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Robert A. Swiech

The Pool of Capital Doctrine

- Why should I be concerned with the Pool of Capital Doctrine?
 - First, there are a number of current structures whose tax consequences can best be understood as they relate to the elements of the Pool of Capital Doctrine that retain their validity.
 - Secondly, development of mineral properties is all about risk sharing. G.C.M. 22730 contains the conceptual framework for structures that have historically been used by members of the industry to allocate the risks and benefits of developments.

Law Before G.C.M. 22730

- 1925 - The IRS ruled that the assignor of a fraction of a working interest, in return for the assignee's promise to drill a free well, realized no gain or loss. SM 3322.
- 1927 – IRS ruled that costs incurred by the assignee were capital in nature, that such costs represented his investment in the property, and, by implication, that he had acquired a property interest. G.C.M. 932. It was held by the courts that the assignee does not realize taxable income to the extent of the value of the interest received. *Dearing v. Commissioner*, 102 F.2d 91, (5th Cir. 1939).
- 1931 – Open transaction doctrine enunciated. *Burnet v. Logan*, 283 U.S. 404 (1931).
- 1932 - Cash payment received for an O&G lease could not be for the sale or exchange of the property interest but must instead represent an advance royalty. *Burnet v. Harmel*, 287 U.S. 103 (1932).
- 1933 – Sublessor was entitled to a depletion deduction, “oil in the ground represented a reservoir of the capital investment of the various parties...” *Palmer v. Bender*, 287 U.S. 551 (1933).

G.C.M. 22730

- G.C.M. 22730 considered the tax consequences of what was described as “leasing transactions.” The facts considered were as follows:
- A the fee owner leases to B for:
 - i) \$100,000;
 - ii) \$100,000 payable out of a 1/16 royalty interest (an oil payment interest which does not by its terms extend throughout the lease term – today what we would call a royalty interest not a production payment retained in a leasing transaction because there is no indication that C's interest would be of shorter duration than the economic life of the mineral property); and,
 - iii) 1/8 royalty interest.
- A recognized ordinary income for the bonus payment of \$100,000 subject to depletion. Proceeds paid to A for production were characterized as ordinary income subject to depletion.

G.C.M. 22730

- B assigned the lease to C for:
 - i) \$200,000; and,
 - ii) \$100,000 payable out of a 1/16 royalty interest (an oil payment interest which does not by its terms extend throughout the lease term; today it would be treated as a royalty interest because there is no indication that C's interest would be of shorter duration than the economic life of the mineral property).
- B recognized \$200,000 as sales proceeds (old law). The retained oil payment was ordinary income subject to depletion. Today this structure would be treated as a sublease with a bonus payment. (Note, that if this qualified as a production payment it would be treated as a mortgage loan under Section 636(b) and a sale.)

G.C.M. 22730

- C assigned the lease to D who agreed to develop and operate the property for:
 - i) 50% net profits interest (“NPI”).
- Because a NPI was not an economic interest at the time of the G.C.M, the Service concluded that C had sold his lease for a nondepletable contract right. Today the retained NPI would be treated as a royalty interest and the transaction would be characterized as a sublease covered by the Pool of Capital Doctrine.

G.C.M. 22730

- D conveyed an oil payment to E for drilling an oil well:
 - i) \$25,000 payable out of a 1/8 royalty interest.
- E had a depletable economic interest for its capital investment in drilling and equipping the well, an oil payment. Today E's interest would be treated as a royalty because there is no indication that E's interest would be of shorter duration than the economic life of the mineral property.

G.C.M. 22730

- D also conveyed an oil payment to F for \$15,000, which was covenanted to use in developing the lease:
 - i) \$25,000 payable out of a 1/8 royalty interest (an oil payment interest which does not by its terms extend throughout the lease term – Today F's interest would be treated as a royalty because there is no indication that F's interest would be of shorter duration than the economic life of the mineral property).
- F was considered to have a depletable economic interest for its capital investment pledged for development.
- D still had an economic interest in the property less the interests agreed upon by him or his predecessors (A, B, E, and F). D's invested capital did not include the sums contributed by either E or F.

G.C.M. 22730

- If the **driller or equipment dealer** is making an investment by which he acquires an economic interest in the oil and gas in place, expenditures made by him represent **capital expenditures returnable tax-free through the depletion allowance** rather than by way of expense deduction, and the oil payment rights acquired **do not represent payment in property for services rendered or supplies furnished.**
- Similarly, one who, in return for an oil payment right, furnishes money which the lessee is **pledged** to use in developing the property would be **regarded as making an investment representing an addition to the reservoir of capital investments in the oil and gas in place***.**

1969 Tax Reform Act

The 1969 Tax Reform Act contained two seemingly contradictory provisions.

