

Publicly traded partnership entity option: a case study of LGS Company

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ABSTRACT

Production of gas from the Marcellus Formation has significantly influenced Pennsylvania's environment, and its laws, politics, economics. The natural gas industry has led to many business prospects as well as opportunities for research by tax professionals. This case study portrays a problem facing the hypothetical startup business LGS Company which is planning to open operations in the Marcellus Shale industry. The company plans to collect, treat, and dispense flowback fluid produced from certain hydraulic fracturing activities used in extracting natural gas from wells. LGS Company's preference would be to be organized as a Publicly Traded Partnership. The main tax research question is whether LGS Company qualifies as a Publicly Traded Partnership according to tax laws. The authors provide an analysis of the tax law to LGS Company's issue, show the corresponding methods of research utilizing CCH, and offer a final determination.

Key words: Accounting, Taxes, Business Law, Entity Choice, Publicly traded partnerships

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CASE OBJECTIVES

This case study is intended for students in a business tax class (i.e. a class not focused solely on individual taxation). The case study provides students an opportunity to develop research and writing skills using a commonly-used research software tool (CCH). It will require students to access and comprehend various types of tax authority. An ideal time to introduce the case study in class is when the students are learning about research and tax authority. In preparation for the case study, instructors may want to explain the various types of authority and their hierarchy. It would also be beneficial to demonstrate research techniques on the software tool.

Learning objectives:

Upon completion of this case study, students should be able to:

- Perform tax research using relevant software;
- Understand the various components of a research memo;
- Write a clear and concise research memo; and
- Understand the technical aspects of a specific tax topic (publicly traded partnerships) and apply them to a specific set of facts.

INTRODUCTION

Production of natural gas from the Marcellus Formation has significantly influenced Pennsylvania's environment, and its laws, politics, and economics. Pennsylvania's Department of Conservation and Natural Resources estimates that some 450 Marcellus shale wells have been completed in 14 counties. Researchers from Pennsylvania State University estimate that the economic impact in 2010 of "\$11.2 billion in value added or the regional equivalent of gross domestic product, contributed \$1.1 billion in state and local tax revenues, and supported nearly 140,000 jobs."

The Marcellus shale well varies from other conventional reservoirs in that horizontal wells will be employed. This method allows greater access to more footage of reservoir than a traditional, vertical hole. Additionally, hydraulic fracturing ("frac" or "fracking") methods are being used. The "slick-water frac" approach allows for the gas to be recovered more efficiently and in greater quantities. However, this method requires as much as 20 times the water volume compared to that used in conventional well reservoirs. (see Pennsylvania Geology article, weblink below, for a more detailed discussion of these methods). Additional Resource(s): Pennsylvania Geology, Vol. 38, No. 1

The natural gas industry has led to many business opportunities across the spectrum of the business arena. One of the opportunities comes from the increased use of water volume in horizontal drilling which produces flowback as a byproduct. After using water in the gas wells, the fluid or "flowback" (water, brine, drilling mud, etc.) must be recovered, removed, treated, recycled, and/or disposed.

ENTITY ORGANIZATION CHOICES

This case study will focus on the LGS Company, a new company which will specialize in the management and treatment of flowback fluid produced from wells extracting natural gas from Marcellus shale. LGS Company may be organized in a number of different ways; for example, as a partnership, as a Corporation under Section C of the Internal Revenue Code, as a Corporation under Section S of the Internal Revenue Code, or as a LLC. However, the founders of the company are interested in another option that they have heard of and that would be to organize as a Publicly Traded Partnership. Operating as a Publicly Traded Partnership will allow LGS Company to realize some of the benefits of a Corporation like access to funding and ease of transferability of ownership which are important issues to the founders. A business that is organized as a public company provides the entity with access to the public capital markets. The ability to raise a large amount of capital may be needed by companies to finance their operations, especially in asset intensive industries such as natural resources. Ownership of public companies is easily transferred through the buying and selling of shares or units of the company using established securities markets.

