(6)(ii), Income Tax Regs., which provides that a taxpayer is allowed to treat services as having been provided (i.e., thereby satisfying the economic performance prong of the "all events test") when the taxpayer makes payment for those services if the taxpayer can "reasonably expect the *** [provider of services] to provide the services *** within 3 1/2 months after the date of payment." This is commonly referred to as "the 3-1/2-month rule." [pg. 31]

A. *The parties' contentions*

The IRS maintains that this 3-1/2-month rule does not allow Caltex to treat the services due under the contract as having been economically performed in 1999 because the rule applies only if Caltex could reasonably expect all services due under the contract to be provided within 3-1/2 months after the date of payment. The IRS acknowledges a distinction (and a different

outcome) where the contract provides for differentiated or severable services to be performed under a single contract. The IRS concedes that, in the case of a divisible contract, also known as a severable contract, [15] economic performance occurs (and any applicable economic performance exception will apply) separately with regard to each distinct service that was contracted for as that service is provided. See 26 C.F.R. sec. 1.461-4(d)(6)(iv), Income Tax Regs. ("If different services *** are required to be provided to a taxpayer under a single contract or agreement, economic performance generally occurs over the time each service is provided"). However, the IRS maintains that the same is not so if a contract—like, it points out, the turnkey contract [16] at issue here—does not specifically provide for differentiated services.

Caltex disagrees and argues that the IRS's interpretation of the 3-1/2-month rule must be rejected because if all the services called for under a turnkey contract had to be performed within 3-1/2 months of payment, the rule could never be applicable to the oil and gas industry. Our record shows that digging an oil well usually takes over two years from conception to production and necessarily requires, among other things, extensive data collection, lease acquisitions, securing access roads, staking and permitting of the well site, negotiating contracts for subcontract services, buying and building [pg. 32] surface facilities, and the actual drilling and production of oil or gas. Instead, Caltex maintains that the rule permits a taxpayer to accelerate a deduction for just the allocable cost of the services that would be provided in the 3-1/2-month period from payment. In taking this position, Caltex does not address the IRS's distinction between a severable and non-severable contract.

Thus, the questions before us are (i) whether the 3-1/2-month rule contemplates that all of the services called for under a contract must be provided within 3-1/2 months of payment, or whether the rule permits a taxpayer to accelerate a deduction for just the portion of the services that would be expected to be provided in the 3-1/2-month period from payment, and (ii) whether the interpretation and application of the 3-1/2-month rule changes depending on whether the contract at issue is severable or non-severable.

B. *Construing 26 C.F.R. section 1.461-4(d)(6)(ii)*

1. *The ambiguity of the regulation*

The starting point for interpreting a regulatory provision is, as with a statute, its plain meaning. Walker Stone Co. v. Sec'y of Labor, 156 F.3d 1076, 1080 (10th Cir. 1998) ("When the meaning of a regulatory provision is clear on its face, the regulation must be enforced in accordance with its plain meaning");Intermountain Ins. Serv. of Vail, L.L.C. v. Commissioner 134 T.C. 211, 218 (2010), rev'd on other grounds, 650 F.3d 691 [107 AFTR 2d 2011-2613] (D.C. Cir. 2011). The 3-1/2-month rule inquires whether Caltex reasonably expected Red River "to provide the services" within the relevant time period. See 26 C.F.R. sec. 1.461-4(d)(6)(ii), Income Tax Regs. (emphasis added). The IRS argues that this rule contemplates that "the services" called for under a contract—i.e., all of the contracted services—must be provided

within 3-1/2 months of payment, while Caltex maintains that the rule permits a taxpayer to claim a deduction for just the portion of the services that would be expected to be provided in the 3-1/2-month period from payment. The IRS thus contends in effect that "the services" means "all of the services", and Caltex contends in effect that it means "any of the services".

We think that the IRS's proffered meaning (i.e., all of the services) is the more likely. The regulation reads: [pg. 33]

> A taxpayer is permitted to treat services or property as provided to the taxpayer as the taxpayer makes payment to the person providing the services or property (as defined in paragraph (g)(1)(ii) of this section), if the taxpayer can reasonably expect the person to provide the services or property within 3 1/2 months after the date of payment.

26 C.F.R. sec. 1.461-4(d)(6)(ii), Income Tax Regs. The regulation thus presumes a correlation between "the services" and "payment" therefor. Where multiple services are provided pursuant to a contract that calls for a single payment, and the single payment is thus not linked to fewer than all of the contracted services but is instead paid for all of the contracted services, "the services" that must be provided within 3-1/2 months would seem to be the services for which "payment" is made—i.e., all the services.

However, the regulation does not include either the phrase "all of" or the phrase "any of". We cannot say that Caltex's interpretation is impossible. Since the meaning of the regulation is thus ambiguous, we will look to other principles and canons [17] o see whether they confirm or correct our initial reading of the regulation.

2. *Narrow construction of deductions*

It is well settled that deductions are a matter of legislative grace and should be narrowly construed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 [13 AFTR 1180] (1934). Caltex asks us to read the 3-1/2-month rule expansively—i.e., giving the taxpayer a greater entitlement to accelerate deductions—whereas the IRS's interpretation is narrower. This tends in favor of the IRS's interpretation, especially since the 3-1/2-month rule, even narrowly construed, is already a relaxation of the general economic performance rule of section 461(h) and expands taxpayers' entitlement to a deduction. [18] [pg. 34]

3. *The history of the 3-1/2-month rule*

It is well settled that where a statute is ambiguous, we may look to legislative history to ascertain its meaning. Burlington N. R.R. v. Okla. Tax Comm'n, 481 U.S. 454, 461 (1987); Griswold v. United States, 59 F.3d 1571, 1575-1576 [76 AFTR 2d 95-5832] (11th Cir. 1995).

The rules of statutory construction also apply to the construction of regulations. See Estate of Schwartz v. Commissioner, 83 T.C. 943, 952-953 (1984). Therefore, when a regulation is ambiguous, we may likewise consult its "regulatory history"—i.e., statements made by the agency contemporaneously with proposing and adopting the regulation—to ascertain its meaning. See Armco, Inc. v. Commissioner, 87 T.C. 865, 868 (1986) ("A preamble will frequently express the intended effect of some part of a regulation *** [and] might be helpful in interpreting an ambiguity in a regulation"); also see Abbott Labs. v. United States, 84 Fed. Cl. 96, 103 [102 AFTR 2d 2008-6332] (2008) ("the court [is] permitted to consult the agency's interpretations or the regulatory history to determine meaning" if the regulation is ambiguous),aff'd, 573 F.3d 1327 [104 AFTR 2d 2009-5579] (Fed. Cir. 2009). Proposed regulations under section 461(h) were issued on June 7, 1990, and adopted on April 9, 1992. See Notice of Proposed Rulemaking, Economic Performance Requirement, IA-258-84, 1990-2 C.B. 805; T.D. 9408 [sic, 8408], 1992-1 C.B. 155. In publishing the proposed regulations, the Secretary explained the origin of the 3-1/2-month rule:

> [I]n the case of a liability of a taxpayer arising from the provision by another person of property or services to the taxpayer, the statute provides that economic performance occurs as the property or services are provided to the taxpayer. The regulations provide rules designed to lessen the burden on a taxpayer incident to determining when property or services are provided to the taxpayer. For example, the regulations provide that a taxpayer may treat property or services as provided to the taxpayer as the taxpayer makes payment for the property or services. However, this treatment is available only if the taxpayer can reasonably expect the property or services to be provided by the other person within 3 1/2 months after the payment is made. [1990-2 C.B. 805, 806; emphasis added.]

[pg. 35]

In promulgating the final regulations (in which it rejected a suggestion to lengthen the 3-1/2-month period; see supra note 18), the Secretary repeated—that the 3 1/2-month rule appropriately operates to *relieve taxpayers of the burdens incident to determining precisely when services and property are provided* , while assuring that economic performance occurs within a reasonable time following payment. [Emphasis added.]

T.D. 8408, 1992-1 C.B. at 157.

Therefore, the history of 26 C.F.R. section 1.461-4(d)(6)(ii) is emphatic about avoiding the burden of having to determine precisely when services were provided. It would be somewhat at odds with such a regime—engineered to avoid difficulties in determining when services have been provided—to allow a taxpayer to accelerate deductions for just the portion of services expected to be provided within 3-1/2 months of payment and, in order to do so, to make ex post facto valuations of those services—valuations that would require fact-intensive analyses

by both the taxpayer and the IRS. This is the very difficulty that the regulation sought to avoid. We hardly think that the Secretary intended this result when promulgating the 3-1/2-month rule.

4. *Difficulty for the oil and gas industry*

Caltex argues that the IRS's interpretation of the 3-1/2-month rule must be rejected because if all the services called for under a turnkey contract have to be performed within 3-1/2 months of payment, the 3-1/2-month rule could never be applicable to the oil and gas industry because of the immensity of its projects, thereby making the rule superfluous.

It is true that, generally speaking, an interpretation that renders a statutory provision superfluous should be avoided, since that interpretation would offend "the well-settled rule of statutory construction that all parts of a statute, if at all possible, are to be given effect." Weinberger v. Hynson, Westcott & Dunning, Inc., 412 U.S. 609, 633 (1973).

However, the 3-1/2-month rule is a general exception to the economic performance rule of section 461(h). It is not an exception that is specific to the oil and gas industry. Cf. sec. 461 (i)(2)(A). As a result, even if it were true that the 3-1/2-month rule could not be used in the oil and gas industry, that fact would not be sufficient by itself to invalidate the[pg. 36] IRS's proposed interpretation, because inapplicability to one particular industry does not make a provision entirely superfluous.

