



Dallas Energy Conference – Tax Update

Joe Lavis, Tax Partner

Tax Law Updates

- Bonus Depreciation Phase Out
 - 100% Bonus under 168(k)
 - Sunset phase out to 80% in 2023, 60% in 24, 40% in 25, 20% in 26, 0% in 27
- Increase in individual tax brackets
 - Inflation adjustments
 - 2023 Top Tax Bracket: 37% for income over \$578,125 (\$693,750 MFJ)
 - 2022 Top Tax Bracket: 37% for income over \$539,900 (\$647,850 MFJ)

“Green Book” Tax Proposals – Published March 2022

- Modify Fossil Fuel Taxation (2023)
 - Eliminate Expensing of IDCs; must capitalize and recover through depletion
 - Repeal 2 year amortization of Geological & Geophysical Costs. Proposal to amortize over 7 years
 - Repeal 15% percentage depletion; only recovery would be from cost depletion
 - Exemption from the corporate income tax for fossil fuel publicly traded partnerships

“Green Book” Tax Proposals – Published March 2022 (cont.)

- Corporate Tax Rate of 28% from 21% (2023)
- Prevent basis shifting (Section 754) from related parties in partnerships (2023)
- Tax capital gains at ordinary rates for earners over \$1MM (2023)
- Impose a minimum income tax on wealthiest taxpayers (wealth tax)
 - Taxpayers over \$100MM of income and unrealized capital gains
 - “prepayment” of unrealized capital gains
 - Paid over 9 installments
- Tax Carried Interests as Ordinary Income
 - investment services partnership interest

Entity Types

- Corporate vs flow-through?
- LLCs elect to be treated as, S Corp, or C Corp
- C Corporation = double taxation partnerships
 - Tax rate reduced to 21% but still have the double taxation problem when taking money out of the C Corp
- S Corporation = SE tax benefit but less flexibility, special allocations are more difficult, limitations on who can be a shareholder
- Partnership = usually preferred entity due to flexibility of property/cash contributions, ability to grant profits interest to management teams and the ability to provide step-up in tax basis to buyer via sale of PC or deemed/actual asset sale.

Partnerships – The Focus

- Partnerships
 - Federal Tax Form – Form 1065
 - Partner’s Share of Income & Deductions – Schedule K-1
 - Due Dates
 - March 15th
 - Extended Due Date – September 15th
 - Common Due Date Delivery of K-1s or Estimated K-1s required by partnership agreements
 - March 31/April 1, April 30, June 30
 - Limited Partnerships vs LLCs

Schedule K-1

651121
OMB No. 1545-0123

Final K-1 Amended K-1

Schedule K-1 (Form 1065) 2021
Department of the Treasury Internal Revenue Service

For calendar year 2021, or tax year beginning / / 2021 ending / /

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership		Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items																																																																																			
A Partnership's employer identification number B Partnership's name, address, city, state, and ZIP code C IRS center where partnership filed return ▶ D <input type="checkbox"/> Check if this is a publicly traded partnership (PTP) Part II Information About the Partner E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.) F Name, address, city, state, and ZIP code for partner entered in E. See instructions. G <input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member H1 <input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner H2 <input type="checkbox"/> If the partner is a disregarded entity (DE), enter the partner's TIN _____ Name _____ I1 What type of entity is this partner? I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here <input type="checkbox"/> J Partner's share of profit, loss, and capital (see instructions): <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 50%;"></th> <th style="width: 25%; text-align: center;">Beginning</th> <th style="width: 25%; text-align: center;">Ending</th> </tr> </thead> <tbody> <tr> <td>Profit _____ %</td> <td style="text-align: center;">%</td> <td style="text-align: center;">%</td> </tr> <tr> <td>Loss _____ %</td> <td style="text-align: center;">%</td> <td style="text-align: center;">%</td> </tr> <tr> <td>Capital _____ %</td> <td style="text-align: center;">%</td> <td style="text-align: center;">%</td> </tr> </tbody> </table> Check if decrease is due to sale or exchange of partnership interest <input type="checkbox"/> K Partner's share of liabilities: <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 50%;"></th> <th style="width: 25%; text-align: center;">Beginning</th> <th style="width: 25%; text-align: center;">Ending</th> </tr> </thead> <tbody> <tr> <td>Nonrecourse . . . \$</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> </tr> <tr> <td>Qualified nonrecourse financing . . . \$</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> </tr> <tr> <td>Recourse . . . \$</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> </tr> </tbody> </table> Check this box if item K includes liability amounts from lower tier partnerships ▶ <input type="checkbox"/> L Partner's Capital Account Analysis <table style="width: 100%; border-collapse: collapse;"> <tbody> <tr> <td>Beginning capital account . . . \$</td> <td style="text-align: right;">\$</td> </tr> <tr> <td>Capital contributed during the year . . . \$</td> <td style="text-align: right;">\$</td> </tr> <tr> <td>Current year net income (loss) . . . \$</td> <td style="text-align: right;">\$</td> </tr> <tr> <td>Other increase (decrease) (attach explanation) \$</td> <td style="text-align: right;">\$</td> </tr> <tr> <td>Withdrawals and distributions . . . \$</td> <td style="text-align: right;">\$</td> </tr> <tr> <td>Ending capital account . . . \$</td> <td style="text-align: right;">\$</td> </tr> </tbody> </table> M Did the partner contribute property with a built-in gain (loss)? <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," attach statement. 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For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2021

