Chapter 14

Federal Taxation of Investors in Oil and Gas Drilling Programs

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§ 14.01. Introduction.

Investors in oil and gas drilling programs seek a return on their investment through revenues produced by the wells drilled and through tax benefits associated with such drilling and production. The nature of the investors, their tax attributes and their economic goals should drive the structure of the legal framework through which the drilling and production is carried out. Unfortunately, this is frequently not the case. Investors regularly invest in drilling programs that are not structured to take into account their particular tax attributes and frequently subject themselves to unnecessary tax liabilities.

The majority of oil and gas wells in Appalachia are drilled and operated through unincorporated joint venture arrangements. Some of these joint ventures elect not to file partnership tax returns but others report income or losses for federal income tax purposes as partnerships. Some of the “partnerships” are actual legal entities structured as general partnerships, limited partnerships and limited liability companies. Some are “tax only” partnerships. “Tax only” partnerships are unincorporated joint ventures that are recognized for income tax purposes only and have no legal status as a separate entity. In addition, each state allows formation of limited liability companies which may qualify as partnerships for tax purposes or which may be taxed as associations taxable as corporations.

This chapter discusses the tax rules applicable to investors in oil and gas drilling programs and the different forms through which such programs may be conducted. Depending upon the investors involved, such programs may be conducted through operating agreements (the Operating Agreement Structure), limited partnerships (the Limited Partnership Structure) or
limited liability companies (the Limited Liability Company Structure). In addition, the tax consequences associated with the sale of oil or gas properties are also discussed.

§ 14.02. Alternative Structures for Oil and Gas Drilling Programs.


Under the Operating Agreement structure, the lease with the oil and gas owner is owned directly by the investors with the operator possibly also owning an interest in the lease. The investors then designate the burden of operation of the oil and gas exploration on the operator through an Operating Agreement. An Operating Agreement typically provides for joint owners of working interests to designate one owner as the operator of their properties. For this purpose the operator is considered to be the person who bears the most responsibility for the management and day-to-day activities of drilling, completing and operating the wells. Normally, the operator performs his tasks and duties in accordance with an operating agreement that all joint owners have endorsed. The operator manages the drilling, completing, and operating efforts on the property; pays all expenses; and bills each joint owner for his or her share of the expenses.

Customarily, oil and gas owners receive 1/8th of all proceeds from the operation. All other proceeds will be divided among the investors. Generally, business arrangements like the Operating Agreement structure are treated for federal income tax purposes as a partnership with the investors being the partners in the partnership. However, the investors may agree to make an election under Section 761(a) of the Internal Revenue Code of 1986, as amended, (the Code) to be excluded from the Code’s rules governing partnerships. The effect of this election is to cause the investors to be treated as co-owners rather than partners for income tax purposes. As co-owners they individually report their share of income, deductions and credits from the drilling and production activity with no partnership return being filed.

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2 I.R.C. § 7701(a)(2).
If the investors are individuals, then they will typically own their interest in the Operating Agreement directly.

Under the Limited Partnership structure a limited partnership is formed and the limited partnership leases the oil and gas property directly from the oil and gas owner. Again, the oil and gas owner customarily receives 1/8th of all proceeds from operations. The limited partnership then typically contracts with a third party for the drilling and operation of the wells. The limited partnership is treated as a partnership for federal income tax purposes. Through the limited partnership agreement investors can become limited or general partners in the partnership and are allocated their share of partnership income, loss, deductions, credits, etc.

Under the Limited Liability Company structure, a limited liability company is formed and the limited liability company leases the oil and gas property directly from the oil and gas owner. Again, the property owner customarily receives 1/8th of all proceeds from the operations. The limited liability company then typically contracts with an operator for the drilling and operation of the wells. Through the limited liability company investors, as members of the limited liability company, are typically treated as partners for federal income tax purposes and are allocated their share of partnership income, loss, deductions, credit, etc.

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3  I.R.C. § 7701(a)(2).
4  I.R.C. § 702(a).
5  I.R.C. § 7701(a)(2). While under the “check the box” regulations (Treas. Reg. § 301.7701-3) limited liability companies with more than one member may affirmatively elect to be taxed as an association (and thus a corporation under Treas. Reg. § 301.7701-2(b)), limited liability companies involved in oil and gas production will typically want the default classification of being taxed as a partnership for federal income tax purposes.
§ 14.03. Basics of Partnership Taxation.

Section 7701(a)(2) of the Code defines the term “partnership” as “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, and which is not, within the meaning of this title, a trust or estate or corporation.”

