Tax Provisions and Considerations
For
Oil and Gas Property Purchase and Sale Agreements

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Introduction

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair…. ” Many of us remember this quote from English literature class, but it seems as appropriate in the winter of 2015 – 2016 in the oil and gas business as it was in the setting of the Charles Dickens book “A Tale of Two Cities”. Oil and gas producers in the United States developed incredible new technology for the production of oil and gas from shale rock formations, which had the ability to unlock massive oil and gas reserves trapped in shale rock here in the United States. Private equity capital and the high yield debt market, with few alternatives as attractive as funding domestic oil and gas exploration, development and production projects, rushed to provide billions of dollars of equity and debt capital to domestic oil and gas companies large and small. The significant increase in the number of operating oil rigs and

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2 Charles Dickens, A Tale of Two Cities, (originally published in 1859, cite from James Nisbet & Co., Ltd. London 1902).
gas rigs as companies rushed to drill shale oil and gas wells from 2010 through mid-2014 brought incredible prosperity to companies, their employees and their contractors involved in shale plays in the Permian Basin and Eagle Ford shale in Texas, the Bakken shale in North Dakota, the Marcellus shale in Pennsylvania, and the Utica shale in Ohio, to name a few. Total oil and gas reserves in the United States for the year 2014 increased nine percent from the year before. Television even got back in the action, as the ABC network commissioned stalwart Don Johnson to star in “Blood and Oil” on Sunday nights.

Yes, those were the best of times at $100 per barrel of oil, but the significant increase in United States oil and gas production pushed the Saudi-led Organization of Petroleum Exporting Countries (“OPEC”) to take action in the fall of 2014 to preserve market share. As preparation of this article for Rocky Mountain Mineral Law Foundation’s presentation on Oil and Gas Purchase and Sale Agreements continues in March of 2016, OPEC producers have opened up the taps full throttle (with conversations beginning on freezing the increases in production), and oil producers now are producing several million barrels a day more of crude oil than world demand requires. Oil prices now trade in a $30 - $40 per barrel range, driving many of those United States shale drillers into significant capital budget reductions, staff reductions, and in some cases, reorganization or liquidation in United States bankruptcy court proceedings. As those in the oil business know all too well, the best of times often leads to the worst of times, but that is why this article is important for those companies that may need to execute one or more oil and gas property purchase and sale transactions in order to restructure their balance sheets and position themselves for the future.

These difficult financial times have caused a number of domestic oil and gas producers to reconsider the size of their oil and gas producing property portfolios. As oil and gas prices have plummeted and favorable price hedges have run off, cash flows from producing operations have decreased and reserve redeterminations have lowered the value of collateral to support term debt, forcing many banks to reduce or eliminate credit to the industry. With public equity markets essentially closed for all but the best of oil and gas investments, many producers are left with no alternative but to raise cash and pay down debt by disposing of some of their domestic oil and gas properties in purchase and sale transactions in an effort to improve their balance sheets and perhaps even preserve their existence. This article will describe the various documents involved in these transactions, explain how those documents work to execute the transfer of ownership of oil and gas properties, and provide guidance and insight into the federal and state tax-related provisions included in those documents and the federal income tax consequences that follow from the execution of these transactions. Key terms in the oil and gas property purchase and sale agreement (the “PSA”) will be defined, key provisions in the PSA impacting the

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expected federal income tax results will be identified and explained, and the expected tax results themselves will be detailed.\(^4\)

**Background**

As mentioned above, current oil and gas property purchase and sale transactions are being driven, at least in part, by the need to shore up the balance sheet by reducing outstanding debt. Other reasons leading a producer to become a seller include a pessimistic view on long-term prices for oil and gas and a determination that future development costs for an oil and gas property will exceed the debt and equity capital available to develop it. Opportunistic purchasers, on the other hand, may have a more optimistic view on long-term oil and gas prices, may have solid balance sheets allowing for additional borrowing for oil and gas property purchases, and may have access to debt and equity capital otherwise not available to the current owner of the oil and gas properties put up for sale.

As a first step in the oil and gas property purchase and sale process, prospective sellers and purchasers may negotiate and then execute a document that may be styled as a “Letter of Intent,” a “Term Sheet,” or a “Heads of Agreement” (referred to collectively in this article as the “LOI”). The LOI sets out the key business elements of the transaction, including the assets being disposed of and any assets being retained, the purchase price, any required deposit, the effective date for the sale, any special conditions that must be met prior to closing the transaction, the expected closing date, and any “drop-dead” date after which all negotiations are terminated. Typically, a due diligence period is provided during which the prospective purchaser may examine documents related to the oil and gas properties to be disposed of in a physical or electronic

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\(^4\) This article addresses United States federal income tax and certain state ad valorem tax matters involved in oil and gas PSAs. This article does not address state income tax matters because those matters depend, in part, upon the tax laws of the state or states in which the oil and gas properties are located. This article assumes that the transaction provided for in the PSA is in fact a “sale” of oil and gas properties for federal income tax purposes and not a “lease” or “sublease.” In a “lease” or “sublease” transaction, the purported seller retains a continuing, non-operating interest such as a royalty or overriding royalty in the assigned oil and gas properties. Rev. Rul. 69-352, 1969-1 C.B. 34. Any cash or property received in such transaction is considered ordinary lease bonus income subject to cost depletion. Treas. Reg. § 1.612-3. In a “sale” transaction, the seller either retains no interest or retains a non-continuing interest such as a production payment in the assigned oil and gas properties. See infra Seller’s Gain or Loss on the Sale for a discussion of the federal income tax consequences to seller of a “sale” transaction involving oil and gas properties, but in general, after satisfying the ordinary income recapture rules discussed infra at Seller's Gain or Loss on the Sale – Ordinary Income Recapture Rules, the remaining gain can, in the right circumstances, be considered more tax-favored capital gain. This author has reviewed numerous transactions intended to be sales for federal income tax purposes that instead resulted in subleases as structured, because, for example, an overriding royalty was to be retained in the “deep rights” to one or more oil and gas leases in the transaction. Depending on the circumstances, the after-tax results for a sublease and a sale transaction can be significantly different. Tax counsel should carefully review the transaction documents as they evolve to assure the client that the tax results for the transaction as documented match up with the tax results intended.
data room before moving forward with a determination to purchase those properties. Care must be taken in drafting the LOI so that there is no misunderstanding between the parties as to whether all or only some portion of its terms and conditions are binding on the parties. If the LOI is not drafted carefully in this regard, litigation can ensue and the results potentially can be devastating. See, for example, the news reports of the award of over five hundred million dollars to Energy Transfer Partners, L.P. (“Energy Transfer”) in its lawsuit with Enterprise Products Partners, L.P. (“Enterprise”) in the District Court of Dallas County, Texas, 298th Judicial District over whether the LOI the parties executed regarding the formation of a partnership to build a pipeline was binding. The jury found that it was binding and awarded damages to Energy Transfer after Enterprise entered into a subsequent agreement with another party to build the pipeline. The case is on appeal to the Texas Court of Appeals for the Fifth District, Dallas, Texas.\(^5\)

After the parties set forth their intentions in the LOI, they will begin the negotiation of the PSA (even though due diligence still may be ongoing). The PSA generally will implement the key terms and conditions agreed to in the LOI, but will provide more detail and fill in gaps not covered in the LOI. For example, if the LOI provides for a deposit from the purchaser, the PSA will provide on what date and to whom (seller or an escrow agent) the deposit will be paid. The parties also will negotiate the representations and warranties to be included in the PSA, including the representations and warranties of seller regarding (a) its ability to enter into the purchase and sale transaction and (b) the assets it intends to dispose of, and the representations and warranties of purchaser, including, most importantly, its ability to obtain financing and pay for the assets. The negotiation of the representations and warranties for each party to the PSA provides an opportunity for the purchaser and seller to agree on the fundamental assumptions upon which they will proceed in closing the transaction. For example, purchaser may request seller to represent and warrant that no third party holds any preferential rights to purchase any of the oil and gas properties included in the transaction. This may be key to purchaser, who, for purposes of this transaction, wants to acquire ownership of all of the properties offered for sale when the transaction closes, and not just those few that are left after preferential rights to purchase the more desirable properties have been exercised by others.

The representations and warranties of each party are expected to be true and correct when the PSA is executed. If, for example, a representation and warranty of seller with respect to the oil and gas properties is not true and correct at that time and the PSA nonetheless is executed by the seller, the seller may be subject to a breach of contract suit for damages and, depending on the provisions of the PSA, the purchaser may be able to terminate the PSA.

The PSA also will provide the circumstances pursuant to which the proposed purchase and sale transaction can be terminated by either party, including, as mentioned above, the breach of a party’s representation and warranty, and the related instances in which upon termination the deposit will be refunded to the prospective purchaser or retained by the prospective seller. Importantly, the PSA will provide the conditions precedent that must be met before each party is obligated to close the transaction, including a condition that all representations and warranties made by each party in the PSA are still true and correct when the transaction is closed. And, the PSA will provide for all post-closing rights and obligations such as indemnification for any breach of a representation or warranty or other substantive provision.

The PSA will include a number of exhibits and schedules. Among the exhibits should be an exhibit listing all of the assets included in the transaction and another listing assets that are excluded from the transaction. Other exhibits will include forms of certain documents to be executed at closing such as a form of Assignment and Bill of Sale (the document that transfers title to the oil and gas property and associated lease and well equipment, geological and geophysical data and information, and any other assets in the transaction), form of Title Indemnity (for any matters that arise with respect to good title to the oil and gas properties), form of Access Agreement (used to provide the prospective purchaser with access to the prospective seller’s property for due diligence inspections prior to closing), form of Performance Bond (used to secure performance of purchaser’s assumption of seller’s obligations such as well plugging and abandonment, platform dismantlement and removal, and site restoration), and form of Parent Guarantee (should the purchaser be a special purpose entity organized to purchase the assets and the seller desire additional security from purchaser’s shareholder for performance of purchaser’s closing and post-closing obligations). Among the schedules included in the PSA should be a schedule that allocates the purchase price among the various oil and gas properties included in the transaction, the associated lease and well equipment for each property, geological and geophysical data and information, and any other assets in the transaction and a schedule that lists the current estimated amount of plugging and abandonment, platform dismantlement and removal, and site restoration obligations for each oil and gas property in the transaction.

Each representation and warranty made by seller will have a schedule listing any exceptions to that representation and warranty that must be disclosed by seller to prospective purchaser to avoid breach of representations or

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6 Seller will recognize ordinary income for the amount of the deposit retained in the year in which the transaction is terminated. Baird v. U.S., 65 F. 2d 911 (5th Cir. 1933). The deposit cannot be considered capital gain income because there has been no gain from a “sale or exchange” of a capital asset or an asset used in a trade or business. I.R.C. §§ 1001, 1221, 1231.

7 See infra Allocations of Taxes, and Tax Representations, Warranties, and Indemnities for a discussion of indemnification of taxes allocated to seller in the PSA.

8 See infra Seller’s Gain or Loss on the Sale – Allocations of Amount Realized for a discussion of the importance of the schedule of Allocated Values and its impact on the ultimate tax results of the purchase and sale transaction.
warranties made in the PSA. During the negotiation of the representations and warranties for the PSA, exceptions listed by seller on the draft schedules help disclose issues that may need to be resolved before the transaction can be closed. For example, were seller’s representation and warranty that all royalties and overriding royalties have been properly paid up to the Effective Date to contain an exception on the schedule listing a royalty owner dispute for a significant amount of money, purchaser might want to obtain further information with respect to the dispute to determine whether the property should be included in the purchase and sale transaction or whether an amount should be withheld from the purchase price to provide for payment. Because one or more of the representations and warranties may be qualified as to knowledge by seller, there may be a schedule that lists the names and offices of the individuals charged with knowledge for seller’s representations and warranties.10

The PSA will provide for several significant dates that will be used to execute the purchase and sale transaction. First, when the negotiations of the parties are complete, they will execute the PSA on a specified date (the “Execution Date”).11 On the Execution Date, the rights and obligations of the parties are established and the deposit, if there is one, becomes payable by the prospective purchaser to seller. Most significantly from a federal income tax perspective, the rights and obligations of the parties are conditioned on the purchase and sale transaction actually closing. Title to the assets and risk of loss thereto typically do not transfer to the prospective purchaser on the Execution Date, so on this date there is no completed sale transaction for the parties to report on their respective federal income tax returns.12

The PSA also will provide for a date from which the PSA is effective (the “Effective Date”).13 The Effective Date is the date the parties choose to set the

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9 Among the representations and warranties made by seller in the PSA will be certain representations and warranties regarding tax matters. See infra Allocations of Taxes and Tax Representations, Warranties, and Indemnities – Tax Representations and Warranties for a discussion of the various tax representations and warranties and their role in the oil and gas property purchase and sale transaction.

