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# Real estate taxation

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# re real estate taxation

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# OIL AND GAS WORKING INTERESTS

If the parties can be flexible in structuring the investment, oil and gas working interests can be qualifying replacement property in Section 1031 transactions.

## AS SECTION 1031 REPLACEMENT PROPERTY

DANIEL F. CULLEN

**A** fellow tax practitioner (and good friend) once said that the federal taxation of oil and gas interests is a world apart from the taxation of partnerships under Subchapter K. As usual, he was correct. This bit of advice rings particularly true when evaluating whether or not an oil and gas working interest constitutes qualified replacement property in a like-kind exchange of real property under Section 1031.<sup>1</sup> The threshold question in making such a determination is whether the working interest is treated as an interest in real property for purposes of Section 1031. One also must consider the impact of certain commonplace arrangements used in traditional oil and gas transactions, including "production payments" and "farm-out" arrangements.

### In general

Section 1031(a)(1) provides that "[n]o gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Nonrecognition treatment does not apply, however, if the

property being exchanged (1) is either a "security" or an "interest in a partnership"<sup>2</sup> and (2) a valid Section 761(a) election to be excluded from the application of Subchapter K is *not* in effect. For Section 1031 purposes, an interest in a partnership for which a valid Section 761(a) election *is* in effect is treated as an interest in each asset of the partnership.<sup>3</sup> Accordingly, interests in such a partnership can be exchanged without gain recognition provided the requirements of Section 1031 are otherwise satisfied.

If, in an otherwise-qualifying Section 1031 like-kind exchange, the taxpayer receives non-qualifying property (sometimes referred to as "boot"), he or she must recognize gain to the extent of the amount of the cash and the value of the boot received.

For purposes of Section 1031, the assumption of a liability to which relinquished property is subject generally is treated as boot by the relinquishing taxpayer.<sup>4</sup> If, however, a taxpayer transfers relinquished property subject

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to a liability, and receives in the exchange replacement property subject to a liability (or otherwise assumes the liability of another party), the amount of liabilities "transferred" and "assumed" are offset against one another.<sup>5</sup> In such a case, the taxpayer will be deemed to have received "boot" only to the extent that the relinquished liability exceeds the replacement liability, if any. As discussed in greater detail below, this rule of Section 1031 becomes highly relevant in determining whether a production payment constitutes a "liability" for Section 1031 purposes.

Another requirement for nonrecognition treatment under Section 1031 is that it be "held" by the taxpayer (the "holding requirement") either for productive use in a trade or business or for investment.<sup>6</sup> This statutory requirement is based on the underlying assumption that nonrecognition treatment requires a substantial continuation of the old investment *still unliquidated*, which occurs when the character of the property relinquished and the property received are substantially similar.<sup>7</sup> Whether an investor has violated the holding requirement is a critical issue in properly analyzing whether a farm-out arrangement qualifies for nonrecognition.

### Working interests as like-kind property

It is well established that a working interest in oil and gas in place is an interest in real property for federal income tax purposes. In Rev. Rul. 68-226,<sup>8</sup> the IRS noted:

[T]he various state jurisdictions are not in agreement as to the characterization of [leasehold interest in oil and gas in place] as real property, personal property, or some other type of interest. The

Federal revenue laws, however, are not to be deemed subject to state law unless the express language or necessary implication of the section involved so requires.

Subsequent revenue rulings and private letter rulings have cited Rev. Rul. 68-226 for the proposition that working interests (as well as other economic interests in minerals in place) constitute real property for federal income tax purposes.<sup>9</sup> Moreover, the Internal Revenue Manual (IRM) provides that "[a]n interest in an oil and gas lease is an interest in 'real property' for federal income tax purposes," citing Rev. Rul. 62-226. This ruling applies *in all cases*, regardless of how the oil and gas lessee's interest is treated under state law."<sup>10</sup>

An oil and gas interest, although an interest in real property, is not "like-kind" to a fee simple interest in real property if the right to oil and gas evidenced by the interest is of limited duration.<sup>11</sup> In contrast, a working interest in a producing oil lease that extends to the exhaustion of the mineral deposit is "like-kind" to a fee simple interest in real property.<sup>12</sup> Thus, unlike a real estate lease, whether an interest in an oil lease is for a stated term of at least 30 years is irrelevant to the "like-kind" inquiry if the oil or gas lease in question remains in effect until the well is exhausted.

