INFORMATIONAL NOTICE REALTY TRANSFER TAX AND PERSONAL INCOME TAX 2012-04

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Division and Transfer of Interests Related to Oil and Natural Gas

I. PURPOSE

This informational notice addresses the Pennsylvania Realty Transfer Tax and Personal Income Tax treatment associated with the division and transfer of interests in oil and natural gas.

II. GENERAL PROPERTY LAW RELATED TO OIL AND GAS

A. Types of Estates

Real estate can be divided into three separate and distinct estates: the surface estate, the mineral rights estate, and the support estate. All three estates can be consolidated under one owner or can be severed and held by different owners.

Oil and natural gas interests are derived from ownership of or rights to subsurface minerals of the mineral rights estate.

B. Oil and Gas Leases

Oil and gas companies typically acquire the right to extract and produce subsurface oil and gas through a lease arrangement whereby the lessee is granted what is known as a “working interest” in the oil or gas.

Under an oil or gas lease, the lessor reserves an interest in the minerals extracted and produced, called a royalty. A royalty is a right to a share of the mineral production or income from the mineral production.

A royalty can be taken “in-kind” or in its monetary equivalent.

C. Real Estate vs. Personal Property

Oil and gas in place are themselves considered real estate. However, once oil or gas is physically severed from the land, it becomes personal property.

An oil or gas lease is not a traditional “lease” in the landlord/tenant sense. Rather, it is a conveyance of real estate (the mineral rights estate), which when production is obtained, creates a fee simple determinable interest in the lessee.
The lessor’s reservation of a royalty under an oil and gas lease creates an estate in land and not a personal property interest. An overriding royalty is also an interest in land and not a personal property interest. The royalty payment itself, whether in cash or in-kind, is personal property.

III. REALTY TRANSFER TAX

A. General

Pennsylvania Realty Transfer Tax is imposed upon any “document” that effectuates or evidences the transfer of “title to real estate.” 72 P.S. § 8102-C.

1. Title to real estate

Title to real estate is any interest in real estate that is perpetual or endures for an indefinite period or is 30 years or longer, including an estate in fee simple, a life estate, a remainder interest, a leasehold interest, and an easement. 72 P.S. § 8101-C (definition of “title to real estate”).

Real estate includes surface estates such as lands and permanent improvements thereon and mineral rights estates in oil, gas and quarries. 72 P.S. § 8101-C (definition of “real estate”).

2. Taxable “documents”

A document can be any writing that effectuates or evidences the transfer of title to real estate. Consequently, the form or designation of the document is irrelevant. A taxable document can include a formal deed, a lease, an assignment agreement or even a memorandum. As long as the document effectuates or evidences the transfer of title to real estate, it is taxable.

3. Mineral Rights

Documents that effectuate or evidence the transfer of mineral rights are taxable for Pennsylvania Realty Transfer Tax purposes. 61 Pa. Code § 91.169.

Taxable documents are those that transfer interests in a mineral rights estate itself or interest in real estate. Note: Because an overriding royalty is an interest in real property, a document that conveys an overriding royalty is subject to tax.

Documents that transfer personal property rights associated with the mineral rights estate are not taxable. For example, the assignment of the right to receive income from an oil or gas lease, such as a royalty
payment, would not be taxable. However, because the reservation of a royalty creates an interest in real estate, if the royalty itself (that is, if the reservation of the interest to the oil and gas production reserved by the lessor) is conveyed, the document of conveyance is subject to Realty Transfer Tax.

The taxable value of mineral rights is determined in the same manner as any other real estate interest. For Realty Transfer Tax purposes, taxable value is the actual monetary worth of the real estate determined either by a bona fide sale or, if the conveyance is for no or nominal consideration, computed value. In the event that there is no sale and no computed value, then the taxable value is the real estate's actual monetary worth. 72 P.S. § 8101-C (definition of “value”). Pennsylvania Department of Revenue (“department”) regulations provide that actual monetary worth is to be determined by appraisal when the real estate is not subject to a bona fide sale or does not have a computed value. 61 Pa. Code § 91.136.

In addition to an appraisal, the department may in its discretion accept other credible evidence of the value of mineral rights such as comparable sales. Also see Inheritance Tax Bulletin 2012-01 for additional acceptable valuation methods for natural gas rights when there is no sale price, appraisal or other credible evidence.