10 Many of seller’s representations and warranties regarding the oil and gas properties involved in the purchase and sale transaction will be qualified with the words “To the knowledge of seller.” The “knowledge” schedule lists those senior executives of seller who will be charged with having such knowledge. A senior tax executive of the seller may be among those listed on the “knowledge” schedule.

11 The Execution Date typically is stated in the preamble to the PSA. In many cases, seller and purchaser will execute the signature page of the PSA at the same time. In other cases, seller and purchaser will execute counterpart signature pages and exchange those executed pages.

12 Merrill v. Comm’r, 40 T.C. 66 (1963); Grodt & McKay Realty, Inc. v. Comm’r, 77 T.C. 1221 (1981). Merrill and Grodt & McKay Realty were cited with approval in I.R.S. Priv. Ltr. Rul. 87-18-003 (Jan. 7, 1987) (ruling that there was no completed sale of oil and gas properties for federal income tax purposes until the closing date because the benefits and burdens of ownership remained with seller until that date).

13 The term “Effective Date” or “Effective Time” usually is defined as a specified time (e.g., 7 a.m. Central Standard Time) on a specified date. To illustrate, suppose seller and purchaser execute a LOI on January 15th of a year specifying that the Effective Date will be January 1 of that year.
value of the assets in the transaction and is often a date that precedes the Execution Date. The Effective Date may be tied to the date of a recent reservoir engineering report, a month-end or year-end date, or some other date on which the parties intend to value the oil and gas properties and provide for the economic transfer of those properties from seller to purchaser, assuming the transaction closes and the actual transfer of title and risk of loss from seller to purchaser occurs.

Adjustments to the purchase price specified in the PSA (the “Purchase Price”) will be tied to the Effective Date to reflect the intended economic transfer of ownership so that, for example, the Purchase Price will be decreased by the proceeds from oil and gas produced and sold from and after the Effective Date that are received and retained by seller (because economically those proceeds belong to the purchaser) and increased by operating expenses and other costs and expenses (including royalties, overriding royalties, lease maintenance payments and production, severance and sales taxes) and capital investment paid by seller that are attributable to the oil and gas properties being sold and are applicable to the period from and after the Effective Date (again, because those costs and expenses economically should be borne by purchaser, not seller).

Other upward purchase price adjustments typically include (a) the value of all oil and gas in storage tanks, gathering systems and pipelines on the Effective Date, (b) any proceeds from the sale of oil and gas produced by seller before the Effective Date but received by the purchaser, net of any royalties and overriding royalties, production, severance or sales taxes, and marketing expenses paid by the purchaser, (c) all costs incurred for plugging and abandonment of wells, platform dismantlement and removal, and site restoration, that are paid by seller and applicable to the period from and after the Effective Date, (d) any ad valorem or property taxes prorated to purchaser but paid by seller, (e) advances or prepayments made by seller for operations conducted or to be conducted on or after the Effective Date, and (f) the amount, if any, of seller’s underproduced natural gas imbalance as of the Effective Date.

Other downward price adjustments typically include (a) all operating expenses and other costs and expenses paid by purchaser that are attributable to the oil and gas properties being sold for the period prior to the Effective Date (including royalties, overriding royalties, lease maintenance payments and production, severance and sales taxes), (b) any proceeds from the sale of oil and gas produced by seller from and after the Effective Date and received by the seller, net of any royalties and overriding royalties, production, severance or sales taxes, and marketing expenses paid by the seller, (c) any other proceeds received by seller to which purchaser is entitled to under the PSA, (d) any ad valorem or property taxes prorated to seller but paid by purchaser, and (d) the

The parties may not conclude negotiations on the PSA until March 1st of that year, and when the PSA is executed by the parties on that date, March 1st becomes the Execution Date.
amount, if any, of seller’s overproduced natural gas imbalance as of the Effective Date.  

Key here from a federal income tax perspective is that because title and risk of loss do not transfer from seller to purchaser on the Effective Date, the purchase price adjustments will impact the reported amount realized on the sale, if it closes, but the actual revenues generated from oil and production and costs, expenses and capital investment for the assets incurred by seller prior to closing remain those reported by seller for federal income tax purposes.  

The PSA also will provide for a date on which the transaction closes, that is, the date on which the purchaser pays the stated consideration to the seller and the seller executes and delivers the Assignment and Bill of Sale to the purchaser (the “Closing Date”). The Closing Date typically is the date on which title and risk of loss for the assets transfer from seller to purchaser, and it is this transfer that completes the sale from a federal income tax perspective. And on this date, the known and estimated adjustments mentioned earlier are made to the Purchase Price to arrive at the consideration paid by purchaser to seller at the closing table (the “Adjusted Purchase Price”). So, for example, if the Effective Date were set in a PSA as November 1, 2014 and the transaction closed on January 31, 2015, the Closing Date would be January 31, 2015 and both seller and purchaser would report the results of the sale transaction in their respective federal income tax returns for their respective tax years that included January 31, 2015.

Finally, the PSA will provide for a date for final post-closing purchase price adjustments. Typically, the date is sixty to ninety days after the Closing Date, which allows for final numbers to replace estimates, and any actual numbers used on the Closing Date to determine the Adjusted Purchase Price to be trued up as necessary. All adjustments then are allocated to the various assets in the transaction to determine final the final purchase price for each asset. Once these final purchase price adjustments have been settled, seller can determine the amount realized for each asset involved in the sale and compute the gain or loss for that asset for federal income tax purposes. Also, with these final purchase

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14 Depending on the facts and circumstances of each oil and gas property purchase and sale transaction, there may be additional upward or downward purchase price adjustments.

15 See Hulbert v. Comm’r, 12 T.C.M. (CCH) 1443 (1953), aff’d 227 F. 2d 399 (7th Cir. 1955) (sellers taxed on income from partnership’s baking business earned from the execution date of the purchase and sale agreement until closing, since during such period the purchaser had no control over the operation of the partnership’s business nor any vested rights in its assets); 2 Lexington Avenue Corp. v. Comm’r, 26 T.C. 816 (1956) (seller taxed on income from hotel property earned from the execution date of the purchase and sale agreement until the closing, since during such period the seller retained the risk of loss to the property). 2 Lexington Avenue Corp. was cited by I.R.S. Priv. Ltr. Rul. 87-18-003, supra note 12, which ruled that the income generated from the oil and gas properties from the Effective Date until the Closing Date was taxable to the seller. See also I.R.S. Gen. Couns. Mem. 34,092 (Apr. 7, 1969).

16 Hulbert, 12 T.C.M. (CCH) 1443; 2 Lexington Avenue Corp., 26 T.C. 816; Rev. Rul. 69-93, 1969-1 C.B. 139.
price adjustments, purchaser now has the information necessary to record the purchase price for each asset on its tax books and records.

Seller’s Gain or Loss on the Sale

In general, the seller computes its gain or loss on the sale of each separate oil and gas property by subtracting (1) its adjusted basis in each property for purposes of computing gain or loss from (2) the final amount of purchase price consideration allocated to such property.\(^{17}\) Gain or loss on the sale of oil and gas lease and well equipment, including any gathering systems, pipelines, and processing plants, other tangible personal property, and any geological and geophysical data or information is computed in the same way but is computed separate from the gain or loss on the sale of the interests in the mineral properties (e.g., working interests, royalty interests, and overriding royalty interests).\(^{18}\) The concepts of “amount realized” and “adjusted basis” are described in more detail below.

Seller’s Amount Realized

For federal income tax purposes, seller’s amount realized on the sale transaction is the “sum of any money received plus the fair market value of any property (other than money) received.”\(^{19}\) In this regard, a production payment\(^{20}\)

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\(^{17}\) I.R.C. § 1001(a); Treas. Reg. § 1.1001-1(a). An oil and gas “property” is defined as “each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.” I.R.C. § 614(a). Rules are provided for determining when separate mineral interests can be combined and when they are kept separate. See I.R.C. § 614(b).

\(^{18}\) Gain or loss is computed separately for each asset disposed of in the purchase and sale transaction because the assets involved in the transaction may be subject to different cost recovery rules (e.g., depletion for oil and gas properties, depreciation for lease and well equipment and other tangible personal property and amortization for geological and geophysical costs) and the cost recovery generated under each of those rules may be subject to different ordinary income recapture rules (e.g., gain on depletable oil and gas properties is recaptured as ordinary income under I.R.C. § 1254 while gain on depreciable equipment and amortizable geological and geophysical costs is recaptured as ordinary income under I.R.C. § 1245). See infra Seller’s Gain or Loss on the Sale – Ordinary Income Recapture Rules for a discussion of the ordinary income recapture rules that can apply to recharacterize gain on the sale of an asset in the purchase and sale transaction.

\(^{19}\) I.R.C. § 1001(b); Treas. Reg. § 1.1001-1(a). Seller’s “amount realized” will include the amount of the deposit, if any, provided for in the PSA. Kellstedt v. Comm’r, 52 T.C.M. (CCH) 462 (1986). The reference in I.R.C. § 1001 to “property” includes property that may be of like-kind to the oil and gas property being disposed of. The federal income tax treatment of exchanges of like-kind property will be addressed later in this article. See infra Like-Kind Exchanges.

\(^{20}\) A production payment is defined as:

a right to a specified share of the production from mineral in place (if, as, and when produced) or the proceeds from such production. . . . Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more mineral properties burdened thereby.

Treas. Reg. §1.636-3(a)(1). Production payments, with one exception not relevant here, are treated as mortgage loans. I.R.C. § 636(a), (b). Production payments that are treated as
retained by the seller is treated as a purchase money mortgage loan and thus "property received", so that the fair market value of the production payment is included in seller’s "amount realized". 21

The PSA typically will provide that purchaser agrees to assume and fulfill, perform, pay and discharge (or cause to be fulfilled, performed, paid or discharged) all known or unknown obligations and liabilities of seller with respect to the oil and gas properties in the purchase and sale transaction that arise prior to the Closing Date. Examples of such assumed obligations and liabilities include the obligation to furnish makeup gas should seller be in an overproduced position under an applicable gas balancing agreement for such oil and gas properties on the Closing Date, the obligation to pay amounts due as of the Closing Date to other working interest owners and royalty owners in the such oil and gas properties, the obligation to perform all well plugging and abandonment, platform dismantlement and removal, and site restoration as required under applicable law for such oil and gas properties, and all obligations under joint operating agreements or unit operating agreements that apply to such oil and gas properties.

Seller’s amount realized for federal income tax purposes should include the fair market value of any accrued liabilities from which seller is discharged as a result of the sale. 22 So, for example, should purchaser assume an accrued liability (such as a mortgage loan) burdening the acquired oil and gas property, seller’s amount realized would include the fair market value of the liability. 23 Similarly, should purchaser acquire an oil and gas property burdened by a carved–out production payment previously sold for cash to a financial investor, seller’s amount realized would include the remaining outstanding balance of the production payment obligation. 24 Well plugging and abandonment costs,

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21 I.R.C. § 636(b); Treas. Reg. § 1.636-2(c). See infra Seller’s Gain or Loss on the Sale – Installment Sale Reporting for a discussion of the application of the installment method of reporting gain under I.R.C. § 453 to the amounts received periodically from the retained production payment.

22 Treas. Reg. § 1.1001-2(a). See I.R.C. § 461(h) for the “all events test” and the definition of “economic performance” that together determine whether an assumed liability can be considered an “accrued liability.”


24 The sale of a carved-out production payment to a financial investor for cash followed by a sale of the burdened working interest to a purchaser is a relatively common transaction in the industry. For example, in July of 2003, Shell Exploration & Production Company ("SEPCo") carved out a $300 million volumetric production payment from certain shallow water properties in the Gulf of Mexico and sold that production payment to Morgan Stanley. SEPCo then sold the burdened working interest in those properties to Apache Corporation. See PRN Newswire, Shell Sells Gulf of Mexico Shelf Properties to Apache Corporation (July 3, 2003), http://www.prnnewswire.com/news-releases/shell-sells-gulf-of-mexico-shelf-properties-to-apache-corporation-70748642.html. Payments made pursuant to the production payment obligation are contingent because of the inherent risk in (a) oil and gas production used to satisfy the production payment and (b) the price for which the oil and gas can be sold. Accordingly, a production
platform dismantlement and removal costs, and other site restoration costs assumed by the seller when the seller originally acquired the oil and properties, if any, and any such costs incurred by the seller during its ownership of the oil and gas properties may not meet the test for an accrued liability for federal income tax purposes, however, because “economic performance” with respect to the liability has not occurred. Nevertheless, provided that the sale of the oil and gas properties is considered a sale of a trade or business, seller’s amount realized should include the fair market value of such costs.