### Deemed partnerships and Section 761

In light of the above, all of the underlying documents creating an oil and gas investment should be reviewed as a threshold matter in connection with establishing that a working interest constitutes an interest in real property for purposes of Section 1031. In making this determination, practitioners should review the terms

**A WORKING INTEREST IN OIL AND GAS IN PLACE IS AN INTEREST IN REAL PROPERTY FOR FEDERAL INCOME TAX PURPOSES.**

<sup>1</sup> Generally speaking, a "working interest" is the operating leasehold estate interest created by an oil and gas lease whereby the holder acquires the exclusive right to exploit the minerals on the leased property.

<sup>2</sup> Sections 1031(a)(2)(C), (D).

<sup>3</sup> Section 1031(a)(2).

<sup>4</sup> See generally Reg. 1.1031(b)-1(c).

<sup>5</sup> Reg. 1.1031(b)-1(c). See also Reg. 1.1031(j)-1(b)(2)(iii).

<sup>6</sup> Section 1031(a)(1).

<sup>7</sup> Reg. 1.1002-1(c).

<sup>8</sup> 1968-1 CB 362.

<sup>9</sup> See Ltr. Rul. 8237017 ("[t]he working interests presently held by the Owners and the overriding royalty interests to be held by them are, accordingly, properties of a like kind within the meaning of Section 1031(a) ... since each is a continuing interest in real property"); Rev. Rul. 55-526, 1955-2 CB 574; Rev. Rul. 88-78, 1988-2 CB 330; GCM 39767, 12/5/88. But see Crichton, 122 F.2d 181, 27 AFTR 824 (CA-5, 1941) (under the predecessor to Section 1031,

"[t]he commissioner concedes, as he must, that under Louisiana law, mineral rights are interest not in personal but real property"); TAM 200424001 ("[I]n the present case, any relinquished property consisting of components of railroad track that are assembled and attached to the land and considered real property for state law purposes cannot be considered like kind to unassembled and unattached components, which are personal property under applicable state law"); Rev. Rul. 55-749, 1955-2 CB 295 (perpetual water rights constituted real property for purposes of Section 1031 where state law characterized such rights as real property). See also Peabody Natural Resources Company, 126 TC 261, (exchange of a gold mine for a coal mine subject to coal supply contracts qualified as a like-kind exchange for purposes of Section 1031, and supply contracts were not taxable as boot).

<sup>10</sup> IRM (Oil and Gas Handbook), 4.41.1.4.1 (last revised 7/31/02).

<sup>11</sup> Crichton, *supra* note 9, *aff'd* 42 BTA 490 (1940), *acq.* 1952-1 CB 2.

<sup>12</sup> Rev. Rul. 68-331, 1968-1 CB 352.



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of all investment agreements presented to a Section 1031 investor, including any production payment agreements or farm-out agreements (discussed below), as well as the underlying oil and gas leases and any joint operating agreements (the "JOAs"). These documents collectively are referred to below as the "operative documents." Under the operative documents, the parties should collectively agree:

- That any tax partnership(s) created by virtue of the relationships and activities pursuant to the JOAs, if any such partnerships are created, are to be excluded from the application of Subchapter K and that there is no intention to create a partnership pursuant to the provisions of the operative documents.
- To report their respective shares of income, deduction, and credit attributable to their respective working interests on their respective tax returns in a manner consistent with the exclusion from Subchapter K.

In addition to the threshold issues discussed above, one must carefully review contractual arrangements under the operative documents to determine if the "deal terms," when viewed in the aggregate, constitute a partnership for federal income tax purposes. For such purposes, it is irrelevant whether the contractual arrangement is or is not recognized as a "partnership" entity under local law.<sup>13</sup> In addressing when a contractual arrangement gives rise to an entity for federal income tax purposes, Reg. 301.7701-1(a)(2) provides:

*A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.... Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes.... Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.*

If a contractual arrangement gives rise to a separate entity for federal income tax purposes, it must then be determined whether that entity is a "partnership" for such purposes. Accordingly, the JOAs governing the oil and gas investment should be carefully reviewed. Section 761(a) defines a "partnership" to include "a syndicate,

group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on," so long as the entity is not a corporation, trust, or estate under the Code.

Section 761(a) permits regulations allowing all the members of a partnership to exclude it from "the application of all or part of" Subchapter K "if it is availed of ... for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted ... if the income of the members of the organization may be adequately determined without the computation of partnership taxable income."

Reg. 1.761-2(a)(3) provides that a Section 761(a) election can be made if the participants in the joint production, extraction, or use of property:

- "Own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights."
- "Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used."
- "Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year."

