

Tax Implications of the Acquisition and Disposition of Oil & Gas Assets

weaver
Assurance • Tax • Advisory

Teresa Garza, CPA
Andy Hall, CPA
May 8, 2023

Energy Industry

weaver
Assurance • Tax • Advisory

Major Issues

- Russia / Ukraine conflict highlights the developed world's dependence on hydrocarbon-based energy; no near-term way to change this
- Sustained high commodity prices appear to be here for the foreseeable future
- Energy commodity and equity markets hanging in amidst broader market weakness (material outperformance of tech and broader markets since 2021)
- Transaction velocity slowed as oil hit +$100 level (lots of sellers, more cautious buyers)
- Public buyers understand the importance of scale to be relevant to investors; smart deals are being rewarded
- Capital is getting hard to come by
- Consolidation is king
- ESG



Why Should You Care?

weaver
Assurance • Tax • Advisory



weaver

Assurance • Tax • Advisory

You Owe it to Your Investor Base to Get the Best Tax Answer Possible



Tax Arbitrage is Key
(37%-20% = 17% savings…or $$$$$)

weaver
Assurance • Tax • Advisory



Acceleration of Deductions (Potential Trade-Off of 1 Year vs. 15 Years)

weaver
Assurance • Tax • Advisory



CFO/CAO/Controller is the Bridge Between Transaction and Results (It's On You)

weaver
Assurance • Tax • Advisory



You (and Your Team) May Have Skin in the Game!!

weaver
Assurance • Tax • Advisory



Overview

- Common Structuring Mechanisms
- Upstream Purchase Price Allocation Considerations
- Midstream Purchase Price Allocation Considerations
- Carried Interest

Common Structuring Mechanisms



Stock Sale (C-Corp)

➢Buyer Considerations

- Buyer purchases the selling shareholders' stock directly
- Assets and liabilities not desired by the buyer will be distributed or paid off prior to the sale
- Does not require separate conveyances of individual remaining assets because title lies within the corporation; if large number of contracts, stock sale may be easier
- Liabilities of the corporation stay with the buyer; can be mitigated through PSA reps and warranties
- Buyer typically prefers asset purchase over stock (step-up in basis on assets, not on stock); Can result in higher future taxes of the corporation due to carryover tax basis; Realize basis upon disposition of stock
- NOL limitations??

Stock Sale (C-Corp)

weaver
Assurance • Tax • Advisory

➢Seller Considerations

- Sellers favor stock sales
- Typically less responsible for future liabilities, but can be mitigated through the PSA
- Receives favorable long-term capital gains treatment upon sale; no recapture in corporate structure
- Avoids double taxation associated with asset sale for a C-Corporation; no dividend tax
- Typically this can cause variances in purchase price and nature of transaction since there are material considerations on both sides

Partnership Interest

weaver
Assurance • Tax • Advisory

➢Buyer Considerations

- Buyer can receive step-up in basis on assets; Section 754 election (Section 743(b) adjustment)
- Purchase price allocation on the underlying assets (depletable, depreciable, or amortizable (intangible))
- Treated as asset purchase if purchasing disregarded entity or purchasing 100% of LLC interests of partnership
- Same legal considerations (assumption of liabilities) apply here
- Be mindful of allocations between pre- and post-close periods on partnership tax return; should not use “days in year,” should use actual financials (“interim closing of the books”)

Partnership Interest

weaver
Assurance • Tax • Advisory

➢Seller Considerations

- Treated as capital gain depending on holding period; contributed capital creates new holding period over time
- Be careful of holding period!! Has capital been contributed over last 12 months??
- Purchase price allocation on the underlying assets; Section 751 (hot assets); Ordinary Income!!
  - Inventory
  - Unrealized Receivables
  - Section 1245 and 1254 Recapture
- Treated as asset sale if selling disregarded entity (but not if 100% of LLC interests sold – different treatment than buyer)

Asset Sale (Cash)

weaver
Assurance • Tax • Advisory

➢Buyer Considerations

- Buyer can receive step-up in basis on assets
- Purchase price allocation on the underlying assets (depletable, depreciable, or amortizable (intangible)); How granular can you get?
- Bonus depreciation now eligible on used property purchases
- Does not entitle buyer to any of the acquired target's tax attributes (NOL, credit carryforwards, etc.)