The schedule in the PSA that sets out the agreed fair market value of well plugging and abandonment costs, platform dismantlement and removal costs, and site restoration costs on payment should be considered a contingent payment debt instrument. Treas. Reg. § 1.1275-4. When a property is sold subject to a debt instrument such as a production payment, the seller’s amount realized attributable to the production payment obligation burdening the oil and gas property is the “adjusted issue price” of the debt instrument. Treas. Reg. § 1.1274-5(d). In this case, assuming that all payments of principal and interest due under the production payment have been made in accordance with its terms, the adjusted issue price of the production payment obligation should equal the remaining outstanding principal balance of the production payment. Treas. Reg. § 1.1275-1(b)(1).

The “economic performance” requirements for accruing liabilities are set forth in I.R.C. § 461(h) and Treas. Reg. § 1.461-4. The Internal Revenue Service view is that although the liability for these costs otherwise may have satisfied the “all events” test (that is, the liability is “fixed and determinable”) required by I.R.C. § 461(h)(4), economic performance with respect to the liability required by I.R.C. § 461(h)(1) does not occur until the taxpayer performs the services for well plugging and abandonment, platform dismantlement and removal, or other site restoration. See, e.g., I.R.S. Priv. Ltr. Rul. 2000-04-040 (Oct. 29, 2000) (citing Treas. Reg. § 1.461-4(d)(4) in ruling that economic performance for a service liability like the liability for these costs does not occur until the services to plug and abandon, dismantle and remove, restore a site are performed). See I.R.C. § 461(h)(2)(A) for the rules for service liabilities (“If the liability of the taxpayer arises out of – (i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services.”).

Treas. Reg. § 1.461-4(d)(5) provides in part:

If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer.

In most cases, the sale of operated and non-operated working interests in one or more oil and gas properties should be considered a sale of a trade or business for purposes of I.R.C. § 461(h) and Treas. Reg. § 1.461-4(d)(5). Cf. Rev. Rul. 68-226, 1968-1 C.B. 362 (interest of a working interest lessee in oil and gas in place is considered real property used in a trade or business for purposes of I.R.C. § 1231); Rev. Rul. 89-27, 1989-1 C.B. 106 (owner or non-operated oil and gas working interests satisfied the “active trade or business” test for purposes of I.R.C. § 355); Rev. Rul. 58-166, 1958-1 C.B. 324 (co-owner of oil and gas working interest engaged in a trade or business for purposes of the self-employment tax imposed by I.R.C. § 1402); Treas. Reg. § 1.367(a)-4T(e) (transfer of oil and gas working interests can be considered the transfer of an active trade or business for purposes of meeting the test for nontaxable transfers of domestic assets to foreign corporations provided for in I.R.C. § 367(a)(3)(A)). Moreover, the seller would have been entitled to accrue the liabilities but for the economic performance requirement. See supra note 25. Accordingly, the amount of the liability for such costs properly should be included in seller’s amount realized.
the Closing Date by well, oil and gas lease, oil and gas unit should be the source of information for the amount of these costs included in seller’s amount realized. Note that when the transaction closes, seller is entitled to an ordinary deduction in the same amount as the increase in the amount realized.\textsuperscript{27}

\textit{Allocations of Amount Realized}

The PSA should include a schedule that allocates the Purchase Price among the various assets involved in the purchase and sale of the oil and gas properties. Values typically are set out on the schedule for each oil and gas lease, the lease and well equipment on that lease (including any oil and gas platforms if the lease is for an offshore oil and gas property), and any gathering lines, pipelines and natural gas compression, dehydration and processing facilities involved in the purchase and sale transaction. The value set out on this schedule for each of these assets typically is defined in the PSA as the “\textit{Allocated Value}” of such asset.\textsuperscript{28}

The Allocated Value of an oil and gas property included in the purchase and sale transaction is the starting point for any negotiated adjustment to reduce the Purchase Price for environmental or title defects. The Purchase Price also will be reduced by the Allocated Value of any such oil and gas property dropped from the transaction due to the severity of such defects. And, the Purchase Price will be reduced by the Allocated Value of any oil and gas property that is dropped from the transaction due to the exercise of preferential rights to purchase by a third party holding such rights.\textsuperscript{29}

\textsuperscript{27} Treas. Reg. § 1.461-4(d)(5)(i). Had seller performed the well plugging and abandonment, platform dismantlement and removal, or other site restoration on the oil and gas properties prior to the Closing Date, the amount incurred in performing these activities would have been an ordinary deduction. I.R.C. § 162.

\textsuperscript{28} See text accompanying supra note 8 referencing this schedule. The PSA might contain a provision similar to this:

\begin{quote}
Seller and Purchaser agree that the Purchase Price shall be allocated among the Assets, in accordance with the principles of section 1060 of the Code and the Treasury regulations, as set forth in Schedule \textsuperscript{[4.6]} of this Agreement. The portion of the Purchase Price allocated to each such Asset in Schedule \textsuperscript{[4.6]} (the “\textit{Allocated Value}”) shall be used in calculating adjustments to the Purchase Price and as otherwise provided herein.
\end{quote}

\textit{See infra} note 31 for an explanation to the reference to I.R.C. § 1060 in the definition.

\textsuperscript{29} During the due diligence phase of the transaction, purchaser typically will review the environmental condition of the oil and gas properties and the title to such properties. The PSA typically provides certain terms and conditions for adjusting the value of, or dropping from the transaction, properties that are found to have significant environmental remediation requirements or significant title defects. Preferential rights to purchase provisions typically are found in joint operating agreements, unit operating agreements or joint development agreements involving two or more parties. These provisions are included in these agreements to provide the other parties the first opportunity to purchase the selling party’s interest in each oil and gas property subject to the particular agreement. The concept is that any party who has assisted in the creation of the
Depending on the circumstances, either or both of the parties may engage a third-party valuation firm to determine the Allocated Values of the assets. The parties certainly may negotiate the Allocated Values for certain strategic reasons. Finally, the parties may negotiate the Allocated Values for federal income tax purposes to impact seller’s amount and character of the gain or loss on the sale of the assets and purchaser’s basis in such assets because the Allocated Values, as adjusted for (1) all purchase price adjustments, including those made post-closing, and (2) certain assumed obligations, including well plugging and abandonment, platform dismantlement and removal, and other site restoration costs, are used by the seller for federal income tax reporting in determining its amount realized for each separate asset in the transaction and are used by the purchaser in determining its basis in each such asset.

value of the property should have the opportunity to purchase the property before an outsider who has made no previous contribution to the creation of such value.

For example, there may be several more desirable and several lesser desirable oil and gas properties included in the package of properties included in the sale. If the more desirable properties are subject to preferential purchase rights, purchaser may attempt to negotiate higher values for the more desirable properties and lower values for the remaining properties in an attempt to keep those rights from being exercised on the more desirable properties. Seller may agree to such values in order to increase the chances that the transaction closes.

In an “applicable asset acquisition,” seller is required to allocate the consideration among the various assets disposed of to determine its gain or loss for each such asset and purchaser is required to allocate the consideration among the various assets acquired to determine its basis in the various assets acquired. I.R.C. § 1060(a). An “applicable asset acquisition” includes any transfer of assets that constitute a trade or business. I.R.C. § 1060(c). The sale of one or more oil and gas properties is considered by most tax practitioners to be a transfer of assets that constitute a trade or business. See supra note 26. The allocations must be made in the same manner as values are allocated under I.R.C. § 338(b)(5). Treas. Reg. § 1.1060-1(a)(1). When seller and purchaser agree in writing (as in a schedule to a PSA as adjusted for all purchase price adjustments) as to the allocation of consideration to the assets included in the transaction, the values set out in the agreement are binding on the parties for federal income tax reporting purposes. Treas. Reg. § 1.1060-1(b)(4). These values are reported to the Internal Revenue Service on Form 8594 with their income tax returns for the taxable year that includes the closing date of the transaction. Treas. Reg. § 1.1060-1(e)(1)(ii)(A). The PSA may contain a provision similar to this one:

Seller and Purchaser agree that the Allocated Values, as adjusted, shall be used by Seller and Purchaser as the basis for reporting asset values and other items for purposes of all federal, state, and local tax returns, including Internal Revenue Service Form 8594 and that neither they nor their Affiliates will take positions inconsistent with such Allocated Values in notices to Governmental Authorities, in audit or other proceedings with respect to taxes, or in other documents or notices relating to the transactions contemplated by this Agreement.

It is this author’s experience that so long as the purchaser and seller have sufficient adverse interests in the transaction, the allocations agreed to and provided for in the schedule will not be disturbed on audit by the Internal Revenue Service. See infra Seller’s Gain or Loss on the Sale – Seller’s Amount and Character of Gain or Loss for a discussion of the impact of the negotiated Allocated Values for the assets on the amount and character of the seller’s gain or loss for each such asset. See infra note 73 and accompanying text for a discussion of the impact of the negotiated Allocated Values for such assets on purchaser’s basis in each acquired asset. While the agreed well plugging and abandonment, platform dismantlement and removal, and other site
Care should be taken to identify (1) the total “amount realized” and (2) each of the assets to which a portion of the total “amount realized” should be allocated. The parties occasionally include other aspects of the disposition of the oil and gas properties in the transaction in the PSA and provide for compensation for those aspects. For example, the purchaser may contract with seller for seller to continue to operate the oil and gas properties for purchaser until certain governmental approvals are obtained. Purchaser typically compensates seller for this service at an agreed monthly rate but the amount of the compensation should be separately identified and not considered in the total amount realized for purposes of computing gain or loss on the sale of the assets disposed of. Instead, seller should separately report such compensation as income from the performance of services.32

**Seller’s Adjusted Basis for Purposes of Computing Gain or Loss**

Seller determines the adjusted basis for purposes of computing gain or loss on each asset disposed of in the transaction by determining all adjustments to the original basis of such asset.33 In most cases, for purposes of computing gain or loss, the adjusted basis of each oil and gas property disposed of should be the sum of its original cost and any subsequent capitalized investment less the accumulated depletion computed for such property.34 Similarly, in most

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32 See infra note 41 for the ordinary income tax rates applicable to such income.
33 In most instances, the original cost of each asset is that asset’s initial basis. I.R.C. § 1012(a).
34 The accumulated depletion computed for each oil and gas property is the sum of the annual depletion deductions for the property as determined under I.R.C. § 611. There may be instances, however, in which seller elected to capitalize intangible drilling and development costs (“IDC”) for its oil and gas properties rather than deducting IDC as permitted by I.R.C § 263(c). In such case, seller’s basis for cost depletion purposes would include such capitalized IDC. Treas. Reg. § 1.612-4. Note, however, that if seller had elected to capitalize IDC incurred with respect to certain oil and gas properties and amortize such capitalized IDC over a period of sixty months in accordance with I.R.C. § 59(e) to avoid having IDC considered an item of tax preference for purposes of the alternative minimum tax imposed by I.R.C. § 55, the amount of such capitalized IDC would not be included in the seller’s basis of the oil and gas property for depletion purposes but the unamortized amount of such capitalized IDC would be included in seller’s basis for purposes of computing gain or loss on the sale of such properties. Cf. I.R.S. Priv. Ltr. Rul. 2001-17-006 (Jan. 17, 2001). If the oil and gas property is located outside of the United States or the costs are incurred for seller’s taxable year beginning prior to the first taxable year beginning after August 8, 2005, seller’s basis for cost depletion purposes would include certain geological and geophysical costs incurred in exploring such property. Rev. Rul. 77-188, 1977-1 C.B. 76. See infra note 36 for the federal income tax treatment of geological and geophysical costs incurred for seller’s first taxable year beginning after August 8, 2005 and all taxable years thereafter. See
cases, for purposes of computing gain or loss, the adjusted basis of each piece of lease and well equipment or other piece of tangible personal property disposed of should be its original cost less the accumulated depreciation computed for such equipment. Finally, for purposes of computing gain or loss, the adjusted basis for geological and geophysical information with respect to domestic oil and gas properties disposed of should be its original cost less the accumulated amortization for such information.

_Seller’s Amount and Character of Gain or Loss_

As stated earlier, seller computes its gain or loss with respect to each asset disposed of in the purchase and sale transaction by subtracting the adjusted basis for each such asset from the amount realized for such asset. The gain or loss with respect to property used in a trade or business is determined separate from other property for federal income tax purposes.

I.R.C. §§ 611, 613 and 613A and the Treasury regulations promulgated under each such section for the rules for computing the cost depletion and percentage depletion deductions, respectively.

The accumulated depreciation computed for each piece of lease and well equipment generally is the sum of the annual depreciation deductions for that piece of equipment as determined under the rules provided for in I.R.C. § 168. Lease and well equipment is considered 7-year property for purposes of applying the rules of I.R.C. § 168(b)(1), (e); Rev. Proc. 87-56, 1987-2 C.B. 674 (asset class 13.2). Note, however, that a taxpayer may elect to compute depreciation under the unit of production method. Treas. Reg. § 1.611-5. See Treas. Reg. § 1.611-2 for an illustration of the unit of production method in the context of computing cost depletion for the oil and gas property.