It is the taxpayer’s burden to provide the true, full and complete value of real estate, including the value of mineral rights. 72 P.S. § 8109-C.

4. Easements

Easements, because they are interests in land, are subject to Realty Transfer Tax to the extent that they are permanent, indefinite or for a term of thirty years or more. This includes easements that may be in support of or in furtherance of oil and gas development and production activities except as explained in Section III.B., below. Types of easements associated with oil and gas exploration, extraction and production include the following: ingress and egress easements, pipeline easements, water line easements, and fracture (“frac”) pond easements.

B. Exclusions and exemptions

1. Public utility easement exclusion

Excluded from the class of taxable documents are those that grant, vest or confirm a public utility easement. 72 P.S. § 8101-C (definition of “document”) and 61 Pa. Code § 91.193(b)(28). This exclusion only applies for the transfer of an easement to a person furnishing public utility service and only if the easement is used in, or useful for, furnishing public utility services.
For purposes of this informational notice, in order to be considered a person furnishing a public utility service, the person must be subject to public utility regulation. Persons that are subject to the jurisdiction of the Pennsylvania Public Utility Commission ("PUC")\textsuperscript{12} or the Federal Energy Regulatory Commission ("FERC"),\textsuperscript{13} or a similar state or federal agency, are considered a qualifying public utility.

\textbf{Pipelines:} As indicated above, the easement itself must be used in, or useful for, furnishing a public utility service. Consequently, the easement itself must be subject to public utility regulation by entities such as the PUC and FERC. This is a particularly important issue in determining whether gas pipelines easements are subject to tax.

Generally, there are 4 types of gas pipelines, as follows:

- **Production pipelines** transport gas from the wellhead to a gathering system.
- **Gathering pipelines** are larger pipelines that accept gas from a series of well sites and transport the gas to a transmission facility.
- **Transmission pipelines** are major pipelines of 30” or larger that transport processed gas on an interstate basis for end use.
- **Distribution pipelines** are pipelines that transport oil or gas to residential, commercial and industrial users.

Production and gathering pipelines do not transport oil or gas in interstate commerce or to end users and are not subject to regulation.\textsuperscript{14} Therefore, documents that convey easements for such pipelines which easements are permanent, indefinite or for a period of 30 or more years are subject to Realty Transfer Tax.

Transmission and distribution lines, on the other hand, transport oil and gas to end users on an interstate or intrastate basis and are generally subject to regulation. Therefore, documents that transfer easements for such pipelines are not subject to Realty Transfer Tax.

2. Oil and Gas Leases

As referenced above, real estate leases that are perpetual, indefinite or for 30 years or more are subject to Realty Transfer Tax. Generally, oil and gas leases have a fixed term for exploration and provisions for lease extensions after oil or gas is found and as long as they are being produced in paying quantities. Therefore, the term of an oil or gas lease is generally indefinite. As a result, such leases would be taxable. However, there is a statutory exemption for leases for the production of minerals such as coal, oil or natural gas. 72 P.S. § 8102-C.3(22) and 61 Pa. Code § 91.193(b)(22). Consequently, such leases are
not subject to tax. The exemption also applies to the assignment of such leases. Easements for the production of minerals that are expressed or implied under an oil and gas lease are also exempt under this provision.

C. Assignments of Oil or Gas Leases

An assignment of an oil or gas lease may or may not be subject to Realty Transfer Tax. The determinative factors related to such assignments are the parties making the assignment and the rights being assigned.15

As stated in Section III.B.2 above, an assignment of a lease for the production or extraction of coal, oil or natural gas is not subject to Realty Transfer Tax. 72 P.S. § 8102-C.3(22) and 61 Pa. Code § 91.193(b)(22).

A lessee who holds a working interest in oil and gas under an oil and gas lease can assign part or all of his interests to another party (often a subsidiary) without the imposition of Realty Transfer Tax.

A lessor’s assignment of an oil or gas lease is more problematic, however. Whenever a lessor “assigns a lease” it is important to determine the rights that are being assigned for Realty Transfer Tax purposes.