The term “partner” is defined in Section 7701 as including “a member in such a syndicate, group, pool, joint venture, or organization.”6

A partnership is not a separate taxpaying entity.7 Instead, partnership income is taxed directly to the partners in their separate or individual capacities.8 However, the determination of whether income has arisen or an item of expense is deductible is made at the partnership level.9 Partnership taxable income is computed in the same manner as that of an individual.10 A number of items of partnership income, gain, loss, deduction, or credit, must be separately stated, thereby retaining their character and identity at the partner level when passed through to the partners.11 Such items are not netted with other partnership items.12

The deductibility of partnership losses (including capital losses) by a partner is limited to the adjusted basis of his or her partnership interest at the end of the partnership year in which such loss is incurred.13 Any excess of such loss over such adjusted basis is allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.14 This limitation of partnership losses contained in Code Section 702(d) is only the first of several hurdles which a taxpayer must typically overcome before a

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6 I.R.C. § 7701(a)(2).
7 I.R.C. § 701.
8 Id.
9 Id.
10 I.R.C. § 703(a).
11 I.R.C. § 702(a).
12 Id.
13 I.R.C. § 702(d).
14 Id.
partner may deduct a partnership loss. Provisions in other areas of the tax law, such as the “at-risk” rules in Section 465 and the “passive activity loss” rules in Code Section 469, may also limit the deductibility of partnership losses by a partner.\(^{15}\)

Like a shareholder in a corporation, a partner has a basis in his partnership interest (“outside basis”)\(^ {16}\) that is separate and apart from the partnership’s basis in its assets (“inside basis”).\(^ {17}\) Under Section 705(a) of the Code, a partner’s basis in his partnership interest is generally equal to the tax basis of any property and the amount of any cash contributed to the partnership, increased to reflect the partner’s share of partnership income and the excess of deductions for depletion over the basis of the property subject to depletion, decreased to reflect his share of partnership losses, decreased for his share of expenditures of the partnership not deductible in computing partnership taxable income and not properly chargeable to capital account, decreased (but not below zero) by the amount of the partner’s deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner under Section 613A(c)(7)(D), and decreased by the tax basis of any property and the amount of any cash distributed to him.\(^ {18}\) Section 752 provides that any increase in a partner’s share of liabilities of a partnership, or any increase in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities, is considered a contribution of money by such partner to the partnership.\(^ {19}\) Accordingly, pursuant to Section 705(a), such deemed contribution of money will increase the partner’s basis in his or her partnership interest.\(^ {20}\)

A partner who deals with a partnership other than in his or her capacity as a partner is generally treated as an unrelated party.\(^ {21}\)

\(^{15}\) I.R.C. § 469.
\(^{16}\) I.R.C. § 705(a).
\(^{17}\) I.R.C. § 1012.
\(^{18}\) I.R.C. § 705(a).
\(^{19}\) I.R.C. § 752.
\(^{20}\) I.R.C. § 705(a).
\(^{21}\) I.R.C. § 707(a).
§ 14.04. Election Out of the Partnership Tax Rules ("Subchapter K").

Subchapter K of the Code is contained in Sections 701 through 777 and contains the income tax rules applicable to partners and partnerships. Code Section 761(a) provides that certain unincorporated organizations that would otherwise be classified as partnerships for federal income tax purposes may elect to be excluded from all or a portion of the provisions of Subchapter K.\(^{22}\) If an organization makes such an election then it would not be required to file a partnership tax return and its members would separately report their respective shares of the income or loss of the organization on their separate tax returns. This is usually the case in drilling joint ventures.


This election is available to organizations that are 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 members of such organization are able adequately to compute their income without the necessity of computing partnership taxable income.\(^{23}\) The ability to make this election is typically available to investors in an Operating Agreement structure.

Treasury Regulation Section 1.761-2(a)(3) provides that a group of participants in an unincorporated joint venture may election exclusion from Subchapter K:

where the participants in the joint production, extraction, or use of property –

(i) Own the property as co-owners, either in fee or under lease or other form of contract granting operating rights, and

(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

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\(^{22}\) I.R.C. § 761(a).

\(^{23}\) I.R.C. § 761(a).
(iii) 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…. However, [the election] does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

The regulations restrict the ability of co-owners who produce natural gas under a joint operating agreement to elect out of Subchapter K.\[24\] If co-owners enter into a gas balancing agreement, all of the co-owners must use the cumulative gas balancing method unless they adopt the annual gas balancing method with the permission of the Service.\[25\] Failure to use the proper method will be treated as the use of an impermissible method, requiring a change to a permissible method, but will not invalidate the election out under Code Section 761 unless the Service determines there has been a willful failure to comply with the Regulations or an abuse of the cumulative method with a principal purpose to avoid tax.\[26\]


Two methods of electing to be excluded from Subchapter K are provided by Treasury Regulation Section 1.761-2(b).

Under the first method, the election must be made not later than the time prescribed for the timely filing of the partnership return (including extensions) for the first taxable year for which the exclusion is desired.\[27\] The partnership return must contain, in lieu of the information typically required to be filed on such return (Internal Revenue Service Form 1065),

(a) the name or other identification and the address of the organization; (b) a statement showing the names, addresses and taxpayer identification numbers of the members of the organization; (c) a statement that the organization qualifies as an organization described in Treasury Regulation Section 1.761-2(a)(3)(as described above, a joint venture for the production or extraction of oil or gas); (d) a statement that all of the members of the organization elect that it be excluded from all of Subchapter K; and (e) a statement indicating where a copy of the agreement under which the organization operates (or if the agreement is oral, from whom the provisions of the agreement may be obtained). The election need not be executed or otherwise affirmatively acknowledged by all of the members.

An election will not be effective if within ninety days after the formation of the organization any member of the organization (1) notifies the Service that he or she desires Subchapter K to apply to the organization and (2) also advises the Service that he or she has so notified all other members of the organization by registered or certified mail.

Under the second election method, an election is deemed made “if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of subchapter K beginning with the first taxable year of the organization.”