Geological and geophysical costs incurred by the seller in taxable years beginning after August 8, 2005 in connection with the exploration for, or development of, oil and gas in the United States should be amortized in accordance with the provisions of section 167 of the Code. I.R.C. § 167(h), as added by the Energy Policy Act of 2005, P.L. 109-58, § 1329(a) (2005), as amended by the Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, § 503(a) (2006) and by the Energy Independence and Security Act of 2007, P.L. 110-140, § 1502(a) (2007). Note that geological and geophysical costs need not be incurred by an oil and gas producing company in order to be amortizable pursuant to I.R.C. § 167(h). See CGG Americas, Inc. v. Comm’r, 147 T.C. No. 2 (2016) (holding that “geological and geophysical expenses” could be incurred by a seismic survey company that licensed its seismic data to oil and gas producing companies). The accumulated amortization for geological and geophysical information with respect to domestic oil and gas properties is the sum of the annual amortization deductions for such information as determined under the rules provided for in I.R.C. § 167(h). Note that the Internal Revenue Service has taken the position in field attorney advice that pursuant to I.R.C. § 167(h)(4), a “retirement” includes a sale of the oil and gas property such that under that section the taxpayer cannot (i) add the unamortized I.R.C. § 167(h) amount to the adjusted basis of the oil and gas property disposed of to reduce the amount of gain or increase the amount of loss recognized on the sale of such oil and gas property or (ii) deduct the unamortized amount, but instead must continue the amortization schedule for such information. F.A.A. 20163501F (Aug. 26, 2016), later published as L.A.F.A. 20163501F (Aug. 26, 2016). The Internal Revenue Service has ruled on the federal income tax treatment of geological and geophysical costs incurred in taxable years prior to the effective date of I.R.C. § 167(h). Rev. Rul. 77-188, 1977-1 C.B. 76, modified by Rev. Rul. 83-105, 1983-2 C.B. 51. For purposes of this article, it is assumed that costs incurred for geological and geophysical data and information with respect to domestic oil and gas properties are incurred after the effective date of I.R.C. § 167(h) so that only the rules in that section of the Code are discussed.

See supra notes 17 - 18 and accompanying text.

I.R.C. § 1231. “Property used in the trade or business” is defined as:
Working interests in oil and gas properties, lease and well equipment and other personal property used in oil and gas exploration, development and production operations, and geological and geophysical information with respect to such oil and gas properties all can be considered Section 1231 property. 39

If seller’s recognized gains on the sale of Section 1231 property for the taxable year exceed seller’s recognized losses from the sale of such property, then all such gains and losses are considered capital gains or losses. 40 Alternatively, if seller’s recognized losses on the sale of Section 1231 property exceed seller’s gains from the sale of such property, then all such gains and losses are considered ordinary gains and losses. 41 Seller’s net capital gains from the sale of such property will be recharacterized as ordinary income to the extent of the net losses from such sales reported as ordinary losses during the five most recent preceding taxable years that otherwise already have not been

 Property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business is not – (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, [or] (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

I.R.C. § 1231(b)(1). Property used in the trade or business commonly is referred to as “Section 1231 property” and this term will be used for the remainder of this article to refer to such property. Section 1231 property should be distinguished from a “capital asset” defined in I.R.C. § 1221 because Section 1231 property cannot be considered a “capital asset.” I.R.C. § 1221(a)(2). If the “more than one year” holding period for the asset is not met such that the asset cannot be considered Section 1231 property, then such asset will be considered an “ordinary” asset and the gains or losses on the disposition of such asset will be considered ordinary gains or losses subject to the tax rate for ordinary income. See infra note 41 for tax rates for ordinary income for both corporations and individuals.

39 See supra note 38 for the definition of “Section 1231 property”. See, e.g., Rev. Rul. 68-226, 1968-1 C.B. 362 (interest of a working interest lessee in oil and gas in place is considered real property used in a trade or business for purposes of I.R.C. § 1231). Oil and gas royalty and overriding royalty interests should be considered “property used in a trade or business” if the royalty or overriding royalty interest is used in the taxpayer’s trade or business. Rev. Rul. 73-428, 1973-2 C.B. 303. Otherwise, the royalty or overriding royalty interest will be considered a capital asset. Id.

40 I.R.C. § 1231(a)(1). The maximum tax rate for capital gains is 35 percent for corporations. I.R.C. § 1201(a). The maximum tax rate for capital gains derived by individuals from the sale of oil and gas properties, related lease and well equipment and other personal property, and geological and geophysical information is 20 percent. I.R.C. § 1(h)(1)(D). See infra Seller’s Gain or Loss on the Sale – Ordinary Income Recapture Rules for a discussion of the amount of gain for each asset disposed of in the transaction that is subject to the ordinary income recapture rules.

Note that the gain also may be considered “net investment income” subject to tax at a rate of 3.8 percent if the taxpayer reports a sufficient amount of income and the gain is considered gain from a “passive activity.” I.R.C. § 1411(a), (b), (c)(1), (c)(2).

41 I.R.C. § 1231(a)(2). Ordinary income tax rates for corporations are specified in I.R.C. § 11, with a maximum rate of 35 percent. Ordinary income tax rates for individuals are specified in I.R.C. § 1, with a maximum rate of 39.6 percent.
recharacterized as ordinary income. For example, assume that seller reported a net loss from the sale of Section 1231 property in the immediately prior taxable year and characterized such loss as an ordinary loss, and that seller reports net gains from the sale of such property for the current taxable year. The current year net gains will be recharacterized as ordinary income to the extent of the net ordinary losses reported in the immediately prior taxable year.

Ordinary Income Recapture Rules

As mentioned earlier, the adjusted basis of an oil and gas property is decreased by the annual depletion deduction claimed with respect to such property. And, the adjusted basis of lease and well equipment is decreased by the annual depreciation deduction claimed with respect to such property. When Section 1231 property is disposed of during a taxable year and the gains and losses from all such dispositions of Section 1231 property for the taxable year after application, if at all, of the Section 1231 ordinary income recapture rules are considered capital gains and losses, some portion of the capital gain still may be recharacterized as ordinary income. Effective for oil and gas properties placed in service by the seller after December 31, 1986, Section 1231 capital gain resulting from the disposition of an operating or working interest in an oil and gas property (such an interest in an oil and gas property, “Section 1254 property”)

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*I.R.C. § 1231(c). The recharacterization of capital gain to ordinary income pursuant to section 1231 will be referred to as the “Section 1231 ordinary income recapture rules” for the remainder of this article.*

*Id.*

*See supra* note 34 and accompanying text.

*See supra* note 35 and accompanying text.

Mineral property law typically uses the term "working interest" to refer to a mineral interest that holds the executive rights, that is, the rights to explore for, develop and produce the mineral. Howard R. Williams & Charles J. Meyers, *Manual of Oil & Gas Terms* 1155 (Patrick H. Martin and Bruce M. Kramer eds. 2014). The terms “operating interest” and “working interest” are used interchangeably in the federal income tax law to refer to such interest. For federal income tax purposes, an “operating interest” in an oil and gas property is defined as:

[A] separate mineral interest as described in section 614(a), in respect of which the costs of production are required to be taken into account by the taxpayer for purposes of computing the limitation of 50 percent of the taxable income from the property in determining the deduction for percentage depletion computed under section 613, or such costs would be so required to be taken into account if the mine, well, or other natural deposit were in the production stage.

Treas. Reg. § 1.614-2(b). IDC is deducted solely with respect to working or operating interests. Treas. Reg. § 1.612-4(a). “Nonoperating interests” include only those interests described in section 614(a) which are not operating mineral interests within the meaning of paragraph (b) of § 1.614-2.” Treas. Reg. § 1.614-5(g). In other words, nonoperating interests include royalty interests and overriding royalty interests.

*I.R.C. § 1254(a) defines “section 1254 property” as “any property within the meaning of section 614 if – (A) any expenditures described in paragraph (1)(A) [IDC] are properly chargeable to such property, or (B) the adjusted basis of such property includes adjustments for deductions for depletion under section 611.” I.R.C. § 1254(a)(3). Oil and gas operating or working interests are property interests to which IDC is properly chargeable. See supra* note 46. Such property
in the amount of the lesser of (1) the IDC and depletion deducted by seller with respect to such Section 1254 property or (2) the excess of seller’s amount realized with respect to the disposition of such Section 1254 property over its adjusted basis is recharacterized as ordinary income. If seller disposes of an undivided interest in Section 1254 property, only the IDC and depletion attributable to such undivided interest will be treated as allocable to such interest. Otherwise, if seller disposes of a portion of its Section 1254 property but retains a portion (for example, seller disposes of the working interest in the north half of an oil and gas lease that is treated as a single Section 1254 property but retains the working interest in the south half), the entire IDC and depletion deducted with respect to the original Section 1254 property will be treated as allocable to the interest disposed of. The Section 1254 ordinary income recapture provisions also apply to a nonoperating mineral interest (such as a royalty interest or overriding royalty interest) that has been retained by a lessor in a leasing transaction in which the lessor had previously owned the working interest as a mineral fee or that has been carved out of a working interest and retained by the lessee/sublessor in a subleasing transaction. Other section 1254 ordinary income recapture provisions address nonproductive wells drilled on the oil and gas property disposed of. Under these provisions, the IDC incurred with respect to nonproductive wells is included in total IDC recaptured as ordinary income under section 1254 only to the extent that the seller recognizes income on the foreclosure of a nonrecourse debt that funded the IDC with respect to the property.

Section 1231 capital gain resulting from the disposition of an interest in lease and well equipment and other tangible personal property subject to

interests also are subject to the deduction for depletion. For purposes of section 1254, the oil and gas property is referred to as “Section 1254 property” and this term will be used for the remainder of this article to refer to such property. Prior to the 1986 amendment, only IDC deducted by the seller with respect to the oil and gas property was considered for purposes of section 1254. The Section 1254 ordinary income recapture rules do not apply to a disposition of an oil and gas property by way of contribution to a partnership or corporation and certain other “dispositions.” See supra note 41 for the ordinary income tax rates applicable to the amount recharacterized as ordinary income. Note that IDC is an item of tax preference for purposes of the alternative minimum tax (“AMT”) imposed by I.R.C. § 55. I.R.C. § 1254(b)(1); I.R.C. § 1245(b). The federal income tax treatment of dispositions of oil and gas properties and the related IDC for purposes of the AMT is beyond the scope of this article.

Treas. Reg. § 1.1254-1(b)(2)(iv) (including such nonoperating interests within the definition of Section 1254 property). The inclusion of such nonoperating interests within the definition of Section 1254 property was necessary to prevent a taxpayer from converting a working interest otherwise subject to the Section 1254 ordinary income recapture rules into a nonoperating interest that generally is outside of such rules.
Treas. Reg. § 1.1254-1(b)(1)(vi).
Id. For this purpose, a “nonproductive well” is defined as “a well that does not produce oil or gas in commercial quantities, including a well that is drill for the purpose of ascertaining the existence, location, or extent of an oil or gas reservoir.” Id.
depreciation (such an interest in equipment and other tangible personal property, "Section 1245 property") in the amount by which the lower of the (1) recomputed basis of the property and (2) amount realized on the disposition of such property exceeds the adjusted basis of such property is recharacterized as ordinary income. Section 1245 property also likely includes geological and geophysical data and information included in the purchase and sale transaction because the costs of such data and information generally are amortized pursuant to section 167 of the Code.

Sale of an Interest in a Partnership Holding Oil and Gas Properties

The oil and gas properties being disposed of in the PSA may include properties subject to a joint operating agreement ("JOA") or a unit operating agreement ("UOA"). Seller and purchaser should exercise care in determining whether the JOA or UOA for any such properties contains the standard election to be excluded from the application of the federal income tax rules applicable to partnerships. If the JOA or UOA does not contain such election, then the

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54 I.R.C. § 1245 (a) provides in part that "the term ‘section 1245 property’ means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167..." I.R.C. 1245(a)(3).

55 For purposes of I.R.C. § 1245(a)(1), the term "recomputed basis" is defined as "with respect to any property, its adjusted basis recomputed by adding thereto all adjustments reflected in such adjusted basis on account of deduction (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization." I.R.C. § 1245(a)(2). In practice, the section 1245 ordinary income recapture amount is the lesser of the amount of depreciation claimed with respect to the property disposed of or the amount of gain recognized with respect to such property. The Section 1245 ordinary income recapture rules do not apply to a disposition of lease and well equipment and other tangible personal property by way of contribution to a partnership or corporation and certain other "dispositions." I.R.C. § 1245(b).