A document that assigns a lessor’s interest under an oil or gas lease, despite its designation, may intentionally or unintentionally convey title to the entire mineral rights estate. The conveyance of the mineral rights interest is taxable.

Any document that conveys a lessor’s reserved real estate interest under the royalty clause of an oil or gas lease is taxable. Even if the document purports to be an assignment of a lease, the tax exemption for oil and gas leases and the assignment thereof is not applicable. The exemption is only applicable to leases for “production or extraction” of oil or gas. The lessor’s interest under the lease is a reservation of the oil or gas in place, a real estate interest, as opposed to the interest that the lessor granted to the lessee to extract and produce a portion of the oil or gas in place. Therefore, any document that conveys the reserved interest is subject to tax.

Other documents that only assign duties or personal property rights under the lease are not subject to Realty Transfer Tax. As explained in Section III.A.3. above, a lessor may seek to assign all or a portion of his royalty “income” under the lease. The right to the royalty income is a personal property interest and the document making such assignment is not taxable.

Any document that commingles the assignment of the real estate interests in the mineral rights estate with the assignment of personal property rights or interests under the lease is subject to Realty Transfer Tax to the extent of the conveyance of the real estate interest.
IV. PERSONAL INCOME TAX

A. Rents and royalties

When an owner of a mineral rights estate enters into an oil or gas lease, the lease typically provides for both rental and royalty payments (whether the usual and customary royalty and/or an overriding royalty) to the owner. A lessee can also reserve an overriding royalty under an oil or gas lease.

The net gains from rental and royalty payments are taxable for Pennsylvania Personal Income Tax purposes and are reportable on Schedule E of the PA-40. 72 P.S. § 7303(a)(4). Calculation of net gains from rents and royalties are beyond the scope of this informational notice. However, it should be noted that real estate taxes are not deductible expenses because they are personal expenses that are not directly related to the production of the rental or royalty payments. Further, even though oil and gas in place are considered real estate, oil and gas in place are not subject to real estate taxes. Therefore, there are no real estate taxes that can be associated with oil and gas interests that could be used to reduce rental or royalty income for Pennsylvania Personal Income Tax purposes.

If a lessee and owner of a working interest under an oil or gas lease, conveys an overriding royalty to someone as consideration for services, the royalty is taxable compensation to the transferee based upon the value of the interest conveyed. The value is based upon the real estate value of the royalty at the time of conveyance and not the present value of the potential future royalty payments. (Presumably, the real estate value of the royalty will be commensurate with the value of the services rendered. The lessee will use this value to calculate any gain from the disposition of the royalty and the transferee will use the value as his cost basis in the overriding royalty interest.) Thereafter, any royalty payment that the transferee receives is taxable to the transferee as royalty income as explained above.

B. Conveyance of mineral rights estate

1. Sale

Net income from the disposition of property is subject to Pennsylvania Personal Income Tax. 72 P.S. § 7303(a)(3). If a mineral rights estate owner sells the mineral rights, the consideration less the owner’s basis in the mineral rights and other costs associated with the sale is taxable. The gain is reported on Schedule D of the PA-40.

If the seller owns both the surface rights and mineral rights in the real estate, the seller must allocate a portion of his basis to the mineral rights estate. If the seller did not allocate his basis when he originally purchased the real estate, then the seller must allocate a portion of the basis to the mineral rights. The amount allocated to the mineral rights is the entire basis multiplied by a fraction, the numerator of which is the fair
2. Gift or transfer for no or nominal consideration

Pennsylvania does not impose a tax on gifts. If a mineral rights estate owner makes a gift of the mineral rights (e.g., to family members), the conveyance is not subject to tax. The transferee receives the owner’s basis in the mineral rights estate as a carryover basis. 61 Pa. Code § 103.13(c).

If a mineral rights estate owner conveys the estate to a private trust for no or nominal consideration, the same rule applies.

If a mineral rights estate owner conveys the estate to a business entity (such as a limited partnership or limited liability company) in a non-taxable exchange for an ownership interest in the entity, the conveyance is considered a capital contribution and the basis in his ownership interest in the business entity is his basis in the mineral rights estate.