The requisite intent is determined from “all the surrounding facts and circumstances.” Although not exclusive, either of the following facts may indicate that the requisite intent was present: (a) at the time of the formation of the organization there is an agreement among the members that the organization will be excluded from Subchapter K from its inception or (b) the members owning substantially all of the capital interests in the organization report their respective share of the items of income, deductions and credits

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31 Id.
of the organization on their respective returns in a manner consistent with having made such election beginning with the first taxable year of the organization.\textsuperscript{32}

An election, once made, is irrevocable, unless the organization ceases to be eligible for the election or the Service consents to its termination.\textsuperscript{33}

\textbf{§ 14.05. Tax Benefits Available to Investors.}

Taxpayers drilling wells and developing property for production must determine whether they should deduct certain expenditures as current operating expenses or capitalize them into the cost of equipment (represented by physical property)\textsuperscript{34} or the leasehold interest (not represented by physical property).\textsuperscript{35} Capitalized costs of equipment or leasehold interests are recovered through either depreciation (in the case of equipment) or depletion (in the case of the leasehold interest). Expenses associated with operating the lease which are not capital expenditures are currently deductible.\textsuperscript{36}


Treasury Regulation Section 1.612-4(a) grants an “operator” the option of treating intangible drilling and development costs (IDC) as either capital expenditures under Section 263(a) or as expenses deductible pursuant to Section 263(c) and Treasury Regulation Section 1.612-4. Treasury Regulation Section 1.612-4(a) of the Code defines the term “operator” as “one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights.” If an operator elects to capitalize such costs, they become part of the depletable investment recoverable through the depletion deduction or if represented by physical property through depreciation. This is an irreversible binding election for the life of the taxpayer.\textsuperscript{37}

\begin{itemize}
\item \textsuperscript{32} Treas. Reg. § 1.761-2(b)(2)(ii)(a)-(b).
\item \textsuperscript{33} Treas. Reg. § 1.761-2(b)(3)(i).
\item \textsuperscript{34} I.R.C. § 167.
\item \textsuperscript{35} I.R.C. § 611.
\item \textsuperscript{36} I.R.C. § 162.
\item \textsuperscript{37} Treas. Reg. § 1.612-4(e).
\end{itemize}
[a] — IDC Defined.

IDC is defined as including all expenditures made for items without a salvage value for such things as wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas.\(^{38}\)

The operator is deemed to have incurred these costs even if the drilling is performed by a third party under contract. The Internal Revenue Manual at Section 4.41.1 classifies the following expenditures as IDC:

(i) Administrative costs in connection with drilling contracts.
(ii) Survey and seismic costs to locate a well site on leased property.
(iii) Costs of drilling.
(iv) Grading, digging mud pits, and other dirt work to prepare drill site.
(v) Cost of constructing roads or canals to drill site.
(vi) Surface damage payments to landowner.
(vii) Crop damage payments.
(viii) Costs of setting rig on drill site.
(ix) Transportation costs of moving rig.
(x) Technical services of geologist, engineer, and others engaged in drilling the well.
(xi) Drilling mud, fluids, and other supplies consumed in drilling the well.
(xii) Transportation of drill pipe and casing.
(xiii) Cementing of casing (but not the casing itself)
(xiv) Rent of special equipment and tanks to be used in drilling a well.
(xv) Perforating the well casing.
(xvi) Logging costs, but not velocity surveys.
(xvii) Costs of removing the rig from the location.

\(^{38}\) Treas. Reg. § 1.612-4(a).
(xviii) Dirt work in cleaning up the drill site.
(xix) Cost of acidizing, fracturing the formation, and other completion costs.
(xx) Swabbing costs to complete the well.
(xxi) Cost of obtaining an operating agreement for drilling operations.
(xxii) Cost of obtaining an operating agreement for drilling operations.
(xxiii) Cost of plugging the well if it is dry.
(xxiv) Costs of drill stem tests.  

[b] — Electing to Treat IDC as a Deductible Expense.

The election to treat intangible drilling costs as an expense is a one-time election that binds the taxpayer for all future years. Once made, it cannot be changed. Treasury Regulation Section 1.612-4 states that if a taxpayer does not deduct IDC as expenses on his return when he first incurs IDC, then he is deemed to have elected to recover IDC through depletion as long as they are not represented by physical property. If the IDC is represented by physical property, then such costs are recoverable through depreciation.  

In the case of a partnership, the partnership, not the individual partners, makes the IDC election. If the joint owners of property have elected under Section 761(a) to exclude the joint venture from taxation as a partnership under Subchapter K, then each individual co-owner must make an election, applicable only to that co-owner, as to the treatment of their share of the IDC.


As a general rule, when an election has been made by a cash method taxpayer to currently deduct IDC it is deductible by such cash method

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40 Treas. Reg. § 1.612-4(e).
41 Id.
taxpayer in the taxable year of payment. In *Keller vs. Commissioner,*\textsuperscript{43} the Eighth Circuit applied the following three-part test for determining when prepayments of IDC made by cash method taxpayers are currently deductible: (i) the prepayments must be a payment rather than an advance deposit; (ii) the prepayments must be made for a business purpose and not for tax avoidance; and (iii) the prepayments must not materially distort income.

