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FEDERAL INCOME TAX CONSEQUENCES UNDER TYPICAL FARM-OUT AGREEMENTS

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Since oil and gas are depletable assets, companies engaged in the petroleum industry must vigorously search for new reserves in order to remain in business as well as to grow. The undeveloped acreage located in the thirty-three producing states represents the principal source of future reserves. In 1962 approximately seventeen per cent of the total land area of the fifty states of our union was under lease.[1] During the ten year period between 1953 through 1963, the total acreage under lease rose from approximately 333 to 381 million acres.[2] However, increased exploration and development costs, coupled with lower discovery rates, recently have caused most oil and gas operators to adopt stringent austerity programs. To spread the risk and cost of evaluating their acreage holdings within the primary terms of their leases, most oil and gas companies are actively engaged in promoting exploratory drilling upon or near their undeveloped acreage under a variety of farm-out agreements.

Originally, the farm-out agreement was basically only a conditional assignment of the working interest under all or a portion of acreage covered by a lease subject to the drilling of one or more test wells and the reservation of certain rights such as an override, a surrender or reassignment obligation, a call on production, and a preferential right to re-purchase the property.[3] Under present usage, the term has been expanded to embrace any sharing arrangement which provides for the transfer of a leasehold of operating interest in exchange for a firm drilling commitment, wherein the grantor retains any number of rights other than lessor's royalty.[4] Indeed, the only limitation upon the terms and conditions which may be incorporated within a farm-out agreement is the skill and imagination of those responsible for negotiating the trade and their draftsmen.

While farm-out agreements as an exploratory tool present a few real operating problems to the petroleum entrepreneur, they present a variety of unsettled questions for his tax counselor. In this day of high taxes, the federal income tax consequences influence, if not dominate, the approach to be employed in most farm-out agreements. As a matter of fact, if a favorable tax consequence can be derived from a particular technical approach, it will frequently outweigh all

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1. Independent Petroleum Ass'n of America, The Oil Producing Industry in Your State 12 (1963).

2. *Id.* at 4, 13.

3. Lamb, *Farmout Agreements—Problems of Negotiation and Drafting*, 8 Rocky Mt. Mineral Law Institute 139 (1963).

4. *Ibid.*

other business considerations. Therefore, where two or more methods will accomplish the same business objectives, it is imperative that both parties to a farm-out agreement be cognizant of the basic principles of taxation applied to natural resources and employ the approach which will be mutually favorable to each. It is well recognized that

> the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.[5]

It is also true that the taxpayer, in an effort to minimize his tax burden, may enter into any legal arrangement he sees fit, even though

> the particular form in which it was cast was selected with the hope of a reduction in taxes . . . .[6]
> But the transaction may always be scrutinized to see whether it is in reality what it appears to be.[7]

In this connection, it should be remembered that substance, not form, controls in the application of income tax law;[8] however, as a practical matter, the substance of a transaction will tend to follow the form in which it is cast. Although there are relatively few explicit tax regulations governing farm-out arrangements, there are certain recognized guide lines which should be followed in order to fix the tax liability of the interested parties at the lowest possible level.

Farm-out agreements may be grouped into eight basic categories: the simple farm-out, the sublease, the undivided interest farm-out, the checkerboard farm-out, the carried interest farm-out, the net profit farm-out, the back-in farm-out, and the carved out drill site farm-out.

I

THE SIMPLE FARM-OUT

If the primary purpose for making the farm-out is to evaluate a lease, gain subsurface geological information, or relieve the farmoutor from an offset obligation, the simple farm-out offers the most practical arrangement. Under a simple farm-out, the farmoutee[9] agrees to drill a test well at his sole cost, risk,

5. Gregory v. Helvering, 293 U.S. 465, 469 (1934).
6. Cowden v. Commissioner, 289 F.2d 20, 23 (5th Cir. 1961).
7. Morsman v. Commissioner, 90 F.2d 18, 22 (8th Cir. 1937).
8. United States v. Phellis, 257 U.S. 156 (1921).
9. The farmoutee is ordinarily the assignee of the lease. For the sake of clarity the term "farmoutee" will be used throughout the remainder of this article. See Sullivan, Oil and Gas Law 526, § 259 (1955).

and expense to a specified depth, either on the farmed out acreage or upon adjacent lands, and furnish the farmoutor[10] with complete well information in order to earn an assignment covering the full leasehold interest to all depths under the drill site. The farm-out agreement is generally drafted as a short letter of agreement, with the form of assignment to be earned attached as an exhibit. It is inexpensive to prepare and by eliminating all reserved rights and options, which are of little practical value as a rule, saves the time and expense required to police it. It also materially reduces the farmoutor's exposure to third party liability.