C. Assignment of an oil or gas lease

As explained in Section III.C. above, it is important to ascertain the rights that are being conveyed under an assignment of an oil or gas lease in order to determine the Pennsylvania Personal Income Tax consequences of the assignment. To the extent such an assignment effectuates the conveyance of the mineral rights estate, the provisions of Section IV.B. apply.

If, however, the mineral rights estate owner retains the ownership and control of the mineral rights estate and only assigns income rights under the oil and gas lease, then there is a different tax result as explained below.

1. Sale of production payments

A mineral rights owner who is the lessor under an oil or gas lease may sell and assign his rights to income from future production payments18 (including royalties) under the lease. For Pennsylvania Personal Income Tax purposes, the sale and assignment are treated as an anticipatory assignment of income.19

Assignor: When a mineral rights estate owner sells and assigns his right to income from production payments under an oil and gas lease, he is considered to receive royalty income to the extent of the sale price (which sale price normally represents the present value of the future production payments assigned). The assignor reports the royalty income...
on Schedule E of the PA-40 in the tax year in which the sale proceeds are received. (The assignor does not receive a subsequent deduction when the production payments are made to the assignee.)

**Assignee:** The assignee, through his purchase of the income from the production payments, acquires a basis in the future production payments. There are two methods by which the assignee must account for his receipt of the future production payments and his basis therein. The proper accounting method depends upon whether the assignment is part of an open or closed transaction.

The transaction is an **open transaction** if the future production payments to which the assignee is entitled are not readily ascertainable. The transaction is a **closed transaction** if the amount is readily ascertainable. Situations involving open transactions are very rare and are determined on a case by case basis. The presumption is that the transaction is closed. The burden is on the assignee to prove otherwise.

If the purchase of the future production payments is a closed transaction, each future payment is considered a partial non-taxable return of the assignee’s basis and the remainder is considered taxable royalty income reportable on Schedule E of the PA-40. The taxable and non-taxable amounts are apportioned based upon the amount of the anticipated future payments and the assignee’s basis.

For **example,** a lessor under an oil or gas lease sells and assigns his right to future production payments for the next 25 years. The assignee agrees to pay $35,000 for the future payments. Assignee, therefore, has a basis of $35,000.00 in the future payments. It is anticipated that the total production payments will be $100,000 (1 yearly payment of $4,000 for 25 years). Based upon those numbers, by the time all future payments are made, the assignee will receive a full return of his basis and an additional $65,000 of taxable royalty income. The assignee’s basis accounts for thirty-five percent of the future production payments and the taxable royalty income accounts for the remaining sixty-five percent. Consequently, the assignee must account for thirty-five percent of each production payment as a return of basis ($1,400) and the other sixty-five percent as taxable royalty income ($2,600).

If the purchase of the future production payments is an open transaction, the purchaser/assignee is permitted to use the cost recovery method to account for the taxable amount of each future production payment. Consequently, any future payment will be applied first as a return of the purchaser/assignee’s basis. Any payment over and above his basis is royalty income to the purchaser/assignee in the tax year in which it is received. The royalty income is reported on Schedule E of the PA-40.
2. Donative transfers of production payments

Like the sale of production payments, a donative transfer (regardless to whom it is made—family, charity, etc.) of income from production payments under an oil or gas lease is an anticipatory assignment of future income. See Flewellen v. Commissioner, 32 T.C. 317 (T.C. 1959). When a production payment is paid, the assignor is deemed to receive the payment and, in turn, transfer the payment to the assignee. Therefore, the production payment remains taxable to the assignor as royalty income. However, the assignor does not report all of the payments assigned at the time of the assignment. Rather, the assignor reports the payments in the year in which each payment is paid.

The conveyance of the payment from the assignor to the assignee is considered a gift to the assignee. There is no tax imposed upon the gift.

Example: A lessor under an oil or gas lease conveys the right to the income from the lease royalties/production payments to his children for the remainder of his life or the remainder of the anticipated production period. The lessor is subject to Pennsylvania Personal Income Tax on each royalty/production payment when paid. He is then considered to make a gift of the payment to his children. When the lessor dies, the royalty/production payments pass to his estate and the gift to the lessor’s children ends. The lessor’s estate reports income from the royalty/production payments until his estate is settled and the lessor’s interest under the oil or gas lease is transferred to his heirs. If his children are the heirs to his estate, they will begin reporting the royalty/production payments as income after the estate transfers the lessor’s rights to the oil or gas lease to them.