In the Internal Revenue Manual the IRS sets forth its guidelines for deductibility of prepayments by cash method taxpayers. It provides at 4.41.1.2.4.5 that prepayments of IDC are deductible by cash method taxpayers only if:

(i) The prepayment is made for a bonafide business purpose
(ii) The prepayment does not substantially distort income;
(iii) The drilling contract requires a prepayment of the agreed amount and not merely a deposit;
(iv) The prepayment covers all the 100 percent working interest;
(v) The actual drilling of the well was begun in the first part of the next year; and
(vi) Some well site work was done prior to the year end.


Under the accrual method of accounting, 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.\textsuperscript{44}

Code Section 461(h)(2) provides that “economic performance” for services and property arises when the services or property is actually

\textsuperscript{43} Keller v. Comm’r, 725 F.2d 1173 (8th Cir. 1984), aff’g 79 T.C. 7 (1982), acq., 1984-1 C.B. 1.

\textsuperscript{44} Treas. Reg. § 1.461-1(a)(2)(i).
provided. Treasury Regulation Section 1.461-4(d)(6)(ii) provides that 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, if the taxpayer can reasonably expect the person to provide the services or property within three and one-half (3 and 1/2 ) months after the date of payment.


For “tax shelter” taxpayers, economic performance with respect to prepaid drilling expenses is deemed to occur in the taxable year of prepayment if the drilling of the well commences before the close of the 90th day after the close of the taxable year.\(^{45}\) This exception only applies to the portion of IDC that does not exceed the partner’s “cash basis” in the partnership.\(^ {46}\) A partner’s cash basis is the partner’s adjusted basis in the partnership computed without regard to any partnership liability, any amount borrowed by the partner with a loan arranged by the partnership or any other person involved with the organization.\(^{47}\)

A “tax shelter” is defined in Section 461(i)(3) of the Code as: (i) any enterprise (other than a C corporation) if the interests have been offered for sale through an offering required to be registered with a federal or state agency, (ii) any partnership or other entity (other than a C corporation) if more than 35 percent of its losses are allocable to limited partners or “limited entrepreneurs,”\(^ {48}\) or (iii) a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of income tax.\(^ {49}\)

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\(^{45}\) I.R.C. § 461(i)(2).

\(^{46}\) I.R.C. § 461(i)(2)(B)(i).

\(^{47}\) I.R.C. § 461(i)(2)(C).

\(^{48}\) I.R.C. § 1256(e)(3)(B)(providing that a limited entrepreneur is a person who does not actively participate in the management of the enterprise).


In addition to the allowance for depreciation for the use of physical properties, the Code provides an annual allowance for depletion of the mineral reserves that is intended to return the taxpayer’s capital investment in reserves consumed in the production of income.\(^{50}\) The federal income tax concept of depletion is simply a deduction from taxable income allowable to the owner of an economic interest in the oil and gas property based on the oil and gas sold.\(^ {51}\) An economic interest is possessed by a taxpayer where the taxpayer has acquired by investment any interest in oil or gas in place and secures, by any form of legal relationship, income derived from the extraction of the oil or gas, to which he must look for a return of capital.

The annual depletion allowance is the greater of cost or percentage depletion.\(^ {52}\) Cost depletion is an allocated portion of the adjusted basis of the depletable property. Percentage depletion is a stipulated percentage (15 percent) of the gross income from the property during the taxable year.\(^ {53}\) The percentage depletion allowance for oil and gas properties cannot exceed 100 percent of the taxable income from the property.\(^ {54}\)


Section 167(h) provides that, for taxable years beginning after August 9, 2005, geological and geophysical exploration expenditures (“G&G”) incurred by an operator in connection with the exploration for, or development of, oil or gas with the United States are amortized over a 24-month period beginning on the date the expense is paid or incurred. Expenses are treated as incurred at the mid-point of the taxable year.\(^ {55}\) Note that prior to the enactment of Section 167(h) G&G paid or incurred in connection with the determination

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50 I.R.C. § 611.
51 Treas. Reg. § 1.611-1(a)(1).
52 Id.
53 I.R.C. § 613A(c).
54 I.R.C. § 613(a).
55 I.R.C. § 167(h)(2).
of a well location or the supervision of a well were classified as IDC and currently deductible if the election to deduct IDC was made.

§ 14.06. Restrictions on Use of Tax Benefits.


While Treasury Regulation Section 1.612-4(a) allows investors to deduct intangible drilling costs, the at-risk rules may still limit an investor’s ability to use those deductions. Under Section 465 of the Code, an individual may deduct losses from business and investment activities only to the extent of the aggregate amount the taxpayer has “at-risk” in the activity at the close of the taxable year.\(^56\) A loss is defined as the excess of allowable deductions allocable to an activity to which the at-risk rules apply over the income received or accrued by the taxpayer during the taxable year.\(^57\)

The at-risk rules apply to investors under each of the Operating Agreement, Limited Partnership and Limited Liability Company structures. While the at-risk rules do not apply to partnerships as entities, they do apply to partners individually in determining the deductibility of partnership losses. Thus, the at-risk rules will be applied to each investor at the individual (i.e. non-entity) level.

