DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR HOUSTON DISTRICT COUNSEL

FROM: Associate Chief Counsel (Passthroughs & Special Industries)
CC:PSI

SUBJECT:

This Field Service Advice responds to your memorandum dated June 28, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Taxpayers =
Partnership A =
Partnership B =
S Corporation =
Management Company =

Trust =
Date =

ISSUES[1]

1. Are the losses reported by the taxpayers in connection with their oil and gas working interests activities conducted through Partnership A passive or nonpassive activity losses for purposes of I.R.C. § 469?

2. Are the losses reported by the taxpayers in connection with their oil and gas working interests activities conducted through the S Corporation passive or nonpassive activity losses for purposes of section 469?

CONCLUSIONS

1. The losses reported by the taxpayers in connection with their oil and gas working interests activities conducted through Partnership A are nonpassive activity losses because, where the taxpayers each own a one percent general partnership interest in Partnership A and the taxpayers have liability with respect to the working interests, the oil and gas working interest activities are *per se* nonpassive activities under section 469(c)(3)(A) and, therefore, any losses reported by the taxpayers in connection with those activities would be nonpassive activity losses.

2. The S Corporation limits the liability of its shareholders and, therefore, the working interest exception is not applicable to the oil and gas interests activities of the S Corporation. The taxpayers have not proven that they materially participated in the oil and gas activities of the S Corporation. Therefore, the losses reported by the taxpayers in connection with these activities would be passive activity losses.

FACTS

On Schedule E of their 1994 joint income tax return, the taxpayers reported passive and nonpassive activity income and losses from three partnerships and an S Corporation. The total amount of passive activity income reported was $ and the total amount of nonpassive activity losses reported was $. For purposes of this memorandum, the significant losses were from Partnership A, $

[1] We have rewritten the issue statement to address the adjustments in the statutory notice of deficiency. The analysis provides the answers to the questions posed in your request for advice.

, and S Corporation, $.[2] The examining agent recharacterized these losses as passive and offset $ of the losses against the taxpayers' passive activity income. The taxpayers' income was adjusted to account for the fact that the remainder of the losses would not offset any nonpassive activity income.

Partnership A is a Texas limited partnership which filed its Agreement of Limited Partnership ("Partnership A Agreement") with the Texas Secretary of State on December 28, 1992. During 1994, taxpayers each owned a one percent general partnership interest and a seven percent limited partnership interest in Partnership A. The remaining 84 percent interest was held by the Trust, a limited partner. The Partnership A Agreement in Section 5.5 indemnified the general partners but did not limit the liability of the general partners. The S Corporation elected S corporation status on December 16, 1986. In 1989, the husband transferred oil and gas working interests to the S Corporation in exchange for stock in the S Corporation. In 1994, the husband was the sole shareholder of the S Corporation. The husband was a general partner of Partnership B during 1994. The taxpayers liquidated their interests in Partnership B in1994.

According to the taxpayers, during 1983 through 1985, and in 1992 and 1994, the taxpayers, through Partnership A and the S Corporation, entered into Exploration Agreements with the Management Company whereby the Management Company, as the Program Manager, set up programs, whereby the Program Manager agreed to acquire property interests and to develop those property interests, and the taxpayers, as the Participants, agreed to incur the costs of carrying out these programs. Under these programs, the Management Company, as the Program Manager, and participants would engage in the joint acquisition of prospects and the drilling of exploratory wells on prospects situated within a program area. Property interests included, for example, interests in petroleum leases, royalty interests, and any rights relating to the acquisition, development, exploration, and production of petroleum substances, within specific geographical areas. "Prospects" are specific geographical areas which would contain one or more property interests.

The Management Company and the taxpayers also entered into Operating Agreements whereby the Management Company, the Operator of the working interests, and the taxpayers, the Non-Operators, agreed to share the costs of operating the mineral interests located in the prospects and share in the oil and gas produced in the prospects.

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[2] You have limited your request for advice to the losses incurred by Partnership A and the S Corporation.

Pursuant to the Exploration Agreements, following designation of a prospect for a program, the Program Manager, would establish an Area of Mutual Interest (AMI) in connection with that particular program. If the participant consents to the acquisition of the property interest located in an AMI, that property interest is deemed to be a portion of the prospect and its development and operation is governed by the terms of the Exploration and Operation Agreements. According to the taxpayers, the working interests held by the S Corporation are mutually owned by Partnership A and the S Corporation because the property interests are located within AMI(s) in which both the partnership and the corporation are participants.