Endnotes:


2 The lease can create other rights in the lessor for additional payments such as cash signing bonuses (either paid in an up-front lump sum or in deferred installment payments) and delayed rental payments.

3 See Kilmer v. Elexco Land Servs., 990 A.2d 1147 (Pa. 2010). In its decision the Supreme Court conceded that it is “unusual and impractical for natural gas royalties to be taken in-kind,” but pointed out that “oil royalties can certainly be so taken.” Kilmer, 990 A.2d at 1158.

The term "overriding royalty" historically has been used to describe numerous different types of interests. In its most generic sense, an overriding royalty is any royalty in excess of the usual and customary royalty reserved by a lessor under an oil or gas lease. In its more modern usage, an overriding royalty is used to describe a royalty carved out of the working interest under an oil and gas lease. Such royalty can be created either by grant or reservation. Thus, an overriding royalty can be created by grant as consideration for services (for example, as consideration to a land man that acquires leases, geologist for evaluating a property, management as an incentive program, a residual ownership to a party that assigns a working interest on a farm out or sale, or an attorney or broker organizing an oil and gas entity for syndication), or it could be created by reservation in cases where the lessee assigns his working interest to another party and retains an interest in the production from the lease. Regardless of the manner in which it is created, an overriding royalty is an interest in real estate. Thus, it is subject to the statute of frauds and can only be conveyed in writing. Patrick H. Martin and Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Fourth Edition*, §§ 418 and 418.1, and 38 Am. Jur. 2d Gas and Oil § 201. See also, *Szymanowski v. Brace*, 987 A.2d 717, 724 (Pa. Super. Ct. 2009).

Determining the nature of a conveyance or grant related to oil and gas instruments can be particularly problematic. As stated by the Pennsylvania Superior Court,

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\text{\ldots we remind ourselves the judicial construction of instruments involving oil and gas is particularly troublesome. Pennsylvania case law evidences a long and tortured trail of attempts to make sense of phrases, parts of phrases, and words of art sometimes used in a common sense manner and sometimes used with a precise technical meaning, and all used in documents sometimes drafted with care and sometimes quickly scribbled by the litigants themselves. Many oil and gas titles trace to agreements from the late 19th or early 20th century and may use antiquated terms foreign to us today. A century ago, a farmer’s understanding of how the surface of his land would be used to extract the oil and gas lying beneath it would be considerably different from the understanding of the surface owner today who is acutely aware of the increased burdens on the surface imposed by modern extraction technology.}
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The legal effect of words clearly understood when used in other contexts, therefore, becomes murky when considered in the context of oil and gas instruments. The fact, for example, that an instrument is titled a "lease," "deed," or "agreement" is not determinative. Even the use of the words "grant and convey" does not necessarily create a fee simple estate in the grantee. Applying the literal meaning to words and phrases found in oil and gas documents is fraught with the opportunity for injustice.

As a result, we must be mindful that the object in interpreting instruments relating to oil and gas interests, like any written instrument, "is to ascertain and effectuate the intention of the parties."

Consequently, it is extremely important to review the instruments to determine the nature of the rights affected by the instrument.

9 Computed Value is the actual monetary worth of the real estate determined by adjusting the assessed value of the real estate for local real estate tax purposes for the common level ratio of assessed values to market values of the taxing district as established by the State Tax Equalization Board. 72 P.S. § 8101-C (definition #2 of “value”).

10 "An easement is a liberty, privilege or advantage which one may have in the lands of another without profit . . . . It may be merely negative . . . and may be created by a covenant or agreement not to use land in a certain way. . . . But it cannot be an estate or interest in the land itself, or a right to any part of it." 'An easement is a right in the owner of one parcel of land by reason of such ownership to use the land of another for a special purpose not inconsistent with a general property in the owner." Clements v. Sannuti, 51 A.2d 697, 698 (Pa. 1947). Although not an estate in land, an easement is an “interest in land” that "must be created and transferred by deed, by prescription which presupposes a grant, by an agreement for a conveyance which may be enforced in equity, or by a sale of property with reference to an existing convenience which entitled the grantee to its continued enjoyment. In order to establish an easement the dominant and servient estates must be owned by different persons. . . . The easement may be created by conveyance of the right when transferring property in favor of which it is to exist, or it may be reserved in favor of the grantor." Riefler & Sons v. Wayne Storage Water Power Co., 81 A. 300, 302-303 (Pa. 1911).

