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Multistate Tax Alert
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Texas Ruling - Oil & Gas Joint Venture Subject to Franchise Tax

Overview

On December 11, 2017, the Texas Tax Policy Division ("Tax Policy") published Private Letter Ruling No. 201010157 ("PLR") addressing whether a joint development agreement between two entities creates a taxable entity for Texas franchise tax purposes.[1] The PLR further addressed whether certain contributions to the joint venture qualified as cost of goods sold ("COGS").

In this tax alert, we summarize the guidance provided by Tax Policy as well as offer some taxpayer considerations.

Background

Company A and Company B entered into a Joint Development Agreement ("JDA") for the development of oil and gas interests.[2] The JDA included a Model Form Operating Agreement ("JOA"), whereby Company A functioned as the operator and Company B as the non-operator. Under the JOA, Company A was responsible for paying all expenses, and Company B was charged for its respective share.[3] For federal tax purposes, the contributions (for purposes of expense outlays by the joint venture) were treated as capital contributions. The JOA also provided that Company A and Company B would agree to take their respective shares of the oil and gas produced in-kind to be separately marketed.[4]

For federal tax purposes, the JDA created a tax partnership by default under Internal Revenue Code ("IRC") § 761(a), which the parties referred to as the "Company A-B Tax Partnership."[5] The parties did not elect out of the default federal tax partnership treatment (provided for under IRC § 761(a)).[6] Because the companies took production from the wells in-kind, the Company A-B Tax Partnership reported no revenue on its federal tax return.[7]

Tax Policy guidance

Joint Venture constitutes a taxable entity. In the PLR, Tax Policy first addressed whether the tax partnership entered into by Company A and Company B created a taxable entity for Texas franchise tax purposes. Under Texas Tax Code ("TTC") § 171.001(a), the franchise tax applies to each taxable entity doing business in Texas or organized in Texas.[8] TTC § 171.0002(a) identifies all entities that are considered "taxable entities" and specifically includes a "joint venture," though the TTC does not define the term "joint venture." Rule 3.581(b)(10) of the Texas Administrative Code defines "joint venture" as a "partnership engaged in the joint prosecution of a particular transaction for mutual profit." Texas statutory law does, however, address what is *not* considered a joint venture for Texas franchise tax purposes.[9] Specifically, TTC § 171.0002(a) provides that "a joint venture does not include joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Section 761(a), Internal Revenue Code."

As outlined in the PLR, Tax Policy explained the JOA between Company A and Company B demonstrated the parties were engaged in the "joint prosecution of a particular transaction for mutual profit" (*i.e.*, oil exploration and production).[10] As a result, the Company A-B Tax Partnership was considered a joint venture under Rule 3.581(b)(10) and subject to the Texas

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[1] Texas Comptroller of Public Accounts, Accession No. 201712002L, Private Letter Ruling No. 201010157 (Dec. 11, 2017), available here.
[2] *Id*. at *2.
[3] *Id*.
[4] *Id*.
[5] *Id*.
[6] *Id*.
[7] *Id*.
[8] *Id*. at *3.
[9] *Id*.
[10] *Id*.

franchise tax.[11] Further, because the Company A-B Tax Partnership did not elect out of the default federal partnership treatment, it failed to fall under the exclusion provided for by TTC § 171.0002(a).[12]

Eligible COGS related to production activities. Subsequent to determining the Company A-B Tax Partnership was subject to the Texas franchise tax, Tax Policy addressed whether Company A and Company B were each entitled to deduct COGS associated with the production taken in-kind. Under TTC § 171.1012(c), a taxable entity's COGS includes all direct costs of acquiring or producing the goods. For partnerships, each partner may include partnership contributions in its COGS if the following conditions are met:

(1) the partnership uses each partner's contribution to fund activities that would qualify as COGS for the partnership;
(2) the goods produced are distributed to the partners as goods-in-kind in the ordinary course of production; and
(3) the activities funded by the contribution relate to the goods distributed to the partner.[13]

Because the Company A-B Tax Partnership produced oil and natural gas, which was distributed to Company A and Company B in the normal course of business, both companies were permitted to deduct contributions to the joint venture that would otherwise qualify as COGS.[14]

Considerations

Entities that have entered into joint ventures and have not elected out of federal partnership tax treatment are advised to consult with their tax advisors to determine whether such entities may have a Texas franchise tax filing requirement. In addition, taxpayers should analyze contributions to a partnership or joint venture where the goods produced are distributed to the partners to determine whether such contributions may qualify as COGS.

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[11] *Id*.
[12] *Id*.
[13] *See id*. (citing Tex. Tax Code § 171.1012(c)(13)).
[14] *Id*.

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