GAAP vs Tax

- Key differences of GAAP versus Tax
 - Depletion Calculation
 - Depletable Base
 - Property by Property
 - Reserves & Safe Harbor Election
 - Percentage and Cost Depletion
 - Depreciation
 - TDC/TCC/LWE (Working Interest) – 7 yr Life
 - Gathering System (Midstream) – 7 yr Life
 - Pipeline (Midstream) – 15 yr Life
 - 100% Bonus under 168(k)
 - Sunset phase out to 80% in 2023, 60% in 24, 40% in 25, 20% in 26, 0% in 27

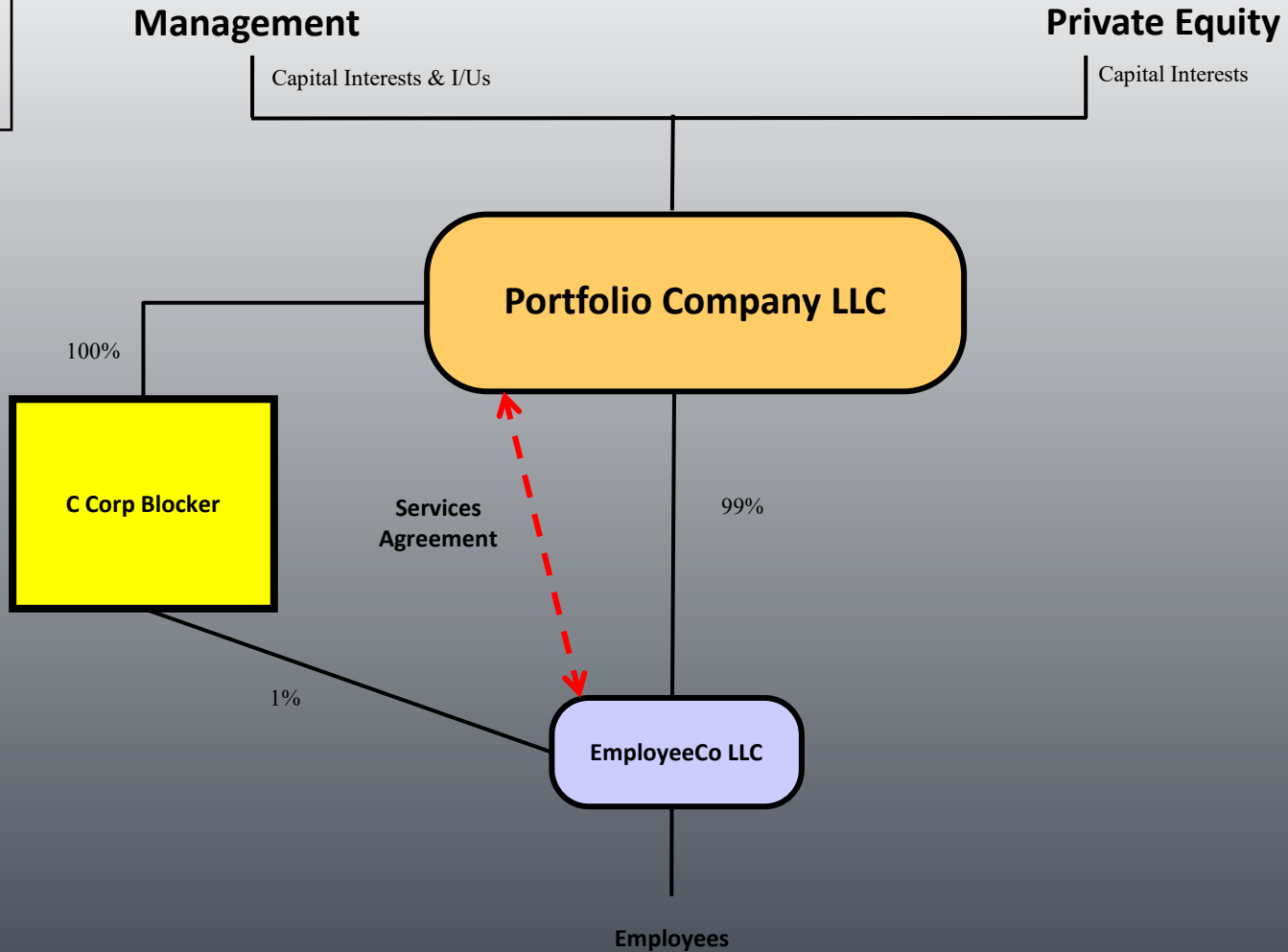
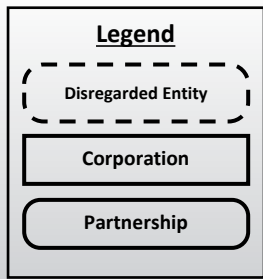
GAAP vs Tax