Section 465(c)(1) specifically provides that the at-risk rules apply to the activity of exploring for, or exploiting, oil and gas resources. Under each of the structures described above, investors will be regarded as making a contribution to an oil and gas exploration activity to which the at-risk rules apply.\(^58\)

An investor’s ability to deduct intangible drilling costs will be limited in accordance with their amount at-risk in the oil and gas exploration activity.\(^59\) A taxpayer’s amount at-risk is initially equal to the amount of personal funds and adjusted basis of unencumbered property which he contributes to the


\(^{57}\) I.R.C. § 465(d).

\(^{58}\) I.R.C. § 465(c)(1).

\(^{59}\) I.R.C. § 465(a).
activity. Typically, under a subscription agreement for an oil and gas drilling program, the investor is required to make a minimum cash investment. Thus, an investor’s amount at-risk will be at least the amount of such investment.

This means that an investor will be able to take deductions, including those made for intangible drilling costs, in an amount equal to his or her share of income from the oil and gas activity in the taxable year, and any remaining deductions can then be taken up to the amount of cash investment. If such losses exceed the investor’s amount at-risk at the end of the taxable year, the excess losses are suspended and carried forward indefinitely to subsequent years until investor’s amount at-risk in such activity is sufficient to absorb them.

Investors are not considered at-risk for required future capital contribution even if the taxpayer is obligated by contract to pay.


The at-risk provisions of Code Section 465 are applied before and independently of the passive loss rules. If an investor is at risk, then the investor must still avoid disqualification for IDC deductions and other losses under the passive loss limitations of Section 469. The passive loss rules disallow “passive activity losses” of individuals.

Under Code Section 469(d)(1), a passive activity loss is defined as the excess of aggregate losses from all passive activities for the taxable year over aggregate income from all passive activities for such year. Losses from passive activities may generally be used only to offset income from passive activities and not from active sources or portfolio income.

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60 I.R.C. § 465(b)(1).
61 Id.
62 Id.
64 Proposed Treas. Reg. § 1.465-22(a).
65 I.R.C. § 465.
66 I.R.C. § 469(a).
67 I.R.C. § 469(e)(1).
Passive activities generally include any activity which involves the conduct of a trade or business in which the taxpayer does not materially participate. Passive losses that are disallowed are suspended and carried over indefinitely to subsequent years. Thus, for investors to whom the passive loss rules apply, intangible drilling costs will only be deductible to the extent that the investors have income from the oil and exploration activity or other passive activity income.

The term “passive activity,” however, does not include a working interest in any oil and gas property which the taxpayer holds directly through an entity which does not limit the liability of the taxpayer. This rule applies without any regard to the participation of the taxpayer. The exemption is designed to treat a working interest as per se nonpassive, provided that the interest is burdened with the cost of development and operation of the property and the nonoperator’s liability is not limited.

Thus, investors under the Operating Agreement structure, who directly hold a working interest in an oil and gas property, and those holding general partnership interests under the Limited Partnership structure, would not have their losses and credits arising from the working interest limited by the passive activity rules.

On the other hand, individuals who are limited partners under the Limited Partnership structure or who are members under the Limited Liability Company structure may be limited by the passive activity rules of Code Section 469 since such investments would be held through an entity which limits their liability and thus would not be able to take advantage of the special exception for certain working interests in oil and gas property set forth in Section 469(c)(3)(A). However, while limited partnership working

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68 I.R.C. § 469(c)(1).
69 I.R.C. § 469(b).
70 I.R.C. § 469(d)(1).
72 I.R.C. § 469(c)(4).
73 Field Service Advice 200102018; I.R.C. § 469(b).
interests are not per se nonpassive, they are neither per se passive. The general rules regarding material participation apply to determine whether the interest is treated as passive activity when an interest is not treated as a working interest since the taxpayer’s liability is limited. In general, a taxpayer is treated as materially participating in an activity if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. 74

Nonetheless, since a limited partner who materially participates in the partnership may endanger the entity’s limited-liability status under state law, it is conclusively presumed, in the case of a limited partnership interest, that the taxpayer has not materially participated in the activity. 75 The Treasury Regulations do, however, provide three exceptions to the passive activity presumption of Code. Section 469(h)(2). 76 The passive activity presumption does not apply to any activity in which the limited partner would otherwise be treated as materially participating for the taxable year because (1) the individual participates in the activity for more than 500 hours during the taxable year; (2) the individual materially participated in the activity for any five taxable years, consecutive or not, during the ten taxable years immediately preceding the taxable year; or (3) the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years, consecutive or not, preceding the taxable year. 77 Thus, if any limited partners under the Limited Partnership structure or the members under the Limited Liability Company structure meet one of the above three requirements, then their limited partnership interest will be treated as nonpassive.

A partnership interest of an individual shall not be treated as a limited partnership interest for passive loss purposes if the individual is a general

74 I.R.C. § 469(h)(1).
75 I.R.C. § 469(h)(2).
76 Treas. Reg. § 1.469-5T(e)(2).
77 Treas. Reg. § 1.469-5T(a), (e)(2).
partner in the partnership at all times during the partnership’s taxable year ending with or within the individual’s taxable year.\textsuperscript{78} Therefore, while most limited partnership interests under the Limited Partnership structure will be treated as nonpassive only if they meet one of the three requirements listed above, any limited partnership interest that is owned by an individual who also owns a general partnership interest will be treated as nonpassive regardless of whether or not the limited partner meets the above requirements.

