

SELECTED U.S. OIL AND GAS TAX ISSUES FOR NON-TAX LAWYERS

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I. Introduction and Scope of Outline.

A. General. *This outline contains generalized discussions of selected topics for non-tax lawyers and is not intended to be used for tax planning. This outline is a fast overview of very detailed and technical areas.*

1. Accelerating Change. Oil and gas is a dynamic industry. In one sense, oil and gas are commodities. However, perhaps inevitably because energy is essential to the global economy, the oil and gas industry is heavily politicized. These political aspects have resulted in anomalies in the taxation of oil and gas from that otherwise expected from the taxation of a commodities business. When you overlay on the politics ever accelerating technological improvements for exploration, development, completion, production, transportation and processing, the results are an everchanging oil and gas industry. Macro forces, such consolidations, BTU convergence and E-commerce, are changing our industry and will change the taxation of our redefined industry.

2. Politics. Oil and gas is a political industry. Early in this century the oil and gas industry was considered a national political threat, a target of the trustbusters. In 1911, the United States Supreme Court ordered the dissolution of the Standard Oil Trust. That same year gasoline, formerly a refining byproduct, overtook kerosene as the industry's largest product. Standard Oil of New Jersey ultimately became Exxon. Standard Oil of New York ultimately became Mobil. Politics change. The oil and gas industry is no longer considered a national political threat. On November 30, 1999, eighty-eight years later, Exxon and Mobil merged. In 1998, not a good year for the industry, on a combined basis ExxonMobil had revenues of \$170 billion, net income of \$8.1 billion, operations in 200 countries and oil and gas production in 50 countries, with 123,000 employees earning an 11% return on capital. Synergy benefits from the merger will exceed \$2.8 billion annually at the expense of 16,000 employees. On December 15, 1999, ExxonMobil had a market capitalization of \$294 billion. Taxes are a reflection of the political side of oil and gas. The taxation of oil and gas is filled with anomalies. Tax systems are reactive and trail market shifts and technological changes. As market, technological and political rates of change accelerate, the rate of change in the tax system can also be expected to accelerate, consistently trailing the underlying industry changes.

3. Stratification and Hand-Me Downs. Integrated oil and gas companies have gone through consolidations that can be viewed by size of oil/natural gas liquids/gas reserves. The three supermajors, ExxonMobil, Royal Dutch Shell and BP/Amoco/Arco, each have reserves in excess of 18 billion barrels of oil equivalents. The other majors, Total/Fina/Elf, Chevron, Texaco and ENI, each have reserves of between 7 and 4 billion barrels of oil equivalents. Size determines what properties can be owned or operated by which companies. Properties that are marginal for a supermajor like Shell can be very attractive for an independent like Occidental. Properties that are marginal for a major like Chevron can be very attractive for an independent like Ocean/Seagull. Oil and gas companies merge for efficiency. Paradoxically, this increases the size of property that they can afford to hold. There is a hand-me down process at work passing properties from larger to smaller companies. So, bigger companies sell properties to smaller companies who can operate the properties more efficiently. This property trade continues down to marginal wells and tiny oil companies. Oil fields never die, they just get worked harder.

4. BTU Convergence. Natural gas has emerged as the fuel of choice for incremental electric power generation. This leads to the convergence view of gas and power. Even batteries may converge. Development is under way for micromachined gas turbines with self-contained fuel that may be used to generate current in lieu of chemical batteries. The deregulation of the \$45 billion wholesale natural gas industry resulted in winners and losers. Houston is home to many of the winners. Stocks of energy companies that outperformed the Standard and Poor 500 over the last five years include Coastal, Dynegy, El Paso Energy, Enron, Kinder Morgan (formerly KN) and Williams. Now that the \$110 billion wholesale electricity industry is deregulating there will be more winners and losers.

5. E-commerce. Business to consumer E-commerce receives public attention and the high stock price. Business to consumer E-commerce also generally loses money. In 1998 amazon.com lost money on less than \$500 million in revenue. In energy business to business E-commerce, Dynegy alone did in excess of \$1 billion of business, profitability, in 1999. Additional energy E-commerce applications predicted include equipment markets, payment processing, procurements, auctioning of oil and gas

properties (which started in October 1999), service company scheduling, inventory management and asset management. Remember, all those E-commerce servers and telecommunication systems run on electrical power that is increasingly generated with gas.

6. The Code. All "Section" references are to the Internal Revenue Code of 1986, as amended ("Code"). All references to "Treas. Reg." sections are to the Treasury Regulations.

B. Anomalies.

The political overtones of oil and gas ensure that tax systems are filled with compromises, assertions of sovereignty and attempts at social engineering. These anomalies prevent oil and gas tax systems from being uniform and rational revenue raisers. Instead, tax systems are replete with inconsistencies and exceptions. Accordingly, this outline will review, but will not attempt to harmonize, selected aspects of U.S. oil and gas federal taxation.

C. Commodity Price Volatility.

The only thing predictable about oil prices is their unpredictability. Our capital intensive industry, which requires long range planning, is driven by volatile commodity prices. This outline is heavily weighted toward insolvency matters because of the consequences of the low commodity prices of 1998 and early 1999.

[Ken Bezozo of Haynes and Boone, LLP is the primary author of Part II of this outline.]

II. Issues Arising From the Taxation of Financially Distressed Oil and Gas Producers.

Leverage swings both ways, up and down. The favorable oil and gas prices through 1997 and the ready availability of credit, including high yield debt, followed by the oil and gas price collapse of 1998, resulted in a number of financially distressed oil and gas producers. Market capitalizations evaporated. Over leveraged producers could not raise additional capital, service debt, fulfill commitments or exploit opportunities. Properties became worth less than the debt that they supported. Strong companies troll the bankruptcy courts looking for properties with expiring owners. Creditors find themselves directly involved in the industry. Properties change ownership both within and outside of bankruptcy with tax consequences. What happens taxwise when a producer goes down for the financial count and its properties are used to pay creditors?

A. Title and Federal Tax Liens.

1. Creation of the Lien. When a debtor fails to pay its taxes, and after certain procedural safeguards under the Code have occurred, the IRS can make an assessment by recording the liability of the debtor in the office of the Secretary of the Treasury or his delegate. Code sections 6201 and 6203. If the tax remains unpaid after the assessment is made, the IRS can give notice of the deficiency to the taxpayer and demand payment. Code sections 6212 and 6303. If payment is still not made, the amount of the tax and any penalties and interest constitute a lien upon all of the taxpayer's real and personal property. Code section 6321. Generally, IRS assessment of an alleged tax liability normally cannot be made until the IRS sends to the taxpayer the statutory notice referred to as a "90-day letter." Code section 6213(a). The IRS can make an assessment, however, before the completion of an audit and the issuance of a 90-day letter under certain circumstances.