- Key differences of GAAP versus Tax (cont.)
 - Intangible Drilling Costs
 - IDC/ICC eligible to be expensed in year incurred (prepaids may expensed for cash basis taxpayer if certain req are met)
 - Can elect to amortize capitalized IDC over 5 years
 - Election made in first year where IDCs are incurred
 - Asset Retirement Obligations/Asset Retirement Costs
 - Not recognized by tax and accretion is added back to income
 - Impairment – not recognized for Tax
 - Geological & Geophysical Costs – Amortized over 24 months
 - Unrealized Hedging
 - Org costs and some legal costs are capitalized
 - Interest Expense – limited to 30% of EBITDA

Life Cycle of Portfolio Company - Formation

- Entity is formed with backing by private equity. Typically as an LLC taxed as a partnership
- Management team either has minority stake in capital interest (contributing cash) and/or profits interest (right to future profits based on hurdles identified in partnership agreement)
- Profits interest
 - Treated as partner and should receive K-1 even if blank
 - No income effect to partner on date it is granted or else would be deemed a capital interest (and therefore taxable)
- Structure Considerations - Employees are usually paid in mgmt. company that does not hold the assets

Example Portfolio Company Structure



Sample Distribution Waterfall

(b) All cash and property distributions by the Company pursuant to this Section 5.4 shall be made to the Members as follows:

(i) first, until the First Threshold has been met, to the Capital Members pro rata in accordance with their respective Class A Sharing Percentages;

(ii) second, after the First Threshold has been met and so long as the First Threshold continues to be met and until the Second Threshold has been met, (A) 90% to the Capital Members pro rata in accordance with their respective Class A Sharing Percentages and (B) 10% to the Class B Members and Class C Members pro rata in accordance with their respective Class B & C Sharing Percentages;

(iii) third, after the Second Threshold has been met and so long as the Second Threshold continues to be met and until the Third Threshold has been met, (A) 85% to the Capital Members pro rata in accordance with their respective Class A Sharing Percentages and (B) 15% to the Class B Members and Class C Members pro rata in accordance with their respective Class B & C Sharing Percentages;

(iv) fourth, after the Third Threshold has been met and so long as the Third Threshold continues to be met and until the Fourth Threshold has been met, (A) 80% to the Capital Members pro rata in accordance with their respective Class A Sharing Percentages and (B) 20% to the Class B Members and Class C Members pro rata in accordance with their respective Class B & C Sharing Percentages; and