The tax consequences of the simple farm-out are favorable to both parties. If the obligation test well is drilled upon the farmed out acreage, the farmoutee may, at his option, under section 263(c) of the 1954 Internal Revenue Code,[11] deduct as an expense all intangible development costs paid or incurred by him; since under the farm-out agreement he earns the full leasehold rights under the drill site for the complete payout period.[12] If the obligation well is located upon adjoining land, the farmoutee's right to deduct as expense intangible drilling costs will depend upon whether or not he owns all of the leasehold or operating rights under the drill site during the complete payout period. The farmed out acreage may be treated by both parties as an acreage contribution. The farmoutee should credit the fair market value of the acreage received, as of the date of the farm-out, against his drilling costs. If the obligation test well is a dry hole, the farmoutee may deduct the fair market value of the assigned acreage, as of the date of the farm-out, as a worthless property loss in the year that he plugs and abandons the well.[13] The farmoutor may deduct an amount equal to his basis in the farmed out property as a loss if the obligation test well is plugged and abandoned as a dry hole, since it is presumed that the obligation test well did not enhance the value of his retained acreage.[14] However, if it is completed as a commercial producer, the farmoutor should allocate an amount equal to the farmoutor's basis in the farmed out acreage as a capital cost of accumulating information for the retention of his remaining properties in the area.[15]

Since the drilling of the obligation test well and the delivery of the pertinent geological data represent the sole consideration under the simple farm-out, the farmoutor, in order to obtain the maximum benefit from his investment, customarily requires the obligation test well to be drilled at a location which will

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10. The farmoutor is ordinarily the lessee-assignor of the lease. For the sake of clarity the term "farmoutor" will be used throughout the remainder of this article. *Ibid.*

11. Int. Rev. Code of 1954, § 263(c).

12. Proposed Treas. Reg. § 1.612-4, 25 Fed. Reg. 3761 (1960).

13. C. C. Harmon, 1 T.C. 40 (1942); G.C.M. 3890, VII-1 Cum. Bull. 168 (1928).

14. Revenue Service letter dated May 4, 1945, signed by Joseph D. Nanan, Jr., Commissioner, P-H 1945 Fed. Tax Serv. ¶ 76,209.

15. I.T. 4006, 1950-1 Cum. Bull. 48.

give him one or more direct offsets. This frequently prevents the farmoutee from obtaining significant financial assistance from other operators in the area. When this situation occurs, the farmoutor is frequently requested to further "sweeten the pot" with either a dry hole or bottom hole cash contribution. The same general tax principles apply to the cash contributions as to the simple farm-out. The dry hole contribution is the more attractive of the two from the contributor's standpoint. If the well is completed as a commercial producer, no payment is required. Should the well be plugged and abandoned, the contribution is payable but may be deducted as an expense by the contributor for tax purposes; however, the recipient must credit the proceeds against his drilling costs. A bottom hole contribution, on the other hand, must be paid by the contributor upon completion of the test well as either a commercial producer or a dry hole. In either case, the contribution must be credited against the recipient's drilling costs. The contributor should capitalize the amount of this contribution as a lease retention cost if the well is productive, or deduct it as a loss if a dry hole results.[16]

II

THE SUBLEASE

The sublease is perhaps the most common type of farm-out arrangement employed today. The typical sublease occurs where the farmoutor contracts to assign a tract of land, conditioned upon the farmoutee's drilling a test well to a specified depth upon the farmed out acreage, subject to the reservation by the farmouter of any number of rights and options[17] including, but not limited to,

1. An overriding royalty; and
2. All rights lying below the total depths penetrated in the drilling of the obligation test well, or some other specified depth; and
3. A "call" or "preferential right" to purchase production; and
4. The right of "first refusal" to reacquire the farmed out acreage.