56 The costs of geological and geophysical data generally are amortized in accordance with the provisions of I.R.C. § 167(h). Since the costs are recovered in accordance with the provisions of I.R.C. § 167, the costs would seem to meet the definition of Section 1245 property. See supra note 54 for the definition of Section 1245 property." See supra note 36 and accompanying text and infra note 75 for specific reference to geological and geophysical data and information.

57 JOAs and UOAs are contracts that govern virtually all aspects of operations of oil and gas properties in which more than one party owns a working interest. The standard joint operating agreement in the industry is the AAPL Model Form 610. Unit operating agreements are used to govern the operations of oil and gas properties that have been unitized pursuant to state or federal law. See Howard R. Williams & Charles J. Meyers, Oil and Gas Law §§ 910 – 912 (Patrick H. Martin and Bruce M. Kramer eds. 2014) for a discussion on unitizations, unit agreements and unit operating agreements. See infra note 90 and accompanying text regarding the due diligence in identifying whether the JOA or UOA has made such an election and infra notes 91 - 92 and accompanying text for a discussion regarding the representation and warranty typically included in the PSA with respect to oil and gas properties subject to JOAs and UOAs.

58 I.R.C. § 761 provides in part that:

Under regulations the Secretary may, at the election of all members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of - . . . (2) for the joint production, extraction, or use of property, but not for the purposes of selling services or property produced or extracts . . . if the income of the members of the
operations conducted pursuant to the JOA or UOA will be classified as a partnership for federal income tax purposes. In such case, the sale of an interest in such oil and gas properties included in the PSA should be considered the sale of an interest in a partnership for federal income tax purposes, and the federal income tax rules applicable to sales of interests in partnerships described below should be applied rather than the rules above.

organization may be adequately determined without the computation of partnership taxable income.

I.R.C. § 761(a). Treas. Reg. § 1.761-2 adds that:

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

(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive 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
(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 term in excess of the minimum needs of the industry, and in no event for more than one year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or process for persons who are not members of the organization.

Treas. Reg. § 1.761-2(a)(3). The election to be excluded from the federal income tax rules applicable to partnerships can be included in the applicable JOA or UOA, and if so included, is effective for federal income tax purposes. Treas. Reg. § 1.761-2(b)(ii)(a). See Article IX of the AAPL Model Form 610 JOA for an example of such an election. The election can be made, however, in a statement attached to a properly executed partnership tax return, Form 1065. Treas. Reg. § 1.761-2(b)(2)(i). If such an election is made in accordance with the Treasury regulations, then the sale of a working interest in the oil and gas properties, lease and well equipment and related tangible personal property subject to the JOA or UOA will not be considered the sale of an interest in a partnership for federal income tax purposes. I.R.S. Tech. Adv. Mem. 92-14-011 (Dec. 26, 1991). Instead, the seller will treat the sale as a direct sale of the working interest in the oil and gas properties, lease and well equipment and related tangible personal property and apply federal income tax rules applicable to such sales referenced herein. See William S. McKee, William F. Nelson and Robert L. Whitmire, Federal Taxation of Partnerships and Partners ¶ 3.08[4] (4th ed. 2007), citing Noah S. Baer, Selling a Partnership Interest After an Election Out of Subchapter K, 9 J. Partnership Tax’n 229 (1992).

59 See, e.g., I.R.S. Priv. Ltr. Rul. 85-47-036 (Aug. 25, 1985) (agreement to undertake oil and gas joint operations resulted in a partnership for federal income tax purposes pursuant to I.T. 3930, 1948-2 C.B. 126, clarified, I.T. 3948, 1949-1 C.B. 161, the applicable law at the time the analysis was conducted). See also Bush #1 c/o Stonestreet Lands Co. v. Comm’r, 48 T.C. 218 (1967), acq. 1968-2 C.B. 1 (court’s analysis of then applicable Treas. Reg. § 301.7701-2). See Treas. Reg. § 301.7701-3(b)(1)(i) (joint operations conducted today pursuant to a typical JOA or UOA classified as a partnership unless the parties elect to be classified as an association taxable as a corporation).
If the sale of an interest in an oil and gas property included in the PSA is considered the sale of an interest in a partnership, or if one of the assets included in the purchase and sale transaction is an interest in a state law general partnership, limited partnership, or limited liability company holding an interest in oil and gas properties and classified as a partnership for federal income tax purposes, then the seller should determine the gain or loss on the sale of the interest in that partnership by subtracting the adjusted basis of such interest from the amount realized allocated to such asset that is in the schedule allocating the total amount realized on the sale among all assets included in the transaction. The resulting gain or loss should be considered gain or loss from the sale of a capital asset, subject to special ordinary income recapture rules described below.

Capital gain resulting from the sale of a partnership interest is recharacterized as ordinary income to the extent of any “unrealized receivables” attributable to such interest. The term “unrealized receivables” includes Section 1245 property and Section 1254 property. In essence, the amount of ordinary income recapture reported on the sale of an interest in a partnership

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60 Treas. Reg. § 301.7701-3(b)(1)(i).
61 I.R.C. § 1001(a). See supra notes 28 – 31 and accompanying text for a discussion of the allocation of amount realized among the assets in the PSA. Section 705 of the Code provides the rules for determining seller’s adjusted basis in the partnership interest included in the PSA. I.R.C. § 705. Note that when the partnership acquired each oil and gas property, it allocated to each partner its proportionate share of the adjusted basis of such property to the partnership. I.R.C. § 613A(c)(7)(D). Seller separately keeps records of its share of the adjusted basis in each oil and gas property held by the partnership. Id. For each taxable year, seller determines the depletion deduction for its interest in each such property and reduces its adjusted basis in such interest for the depletion deduction claimed. Id. Accordingly, section 705 provides that the seller’s adjusted basis in its partnership interest is decreased (but not below zero) by the amount of the seller/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). I.R.C. § 705(a)(3).
62 I.R.C. § 741. See generally I.R.C. § 1221 for the definition of a “capital asset.” If the partnership interest has been held for not more than one year, then the gain or loss should be considered “short-term” capital gain or loss. I.R.C. § 1222(1), (2). If the partnership interest has been held for more than one year, then the gain or loss should be considered “long-term” capital gain or loss. I.R.C. § 1222(3), (4). See generally I.R.C. § 1223 for the rules applicable to determining the holding period of an asset, including I.R.C. § 1223(2) providing that the holding period of a partnership interest includes the holding period of an asset contributed to the partnership. See Treas. Reg. § 1.1223-3 for the rules relating to the holding period of a partnership interest involving the contribution of multiple assets to a partnership at different times. For individuals, the excess of net long-term capital gain over the net short-term capital loss for the taxable year, that is, “net capital gain” as defined in I.R.S. § 1222(11), is subject to a maximum tax rate of 20 percent. I.R.C. § 1(h)(1)(D); I.R.C. § 1222(11). See I.R.C. § 1411 and supra note 40 for possible application of the 3.8 percent tax on “net investment income” to individuals. For corporations, the net capital gain defined in I.R.C. § 1222(11) is subject to a maximum tax rate of 35 percent. I.R.C. § 1201(a)(2). See infra notes 63 - 65 and accompanying text for the ordinary income recapture rules that, when applicable, act to recharacterize some portion or all of the capital gain that otherwise would be reported on the sale of the partnership interest as ordinary income.
63 I.R.C. § 751(a).
64 I.R.C. § 751(c).
holding oil and gas properties should be the same as if such properties had been held outside of a partnership.\textsuperscript{65}

\textit{Installment Sale Reporting}

The PSA may provide that the Purchase Price is to be satisfied in part through a payment of a specified amount delivered at Closing and one or more payments delivered at subsequent specified dates or milestones. If at least one future payment will be made after the close of the taxable year in which the sale occurs, the transaction may qualify as an “installment sale” for federal income tax purposes with the gain on such sale being reported pursuant to the installment method reporting rules provided for in section 453 of the Code.\textsuperscript{66} Provided that seller does not affirmatively elect out of the installment method reporting rules,\textsuperscript{67} then seller will report gain on the sale of the oil and gas properties in each taxable year in which a payment is received in an amount equal to the amount of the payment received in such year multiplied by a fraction the numerator of which is the “gross profit” realized or to be realized and the numerator of which is the “total contract price.”\textsuperscript{68} There is an exception to the installment method of reporting for gain described above in that gain up to the amount of gain

\textsuperscript{65} See supra Seller’s Gain or Loss on the Sale – Ordinary Income Recapture Rules for a discussion of the ordinary income recapture rules applicable to Section 1254 property and Section 1245 property.

\textsuperscript{66} An “installment sale” is a sale in which at least one payment is received by seller after the close of the taxable year in which the sale of the oil and gas property occurs. I.R.C. § 453(b)(1). The installment method of reporting is defined as a “method under which the income recognized for any taxable year from a disposition 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.” I.R.C. § 453(c). Note that the payment to be received in a subsequent taxable year cannot be in the form of a note that is payable on demand or “readily tradable” and delivered at Closing. I.R.C. § 453(f)(3), (4) (The term “readily tradable” is defined in I.R.C. § 453(f)(5)). If seller retains a production payment in the transaction and one or more payments under that production payment are due after the close of the taxable year of the sale, the payments received pursuant to the production payment in taxable years after the year of the sale should qualify for installment reporting. KPMG LLP, Income Taxation of Natural Resources ¶ 7.25 (2014). Note further that installment sales for purposes of section 453 of the Code do not include sales by dealers in oil and gas properties or sales of oil and gas properties that are required to be included in the inventory the seller. I.R.C. § 453(b)(2)(A), (B).

\textsuperscript{67} If the requirements for the installment method of reporting are met, then seller must use that method unless it affirmatively elects not to apply such method. I.R.C. § 453(d). Seller, for example, might elect out of the installment method of reporting in order to report all gain from the sale in the year of the sale to absorb otherwise expiring net operating loss and capital loss carryforwards.

\textsuperscript{68} Treas. Reg. § 15A.453-1(b)(2). “Gross profit” is defined as the selling price less the adjusted basis of the property (which for this purpose includes selling expenses). Treas. Reg. § 15A.453-1(b)(2)(v). “Selling price” is defined as the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the purchaser) and without reduction to reflect any selling expenses. Treas. Reg. § 15A.453-1(b)(2)(ii). See Treas. Reg. § 15A.453-1(b)(2)(iii) for the complete definition of “contract price,” which, for purposes of this article, is the selling price less any “qualifying indebtedness” (as defined in Treas. Reg. § 15A.453-1(b)(2)(iv)) assumed or taken subject to by the purchaser. Treas. Reg. § 15A.453-1(b)(2)(iii).
recharacterized as ordinary income pursuant to section 1245 of the Code\textsuperscript{69} must be reported for the taxable year of the sale.\textsuperscript{70} Interestingly, gain recharacterized as ordinary income pursuant to section 1254 of the Code is not subject to this exception.\textsuperscript{71} Gain in excess of the amount of gain recharacterized as ordinary income pursuant to section 1245 remains subject to the installment method of reporting.\textsuperscript{72}

\textit{Purchaser’s Basis in the Acquired Assets}

\textbf{Acquired Oil and Gas Properties}

Once the transaction has closed and the Adjusted Purchase Price has been settled in accordance with the terms of the PSA, purchaser can determine and record its tax basis in the acquired oil and gas properties and related assets. Provided that the seller and purchaser have agreed to the value of each of the assets included in the transaction, those values should be the starting point for determining purchaser’s cost for each of the specified assets and thus purchaser’s initial tax basis for each such asset.\textsuperscript{73} There are two items to note in this regard. First, the industry’s view has been that amounts allocated to purchased geological and geophysical data and information should be capitalized and amortized by purchaser in accordance with section 167 of the Code.\textsuperscript{74} But this view has been challenged by the Internal Revenue Service in recent Chief Counsel Advice wherein the ruling was that amounts allocated by the seller and purchaser to geological and geophysical data and information in the PSA could not be capitalized and amortized by purchaser in accordance with section 167 because those amounts were not incurred by the purchaser to locate and identify oil and gas properties with the potential to produce commercial quantities of oil.

