Utica Shale: Federal Income Taxation for Landowners

Cleveland-Marshall College of Law
September 14, 2012

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Determining whether the transfer of an interest in oil and gas properties will be treated as a sale or as a lease is an important matter for tax purposes.
Sale

- The sale of a mineral interest ordinarily triggers the recognition of gain. Part of this gain may constitute depreciation recapture, or the recapture of intangible drilling and development costs or depletion under Code Sec. 1254.
- The balance of the gain may qualify for long-term capital gain treatment under Code Sec. 1231, provided the required holding period is met and the seller is not a dealer.
Lease

• A lease, on the other hand, results in ordinary income to the lessor since the lessor has retained an economic interest in the mineral interest.

• The seminal Supreme Court decision is *Burnet v. Harmel* (287 U.S. 103, 1932) addressed the question of how to handle retained economic interests in a leasing transaction. In its decision, the Supreme Court made the analogy of royalties paid in connection with mineral leases to rent, thereby differentiating mineral leases from sales for federal income tax purposes.
Lease

• This lease income is recognized when received or accrued, depending upon the lessor's method of accounting
• The lessor is also entitled to any corresponding deductions for cost or percentage depletion applicable to future production
Lease v Sale

• **Lease:**
  • Landowner retains a royalty
  • Lease bonus taxable as ordinary income
  • Royalty payments are ordinary income
  • Not eligible for capital gains treatment

• **Sale:**
  • Landowner does not retain a royalty
  • Landowner transfer all legal rights to mineral interests
  • Landowner qualifies for lower capital gain tax rates
Ordinary Income

- Graduated tax rate system
- Brackets - 2012 (Married filing jointly)

<table>
<thead>
<tr>
<th>Bracket Range</th>
<th>Tax Rate</th>
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</thead>
<tbody>
<tr>
<td>$0 – 17,400</td>
<td>10%</td>
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<tr>
<td>17,401 – 70,700</td>
<td>15%</td>
</tr>
<tr>
<td>70,701 – 142,700</td>
<td>25%</td>
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<tr>
<td>142,701 – 217,450</td>
<td>28%</td>
</tr>
<tr>
<td>217,450 – 388,350</td>
<td>33%</td>
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<tr>
<td>388,351 -</td>
<td>35%</td>
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Beginning in 2013 Medicare surtax will add 3.8% to top rate on certain investment income
Ordinary Income

• Beginning in 2013 the top Federal income tax rate is scheduled to be 39.6%
• Add to that the 3.8% Medicare tax rate and the phase-out of deductions, the top Federal income tax rate will be almost 45%
• Add to that the Ohio’s 5.925% top tax rate and the total tax rate can be about 50%
• What will the tax rates be in 2013??????
Structured Settlements

Cash basis taxpayer

- Fair market value of the installment lease bonus contract is taxable in the year of execution if the obligation is transferable and readily saleable
- If the contract is not transferable and readily saleable, the bonus payments are taxable in the year received
- Revenue Ruling 68-606
Structured Settlements

• Is it possible to defer income recognition of an installment lease bonus payment under the RR 68-606?
• Yes. However, an oil and gas company will not likely agree to an installment lease bonus because it wants to make a one-time payment
• However, the oil and gas company could transfer its obligation to an insurance company by purchasing an annuity/structured settlement with the landowner named as beneficiary
Structured Settlements

Insurance Company Annuity Arrangement

- Lease bonus payments over time must be negotiated with the oil company
- Oil company assigns their lease bonus payment obligation to the insurance company
- Payments can be structured over any time period
- In our view the “Order of Payment” document from the oil company should mirror the payment arrangement by the insurance company
Structured Settlements

Insurance Company Annuity Arrangement

• Under current interest rates and the insurance company costs, the gross annuity payments may be equal to or less than the payment if made in a lump sum if the annuity period is 6 years or less.

