INCOME TAX IMPACT OF SURFACE OWNER PIPELINE RIGHT-OF-WAY AGREEMENTS

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Introduction

- Mineral owners have received bonus payments for mineral leases related to the Marcellus and Utica Shale.
- Surface landowners in the Marcellus and Utica Shale regions are seeing significant activity in receiving offers to sign "pipeline right-of-way”.
- Pipelines occupy a critical role in the development of shale resources.
- As shale development continues to expand, so does the need for pipelines that transport shale gas resources. .

Payments For Pipeline Right-Of-Way

- The payment for this right-of-way amounts to an easement.

- The income tax treatment of easements may trigger
  - ordinary income,
  - capital gain income ,
  - a reduction in basis of all
  - or part of the land, or combination of the three.

Pipelines

Time To Report The Payment To The IRS

What to do?

Real Property Interests

- Understand what interest is being conveyed, if any.
- Property is a bundle of rights” or a “bundle of sticks.
- Property law comes from three sources: the common law, statutes, and the Constitution.

General Principles of Oil and Gas Interests

- Economic Interest
- Operating v. Non-Operating Interest
- Lease
- Conveyances —Sale or Lease General Considerations
- Lease Rights
- Royalties
- Production Payments
- Retained Production Payment

Easements Generally

- An easement is an interest in real estate that gives the holder the right to use, but not to possess, the real estate.
- Express easement
- Easement appurtenant
  - dominant tenement
  - servient tenement
  - affirmative easement
  - negative easement
- Easement in gross
- Implied easement
- Easement by necessity
- Easement by prescription
- Conservation Easement

Types of Easements

- Rights of way
- Driveway easements
- Utility easements
- Light and air easements
- Fence easements
- Water easements
- Sport or recreational easements
- Flowage easements
- Pipeline Easement - gives the easement holder the right to build and maintain a pipeline on a landowner’s property. It does not grant the easement holder actual ownership of the land, just a right to use the land for pipeline purposes.
  - The term “right-of-way agreement” = “easement”

Income Taxation Of Payments

- **Income.** § 61, except as otherwise provided in the Code, a taxpayer must include in gross income "all income from whatever source derived."
- **Character of Income** – Ordinary Capital Gain
- **Burden of Proof.** As with most civil tax matters, the burden is on the taxpayer to prove the underlying nature of a particular payment.
- **Damages to Property**. "In lieu of what were the damages awarded?
  - Payment for damage to property = recovery of capital
  - Payment for use of property = ordinary income
  - Payment for lost profits = ordinary income
- **Constructive Receipt** and **Economic Benefit Doctrine**.

Income Tax Treatment of Pipeline Payments.

- **Recognition of Gain or Loss**. Code § 61(a)(3) provides that gross income includes gains derived from dealings in property. A sale of a perpetual easement constitutes a sale of an interest in land.
  - Payment for temporary easement = rent
  - Payment for permanent easement = recovery of basis

- **Nature of Property**. The nature of the asset conveyed must be determined. Land may be a capital asset held for investment or personal use, Code § 1231 property (which is property used in a trade or business, including property subject to involuntary conversion), or stock in trade.

- **Impairment (Damage) To Property**. The return of capital doctrine provides an exception to the definition of gross income under § 61.

Income Tax Treatment of Pipeline Payments.

- **Timber**. The capital gain/loss general rules of Code § 1221 or § 1231 usually apply to a sale or exchange of standing timber and timberlands if the property is not inventory or other property held for sale to customers in the ordinary course of business.

- **Allocation.** The property owner must allocate basis to the easement tract to determine the amount of gain or loss realized.

- Reg. 1.61-6(a) provides more specifically that ‘[w]hen a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part.

Income Tax Treatment of Pipeline Payments.

- ***Inaja Land Co., Ltd*****.** Tax Court Case

- **Leases and Licenses**. Transactions characterized as leases or licenses give rise to rental income, with no offset of basis.

- **Reversionary Rights**. Retaining certain reversionary rights can frustrate sale treatment. A reversion right causes the easement to revert to the original owner upon the occurrence or nonoccurrence of an event, condition, or fact.

- A reversionary event that necessarily or probably will occur, such as the passage of a term of years, is fatal to easement status. Easements for pipelines, surface sites, and roads that are for a definite term of years are considered leases.

Income Tax Treatment of Pipeline Payments.

- **Periodic Payments**. Provisions calling for periodic payments bear indicia of a lease.