2. Perfection of the Lien. Although assessment of tax by the IRS creates a valid tax lien, the tax lien is a secret, unrecorded lien and is not enforceable against third parties until notice of the lien is given. Code section 6323(a). Notice of a tax lien is normally given with respect to real property by filing in the county where the real property or fixtures affected by the lien are located, and with respect to personal property by filing in the office of the Secretary of State or other central filing office designated by applicable state law. The procedures vary from state to state.

A tax lien that secures a tax obligation that is discharged under the Bankruptcy Code does not attach to property acquired by the debtor post-bankruptcy. United States v. Sanabria, 424 F.2d 1121 (7th Cir. 1970); In re Braund, 423 F.2d 718 (9th Cir. 1970), cert. denied, 400 U.S. 823 (1970). Code section 6325 requires the issuance of a certificate of release of any lien for any internal revenue tax within thirty days after the tax liability has been satisfied, becomes legally unenforceable, or upon the acceptance of a bond conditioned upon the payment of the amount assessed.

3. Priorities. A federal tax lien in a bankruptcy case is subject to several provisions of the Bankruptcy Code. First, section 545 of the Bankruptcy Code overrides the tax lien if the tax lien is subject to the rights of a bona fide purchaser. Second, section 724(b) of the Bankruptcy Code states that in a liquidation case under Chapter 7, a tax lien is treated as a seventh-priority item, rather than as a secured claim. In re Darnell, 834 F.2d 1263 (6th Cir. 1987). In Chapter 11 reorganizations, a valid tax lien is treated as a secured claim.

If a secured creditor has properly perfected a security interest in the debtor's property before the tax lien is filed, the security interest will have priority over the tax lien. This is probably not true with respect to after-acquired property subject to a perfected security interest because of the "choateness" doctrines surrounding tax lien law. Texas Oil & Gas Corp. v. United States, 466 F.2d 1040 (5th Cir. 1972), cert. denied, 410 U.S. 929; Rice Investment Co. v. United States, 625 F.2d 565 (5th Cir. 1980). Furthermore, if the security interest is not perfected or has not attached prior to the filing of the tax lien, the tax lien will take priority. United States v. McDermott, 113 S. Ct. 1526 (1993).

Special treatment is given, however, to security interests in connection with certain financing agreements. Such interests are valid if the security or lien interest comes into existence within 45 days after the filing of the tax lien. Code section 6323(c). Shawnee State Bank v. United States, 735 F.2d 308 (8th Cir. 1984). In addition, many parties have priority over a filed tax lien, including purchasers in the ordinary course of business and purchasers of securities without actual notice. Code sections 6323(b)(1)-(10).

4. Redemption. Care should be taken by a senior lienholder with respect to property that has a federal tax lien attached. In certain situations described in Code section 7425(d), the IRS has a right of redemption to acquire the property from the purchaser at a foreclosure sale. Thus, if a senior lienholder bids in a low amount for the property, the IRS could acquire the property for the bid-in amount and leave the lienholder only with the right to pursue a deficiency against the debtor. Delta Savings & Loan Assoc., Inc. v. United States, 847 F.2d 248 (5th Cir. 1988).

B. Federal Income Tax Aspects of Sales And Other Dispositions of Property Occurring Outside Bankruptcy.

1. Sale Of Property. Gain from the sale or exchange of property will be equal to (i) the excess of the amount realized from the sale over (ii) the adjusted basis of the property sold or exchanged. Loss from the sale or exchange of property will be equal to (i) the excess of the adjusted basis of the property over (ii) the amount realized. Code section 1001(a). The amount realized from the sale or exchange of property will equal the sum of the money plus the fair market value of property received. In addition, the amount realized will include the amount of indebtedness from which the transferor is discharged (i.e., the indebtedness is assumed or the transferred property is taken subject to the indebtedness). Treas. Reg. section 1.1001-2. **If property held by the taxpayer has been depleted, depreciated or if the indebtedness securing the property exceeds the property's adjusted tax basis, the sale of property may give rise to a taxable gain even though the transaction results in an economic loss to the transferor.**

Example: Taxpayer sells a producing property to a third party that has an adjusted tax basis equal to \$30,000,000 and that is encumbered by a \$40,000,000 debt in return for the assumption by the third party of the \$40,000,000 indebtedness. Taxpayer has lost all of Taxpayer's equity investment in the field. However, Taxpayer recognizes \$10,000,000 of gain, computed as follows:

| | |
|--------------|-----------------|
| \$40,000,000 | Amount Realized |
|--------------|-----------------|

| | |
|-----------------------|-----------------|
| | (debt assumed) |
| <u>(\$30,000,000)</u> | Adjusted Basis |
| \$10,000,000 | Gain Recognized |

Another loss situation that may arise from the disposition of property is as follows:

Example: Wildcatter owes Bank \$12,000,000. This loan is secured by Gas Field. Wildcatter took a rank prospect, discovered and developed Gas Field and has always had a low tax basis compared to market value in Gas Field. Through depletion and depreciation, Wildcatter's adjusted tax basis in Gas Field is down to \$1,000,000. Wildcatter obtained the \$12,000,000 loan against Gas Field when its market value was \$20,000,000. The present fair market value of Gas Field is \$9,000,000. Wildcatter has lost all of Wildcatter's equity interest in Gas Field. However, if Gas Field is foreclosed by Bank, or if Wildcatter conveys Gas Field to Bank in lieu of foreclosure, Wildcatter will recognize gain in the amount of \$8,000,000.

| | |
|----------------------|--------------------------------|
| \$9,000,000 | Amount realized (debt assumed) |
| <u>(\$1,000,000)</u> | Adjusted Basis |
| <u>\$8,000,000</u> | Gain Recognized |

In addition, Wildcatter remains indebted to Bank for \$3,000,000 (the amount that Wildcatter still owes to Bank after receiving \$9,000,000 credit for Gas Field).