• If production begins during the installment period, the delayed payments may actually be subject to equal to or higher tax rates and the objective of spreading out the lease bonus payments over time to lower the tax cost may be lost.
Percentage Depletion

- Royalty payments are tied to production and the landowner may generally claim a deduction for percentage depletion to offset the royalty income.
- The deduction is currently computed at a rate of 15% of the gross royalty.
- Does not apply to lease bonus payments.
- Continues regardless of the lessor’s cost.
- Certain limitations based on income applies.
Capital Gain Taxation

- Must hold property for more than 12 months for long-term capital gain treatment
- Maximum 15% Federal rate for long-term gains in 2012
- Top Federal capital gain rate in 2013 is scheduled to increase to 20%
- The 3.8% Medicare tax can also apply to capital gain income increasing the potential capital gain tax rate to about 25% with the phase out of deductions
Capital Gain Taxation

Production Payments

• Production payments are not treated the same as a royalty interest and can result in capital gain treatment
• Production payments are treated as sale proceeds
• Production payments are a right to a specific share of production over a period shorter than the economic life of the mineral interest
Capital Gain Taxation

Production Payment

• Rev Proc 97-55 sets forth the conditions IRS would rule that a right constitutes a production payment under Section 636
  — The right must be an economic interest
  — The right is limited to a specific 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 percent of the minerals then known to exist
  — The present value of the production expected to remain after the right terminates is five percent or more of the present value of the entire burdened property (determined at the time the right is created)
Capital Gain Taxation

Structuring the Capital Gain Result

• Mineral interests can be severed to plan to achieve a capital gain result on the disposition of mineral interests

• Prior to the sale of the mineral rights to an oil and gas company, the landowner could sell all landowner and overriding royalty interests ("Royalties") in the subject mineral interest to Trusts in exchange for a production payment and residual note
Capital Gain Taxation

Structuring the Capital Gain Result

• The production payment will be defined as a percentage of the anticipated future production measured in MCFs, as determined in advance by reserve study performed by a petroleum engineer or geologist.
Capital Gain Taxation

Structuring the Capital Gain Result

• The landowner should realize a capital gain on the receipt of the production payments

• Provided the Royalties are transferred to the Trusts in advance of the assignment to the oil and gas company, the landowner should be deemed to have sold its deep gas rights and should realize a capital gain on the receipt of the payment received
Capital Gain Taxation

Structuring the Capital Gain Result

• If the purchaser of the Royalty interests is an entity, it would be an S corporation, not a partnership
• The S corporation should not have the same owners as the landowner entity
• The structuring of a transaction to gain capital gain treatment would need to be negotiated with the oil and gas company
Capital Gain Taxation

Other Capital Gain Opportunities

• Proceeds received for a perpetual easement or right of way is eligible for capital gain treatment

• An easement for a limited period of time is not eligible for capital gain tax rates
Lease is a Capital Asset

• Oil and gas lease is a capital asset
• Can be sold and qualify for preferential capital gain treatment – see Revenue Ruling 73-428
• Can be traded in a like-kind exchange for other investment or business real estate under Section 1031 – see Revenue Ruling 68-331
Social Security

• Lease bonus payments, royalties and capital gain income is not subject to social security tax
• Also does not reduce social security benefits
Planning

• Contact tax advisor as early as possible
• Identify goals and objectives
• Consider accelerating deductions
• Defer other sources of income where possible
• Estimated taxes
• Does charity fit in the landowner’s plans?
Planning

• Maximize employment retirement contributions or IRA contributions related to other sources of earned income
• Limit withdrawals from retirement plans, where possible
• Lease bonus payments and royalty income are not earnings for qualified plan and IRA purposes
Planning

- Consider opportunities to use lease bonus payment for investments in other business interests to shelter the lease bonus income
- “New” business equipment can qualify for faster write-offs in 2012 (50% Bonus depreciation)
- “Section 179 Expensing” allows up to $139,000 of new or used business equipment to be written off in 2012
- These limits were much greater in 2011 and could possibly be extended to 2012
Nonprofits

• Mineral royalties, including overriding royalties and lease bonus payments are excluded from unrelated business income whether measured by production or by gross or taxable income from the property.

• However, if the organization's ownership interest in a mineral property must share operating costs (i.e. it is a working interest), the income from such an interest is unrelated business income.
Nonprofits

• If an exempt organization receives a mineral lease bonus for the right to drill on its debt-financed property (i.e., property held for the production of income for which there is acquisition indebtedness), the income may be unrelated business income.

• Property used eighty-five percent or more for the organization’s exempt purpose is not treated as debt-financed property.
Nonprofits

• Social and recreational clubs exempt under Section 501(c)(7) are subject to unrelated business income on all its nonmember income, including its investment income

• Royalty income and lease bonus income received by a social club will be subject to tax

• A 501(c)(7) social club may risk its exempt status if it has substantial amounts of income from activities other than those traditionally carried on by such organizations

• Tax exempt clubs such as hunting clubs, duck clubs, etc.
Questions?

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