Like the simple farm-out agreement, the sublease is generally drafted as a simple letter of agreement, with the form of assignment which is to be earned by performance of the drilling obligations being attached as an exhibit. While the main disadvantage of the sublease is the retention of primary responsibility and liability under the lease, the tax consequences can be significant. Many attorneys who are actively engaged in the preparation of farm-out agreements

16. Breeding & Burton, Income Taxation of Oil and Gas Production 806 (1961).

17. For tax purposes this transaction is regarded essentially as a sublease, although the local law may not apply these rules of sublease to the transaction. The transaction is, therefore, not subject to capital gains treatment. Palmer v. Bender, 287 U.S. 551 (1932).

seriously question whether the cost of policing and the liability attached to such reservations are truly justified.[18]

One of the first questions to be solved in order to determine the tax consequences of a farm-out is whether or not the agreement creates a sale or a sublease. The basic rule is that a sublease has been made if the farmoutor has retained a continuing economic interest in the farmed out acreage.[19] A continuing economic interest is an interest in production which is co-extensive with the leasehold life.[20]

The tax consequences under the usual sublease arrangement are more complicated than under the simple farm-out. First, and most important, the farmoutee is entitled, at his option, under section 263(c) of the 1954 Internal Revenue Code,[21] to deduct all of his intangible drilling costs. This is because he receives the full operating right under the sublease arrangement to the drill site during the entire payout, even though the sole consideration for the drilling of the obligation test well was the assignment which was delivered subsequent to the completion of the well. The farmoutor in this situation occupies the same tax position as the original lessor, and the farmoutee assumes the position of a lessee.[22] If any cash is received by the farmoutor under the sublease, it is treated as bonus and is taxable as ordinary income, subject to depletion and bonus restoration. If no cash consideration passes between the parties, the arrangement is considered to be a sharing arrangement, whereby the farmoutee assumes the development obligation in exchange for his interest. Therefore, neither party realizes a gain or loss from the farm-out transaction.[23]

If an overriding royalty is reserved, it is treated as economic interest, subject to depletion as royalty, when the proceeds attributable to it are received. The reservation of only a limited overriding royalty or production payment will not convert the sale of a leasehold interest into a sublease.[24] The farmoutee is entitled to a depletion deduction on his share of the production as it is produced, and he is taxed only upon his share of the production.[25]

There seems to be no justifiable legal distinction between the override and production payment. Under local property law, both are a retained interest in oil and gas.[26] The tax distinction appears to rest upon the fact that in case of

18. Lamb, *Farmout Agreements—Problems of Negotiation and Drafting*, 8 Rocky Mt. Mineral Law Institute 144 (1963).
19. Palmer v. Bender, 287 U.S. 551 (1932).
20. G.C.M. 22730, 1941-1 Cum. Bull. 214.
21. Int. Rev. Code of 1954, § 263(c).
22. Palmer v. Bender, 287 U.S. 551 (1932).
23. S.M. 3322, IV-1 Cum. Bull. 112 (1925).
24. Thomas v. Perkins, 301 U.S. 655 (1937).
25. Palmer v. Bender, 287 U.S. 551 (1932).
26. Standard Oil Co. of Texas v. Marshall, 265 F.2d 46 (5th Cir. 1959); Walker, *Oil Payments*, 20 Texas L. Rev. 259, 269 (1942).

the production payment, the assignee has a vested interest in the reversionary interest; while in the case of the overriding royalty, the assignor has the title represented thereby during the entire life of the lease. In an effort to obtain capital gains treatment on an assignment, together with what is in substance a perpetual overriding royalty, many ingenious assignors have reserved production payments which will never pay out. To plug this loophole, the Internal Revenue Service, in private rulings, has held that unless it may reasonably be presumed that the reserved production payment will pay out, the reservation will be presumed to be an unlimited overriding royalty.[27]

This means that in farmouts of "wildcat" or semi-proven acreage, any reserved production payment will probably be treated as an overriding royalty.

It is important to observe that the rules stated above are applicable to all situations where the farmoutee or assignee makes a contribution to the development of oil and gas properties. Hence, where a geologist, driller, landman, attorney, oil field supply man, or accountant renders services or material related to the acquisition or development of the property in return for a sublease, the conveyance qualifies as a tax-free sharing arrangement.[28]

III

THE UNDIVIDED INTEREST FARM-OUT

While the undivided interest farm-out has many attractive operating features and once was very popular, the adverse tax consequences accruing under it since 1947 have tended to restrict its use. Under the typical undivided interest farm-out, the farmoutor agrees to assign to the farmoutee a specified undivided interest in the farmed out acreage if the farmoutee drills an obligation test well on such land to a specified depth or to the "casing point." The farm-out agreement is usually drafted as a simple letter of agreement with two exhibits attached; the first being the form of assignment to be earned by the farmoutee, and the second being an operating agreement between the parties covering the subsequent operation and development of the farmed out acreage. The assignment or a collateral bill of sale will either convey or recognize that title to the obligation test well and all personal property used in connection with it is owned by the parties in the same proportions as their respective interests in the farmed out acreage. The operating agreement will provide for future operating and development costs, and production from the farmed out acreage shall likewise be allocated between the parties.