Asset Sale (Cash)

➢Seller Considerations

- Seller receives capital gain treatment on assets held more than 12 months (subject to depreciation recapture) and ordinary treatment on assets acquired in last 12 months
- Purchase price allocation on the underlying assets (depletable, depreciable, or amortizable (intangible); How granular can you get – want to be as detailed as possible to minimize recapture?
- Holding period of assets?? – What leases or construction in last 12 months? – Anything within 12 months short term. Can PPA bifurcate these assets to get closer to original cost?
- Asset sale not desirable in corporate structure (double taxation)

Asset Sale (Installment Sale)

weaver
Assurance • Tax • Advisory

- **Considerations**
  - Can defer gain into tax year in which you receive the cash
  - Ordinary recapture income must be picked up in the year of sale
  - Gain is applied at gross profit times cash received
  - Can be utilized in situations where there is significant escrow
  - Is it always a good idea?? – Should take into account investors tax position (carryovers, other losses?) and tax rate changes (tax rates rising??)

Contribution of Property to Partnership

weaver
Assurance • Tax • Advisory

➢ Considerations

- Typical structure is one partner contributes property (lease or other intangible) to the partnership in exchange for partnership interest and defined value
- Other equity partners included who contribute cash in proportion to the value of the defined value of the property
- Most situations tax-free contribution of property to the partnership *(IRC § 721)*
- Beware of cash distributions or relief of recourse liabilities to contributing partner, could result in tax
- Disguised sale can result in a taxable transaction if a partner's transfer to a partnership is preceded or followed by a transfer from the partnership to the partner within 2 years
- Can result in special allocations of tax attributes related to contributed property between partners (contributed property has carryover tax basis)

Use of Tax Partnerships

weaver
Assurance • Tax • Advisory

➢ Cash and Carry Transactions

- Owner of lease agrees to assign a portion of such leases to a grantee in exchange for grantee's upfront cash payment plus an agreement to fund all or a portion of the grantor's share of costs to develop the properties
- In most cases, the cash partner will want to deduct all of the costs of the intangible drilling costs (IDCs)
- Without a tax partnership, the cash partner will only be able to deduct their portion of the drilling costs; the carry portion must be capitalized and recovered through depletion

Use of Tax Partnerships

weaver
Assurance • Tax • Advisory

- **Cash and Carry Transactions**
  - If a tax partnership is used, the parties do not have to comply with the complete payout rule and the cash partner can deduct the cash and carry IDCs
  - The tax partnership will elect to deduct the IDCs and is allowed to specially allocate them to the cash partner that incurred them

Use of Tax Partnerships

➢**Formation – Typically 2 Alternatives:**

– Sale of WI followed by a joint contribution to the partnership of remaining interest
  - Results in gain/loss on WI sold and deferral on amount contributed

– Contribution of cash by the carrying party, a contribution of the properties by the carried party, and a distribution of cash to the carried party
  - Typically would be disguised sale to carrying partner upon distribution of cash, but can apply exception for reimbursement of preformation capex (during last two years) to avoid or minimize gain


Upstream
Considerations

Upstream Considerations

- Sale vs. Lease
- Allocation of proceeds
- Minimizing Recapture
- Section 199A Implications

Sale vs. Lease – Get this part right!

weaver
Assurance · Tax · Advisory

SALE CONSIDERATIONS

- The transaction will generally be treated as a sale if the transferor does not retain a non-operating interest in transferred property
- Sale = Dispose of entire interest
- Results in 1231 gain after recapture

LEASE CONSIDERATIONS

- The transaction will be a lease when the transferor does retain a non-operating interest in the transferred property
- Lease = Dispose of WI and retain an ORRI
- Results in ordinary income not subject to depletion
- Basis in WI carries over to RI retained