\section*{[3] — Anti-Flip-Flop Rule.}

Section 469(c)(3)(B) of the Code prevents investors from switching from treating their investment as an activity producing nonpassive losses in one year to treating it as an activity producing passive income in subsequent years. If an investor treats net losses from a working interest as nonpassive during a prior taxable year, any net income from such property is generally treated as nonpassive.\textsuperscript{79} Once an investor treats losses from a working interest as nonpassive, any net income received from the oil and gas activity in the following year and any year thereafter will be treated as nonpassive. Thus, any future net income from such activity cannot be used to offset losses that investors may later incur from other passive activity investments. This is true even if the investor were to later contribute their working interest to a limited partnership. Note that the anti-flip-flop rules apply to net income only.\textsuperscript{80} Thus, the fact that investors have treated IDC as nonpassive losses does not necessarily mean that subsequent losses will be treated as nonpassive.

The regulations do make an exception and provide that the anti-flip-flop rule applies only if the taxpayer deducted nonpassive losses in a year in which he did not materially participate in the oil and gas activity.\textsuperscript{81}

The anti-flip-flop rule can have wide ranging implications. This rule applies to any net income arising from the entire property on which the activity took place that produced the loss, net income from property the basis

\begin{footnotesize}
\begin{enumerate}
\item Treas. Reg. § 1.469-5T(e)(3)(ii).
\item I.R.C. § 469(c)(3)(B).
\item \textit{Id}.
\item Treas. Reg. § 1.469-2(c)(6)(i)(A).
\end{enumerate}
\end{footnotesize}
of which is determined by reference to the basis of the property that produced
the nonpassive loss (e.g. a like-kind exchange), and net income from any well
which has a value that is enhanced by the working interest well.\footnote{I.R.C. § 469(c)(3)(B); Treas. Reg. § 1.469-2(c)(6)(i)(B), (c)(6)(iii).} Treating
losses as nonpassive may enable investors to use the intangible drilling cost
deductions of the first year, but the consequences could be that future passive
activity losses will not be able to be used since future net income from the
oil and gas activity will be treated as non-passive income not able to offset
such losses. Investors need to consider all of their projected future sources
of passive income in loss in making the decision as to whether to treat losses
associated with a working interest as active or passive.

\[ \text{[4] — Anti-Risk Rule.} \]

Direct co-owners in the Operating Agreement structure or general
partners in the Limited Partnership structures may attempt to limit their
liability after taking advantage of the working interest exception of the
passive loss rules. To discourage this, the Service promulgated the “anti-
risk rule” which discourages investors from taking nonpassive deductions
that arise while the investors hold working interests directly or through a
non-limiting liability entity, and then contributing the working interest to a
liability-limiting entity.\footnote{Treas. Reg. § 1.469-1T(e)(4)(ii).}

Under the anti-risk rule a taxpayer’s “disqualified deductions” from an
oil or gas well for a year are treated as passive activity deductions for such
year and a ratable portion of the taxpayer’s gross income from such oil or gas
well for such year is treated as passive activity gross income for such year.\footnote{Treas. Reg. § 1.469-1T(e)(4)(ii)(A).} “Disqualified deductions” are deductions with respect to which economic
performance occurs at a time when the taxpayer’s only interest in the working
interest is held through an entity that limits the taxpayer’s liability with
respect to the drilling or operation of such well.\footnote{Treas. Reg. § 1.469-1T(e)(4)(ii)(C)(2).} The “ratable portion” of
the taxpayer’s gross income from an oil or gas well for a taxable year is equal to the total amount of such gross income multiplied by a fraction obtained by dividing the “disqualified deductions” from the oil and gas activity over the total deductions from the oil and gas activity. Under the anti-risk rule, when an investor incurs a loss that is treated as nonpassive simply because of the working interest rule, “disqualified deductions” from the well are treated as passive activity deductions, and the ratable portion of gross income from the activity is treated as passive activity gross income.

The following examples from Treasury Regulation Section 1.469-IT(e)(4) illustrate the application of the anti-risk rule:

Example (1). (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil or gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1987, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A’s interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

(ii) Throughout 1987, A holds the working interest through an entity that does not limit A’s liability with respect to the drilling of the well pursuant to the working interest. In 1988, however, A holds the working interest through an entity that limits A’s liability with respect to the drilling and operation of the well throughout such year.

87 Treas. Reg. § 1.469-IT(e)(4)(ii).
Accordingly, under paragraph (e)(4)(i) of this section, A’s interest in P’s well is not an interest in a passive activity for 1987 but is an interest in a passive activity for 1988. Moreover, since economic performance occurs in 1987 with respect to all items of deduction for drilling costs that are allocable to 1987, A has no disqualified deductions for 1987.

Example (2). The facts are the same as in example (1), except that all costs of drilling under the contract with D (including costs of drilling performed after 1987) are paid before the end of 1987 and A has a net loss for 1987. In addition, A has $15,000 of total deductions that are attributable to the well and allocable to 1987, but economic performance (as that term is used in paragraph (e)(4)(ii)(C)(2)(ii) of this section) does not occur with respect to $5,000 of those deductions until 1988. Under paragraph (e)(4)(ii) of this section, the $5,000 of deductions with respect to which economic performance occurs in 1988 are disqualified deductions and are treated as passive activity deductions for 1987. In addition, one-third ($5,000/$15,000) of A’s gross income from the well for 1987 is treated as passive activity gross income.