Under this arrangement, the farmoutee receives an interest in land in exchange for an interest in the well. At first it was believed that the arrangement

27. Breeding & Burton, Income Taxation of Oil and Gas Production 206 (1961).
28. Rawco, Inc., 37 B.T.A. 128 (1938).

resulted in a taxable exchange of unlike property. However, the Internal Revenue Service has ruled that this is a sharing arrangement and that no taxable exchange results. This ruling is based upon the theory that an undivided interest in the obligation test well apart from the lease has no fair market value and, consequently, the assignor derives no gain or loss from the exchange.[29] Since the farm-out results in no gain or loss, the farmoutor's basis in the original lease becomes the basis for his retained undivided interest.

The undivided interest farm-out is now seldom used, because the farmoutee may deduct as expense only the proportionate part of the intangible drilling costs which his undivided interest during the complete payout period bears to the entire leasehold operating interest under the well. The farmoutee must capitalize the remaining intangibles at leasehold acquisition cost.[30] The farmoutor, even though he holds title to an undivided interest in the land and a similar interest in the obligation test well, is not entitled to deduct as expense or capitalize any of the intangible drilling costs, since he did not pay them.

If, in addition to drilling the obligation test well to the "casing point," the farmoutee is obligated, in order to earn his interest, to complete and equip the well "into the tanks," then the fractional share of the completion and equipment costs attributable to the farmoutor's interest must be capitalized by the farmoutee as additional lease acquisition costs.

The undivided interest farm-out also presents a tax problem in connection with the handling of the depreciation deduction which is allowed under section 167 of the 1954 Internal Revenue Code on the tangible well equipment.[31] Since the farmoutor pays none of the costs of equipping the obligation test well, he has a zero basis in such equipment and cannot claim a depreciation deduction on it. The farmoutee pays all the tangible equipment costs, but he is entitled to take only his proportionate share of the depreciation allowance. The depreciation allowance attributable to the farmoutor's interest in tangible equipment is, therefore, lost under the undivided interest farm-out.

Operations under the joint operating agreement also present several tax pitfalls. Should the operating agreement fail to contain an adequate marketing clause, the joint venture may be classified as an association taxable as a corporation.[32] Should this occur, serious tax consequences would result. The venture would have to pay income taxes at the statutory rate, any payments made to the joint venturers would be taxed as dividends, and depletions would belong to

29. S.M. 3322, IV-1 Cum. Bull. 112 (1925); G.C.M. 932, VI-1 Cum. Bull. 241 (1927); Helvering v. Archbald, 70 F.2d 720 (2d Cir. 1934).

30. Proposed Treas. Reg. § 1.612-4, 25 Fed. Reg. 3761 (1960); Manahan Oil Co., 8 T.C. 1159 (1947).

31. Int. Rev. Code of 1954, § 167.

32. United States v. Stierwalt, 287 F.2d 855 (10th Cir. 1961); John Province #1 Well, 37 T.C. 376 (1961).

the association. If the association failed to timely elect to deduct as expense the intangibles, then such costs would have to be capitalized. To avoid these dire results, the provisions contained in the operating agreement concerning the marketing of production must meet the requirements of I.T. 3930 and I.T. 3948.[33] The typical marketing clause now reads as follows:

> Each of the parties hereto shall own its proportionate share of the production under this agreement, and each of the parties shall take in kind or separately dispose of its proportionate share of production from the Contract Area, exclusive of production which may be used in development and producing operations on said premises and that unavoidably lost; and shall pay or cause to be paid all applicable royalties thereon. Each party hereto shall be entitled to receive direct payment for its proportionate share of the proceeds from any sale of all such production saved and sold from said premises, and on all purchases or sales, each party shall execute proper division orders or contracts of sale pertaining to its interest. Any extra expenditure incurred by the taking in kind or separate disposition by any party of its proportionate share of the production shall be borne by such party.
>
> In the event any party shall fail to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the production from the Contract Area, Operator shall have the right, subject to revocation at will by the party owning it, but not the obligation, to purchase such production or sell it to others for such reasonable periods of time as are consistent with the minimum needs of the industry, but not to exceed one year, at not less than the market price prevailing in the area, which shall in no event be less than the price which Operator receives for its portion of such production from the Contract Area. Any such purchase or sale by Operator shall be subject always to the right of the owner of the production to exercise at any time its right to take in kind, or separately dispose of, its share of all such production not previously delivered to a purchaser. Notwithstanding the foregoing, Operator shall not make a sale into interstate commerce of any other party's share of gas production without first giving such other party sixty (60) days' notice of such intended sale.