- **Payments for Temporary Workspace**. Designating such space as a temporary easement and allocating payments to its use will trigger rental income

- **Damage Payments**. Rev. Rul. 73–161, the Commissioner considered the tax consequences of a lump sum payment for damages caused by the construction of a pipeline. Commissioner adopted the traditional recovery of basis analysis used in *Raytheon* and *Inaja Land*, but found that, although the agreement specified that damages to fences, improvements, and crops were included in the advance payment, <u>the only damage incurred at the time of the payment was an anticipated loss of rental income due to crop curtailment</u>. Therefore, taxpayer was not entitled to treat the payment as return of capital.

Income Tax Treatment of Pipeline Payments.

- **Severance Damage Allocation**. Severance damages are payments in addition to a condemnation award which are paid to the owner where only part of the property was condemned and the value of the part of the property retained was decreased as a result.

- ***Gilbertz* Case.** In Gilbertz, the Tenth Circuit construed payments for future damages as rentals, where a statute limited the landowner’s right to recover to instances of unreasonable or negligent use, and there was no evidence of actual damages caused by such conduct.

- **Eminent Domain**. Eminent domain (sometimes referred to as condemnation), is the power of the government to take private property for the public use without the consent of the owner. I

Income Tax Treatment of Pipeline Payments.

- **Relocation Payments**. Some eminent domain statutes require payments for the expense of relocating fixtures and personalty.

- **Condemned Property**. The IRS position is that a condemnation award must segregate severance damages and other components, or else a presumption exists that the award was only for the property taken.

- **Involuntary Conversion**. An involuntary conversion is the complete or partial destruction, theft, seizure, requisition or condemnation or sale or exchange under threat of imminent requisition or condemnation of a taxpayer's property.

Income Tax Treatment of Pipeline Payments.

- **Deferral Under Code § 1033**. Under Code § 1001(c) gain or loss realized from the sale or other disposition of property must generally be recognized. An important exception to this general rule is provided by Code § 1033, which allows gain realized from certain involuntary conversions of property to be recognized or deferred at the taxpayer's election.

- **Condemnation of Property With Residence**.

- **Transaction Reporting**. The party acquiring the easement is responsible for reporting the real estate transaction on Form 1099-S. Where damages or rents are paid, they are reported on Form 1099-MISC. The IRS has stated that, for dispositions of timber, payments of timber royalties under a “pay-as-cut” contract are to be reported on Form 1099-S, Proceeds From Real Estate Transactions.

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Case Study

- Land Owner A received the following checks from Energy Company C during the calendar tax year:
  - $160,500.00
  - 2,433.86
  - 840.00
  - 15,000.00
  - 4,050.00
  - 2,500.00
  - 11,000.00

  - $196,323.86

Case Study

- Land Owner A received two Form-1099s for the tax year:

Form 1099-Misc Box 3 Other Income	97,721.36
Form 1099-S Proceeds from Real Estate Transactions	98,602.50
Total	**$196,323.86**

- Other facts to consider are the Land Owner basis in the real estate:

Purchased 2/3 land & minerals	78,300
Inherited 1/3 land	100,000
Inherited 1/3 minerals	100,967
Cost of Land & Mineral Appraisals	3,350
Land Owner is a Farmer with 112.33 acres	

Case Study

- Land Owner and the tax preparer had to figure out the following when preparing the tax return:
  - How do you reconcile the checks with the 1099s received?
  - Where do you report the above checks and corresponding 1099s?
  - Basis needs calculated.
  - How do you allocate basis between the different transactions?
  - On what Form or Schedule do you report the transactions?