A Section 761(a) election is made by filing a statement with a properly executed partnership tax return.<sup>14</sup> Alternatively, an election will be deemed to be made if the facts and circumstances demonstrate that it was the intention of the members that the arrangement be excluded from the application of Subchapter K commencing with the first tax year of the arrangement.<sup>15</sup> The Treasury regulations provide that either of the following facts may indicate the requisite intent:

- At the time the venture is formed, there is an agreement among the participants that the organization be excluded from Subchapter K beginning with the first tax year of the venture.
- The participants of the venture report their respective shares of the items of income, deductions, and credits of the venture on their respective tax returns,

<sup>13</sup> Reg. 301.7701-1(a)(1).

<sup>14</sup> Reg. 1.761-2(b)(2).

<sup>15</sup> Reg. 1.761-2(b)(2)(ii).



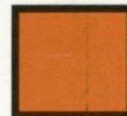
and make elections as to individual items as may be appropriate in a manner consistent with the exclusion of the venture from Subchapter K, beginning with the first tax year of the venture.<sup>16</sup>

If a Section 761(a) election is not made or is not available, the activities conducted pursuant to the agreements may constitute a partnership for federal income tax purposes among the working interest owners and the operator, even though no state law "partnership" entity is formed.<sup>17</sup>

It also is possible that the contractual relationship among the investors, the operating company, and/or a promoter created by the operative documents could be classified as a partnership for federal income tax purposes as a result of the compensation provided to the participants. There is no bright-line test in making this determination. The determination seems primarily to depend on whether the operating company or promoter is a true co-owner of an enterprise with the investors. In determining whether a participant is a partner or an independent contractor, the IRS and the courts generally have used the nine factors set forth below as a framework.<sup>18</sup> The courts point to the absence of a right to participate in overall management and control of the business or venture as having particular importance in distinguishing partners from employees or servants.<sup>19</sup> Even if managerial discretion is vested in a person, however, the courts have concluded that the person may nevertheless be held to be an employee, agent, or independent contractor if he or she has no substantial interest in the capital and has no liability for losses of the venture.<sup>20</sup> If the participants can realize income only by joining together to operate or sell the product produced by the venture, however, a partnership exists.<sup>21</sup>

The courts have focused on the following factors when analyzing whether a partnership exists:

1. *Intent.* In *Culbertson*,<sup>22</sup> the Supreme Court indicated that the existence of a partnership depends on whether, considering all of the facts and circumstances, the parties intended to join together in the conduct of an enterprise. The test set out in *Culbertson* applies to determining whether a manager is an independent contractor or a partner. In light of this factor, the operative documents should specifically state that the investors do not intend to form a partnership with the operating company or other participants in the oil and gas investment.
2. *Joint contribution of capital or services.* A person generally must contribute capital or services to a venture to be classified as a partner. Accordingly, all services to be provided pursuant to the operative documents should be in exchange for a fee and not in exchange for an ownership interest in the underlying oil and gas project. In determining whether an independent contractor is a partner, the fact that services are provided generally is not a significant factor. Instead, the courts have held that the intent of the parties, whether the parties are co-proprietors, and the control of the business are the important elements.<sup>23</sup> Likewise, the provision of development services in exchange for a mineral interest is viewed, not as creating a joint venture relationship, but simply as payment for increasing the value of the mineral interest.
3. *Joint capital and ownership of capital and earnings.* One of the most important elements is whether the participant will have



**ONE MUST CAREFULLY REVIEW CONTRACTUAL ARRANGEMENTS TO DETERMINE IF THE 'DEAL TERMS,' VIEWED IN THE AGGREGATE, CONSTITUTE A PARTNERSHIP.**

A JOINT UNDERTAKING MERELY TO SHARE EXPENSES DOES NOT CREATE A SEPARATE ENTITY FOR FEDERAL TAX PURPOSES.

<sup>16</sup> Regs. 1.761-2(b)(2)(ii)(a), (b).

<sup>17</sup> See generally Reg. 301.7701-1(a)(1); Cokes, 91 TC 222 (1988) (owner of a working interest in oil and gas properties was a partner in a partnership); Ltr. Rul. 7951080 (an arrangement between co-owners of undivided fractional interests in oil and gas leases was a partnership unless a Section 761(a) election was deemed to have been made); McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* (Warren, Gorham & Lamont, 2007) ¶ 3.02[4] ("[a] partnership may result from a joint extraction or production arrangement among co-owners of mineral property ... even though the co-owners separately take and sell (or reserve the right to take and sell) their shares of production").