2. Foreclosure Of Property. Although a foreclosure generally results in an economic loss, the property owner often realizes a taxable gain. The property owner often has taken depletion and depreciation deductions with respect to the property, reducing the property's adjusted tax basis, and the owner's borrowings secured by the property can exceed the property's fair market value. Although an involuntary act, a foreclosure is treated as a sale or exchange of the property by the property owner. Helvering v. Hammel, 311 U.S. 504 (1941); Electro-Chemical Engraving Co., Inc. v. Comm'r., 311 U.S. 513 (1941); Comm'r. v. Abramson, 42-1 USTC ¶9200 (2d Cir. 1942); Russo v. Comm'r., 68 T.C. 135 (1977). A taxpayer's gain or loss from the foreclosure of property is generally determined in the same manner as an ordinary sale of the property. Gain will be recognized to the extent that the amount realized from the foreclosure exceeds the taxpayer's adjusted basis in the property.

3. Recourse Indebtedness. Determining the amount realized is sometimes difficult in the case of recourse indebtedness. This situation may be complicated because the amount bid-in by the lender at the foreclosure transaction does not necessarily equal the fair market value of the property. A lender typically will bid the minimum amount required to ensure that the lender acquires the property free of other liens. There are many other reasons that would also cause a lender to try to acquire the property at an amount that is less than the property's true fair market value. Durett v. Washington Nat'l. Insurance Co., 621 F.2d 201 (5th Cir. 1980). Nevertheless, there is a tax presumption upon foreclosure that the amount realized is equal to the amount bid-in at the foreclosure proceeding. Community Bank v. Comm'r., 79 T.C. 789 (1982), aff'd, 819 F.2d 940 (9th Cir. 1987); Treas. Reg. section 1.166-6. This presumption may only be rebutted by clear and convincing evidence that the amount bid-in is not the true fair market value of the property. Bialock v. Comm'r., 35 T.C. 649 (1961), acq. 1961-2 C.B. 4; Heath v. Comm'r., 30 TCM 545 (1971).

If property is foreclosed or otherwise disposed of and a portion of the indebtedness that is secured by the property remains unsatisfied, the foreclosure transaction is bifurcated and treated in part as a sale or exchange and in part as a continuing debt of the debtor that may result in cancellation of indebtedness income. Rev. Rul. 90-16; Treas. Reg. section 1.1001-2(a)(2).

If a lender bids in less than the face amount of indebtedness at the foreclosure sale, or if the property is acquired by a third party for an amount less than the face amount of the indebtedness, the lender may pursue a deficiency judgment against the debtor. If the debtor pays the deficiency, then the debtor will recognize no cancellation of indebtedness income under Code section 108. However, if the debtor ultimately fails to pay the amount of the deficiency or if the debtor is released by the lender with respect to the deficiency, the debtor will be required to recognize cancellation of indebtedness income at the time that the debtor is relieved of the debt.

4. Non-Recourse Indebtedness. With respect to non-recourse indebtedness, the amount realized on the foreclosure of property securing non-recourse indebtedness is equal to the face amount of the indebtedness discharged, regardless of the property's fair market value. Tufts v. Comm'r., 461 U.S. 300 (1983). Therefore, in every case where there is a disposition of property that secures non-recourse indebtedness, the taxpayer will recognize gain equal to the positive difference between the face amount of the debt and the property's adjusted tax basis.

Example: In 1997, Taxpayer obtained a non-recourse loan, with a remaining unpaid balance of \$3,000,000, secured by a production payment burdening Taxpayer's working interest. Taxpayer's adjusted tax basis in the working interest is \$750,000. When the loan was acquired, the working interest was worth \$5,000,000, but has now declined in value to \$1,800,000. If Taxpayer disposes of the working interest to the lender, he will recognize gain equal to \$2,250,000 (\$3,000,000 loan amount realized less \$750,000 adjusted tax basis).

5. Conveyance In Lieu Of Foreclosure. In many workout transactions a debtor will voluntarily transfer property to a lender in lieu of foreclosure. In some cases, the lender will agree not to assert a deficiency against the debtor. Absent evidence to the contrary, the transaction will be treated as a sale of the property directly to the lender and the debtor's amount realized will equal the face amount of the indebtedness. Freeland v. Comm'r., 74 T.C. 970 (1980); Estate of Delman v. Comm'r., 73 T.C. 15 (1979). If the lender does not assert a deficiency against the debtor, the amount realized will be presumed to be the amount of the mortgage obligation.

However, if the debtor's obligation is recourse and an agreement is reached regarding the property's fair market value or if it can be shown that the fair market value of the property is less than the face amount of the mortgage obligation, then the transfer of the property to the lender should be bifurcated into two separate transactions. First, there is a sale or exchange with the amount realized being equal to the property's fair market value. Second, unless the lender pursues a deficiency, there is a cancellation of indebtedness under Code section 108 to the extent that the amount of indebtedness exceeds the property's fair market value.

As a practical matter, a debtor in this position should reach an agreement with the lender to avoid a subsequent confrontation with the IRS. The creditor is required to file an information return on Form 1099-A, (Code section 6050J), with the IRS that states the fair market value of the property at the time of the transfer.

Example: Small Producer owns property with an adjusted tax basis of \$20,000,000 that has a fair market value of \$50,000,000 and that secures a \$60,000,000 recourse loan from Bond Holders. Small Producer and Bond Holders agree that Small Producer will deliver the property to Bond Holders, and Bond Holders will not assert a deficiency against Small Producer. The tax consequences to Small Producer of this disposition of property are that first, Small Producer will recognize gain under Code section 1001 equal to \$30,000,000 (the difference between the \$50,000,000 fair market value of the property and its \$20,000,000 adjusted tax basis). In addition, Small Producer will recognize \$10,000,000 discharge of indebtedness income under Code section 108 to the extent that Bond Holders discharge Small Producer from repaying this obligation.

If the obligation is non-recourse, then the transaction is a sale or exchange with the amount realized equal to \$60,000,000, the total amount of the indebtedness, resulting in a \$40,000,000 gain by Taxpayer.

6. Tax Abandonment by Owner. Property which is subject to a recourse obligation cannot be unilaterally abandoned for tax purposes by its owner. The transfer is not considered complete until an actual foreclosure occurs. Comm'r. v. Green, 126 F.2d 70 (2d Cir. 1942). The IRS takes the position that where a taxpayer has a right of redemption with respect to the property, the transaction is not closed (and no gain or loss can be realized) until the right of redemption expires. Rev. Rul. 69-31, 1969-1 C.B. 307. Hawkins v. Comm'r., 34 B.T.A. 918 (1936), aff'd., 91 F.2d 354 (5th Cir. 1937). However, abandonment of property subject to a non-recourse debt constitutes a sale or exchange with the amount realized being equal to the amount of the non-recourse debt. Yarbro v. Comm'r., 84-2 USTC ¶9691 (5th Cir. 1984), cert. denied 105 S.Ct. 959; Middleton v. Comm'r., 77 T.C. 310 (1981), aff'd., 693 F.2d 124 (11th Cir. 1982).