The taxpayers contend that all of the activities with respect to Partnership A and the S Corporation were conducted by the husband and his office manager, not the wife. These activities were described by the taxpayers in the Date letter:

> [The husband] received daily exploration, work over, completion and re-completion reports related to approximately 42 wells via fax from [the Management Company]. [The husband] spent approximately one hour each day (usually during his lunch hour) reviewing the reports, determining the price per barrel of oil and gas condensate on the open market, and if necessary, discussing issues arising from the reports with [the Management Company] operation personnel. [The husband] also received and reviewed the production logs (summaries of the amount of number of barrels and quality of oil and gas being produced from a well) two or three times a week.
>
> Several times each week, [the husband] would also receive and review authorizations for expenditures (AFE's) ... . The time spent reviewing and approving the AFE's varied based upon the nature of the expenditure. [The husband] would review the well files and determine whether the expenditure was reasonable and necessary to the operation of the well prior to approving the AFE. If the AFE related to a new exploration or drilling opportunity (there were approximately 13 in 1994), [the husband] would make a determination as to whether to participate, usually based upon his review of the seismic data, available drilling and production logs for the field, and conversations with geologists, drilling engineers and operations executives of [the Management Company]. If [the husband] approved of the new venture, he would sign the AFE, usually on behalf of both [the S Corporation] and [the Partnership].
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> On or about the tenth day of the month, [the husband] would receive revenue checks for the wells for his review. [The husband], with the assistance of [his office manager], would spend approximately two or four hours reconciling the revenue checks with the price per barrel of oil and gas condensate on the open market for each day in

> the month. On or about the twentieth of each month, [the husband] and the office manager would receive and review the bills for the month for approximately two to four hour. [The husband] would determine which bills should be approved for payment. On the fifteenth and the last day of each month, [the husband] would spend approximately one hour cutting and signing the checks for the approved bills.

The taxpayers claim that the husband spent a total of 308 hours in 1994 carrying out various activities with respect to the working interests. Specifically, the husband alleges he spent: 240 hours for daily review of reports, 56 hours for review of AFE's bills and new exploration and drilling prospects, and 12 hours for review. In addition to holding interests in the partnerships and the S Corporation, the husband was a prominent surgeon, a director and professor at a medical school, and a partner in a medical partnership.

LAW

Section 469(a) disallows a deduction for passive activity losses of individuals, estates, trusts, closely held C corporations, and personal service corporations for the taxable year. The passive activity loss is the amount by which the taxpayer's aggregate passive activity deductions exceed the taxpayer's aggregate passive activity income for the taxable year. I.R.C. §§ 469(a), (d). The term "passive activity" means any activity which involves the conduct of any trade or business and in which the taxpayer does not materially participate. I.R.C. § 469(c)(1). The term "trade or business" is defined as an activity (i) involving the conduct of a trade or business (within the meaning of section 162); (ii) conducted in anticipation of the commencement of a trade or business; or (iii) involving research or experimental expenditures that are (or would be) deductible under section 174. Treas. Reg. § 1.469-4(b)(1). We have been asked to assume that the activities at issue qualify as a trade or business.

A passive activity does not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest. I.R.C. § 469(c)(3)(A); Temp. Treas. Reg. § 1.469-1T(e)(4)(i). This rule applies without regard to the degree of participation of the taxpayer. I.R.C. § 469(c)(4). For purposes of section 469 and the regulations thereunder, the term "working interest" means a working or operating mineral interest in any tract or parcel of land (within the meaning of Treas. Reg. § 1.612-4(a)). Treas. Reg. § 1.469-1(e)(4)(iv). An entity limits the liability of the taxpayer with respect to the interest, i.e., drilling or operation of a well pursuant to a working interest, held through such entity if the taxpayer's interest in the entity is, in part, in the form of a limited partnership interest in a partnership in which the taxpayer is not a general partner or stock in a corporation. Temp. Treas.

Reg. § 1.469-1T(e)(4)(v)(A). The following examples illustrate the application of this rule.