11 The Realty Transfer Tax statute contemplates the taxation of easements as evidenced by the definition of value, which provides that the taxable value of real estate shall be its actual monetary worth "in the case of easements or other interests in real estate the value of which is not determinable . . . ." 72 P.S. § 8101-C (definition #3 of “value”) (emphasis added).

12 The PUC has the “administrative power and authority to supervise and regulate all public utilities doing business” within Pennsylvania. 66 Pa.C.S. § 501. A “public utility” includes a person or corporation that owns or operates equipment or facilities in Pennsylvania for producing, generating, transmitting, distributing or furnishing natural or artificial gas to or for the public for compensation. It does not include a producer of natural gas not engaged in distributing such natural or artificial gas directly to the public for compensation. 66 Pa.C.S. § 102


14 The United States Supreme Court "has stated that ‘production’ and ‘gathering’ ‘are terms narrowly confined to the physical acts of drawing the gas from the earth and preparing it for the first stages of distribution.’ For purposes of the NGA [(the Natural Gas Act of 1938)], gathering is the activity that occurs between the production of the gas and delivery to a

"An encumbrance has been defined as ‘every right or interest in the land which may subsist in third persons to the diminution of the value of the land, but consistent with the passing of the fee by the conveyance.’ It may be such as affects the title, or only the physical condition of the property. Illustrations of the first class are found in mortgages or other liens of record, claims for taxes, assessable benefits, outstanding articles of agreement to sell, or the inchoate rights of dower. As affecting the free enjoyment of the land, easements, such as the existence of a railroad right-of-way, though merely an adopted location, or for private use, unless apparent and notorious, are encumbrances. The same is true as to restrictions on the use of the property, so long as the value of the land may be diminished, though the contrary is held where the existing claim works no injury." Ritter v. Hill, 282 Pa. 115, 118 (Pa. 1925)

In the case real estate lease, a lease encumbers the real estate being leased. In the case of an oil or gas lease, the lease is an encumbrance over the mineral rights estate. As an encumbrance, the lease itself cannot be severed from the real estate interest. In fact, as explained by the Duquesne and Jacobs Courts (as cited above), an oil and gas lease is more than just a lease. It is a defeasible deed. It doesn’t just encumber the mineral rights.

It effectuates a conveyance and a reservation. There is a conveyance of the mineral rights to the lessee and a partial reservation of the mineral rights to the lessor in the nature of the royalty interest. Consequently, when the lessor attempts to convey his interest in the lease, it is important to determine what interest is being conveyed.

See 61 Pa. Code § 125.51 for rules related to cost depletion. For rules related to intangible drilling costs see CHAPTER 23 (NATURAL RESOURCES) of the department’s on-line PENNSYLVANIA PERSONAL INCOME TAX GUIDE.


Treasury Regulation § 1.636-3 defines a “production payment” generally as “a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production.” 26 CFR § 1.636-3(a).
Historically, for Federal Income Tax purposes, such sales were treated as an anticipatory assignment of income rather than the sale of a capital asset. See Commissioner of Internal Revenue et al. v. P. G. Lake, Inc., et al., 356 U.S. 260 (1958). As the Supreme Court explained:

The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

Lake, 356 U.S. at 266. Consequently, the assignor is considered to receive taxable ordinary income when the purchase price for the production payment is paid to him by the assignee.

The rule in the Lake case was superseded by amendments to the Internal Revenue Code in 1969. Now, IRC § 636 and applicable Treasury Regulations provide the rules for the assignment of mineral production payments. Under those rules, the purchase price for the assignment of a production payment is considered a loan from the assignee to the assignor. The production payments when made are considered income to the assignor. Such payments are then paid over to the assignee, as a principal and interest payment, in repayment of the loan. Pennsylvania Personal Income Tax law does not contain a similar provision to IRC § 636. Instead, Pennsylvania applies rules similar to those established by the Supreme Court in Lake.