7. No Exception to Recognition of Gain or Loss From Sale or Other Disposition for Insolvency or Bankruptcy. The fact that a taxpayer is insolvent or bankrupt at the time property is sold or disposed will not affect the recognition of the gain realized (although if the property is disposed of by a bankrupt taxpayer's estate, the estate will be required to recognize the gain or loss from the disposition). Danenberg v. Comm'r., 73 T.C. 370 (1979), acq. 1980-2 C.B. 1; Peninsula Properties Co. v. Comm'r., 47 B.T.A. 84 (1942); R. O'Dell & Sons Co. v. Comm'r., 8 T.C. 1165 (1947), aff'd., 169 F.2d 247 (3rd Cir. 1948); Treas. Reg. section 1.1017-1(b). An insolvent individual taxpayer will be required to include in taxpayer's income any gain resulting from the sale or other disposition of the property. Any gain realized from the disposition of property by a bankrupt taxpayer's estate will be recognized and included in the income of the bankrupt estate and not in the income of the individual. In addition, the insolvency or bankruptcy of a taxpayer will not change the character of gain recognized in the sale or other disposition of property to income from discharge of indebtedness even if the taxpayer is unable to repay any deficiency. Danenberg v. Comm'r., 73 T.C. 370 (1979).

C. Character and Timing of Gains (and Losses).

1. Character. The character of the debtor's gain or loss from the sale or exchange of property as either ordinary or capital depends on whether the property sold is a capital asset under Code section 1221 or a business asset under Code section 1231. The recourse and non-recourse nature of the indebtedness secured by the property does not affect the character of the gain or loss realized on the sale or exchange. In addition, all applicable recapture will be treated as ordinary income.

2. Timing. The debtor's gain or loss generally is recognized in the year that the sale is closed or the foreclosure is completed. However, where the debtor has a right of redemption, the sale or foreclosure is considered open until the right of redemption expires or is released by the debtor.

3. Effect of Differences in Tax Rates. There can be a significant difference between the taxability of gain from a sale or exchange of property and income that accrued from the discharge of indebtedness. In the former case, gain resulting from the sale or exchange of property may qualify as a capital gain (assuming the property was not held as inventory or primarily for sale or to the extent of any recapture of depreciation). Income resulting from the discharge of indebtedness is taxed as ordinary income at the regular tax rate.

D. Federal Income Tax Aspects of Sales and Other Dispositions of Property by The Bankruptcy Estate.

1. Transfer of Property as Payment of Debt. Any time a financially troubled individual owns property that has a built-in tax gain, the individual should review his overall situation including built-in gains in his assets and his tax attributes in order to determine the best alternative plan for his circumstances. After the assets of the debtor become the property of the debtor's bankruptcy estate (i.e., upon the filing of a bankruptcy petition assuming the bankruptcy petition is not later dismissed), the estate will be liable for any tax liability resulting from gains that accrue upon the sale or other disposition of that property.

Example: Individual Taxpayer owns a working interest that he acquired by inheritance in 1992. Taxpayer's adjusted tax basis in this property is \$1,000,000. Taxpayer incurred \$3,000,000 of indebtedness

that is secured by the working interest. Taxpayer filed for bankruptcy on August 20, 1999, and, as of that date, the working interest is deemed transferred to Taxpayer's bankruptcy estate. The working interest's fair market value at that time is \$2,000,000. Subsequently, the working interest is transferred to the Bank and the Bank files an unsecured claim against the bankruptcy estate for the \$1,000,000 deficiency. As a result, the bankruptcy estate has incurred a taxable gain equal to \$1,000,000 (the fair market value of the working interest less the working interest's adjusted basis in the hands of the estate). The remaining \$1,000,000 unsecured claim, if not repaid, will result in discharge of indebtedness income to the estate.

2. Recognition of Gain. On the sale or other disposition of assets by a bankruptcy estate, it (and not the individual debtor) should recognize gain or loss, notwithstanding that the debtor may have obtained the benefit of the depletion and depreciation deductions from the property. In re Bentley, 916 F.2d 431 (8th Cir. 1990).

The bankruptcy estate will recognize gain or loss equal to the excess of the amount realized (including the amount of indebtedness discharged) over the adjusted basis for purposes of determining gain, and the excess of the adjusted basis over the amount realized for purposes of determining loss. Code section 1001(a). As described above, the adjusted basis of property held by the bankruptcy estate is the same as the adjusted basis of the property in the hands of the debtor prior to the transfer to the estate. Code section 1398(g)(6).

E. Cancellation of Indebtedness Outside Bankruptcy.

1. In General. In many cases, a debtor that has not filed for bankruptcy protection is able to negotiate an arrangement that allows the debtor to repay less than the full principal amount owed by the debtor to the creditor. For example, if a debtor agrees to convey property securing indebtedness to a lender in lieu of foreclosure, the lender may agree not to assert a deficiency against the debtor for the difference between the fair market value of the property and the face amount of the indebtedness. Although this may be economically beneficial to both the debtor (who may avoid a potential bankruptcy) and the lender (who can avoid the cost of litigation and/or the expense of acquiring the property through a bankruptcy proceeding), the debtor must consider the potential tax consequences of the income that arises from the discharge of indebtedness. As discussed above, where property is transferred to a lender in exchange for relief of liability on indebtedness, the transfer is treated as a sale or exchange of the property. However, where the fair market value of the property is less than the face amount of indebtedness secured by the property, then the difference, if forgiven, will result in the discharge of indebtedness income to the debtor.

2. Solvent Debtors. Gross income includes income realized from the discharge of indebtedness. Code section 61(a)(12); United States v. Kirby Lumber Co., 284 U.S. 1 (1931). The amount of discharge of indebtedness income realized is equal to the amount of indebtedness discharged. Thus, solvent debtors (i.e., debtors who are not insolvent or bankrupt) will realize taxable income from a discharge of indebtedness. Any discharge of indebtedness, other than a discharge in a bankruptcy case or a discharge that occurs when the taxpayer is insolvent, will result in the current recognition of income in an amount equal to the discharged indebtedness. There is a limited exception that allows a reduction in basis for a discharge of "qualified real property business indebtedness" in lieu of cancellation of indebtedness income. Code section 108(c).