> *Example (1)*. A owns a 20 percent interest as a general partner in the capital and profits of P, a partnership which owns oil or gas working interests. The other partners of P agree to indemnify A against liability in excess of A's capital contribution for any of P's costs and expenses with respect to P's working interests. As a general partner, however, A is jointly and severally liable for all of P's liabilities and, under paragraph (e)(4)(v)(B)(1) of this section, the indemnification agreement is not taken into account in determining whether A holds the working interests through an entity that limits A's liability. Accordingly, the partnership does not limit A's liability with respect to the drilling or operation of wells pursuant to the working interests.
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> *Example (3)*. C is both a general partner and a limited partner in a partnership that owns a working interest in oil or gas property. Because C owns an interest as a general partner in each well drilled pursuant to the working interest, C's entire interest in each well drilled pursuant to the working interest is treated under paragraph(e)(4)(i) of this section as an interest in an activity that is not a passive activity (without regard to whether C materially participates in such activity).

Temp. Treas. Reg. § 1.469-1T(e)(4)(iii).

If the working interest exception in section 469(c)(3)(A) does not apply, an activity is a passive activity if the taxpayer does not materially participate in the activity. I.R.C. § 469(c)(1). A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. I.R.C. § 469(h)(1). The regulations provide seven tests for purposes of establishing material participation. Temp. Treas. Reg. § 1.469-5T(a). Generally, limited partners are not permitted to use all of the seven tests, but this limitation does not apply if a partner also holds a general partnership interest. Temp. Treas. Reg. § 1.469-5T(e).

Each test under Temp. Treas. Reg. § 1.469-5T(a) requires some degree of participation. Participation is defined as any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done. Treas. Reg. § 1.469-5(f)(1). Work done by an individual in the individual’s capacity as an investor in an activity will not be treated as participation in the activity for purposes of determining material participation unless the individual is directly involved in the day-today management or operations of the activity. Temp. Treas. Reg. § 1.469-5T(f)(2)(ii).

ANALYSIS

Issue 1.

The parties have treated the oil and gas interests held through Partnership A and the S Corporation as "working interests" for purposes of section 469. The working interest activities conducted through Partnership A constitute *per se* nonpassive activities pursuant to section 469(c)(3)(A). In 1994, the taxpayers each owned a one percent general partnership interest and a seven percent limited partnership interest in Partnership A. As general partners and under Texas law, they were generally liable with respect to oil and gas working interests. The partnership agreement did not limit the general partner's liability. Under Texas partnership law the taxpayers were each jointly and severally liable for 100 percent of Partnership A's working interests. Tex. Rev. Civ. Stat. Ann. art. 6132a-1, @ 4.03(b) provides that, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and the other partners and, except as provided in the partnership agreement, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners. Tex. Rev. Civ. Stat. Ann. art. 6132b-3.04 provides that all partners are liable jointly and severally for all debts and obligations of the partnership unless otherwise agreed by the claimant or provided by law.

In enacting section 469(c)(3)(A), Congress recognized that the typical oil and gas industry deal involved the sharing of the aspects of working interests between several parties including operators and investors. The activities of these parties without the exemption would probably lead to passive activity treatment for the nonoperators involved in these arrangements. The exemption is designed to treat a nonoperator's interest in a working interest as *per se* nonpassive provided that the nonoperator did not have limited liability respecting the interest and the interest was burdened with the cost of development and operation of this property. With respect to this exemption, the Senate Report indicated that:

> In certain situations, however, the committee believes that financial risk or other factors, rather than material participation, should be the relevant standard. A situation in which financial risk is relevant relates to the oil and gas industry . . . The committee believes that relief for this industry requires that tax benefits be provided to attract outside investors. Moreover, the committee believes that such relief should be provided only with respect to investors who are willing to accept an unlimited and unprotected financial risk proportionate to their ownership interests in the oil and gas activities.

See S. Rep. No. 99-313, at 717-18 1986.