- Under new Section 636(a) the carving out of a production payment, is treated as the making of a mortgage loan on the property and not as a grant of an economic interest unless that production payment was not treated as income from services under prior law (i.e., G.C.M. 22730 – drill or equip a well, pledged for development of the property).
- New Section 83 dealt with property transferred in connection with the performance of services. That section created numerous rules dealing with property received for services but did not alter its taxability under Section 61.

Rev. Rul. 77-176

- The IRS ruled that a driller "X", who drilled an oil and gas well at a designated location on a leased tract of land in return for an assignment from the owner "Y" of the entire working interest in the drill site *and* an undivided fraction in the remainder of the tract, realized ordinary income for services. Reason: The driller received a fractional interest in the tract, outside the drill site. The IRS said that to come within G.C.M. 22730, the economic interest acquired must be in *the same* property as that for the development of which the materials and services are contributed, and "property" meant each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.
- As a practical matter the conveyance likely gave X a 50% working interest in the entire lease and a payout from the from Y's carried interest in the drill site. Y would have retained a 1/16th overriding interest in the well site that converted to a 50% working interest at payout. See Rev. Ruls. 69-332, 71-207 and 75-446. Y's lease was on a single tract of land. Query, why were all of X's operating interests in that tract not combined and treated as one property under Section 614(b)(1)?

Expansion of the POC Doctrine

TAMs 8047005 (promoter), 8129006 (independent geologist) and 8137006 (acquirer of properties for itself and others):

- “As used in G.C.M. 22730, services for development of the property include drilling prior to discovery of oil and gas, **and also, services performed prior to the value of the property being known.**”
- “if an economic interest is received in a transaction that meets the requirements of G.C.M. 22730, **neither section 61 nor section 83 requires the inclusion in gross income** of the value of the economic interest received.”
- “Where an economic interest is received by a taxpayer for the contribution of services to a reservoir of capital under circumstances that meet the requirements of G.C.M. 22730, the **economic interest received does not represent compensation or payment in property for services.**”

Reversing the Expansion of the POC Doctrine

Rev. Rul. 83-46

- In the above situations, [syndicator, attorney and administrative employee] have each received property interests in the form of overriding royalties for the services each performed in connection with the oil and gas leases acquired and/or developed.
- [Syndicator, attorney and administrative employee] must include in gross income the fair market value of each overriding royalty interest received pursuant to Section 83 of the Code.
- G.C.M. 22730 and Rev. Rul. 77-176 were intentionally not mentioned.

Unextended POC Doctrine Questioned

In *Zuhone v. Comm'r.*, 883 F.2d 1317 (7th Cir. 1989) the Court in reviewing the development of the IRS's position in Rev. Rul. 83-46, and in spite of the IRS's defense of the pool of capital doctrine in its brief, stated:

In this 1983 revenue ruling, the IRS, although not formally rejecting G.C.M. 22730, has indicated its disfavor with the exception therein by severely limiting the application of the pool of capital investment doctrine. We likewise express doubt as to the wisdom of judicially endorsing this exception to sections 61 and 83 of the Code for the oil and gas industry in the absence of legislative intent. For the purposes of this appeal, however, it is unnecessary to reject the doctrine under all factual circumstances, since taxpayer does not meet the exception.

Today's Paradigm

- Using the construct of Rev. Rul. 77-176, does the oil company (i.e., X) perform any “services” by paying cash to the drilling company? If X performs no services do Sections 61 and/or 83 apply?
- Are X's operating interests in the tract acreage outside of the drill site and its operating interest in the tract acreage inside the drill site aggregated under Section 614(b)(1)?
- The agreement by the oil company to pay someone else to drill a well should clearly be considered a Pool of Capital contribution of cash, not services subject to Sections 61 and 83.

Revenue Ruling	Farmee's Permanent Interest	Payout Terms	Percentage IDC Deduction Allowed
69 - 332	5/8	100% Payout	
70 - 657	50%	None	
71 - 206	25%	50% Payout	
71 - 207	50%	100% Payout	
75 - 446	0	200% Payout	
80 - 109	75%	100% Basket Payout	

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80 - 109	75%	100% Basket Payout	75%