Moreover, we do not find that the IRS's interpretation of the 3-1/2-month rule would always make it inapplicable to the oil and gas industry. For example, if a contract for the drilling of an oil or gas well were drafted in such a manner that payments were allocated to specified services, the 3-1/2-month rule could apply to such oil and gas contracts. See 26 C.F.R. sec. 1.461-4(d)(6)(iv), Income Tax Regs. Or, if some or all of the preparatory activities were already completed at the time the taxpayer entered into a turnkey contract and made payment and the remaining services that were the subject of the contract could be completed in 3-1/2 months, then under such a contract all the services under the contract could be completed within that 3-1/2-month period.

In any event, we do not reject the IRS's interpretation of the 3-1/2-month rule simply because the rule might be used in the oil and gas industry only infrequently.

C. *Application to Caltex*

1. *Caltex is not entitled to the special timing provisions of the 3-1/2-month rule.*

We hold that the 3-1/2-month rule contemplates that all of the services called for under an undifferentiated, non-severable contract must be provided within 3-1/2 months of payment.

Therefore, a determination of Caltex's entitlement to use the 3-1/2-month rule requires (1) a determination of whether the contract at issue is an undifferentiated, non-severable contract (see supra note 15), versus a severable one, and (2) a determination of whether the services called for thereunder could have reasonably been expected to be performed within 3-1/2 months of payment. In doing so, we find that Caltex is not entitled to the special timing provisions of the 3-1/2-month rule.

Caltex's contract with Red River fits the definition of a "turnkey contract", (see supra note 16). It did not provide an exhaustive, itemized list of services to be provided to Caltex by Red River (or its subcontractors) with particular payments associated with or allocated to each service. Instead, the contract enumerated some, but not all, of the services to be provided [pg. 37] in order for Red River to "commence or cause to be commenced" the drilling of wells at the two sites, and it called for lump-sum payments of $4,123,333 for drilling costs and $1,049,333 for completion costs without any allocation of those sums to particular services. As a result, we hold that the contract at issue here is an entire, non-severable contract, as the IRS contends.

Given that the contract is non-severable, Caltex may use the 3-1/2-month rule only if all the services called for in the contract with Red River could have been reasonably expected to be performed within 3-1/2 months of payment. Caltex has never alleged that it expected all of the services to be provided within 3-1/2 months of payment. On the contrary, Caltex concedes that it did not reasonably expect all services to be performed within 3-1/2 months of payment, since "turnkey contract services in the oil and gas industry could never be completed in such a limited time frame." As a result, we find that Caltex may not treat any of the services due under the contract as having been economically performed in 1999 by operation of the 3-1/2-month rule of 26 C.F.R. section 1.461-4(d)(6)(ii).

2. *Deductions under the 3-1/2-month rule are limited to payments made by cash or cash equivalents, not notes*

For purposes of the regulation at issue, "payment" has the same meaning as it has for taxpayers using the cash receipts and disbursement method of accounting. See 26 C.F.R. sec. 1.461-4(d)(6)(ii), Income Tax Regs. (defining "payment" by reference to 26 C.F.R. section 1.461-4(g)(1)(ii)). Pursuant to 26 C.F.R. section 1.461-4(g)(1)(ii)(A),

> payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a government agency).

After this regulation was proposed, *see* Notice of Proposed Rulemaking, Economic Performance Requirement, IA-258-84, 1990-2 C.B. 805, 814, commentators objected to this

rule and, among other things, asked that the regulation provide that a note or other evidence of indebtedness which bears an arm's-length rate of interest be included as "payment". [pg. 38] T.D. 8408, 1992-1 C.B. at 159. The Secretary rejected this suggestion because they "believe[d] that consistent use of the cash method definition of payment provides an administrable rule that is consistent with congressional intent." Id. Therefore, for purposes of the 3-1/2-month rule, the "payments" made by Caltex would not include any notes executed in favor of Red River, but instead would include only the two payments made by Caltex to Red River via checks in the amounts of $308,293.50 and $119,892. As a result, even if Caltex were able to invoke the 3-1/2-month rule, it would be able to deduct only the amount of its actual payments (i.e., $428,185.50), not the approximately $5.2 million it attempted to deduct.

V. *Economic performance under the general rule of section 461(h)*

Even though Caltex does not qualify for the exceptions discussed above, it may still invoke the general rule of section 461(h). That statute provides that "the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs"; and, if the liability of the taxpayer arises from a third person providing services to the taxpayer, "economic performance occurs as such person provides such services". Sec. 461(h)(1), (2)(A)(i). Thus, Caltex remains entitled to deduct for 1999 the payments it made in 1999 for services actually performed in 1999.

The IRS acknowledges this principle but argues that economic performance with respect to at least $5,165,593.20 of the claimed IDCs of $5,172,666 did not occur in 1999, because (it says) Caltex stipulated that only $7,072.80 of the IDCs due under the contract was incurred in 1999. The actual language of the stipulation is: "Petitioner contends that it incurred $7,072.80 of intangible drilling costs relating to *** [the contract] during 1999." Therefore, reasons the IRS, Caltex's maximum potential deduction for IDCs for 1999 under section 461(h) is $7,072.80.

Caltex counters that while it stipulated that it contends that $7,072.80 of IDCs was incurred in 1999, it did not stipulate that it contends that only $7,072.80 of IDCs was incurred in 1999. As a result, Caltex maintains that the precise amount of IDCs incurred in 1999 remains in dispute. [pg. 39]

We think the IRS's reading of the stipulation is the more likely reading. However, we cannot say that Caltex's reading is impossible, and we currently address this question not after a trial but under Rule 121. In deciding the IRS's motion for partial summary judgment, we must draw every inference in favor of the non-moving party, Caltex. As a result, there remains a genuine issue of material fact regarding the amount, if any, of IDCs incurred by Caltex in 1999 (and the effect, if any, of the parties' stipulation on Caltex's ability to claim deductions in excess of $7,072.80).

Moreover, we note that the IRS does not maintain that, by way of summary judgment on this point, we can use the stipulation to avoid a trial on the issue of the amount of Caltex's 1999 IDC deductions under the general rule of section 461(h). The IRS does not concede that Caltex may actually deduct $7,072.80 in IDCs for 1999. Instead, the IRS argues that factual issues relating to the deductibility even of the $7,072.80 should remain for trial and that such issues include (i) whether the services to which the $7,072.80 relate were performed in 1999, and (ii) if so, whether the services were performed before Caltex acquired interests in the wells. See Haass v. Commissioner, 55 T.C. 43, 50 (1970) (holders of interests in oil and gas wells may deduct IDCs only after they have been granted operating rights to the wells to which those costs relate). It is not worthwhile for us to attempt resolve under "genuine issue of material fact" standards a controversy about the interpretation of a stipulation, only to then have to address in large part the issue that summary judgment should resolve. These considerations also tilt this question in Caltex's favor, for purposes of the IRS's motion.

Conclusion

The IRS is entitled to summary judgment on two issues: (1) Caltex is not entitled to the 90-day special timing rule of section 461(i)(2)(A); and (2) Caltex is not eligible to treat any services due under the contract as having been economically performed in 1999 under the 3-1/2-month rule of 26 C.F.R. section 1.461-4(d)(6)(ii), Income Tax Regs. Whether, and to what extent, Caltex may be entitled to deduct some of its IDCs for 1999 on the basis of the general economic performance rule of section 461(h) is still in dispute. [pg. 40]

To reflect the foregoing,

An appropriate order will be issued.

1

Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 as in effect for the year in issue (codified in 26 U.S.C., and referred to herein as "the Code"), and all Rule references are to the Tax Court Rules of Practice and Procedure.

2

IDCs are drilling cost outlays associated with oil and gas drilling operations. IDCs range from amounts paid for the clearing of ground, draining, road-making, and surveying work to all amounts paid for labor, fuel, repairs, hauling, and supplies (e.g., drilling muds, chemicals and cement) incident to and necessary in the drilling and preparation of wells for the production of oil and gas. See 26 C.F.R. sec. 1.612-4, Income Tax Regs.

3

Steps in this process may overlap, but they include: (i) collecting data, acquiring leases, securing access roads, staking and permitting the well (one to two years); (ii) designing the procedures and getting estimates from various service companies (three to four months); (iii) negotiating contracts for subcontract services, equipment, rigs, and specialists, as appropriate (three to four months); (iv) location work, including site operations, equipment delivery, and installation (four weeks); (v) actual drilling operations (four to eight weeks); (vi) completion and testing operations (four weeks); (vii) buying and building surface facilities (four weeks); and (viii) negotiating gas sales, saltwater disposal, and field supervision.

4

The record also reflects that on December 27, 1999, Caltex paid Red River an additional $30,481 for "Int", presumably interest.

5

The record does not include any note executed by Caltex in favor of Red River, but for purposes of the IRS's motion we assume (in Caltex's favor) that Caltex satisfied its payment obligations under the contract by executing a note in favor of Red River on or before December 31, 1999.

6

On the basis of a stipulation agreed to by Caltex, the IRS asserts that this maximum potential deduction is $7,072.80. We hold that summary judgment is not appropriate as to the precise amount (see section V of the argument below), but we hold in favor of the IRS on the interpretation and application of the economic performance requirement.