3. Purchase-Money Debt Reduction. A limited exception to the discharge of indebtedness rule is provided for the reduction of purchase-money debt of a solvent debtor due to an adjustment in the purchase price by the seller. A solvent debtor may avoid the recognition of discharge of indebtedness income if the original seller of property subsequently reduces the price of the property sold. Code section 108(e)(5); Rev. Proc. 92-92, 1992-2 C.B. 505.

4. Insolvent Debtors. With respect to an insolvent debtor who has not filed a petition in bankruptcy, the amount of debt discharged is excludable from the taxpayer's gross income up to the amount of the insolvency. Code section 108(a)(3). The term "Insolvent" means the excess of the taxpayer's liabilities over the fair market value of his assets. Code section 108(d)(3) Rev. Rul. 92-53, 1992-2 C.B. 391. If the insolvency exception applies to a taxpayer and the debtor is able to exclude discharge of indebtedness income from gross income, the taxpayer will be required to reduce tax attributes. In addition,

to the extent the amount of indebtedness discharged exceeds the insolvency amount, the debtor is required to include any such excess amount in his gross income.

5. Amounts That Would Have Been Deductible. A debtor will not realize income to the extent that payment of the liability would have given rise to a deduction, such as the payment of interest. Code section 108(e)(2). Thus, for planning purposes, any payments made to a creditor where there may be discharge of indebtedness income (especially to a solvent taxpayer) probably should be specifically applied to the principal amount of the debt rather than the interest. However, there may be circumstances where it would be more advantageous for a debtor to pay interest instead of principal. The facts of each situation should be carefully reviewed before making a decision regarding the application of a payment.

6. Acquisition of Debt By a Related Party. Discharge of indebtedness income may be realized by a debtor if a party related to the debtor acquires an outstanding debt of the debtor from an unrelated creditor. Code section 108(e)(4).

7. Modification or Substitution of Debt. It may be possible to modify or substitute one debt for another without recognizing income, such as by (i) extending the maturity of indebtedness, (ii) subordinating the old indebtedness to new indebtedness secured by the same property, (iii) modifying the interest rate, or (iv) substituting new security for old security. Rev. Rul. 73-160, 1973-1 C.B. 365; Rev. Rul. 72-570, 1972-2 C.B. 241; Rev. Rul. 68-419, 1968-2 C.B. 196 and Rev. Rul. 55-5, 1955-1 C.B. 331. However, modifying the interest rate or extending the maturity date of indebtedness could result in the application of the imputed interest rules to the transaction. Code sections 483 and 1274.

8. Conversion of Recourse Debt into Non-Recourse. In certain circumstances, a lender may be willing to convert a recourse debt into a non-recourse debt, particularly if the lender is offered incentive for such conversion. Although it is not clear, it would appear that a conversion from recourse to non-recourse should not give rise to any discharge of indebtedness income provided that the fair market value of the property securing the new non-recourse indebtedness is at least equal to the amount of such non-recourse indebtedness. Comm'r. v. Rail Joint Co., 22 B.T.A. 1277, aff'd., 61 F.2d 751 (2d Cir. 1932). Alexander v. Comm'r., 61 T.C. 278 (1973).

9. Application of Section 108 to the Discharge of a Guarantee. In many cases, the guarantor of an indebtedness will be released by a lender for various reasons prior to becoming primarily liable on the indebtedness. In those cases, it appears that the release of such guarantor from his guarantee will not result in the realization of discharge of indebtedness income. Bradford v. Comm'r., 233 F.2d 935 (6th Cir. 1956), non acq., 1958-2 C.B. 9. At least one argument that can be made to support this result is that a guarantee is too contingent or indefinite an obligation to constitute a debt of the taxpayer. If, however, the taxpayer becomes primarily liable in his capacity as a guarantor, any failure to pay this obligation may result in the realization by the taxpayer of discharge of indebtedness income. In this case, the taxpayer probably also should be able to claim a bad debt deduction if the party for whom the guarantee was made subsequently fails to repay the indebtedness to the guarantor.

E. Cancellation of Indebtedness - Bankrupt Debtor.

1. In General. The debt cancellation rules discussed above apply to situations in which the debtor is either solvent or insolvent, but is not in bankruptcy. When a debtor files a petition in bankruptcy, any indebtedness previously owed by the debtor is transferred to the bankruptcy estate under Section 541 of the Bankruptcy Code and is then owed by the estate. The important distinction in Code section 108 is whether the debtor is in bankruptcy. "Bankruptcy" for purposes of Code section 108, means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of, and discharge of indebtedness is granted by, or occurs pursuant to a plan approved by, the court. Code section 108(d)(2).

2. Reduction of Tax Attributes. When a debtor is in bankruptcy, cancellation of debt income is not included in the debtor's or estate's gross income. Code section 108(a)(1). Instead, the amount

of canceled debt is applied under Code section 108(b)(2) to reduce the estate's tax attributes in the following order of priority:

- (a) The net operating loss for the taxable year of the discharge and any net operating loss carry-overs;
- (b) Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under Code section 38 (relating to general business credit);
- (c) The amount of the minimum tax credit available under Code section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge;
- (d) Any net capital loss for the taxable year of the discharge, and any capital loss carryover;
- (e) The basis of the property of the taxpayer;
- (f) Any passive activity loss or credit carryover of the taxpayer under Code section 469(b) from the taxable year of the discharge; and
- (g) Any foreign tax credit carry-overs.

3. Optional Election to Reduce Basis of Depreciable Property. The bankrupt debtor may elect to apply all or any portion of the canceled debt to first reduce the basis of depreciable property instead of having tax attributes reduced as discussed above. Code section 108(b)(5). This provision could be particularly important to a bankrupt debtor that is reorganizing under Chapters 11, 12 or 13 because, in planning the debtor's reorganization, it may be more important for the debtor to retain tax attributes than the basis in depreciable property.