<sup>18</sup> See GCM 36436 (9/25/75); GCM 36961 (12/21/76).

<sup>19</sup> Estate of Kahn, 499 F.2d 1186, 34 AFTR2d 74-5278 (CA-2, 1974); James, 16 TC 930 (1951), *aff'd per cur.*, 197 F.2d 813, 42 AFTR 242 (CA-5, 1952); Kirk, 179 F.2d 619, 38

AFTR 1331 (CA-1, 1950); Estate of McDaniel, TCM 1961-302; Finch, TCM 1955-179; Allison, TCM 1976-248 (financial service corporation received lots as payment for services and not as a joint venture; absence of shared control a factor negating joint venture status).

<sup>20</sup> Duley, TCM 1981-246 (no partnership even though profit sharing because no intent to form partnership, no sharing of losses, and no material interest in capital); Koss, TCM 1989-330 (no partnership when joint sharing of profits because no obligation to contribute capital or share losses and no proprietary interest in profits); Ltr. Rul. 8003027.

<sup>21</sup> Bussing, 89 TC 1050 (1987); Alhouse, TCM 1991-652 (1991).

<sup>22</sup> 337 U.S. 733, 37 AFTR 1391 (1949).

<sup>23</sup> Kessler, TCM 1982-432 (no partnership when participants received share of profits because in the absence of the interest there was no interest in capital).



joint control over the capital and earnings of the venture. Without such control, a service provider will usually be treated as an independent contractor. In most cases, the operating company will have some degree of limited control over cash from the oil and gas project. However, in most cases, the operating company will not have the power to spend such funds as it desires. Rather, it will be limited to acting pursuant to the specific terms provided under the operative documents.

4. *Sharing of profits as co-proprietors.* Partners generally share profits as co-proprietors. A sharing of profits alone, however, is not sufficient to make partners or joint venturers out of participants in a business enterprise if the requisite element of co-ownership is not established.<sup>24</sup> A profit share in a business enterprise can be received by an employee or independent contractor as a measure of his or her compensation for services without the employee or independent contractor becoming a partner in the enterprise. A share of net receipts, as opposed to gross receipts, is stronger evidence that a partnership relationship exists. In light of this, most fees paid to an operator or promoting company should not depend on profits from the property, but instead merely whether there is commercially producing quantities from the property.
5. *Sharing of losses.* Although not required to obtain partner status, in close cases an agreement to share losses may be the difference between being treated as a partner or an independent contractor. A mere profit-sharing agreement would not be taxed as a partnership absent an intent to form a partnership, especially if there was no agreement to share losses.<sup>25</sup> In most cases, the operator or promoter will not share in losses generated by the property as long as the operative documents do not obligate the operator or promoter to bear any expenses of the property.

6. *Control over the business.* An arrangement whereby two or more persons share the profits of a common undertaking does not constitute a joint venture in the absence of the power to control.<sup>26</sup> However, a partner can delegate authority to others, and the failure to exercise daily managerial control will not prevent a relationship from being characterized as a partnership.<sup>27</sup> Accordingly, the operator promoter should not have control over any significant issue regarding the property, such as the power to sell. Instead, the operative documents should simply allow the operator to provide for convenient administration of the investor's interest.

7. *Parties' agreement and conduct in executing its terms.* The operative documents should specifically state that the parties do not intend to create a partnership or joint venture. In most cases, the agreements among the parties, and their conduct in executing their terms, should not be indicative of a partnership for federal income tax purposes.
8. *Maintenance of separate books.* In almost all cases, the operator or promoter should not keep books or records on behalf of the investors as an entity. Instead, information should be maintained so that each investor can separately report his or her share of income.
9. *Filing of tax returns or other partnership action.* The operative documents should prohibit the parties from otherwise acting or holding themselves out as partners in a partnership.

### **Production payment treated as 'liability' for Section 1031 purposes**

In many cases, parties to an oil and gas working interest transaction enter into a "production payment" arrangement in connection with an investor's purchase of an interest. Generally speaking, a production payment is a contractual arrangement giving the owner or holder a right to receive a fraction of production—or of the proceeds of the sale of production—until a specified quantity of production or a definite sum of money (including interest) has been received.

In most cases, a production payment should constitute a liability for Section 1031(b) purposes if, for federal income tax purposes, it

<sup>24</sup> See GCM 36113, 12/19/74; Rev. Rul. 75-43, 1975-1 CB 383.