7

Apart from the special allowances of the Code, IDCs would be capital expenditures. Since they benefit future periods, they would have to be capitalized and recovered over those periods for income tax purposes, rather than being expensed for the period the costs are incurred. See, e.g., 26 C.F.R. sec. 1.461-1(a)(2)(i), Income Tax Regs. Notwithstanding this general rule, section 263(c) grants taxpayers the option to currently expense IDCs. See Keller v. Commissioner, 725 F.2d 1173, 1178 [53 AFTR 2d 84-663] (8th Cir. 1984), aff'g 79 T.C. 7 (1982). However, "this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value." 26 C.F.R. sec. 1.612-4(a), Income Tax Regs.

8

A third exception is the recurring item exception of section 461(h)(3)(A)(iii), which allows a taxpayer to claim a deduction in advance of economic performance if certain requirement are met. In its motion the IRS argues that Caltex is not entitled to the recurring item exception because, inter alia, the liability under the contract is not recurring in nature. Caltex does not counter the IRS's argument or explicitly argue that it is entitled to invoke the recurring item exception of section 461(h)(3)(A)(iii). We therefore infer that Caltex concedes this issue and does not invoke the recurring item exception.

9

Caltex does contend that, even if all its other arguments fail, it is still entitled to a deduction for the cost of any services that Red River actually performed in 1999 under the terms of the contract. The IRS acknowledges that entitlement but argues that Caltex's maximum possible deduction under that theory should be $7,072.80 because Caltex stipulated that "it incurred $7,072.80 of intangible drilling costs relating to Exhibit 5-J (the document entitled 'Turnkey Contract' between Caltex Oil Venture and Red River Exploration, Inc.) during 1999." We address this issue briefly in section V below.

10

See also Graves v. Commissioner, 89 T.C. 49, 51 (1987); Keeble v. Commissioner, 2 T.C. 1249, 1252-1253 (1943)). The Court of Appeals for the Third Circuit, to which an appeal of this case would lie, follows this principle: "'[T]he title of a statute and the heading of a section are tools available for the resolution of a doubt about the meaning of a statute." Gay v. CreditInform, 511 F.3d 369, 385 (3d Cir. 2007) (quoting Almendarez-Torres v. United States, 523 U.S. 224, 234 (1998)); see also United States v. Thayer, 201 F.3d 214, 221 [84 AFTR 2d 99-7497] (3d Cir. 1999) ("the title of a [statutory] section can assist in resolving ambiguities").

11

The word "spudding" was used not only in the title of the statute but several times in the legislative history. See S. Rept. No. 100-445, at 100-101 (1988), 1988 U.S.C.C.A.N. 4515, 4618 ("When the special spudding rule for economic performance was adopted by Congress *** economic performance was deemed to occur at the time of spudding of an oil or gas well where the taxpayer had paid for the drilling costs prior to the close of the taxpayer's year. *** the special spudding rule *** in order for spudding to be considered as economic performance" (emphasis added)); H.R. Conf. Rept. No. 98-861, at 884-885 (1984), 1984-3 C.B. (Vol. 2) 1, 138 ("economic performance is deemed to occur with respect to all intangible drilling expenses of a well when the well is spudded.' *** [If] the spudding of the well commenced within 90 days after the close of the taxable year, the entire amount of the prepaid intangible

drilling expense would be deductible"). Thus, if there were any doubt, the legislative history could be cited to confirm the interpretation we have found.

12

If "spudding", as a specialized term, should be defined by reference to oil and gas sources, then such sources only confirm the dictionary meaning. See Marathon Oil Co. v. FERC, 68 F.3d 1376, 1377 (D.C. Cir. 1995) (spudding occurs "where surface drilling had commenced"); American Petroleum Institute, Glossary of Oilfield Production Terminology (1988) (citing API Bulletin D11, "Glossary of Drilling-Fluid and Associated Terms" (2d ed. 1979) (defining "spudding in" as "[t]he starting of the drilling operations of a new hole")) (available at http://www.occeweb.com/og/api-glossary.pdf); Howard R. Williams & Charles J. Meyers, Manual of Oil and Gas Terms 1084 (12th ed. 2003) (defining "spudding in" as "[t]he first boring of the hole in the drilling of an oil well"). In addition, an abridged version of the Dictionary of Petroleum Terms provided by Petex and the University of Texas Austin (c) Petex 2001 (provided on the Department of Labor's website at http://www.osha.gov/SLTC/etools/oilandgas/glossary_of_terms/ glossary_of_terms_a.html) defines "spud" as "1. to begin drilling a well; such as, to spud in. 2. to force a wireline tool or tubing down the hole by using a reciprocating motion", where "spud in" means "to begin drilling; to start the hole." Caltex does not dispute that "spudding" has this specific meaning, nor does Caltex cite any sources that give a different definition of "spudding".

13

See Allen v. Cont'l Oil Co., 255 So.2d 842 (La. App. 1971) (interpreting contract term that required "operations for drilling" to have commenced);Walton v. Zatkoff, 127 N.W.2d 365 (Mich. 1964) (interpreting contract term requiring commencement of "operations for the drilling of a well" or "the commencement of drilling operations"); Henderson v. Ferrell, 38 A. 1018 (Pa. 1898) (interpreting contract term that required lessee "to commence operations on the premises within 30 days"); Pemco Gas, Inc. v. Bernardi, 5 Pa. D & C.3d 85 (1977) (interpreting lease term that required "commencement of operations" by a certain date); Petersen v. Robinson Oil & Gas Co., 356 S.W.2d 217 (Tex. Civ. App. 1962) (interpreting contract term requiring the commencement of "operations for drilling"); Edgar v. Bost, 14 S.W.2d 364 (Tex. Civ. App. 1929) (interpreting contract term that "well be commenced"); Fast v. Whitney, 187 P. 192 (Wyo. 1920) (interpreting contract term that "well be commenced") None of these sheds any light on the meaning of "if drilling of the well commences" (emphasis added) in section 461.

14

Caltex also cites, to the same effect, 2 Walter Lee Summers, Oil and Gas, sec. 349 (1959), cited in Anderson v. Hess Corp., 733 F. Supp. 2d 1100, 1108 (D. N.D. 2010), aff'd, 649 F.3d 891 (8th Cir. 2011).

15

Where several things are to be done under a contract, and the money consideration to be paid is apportioned to each of the items, the contract is ordinarily regarded as severable. MacArthur v. Commissioner, 168 F.2d 413 [36 AFTR 1058] (8th Cir. 1948), aff'g 8 T.C. 279 (1947); Canister Co. v. Wood & Selick, Inc., 73 F.2d 312, 314 (3d Cir. 1934). On the other hand, if the consideration to be paid is single and entire, the contract will ordinarily be held as entire,see United States v. U. S. Fid. & Guar. Co., 236 U.S. 512, 524-525 (1915); Traiman v. Rappaport, 41 F.2d 336, 338 (3d Cir. 1930), "although the subject thereof may consist of several distinct and wholly independent items,"Fullmer v. Poust, 26 A. 543, 543 (Pa. 1893).

16

"A turnkey contract has a definite meaning in the oil industry. It is a contract where the driller undertakes to furnish everything, and to do all the work required to complete the well, place it on production, and turn it over ready to 'turn the key' and start the oil running into the tanks." Cont'l Oil Co. v. Jones, 177 F.2d 508, 510 [38 AFTR 815] (10th Cir. 1949).

17

The IRS's interpretation of 26 C.F.R. sec. 1.461-4(d)(6)(ii) has not been announced in any published guidance. Because we uphold this interpretation on other grounds, we need not reach the question whether, as the IRS contends, this is a circumstance in which we should defer to the agency's unpublished interpretation of its own regulation.

18

The Secretary showed an intention to limit the relaxation of the economic performance rule. Some commentators on the Secretary's initial proposed regulations encouraged the IRS to adopt final regulations with a "payment trump" rule—i.e., treating the time of payment as full economic performance, see T.D. 8408, 1992-1 C.B. 155, 157—and others suggested that the proposed 3-1/2-month rule be extended to six months, see id., 1992-1 C.B. at 157. Rejecting these suggestions in the final regulations, the Secretary determined that "the policy of section 461(h) would be frustrated" by adopting the "payment trump" rule and that "the 3 1/2-month rule appropriately operates to relieve taxpayers of the burdens incident to determining precisely when services and property are provided, while assuring that economic performance occurs within a reasonable time following payment." Id.

END OF DOCUMENT -

© 2014 Thomson Reuters/Tax & Accounting. All Rights Reserved.

pennsylvania
DEPARTMENT OF REVENUE

INHERITANCE TAX BULLETIN 2012-01

Issued: July 10, 2012
Revised: July 13, 2012

Taxation and Valuation of Mineral Rights and Natural Gas Interests for Pennsylvania Inheritance Tax

Under provisions of the Inheritance and Estate Tax Act of 1991, (72 P.S. §§ 9102, 9121), the Secretary of the Department of Revenue ("Department") announces that the Department has clarified existing Department policy concerning the taxation of mineral rights and natural gas interests for Pennsylvania inheritance tax purposes. All mineral and natural gas rights shall be reported on *Inheritance Tax Schedule E (REV-1508)* as Cash, Bank Deposits & Misc. Personal Property. The Department clarifies its policy as follows:

(1) The **taxable value of mineral rights** shall be determined using the same methodology used to value any real property or tangible personal property interest. Taxable value is established by determining the actual monetary worth of the interest determined by either a *bona fide* sale or, if the transfer is for no or nominal consideration, computed value (based on the common-level ratio applied to the assessed value of the mineral right). In the event that there is no sale and no computed value, then the taxable value is the interest's actual monetary worth, based upon the best available evidence.