If this election is made, the reduction in the property's adjusted bases is not limited by the amount of remaining undischarged liabilities. Code section 1017(b) (2). Instead, the debtor is permitted to reduce the full amount of adjusted basis of depreciable property, but not below zero. Code section 108(b)(5). For this purpose, the aggregate adjusted bases of the debtor's depreciable property is determined as of the beginning of the taxable year following the taxable year in which the discharge occurs. Code section 108(b)(5)(B). After the basis of depreciable property is reduced to zero, any remaining canceled debt is subject to the rules regarding the reduction of tax attributes discussed above.

For purposes of this election, the term "depreciable property" means any property which is subject to an allowance of depreciation (or cost recovery), including real property which is held as inventory by the debtor under Code section 1221(1). The reduction of the basis of property is treated as additional depreciation deductions for purposes of recapture under Code sections 1245 and 1250 upon the future sale or other disposition of the property, even if the depreciation of such property would not otherwise have been recapturable. Code section 1017(b). In addition, certain property, such as a partner's interest in a partnership, will be treated as depreciable property to the extent of the partner's proportionate interest in the depreciable property held by the partnership. Code section 1017(b)(3)(C).

F. Section 382 Limitation on Net Operating Loss Carry Forward Following Ownership Change.

1. In General. Code section 382 limits the use of net operating loss ("NOL") carry forward (and other loss and tax credit carry forward) that may be used by a corporation following an "ownership change." An "ownership change" occurs if, immediately following the close of a testing date, the percentage of stock of a loss corporation owned by one or more five percent shareholders has increased by more than fifty percentage points over the lowest percentage of stock of the loss corporation owned by shareholders at any time during the testing period. Code section 382(g).

A determination of when an ownership change has occurred for Code section 382 purposes can be quite complex. Outside of bankruptcy, if there is an ownership change, the use of NOL carry forward in the post-change year is limited to an amount equal to the equity value of the loss corporation immediately prior to the change multiplied by the federal long term tax exempt rate. Code section 382(b). Any unused limitation can be carried forward to the next year. This limitation is completely disallowed, however, if the loss corporation does not continue its business enterprise for a period of two years from the date of the ownership change. Code section 382(c). The continuity of business rules under Code section 368 business reorganizations apply in making this determination.

2. In Bankruptcy. Code sections 382(l)(5) & (l)(6) specifically address the treatment of the NOL carry forward in a bankruptcy context. These provisions apply to a corporation that has undergone an ownership change pursuant to a court order or a confirmed bankruptcy plan where creditors receive stock in the reorganized corporation pursuant to the plan. Treas. Reg. section 1.382-9(a).

Code section 382(l)(6) applies to any reorganization which qualifies under Code section 368(a)(1)(G) or any exchange of debt for stock which occurs pursuant to a plan of reorganization in a Title 11 or similar case if Code section 382(l)(5) does not apply. Code section 382(l)(6); Treas. Reg. section 1.382-9(j). Under this exception, the annual limitation on NOLs is equal to the federal long term tax exempt rate multiplied by the new equity value post-reorganization (i.e. the old equity value of the corporation increased by any amount of debt reduction occurring in the transaction, including the conversion of debt to stock). Id.

Alternatively, under Code section 382(l)(5), the loss corporation may take a one-time reduction in its NOLs and other tax attributes in lieu of the annual limitation described above if the old shareholders and the "old and cold" creditors of the loss corporation own (any new value excluded) at least 50% in vote and value of the new loss corporation (including stock of a controlling corporation if also in bankruptcy). Code section 382(l)(5). An "old and cold" creditor for this purpose must have held the debt either (1) for at least eighteen months prior to the bankruptcy or (2), since the debt's creation, which must have been in the ordinary course of business. Code section 382(l)(5)(E). Indebtedness will be treated as having been continually owned for purposes of the 50% requirement if the beneficial owner is not, immediately after the ownership change, either a 5% shareholder or an entity through which a 5% shareholder owns an indirect ownership interest in the loss corporation. Treas. Reg. section 1.382-9(d)(3)(i). This safe harbor does not apply, however, to indebtedness beneficially owned by a person whose participation in formulating a plan of reorganization makes evident that the person has not owned the indebtedness for the requisite period of time.

If a corporation qualifies under Code section 382(l)(5), the NOLs and other tax attributes are reduced by the sum of (i) fifty percent of the cancellation of debt income less the fair market value of the stock issued in the exchange and (ii) the amount of interest paid or accrued by the old loss corporation for three years prior to the exchange of the converted debt. Code section 382(l)(5)(B) & (C).

Example: E&P corporation has \$40,000,000 in NOLs, a \$10,000,000 debt bearing simple interest at the rate of 10% per annum which is exchanged for stock and \$2,000,000 in post exchange equity. E&P's cancellation of debt income is \$8,000,000 (\$10,000,000 debt canceled minus \$2,000,000 equity issued in exchange). Interest on the debt for three years is \$3,000,000 (3 X 10% X \$10,000,000). E&P would reduce its NOLs as follows: (i) by \$4,000,000, which represents 50% of the cancellation of debt income and (ii) by \$3,000,000, which represents the interest accrued or paid on the debt for three years.

If there is a second ownership change during the two year period immediately following the ownership change to which section 382(l)(5) applies, the exception is destroyed as to the original ownership change and the non-bankruptcy limitation applies until the second ownership change. After the second ownership change, the Code section 382 limitation is zero. Code section 382(l)(5)(D).

III. Amortization of Intangibles.

A. Increasing Significance.

1. Heavy Industry History. Oil and gas comes from a steel and brawn heavy industry heritage. Drilling, production, transportation, refining and marketing all involve heavy equipment. Oil and gas are themselves physical and dangerous, the source of prodigious power. Like other heavy industries, oil and gas is a capital intensive business. The large amounts of capital invested in tangible items were (and are) recovered, for tax purposes, through depletion and depreciation.

2. Shifting Significance. Intellectual property items have historically been a small part of the oil and gas budget. Recovery of intellectual property expenditures for tax purposes has been incidental to the depletion and depreciation of tangible items and the deduction of non-intellectual property intangibles directly supporting the tangibles. The necessity for ever increasing productivity and efficiency can only be met through innovative technology. Knowledge continues to become an ever larger piece of the expenditure and value equations. There is no apparent reason that the pace of advancements in finding, extracting, processing, transporting and marketing oil and gas should slacken. Intangible knowledge, increasing the probability of success in drilling, increasing the amount recoverable from reserves and decreasing the cost of transport and delivery to end-users, will become more valuable and will claim a larger share of budgets and balance sheets. How and when these expenditures are recovered against revenues, and how knowledge that changes hands is taxed, will become increasingly significant.