In addition, operating as a Publicly Traded Partnership will allow LGS Company to receive the tax benefits afforded to pass-through entities like partnerships and benefit of a single level of taxation and management flexibility of a partnership. An organization classified as a Publicly Traded Partnership would receive the benefits of the partnership classification in addition to many of the benefits available to corporations. Income tax is one such advantage that a Publicly Traded Partnership enjoys over that of a corporation.

Income of a corporation is basically taxed twice, once at the corporate level when it is earned and again at the shareholder level when it is distributed. For U.S. federal income tax purposes, a partnership is a “passthrough” entity. Income is not taxed at the entity level but instead flows through to each partner and is taxed at the individual partner level. Because the company is not subject to income tax at the entity level, it may have more cash available for operations, acquisitions, and distributions to investors. An additional advantage for investors is that a large portion of the distributions received qualify as a tax-free return of capital rather than ordinary income. Tax upon much of the income is deferred until the investor sells the partnership units.

QUESTION OF ELIGIBILITY

The founders of LGS Company are very interested in organizing the company as a Publicly Traded Partnership. If the company would be eligible for Publicly Traded Partnership designation, LGS Company would receive the tax benefits afforded to pass-through entities of partnership taxations, access funding streams to capital, and enjoy ease of transferability of ownership. The research tax question as posed for the case study follows:

Is LGS Company eligible to become a Publicly Traded Partnership?

Students should understand Primary tax authorities: Code, Regulations, & Cases and also secondary authorities: tax services, treatises, IRS publications, private letter

rulings. Students should utilize CCH to navigate the answer to the question of eligibility of LGS Company. Students should answer the question in the form of a tax research memo with the following outline per Weirich, Pearson & Churyk:

Heading
Issue:
Facts:
Conclusion:
Reasoning:

TEACHING NOTES, SOLUTION, AND ANSWER GUIDANCE

The appendices contain the suggested solution and answer guidance for this case study.

CONCLUSION

The case study advanced a hypothetical tax research question facing LGS Company. This case study discussed the significance of the “type” of income from certain hydraulic fracturing activities used in extracting gas from Marcellus shale, focusing on Publicly Traded Partnership. The key aspect of the case study was whether fluid flowback income from fracking activities meets the requirements for qualifying income. Publicly Traded Partnerships are defined for purposes of taxation under I.R.C. § 7704. However, the code did not clarify if fluid flowback was qualifying income. The question of what constitutes qualifying income arises from reading the code section. Students had to look to a lower level in the hierarchy to an IRS Letter Ruling for a more definitive explanation. Since the drafting of this case study, other companies have requested similar letter rulings. Therefore, there could be multiple correct citations to letter rulings for this case study. The list of acceptable answers will continue to grow as more companies seek guidance from the IRS on this topic.

REFERENCES AND FURTHER READING

Pennsylvania Department of Conservation and Natural Resources,
http://www.dcnr.state.pa.us/topogeo/econresource/oilandgas/marcellus/marcellus_faq/marcellus_shale/index.htm, retrieved 9/19/2012

Timothy, J. C., Watson, R.W., and Bloomsack, S. (July 20, 2011.) *The Pennsylvania Marcellus Natural Gas Industry: Status, Economic Impacts and Future Potential,* Pennsylvania State University, p. V, retrieved 9/19/2012 from <http://marcelluscoalition.org/wp-content/uploads/2011/07/Final-2011-PA-Marcellus-Economic-Impacts.pdf>

Weirich, T.R., Pearson T.C., and Churyk, N.T. (2009.) *Accounting and Auditing Research: Tools and Strategies, 7th edition.* Hoboken, N.J.: Wiley.