By voluntarily entering into a joint operating agreement which meets the marketing standards prescribed by I.T. 3930 and I.T. 3948, the farmoutor and farmoutee fall squarely within the definition of a partnership.[34] However, the 1954 Internal Revenue Code permits the parties to elect to be excluded for

33. I.T. 3930, 1948-2 Cum. Bull. 126; I.T. 3948, 1949-1 Cum. Bull. 161.
34. Int. Rev. Code of 1954, §§ 761(a), 7701(a)(2).

tax purposes from the provisions of the Code relating to partnerships.[35] A typical election reads as follows:

> It is the intention of each of the parties hereto that this agreement and the operations hereunder shall not constitute a partnership, and each party elects to be excluded from the application of all of Subchapter K, Chapter 1, Subtitle A, of the Internal Revenue Code of 1954. Operator is hereby authorized and directed to make this election and execute, on behalf of the parties hereto, such evidence of this election as may be required by the Secretary of the Treasury of the United States. Each party hereto agrees not to give any notices or take any other action inconsistent with election here made. In making this election, each of the parties hereto states that the income derived by him from the operations under this agreement can be adequately determined without the computation of partnership taxable income.

The non-consent well provision contained in most joint operating agreements offers potential tax problems. The clause is designed to prevent one party from impeding the development of the operated property. It usually provides that the participating party shall be entitled to recoup 200 per cent of his intangible drilling costs, plus one hundred per cent of his tangible property costs out of the production from the operated area. To insure that the participating party may deduct as expense all of his intangible drilling costs, care must be exercised to provide that the participating party shall be entitled to recoup all of his intangible drilling costs from all of the production from the operated property during the complete payout period. At the end of the payout period the non-consenting party's interest reverts to him, and the government requires the participating party to transfer to leasehold costs the non-consenting party's share of the non-depreciated costs applicable to such tangibles.[36] To avoid this harsh result, many operating agreements provide that the non-consenting party shall not be entitled to any tangible property upon payout, but he shall be entitled to only his proportionate share of the proceeds derived from the sale or salvage of such tangible property.

IV

THE CHECKERBOARD FARM-OUT

The checkerboard farm-out evolved as an extension of the simple farm-out. It frequently became necessary to give the farmoutee greater representation in

35. Int. Rev. Code of 1954, § 761(a)(2). See Treas. Reg. § 1.761-1(a) (1956); T.D. 6198, 1956-2 Cum. Bull. 461.

36. Choate v. Commissioner, 324 U.S. 1 (1945), and Keystone Coal Co., 30 T.C. 1008 (1958), cast considerable doubt as to the validity of the government's position in this connection.

the area in order to promote the drilling of an exploratory test well. Since eight additional tracts usually surround a square drill site, the practice developed to give the farmoutee a full interest in one or more of the offsetting or cornering checkerboard tracts, or perhaps even a checkerboard throughout the entire lease. The checkerboard farm-out is particularly attractive to farmoutees, since under this arrangement they own the obligation test well and thereby receive the favorable tax treatment afforded under the simple farm-out; and at the same time they may acquire the equivalent net acre representation in the area afforded under the undivided interest farm-out. While the farmoutor does not participate in the initial test well, if it is productive he has retained four drillable direct offsets. To insure additional information and evaluation of his retained tracts, the checkerboard farm-out may require the farmoutee to conduct a continuous drilling program upon the farmed out acreage.

Since the handling of lease acquisition costs and intangible drilling costs for tax purposes under the checkerboard farm-out are substantially the same as under the simple farm-out, it is not necessary to discuss them here.[37] However, the checkerboard farm-out highlights two additional problems which are not encountered in the simple farm-out.

The first is the question of the treatment of separate properties for tax purposes. The word "properties" in tax parlance has a very special meaning, and it is important to correctly define and understand the term, because (1) each property acquired by the farmoutee must be set up separately for tax accounting purposes; (2) a portion of the acquisition costs must be allocated to each separate property; and (3) each separate property stands on its own for the purpose of computing depletion and abandonment loss. The term "property" is defined by the regulations[38] as

> each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

Each non-contiguous tract acquired under a checkerboard farm-out, therefore, constitutes a separate property for tax purposes.[39] Such a position has caused inequitable results and has proved difficult for the Internal Revenue Service to administer. This has led to promulgation of a regulation[40] which grants to a taxpayer the right to elect to aggregate separate operating mineral interests and treat the aggregation as one property.