\begin{itemize}
\item \textsuperscript{69} See supra notes 54 - 56 and accompanying text for the discussion of the ordinary income recapture rules of I.R.C. § 1245.
\item \textsuperscript{70} I.R.C. § 451(i)(1)(A), (2).
\item \textsuperscript{71} I.R.C. § 451(i)(2). Note that section I.R.C. § 451(i)(2) only refers to I.R.C. § 1245 and I.R.C. § 1250 of the Code. There is no reference to I.R.C. § 1254 in I.R.C. § 451(i).
\item \textsuperscript{72} I.R.C. 453(i)(1)(B). Note that this amount would include gain recharacterized as ordinary income pursuant to I.R.C. § 1254 of the Code.
\item \textsuperscript{73} I.R.C. § 1012(a) (providing that the basis of a purchased asset shall be its cost). See supra Seller’s Gain or Loss on the Sale – Allocations of Amounts Realized for a discussion of the allocation of the Purchase Price, as adjusted, among the assets included in the transaction on a schedule of Allocated Values. Seller and purchaser may not have included assumed accrued liabilities in the Adjusted Purchase Price reported on Internal Revenue Service Form 8594 and if not, the amounts of such liabilities should be included in purchaser’s cost. Treas. Reg. § 1.1012-1(g). The cost basis of each oil and gas property should be recovered through the deduction for depletion. The cost basis of each item of lease and well equipment and other tangible personal property should be recovered through the deduction for depreciation. It is uncertain how the cost basis of geological and geophysical data and information should be recovered. See infra notes 74 – 75 and accompanying text for a discussion of the reasoning behind the uncertainty.
\item \textsuperscript{74} I.R.C. § 167(h). The industry view is that the wording of I.R.C. § 167(h) does not require the purchaser to be the first party to incur the costs for such geological and geophysical data and information.
\end{itemize}
and gas but instead were incurred pursuant to the PSA.\textsuperscript{75} It remains to be seen whether the taxpayer in the ruling will challenge the Internal Revenue Service position in the courts, and if so, what the outcome will be. Second, some purchasers in industry may have taken the position that well plugging and abandonment, platform dismantlement and removal, and other site restoration costs assumed by the purchaser pursuant to the PSA are included in the basis of the acquired oil and gas properties. But the United States Court of Appeals for the Federal Circuit in \textit{Amergen Energy Company, LLC v. United States}\textsuperscript{76} has held under analogous facts that the costs of dismantling and removing a nuclear power facility and the related site restoration costs assumed by the purchaser of such a facility could not be capitalized and recovered through depreciation because the assumed obligation was not an accrued liability under the rules for “economic performance.”\textsuperscript{77} Instead, the court held that such costs could only be deducted when actually incurred by the purchaser in the future when the facility was dismantled and the site restored.\textsuperscript{78} It remains to be seen whether the holding of \textit{Amergen Energy} will be applied by the courts with respect to assumed well plugging and abandonment, platform dismantlement and removal, and other site restoration costs incurred with respect to oil and gas properties or whether purchasers who assume the obligation to incur such costs can convince the courts that \textit{Amergen Energy} was wrongly decided. If the courts apply the holding of \textit{Amergen Energy} with respect to these assumed costs, they will not be added

\begin{footnotes}
\footnotemark[75] I.L.M. 2015-52-024 (Aug. 28, 2015), later published as C.C.A. 2015-52-024 (Aug. 28, 2015). Note that under the facts of the ruling, the oil and gas properties purchased pursuant to the PSA consisted mainly of proved, developed and probable properties. The ruling concluded that the purchaser did not use the acquired geological and geophysical data and information to obtain and accumulate data that would serve as the basis for the acquisition and retention of mineral properties, which, in the Internal Revenue Service’s view, is a requirement for such costs to be amortizable pursuant to I.R.C. § 167(h) of the Code. The document provides no specific guidance on how the purchaser instead should recover such amounts, but presumably, in the Internal Revenue Service’s view, such amounts would be added to the tax basis of the purchased oil and gas properties and recovered through depletion. This should be distinguished from the situation in which the taxpayer acquires the oil and gas properties and then performs additional geological and geophysical work on the properties. In this latter situation, the Internal Revenue Service Field Attorney Advice has taken the position in field attorney advice that when those properties subsequently are sold, the seller cannot (i) add the unamortized I.R.C § 167(h) amounts to the adjusted basis of the oil and gas properties disposed of to reduce gain or increase loss on the disposition or (ii) deduct the unamortized amounts, but instead must continue to amortize those amounts over their remaining amortization period. F.A.A. 20163501F supra note 36.
\footnotemark[76] 779 F.3d 1368 (Fed. Cir. 2015). The government argued that the assumed liability could not be considered an accrued liability and therefore added to the tax basis of the purchased facility because the economic performance test provided for in I.R.C. § 461(h)(2)(B) of the Code (which provides that if the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services) was not met. The taxpayer argued that economic performance should be tested under I.R.C. § 461(h)(2)(A)(ii) (which provides that if the liability of the taxpayer arises out of the providing of property to the taxpayer, then economic performance occurs as the person provides such property). The court agreed with the government’s argument.
\footnotemark[77] Id. at 1376.
\footnotemark[78] Id.
\end{footnotes}
to the cost basis of the oil and gas properties, but instead will be deductible under section 461(h) of the Code when the services for these assumed costs actually are performed by the purchaser.\textsuperscript{79}

**Acquired Interests in Partnerships**

Provided that the seller and purchaser have agreed to the value of the interest in the partnership (or the value of the oil and gas properties and other assets considered owned by the contractual joint operation classified as a partnership for federal income tax purposes) in the schedule of Allocated Values, that value should be the starting point for determining purchaser’s cost for the acquired partnership interest and thus purchaser’s initial tax basis for such partnership interest.\textsuperscript{80}

The analysis does not stop here, though, because even though purchaser takes a cost basis in the acquired partnership interest (the partner’s “outside basis”), the purchaser’s share of the partnership’s tax basis in its assets (the partner’s “inside basis”, which may be more or less than purchaser’s tax basis in the acquired partnership interest) is not adjusted to equal the purchaser’s outside basis unless the partnership has made an election providing for such an adjustment pursuant to section 754 of the Code (a “Section 754 election”).\textsuperscript{81} To illustrate, assume that one of the assets acquired by purchaser in the transaction is a forty percent interest in a partnership owning an oil and gas property and that the schedule of Allocated Values in the PSA allocates one hundred dollars to such asset (thus, the one hundred dollars is purchaser’s outside basis in the partnership interest). Assume further that the partnership’s tax basis in the oil and gas property is twenty-five dollars, so that purchaser’s inside basis in the oil and gas property otherwise would be forty percent of twenty-five dollars, or ten dollars. If the Section 754 election is in effect for the partnership, purchaser will increase its inside basis in the partnership’s oil and gas property to one hundred dollars, providing an additional tax basis of ninety dollars to be recovered for federal income tax purposes through depletion and depreciation. If the Section 754 election is not in effect, then purchaser will recover its inside basis of ten dollars through depletion and depreciation (which reduces the purchaser’s

\textsuperscript{79} I.R.C. § 461(h)(2)(B).

\textsuperscript{80} I.R.C. § 1012(a) (providing that the tax basis of a purchased asset shall be its cost). See *supra* Seller’s Gain or Loss on the Sale – Allocations of Amount Realized for a discussion of the allocation of the Purchase Price, as adjusted, among the assets included in the transaction on a schedule of Allocated Values.

\textsuperscript{81} I.R.C. § 743(a) (providing that the tax basis of partnership property shall not be adjusted as a result of a transfer of an interest in a partnership by sale or exchange unless the partnership has made the election to adjust such basis provided for in I.R.C. § 754). If the Section 754 election is in effect for the partnership, then the purchaser’s inside basis essentially is adjusted to equal the purchaser’s outside basis. I.R.C. § 743(b). See McKee, Nelson and Whitmire, *supra* note 58, ¶ 24.01 for a more detailed discussion of the I.R.C. § 743 rules for adjusting the basis of partnership assets with respect to a partner who purchases an interest in a partnership with a Section 754 election in effect.
outside basis) and the remaining ninety dollars of outside basis will be recovered when the purchaser sells the partnership interest or abandons it.\textsuperscript{82}

Like-Kind Exchange Provisions

A discussion of the structuring of oil and gas exchange agreements to meet the requirements for a nontaxable like-kind exchange under the Code is beyond the scope of this article.\textsuperscript{83} Nevertheless, because in certain instances either seller or purchaser may desire to structure the transaction to involve, in part, a nontaxable like-kind exchange in order to avoid significant adverse federal income tax consequences, it is common to see provisions dealing with such exchanges included in the PSA. These provisions typically state that either party

\textsuperscript{82} The differences between the tax results to purchaser (1) with a Section 754 election in effect and (2) without a Section 754 election in effect are both in the timing of purchaser’s recovery of its one hundred dollar investment and the character of such recovery. With the election, purchaser recovers its investment of one hundred dollars through annual tax depletion and tax depreciation deductions, which are ordinary deductions. Without the election, purchaser recovers ten dollars through ordinary tax depletion and depreciation deductions, and the remaining ninety dollars as either a decrease in capital gain (subject to the ordinary income recapture rules in I.R.C. § 751) or an increase in capital loss on the taxable disposition of the partnership interest. \textit{See supra} notes 40 - 41 for the maximum tax rates applicable to capital gain and ordinary income, respectively. \textit{See} McKee, Nelson and Whitmire, \textit{supra} note 58, ¶ 24.01[3] for additional discussion regarding the timing and character issues with respect to the I.R.C. § 743 basis adjustment or lack thereof because the partnership does not have a Section 754 election in effect. Because these timing and character differences can be significant on an after-tax basis, purchaser’s due diligence review of each JOA for oil and gas properties included in the transaction to determine whether the operations conducted pursuant to that JOA are classified as a partnership or not (assuming the I.R.C. § 761 election to be excluded from the partnership tax rules is in effect for the JOA) is critical. \textit{See supra} notes 57 – 58 and accompanying text for a discussion of the I.R.C. § 761 election for the operations conducted pursuant to the JOA to be excluded from the partnership tax rules. Moreover, purchaser should request a representation and warranty from seller with respect to the classification of all JOAs for federal income tax purposes and whether or not each JOA whose operations are classified as a partnership for federal income tax purposes has a Section 754 election in effect. \textit{See infra} notes 90 – 91 and accompanying text for additional discussion regarding such a representation and warranty. \textit{See infra} note 91 for a sample representation and warranty.

\textsuperscript{83} See I.R.C. § 1031(a), which provides in part:

\begin{quote}
No 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.
\end{quote}

I.R.C. § 1031(a)(1). The gain or loss not recognized on the oil and gas property disposed of in a qualifying like-kind exchange is preserved in the oil and gas property received in the exchange because the tax basis of the property received in such an exchange is equal to the tax basis of the property disposed of. I.R.C. § 1031(d). Thus, recognition of the gain or loss realized on the disposition is deferred until the property received in the exchange is disposed of in a taxable transaction. \textit{See} KPMG LLP, \textit{Income Taxation of Natural Resources} ¶ 6.13 (2014) for a more detailed discussion of the application of the section 1031 like-kind exchange rules to exchanges of oil and gas properties. \textit{See also} Richard M. Lipton, Samuel P. Grilli, and Samuel Pollack, \textit{The State of the Art in Like-Kind Exchanges – 2015}, 124 J. Tax’n 5 (2016) for a more general discussion of the current techniques in like-kind exchanges under section 1031.
may elect to structure the assignment and conveyance of the interests in the oil and gas properties covered in the PSA as part of a nontaxable like-kind exchange and in such case, the parties will cooperate with one another with respect to the exchange to achieve the desired objectives.\textsuperscript{84}

For example, seller might elect to structure the disposition of its oil and gas properties as part of a like-kind exchange. Seller might instruct purchaser to use the purchase price to acquire a replacement oil and gas property and exchange that replacement property with seller for seller’s oil and gas properties. Or, seller might structure the nontaxable like-kind exchange as a deferred exchange, and thus engage the services of a qualified intermediary, transfer the oil and gas properties to that intermediary, have that intermediary sell the oil and gas properties to purchaser, have the intermediary use the sales proceeds to acquire a designated replacement oil and gas property, and then have that replacement property delivered to seller.\textsuperscript{85}

The party requesting the involvement of a nontaxable like-kind exchange usually bears all incremental costs associated with the execution of the exchange pursuant to these provisions in the PSA.

\textit{Allocations of Taxes and Tax Representations, Warranties and Indemnities}

\textit{Allocations of Taxes}

The PSA should contain a provision allocating responsibility for all taxes related to the transaction between seller and purchaser. Seller typically retains responsibility for reporting and paying all federal, state and local income taxes (including any interest and penalties) imposed on any gain recognized by seller on the transaction and on any income from the sale of oil and gas produced prior to Closing. Seller and purchaser will negotiate which party bears any state and local sales, use or gross receipts taxes (including any interest and penalties) and any documentary, filing and recording fees and expenses imposed on the transaction. Unless one party or the other has a particularly strong bargaining position, the parties often agree to split the burden for such state and local taxes and fees and expenses. The PSA should contain a provision requiring purchaser to provide seller at the Closing with an exemption certificate required by applicable state law for any exemption from state and local sales and use taxes.