APPENDIX**SOLUTION**

Tax File Memorandum

Date: September 30, 20XX

From: Accounting

Subject: Publicly Traded Partnership Eligibility

Facts: Startup business LGS Company is planning to open operations in the Marcellus Shale industry. The company plans to collect, treat, and dispense flowback fluid produced from certain hydraulic fracturing activities used in extracting natural gas from wells. The preferred method of organization by the ownership would be a Publicly Traded Partnership.

Issue: Whether LGS Company can qualify as a Publicly Traded Partnership under the strict guidelines for purposes of taxation under I.R.C. § 7704.

Conclusion: LGS Company, engaged the collection, treatment, and disposal of fluid flowback from Marcellus shale wells, would be able to organize as a Publicly Traded Partnership and would have the benefit of a single level of taxation.

Reasoning: Publicly Traded Partnerships are defined for purposes of taxation under I.R.C. § 7704(b). “For purposes of this section, the term “publicly traded partnership” means any partnership if the interests in such partnership are traded on an established securities market, or interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof.”

I.R.C. § 7704 *et. seq.* goes on to define a Publicly Traded Partnership as a Corporation for tax purposes unless 90 percent or more of the gross income of such partnership for such taxable year consists of qualifying income. Thus, a Publicly Traded Partnership where 90 percent or more of the gross income of such partnership for such taxable year consists of *qualifying income* may offer the benefits of a partnership in terms of management and in terms of a single level of taxation, while offering the benefits of regular Corporation in terms of transferability of ownership and the ability to raise capital. Under I.R.C. § 7704 *et. seq* qualifying income is generally such things as interest and dividends and capital gains – what practitioners term portfolio income.

Continuing, I.R.C. § 7704(d)(1)(E) defines qualifying income as income and gains resulting from various activities (e.g., exploration, development, mining, production, processing, refining, transportation or marketing) associated with minerals, natural resources, or certain fuels.

However, I.R.C. § 7704(d)(1)(E) still does not give us the detailed information to reach our decision. The answer to the problem comes from the IRS in Letter Ruling 201227002 (Mar. 01, 2012). It confirmed that “we conclude that ... gross income from the removal, treatment, recycling, and disposal of fracturing flowback, produced water, and other residual waste products generated by oil and gas wells during the fracturing process is qualifying income within the meaning of § 7704(d)(1)(E).

ANSWER GUIDANCE

The following provides step-by-step instructions on how to navigate CCH to find the answers:

A) The search bar approach

1. In the search bar, type ““publicly traded partnership” and “flowback”” or ““publicly traded partnership” and “fracturing”” → On the left sidebar, narrow your results by clicking IRS Materials → IRS Private Rulings → click view all on search results → sort by most recent → click IRS Letter Rulings and TAMs (1998-2012), UIL No. 7704.03-00 Certain publicly traded partnerships treated as corporations; Qualifying income. IRS Letter Ruling 201227002 (Mar. 01, 2012), Internal Revenue Service, (Mar. 1, 2012)
2. From within the resulting private letter ruling, click “Code Sec. 7704” to learn more about the specific rules on the subject. Within the code section, click on the “CCH Explanations” to gather additional information and explanations on the relevant materials.

B) The side bar approach

1. Topical index

Federal Tax → Federal Tax Primary Sources → Topical Indexes → Current Internal Revenue Code Topical Index → Topical Index → P → Partners and partnerships → publicly traded

2. Or if the I.R.C. section (I.R.C. § 7704) is known

Federal Tax → Federal Tax Primary Sources → Current Internal Revenue Code → Subtitle F—Procedure and Administration → Chapter 79—Definitions → SEC. 7704, CERTAIN PUBLICLY TRADED PARTNERSHIPS TREATED AS CORPORATIONS.

3. CCH Explanations

At the top of the results page from step 1 or 2 above, click CCH Explanations → Find the relevant explanation to what you are looking for → CCH Tax Research Consultant, PART: 3,254.05, Qualifying Passive-Type Income for Publicly Traded Partnership Exception