The earnings from oil and gas exploration activities of investors in the Operating Agreement structure and those who have general partnership interests of the Limited Partnership structure will be subject to the self-employment tax of Section 1401 of the Code. For self-employment tax purposes, a partner’s distributive share of partnership trade or business income generally constitutes net earnings from self-employment.88

Investors in the Operating Agreement structure have unsuccessfully argued that their earnings from the oil and gas exploration activities should not be subject to the self-employment tax since those investors will have

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88 I.R.C. § 1402; Treas. Reg. § 1.1402(a)-1(a)(2).
made a Section 761(a) election to not be treated as a partnership. In *Cokes v. Commissioner*, the Tax Court held that even an inactive co-owner of an oil and gas working interest was subject to the self-employment tax.\(^89\) The court ruled that a Section 761(a) election does not change the nature of an entity.\(^90\) The election only prevents the application of Subchapter K, and the partnership remains a partnership for purposes of the other sections of the Code outside of Subchapter K. In making its decision, the *Cokes* court relied on Section 7701(a)(2) of the Code which defines “partnership” and “partner” broadly by exclusion.\(^91\) Thus, although investors in the Operating Agreement structure will make the election to not be treated as a partnership for purposes of Subchapter K, they will nevertheless be treated as partners of a partnership for purposes of Section 1402.

Moreover, the fact that investors of the Operating Agreement structure do not participate in the operation of the oil and gas exploration activity will not prevent their interests from being subject to self-employment tax. The *Cokes* court made clear that the relevant factor is whether or not an investor is a member of a partnership and not the amount of his or her participation.\(^92\) Therefore, investors of the Operating Agreement structure will be liable for self-employment tax on the net income received from their working interests despite the fact that their participation in the oil and gas exploration activity may be minimal.

General partners of the Limited Partnership structure will be subject to the self-employment tax since they, like the investors of the Operating Agreement structure, are partners in a partnership. On the other hand limited partners in the Limited Partnership structure will fall under an exception to Section 1402 for limited partners. Except for guaranteed payments to a partner for services rendered, the distributive share of any item of income or loss from of a limited partner shall be excluded from the taxpayer’s “net


\(^{90}\) *Id.*

\(^{91}\) *Cokes*, 91 T.C. 222 (1988).

\(^{92}\) *Cokes*, 91 T.C. 222 (1988).
earnings from self-employment.” Thus, earnings from the oil and gas exploration activity will not be subject to the self-employment tax for the limited partners of the Limited Partnership structure, unless those limited partners were to receive remuneration for services rendered to the Limited Partnership.

§ 14.08. Tax Consequences of Sales of Interests in Oil and Gas Properties.

At some point investors in oil and gas drilling programs will sell or otherwise dispose of their investment. Such interests may be held in various forms of entities depending on the specific circumstances of the owners. Selling the interests may take the form of an asset sale, or a stock or other membership interest sale. There are numerous articles and other resources describing the general tax impact of selling assets, stock or interests in partnerships or limited liability companies. The remainder of this section focuses on select special rules that apply upon the sale of ownership interests in oil or gas properties.

From a purely tax standpoint, the buyer will generally prefer to purchase the interest pursuant to an asset sale. An asset sale allows the buyer to obtain a “step up” basis in the assets purchased based upon the allocation of the purchase price. On the other hand, the seller determines their gain or loss for each individual asset sold.


When selling oil and gas properties, sellers frequently retain “production payments” associated with the property being sold. Section 636(b) of the

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93 I.R.C. § 1402(a)(13).
94 E.g., membership interest in an LLC, partnership interest in a partnership.
95 Naturally, the decision as to whether to structure an acquisition as a stock sale or an asset sale is not limited to tax considerations. Each parties desires as to what will be bought and sold, assumption of liabilities, and assignment of contracts are among the other issues to be negotiated between the parties.
96 I.R.C. § 1012, I.R.C. § 1060.
97 Usually leasehold interests.
Code provides that a production payment retained on the sale of a mineral property is treated for income tax purposes as if it was a purchase money mortgage loan and does not qualify as an economic interest in mineral property.

“Production payments” are defined in Treasury Regulation Section 1.636-3(a)(1) as meaning, in general, a right to a specified share of production from mineral in place (if, as and when produced), or the proceeds from such production. In order to qualify as a production payment such right must be an economic interest in such mineral in place and must have an expected economic life at the time of its creation that is shorter than the projected economic life of the mineral property it burdens.\(^\text{98}\) Production payments may be limited by a dollar amount, a quantum of mineral, or a period of time.\(^\text{99}\)

This rule means that the seller of the underlying property must include the production payment in determining the amount realized on the sale, cannot deplete the production income received as the payment is made, and must report portions of the amounts received as interest.\(^\text{100}\)

Generally, the amount included in the amount realized and the interest to be reported are the amounts identified as principal and interest in the parties’ agreement unless interest is at a rate less than the applicable federal rate (AFR) (a rate published monthly by the IRS), in which case the principal and interest amounts are recalculated so that interest is at the AFR.\(^\text{101}\)

Since production payments will be paid after the close of the taxable year of disposition, the seller is provided the option of treating the production payment under the installment sale method or electing out of that method.\(^\text{102}\) This means that the seller will report the portion of the gain on the sale of assets as an installment sale, with certain exceptions discussed below, and

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\(^{98}\) Treas. Reg. § 1.636-3(a)(1).
\(^{99}\) Id.
\(^{100}\) See Treas. Reg. §1.636-1.
\(^{101}\) I.R.C. §7872(a).
\(^{102}\) I.R.C. §453.
will recognize gain as those amounts are actually received. Typically, a seller
will not elect out of the installment method as it usually works to delay the
payment of tax on the sale.