(2) The **taxable value of natural gas rights** shall be determined using the same methodology used to value any real property or tangible personal property interest. Taxable value is most clearly established by determining the actual monetary worth of the interest determined by a *bona fide* sale. If there is no *bona fide* sale, natural gas rights can be determined from an appraisal or other credible evidence. A computed value using assessed value cannot be accomplished because natural gas rights do not have assessed values. Therefore, **absent a *bona fide* sale, an appraisal or other credible evidence to the contrary**, value shall be determined as follows:

(i) **For leased and producing properties**, an estate shall value natural gas rights at an amount equal to any amounts received that were attributable to actual production of the natural gas interests at issue during the twelve months prior to the decedent's date of death, multiplied by two.

(ii) **For leased, non-producing properties**, interests shall be reported at a value of zero unless, at the time of death, the properties were part of a contractual arrangement whereby the properties generated fixed future payments, in which case the

Bureau of Individual Taxes | P.O. Box 280601 | Harrisburg, PA 17128-0601 | 717.787.8327 | www.revenue.state.pa.us

natural gas rights shall be calculated by reducing the fixed future payments to present value as of the decedent's date of death using established Internal Revenue Service actuarial tables as found in *IRS Publication 1457 Actuarial Values* Table B, Section 3 Annuity, Income, and Remainder Interests For a Term Certain.

(iii) **For non-leased, non-producing properties**, interests shall be reported at a value of zero.

CONTACT INFORMATION
PA Department of Revenue
Bureau of Individual Taxes
Inheritance Tax Division
P.O. Box 280601
Harrisburg, PA 17128-0601
TEL: 1.717.787.8327
www.revenue.state.pa.us

INFORMATIONAL NOTICE REALTY TRANSFER TAX AND PERSONAL INCOME TAX 2012-04

Issued: October 10, 2012

Division and Transfer of Interests Related to Oil and Natural Gas

I. PURPOSE

This informational notice 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 lessor's reservation of a royalty under an oil and gas lease creates an estate in land and not a personal property interest.[6] An overriding royalty is also an interest in land and not a personal property interest.[7]

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.[8] 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 or interest in real estate. Note: Because an overriding royalty is an interest in real property, a document that conveys an overriding royalty is subject to tax.

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.[9] 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. Also see *Inheritance Tax Bulletin 2012-01* for additional acceptable valuation methods for natural gas rights when there is no sale price, appraisal or other credible evidence.

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,[10] 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.[11] This includes easements that may be in support of or in furtherance of oil and gas development and production activities 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 informational notice, 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")[12] or the Federal Energy Regulatory Commission ("FERC"),[13] or a similar state or federal agency, are considered a qualifying public utility.

Pipelines: 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.[14] 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. Easements for the production of minerals that are expressed or implied under an oil and gas lease are also exempt under this provision.

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.[15]

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 (whether the usual and customary royalty and/or an overriding royalty) to the owner. A lessee can also reserve an overriding royalty under an oil or gas lease.

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 informational notice.[16] However, it should be noted that real estate taxes are not deductible expenses because they are personal expenses that are not directly related to the production of the rental or royalty payments. Further, even though oil and gas in place are considered real estate, oil and gas in place are not subject to real estate taxes.[17] Therefore, there are no real estate taxes that can be associated with oil and gas interests that could be used to reduce rental or royalty income for Pennsylvania Personal Income Tax purposes.

If a lessee and owner of a working interest under an oil or gas lease, conveys an overriding royalty to someone as consideration for services, the royalty is taxable compensation to the transferee based upon the value of the interest conveyed. The value is based upon the real estate value of the royalty at the time of conveyance and not the present value of the potential future royalty payments. (Presumably, the real estate value of the royalty will be commensurate with the value of the services rendered. The lessee will use this value to calculate any gain from the disposition of the royalty and the transferee will use the value as his cost basis in the overriding royalty interest.) Thereafter, any royalty payment that the transferee receives is taxable to the transferee as royalty income as explained above.

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 seller owns both the surface rights and mineral rights in the real estate, the seller must allocate a portion of his basis to the mineral rights estate. If the seller did not allocate his basis when he originally purchased the real estate, then the seller must allocate a portion of the basis to the mineral rights. The amount allocated to the mineral rights is the entire basis multiplied by a fraction, the numerator of which is the fair

market value of the mineral rights estate and the denominator of which is the fair market value of the entire real estate. The fair market values shall be determined as of the date that the seller originally purchased the real estate. 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[18] (including royalties) under the lease. For Pennsylvania Personal Income Tax purposes, the sale and assignment are treated as an anticipatory assignment of income.[19]

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

pennsylvania
DEPARTMENT OF REVENUE

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 (regardless to whom it is made—family, charity, etc.) of income from production payments under an oil or gas lease is an anticipatory assignment of future income. *See* Flewellen v. Commissioner, 32 T.C. 317 (T.C. 1959). When a production payment is paid, the assignor is deemed to receive the payment and, in turn, transfer the payment to the assignee. Therefore, the production payment remains taxable to the assignor as royalty income. However, the assignor does not report 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 paid.

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.

Example: A lessor under an oil or gas lease conveys the right to the income from the lease royalties/production payments to his children for the remainder of his life or the remainder of the anticipated production period. The lessor is subject to Pennsylvania Personal Income Tax on each royalty/production payment when paid. He is then considered to make a gift of the payment to his children. When the lessor dies, the royalty/production payments pass to his estate and the gift to the lessor's children ends. The lessor's estate reports income from the royalty/production payments until his estate is settled and the lessor's interest under the oil or gas lease is transferred to his heirs. If his children are the heirs to his estate, they will begin reporting the royalty/production payments as income after the estate transfers the lessor's rights to the oil or gas lease to them.

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] The term "overriding royalty" historically has been used to describe numerous different types of interests. In its most generic sense, an overriding royalty is any royalty in excess of the usual and customary royalty reserved by a lessor under an oil or gas lease. In its more modern usage, an overriding royalty is used to describe a royalty carved out of the working interest under an oil and gas lease. Such royalty can be created either by grant or reservation. Thus, an overriding royalty can be created by grant as consideration for services (for example, as consideration to a land man that acquires leases, geologist for evaluating a property, management as an incentive program, a residual ownership to a party that assigns a working interest on a farm out or sale, or an attorney or broker organizing an oil and gas entity for syndication), or it could be created by reservation in cases where the lessee assigns his working interest to another party and retains an interest in the production from the lease. Regardless of the manner in which it is created, an overriding royalty is an interest in real estate. Thus, it is subject to the statute of frauds and can only be conveyed in writing. Patrick H. Martin and Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Fourth Edition*, §§ 418 and 418.1, and 38 Am. Jur. 2d Gas and Oil § 201. *See also*, Szymanowski v. Brace, 987 A.2d 717, 724 (Pa. Super. Ct. 2009).

[8] 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.

[9] 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 established by the State Tax Equalization Board. 72 P.S. § 8101-C (definition #2 of "value").

[10] "'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).

[11] 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).

[12] 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

[13] 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).

[14] 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

[15] 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.

[16] *See* 61 Pa. Code § 125.51 for rules related to cost depletion. For rules related to intangible drilling costs see *CHAPTER 23 (NATURAL RESOURCES)* of the department's on-line *PENNSYLVANIA PERSONAL INCOME TAX GUIDE*.

[17] Indep. Oil & Gas Ass'n of Pa. v. Bd. of Assessment Appeals, 572 Pa. 240, 814 A.2d 180 (2002)

[18] 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).

[19] 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.

pennsylvania
DEPARTMENT OF REVENUE

INFORMATION NOTICE
PERSONAL INCOME TAX 2013-04

Issued: December 02, 2013

Intangible Drilling & Development Costs

Purpose

This notice provides Personal Income Tax ("PIT") taxpayers with guidance on how to recover intangible drilling and development costs associated with oil, gas and geothermal wells.

The notice does not govern the treatment of intangible drilling costs ("IDCs") for Corporate Net Income Tax purposes regardless of whether such IDCs are incurred directly by a corporation or by a partnership with corporate partners.

Effective Date

The rule described in this Informational Notice is applicable to taxable years beginning after December 31, 2013.

Background

Act 52 of 2013 amended section 303 of the Tax Reform Code of 1971 (72 P.S. § 7303) by providing a rule for the capitalization of intangible drilling and development costs ("IDCs") and the amortization of such costs over a fixed period. It also provides for an election to currently expense a portion of IDCs.

Prior to Act 52, a person could not currently expense any IDCs for Pennsylvania Personal Income Tax purposes. Rather, a person was required to capitalize IDCs and recover them through amortization ratably over the life of the well.

IDCs Defined

For Pennsylvania Personal Income Tax purposes, IDCs are those costs properly reported as IDCs for Federal income tax purposes. *See* I.R.C. § 263(c), and the Treasury Regulations thereunder, for costs that qualify as IDCs.

Capitalization and Recovery of IDCs

Pursuant to Act 52, a person is generally precluded from expensing IDCs and instead must capitalize them and recover them through amortization ratably over a 10-year period beginning with the tax year in which they are incurred.

Election to Currently Expense a Portion of IDCs

Act 52 provides for an election to currently expense a portion of IDCs. A person that incurs IDCs as defined under Section 263(c) of the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, may elect for Pennsylvania Personal Income Tax purposes to expense up to one-third of such costs in the tax year in which they are incurred and recover the remaining costs through amortization ratably over a 10-year period beginning in the tax year in which they are incurred. A person may expense IDCs for Pennsylvania Personal Income Tax purposes without regard to whether the person currently expenses IDCs for Federal Income Tax purposes under IRC § 263(c) or 59(e).

Who Makes the Election?

The person directly incurring the IDCs is the only person eligible to make an election to currently expense up to one-third of the IDCs.