3. Section 197. Tax law is reactive and trails industry practices. It will be years before administrative rules and interpretations and court decisions provide detailed guidance for the tax treatment of the new intellectual property intangibles in oil and gas that are being, and will be, created and implemented now and in the near future.

B. Code Section 197.

1. Exclusivity. Code section 197 divides all intangible assets into two sets. One set contains amortizable Code section 197 intangibles ("Code section 197 Intangibles"). The other set contains every other intangible. Section 197 Intangibles must be capitalized and the adjusted tax basis amortized straight line over 15 years. Code section 197(a). No other depreciation or amortization may be claimed by the taxpayer for Code section 197 Intangibles. Code section 197(b).

2. Items Constituting Code Section 197 Intangibles. Code section 197 Intangibles include, subject to exceptions, goodwill, going concern value, workforce in place, business books and records, operating systems, information bases, patents, copyrights, formulas, processes, patterns, knowhow, formats, customer based intangibles, supplier based intangibles, licenses and permits granted by government, covenants not to compete, franchises, trademarks, tradenames and similar items. Code section 197(d)(1).

3. Self Created Exceptions. A taxpayer created intangible generally cannot be a Code section 197 Intangible. Exceptions include assets created specifically for a sale transaction, government licenses and permits, covenants not to compete, franchises, trademarks and trade names. Code section 197(c)(2).

4. Other Exceptions. Assets that cannot be Code section 197 Intangibles include interests in entities, financial contracts, land, leases of tangible property, existing debt, professional athletic franchises and certain transaction costs and professional fees not otherwise deductible under the Code. Code section 197(a). Unless acquired as part of the purchase of an entire business, assets that cannot be Code section 197 Intangibles include interests in off-the-shelf computer software, print, audio, video or similar works, government contracts, patents, copyrights and rights to service debt. Code section 197(c).

5. Dispositions. Code section 197 Intangibles acquired in a group are indivisible while still owned by the taxpayer. Assume that asset x and asset y are acquired in a single transaction by taxpayer. Taxpayer discovers that asset x is worthless but asset y is valuable. Taxpayer wishes to keep asset y and recognize taxpayer's loss in asset x by abandoning or selling asset x for a nominal price.

Taxpayer cannot sell asset x and recognize a loss. Taxpayer cannot abandon asset x and write-off the basis in asset x. Instead, when taxpayer abandons or sells asset x at a loss, taxpayer must add the asset x basis to the basis in retained asset y. Code section 197(f)(1).

6. Anti-Churning Provision. Code section 197 contains rules designed to prevent a taxpayer from converting intangibles, not eligible for amortization under prior law, into Code section 197 Intangibles through related party transactions. Code section 197(f)(9).

7. Geological and Geophysical Exploration Costs. Geological and geophysical exploration costs are capital expenditures. Rev. Rul. 77-188, 1977 - 1 C.B. 76. The costs of geological and geophysical exploration in a single, integrated "project area" must be allocated equally among the various "areas of interest." An area of interest is a separate, non-contiguous portion of a project area that is explored intensively. The costs of additional, detailed surveys of the particular area of interest, and the preliminary survey costs allocated to that area, are allocated on a net acreage basis to the properties acquired as leasehold costs. Leasehold costs are recoverable through depletion. If no leases are acquired, the exploration geophysical and geological costs are deductible as losses from the abandonment of the properties under Code section 165.

IV. Three Party Like Kind Exchanges.

A. Tax Effect. In a like kind exchange a taxpayer swaps property with someone else. A like kind exchange defers recognition of gain or loss for tax purposes. Code section 1031(a).

1. Eligible Assets. Property held for productive use in a trade or business, other than inventory, securities, partnership interests, beneficial interests and causes of action, is eligible property for like kind exchange purposes. Code section 1031(a)(1)(2).

2. Time Requirements. In a deferred exchange, replacement property must be identified within 45 days of the taxpayer's transfer of the exchanged property and the replacement property must be acquired within the first to occur of 180 days of the transfer or the tax due date for the taxpayer's tax year. Code section 1031(a)(3).

3. Divisible. A transaction can be in part like kind exchange and in part a recognition event. Code sections 1031(b) and (c).

4. Basis. Tax basis carries over from the property transferred to the property received in a like kind exchange. Code section 1031(d).

5. Insider Trades. Exchanges between affiliates result in non-recognition only if both the taxpayer and affiliate hold the respective property received for two years. Code section 1031(f).

B. Like Kind Property. There is tax deferral only if the property exchanged is of like kind. Domestic operated working interest for domestic operated working interest is like kind property. Any variance between the interest received and the interest conveyed should be very carefully reviewed to determine whether the property is in fact like kind.

1. Oil and Gas in Place is Real Estate. The lessee of oil and gas in place owns real property for federal income tax purposes. Rev. Rul. 68-226, 1968-1, C.B., 362. However, if the property is inventory in the hands of the taxpayer, Code section 1031 is not available.

2. Real Estate May be Traded for Real Estate. A ranch and a producing oil and gas leasehold interest have been determined to be like kind, both real property, for purposes of a like kind exchange. Rev. Rul. 68-331, 1968-1 C.B. 352. Raw land has been determined to be real property of like kind with overriding oil and gas royalties. Rev. Rul. 72-117, 1972-1 C.B. 226.

C. Deferred Exchanges. The chance that two companies will show up at closing to swap title to oil and gas properties is not very high. Taxpayers are permitted greater freedom in taking advantage of Code section 1031 through deferred exchanges. The risk of a deferred exchange is that any error in procedure can eliminate the tax deferral and result in tax treatment of the exchange as a sale of property followed by reinvestment of the sales proceeds.

1. Prior Agreement. Written agreements are critical to deferred exchanges. Purchase agreements should be drafted to reflect like kind exchanges if that is the intent of the parties. The taxpayer cannot receive, actually or constructively, sales proceeds, reinvest those sale proceeds and still use Code section 1031.

(a) Replacement property must be identified in writing by the 45th day after the taxpayer relinquishes control of the property to be conveyed out. Treas. Reg. section 1.1031(k)-1(b)(2)(i) and -1(c).

(b) Replacement property must be conveyed to the taxpayer prior to the first to lapse of (i) 180 days after the taxpayer relinquishes control of the property conveyed out or (ii) the due date for the taxpayer's annual tax return (which is calculated including any filing extensions obtained). Treas. Reg. section 1.1031(k)-1(b)(2)(ii) and -1(c).