<sup>25</sup> See Duley, TCM 1981-246; see also Ltr. Rul. 8508024; Kessler, TCM 1982-432 (noting that a party who held a profits interest had no obligation to share in losses).

<sup>26</sup> Joe Balestrieri and Co., 177 F.2d 867, 38 AFTR 989 (CA-9, 1949).

<sup>27</sup> See S. & M. Plumbing Co., 55 TC 702 (1971), *acq.*, 1971-2 CB 3; Podell, 55 TC 429 (1970).



meets the definition of a "retained" production payment that is treated as a purchase money mortgage loan. Accordingly, an investor that disposes of real property subject to a liability and acquires an working interest burdened by a liability—i.e., an oil and gas "production payment"—in the same amount as the transferred liability should not be treated as having received taxable boot under Section 1031(b).

Under Section 636(b), a production payment that is created and "retained" on the sale of a mineral property burdened by the production payment (i.e., retained by the seller of the mineral property) is treated, for federal income tax purposes, as if it were a purchase money mortgage loan.<sup>28</sup> On the other hand, a production payment "carved out" of mineral property by the person who continues to own that property after the transfer of the production payment (i.e., a production payment that is transferred to another person) may or may not be treated as a purchase money mortgage loan.<sup>29</sup>

For federal income tax purposes, a production payment must confer specific rights with respect to a mineral property.<sup>30</sup> The holder must have a right to a specified share of production from minerals in place or the proceeds therefrom. It must be an economic interest in the minerals in place, and must have an economic life shorter than the economic life of the mineral properties burdened with the production payment. Economic lives are determined at the time the right is created. A right has an economic life shorter than that of the burdened mineral property only if the right is not "reasonably expected" to extend in "substantial amounts" over the entire productive life of such burdened mineral property. A production payment may burden more than one property.

The courts have not articulated a bright-line test for determining when it is reasonably expected that the economic life of the right will not extend in substantial amounts over the entire productive life of the burdened property. Such courts generally have determined, however, that "some reasonable degree of certainty, but less than absolute, is required."<sup>31</sup> Nonetheless, the IRS has concluded that favorable geological and geophysical surveys are not sufficient to establish a "reasonable expectation" without other supporting facts (e.g., production by adjoining properties of a similar nature, etc.).<sup>32</sup>

According to Rev. Proc. 97-55,<sup>33</sup> the IRS generally will issue an advance ruling that a right


to minerals in place constitutes a production payment under all of four conditions:

- The right is an economic interest in a mineral in place as defined in Reg. 1.611-1(b) without regard to the application of Section 636.
- The right is limited by a specified dollar amount, a specified quantum of mineral, or a specified period of time.
- It is reasonably expected, at the time the right is created, that it will terminate upon the production of not more than 90% of the reserves then known to exist.
- The present value of the production expected to remain after the right terminates is 5% or more of the present value of the entire burdened property (determined at the time the right is created).

As to the first condition, Reg. 1.611-1(b) states that a taxpayer possesses an economic interest whenever he or she "has acquired by investment any interest in mineral in place ... and secures, by any form of legal relationship, income derived from the extraction of the mineral ... to which he must look for a return of his capital." An economic interest, then, itself must have three elements. It must entitle the operator or promoter to an interest in the minerals in place (i.e., the oil and gas in the ground). It must secure the right of the operator or promoter to derive income from the production (i.e., extraction) of the oil and gas. Finally, it must be the only source to which the operator or promoter will look for a return of the capital previously invested in acquiring the working interests sold to investors.

### Drilling assignments and the holding requirement of Section 1031

Many oil and gas working interest transactions also involve the use of drilling assignments or "farm-out" arrangements. Generally speaking, a drilling assignment is an agreement with the



**A JOINT UNDERTAKING MERELY TO SHARE EXPENSES DOES NOT CREATE A SEPARATE ENTITY FOR FEDERAL TAX PURPOSES.**

<sup>28</sup> See also Reg. 1.636-1(a)(1)(i).

<sup>29</sup> Section 636(a); Reg. 1.636-1(a)(1)(i). A production payment "carved out" for exploration or development of mineral property is treated as a purchase money mortgage loan only if and to the extent that gross income from the property would be realized by the taxpayer creating the production payment in the absence of Section 636(a). Reg. 1.636-1(b).

<sup>30</sup> Reg. 1.636-3(a)(1).

<sup>31</sup> See generally *Yates*, 924 F.2d 967, 67 AFTR2d 91-462 (CA-10, 1991).