Method of Making Election

The person directly incurring the IDCs shall make the election to expense up to one-third of the IDCs by taking a current expense deduction on his/her tax return. If an individual directly incurs the IDCs, the election is made on his/her PA-40 by simply showing the expense. If a partnership or S corporation directly incurs the IDCs, the election is made on its PA-20S/PA-65 by showing the expense. If the PA-20S/PA-65 is not filed, or no RK-1 is provided, then the IDCs must be amortized.

The election to currently expense a portion of a person's IDCs is not a one-time election. A person may elect each tax year to expense up to one-third of the IDCs that the person incurs during that tax year. A person may also choose not to currently expense any IDCs in a tax year even if the person elected to currently expense IDCs in a prior tax year.

Pass-Through Entity Issues

If IDCs are directly incurred by a partnership or S corporation, such entity, as opposed to its partners or shareholders, is required to decide how to recover such IDCs. The method of recovering IDCs utilized by a partnership or S corporation is binding on and must be followed by such entity's partners or shareholders. If the partnership or S corporation does not make an election to expense the IDCs for Pennsylvania Personal Income Tax purposes, its partners or shareholders must capitalize and amortize their share of the IDCs ratably over a 10-year period beginning with the tax year in which they are incurred.

No Carry Forward of IDCs

IDCs, whether recovered through current expensing or amortization, cannot be carried forward and deducted in a subsequent tax year regardless of whether the taxpayer derives a tax benefit from the IDCs.

When is an IDC Incurred?

For Pennsylvania Personal Income Tax purposes, an IDC is "incurred" when the cost is required to be recorded on the person's books according to the person's method of accounting. A cash method taxpayer records an IDC when he/she/it pays such cost. An accrual method taxpayer records an IDC when the cost is fixed and determined, even if not yet paid.

Dry Hole IDCs

Dry Hole IDCs (capitalized IDCs attributable to an unproductive exploratory well) are reported as a Pennsylvania Personal Income Tax Schedule D loss in the year in which the well is determined to be unproductive.

Disposition of Certain Oil and Gas Property

Disposition of the oil and gas related property or entity on which the one-third expensing of IDCs was taken does not require the associated gain from such disposition to be treated as ordinary income for Pennsylvania Personal Income Tax purposes. All amortization and direct expensing of IDCs are adjustments to basis and will be reflected in the determination of the gain or loss on the sale, exchange or disposition of property.

Examples

Example # 1

Jane Taxpayer, an individual, directly incurs $99,000 of intangible drilling and development costs in 2014. She elects to currently expense these costs for Federal income tax purposes. For Pennsylvania Personal Income Tax purposes, Jane Taxpayer has three options:

1. Capitalize the costs and recover $9,900 per year in tax years 2014 through 2023;

2. Expense $33,000 in 2014 and recover the remaining $66,000 in $6,600 per year increments in tax years 2014 through 2023; or

3. Expense less than $33,000 in 2014 and recover the remainder ratably in tax years 2014 through 2023.

Example # 2

Same as Example # 1, except that XYZ Partnership replaces Jane Taxpayer. For Pennsylvania Personal Income Tax purposes, XYZ Partnership has the same three choices as Jane Taxpayer in Example # 1. XYZ Partnership would make this choice by completing its PA-20S/PA-65 accordingly. XYZ Partnership's partners are bound by the decision XYZ Partnership makes and the income as reported on their respective RK-1s/NRK-1s will already reflect their share of IDC deductions.

Example # 3

Same as Example # 2, except that ABC Partnership, a Delaware partnership with no PA-source income, replaces XYZ Partnership. For Pennsylvania Personal Income Tax purposes, ABC Partnership has the same three choices as XYZ Partnership in Example # 2. ABC Partnership would make this choice by completing a PA-20S/PA-65. If ABC Partnership chooses not to file a PA-20S/PA-65, ABC Partnership's partners are required to recover their share of ABC Partnership's IDCs ratably in tax years 2014 through 2023.

pennsylvania
DEPARTMENT OF REVENUE

INFORMATION NOTICE
SALES AND USE TAX 2014-02

Natural Gas Mining

Issued: September 22, 2014

General Overview

The Department of Revenue (the "Department") provides this Sales and Use Tax Information Notice to taxpayers in the natural gas mining industry and related activities. Pennsylvania law exempts the purchase of taxable tangible personal property and services from tax when such property and services are predominantly used directly in mining activities (the "mining exemption") 72 P.S. §§ 7201(k)(8) and (o)(4). The Department's Mining Regulation set forth at 61 Pa. Code § 32.35 governs the scope of the mining exemption. This Information Notice applies the law, the Mining Regulation and other applicable regulations specifically to the natural gas industry and related activities.

Mining activities are defined in the law and regulations as including exploring, extracting, blasting, mining, or drilling for purposes of removing natural resources from the earth or refining natural resources removed from the earth. For natural gas mining, these activities would include cementing (pumping of cement slurry to bond casing or piping to the wall of the bore hole), fracturing (using fluids, a mixture of water and chemicals, to crack the rock formation and the injection of proppants such as sand and ceramic materials into cracks in the formation to open channels through which the gas flows) and acidizing (injecting acid below rock fractures to create flow channels within the rock formation). In this Information Notice these activities will be collectively known as "gas mining".

The mining exemption applies to the purchase or use of tangible personal property or services predominantly used directly in gas mining. Additionally, if a miner is entitled to purchase otherwise taxable property that is predominantly used directly in a gas mining activity exempt from tax, then a third-party vendor performing the same mining activity for the miner is also entitled to the exemption on the purchase of property predominantly used directly in that mining activity. *Commonwealth v. R.G. Johnson Co.*, 433 A.2d 465 (Pa. 1981).

However, the mining exemption does not extend to all property or services used in gas mining. The taxability determination of any property or services used in gas mining is fact-specific and depends on the use of the property or service as it relates to the mining process. The factors that determine whether property or services are directly used and thereby exempt are: (1) physical proximity to the mining operation, (2) temporal proximity to the mining operation, 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". Furthermore, when property is used in two different

activities, one of which is direct-use and the other is not, the property is not considered exempt property unless it is used more than 50% of the time in direct-use activities. 61 Pa. Code § 32.35(a)(2).

The mining exemption only applies to"[m]achinery, equipment, parts and foundations therefor, and supplies which are used in the actual mining production, to transport or convey the product ... [other than vehicles required to be registered under the Vehicle Code], or to handle or store the product during the production." 61 Pa. Code § 32.35(a)(2)(i) (emphasis added).

Consequently, property used prior or subsequent to the actual mining operation, to collect, convey or transport property to a mining activity or to remove the mined product after the final mining operation, and storage facilities or devices used to store property prior or subsequent to actual mining operation are subject to tax. 61 Pa. Code §§ 32.35(a)(3)(iii)(G) and (I). Similarly, 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). For example, monitoring equipment that merely tracks and records drilling data is not exempt property even though it may be used during drilling operations.

A common issue in determining taxability is whether a transaction should be classified as a service or sale at retail of property. The answer often turns on the wording of contracts and invoices. Generally, if a transaction is determined to be a sale at retail of services that are predominantly used directly in exempt activities, then the service fees and any separately-stated charges incurred in conjunction with providing the services (*e.g.*, set-up fees, standby fees, travel costs or additional materials or labor fees, etc.) are also exempt.

If a transaction involves the sale at retail of property (which includes a rental or lease) and the property, such as equipment is furnished with the services of an operator with the charges for each billed separately, it is presumed that the transaction involves a transfer of the right to direct the use of the equipment. 61 Pa. Code § 31.4(a)(1). As such, the transaction is treated as equipment rental and provision of help supply services respectively. Assuming the leased property is taxable because it is not used predominantly and directly in mining, the rental charges are taxable. Furthermore, any additional charges incurred in conjunction with renting the taxable property such as those for set up time, standby time, additional pumping time, travel costs or additional labor or materials are also taxable. On the other hand, if the leased property is nontaxable, any separately stated charges incurred in conjunction with the exempt property (*e.g.*, set-up fees, standby fees, travel costs or additional materials or labor fees, etc.) are also exempt. However, the mining exemption is inapplicable to taxable help supply services. Thus, the separately-stated operator charges remain taxable regardless of the taxability of the rental property.

Also, no exemption is to be given to maintenance facilities or for materials or supplies to be used or consumed in construction, reconstruction, or remodeling of real estate other than exempt machinery, equipment and parts therefor that may be affixed to real estate. 72 P.S. §§ 7201(k)(8) and (o)(4); Pa. Code 61 § 32.35(a). Finally, vehicles required to be registered under 75 Pa. C.S. §§ 101-9909 (the "Vehicle Code").

Based on information currently available to the Department, the taxability of property and services commonly used in or in conjunction with gas mining is as follows:

A. Exploration

"Mining" as defined by law includes exploration for natural gas so otherwise taxable tangible personal property and services are exempt from tax when they are predominantly used directly in exploration. Examples of exempt exploration property and services include:

1. Seismic exploration services.
2. Exploratory well drilling services.
3. Seismic imaging services.
4. Seismic data.

B. Site Preparation & Pre-Production Construction

Generally, the mining exemption does not apply to property or services used in the construction, reconstruction, alteration, remodeling, servicing, repairing, maintenance or improvement of real estate. The mining regulation further states that property used in the removal of trees and clearing of land in preparation for extraction activities is not directly used and therefore taxable.