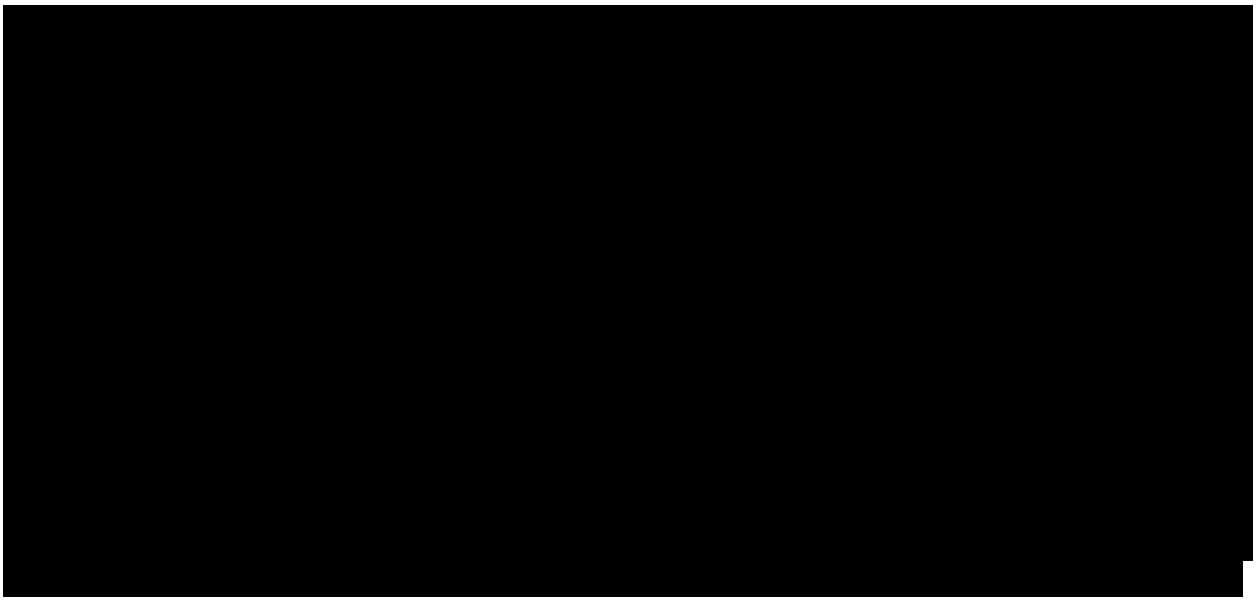
In this case, while the taxpayers were both general and limited partners in Partnership A, the fact that they each held a one percent general partnership interest in Partnership A and, as a result, are jointly and severally liable for Partnership A's activities under the partnership agreement and under Texas law, is sufficient to satisfy the rule in section 469(c)(3)(A). Accordingly, the oil and gas working interests activities conducted through Partnership A constitute *per se* nonpassive activities and the losses reported by the taxpayers in connection with these activities are nonpassive activity losses. See I.R.C. § 469(c)(3)(A) and examples 1 and 3 of Temp. Treas. Reg. § 1.469-1T(e)(4)(C).

Issue 2.

An S corporation is an entity which limits liability for purposes of the working interest exception of section 469(c)(3). Therefore, the working interest exception does not apply to the oil and gas activities of the S Corporation. Temp. Treas. Reg. § 1.469-1T(e)(4)(v)(A)(2). Accordingly, any losses incurred in connection with these activities are passive activity losses if the taxpayers do not materially participate in the underlying activities.

Further, the losses incurred in connection with the oil and gas activities held solely by the S Corporation would be passive activity losses because the taxpayers have failed to prove that they materially participated in those activities. The taxpayers have attempted to establish their participation through the actions claimed for taxpayer-husband in the Date letter. For purposes of meeting the tests for material participation, the work done by the husband in his capacity as an investor in the activity is not treated as participation, unless the individual is directly involved in the day-to-day management or operations of the activity. Temp. Treas. Reg. § 1.469-5T(f)(2)(ii)(A). In this case, husband's participation in these activities involved studying and reviewing reports, making financial decisions and determining the extent of his participation in the working interests; activities identified as investor-type activities in Temp. Treas. Reg. § 1.469-5T(f)(2)(ii)(B). See also, Temp. Treas. Reg. § 1.469-5T(k), *Example (8)*. The husband was not actively involved in the day-to-day operations of these working interests. The Management Company was responsible for the day-to-day management and operation of these interests. Accordingly, the taxpayers failed to establish participation within the meaning of Treas. Reg. § 1.469-5(f)(1) in the oil and gas activity and so are precluded from meeting any of the tests for material participation requirements under Temp. Treas. Reg. § 1.469-5T(a). The failure to establish any participation will also preclude the finding of minimum participation necessary to treat the oil and gas activity as a significant participation activity under Temp. Treas. Reg. § 1.469-5T(c)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



Please call if you have any further questions.

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