<sup>32</sup> Rev. Rul. 86-119, 1986-2 CB 81.

<sup>33</sup> 1997-2 CB 582.



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owner of a lease who is not interested in drilling. Under the agreement, such an owner assigns the lease or a portion of it to another party that will earn a share of the resulting production by undertaking exploration.

Neither the Code nor regulations establish an objective rule for determining how long a taxpayer must hold replacement property to satisfy the holding requirement. Rather, the facts and circumstances surrounding the exchange of property must be examined. The taxpayer's intent at the time of the exchange controls.<sup>34</sup>

The transfer of replacement property subsequent to the Section 1031 exchange in which it was received might violate the holding requirement. A disposition of such property in a recognition (i.e., a taxable) transaction shortly after it is received will be significant evidence that the taxpayer did not intend to "hold" it. Whether a disposition in a nonrecognition (i.e., non-taxable) transaction shortly after the exchange violates the holding requirement, however, generally depends on what the transferring taxpayer receives in exchange. More specifically, the courts have concluded that the holding requirement generally will not be violated if the taxpayer continues to maintain an economic interest in the replacement property received in the exchange.

For example, in *Maloney*,<sup>35</sup> the Tax Court determined that a corporation did not violate the holding requirement when it received replacement property in a Section 1031

exchange, then distributed the replacement property to the corporation's shareholders in complete liquidation. In so doing, the Tax Court noted that the exchange reflected "both continuity of ownership and of investment intent.... *Petitioners [the distributee shareholders] continued to have an economic interest in essentially the same investment.*"<sup>36</sup>

On the other hand, in Rev. Rul. 75-292,<sup>37</sup> the Service determined that a prearranged exchange of like-kind property by an individual followed by a contribution of the property received to the individual's newly created corporation violated the holding requirement. It is critical to note that when evaluating the impact of a "drilling assignment" on an investor's like-kind exchange into a working interest, the test to be considered is the "pool of capital doctrine."

The "pool of capital doctrine," in its basic form, provides that a taxpayer who assigns an economic interest to another person, which interest will contribute materials and/or services in connection with the development of a mineral property, is not treated as making a taxable disposition of property.<sup>38</sup> The underlying theory of the pool of capital doctrine, as applied to the assignor of an economic interest, is that the assignor has not parted with any capital interest. Rather, the assignor has merely lessened its required investment in the development of the mineral properties and the risks and burdens associated therewith.<sup>39</sup>

The pool of capital doctrine originated in the Supreme Court decisions in *Burnet v. Harmel*<sup>40</sup> and *Palmer v. Bender*,<sup>41</sup> and came into full force in GCM 22730.<sup>42</sup> In GCM 22730, the IRS addressed leasing and subleasing of mineral interest as follows:

[T]he lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed from the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation.... So considered, the view that a "lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee, acquires a capital interest upon the execution or assignment of a lease presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery."<sup>43</sup>

<sup>34</sup> See *Click*, 78 TC 225 (1982) ("A taxpayer's intent to hold property for investment must be determined as of the time of the exchange"); Section 1031(a)(1) ("...if such property is exchanged solely for property of a like kind which is to be held either for productive use in a trade or business or for investment" [emphasis added]).

<sup>35</sup> 93 TC 89 (1989).

<sup>36</sup> *Maloney*, *id.* (emphasis added). See also *Magneson*, 81 TC 767 (1983) (holding, prior to exclusion of partnership interests from nonrecognition under Section 1031, that the exchange of property, followed by the contribution of the replacement property to a partnership in exchange for a general partnership interest, did not violate the holding requirement because the taxpayers "merely effected a change in the form of the ownership of their investment."); Ltr. Rul. 8126070 ("the mere fact that the trust will terminate shortly after the [Section 1031 exchange] will not by itself preclude the property received ... from being property held either for productive use in a trade or business or for investment within the intent of [Section 1031(a)]").

<sup>37</sup> 1975-2 CB 333.

<sup>38</sup> See generally Rev. Rul. 77-176, 1977-1 CB 77 (discussed below).

<sup>39</sup> *Id.*

<sup>40</sup> 287 US 103, 11 AFTR 1085 (1932).

<sup>41</sup> 287 US 551, 11 AFTR 1106 (1933).

<sup>42</sup> 1941-1 CB 214.

<sup>43</sup> GCM 22730, 1941-1 CB 214 (emphasis added).