Sale vs. Lease - Example

- Taxpayer holds a single working interest with unadjusted basis of $10M. Interest was held for over 1 year. Accumulated depletion on the property is $5M. Taxpayer sells 100% of his interest in the working interest for $15M.
- Transaction will be regarded as a sale
- Gain on sale is $10M ($15M - $5M adjusted basis)
- The gain will be taxed as follows:
  - $5M Ordinary Income as Section 1254 recapture on the accumulated depletion
  - $5M Section 1231 Income

Sale vs. Lease - Example

- Taxpayer holds a single working interest with unadjusted basis of $10M. Interest was held for over 1 year. Accumulated depletion on the property is $5M. Taxpayer sells 100% of his interest in the working interest for $15M, but retains an ORRI on the property
- Transaction will be regarded as a lease
- The entire $15M in proceeds will be taxed as ordinary income not subject to the depletion allowance
- The $10M unadjusted basis carries over to the ORRI retained

Allocations of Proceeds

- Purchase price must be allocated between the leasehold and depreciable properties in proportion to their respective fair market values
- Common best practice in the absence of an agreed upon PPA is to allocate 80% of the purchase price to leaseholds and the remaining 20% to lease and well equipment.
- Buyer and seller can desire different allocations.
- New depreciation rules can align buyer and seller objectives to heavily weight proceeds to LWE.

Allocations of Proceeds

- Cumulative IDC and accumulated depletion are subject to recapture under Section 1254
- Accumulated deprecation on tangible assets are subject to recapture under Section 1245
- Recapture impact changes the character of the gain, not the amount of the gain
- Significant planning opportunities on sale transactions
  - The allocation rules of Section 1060 need to be taken into account if the assets sold constitute a trade or business.

Section 199A Implications

- Section 199A enacted by the Tax Cuts and Jobs Act
- Proposed regulations issued on August 8th, 2018 provided additional guidance on Section 1231 gains and losses and their inclusion as qualified business income (QBI)
- Section 1231 gains or losses treated as capital are NOT includable as QBI
- Section 1231 gains or losses treated as ordinary are includable as QBI
- Simplified – Realized amounts subject to recapture under Sections 1245 or 1254 can be included in the Section 199A QBI calculation

Midstream Purchase Price Allocation (PPA) Considerations

weaver
Assurance • Tax • Advisory

Midstream PPA Considerations

weaver
Assurance • Tax • Advisory

- **Midstream Asset Categories**
  - Hard Assets (Pipelines, plant facilities, ROW, easements)
  - Contracts
  - Goodwill
  - Requires proper analysis and valuation methodology for each category

Midstream PPA Considerations

weaver
Assurance • Tax • Advisory

- **Entity vs. Asset Sale**
  - Typically see disregarded entity sale (LLC interests) in midstream space; primarily due to transfer of contracts
  - Common structure is holding company with DREs under for each asset bundle
  - Holding period can guide structuring
    - Capital within last 12 months?
    - Assets within last 12 months?
    - Contracts within last 12 months?

Midstream PPA Considerations

weaver
Assurance • Tax • Advisory

- **Entity vs. Asset Sale**
  - DRE's treated as an asset sale
  - Ordinary recapture either way
  - C Corporations can complicate things (double taxation)

Midstream PPA Considerations

weaver
Assurance • Tax • Advisory

➢Holding Period

- Capital contributed over time creates new holding period in portion of partnership interest
- Pipeline construction over time creates new holding period in portion of hard assets
- Contracts executed over time creates new holding period for newly executed contracts
- Rapid appreciation in value could mean a short-term holding period in intangible values
- Short-term goodwill if value has escalated over prior 12 months (when was management team put in place, business plans, modeling, etc.)

Midstream PPA Considerations

weaver
Assurance • Tax • Advisory

➢Purchase Price Allocation

– Allocation is necessary in either an entity or an asset sale

– Allocation to hard assets will determine recapture

- Seller typically wants to allocate minimal amount to hard assets to avoid recapture
- Buyer typically wants to allocate more to hard assets to take advantage of shorter depreciable life (bonus!!)
- GAAP net book value
- Fair market value – third party valuation