1. Equipment, parts and materials used in site preparation including, but not limited to, removal of timber, building of access roads and removal of dirt and rocks from the land are taxable, including, but not limited to the following:
    a. Bulldozer.
    b. Backhoe/front loader.
    c. Stone for roads.
    d. Road fabric.
    e. Sluice pipe.
    f. Security fencing.
    g. Bridges and bridge construction materials.
2. Equipment, parts and materials used in the construction of ponds or any other vessels for storage of fresh water or raw materials prior to their use in drilling or hydraulic fracturing such as liners are taxable.
3. Geosynthetic materials used to store clean water used in the drilling operations are taxable.
4. Equipment, parts and materials used in the construction, reconstruction, alteration, remodeling, servicing, repairing, maintenance or improvement of real estate even if the structure may house or otherwise contain equipment or other facilities used directly in mining are taxable.
5. Equipment, parts and materials used to construct an electrical system used to deliver electricity to exempt property from the point the electricity leaves the local distribution company transmission line to the point immediately prior to the last transformer prior to the exempt equipment are taxable. All property used to deliver electricity from this point to the exempt equipment, including the last transformer, is exempt from tax. If the equipment to which the electricity is delivered is taxable, the materials incorporated into an electrical system, even the last transformer and property between that transformer and the taxable equipment are taxable.

If the equipment the electricity powers is both taxable and nontaxable, predominant use determines the taxability of the materials incorporated into the electrical system. The building of the electrical system is a construction contract. Whatever the use of the equipment to which the electricity is delivered, equipment used to construct the electrical system is taxable if it is not incorporated into the electrical system.

C. Extraction and Production

For purposes of the mining exemption, the actual gas mining process begins with the drilling of the wellbore and ends with the last physical change of the gas prior to it being sold and transferred by the miner to another. Therefore, property and services predominantly used directly during this process are exempt.

1. Exempt
    a. The well pad and the foundation directly under the well pad including, but not limited to materials such as sand, stone, gravel or other similar material directly supporting the well pad and any materials used in the well pad itself such as liners and mats are exempt as pollution control property if the well pad was constructed after April 16, 2012 in accordance with 58 P.S. § 3218.2 (relating to containment for unconventional wells).
    b. Materials, such as liners, sand, gravel, etc. used in the construction of storage ponds or vessels from which fracturing fluids (a mixture of water and chemicals) are pumped into fracturing well holes. The exemption also applies to holding ponds, tanks and other containment vessels for fluids that are pumped from the well hole and reused in fracturing multiple wells.
    c. Digging and extracting equipment, machinery, and tools directly used in gas mining:
        i. Drilling rig unit.
        ii. Drilling head.
        iii. Drilling bits.
        iv. Drilling extensions.
        v. Drill string and downhole equipment.
        vi. Drilling mud.
        vii. Casing.
        viii. Cement to encase the casing.
        ix. Twin cement unit (a system located at the well site that mixes cement to be added to the batch mixer).
        x. A frack unit (affixed to the back of a truck chassis) and all repair parts and fuel used in running the fracturing unit, not including the licensed chassis.
        xi. Frack pumps (equipment that injects fluids into a rock formation).
        xii. Gases, sand and cement used in fracturing.
        xiii. Pumps used to extract gas from the ground.
        xiv. Pump down acid equipment (pumping equipment used to perform fracturing, which includes a positive placement pump to expand a

cavity and a boost pump for increasing system pressure of the operation).

xv. Pump rod (connected to the pump).

xvi. Acid pumper (equipment used to pump specially blended acid into the wellbore).

xvii. Bath mixer (equipment used at the well site to mix cement slurry).

xviii. Sucker pipe (pipe that allows oil to flow to the surface).

xix. Cap affixed to the top of the wellhead.

xx. Pump jack (provides upward and downward movement to the pump rod directly resulting in the operation of the pump).

xxi. Manifold trailer (equipment that attaches piping lines to the well head to facilitate the pumping operation).

xxii. Fishing or extracting tools used predominantly to retrieve and remove objects from a drilled hole during the drilling operation.

xxiii. Electricity or fuel used to run direct-use equipment.

xxiv. Frack tanks predominantly used to hold in-process materials, including flow-back water.

d. Remote control and accompanying monitoring equipment used to control and operate frack pumps, blenders and liquid additive units during fracturing only if the equipment makes automatic adjustments to the pumps, blenders, etc. during fracturing.

e. Lighting equipment and supplies used to light production activities. Protective devices worn by production personnel in their work. Communication devices such as handheld radios used predominantly in mining activities such as work coordination among production employees of equal authority.

f. Compression machinery and equipment used up to the last physical change of the gas prior to its being sold and transferred by the miner to another.

g. Refining machinery and equipment used to remove water, vapors or hydrocarbons from gas.

h. Waste extraction, removal, handling, disposal equipment and machinery used in the course of production operations.

   i. Half tanks – large open tanks hold drill cuttings during the course of drilling operation.

   ii. Geotechnical products such as liners used to hold contaminated fracturing water during the course of drilling operation.

   iii. Pit liner used in the sludge holding ponds to hold sludge during the course of drilling operation.

i. Pollution Control Devices

   i. Equipment, machinery and supplies designed and used to control, abate, or prevent air, water or noise pollution generated in the mining operation, including but not limited to flare stacks.

   ii. Materials such as liners, sand and gravel used in constructing a pond used predominantly in controlling, abating, or preventing pollution generated in the mining operation.
   iii. Geosynthetic materials used to prevent contamination generated in the mining operation.
   iv. Back-up containment systems.
   v. Erosion control property, such as silt fences, stakes or hay bales, is exempt, only if used to control, abate or prevent air, water or noise pollution generated in the mining operation.

j. Property to test and inspect the product up to the last physical change of the gas prior to its being sold and transferred by the miner to another party.

k. Reclamation machinery, equipment and materials such as bulldozers, graders, fill, seedlings, grass seed, shrubs, stone, concrete and soil nutrients used in backfilling and reclamation of directly used mining facilities only when the backfilling and reclamation is required by law.

l. Gyroscopes and the wireline with which a gyroscope is hoisted and lowered into the wellbore when the gyroscopic data is used by the miner to guide and direct equipment used during drilling production.

m. Any otherwise taxable property purchased by a nonresident outside of and brought into Pennsylvania for use in the Commonwealth for a period of not more than seven days.

2. Taxable

a. Equipment used to construct well pads.

b. Equipment used to construct ponds or other vessels for storage of fresh water, raw materials or in-process fluids.

c. Property, including liners, used in constructing ponds for storage of water prior to its use in drilling.

d. Property used in water transportation system that pumps water from a body of water to the water storage pond.

e. Property used in construction, reconstruction, alteration, remodeling, servicing, repairing, maintenance or improvement of real estate even if the structure may house or otherwise contain equipment or other facilities used directly in mining.

f. Erosion control property, such as silt fence, stakes, hay bales, is taxable if such property is not used to control, abate or prevent air, water or noise pollution generated in the mining operation.

g. Pipe racks/pipe boats for pipe storage.

h. Fuel storage unit.

i. Sand or gravel storage unit.

j. Tanks predominantly used to store raw materials prior to use in a mining operation.

k. Mine management and administration.
    i. Office furniture, supplies and equipment, textbooks and other educational materials, books and records and other property used in mining recordkeeping and other administrative and managerial work.
    ii. Property, including but not limited to supplies used to record the quality and quantity of work in production or goods in storage, the flow of work, the results of inspection, or to instruct workers in routing work or other production activities.
    iii. Property used to record the volume and pressure of gas coming from the wellhead.
    iv. Communication devices used for managerial direction and supervision.

D. Transport

Machinery, equipment, parts and foundations therefor, and supplies used to transport or convey extracted product during production are directly-used in mining and therefore exempt.

1. Exempt
    a. Transportation devices and equipment such as gathering lines used to transport gas from the wellhead to the miner's compression or refinery operations up to the last physical change of the gas prior to its being sold and transferred by the miner to another.
    b. Pump and power for pump used to move the gas through a pipeline prior to the last change.
    c. Pipes and any foundation materials directly under the pipes, such as sand, stone or other similar materials.
2. Taxable
    a. Vehicles required to be registered under 72 Pa. C.S. §§ 101-9909 (the "Vehicle Code"), supplies, repair parts and repair services for the vehicles.
        i. Truck chassis to which a drilling unit, frack unit, or service rig is affixed.
        ii. Acid transport (a tractor trailer used to move raw or blended acid to well sites).
        iii. Bulk truck (a truck that transport dry products to the batch mixer).
        iv. Vehicles and trailers registered under the International Registration Plan ("IRP") as they are required to be registered under the Vehicle Code.
        v. Cargo trailer such as an enclosed utility trailer that transports testing equipment.
        vi. Chemical liquid additive tractor trailer that transports chemicals to be used at well sites. The unit maintains the temperature of the chemicals in transit.
        vii. Chemical transfer tractor trailer used to transport the chemical liquid additive unit to well sites.

viii. Mechanic service truck.
ix. Crew bus.
x. Data van (a van used to house remote control equipment).
xi. Frack iron float (a tractor trailer that transports piping to the well site to connect the manifold and wellhead).
xii. Hydration unit (a tractor trailer hydration unit that mixes and retains fluids on the surface for polymers to hydrate).
xiii. Mobile food trailers.
xiv. Pick-up trucks.
xv. Sand conveyor (a trailer-mounted belt used at well site to transport sand from sand storage bins to the blender).
xvi. 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).
xvii. Sand transport (a tractor trailer used to transport sand from the bulk plant to the well site).
xviii. Equipment used to build the pipelines such as bulldozers, front loaders, or road fabric, except for equipment used in reclamation.