GCM 22730 addresses arrangements made by the owner of a lease interest, with a driller to drill wells, equipment dealers to furnish equipment, or investors to furnish money, each for the development of the mineral property. When such an arrangement is made in exchange for a stated share of the oil:

...a lessee commonly lessens his own investment and the risk and burdens attending development by agreements to share the investment obligation and the proceeds of production. *The lessee or assignee ... has parted with no capital interest* but has merely in turn given another a right to share in production in consideration of an investment made by such other person.... [O]ne who, in return for an oil payment right, furnishes money which the lessee is pledged to use in developing the property would be regarded as making an investment representing an addition to the reservoir of capital investments in oil and gas in place (as distinguished from the purchase of an oil payment right from the lessee wherein there is no such pledge to invest the proceeds in development, and the buyer's capital investment would be replace the lessee's capital investment allocable to the interest sold).<sup>44</sup>

The essence of GCM 22730 and, more specifically, the pool of capital doctrine, is that where two or more parties pool their resources in furtherance of the exploration and development of a mineral property, no disposition of property giving rise to a taxable event has occurred. Shortly after the issuance of GCM 22730, the IRS attempted to ignore the pool of capital doctrine by arguing that a taxpayer engaged in a taxable exchange of an oil payment, but was unsuccessful in doing so.<sup>45</sup>

More than three decades after the issuance of GCM 22730, and in spite of questions raised by courts as to the applicability of the pool of capital doctrine to service providers,<sup>46</sup> the IRS confirmed the validity of the doctrine with respect to drilling assignments. Rev. Rul. 77-176, 1977-1 CB 77 involved a driller that assumed, pursuant to an assignment agreement, the obligation to drill a well and either complete and equip it if commercially productive or plug and abandon it if it was dry. In consideration for assuming that application, the driller received (1) the owner's entire working interest in the drill site, subject to the reservation by the owner of an overriding royalty interest<sup>47</sup> of an undivided 1/16th of all oil, gas, and other hydrocarbons produced, saved, and sold from the drill site; and (2) an undivided one-half of the working interest in property adjacent to the drill site. The assignment agreement further provided that after the driller recovered all costs of drilling, equipping,

and operating the well out of the proceeds from the working interest in the drill site, the assigning owner had the right to convert its overriding royalty interest to an undivided one-half working interest in the drill site.

Rev. Rul. 77-176 relied on the pool of capital doctrine espoused in GCM 22730 to conclude that the owner did not realize income upon the assignment of the working interest in the drill site because the owner "is not regarded as having parted with a capital interest but has only lessened the required investment and the risks and burdens attending development of the drill site."<sup>48</sup> In contrast, the IRS concluded that the pool of capital doctrine did not apply to the assignment of one-half of the working interest in the property adjacent to the drill site because the assignment did not relate to any development activity taking place on the adjacent property (i.e., there was no capital investment in the development of the adjacent property). Thus, Rev. Rul. 77-176 concluded that the pool of capital doctrine applies to assignments of working interests in the drill site, but not to assignments where the exploitation and development efforts of the driller are not with regard to the property in which the driller receives the mineral interest.

The IRS has limited the applicability of the pool of capital doctrine in certain circumstances. It indirectly restricted the applicability of the doctrine in Rev. Rul. 83-46<sup>49</sup> by instead applying Section 83 to require recognition of compensation income. In so doing, the IRS



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<sup>44</sup> *Id.* (emphasis added).

<sup>45</sup> See M.H. Marr, BTA Memo 1942-644.

<sup>46</sup> Courts have questioned the validity of the pool of capital doctrine as applicable to service providers. See e.g., James A. Lewis Engineering, Inc., 339 F.2d 706, 15 AFTR2d 9 (CA-5, 1964); Zuhone, 883 F.2d 1317, 64 AFTR2d 89-5451 (CA-7, 1989).

<sup>47</sup> A net profits interest is treated as an overriding royalty interest. See Rev. Rul. 73-541, 1973-2 CB 206 ("[W]here the payment for the privilege of extraction made to the lessor by the lessee is the portion of 'net income' paid under the lease, such payment of 'net income' is rent or royalty paid by the lessee for the privilege of extraction."), cited by IRM (Oil and Gas Handbook) 4.41.1.2.3.4. (last revised 7/31/02); and Rev. Rul. 94-48, 1994-2 CB 3. As such, both overriding royalty interests and net profits interests constitute economic interests in the underlying mineral property. See Southwest Exploration Co., 350 US 308, 48 AFTR 683 (1956); Kirby Petroleum Co., 326 US 599, 34 AFTR 526 (1946); Burton-Sutton Oil Co., 328 US 25, 34 AFTR 1017 (1946); IRM (Oil and Gas Handbook) 4.41.1.3.5 (last revised 7/31/02).