2. Three Safe Harbors. There are three regulatory safe harbors for deferred like kind exchanges. Treas. Reg. section 1.1031(k)-1(g)(1). The safe harbors are means by which a taxpayer may ensure that the taxpayer actually receives the replacement property without losing the tax deferral of the like kind exchange. This is of great interest to taxpayers since in a deferred exchange the taxpayer conveys title to the property exchanged, the purchaser pays for the property exchanged and either a third party or the purchaser controls the sales proceeds pending purchase of the replacement property. The taxpayer is vulnerable during this deferral period and wants assurance of performance. The key is delivering both assurance and tax deferral.

3. Guarantee Safe Harbor. So long as the taxpayer does not have an immediate or unrestricted right to receive the collateral or guarantee proceeds, performance of conveyance of the replacement property may be assured with the following:

(a) a security interest in property (other than cash or cash equivalents);

(b) a standby letter of credit that may be drawn upon only upon default in the obligation to convey replacement property; or

(c) a third party guarantee.

Treas. Reg. section 1.1031(k)-1(g)(2).

4. Escrows and Trusts Safe Harbor. Performance of conveyance of the replacement property may be assured with cash or cash equivalents if the following conditions are met:

(a) an escrow account, established by agreement, is used;

(b) the escrow agent is in fact independent of the taxpayer (not a "disqualified person", a defined term); and

(c) the escrow agreement provides that the taxpayer cannot receive, pledge, borrow or otherwise obtain the benefits of the escrow account until the replacement property is identified in writing by the taxpayer or the exchange has failed.

Treas. Reg. section 1.1031(k)-1(g)(3).

5. Use of Qualified Intermediaries Safe Harbor. A qualified intermediary may receive the sales proceeds from the sale of the safe harbor taxpayer's property and acquire for the taxpayer the replacement property without being considered the taxpayer's agent or the taxpayer being considered to control and reinvest the proceeds if the following conditions are met:

- (a) a written exchange agreement is entered into with a qualified intermediary;
- (b) the exchange agreement provides that the taxpayer cannot receive, pledge, borrow or otherwise obtain the benefits of the sales proceeds held by the qualified intermediary;
- (c) the exchange agreement requires the qualified intermediary to acquire and transfer the taxpayer's property in the disposition side of the exchange and to acquire and transfer the replacement property in the replacement side of the exchange;
- (d) the qualified intermediary need not take legal title to the properties but may enter into purchase and sale agreements and transfer the contract rights prior to the closing; and
- (e) to be a qualified intermediary the person acting as intermediary must be in fact independent of the taxpayer and must not be a disqualified person.

Treas. Reg. section 1.1031(k)-1(g)(4).

D. Recapture-No Mixing of Types of Assets. Do not forget to review recapture issues with a like kind exchange. Recapture can be delayed only if depletable assets are matched with other depletable assets in the exchange and depreciable assets are matched with other depreciable assets in the exchange. Treas. Reg. sections 1.1245-2(c)(4) and 1.1245-4(d). Prop. Treas. Reg. section 1.1254-2(d).

V. Tax Law-The Trailing Edge On Defining A Separate Property.

A. Separate Property Elections.

1. A Single Property. Oil and gas taxation is tied to the concept of "the property". The property bears costs, some of which are capitalized and some of which are currently deducted, produces revenues and generates credits. Disposition of the property results in gain, loss or recapture. Determining how to define "the property" is significant for tax purposes.

2. Default to Surface Geography. Unless otherwise elected by a taxpayer, all properties owned by a taxpayer in a single tract will be combined into a single property. Code section 614(b)(1). Code section 614(a) defines the property as each separate interest in a mineral deposit. Code section 614(b)(2) allows taxpayers to file elections defining separate properties. The plain language of the Code reads in a manner consistent with economic reality. The interpretive Treasury Regulations are another story.

3. Methods for Defining Separate Properties. There are three methods for defining separate properties:

(a) Separate legal rights based upon contiguous surface geography and the time and source of acquisition. Treas. Reg. section 1.614-1(a)(3);

(b) Tracts separated by legal ownership determined from surface geography. Id.; and

(c) Subsurface geology, or strata of mineral deposits, after discovery and development begin. See the example, Treas. Reg. section 1.614-8(a)(2)(ii).

This "after the fact" requirement, that strata of mineral deposits may be designated as separate properties by a taxpayer only after discovery and development, is a source of friction between taxpayers and the IRS.

B. The Indivisible Lease.

1. Oil and Gas Are In The Ground Subsurface Substances. The ultimate value of a working interest rests upon ownership of producing zones. Producing zones are depth specific. Subsurface geology is horizontally stacked. Valuable property rights that are horizontally stacked are created and traded. Code section 614 allows the taxpayer to designate horizontally stacked discrete producing zones as separate properties in a single lease. This matches economic reality. The after discovery and development requirement of the IRS for separate property designation does not match economic reality.

2. Dry Holes. Not every oil and gas venture is a success. Many times substantial amounts have been spent and capitalized only to prove that a depth defined prospect lacks commercial value. At this point those expenditures represent an economic loss.

(a) Under an income based tax the taxpayer should be able to deduct that loss and move on to the next prospect, which may lie under the same surface area but at a different depth. The Code in fact does allow a deduction for losses in Code section 165.

(b) However, a loss on a property under Code section 165 is not allowed unless the entire property becomes worthless. The taxpayer bears the burden of establishing the worthlessness of the property to claim the Code section 165 loss.

3. Abandoning The Worthless Property. The most straightforward means of establishing worthlessness is abandonment of the property. The most straightforward means of proving abandonment is for the taxpayer to carve out and surrender title to the property. This is an example of tax law trailing industry reality. Consider a lease that may not be horizontally divisible for purposes of legal title. Phillips Petroleum Co. v. Comm'r., 104 T.C. 256 (1995), *aff'd* 96-1 USTC 50,006 (10th Cir. 1995). Federal regulations applicable to the leasing of outer continental shelf blocks may enable government agencies, for unrelated issues at the surface, to effectively preclude relinquishment of legal rights to horizontally stacked zones. 30 C.F.R. sections 256.62, 256.76(b). The taxpayer must then, to claim the economic loss for tax purposes, develop an alternate method of establishing that the property is worthless. This alternate method may include the farce of going through the motions of an unsuccessful marketing effort to sell the unproductive property, for development and production purposes, to other taxpayers.