E. Vehicles and Special Mobile Equipment ("SME")

The mining exemption does not apply to any vehicles required to be registered under The Vehicle Code. Under the Vehicle Code, non-self-propelled SME are exempt from registration. Thus, such SME is eligible for the mining exemption if it is predominantly used directly in mining.

1. Exempt
   1. Non-self-propelled equipment with an SME-plate issued by the Pennsylvania Department of Transportation ("PennDOT") if used predominately and directly in gas mining.
   2. Non-self-propelled equipment without a SME-plate only if it is:
      i. Not designed for or used in transportation of property other than tools or parts for the equipment,
      ii. Primarily for off-highway use and only operates incidentally on the highway, and
      iii. Used predominantly and directly in gas mining.

   NOTE: The burden of proof is on the person who claims that equipment is an SME not required to be registered under the Vehicle Code. This burden will be met if the person obtains a written PennDOT determination that the equipment qualifies as a non-self-propelled SME, *e.g.*, frack tank trailers.
2. Taxable
   1. All self-propelled SME.
   2. Mobile dormitories and offices.

F. Gas Storage

The definition of "mining" includes the extraction of natural resources from stockpile. As such, the withdrawal of gas from gas storage is considered an exempt mining activity. Consequently, equipment predominantly used directly in withdrawing natural gas from a storage facility is exempt. On the other hand, equipment used to inject gas into storage, storage equipment and facilities for finished product are taxable.

G. Distribution

Meters used to measure gas usage of the property owner are taxable unless used by a public utility.

H. Research

Property used directly in research activities with the objective of producing a new or improved product or method of producing a product is exempt whereas property used in market research or in other research that is conducted with the objective of improving administrative efficiency is taxable.

I. Services

1. Maintenance, repair and cleaning services on exempt property are exempt, as are repair or replacement parts for exempt machinery and equipment. Operational supplies such as fuel, lubricants, paint, etc. are exempt if actively and continuously used in the operation of exempt machinery and equipment.
2. Maintenance, repair and cleaning services on taxable property are taxable. Also taxable are repair or replacement parts for taxable machinery and equipment.
3. The purchase or rental of property used to perform maintenance, repair and cleaning services are taxable regardless of the taxability of the property on which the services are performed. Equipment and supplies used in general cleaning and maintenance of mining property such as soaps, cleaning compounds, brushes, brooms, mops and similar items are also taxable.
4. Services, other than cleaning services, which do not alter the property on which the service is performed, such as calibration, inspection or testing, are exempt.
5. The other enumerated taxable services in the statute, including lobbying, adjustment services, collection services, credit reporting services, secretarial or editing services, disinfecting or pest control services, building maintenance or cleaning services, employment agency or help supply services, lawn care services or self-storage services are taxable even if directly used in a mining activity.

Information Notice
Realty Transfer Tax 2014-01

Real Estate Company Acquisitions after Act 52 of 2013
Issued: October 17, 2014

General Overview

Act 52 of 2013 was signed into law on July 9, 2013. Act 52 made numerous changes to the Tax Reform Code of 1971, including changes to the Realty Transfer Tax rules related to real estate company acquisitions. The changes related to the real estate company acquisitions became effective on January 1, 2014.[1]

Purpose

The purpose of this notice is to explain the Act 52 changes related to real estate companies and real estate company acquisitions for Pennsylvania realty transfer tax.

Summary of Changes

Act 52 made the following changes related to real estate companies and real estate company acquisition rules for Pennsylvania Realty Transfer Tax purposes:

1. Gross Receipts and Asset Tests: It clarified that a real estate company is determined by taking into consideration its real estate everywhere, not just real estate located in Pennsylvania.
2. Expanded Definition of Real Estate Company: It provides that a corporation or an association can be a real estate company even if it doesn't own real estate. Now, a corporation or association that is owned by thirty-five or fewer persons and which has assets 90 percent of the fair market value of which are interests in one or more real estate companies is a real estate company.
3. Binding Commitments and Options: It provides that a legally binding commitment or option to transfer an interest in a real estate company, enforceable at a future date, is deemed a transfer of an interest in a real estate company at the time of the execution of the commitment or grant of the option.

[1] Local Realty Transfer Tax under Article XI-D of the Tax Reform Code mirrors the State Realty Transfer Tax Law. Therefore, Act 52's changes also apply to Local Realty Transfer Tax. The Department has the authority to assess can collect Realty Transfer Taxes for the local municipalities (not including the City of Philadelphia) and school districts.

GROSS RECEIPTS AND ASSET TESTS

Historically, the only way for a corporation or an association to be a real estate company was if the corporation or association directly owned real estate and it was primarily engaged in the business of holding, selling or leasing the real estate. If a corporation or association satisfied this criterion, there were two tests used to determine if a corporation or association holds sufficient real estate to be considered a real estate company—the gross receipts test and the asset test. Under these tests, the corporation or association must either:

1. Derive sixty per cent or more of its annual gross receipts from the ownership or disposition of real estate ("gross receipts" test); or
2. Hold real estate, the value of which comprises ninety per cent or more of the value of its entire tangible asset holdings exclusive of tangible assets which are freely transferable and actively traded on an established market ("asset" test).

Act 52 clarified that these two tests are applied to the corporation or association's entire real estate holdings, not just Pennsylvania real estate.

It should be noted that even though the corporation or association's entire real estate holdings are used to determine if the corporation is a real estate company, the Pennsylvania Realty Transfer Tax that is imposed upon the acquisition of a real estate company is only imposed upon the value of company's Pennsylvania real estate.

EXPANDED DEFINITION OF REAL ESTATE COMPANY

After Act 52, a corporation or association can be a real estate company (even if it doesn't own real estate) by virtue of its direct ownership interest in a real estate company or ownership in a real estate company through a tiered structure.

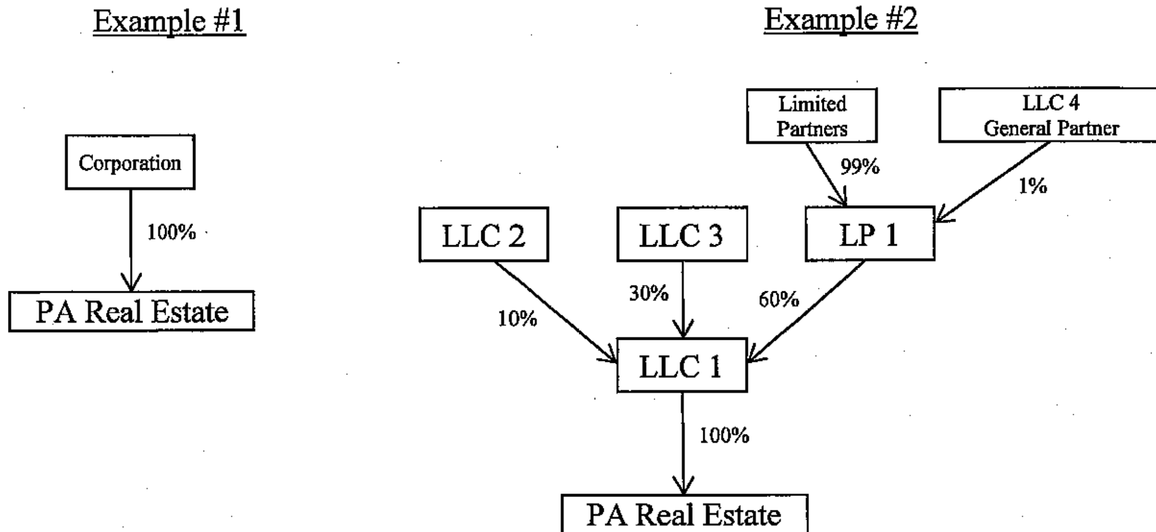
Under Act 52, a corporation or association is a real estate company if:

1. Ninety per cent or more of the ownership interest in the corporation or association is held by thirty-five or fewer persons, and
2. The corporation or association owns, as ninety per cent or more of the fair market value of its assets, a direct or indirect interest in a real estate company.

Examples of Real Estate Company Structures

In the following examples, it is assumed that all of the corporations or associations are owned by thirty-five or fewer people and their sole assets are real estate or interests in their respective corporation or association.

In Example #1 below, Corporation is a real estate company due to its direct ownership of Pennsylvania Real Estate. In Example #2, LLC 1 is a real estate company due to its direct ownership of Pennsylvania Real Estate. Further, LLC 2, LLC 3 and LP 1 are all real estate companies due to their ownership in LLC 1, which is a real estate company. LLC 4 is also a real estate company due to its ownership of LP 1, which is a real estate company.