<sup>48</sup> *Id.* See also TAM 8047005 (taxpayer "was contributing its services to the pool of capital in rendering the services that led to its acquisition of the undivided economic interest in the oil and gas properties acquired").

<sup>49</sup> 1983-1 CB 16. Rev. Rul. 83-46 did not explicitly mention the pool of capital doctrine, GCM 22730, or Rev. Rul. 77-176.



determined that a corporate promoter, an attorney, and an employee of a closely held corporation who received overriding royalty interests in exchange for the performance of services provided to the corporation in regard to the acquisition and/or development of oil and gas leases all were required to include the fair market value of the overriding royalty interests in their gross income under Section 83.<sup>50</sup> A background information note in the ruling explains the absence of references to the pool of capital doctrine and authorities as follows:

[I]n view of the length of time GCM 22730 and Rev. Rul. 77-176 have been outstanding, it would not be feasible to revoke them. Reference to GCM 22730, Rev. Rul. 77-176, and the pool of capital doctrine, has been intentionally omitted in the proposed revenue ruling in favor of related factual scenarios, though sufficiently distinct from the GCM 22730 and Rev. Rul. 77-176. It is believed that this approach is the most effective way to accord compensatory arrangements relating to the acquisition and development of oil and gas properties the same tax treatment under §§ 61 and 83 of the Code as other compensatory arrangements in which property interests are received.... Because there has been little guidance from the courts on the scope of the doctrine, restrictive interpretations are justified.<sup>51</sup>

Despite this reference to restrictive interpretations of the pool of capital doctrine, taxpayers falling within the purview of Rev. Rul. 77-176 should be entitled to apply the doctrine to determine the federal income tax treatment of mineral interest assignments in connection

with drilling operations undertaken on the assigned mineral interest property.<sup>52</sup> The IRM confirms the validity of the doctrine as to drilling assignments by specifying that the following must occur for the pool of capital doctrine to apply:<sup>53</sup>

- The contributor of services must receive a share of production, and the share of production is marked by an assignment of an economic interest in return for the contribution of services.
- The services contributed may not in effect be a substitution of capital.
- The contribution must perform a function necessary to bring the property into production or augment the pool of capital already invested in the oil and gas in place.
- The contribution must be specific to the property in which the economic interest is earned.
- The contribution must be definite and determinable.
- The contributor must look only to the economic interest for the possibility of profit.

Additionally, the IRM confirms that "the acquisition or disposition of the interest in property by a farm-in or farm-out will not normally result in a taxable event, except for that property which is outside the "drill site" as described in Rev. Rul. 77-176."<sup>54</sup>

In many cases, if the above requirements are satisfied, the transfer of property rights under a drilling assignment should not violate the "held for investment" test under Section 1031.

## Conclusion

Investing in oil and gas working interests as "replacement property" in connection with a Section 1031 like-kind exchange raises a number of issues that must be closely evaluated and almost always requires a careful review (and possible restructuring) of the key operative documents.

If the parties are willing to be flexible in how they structure the investment, many oil and gas working interest investments have the potential to be qualifying replacement property under Section 1031.<sup>55</sup> ■

<sup>50</sup> The services included locating available oil and gas properties, conducting title examinations and drafting lease agreements, and arranging for financing of oil and gas properties and overseeing the development operations of its employer.

<sup>51</sup> Schwidetzky, "The Pool of Capital Doctrine: A Peace Proposal," 61 Tul. L. Rev. 519 (1987), citing background information note to Revenue Ruling 83-46, 1983-1 C.B. 16. See also TAM 8520004, TAM 8520005.

<sup>52</sup> See Schwidetzky, *supra* note 49; TAM 8520004 ("the transfer of the 95% working interest is governed by the principles stated in [Rev. Rul.] 77-176...").

<sup>53</sup> IRM (Oil and Gas Handbook) 4.41.1.2.3.1 (last revised 7/31/02) ("While the pool of capital doctrine is still viable in specific factual circumstances, it does not equate to a special exemption from [Section] 83 for the oil and gas industry").

<sup>54</sup> IRM (Oil and Gas Handbook) 4.41.1.2.3.8 (last revised 7/31/02).

<sup>55</sup> Note that an investor wishing to exchange an oil and gas working interest investment into a real estate investment in a subsequent Section 1031 like-kind exchange may be subject to recapture income.