



**Various Structures for Shifting
Section 29 Credits from Producer to Investor**

Dennis J. Grindinger
Thompson & Knight, P.C.
Dallas, Texas

Synopsis

§ 13.01.	Introduction.	386
§ 13.02.	Why Buy Section 29 Properties: Benefits of Ownership and Potential Reductions to Investor’s Share of Section 29 Credits.	387
	[1] — Credits Provide High After Tax Yields; Reduce Regular Income Tax on Dollar-for-Dollar Basis	387
	[2] — Key Limitation on Investor’s Use of Section 29 Tax Credits: the Annual Credit Ceiling Amount under Section 29(b)(6).	389
	[3] — Theoretical Risk: Reduction from Phase-out of the Credit.	391
	[4] — Other Risk in Credit Amount: Reductions from Government Subsidies, Grants, Tax-exempt Financing, and Other Tax Credits.	391
§ 13.03.	Representations Regarding Qualifying the Property Obtained from the Seller: Statutory Requirements for Eligibility.	393
	[1] — Source of the Production: Qualified Fuel Requirement.	393
	[2] — Ownership Requirement.	396
	[3] — Sharing Credits Among Investors: Apportioning Section 29 Credits Between Holders of Economic Interests.	397
	[4] — Drilling Requirement.	399
	[5] — Prior Production Limitation.	401
	[6] — Sale Requirement.	402
§ 13.04.	Passive Activity Limitations.	404
§ 13.05.	Pay-As-You-Go Structures; Leveraged Acquisitions of Section 29 Properties.	405
	[1] — Partnership with Special Allocations.	413
	[2] — Royalty Trust Holding Qualifying Interest.	415
§ 13.06.	Conclusion.	416

§ 13.01. Introduction.

Investors searching for high after-tax yields have rediscovered oil and gas acquisitions, in large part due to the tax incentive provided by the section 29 credit.¹ For the first 10 years of its existence, the section 29 credit was beset by uncertainty arising from the loose language of the statute. Tax practitioners struggled with technical questions regarding (1) which properties qualified, (2) which taxpayers were eligible and whether the credit could be shared, and (3) how the potential reductions could apply.² In addition to statutory uncertainty, the legislative history of section 29 provides only limited guidance. Finally, the Internal Revenue Service (the “Service”) declined to issue any regulatory guidance under section 29,³ and, while private rulings have proliferated under section 29,⁴ it is uncertain whether such private rulings can be relied on as “substantial authority.”⁵ As a result, taxpayers were forced to rely on their tax advisor

¹ The section 29 credit was passed into law on April 2, 1980, as part of the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 96th Cong., 2d Sess. § 231 (1980). The reference to section 44D is to the Code in effect in 1980. Section 44D was redesignated as section 29 in 1984. *See* Pub. L. 98-369, 98th Cong., 2d Sess. § 471 (1984). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (26 U.S.C.), as amended (the “Code”).

² For an empirical analysis of the effectiveness of the section 29 credit in achieving the stated congressional goals *see* Kiss, Robert M. and Kattelus, Susan C., “The Effectiveness of the Section Fuel from a Nonconventional Source Credit,” 44 *Oil & Gas Tax Q.* 267 (1996).

³ The lack of regulatory guidance together with the chilling effect of various failed oil and gas partnerships from the early 1980s may have caused many investors to shy away from this investment. This chilling effect also may have been supplemented recently by the issuance of the partnership anti-abuse regulations.

⁴ From the mid-1980s, the Service has attempted to counterbalance this lack of regulatory guidance by issuing numerous private rulings. *See* footnote 6, *infra*. Most of these private rulings have tended to address questions as to qualification of the property rather than the structure of the proposed transaction.

⁵ *See* I.R.C. § 6662 and Treas. Reg. § 1.6662-4(d). Although each letter ruling states that taxpayers may not use or cite the ruling letter as precedent, Treas. Reg. § 1.6662-4(d)(3)(iii) provides that private letter rulings are authority for purposes of determining whether there is substantial authority for the tax treatment of an item.

with respect to issues arising from the interworkings of the section 29 credit.⁶

Recently, the Service has begun issuing private rulings regarding transactional structures for shifting the eligibility for the tax credits from producer to investor. This chapter will discuss these rulings and the issues arising under the “pay-as-you-go” structure addressed in these rulings. This chapter will also discuss briefly possible alternatives to the “pay-as-you-go” arrangement. To assist the reader’s understanding of this area, this chapter will first discuss the benefits arising from the ownership of section 29 credit properties (and why producers are willing to sell these properties). Second, this chapter will review the requirements for eligibility for the section 29 credit (and the type of representations regarding such requirements that buyers usually obtain from sellers).

§ 13.02. Why Buy Section 29 Properties: Benefits of Ownership and Potential Reductions to Investor’s Share of Section 29 Credits.

This section of the chapter will discuss the benefits of owning section 29 properties. In addition, this section will briefly discuss the potential reductions to an investor’s use of the section 29 credit, and why producers are unable to benefit directly from ownership of section 29 properties. Finally, this section of the chapter will discuss how buyers and sellers share the risk as to the potential application of these reductions.

[1] — Credits Provide High After-Tax Yields; Reduce Regular Income Tax on Dollar-for-Dollar Basis.

The high after-tax yield in section 29 deals is derived from the amount by which the section 29 tax credit reduces investors’s regular income tax. Each dollar of section 29 credit reduces the investor’s regular federal income tax by a dollar. For 1995, the section 29 credit was \$1.0055 per MMBtu (except for the credit for tight formation gas, which remains

⁶ The Service has issued numerous private rulings (80 over the last 10 years). However, there have been few public rulings or pronouncements with regard to section 29 transactions.