Income recognized in any taxable year from an installment sale “is
that proportion of the payments received in that year which the gross profit
(realized or to be realized when payment is completed) bears to the total
contract price.”\textsuperscript{103} In general, “gross profit” is the “selling price” of the
property less the property’s adjusted basis.\textsuperscript{104} The “total contract price” is
the total amount to be paid for the property, reduced for any indebtedness
assumed or taken subject to by the buyer.\textsuperscript{105}

There is an important exception to the installment method reporting rule.
Installment reporting is prohibited for the portion of the gain that is subject
to depreciation recapture income under I.R.C. § 1245.\textsuperscript{106} This also applies
if Section 1250 property was sold. “Section 1250 property” is depreciable
real estate. Generally speaking, Section 1250 recaptures only the excess
of depreciation actually taken over the depreciation that would have been
allowed under the straight-line depreciation method.\textsuperscript{107}

“Section 1245 property” is depreciable property other than real estate.
When Section 1245 property is sold, the seller must first recapture the amount
of depreciation taken on the asset over the asset’s life.\textsuperscript{108} This is important
since depreciation recapture amounts are taxed at ordinary income rates.\textsuperscript{109}
Depreciation recapture income must be recognized in the year of the sale,
even if no payments are received.\textsuperscript{110}

\textsuperscript{103} I.R.C. §453(c).
\textsuperscript{104} Treas. Reg. § 15a.453-1(b)(2)(v).
\textsuperscript{105} Treas. Reg. § 15a.453-1(b)(2)(iii).
\textsuperscript{106} I.R.C. § 453(i).
\textsuperscript{107} Note that straight-line depreciation is required with respect to all real property acquired
after 1986, so that recapture under Section 1250 applies only to property placed in service
before that date.
\textsuperscript{108} I.R.C. § 1245.
\textsuperscript{109} I.R.C. §§ 1245(a)(1), 1250(a)(1).
\textsuperscript{110} I.R.C. § 453(i)(2).

Depletion previously deducted must be recaptured as ordinary income on the disposition of the depleted property.\textsuperscript{111} The amount recaptured is the lesser of: (1) the property’s adjusted basis was reduced by the depletion deduction; or (2) the gain realized.\textsuperscript{112}

Note that unlike recapture pursuant to Section 1245 on depreciable property used in a trade or business, recapture of depletion pursuant to Section 1254 applies on the installment method (described above).\textsuperscript{113} Thus, gain on a sale in which Section 1254(a)(1) applies is reported on the installment method, assuming the installment method would otherwise apply.


Expenses incurred for IDC may be deducted as expenses instead of being capitalized.\textsuperscript{114} Previously deducted intangible drilling costs must be recaptured as ordinary income on the disposition of Section 1254 property. “Section 1254 property” means (1) an interest in a natural deposit to which IDC, or mine development, or mine exploration costs, are properly chargeable, or (2) any interest in a natural deposit whose adjusted basis includes adjustments for depletion deductions.\textsuperscript{115} To qualify as Section 1254 property, the property must have been placed in service after December 31, 1986. Property with IDC placed in service prior to January 1, 1987 is referred to as “oil, gas or geothermal property.”\textsuperscript{116} As with depletion, the recapture amount is limited to the lesser of: (1) the property’s adjusted basis reduced

\textsuperscript{111} This rule generally applies to property placed in service after December 31, 1986. See Treas. Reg. §1.1254-1(b)(2)(ii).
\textsuperscript{112} I.R.C. § 1254(a)(1).
\textsuperscript{113} I.R.C. § 453(i) by its terms applies to prohibit installment method treatment for the recapture under I.R.C. §§1245 and 1250, but does not apply to recapture under I.R.C. §1254.
\textsuperscript{114} I.R.C. § 263(c); Treas. Reg. § 1.612-4.
\textsuperscript{116} Treas. Reg. § 1.1254-1(b)(2)(iii).
by the depletion deduction; or (2) the gain realized.\textsuperscript{117} For an oil, gas or geothermal property, Section 1254 costs are limited to the amount of IDC that would have been deductible as depletion had the IDC been capitalized, less the amount of such capitalized IDC that would have been recovered through actual depletion.\textsuperscript{118} If IDC is capitalized,\textsuperscript{119} Intangible drilling cost is treated as Section 1254 cost in the year in which the amortization deduction is claimed.

Note that like depletion recapture and unlike recapture pursuant to Section 1245 on depreciable property used in a trade or business, recapture of IDC pursuant to Section 1254 applies to the installment method (described above).

\textsuperscript{117} I.R.C. § 1254(a)(1).
\textsuperscript{118} Treas. Regs. § 1.1254-1(b)(1)(i), (ii).
\textsuperscript{119} Under I.R.C. § 291(b) or an election under I.R.C. § 59(e).