Case Study

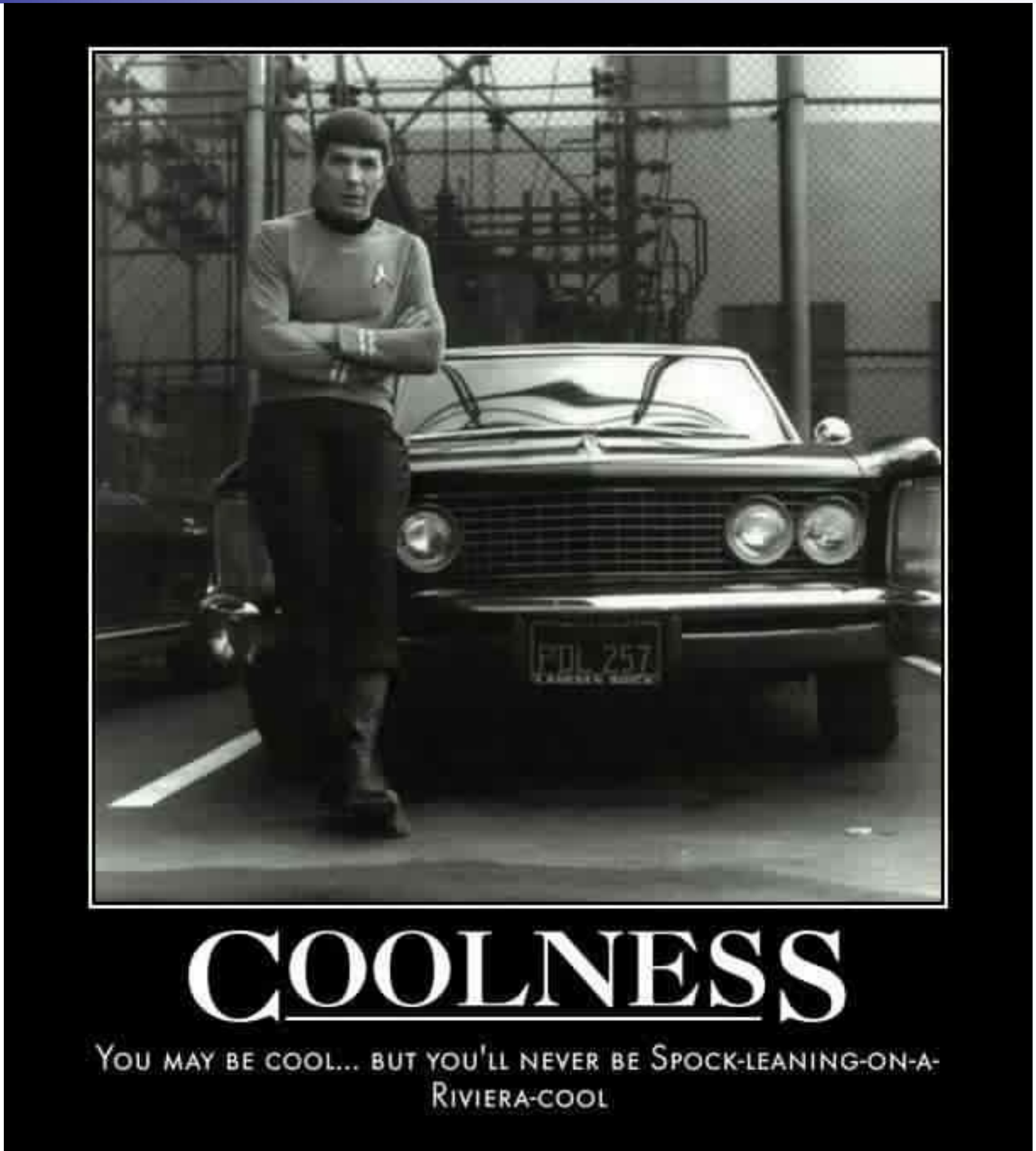
The case study tax return as filed	Reported on Form	
Schedule F income from crop damage	840.00	1099-Misc Box 3
Damages with basis allocated on Form 4797	79,447.50	1099-Misc Box 3
ROW with basis allocated on Form 4797	81,052.50	1099-S
Damages with basis allocated on Form 4797	17,433.86	1099-Misc Box 3
Roadway Option with basis allocated on Form 4797	4,050.00	1099-S
Surface Site Damages with basis allocated on Form 4797	2,500.00	1099-S
ROW with basis allocated on Form 4797	11,000.00	1099-S
Total	196,323.86	

Case Study

- Tax Return Analysis
  - Since the taxpayer is a Farmer and had definable crop damages, a portion of the proceeds ($840) were reported on Schedule F.
  - Since the taxpayer is a Farmer, all of the money received for ROWs and damages were reported on Form 4797.
  - Properly allocating basis can reduce taxable income.
  - Properly identifying the nature of the income allowed for recognition of lower capital gain tax treatment versus ordinary income.
  - Proper treatment of income, use of basis and the applicability of capital gain treatment versus ordinary income saved the taxpayer $47,000 (other facts, income and deductions about the case study tax return have been left out for simplicity reasons).

Case Study

- This case study demonstrates the need to reach beyond the actual 1099 reporting forms received (and even in some cases not received) to understand the nature and character of the payments. Use the agreements and documentation available to support the proper filing of the return with the understanding that the IRS may eventually send correspondence where we need to respond and support the filed return.


COOLNESS
YOU MAY BE COOL... BUT YOU'LL NEVER BE SPOCK-LEANING-ON-A-RIVIERA-COOL

The End

Thank you