\textsuperscript{84} A typical provision might read something like:

\textit{Either Party may elect to structure the assignment and conveyance of the Assets as part of a like-kind exchange under section 1031 of the Code. The Parties agree to cooperate with one another with respect to the like-kind exchange and to execute all documents, conveyances, and other instruments necessary to effectuate an exchange. The Party requesting a like-kind exchange shall bear all costs and expenses and liability associated therewith.}

\textsuperscript{85} Treas. Reg. § 1.1031(k)-1. Section 1.1031(k)-1 of the Regulations contains the rules for seller’s timely identification of the property to be received, seller’s timely receipt of the property to be received in the deferred exchange, and the conduct of the qualified intermediary who assists in the completion of the deferred exchange. \textit{Id.}
Without such a certificate, those taxes otherwise apply, and the burden for such taxes should be allocated in accordance with the provision negotiated in the PSA.

Seller typically is allocated responsibility for, and bears and pays, all ad valorem, severance, production and similar taxes (including interest and penalties) based upon or measured by the ownership of the oil and gas properties, the production of oil and gas from such properties, or the receipts of proceeds from the sale of such oil and gas for all taxable periods prior to the Effective Date, while purchaser is allocated responsibility for, and bears and pays, all such taxes (including interest and penalties) from and after the Effective Date. Because seller remains the owner of the oil and gas properties until the Closing Date, seller usually retains responsibility for reporting and paying such taxes to the appropriate taxing authority, and any amounts paid by seller that are allocated to purchaser as provided above will be recovered as adjustments to the Purchase Price either at Closing or in the final post-Closing adjustments.

The PSA typically includes a provision requiring the parties to cooperate with each other in connection with the preparation and filing of any state and local tax return pursuant to which taxes will be allocated between the parties. This cooperation entails not only providing data and information required to file such returns but also retaining records relevant to such returns and assisting in the audit and defense of such returns.

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86 Such an allocation provision might read something like:

Seller shall assume responsibility for, and shall bear and pay, all ad valorem, property, severance, production, and similar taxes and assessments based up or measured by the ownership of the Assets, the production of Hydrocarbons, or the receipt of proceeds therefrom (including any applicable penalties and interest), but exclusive of income taxes, assessed against the Assets by any taxing authority for an period prior to the Effective Date, and Buyer shall be responsible for, and shall bear and pay, all such taxes and assessments assessed against the Assets by any taxing authority for any period that begins on or after the Effective Date.

See infra Special Drafting Issues in the Allocation of Ad Valorem Taxes for a more detailed discussion of the allocation of ad valorem and property taxes between seller and purchaser and how such taxes are reported and paid to the appropriate tax authorities. Note that if the PSA uses the defined term “Taxes” in a tax allocation provision like the one set out above, the definition of that term should exclude any tax imposed on or measured by income because federal and state income taxes due on the sale of the oil and gas properties are allocated to seller based on its ownership prior to Closing and federal and state income taxes due on the sale of produced oil and gas are allocated to seller for the period prior to Closing and to purchaser from and after Closing, as indicated above.

87 See the two paragraphs of text immediately preceding supra note 14 for a discussion of adjustments to the Purchase Price for allocations of such taxes.

88 Such a cooperation provision might read something like:

Purchaser and Seller shall cooperate fully, as and to the extent reasonably requested by the other Party, in connection with the filing of any Tax Return and
Tax Representations and Warranties

This article earlier mentioned the due diligence period for purchaser’s review of key data and information regarding the oil and gas properties to be included in the purchase and sale transaction. Also mentioned was that the PSA will provide the respective representations and warranties of seller and purchaser for the transaction. From the purchaser’s perspective, these two concepts go hand-in-hand, but seller’s representations and warranties should not be considered a substitute for purchaser’s review of all data and information made available in seller’s data room, including purchaser’s review of the tax data and information regarding the subject oil and gas properties. Instead, this review and the negotiation of seller’s representations and warranties regarding taxes and other matters, including any exceptions listed on the appropriate schedules, assists purchaser in developing the fundamental tax assumptions on which it will proceed to close the transaction.

For example, seller’s data room as supplemented should include evidence of the filing of all state production or severance tax returns and the payment of all such production or severance taxes imposed on oil and gas produced from the properties included in the purchase and sale transaction up to the Effective Date. These taxes may have been paid by seller or withheld and paid by the first purchaser of the oil and gas, depending on the laws of various states in which the properties are located. There also should be data and information regarding whether any relevant state or local tax authority has opened an audit of any prior tax year with respect to such taxes and if an audit has been undertaken, what issues are involved and the tax exposure associated with such issues. Evidence of any audit assessments that have been challenged either administratively or in the courts should be included in the data room as well. Similarly, seller’s data room as supplemented should include evidence of the filing of all state and local ad valorem or property tax returns and payment of all such ad valorem or any audit, litigation or other proceeding with respect to Taxes. Such cooperation shall include the retention and (upon the other Party’s request) the provision of records and information which are reasonably relevant to any such audit, litigation or other proceeding and making employees available on a mutually convenient basis to provide additional information and explanation of any material provided hereunder. Each of Purchaser and Seller agrees (a) to retain all books and records with respect to Tax matters, and the allocation of the Purchase Price provided for in Section [2.6], pertinent to the acquired Assets relating to any taxable period beginning before the Closing Date until the expiration of the statute of limitation (and, to the extent notified by Purchaser or Seller, any extensions thereto) of the respective taxable periods, and to abide by all record retention agreements entered into with any Taxing Authority, and (b) to give the other Party reasonable written notice prior to transferring, destroying or discarding any such books and records and, if the other Party so requests, each Party shall allow the other Party the option of taking possession of such books and records prior to their disposal. Purchaser and Seller further agree, upon request, to use their commercially reasonable efforts to obtain any certificate or other document from any Taxing Authority or any other Person as may be necessary to mitigate, reduce or eliminate any Tax that could be imposed with respect to the transactions contemplated in this Agreement.
property taxes imposed on the properties and any relevant audit and tax assessment data and information, including any administrative or legal challenges to such assessments.

Purchaser’s review of the relevant tax data and information in seller’s data room assists purchaser in determining the extent of its requests for seller’s tax representations and warranties included in the PSA. Most likely, purchaser will request seller to represent and warrant in the PSA that seller has filed all state and local tax returns for all production, severance, ad valorem, property taxes and similar taxes and has paid all such taxes that have become due and payable prior to the Effective Date, other than such taxes that seller has contested in good faith. Purchaser also will most likely request seller to represent and warrant that (1) seller has not extended the time within which to file any required state and local tax returns, (2) seller has not granted any state or local taxing authority any waiver of the applicable statute of limitations within which to assess additional tax with respect to tax returns already filed, (3) no audit or litigation with respect to such taxes has been commenced against seller, and (4) seller has not received notice of any pending tax claim against with respect to such taxes. Purchaser should investigate any exceptions listed by seller on the relevant schedule for each of these representations and warranties.

Purchaser will want the PSA to provide that responsibility to pay any taxes that have become due prior to the Effective Date, including those contested, remains with seller even after the purchase and sale transaction has closed and the final adjustments to the Purchase Price have been accounted for. Purchaser also will want seller to indemnify purchaser for any such taxes it is required by any state taxing authority to pay on seller’s behalf.

Purchaser’s review of the JOAs in the data room should disclose whether the operations of each JOA for any oil and gas property in the purchase and sale transaction are classified as a partnership for federal income tax purposes and whether there are any issues with respect to its tax recovery for amounts allocated to the acquisition of interests in partnerships. Regardless of the outcome of such a due diligence review, purchaser typically will request a representation and warranty of seller regarding whether the operations of each JOA are classified as a partnership for federal income tax purposes, and whether, for those that are so classified, the partnership has a section 754 election in effect. Again, purchaser should investigate any exceptions on

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89 See infra notes 100 – 102 and accompanying text for a discussion of the survival period for tax indemnification that purchaser should require in the PSA.
90 See supra notes 80 – 82 and accompanying text for a discussion of the issues regarding tax basis and its recovery that are associated with the acquisition of interests in partnerships owning oil and gas properties.
91 Such a representation and warranty might look something like this:

Except as disclosed on Schedule [5.9], the parties with respect to all unit operating agreements, joint operating agreements and similar agreements governing operations of the Properties have elected to be excluded from the
seller’s schedule for this representation and warranty to determine the after-tax impact on purchaser.

During the course of the negotiation of the LOI with seller, purchaser should determine whether seller is a “United States person“ for federal income tax purposes or instead is a “foreign person.” This determination is important because gain or loss on the disposition of an oil and gas real property interest located in the United States by a nonresident alien individual or a foreign corporation is subject to federal income tax. To enforce the payment of the federal income tax obligation imposed on such a foreign seller, effective for dispositions after February 16, 2016, the purchaser is required to withhold from its payment to seller an amount equal to fifteen percent of the amount realized on the purchase and sale transaction and pay such amount to the Internal Revenue Service. A purchaser who fails to withhold and pay such tax becomes liable for payment of such tax and any applicable interest and penalty. To confirm that seller is not a “foreign person” so that any issue with respect to the required withholding can be avoided, purchaser should ask seller for a representation and warranty to that effect. Moreover, with the request for such a representation and warranty in the PSA, purchaser also should insist that the PSA contain a requirement that at the Closing seller deliver to purchaser a certification that seller is not such a foreign person. With this certification in hand, purchaser

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**Note References:**

92 Included within the definition of a “United States person” are a citizen or resident of the United States, a domestic partnership, a domestic corporation, an estate other than a foreign estate, and a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have authority to control all substantial decisions of the trust. I.R.C. § 7701(a)(30). See I.R.C. § 7701(a)(31) for the definition of a “foreign estate.”

93 A “foreign person” is any person other than a United States person. I.R.C. § 1445(f)(3).

94 See I.R.C. § 897(a)(1) for the imposition of federal income tax on the disposition of a United States real property interest by a foreign person. I.R.C. § 897(c)(1)(A)(i) includes within the definition of a “United States real property interest” an interest in a mine, well or other natural deposit located in the United States or the Virgin Islands.

95 I.R.C. § 1445(a), as amended by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113, § 324(a) (the “PATH Act”). For dispositions prior to February 17, 2016, the withholding rate is 10 percent. Section 324(b) of the PATH Act retained the 10 percent withholding rate for dispositions of certain real property acquired by a transferee for use as a residence with respect to which the amount realized is greater than $300,000 but does not exceed $1,000,000. See T.D. 9751, 81 Fed. Reg. 8398 (February 19, 2016) for final and temporary regulations implementing the changes to I.R.C. 897 enacted in the PATH ACT.

96 Treas. Reg. § 1.1445-1(e)(1).

97 Such a representation and warranty might look something like this: “Seller is not a ‘foreign person’ within the meaning of section 1445 of the Code.”

98 The form of such certification typically is included in the PSA as an exhibit or schedule. See infra note 99 for the requirements of the certification.
can be assured that it will have no obligation to withhold any tax with respect to consideration paid to seller.\footnote{\textit{Treas. Reg.} § 1.1445-2(b)(2)(i). To achieve the desired effect of absolving purchaser of any responsibility to withhold, the certification must state that the transferor is not a “foreign person” as defined in the Code, must include the transferor’s name, its taxpayer identifying number and its address and be signed under penalties of perjury. \textit{Treas. Reg.} § 1.1445-2(b)(2)(i)(A) – (C).}

\textit{Tax Indemnities}

The PSA typically will contain provisions pursuant to which seller will indemnify purchaser and its affiliates, and all of its and their respective shareholders, partners, members, directors, officer, managers, employees, agents and representatives (collectively, “\textit{Purchaser Indemnified Persons}”) from all liabilities for any breach by seller of its representations or warranties and covenants and agreements contained in the PSA. Seller also typically will indemnify Purchaser Indemnified Persons from all liabilities associated with (a) any litigation arising before the Effective Date for which seller has retained responsibility, (b) any claim with respect to operating expenses and royalties and overriding royalties attributable to oil and gas produced before the Effective Date (provided any claim for such an item is presented to seller before the expiration of the period of limitations applicable to such claim), and (c) any claim with respect to natural gas production imbalances as of the Effective Date.

Similarly, the PSA typically will contain provisions pursuant to which purchaser will indemnify seller and its affiliates, and all of its and their respective shareholders, partners, members, directors, officer, managers, employees, agents and representatives (collectively, “\textit{Seller Indemnified Persons}”) from all liabilities for any breach by purchaser of its representations or warranties and covenants and agreements contained in the PSA. Purchaser also typically will indemnify Seller Indemnified Persons from (a) all of purchaser’s post-closing financial commitments, (b) all obligations of seller assumed by purchaser pursuant to the PSA (including seller’s well plugging and abandonment, platform dismantlement and removal, and other site restoration obligations), and (c) any title defects related to the oil and gas properties in the purchase and sale transaction (as such defects should have been raised and dealt with prior to Closing).