Midstream PPA Considerations

weaver
Assurance • Tax • Advisory

➢Purchase Price Allocation

- –Amount allocated to contracts may be eligible for capital gain if LT (law unclear)
  - Some appraisers take position that contracts have significant value
  - Some appraisers take position that contracts have no value unless they contain above-market terms
- –Amounts allocated to goodwill generally LTCG
  - Difficult to determine holding period when sold shortly after first year of operations
  - Buyer side – all intangibles amortized over 15 years

Carried Interest

- 83b Election
  - Some argue not necessary, but recommended
  - Remove requirement to attach to personal tax return
- Character of gain follows character of gain on event that generated the cash
- Beware of the 3 year hold
- Doesn't always equate to long-term capital gains
- Can issue units later in the deal, but:
  - Does it dilute others, may be a guaranteed payment
  - Is there value at that point?
  - Easier to issue value through bonus pool?
  - If argument is no value, does that put character of goodwill when sold at risk for LT treatment?


weaver
Assurance • Tax • Advisory
Meet
Weaver

Weaver at a Glance

weaver
Assurance • Tax • Advisory

1000+

employees **and counting**

#32

Top 100 Firms,
Inside Public Accounting



15

U.S Locations

Austin, Conroe, Dallas, Fort Worth, Houston, Lafayette, Los Angeles, Manhattan Beach, Midland, New York City, Oklahoma City, Portland, San Antonio, San Diego, Woodland Hills

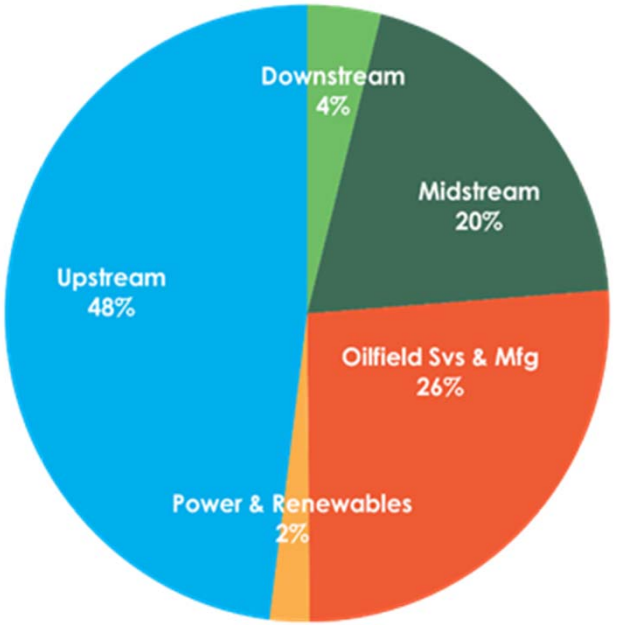
Energy at Weaver

weaver
Assurance • Tax • Advisory

ENERGY IS A LARGE PART OF THE FIRM'S REVENUE

- Upstream
- Oilfield Services
- Midstream
- Downstream
- Power & Renewables

OIL AND GAS AT WEAVER



Transaction Lifecycle

weaver
Assurance • Tax • Advisory

RELATIONSHIPS MATTER

- PE backed portfolio companies
- Privately held companies
- Client (not IRS) Deadlines
- Transaction Planning
- Investment Strategy
- Tax Planning



Tax Compliance

weaver
Assurance • Tax • Advisory

Gathering Information

To start, we will meet with you to set timelines and identify data needs. We will also provide access to the secure client portal for easy exchange of documents and data.

Compliance Analysis

We will identify federal and state requirements, as well as any operational, regulatory or other changes that may impact the current filing. After this review and analysis, we will meet with you to discuss our results.

Return Preparation

If needed, we will file extensions on your behalf to allow time for closing your books and completing your financial audit. Next, we will prepare your federal return, which serves as a foundation for various state and local returns.

Year-End Planning

After the current year's returns are completed and filed, we will meet with management to discuss any issues that arose, as well as plan for the following year, including the proactively working to address the implications of any upcoming operational, regulatory or other changes.

weaver

Assurance • Tax • Advisory

Teresa Garza, CPA

teresa.garza@weaver.com

(972) 448-9893

Andy Hall, CPA

andy.hall@weaver.com

(817) 882-7378


weaver
Assurance • Tax • Advisory