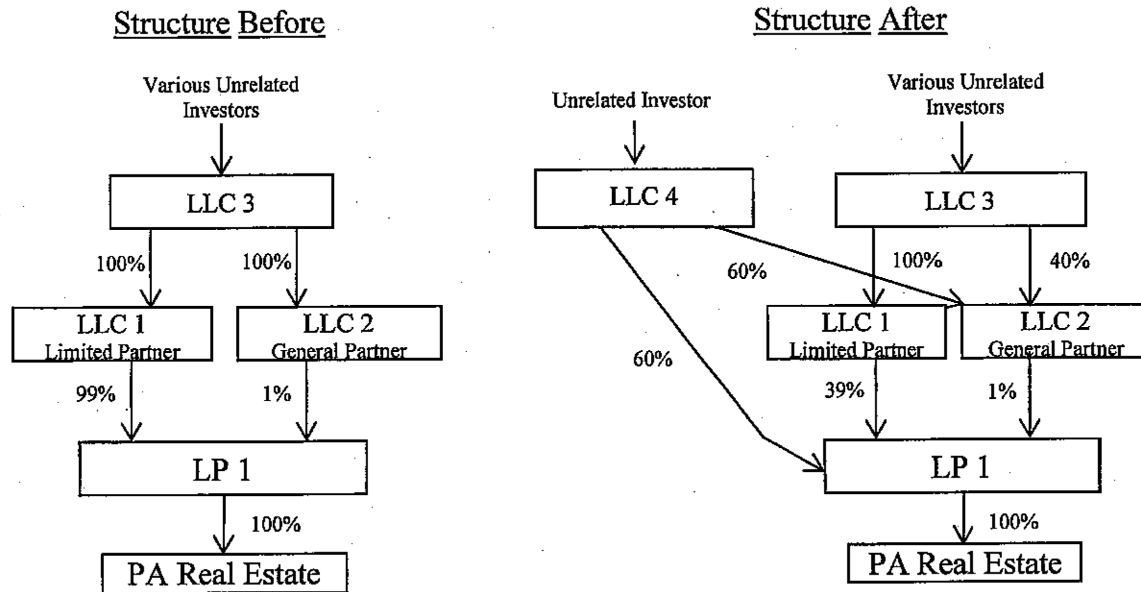


Real Estate Company Acquisitions

For Realty Transfer Tax purposes, tax is imposed upon the value of a real estate company's Pennsylvania real estate when the real estate company is acquired. An acquisition occurs when ninety percent or more of the ownership interest in the real estate company changes within a three year period.

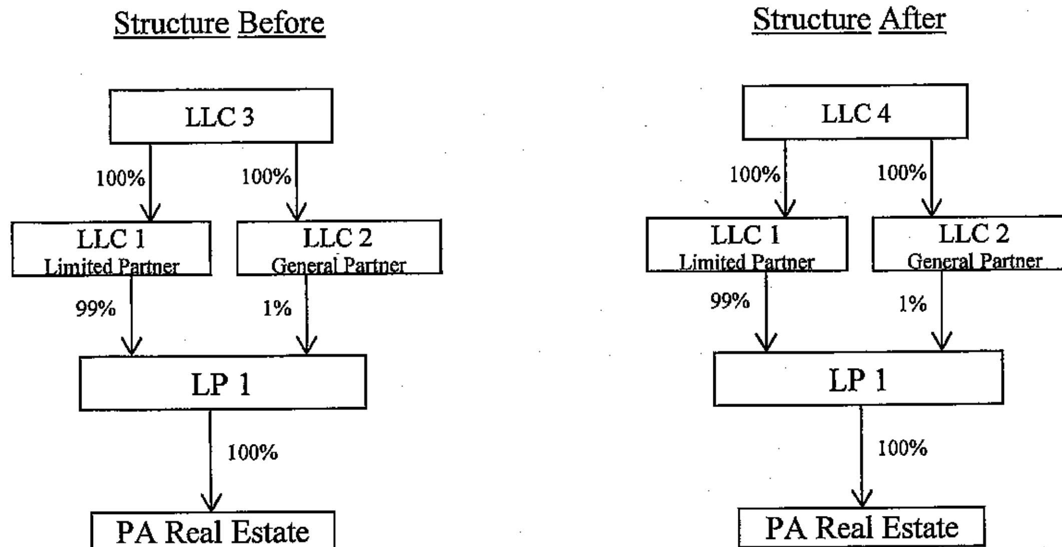
For Pennsylvania Realty Transfer tax purposes, the Department does not "look through" real estate companies ("tiers of ownership") to determine if the company has been acquired. The Department only looks to direct changes in ownership of the real estate company itself. (A corporation or association that owns an interest in a real estate company may itself be a real estate company that can become acquired, but the Department will not look to ownership changes in upper-tiered entities to determine if an acquisition of a lower-tiered real estate company has occurred.)

Example #3



In the "Before" structure above, LP 1 is the only entity that directly owns Pennsylvania real estate. LP 1 is a real estate company. LLC 1, LLC 2 and LLC 3 are all real estate companies by virtue of their ownership in LP 1. In the "After" structure, LLC 4 acquires a 60% ownership interest in LP 1 (it acquires 60% of LLC 1's ownership interest in LP 1) and a 60% ownership interest in LLC 2 (it acquires 60% of LLC 3's ownership interest in LLC 2). In this example, the Department looks to each tier of ownership to determine if an acquisition has occurred. Because there has only been a direct 60% ownership change in LP 1, there is no acquisition of LP 1. Further, because there is only a direct 60% ownership change of LLC 1, there is no acquisition of LLC 1. The 60% change of LP 1 and the 60% change in ownership of LLC 1 are not combined together to determine if an acquisition has occurred because the acquisitions occur on different tiers of ownership.

Example #4



In the "Before" structure above, LP 1, LLC 1, LLC 2 and LLC 3 are all real estate companies. LP 1 is the only real estate company that directly owns Pennsylvania real estate. In the "After" structure, LLC 4 purchases LLC 3's interests in LLC 1 and LLC 2. In this case, LLC 1 and LLC 2 are acquired real estate companies. LP 1 is not an acquired real estate company because LLC 1 and LLC 2 remain the owners of Real Estate LP 1.

Three Year Look-Back Rule

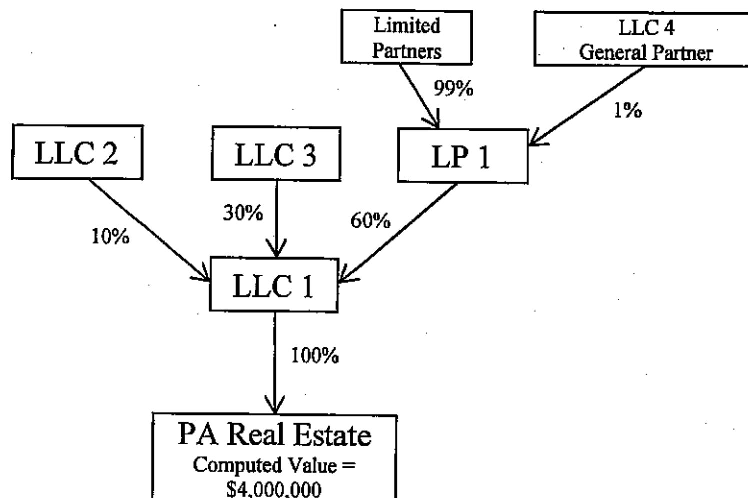
For purposes of determining if a corporation or association is an acquired real estate company, changes of ownership interest are only counted if they occur during a period when the corporation or association is a real estate company. For example, if in a three year period 30% of the stock ownership of a real estate company changes hands in year 1 and 65% changes hands in year 3, the company is acquired because there has been a 95% change within a three year period. However, under those same facts, if the company was not a real estate company during year 1, then the company would not be an acquired real estate company because 30% (of the 95%) was acquired when the company was not a real estate company.

Some corporations and associations that were not real estate companies will become real estate companies after the effective date of Act 52. When applying the three year look-back period for real estate company acquisition purposes, the Department will not look to changes of ownership interests in such corporations or associations prior to January 1, 2014, when those corporations and associations were not real estate companies.

Valuation

When a real estate company is acquired, realty transfer tax is imposed upon the computed value[2] of the company's real estate located in the Commonwealth. After Act 52, a real estate company may own Pennsylvania real estate either directly or indirectly through its ownership of interests in other real estate companies. In cases where a real estate company becomes acquired, it must pay tax on the computed value of real estate it owns directly and on the computed value of real estate it owns indirectly through its ownership in other real estate companies. The taxable value of real estate owned indirectly will be the computed value of the real estate multiplied by the real estate company's proportionate ownership interest in the real estate company that owns the Pennsylvania real estate directly.

Example #5



LLC 1, LLC 2, LLC 3, LLC 4 and LP 1 are all real estate companies. LLC 1 is the only real estate company that directly owns Pennsylvania real estate. All the other companies are real estate companies by virtue of their ownership in LLC 1. If LLC 1 becomes an acquired real estate company, tax would be imposed upon the $4,000,000 computed value of the Pennsylvania real estate that it owns. If one of the other companies would become acquired, tax would be imposed upon the proportion of the $4,000,000 computed value of the Pennsylvania real estate that it owns through LLC 1. Acquisition of those entities would result in tax on the following values:

LLC 2: $ 4,000,000 x 10% = $ 400,000
LLC 3: $ 4,000,000 x 30% = $ 1,200,000
LP 1: $ 4,000,000 x 60% = $ 2,400,000
LLC 4: $ 4,000,000 x (60% x 1%) = $ 24,000

[2] Computed value is real estate's assessed value for local real estate tax purposes adjusted by the common level ratio of assessed values to market values of the taxing district as established by the Pennsylvania State Tax Equalization Board.

BINDING COMMITMENTS AND OPTIONS

Another significant change under Act 52 is that the execution of a legally binding commitment (an executory agreement) or the grant of an option to transfer an interest in a real estate company at a future date is deemed to be a transfer of an interest in a real estate company at the time of the execution of the commitment or grant of the option. It is irrelevant whether the option is ever exercised or if the interest in the real estate company under executory agreement or option is ever transferred. The execution of the agreement or the grant of the option is deemed a transfer of the interest at the time the agreement is executed or the option is granted.

A legally binding commitment or option should be distinguished from a mere non-binding agreement to negotiate a future transfer of an interest in a real estate company. The former triggers a deemed transfer of the interest in the real estate company, where the latter does not. In order to be a non-binding agreement to negotiate a future transfer, the parties must be free to fully negotiate for the transfer of interests in a real estate company in the future. The terms of the transfer may not be established in advance and all parties must be free to accept or reject any or all terms of the future transfer.