The second problem is purely an operating problem concerning the formation of spacing and proration units. With the advent of wider spacing and larger

37. See text at 472, *supra*.
38. Treas. Reg. § 1.614-1(a)(1) (1961).
39. Berkshire Oil Co., 9 T.C. 903 (1947); Treas. Reg. § 1.641-1(a)(5) Example 4 (1961).
40. Treas. Reg. § 1.614-2 (1961).

production units, the checkerboard farm-out arrangement has become less popular, because the farmoutor has had to either increase the size of the checkerboard or be prepared to enter into joint operating arrangements with the farmoutee. Each of these alternatives can prove undesirable. By increasing the size of the checkerboard, the farmoutee might receive, at the expense of the farmoutor, a larger portion of the reservoir in the event the obligation test well was productive and the field covered a relatively small area. Under the other alternative, the farmoutee is faced with having to permit the farmoutor to buy into his well in order to form a standard proration unit. This, of course, would lead to the problems encountered under joint operation.

V

THE CARRIED WORKING INTEREST FARM-OUT

The problems encountered under the undivided interest farm-out and the checkerboard farm-out, pertaining to the development of the farmed out acreage after the farmoutee had earned his interest, led to the development of the carried working interest concept. Under this arrangement, the consenting party agrees to completely develop the property and pay the entire cost therefor, subject to recovering his cost out of the production from each well. There are three recognized types of carried working interest arrangements.

The first, or Manahan type, arises where the farmoutor assigns all his working interest to the farmoutee, pending the recoupment of all the farmoutee's development costs. After payout, a fractional part of the farmoutor's working interest either automatically reverts or is reassigned to him. Inasmuch as the farmoutee holds all of the working interest under the farmed out acreage, together with the right to receive all production therefrom during the complete payout period, he is entitled to deduct as expense all of the intangible drilling costs and may deduct all of the depreciation permitted on any capitalized tangible property during the payout period. The farmoutee is also taxed on all of the production during payout. All operating costs incurred during the payout period are also paid by the farmoutee. After payout, the depreciation deduction attributable to the farmoutor's interest in tangible property is lost if his proportionate interest in such tangible property reverts to him. All operating costs and production accruing after payout are apportioned between the parties in proportion to their working interests.[41] An appropriate operating agreement is generally entered into by the parties covering the operation of the farmed out acreage.

The second, or Herndon, type of carried working interest arises when the farmoutor assigns only a fractional part of the working interest to the farm-

41. Manahan Oil Co., 8 T.C. 1159 (1947); G.C.M. 22730, 1941-1 Cum. Bull. 214.

outee. The farmoutee in turn agrees to drill an exploratory well on the farmed out acreage for their joint account. The farmoutor then assigns to the farmoutee a production payment payable out of all of the farmoutor's retained interest in the farmed out acreage which is equivalent to his proportionate share of tangible and intangible drilling costs and operating costs incurred during the complete payout period. In this situation the farmoutee deducts as expenses only the proportionate part of the intangible costs which are equal to his working interest. The balance of the intangible costs must be capitalized as the cost of the production payment. The farmoutee is also entitled only to that portion of the depreciation deduction which his working interest bears to the entire leasehold estate. The balance of the tangible expenses is likewise capitalized as acquisition costs. Payments recovered under the production payments by the farmoutee are treated as ordinary income, subject to depletion. Since the production payment was carved out of the farmoutor's interest and devoted solely to development, the farmoutor realizes no gain or loss on the transaction and recognizes no income on the production attributable to his interest. He is not entitled to take any intangible or depreciation deductions, even though he assigned the production payment to cover his proportionate share.[42]

The third type of carried working interest is commonly known as the Abercrombie carried working interest. Under this situation, the farmoutor assigns the entire working interest to the farmoutee but retains a fractional carried working interest. The farmoutee agrees to drill a well but is not required to look solely to the production attributable to the carried working interest for the recovery of the development costs attributable to the farmoutor's carried interest. The courts construe this as a loan.[43] The tax consequences on the arrangements are surprising. During the payout period the income attributable to the farmoutor's carried working interest is taxable to him, even though it is paid to the farmoutee as a credit against the drilling and development costs attributable to such carried interest. The farmoutor is entitled to the intangible deduction, depreciation deduction, and depletion accruing to his carried interest. This is true even though the farmoutor did not actually pay the cost of the tangible and intangible drilling costs.[44]

The big problem under any carried working interest is determining who has the operating rights during the complete payout period. The decision in *H. H. Weinert*[45] gives the latest and most complete review of the problem. In the *Weinert* case the farmoutor assigned a fractional interest to the farmoutee, and the farmoutee agreed to develop the farmed out property and advance the funds necessary to pay the farmoutor's share of the development costs. The