Seller’s and purchaser’s obligations regarding indemnification typically survive the Closing for only a specified period of time. In many cases, the survival provisions will differentiate among the various indemnity obligations, with some obligations having a shorter survival period (for example, six (6) or nine (9) months), others having a longer survival period (for example, two (2) years or until the expiration of the applicable period of limitations) and still others surviving with no time limit.

From a tax perspective, the key indemnifications that purchaser should seek are the indemnification from all taxes applicable to any period before the...
Effective Date that have been allocated to seller pursuant to the PSA\(^{100}\) and the indemnification for breach of any representation or warranty with respect to tax partnerships and the Section 754 election.\(^{101}\) Buyer should insist that the survival period for seller’s indemnification with respect to a breach of seller’s representations and warranties with respect to taxes be tied to the applicable period of limitations for each such tax allocated to seller.\(^{102}\)

The PSA may include a provision that that no claim for indemnification is allowable unless the amount for which indemnification is sought exceeds a certain amount (typically referred to as a “deductible”). Purchase should insist that this limitation not apply to indemnification of tax allocated to seller in the PSA. Finally, the PSA may include a provision that reduces any indemnification payments due Seller Indemnified Persons or Buyer Indemnified Persons, as the case may be, by the corresponding tax benefit created or generated for the recipient on the receipt of such payment.

**Special Drafting Issues in the Allocation of Ad Valorem Taxes**

This article earlier mentioned the standard for the allocation between seller and purchaser of ad valorem taxes incurred with respect to the oil and gas properties included in the purchase and sale transaction, that is, seller assumes responsibility for, and bears and pays, all ad valorem taxes (including interest and penalties) with respect to such properties for all taxable periods prior to the Effective Date and purchaser assumes responsibility for, and bears and pays, all ad valorem taxes from and after the Effective Date.\(^ {103}\) While the drafting of the provision to accomplish this allocation seems simple enough, depending on the location of the oil and gas properties and the related ad valorem tax law applicable to such properties, the drafting can become quite complex.

Consider that in states like Texas, the ad valorem tax is imposed on the present value of the oil and gas producing property’s reserves in the ground as of January 1 of the taxable year.\(^ {104}\) Owners of such properties receive notice of the local taxing district’s valuation, and have an opportunity to contest such

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\(^{100}\) See the two paragraphs of text immediately preceding supra note 87 for a discussion of the allocation of responsibility for taxes between seller and purchaser.

\(^{101}\) See supra notes 90 – 91 and accompanying text for a discussion regarding the tax representation and warranty regarding tax partnerships and the Section 754 election to adjust basis pursuant to I.R.C. § 743.

\(^{102}\) For example, the period of limitations for assessing additional production or severance taxes might be three (3) years but the period of limitations for assessing additional ad valorem or property taxes in the same state taxing jurisdiction might be four (4) years. The survival period for taxes needs to be carefully drafted so that seller’s indemnification obligation for each such tax does not expire prior to the expiration of the period of limitations applicable to that tax. The typical survival periods for tax representations extend thirty to ninety days after the expiration of such period to allow for addressing any last minute claims by taxing authorities.

\(^{103}\) See supra Allocations of Taxes and Tax Representations, Warranties and Indemnities – Allocations of Taxes for a discussion of the tax allocation provisions typically included in PSAs.

valuation. The ad valorem taxes for the property are due by January 31 of the year following the year of valuation. So, for example, if a PSA covering Texas oil and gas properties was executed in November of 2015 with an Effective Date of August 31, 2015, at the Closing sometime early in 2016 seller and purchaser would have knowledge of the taxable values of the properties for 2015 and actual tax due with respect to those properties. The ad valorem tax proration between seller and purchaser for ad valorem tax year 2015 based on the “economic ownership” of the parties (determined by the Effective Date of the sale of the properties) easily could be computed and included in the purchase price adjustments either at Closing or in the final post-Closing purchase price adjustment statement. Even if the PSA was executed in May of 2015 with an Effective Date of February 1, 2015, at the Closing later in 2015 the parties could use the taxing district’s valuation and an estimated ad valorem tax rate to determine an amount of 2015 ad valorem tax to adjust downward the Purchase Price for 2015 ad valorem taxes prorated to seller (with perhaps a final purchase price adjustment in early 2016 when the ad valorem taxes were known and paid by purchaser). Thus, for states that impose an ad valorem tax on oil and gas properties based on each property’s value on January 1 of the taxable year and collect that tax early in the next year, the tax allocation provisions previously mentioned will work well administratively.

But what if the oil and gas producing properties are located in a state with ad valorem tax laws like those in Colorado? There, the ad valorem taxes are imposed not with respect to the value of reserves of the properties, but instead with respect to oil and gas produced from the properties. Pursuant to the operative statutes, oil and gas produced in a calendar year by seller would be reported by seller in its ad valorem tax report filed during the following calendar year and the resulting tax would be assessed by the local tax authorities during that year, but the ad valorem tax assessed with respect to that production would be payable in the second calendar year following the calendar year of production. To illustrate, suppose that the parties execute a PSA for oil and gas properties located in Colorado in May of 2015, with an Effective Date of April 1, 2015 and close the transaction in October of 2015. Seller in theory should be responsible and pay the ad valorem tax based on 2014 production it received and the ad valorem tax based on 2015 production it received up to the Effective Date. But ad valorem tax imposed for tax year 2015, based on tax year 2014 production, will not be become payable until 2016, and the tax year 2015 production has not yet been reported in an ad valorem tax report (which report will not be due until 2016 with tax assessed in 2016 and payable in 2017). How are the parties to handle the allocation of ad valorem taxes with respect to the period prior to the Effective Date and the period from and after the Effective Date? There are two approaches that have been developed to address this issue.

105 Id. at § 31.02.
106 See supra note 86 for a sample tax allocation provision.
First, under a “seller friendly” ad valorem tax allocation provision applicable to the facts above, the ad valorem tax liability assessed in 2014 (with respect to oil and gas produced in 2013 but payable in 2015) would be allocated entirely to seller. The ad valorem tax liability assessed in 2015 (with respect to oil and gas produced in 2014 but payable in 2016) would be prorated between the parties based on the number of days each was considered the economic owner of the oil and gas properties in 2015 pursuant to the Effective Date provisions. Based on the Effective Date of April 1, 2015, seller would be considered the economic owner for thirty-one days in January, twenty-eight days in February and thirty-one days in March of 2015, or ninety of the three hundred sixty-five days in the year. So, under the “seller friendly” tax allocation provision, seller would be allocated 90/365 of the ad valorem tax liability assessed in 2015 (and payable in 2016). The Purchase Price in the PSA would be decreased by the computed ad valorem tax amount allocated to seller assuming that purchaser would pay the entire ad valorem tax liability assessed in 2015 in 2016 when due.\textsuperscript{109} Purchaser would be allocated the remainder of the ad valorem tax liability assessed in 2015 and the ad valorem tax liability assessed in 2016 for all of the oil and gas produced from the property during 2015.\textsuperscript{110} This is the case even

\textsuperscript{109} See supra text accompanying note 14 for a discussion of the purchase price adjustment required in this instance.

\textsuperscript{110} Such a “seller friendly” provision might read something like:

The Parties acknowledge that the state of Colorado ad valorem taxes assessed with respect to the Properties in any year are measured by the preceding year’s production and sales of Hydrocarbons and are payable in the year following the year of assessment (“Oil and Gas Ad Valorem Taxes”). Oil and Gas Ad Valorem Taxes other than Settled Oil and Gas Ad Valorem Taxes shall be the responsibility of and be allocated to the Party that owned the Properties during the taxable period or portion thereof for which the Oil and Gas Ad Valorem Tax is assessed. 2014 Oil and Gas Ad Valorem Taxes, payable in 2015, are based on production and sales of Hydrocarbons from the Properties in 2013, shall be allocated entirely to Seller. 2015 Oil and Gas Ad Valorem Taxes, payable in 2016, are based on production and sales of Hydrocarbons from the Properties in 2014, shall be allocated between Seller and Purchaser in accordance with their proportionate ownership periods with respect to the Properties during 2015 prior to the Effective Date and from and after the Effective Date. 2016 Oil and Gas Ad Valorem Taxes, payable in 2017, are based on production and sale of Hydrocarbons from the Properties in 2015, and shall be the responsibility of and be allocated entirely to Purchaser. For the purpose of determining adjustments to the Purchase Price for 2015 Oil and Gas Ad Valorem Taxes pursuant to section [ ] of this Agreement, 2015 Oil and Gas Ad Valorem Taxes determined by reference to production and sale of Hydrocarbons in 2014 shall be estimated based on the then current mill levies with the resulting adjustment to the Purchase Price being considered the full and final settlement of all such 2015 Oil and Gas Ad Valorem Taxes for such production without regard to the actual tax rates or assessments; provided, however, that if the actual amounts of such production and mill levies are not known at the time of Closing, the amounts shall be re-estimated based on the best information available at the time of the Final Settlement Statement, and such re-estimated amounts shall thereupon become full and final settlement of such Oil and Gas Ad Valorem Taxes for such production.
though seller was entitled to all of the oil and gas produced during 2014 and the oil and gas produced in 2015 through March 31, 2015.

Second, under a “purchaser friendly” ad valorem tax allocation provision applicable to the facts above, the ad valorem tax liability would be allocated between seller and purchaser based on which party was economically entitled to the production from the oil and gas properties for each taxable period. So the ad valorem tax liability assessed in 2015 (with respect to oil and gas produced in 2014 but payable in 2016) would be allocated entirely to seller. The ad valorem tax liability to be assessed in 2016 (with respect to oil and gas produced in 2015 but payable in 2017) would be prorated between seller and purchaser based on the number of days each was considered the economic owner of the oil and gas properties in 2015 pursuant to the Effective Date provisions. Based on the Effective Date of April 1, 2015, and from the computation above, seller would be considered the economic owner for ninety of the three hundred sixty-five days in 2015 and would be allocated 90/365 of the estimated ad valorem tax liability assessed in 2016 (and payable in 2017). The Purchase Price in the PSA would be decreased by the computed ad valorem tax amounts allocated to seller with respect to 2014 and 2015 oil and gas production, assuming that the ad valorem tax assessed in 2015 with respect to 2014 production and payable in 2016 and the ad valorem tax assessed in 2016 with respect to 2015 production

111 Such a “purchaser friendly” provision might read something like:

Ad valorem taxes that are based on or measured by the production of Hydrocarbons (“Oil and Gas Ad Valorem Taxes”) shall be deemed attributable to the period during which the production giving rise to the Oil and Gas Ad Valorem Taxes occurs, and liability therefor allocated to Seller for Oil and Gas Ad Valorem Taxes attributable to oil and gas produced from the Properties before the Effective Date and to Purchaser for Oil and Gas Ad Valorem Taxes attributable to oil and gas produced from the Properties from and after the Effective Date. For the purpose of determining adjustments to the Purchase Price for Oil and Gas Ad Valorem Taxes pursuant to section [ ] of this Agreement, Oil and Gas Ad Valorem Taxes attributable to oil and gas produced prior to the Effective Date but not yet assessed shall be estimated based on the then current mill levies with the resulting adjustment to the Purchase Price being considered the full and final settlement of all such Oil and Gas Ad Valorem Taxes for such production without regard to the actual tax rates or assessments; provided, however, that if the actual amounts of such production and mill levies are not known at the time of Closing, the amounts shall be re-estimated based on the best information available at the time of the Final Settlement Statement, and such re-estimated amounts shall thereupon become full and final settlement of such Oil and Gas Ad Valorem Taxes for such production.

112 The estimate of the ad valorem tax liability assessed in 2016 with respect to oil and gas produced in 2015 likely would be based on the then current mill levies and production occurring prior to the Effective Date in 2015. The operative provisions would need to provide whether the estimated amount would be the full and final settlement or whether there would be a subsequent post-Closing adjustment to true up any differences in the estimated and actual amounts due.
and payable in 2017 would be paid by purchaser as the owner of record title on the due dates for payment in 2016 and 2017.\textsuperscript{113}

Conclusion

This article discussed many of the provisions in the PSA that are key to seller and purchaser realizing the intended after-tax results of the oil and gas property purchase and sale transaction. Those results can vary significantly depending on whether the provisions are negotiated into the PSA and if they are, how those provisions are drafted. Tax counsel for each party to the transaction should be involved as early in the proposed transaction as possible so that the transaction can be structured to achieve that party’s intended tax results. Well-drafted tax provisions in the PSA will provide a proper road map for the determination and reporting of gain or loss on the sale by seller and for the reporting of the initial tax basis for the assets acquired by purchaser. Well-drafted tax provisions in the PSA also will prevent seller and purchaser from being responsible for and paying taxes that were intended to be borne by the other party.

\textsuperscript{113} See \textit{supra} text accompanying note 14 for a discussion of the purchase price adjustment required in this instance.