Life Cycle of Portfolio Company – Asset Acquisition

- Acquisition of Assets
 - Typically through PSA
 - Effective Date vs Closing Date
 - Purchase Price Adjustments
 - Purchase Price Allocations
 - Needs to be assigned property by property (PV10)
 - Equipment needs to be carved out
 - Reserves
 - Allocated on a property by property basis and used to calculate cost depletion
 - Make safe harbor election to gross up reserves by 105% and “freeze” reserves by well

Life Cycle of Portfolio Company – Current Year Operations

- Working Interest vs Royalty Interest (RI, ORRI, NPI)
 - Working Interest
 - IDCs
 - Equipment
 - LOEs
 - Ordinary Income
 - 199A – QBI
 - Royalty Interest
 - Gross Revenue, prod/sev taxes, marketing
 - Portfolio Income
 - UBTI and tax-exempt entities
 - No QBI deduction

Life Cycle of Portfolio Company – Computing Tax Depletion

- Cost Depletion & Percentage Depletion
 - Compute both method on each property and take the greater of. Both methods reduce basis
- Cost Depletion
 - Units of production calculation
 - Basis - Leasehold Costs, Lease Bonus, legal costs/prof costs less accumulated depletion
 - Numerator - Current year production
 - Denominator – Total remaining reserves
 - Cost depletion = $CY\ Prod / Total\ reserves * Adjusted\ Basis$
 - No limitations
- Percentage Depletion
 - Gross revenue x 15% limited to net income by well
 - Limited to 65% of taxable income
 - Can exceed basis

Life Cycle of Portfolio Company - Divestiture

- Sale of Partnership Interest vs Sale of Assets
 - Partnership Interest Sale
 - Holding Period of interest > 1 year for capital gain rate
 - Subject to 751 Recapture
 - Sale of Assets
 - Holding period of assets > 1 year for capital gain rate
 - Subject to recapture
 - Recapture
 - Taxed at ordinary rates
- Installment Sales
 - Typical with holdbacks and held in escrow
 - Can elect out and losses are not eligible
- “Sale” of Assets in Exchange for Partnership Interest
 - Nontaxable event
 - Creates built in gain and built in loss situations
 - Disguised Sales

Bridging the Gap Between Accounting and Tax

- What does tax need from accounting?
 - Trial Balances - excel
 - Financials – excel
 - Well data – Reserves, location (state), need to know how reserves and CY Production are quantified (bbls, mcf, gallons)
 - Conversion to barrels of equivalency (boe)
 - $\text{bbl} = \text{boe}$; $\text{mcf}/6 = \text{boe}$; $\text{gallons}/42 = \text{boe}$
 - Net income, CY Production, IDCs and Equipment by property
 - LOS Statements
 - GL Data Dumps (i.e. out of Ogsys we can usually pivot table what we need out of the GL)
 - We have to be able to link well data to current year information with unique identifier (i.e. well name, tract #, etc) because the tax depletion schedules need to rollforward each year
 - 1099s that have state withholding
 - Whiskey

State Tax Issues

- Each state is unique and has its own sets of rules and nuances
 - TX – Gross margin tax. Entity level tax
 - NM – Flow through tax, 3 factor apportionment, withholding required on behalf of partners, if royalty interest operators are required to withhold unless RI owner elects out. Need to attach 1099s
 - OK - Flow through tax, separate accounting, withholding required on behalf of partners, if royalty interest operators are required to withhold unless RI owner elects out. Need to attach 1099s OK allows for 22% depletion rate
 - LA - Flow through tax, separate accounting, no withholding required, LA allows for 22% depletion rate

Other Topics

- Sale of working interest and retain ORRI/NPI/RI is treated as lease
 - Ordinary Income
 - No basis allowed to offset income
- Farmouts/Drillcos
 - Be aware there could be a tax partnership that would be designated in the Joint Development Agreement and separate set of books would need to be kept
- State Tax Withholding
 - Is deemed to be an equity distribution; not expense
- Like Kind Exchange
 - Tax deferred arrangement for sale of real property and subsequent purchase of “like” real property

Questions?

whitleypenn 



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