42. Herndon Drilling Co., 6 T.C. 628 (1946).
43. Commissioner v. J. S. Abercrombie Co., 162 F.2d 338 (5th Cir. 1947).
44. *Ibid.*
45. 31 T.C. 918 (1959), *rev'd sub nom.*, Estate of Weinert, 294 F.2d 750 (5th Cir. 1961).

farmoutor assigned his retained interest to a trustee who was to collect the proceeds and pay all the debts and expenses. The Tax Court, following the *Abercrombie* case,[46] held that the carried interest portion of the transaction was merely a loan arrangement, even though the farmoutor was not personally liable for its repayment. The income from the carried interest was, therefore, charged to the farmoutor.[47] On appeal, the Court of Appeals[48] reversed on the grounds that (1) the economic realities of the transaction demonstrated that it was not a loan, and (2) substance, not form, should prevail. While the Court of Appeals only distinguished *Abercrombie*, it is arguable that the *Abercrombie* rule is no longer to be relied on.

Weinert appears to stand for the proposition that the carrying party will be allowed the tangible and intangible deductions in situations where he holds the full economic interest or the right to production during the complete payout period, even though he may not hold the operating rights or represented working interest.

VI

THE NET PROFIT FARM-OUT

The flail over the right of the farmoutee to deduct his intangible drilling and development costs under the undivided interest and other partially free well type farm-outs led to the creation of the net profit farm-out. Under this device, the farmoutor assigns all of his interest to the farmoutee under the farm-out acreage, subject to the reservation of a certain percentage of the net profit derived from such land. The consideration for the farm-out is the farmoutee's covenant to drill a test well to a specified depth. The term "net profit" is generally defined in a farm-out agreement as:

> It is agreed that in determining whether or not net profits have been realized by assignee from the interest herein assigned, all expenses incurred in the development and operation of said interest conveyed shall be taken into consideration, including, by way of illustration but not by way of limitation, expenses incurred in connection with the drilling of wells whether productive or dry, the completing, equipping, plugging and abandoning of wells, the producing of wells and treatment, storage and marketing of the production therefrom, the making of improvements upon the leasehold premises in connection with the operation thereof, expenses incurred in connection with the examining, perfecting of, and defense of title to said interest, including attorney's fees incurred in connection therewith, losses, damages or liabilities sustained or incurred in connection with the operation of

46. Commissioner v. J. S. Abercrombie Co., 162 F.2d 338 (5th Cir. 1947).
47. H. H. Weinert, 31 T.C. 918 (1959).
48. Estate of Weinert, 294 F.2d 750 (5th Cir. 1961).

> said interest, gross production and ad valorem taxes, premiums paid for workmen's compensation insurance, public liability, fire, wind, tornado or other insurance, and any other expense or charges that are reasonable and customary in connection with the operation and developing of said property and which are properly chargeable against the interest herein conveyed.[49]

The net profit interest was originally held by the United States Supreme Court to be merely an "economic advantage."[50] Accordingly, the farmoutor was not entitled to take depletion upon the net profits received by him. Since the farmoutor retained no economic interest in the farm-out acreage, he had made a sale and was entitled to capital gains treatment upon any profit he received over and above his basis in the property. The farmoutee was allowed to take all of the depletion deduction, deduct all of his intangible drilling costs, deduct the full depreciation allowance permitted on tangible property, and deduct all of the operating expense. The tax consequences flowing from this type of transaction benefited the farmoutor since, while losing depletion, he was more than compensated by the more favorable capital gains treatment. In 1946 the Supreme Court reviewed its position on net profit interests. Without specifically overruling its earlier decisions, it held that a net profit interest was an economic interest, which was similar to a royalty interest.[51] Therefore, payments under a net profit interest are now treated as ordinary income subject to depletion, instead of capital gains. This reversal of the Court's position means that the farmoutee is still entitled to deduct all of the intangible drilling costs, since he owns all of the operating rights during the complete payout period, all of the depreciation allowance, and the costs of operating the property. The farmoutee is also authorized to deduct payments under the net profits farm-out from his income.

Many modern net profit farm-outs grant the farmoutor the option to convert his net profit interest to an equivalent working interest after the farmoutee recovers all of his cost of developing and operating the farmed out acreage.

VII

THE BACK-IN FARM-OUT

The basic premise under most exploration farm-out agreements is to permit the farmoutee to earn a specified interest in the farmed out acreage by drill-

49. Southwestern Legal Foundation, Appendix to the Second Annual Institute on Oil and Gas Law and Taxation 2-3 (1951).

50. Helvering v. O'Donnell, 303 U.S. 370 (1938); Helvering v. Elbe Oil Land Dev. Co., 303 U.S. 372 (1938); Helvering v. Bankline Oil Co., 303 U.S. 362 (1938).

51. Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946).

ing a well free of cost to the farmoutor. However, due to the adverse economic consequences arising from the inability to deduct as expense the intangible drilling costs in cases where the farmoutee does not hold the entire operating rights during the complete payout period, various sophisticated technical schemes have been devised to accomplish as near as possible the desired results. Once the well has paid out and the deducting as expenses of intangible drilling costs is no longer an obstacle, the parties are free to readjust their artificial interests. One common method used to accomplish the original desires of the respective parties is to exercise the options contained in the back-in farm-out. If the farmoutor reserved an override, a production payment, or a net profits interest with an option to convert it into a specific undivided working interest after the end of the complete payout period, the decision in *Commissioner v. Critchton*[52] indicates that the exercise of the option will be treated as tax-free exchange under section 1031 of the 1954 Internal Revenue Code.[53] If the option is exercised, care should be exercised in drafting the operating agreement to be entered into by the parties covering subsequent operations, in order to escape the tax pitfalls discussed under the undivided interest farm-out.[54]

VIII

THE CARVED OUT DRILL SITE FARM-OUT

The carved out drill site farm-out is, in essence, a combination of the simple farm-out and the undivided interest farm-out. A typical carved out drill site farm-out is the situation where the farmoutor agrees to assign a full interest under the drill site to the farmoutee in consideration for his agreeing to drill a test well. The assignment will be subject to the reservation of a net profits interest, with an option to convert it into a working interest after the end of the complete payout period. A separate assignment will convey an undivided interest in one or more checkerboard tracts around the drill site. However, in some situations the drill site will be a "wildcat" area, while the additional acreage may be given in a semi-developed area as a "sweetener" to "kick-off" the deal. Frequently, the deal on the drill site will be a carried interest farm-out instead of a net profit farm-out. Since we have already reviewed the tax consequences on such farm-outs,[55] it is only necessary to consider their effect on the additional acreage. While the question has not been decided, it is likely that the Internal Revenue Service will take the position that the additional

52. 122 F.2d 181 (5th Cir. 1941).
53. Int. Rev. Code of 1954, § 1031.
54. See text at 475-78, *supra*.
55. See text at 480-83, *supra*.

acreage represents a separate property for tax purposes and must be treated as an acreage contribution.[56]

SUMMARY

As pointed out above, the depletion allowance and the right to deduct as expense intangible drilling costs are the principal incentives which attract farmoutees to invest their capital in oil and gas drilling ventures. President Kennedy's 1963 tax program has caused considerable concern in the petroleum industry, for if several of the proposals therein are enacted, they undoubtedly will remove much of the luster from sharing arrangements. The principal recommendations affecting farm-out operations are (1) the revision of the application of intangible drilling and development costs as related to the computation of percentage depletion, (2) the restriction on the aggregation of properties for depletion computation, and (3) a change in the treatment of capital gains.[57] The President's tax message[58] makes it clear that while the deduction of drilling and development expenditures would not be affected, they would have to be taken into account in computing the fifty per cent of net income limitation on percentage depletion. The new tax proposals would also tighten the rules on the grouping of properties for tax purposes in an effort to prevent producers from avoiding the fifty per cent limitation on percentage depletion. However, the most objectionable proposal is the one which provides that upon the sale of a property ordinary income taxes will be applicable to the extent that depreciation or depletion had been taken.[59]

Increased development costs, coupled with lower rates of returns resulting from the depressed conditions presently prevailing in the petroleum industry, should cause Congress to give serious consideration to any proposal which would result in a further restriction of domestic drilling operations. Instead of penalizing farmoutees by further restricting their right to intangible drilling costs and percentage depletion, it would help if a provision were included in section 263(c) of the 1954 Internal Revenue Code[60] to allow the person who actually expends the capital for the development of a property the right to deduct as expense all his intangible costs in accordance with economic realities, instead of the artificial "complete payout period" test contained in section 1.612-4 of the 1961 proposed regulations.

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56. See Arthur Anderson & Co., Oil and Gas Federal Income Tax Manual 85 (1960).
57. See Oil and Gas Journal, Jan. 28, 1963, p. 115.
58. 1 U.S. Code Cong. & Ad. News 56-58, 88th Cong. 1st Sess. (1963).
59. Oil and Gas Journal, Jan. 28, 1963, pp. 115-16.
60. Int. Rev. Code of 1954, § 263(c).