

April 17, 2009

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## Real Property Taxation of the Marcellus Shale and Other Mineral Interests in Pennsylvania

The development of the Marcellus Shale has resulted in proposals in Pennsylvania both to impose a severance tax on the extraction of natural gas and to expand the state's real property tax assessment laws to apply to ownership interests in oil and gas reserves. These proposals have also focused greater attention by tax assessors, local governments and property owners on the manner in which the value of mineral interests currently subject to taxation, including coal, limestone, iron ore and other "hard" minerals, is determined.

This *Alert* reviews Pennsylvania's current assessment laws pertaining to mineral interests and improvements made to land to extract and process minerals; summarizes pending legislative proposals to modify the state's assessment laws to tax real property interests in gas reserves; and discusses critical issues that should be considered by businesses engaged in the extraction of natural gas and other mineral resources in Pennsylvania, property owners and local governments relating to the assessment of natural gas reserves and other mineral rights.

The *Alert* also considers whether it is permissible for real property tax purposes to assess mineral interests severed from fee-simple title to property, but to exempt from taxation equivalent mineral interests retained by the surface owners of properties in order to minimize the extent to which taxes will be imposed upon Pennsylvania residents.

### Current Law

In Pennsylvania, taxes may be imposed only to the extent expressly authorized by law, and statutes imposing taxes are strictly construed against the government and in favor of taxpayers. Based upon these principles, in 2002 the State Supreme Court interpreted Pennsylvania's assessment laws as excluding oil and gas reserves. The Court concluded that because real estate subject to assessment was defined by state law to mean land, coal, houses, mobile homes, trailer parks, buildings, offices, parking lots, mills and "manufactories," and "all other real estate," the catch-all category of "all other real estate" included only real property interests with characteristics similar to the expressly designated subjects of taxation. The Court reasoned that because liquid and gaseous minerals are different from "land" based on the generally used and non-technical meaning of the term, and also do not share the same commonly recognized characteristics as coal, oil and gas interests are not subject to assessment and taxation.<sup>1</sup> Conversely, the Court concluded that limestone reserves are subject to taxation because limestone is hard rock commonly understood as land and with tangible characteristics similar to coal.<sup>2</sup>

<sup>1</sup> *Independent Oil & Gas Ass'n v. Fayette Co.*, 572 Pa. 240, 814 A.2d 180 (2002).

<sup>2</sup> *Coolspring Stone Supply, Inc. v. Fayette Co.*, 593 Pa. 338, 919 A.2d 1150 (2007).

The significance of the exclusion of oil and gas interests from assessment is enhanced in Pennsylvania by an exclusion from assessment provided for machinery and equipment used in manufacturing, mining or “industrial establishments.” As a result, many types of land improvements associated with natural gas exploration and extraction may also be excluded from assessment either as machinery and equipment, or as falling outside of the categories of land improvements subject to taxation. For example, drilling rigs, gas wells, and machinery and equipment used for gas extraction and processing are excluded from assessment for real property tax purposes. Other improvements made to land to facilitate mineral extraction, such as settlement basins, wastewater treatment plants, and other specialized types of structures and fixtures, may also be excluded from assessment depending upon site-specific facts and circumstances.

### Proposed Legislation

House Bill 10 of 2009, sponsored by Representative Bill DeWeese and 27 other members of the General Assembly, provides that rights held pursuant to a lease or other agreement to extract, remove or recover gas, oil or coal bed methane shall be subject to taxation as real estate and assessed and taxed separately from the surface property in the name of the holder of such rights. The legislation further provides that these mineral interests will be assessed utilizing the discounted income approach to value as supplemented by the sales comparison data.

To facilitate the assessment of mineral interests, House Bill 10 requires a lessee or operator to provide annually to the county assessor “such nonproprietary lease and lease income information as the assessor determines is reasonably needed to determine value.” Using this information, the legislation would allow counties to change the assessed value of gas, oil, and coal bed methane mineral rights whenever “information becomes available that would significantly affect the valuation” of the property, including the “commencement of production on or near the property,” or the “depletion of the hydrocarbon gas subject to the lease and related production.”

The Pennsylvania County Commissioners Association has expressed support for House Bill 10

and similar legislative proposals that will “reinstate the ability to assess oil and gas interests as real property” and to assign “standardized valuations” to natural gas storage facilities in order to assess the value of the property for real estate tax purposes. Associations representing school districts, which would likely receive the majority of any revenues generated by the legislation, as well as associations representing Pennsylvania municipalities, have also endorsed House Bill 10.

### Critical Issues Arising in the Taxation of Mineral Interests

#### Discounting to Present Value

House Bill 10 provides that when the income approach to value is used, future income streams must be discounted to present value to provide an estimate of the value of the property. Discount rates are amounts which reflect the reasonable net returns expected by a person investing in a particular class of real property. The higher the discount rate is established, the lower the assessed value of property will become based upon the income approach.

Unfortunately, House Bill 10 fails to provide any useful guidance regarding how discount rates should be established. Given the unique nature of oil and gas interests in property, the lack of guidance on this important topic is likely to generate substantial controversy ensuring extensive litigation and greater administrative costs for county governments. To properly undertake the income approach to valuation, discount rates should be used which reflect the anticipated rate of return customarily used to justify investments in projects in the oil and gas industry, taking into account factors relevant to investments in the industry including the risks associated with market price variations, the potential that yields will be less than predicted or will be subject to interruption or variation, and the cost of financing mineral development. While it is possible to amend the legislation to provide clarification that discounting must reflect the rates of return required by investors in oil and gas properties, because there are several different and generally recognized methods to measure these rates of return, and the degree of risk associated with development may vary significantly based upon the characteristics and location of the mineral resources,

the assessment of mineral interests will remain a difficult and highly contentious process.

These principles regarding the establishment of discount rates apply not only to the assessment of oil, natural gas, and coal bed methane, but also apply to other types of mineral interests already subject to local property tax assessment, including coal, limestone, iron ore and other “hard” minerals.

### **Avoiding Value-in-Use Assessments**

In assessment law, an important distinction is made between the value of business activities conducted on a property (referred to as the “value-in-use” of property) and the market value of the real estate itself. Business income is generated by the use of realty together with personal property, intangible property, and the skill and business expertise of a property owner to conduct a business enterprise. Real property income, in contrast, reflects only income flows that can be reasonably ascribed to the use solely of the ownership of real property.

It is important to distinguish the value-in-use of real property from the value of the property itself because the rental value of realty is typically only a small portion of the total value of operating a business on a property. In addition, when considered as separate and apart from the value of an ongoing business, the “value-in-exchange” of real property sold or leased separate from the underlying business may be far less than the value as determined from the perspective of a business owner operating a profitable business using the property.

Recognizing these important distinctions, Pennsylvania courts have consistently held that to properly determine the fair market value of real property it is impermissible to directly use business income to determine the value of real property by capitalizing the business income stream itself. Similarly, Pennsylvania courts have also held that it is impermissible to indirectly rely on business income to determine the value of real property by first calculating business income and then subtracting the value added by specific types of assets other than realty.

To guard against improper value-in-use assessments, if legislation such as House Bill 10 is considered by the General Assembly, language should be added to

the legislation to clarify that income subject to capitalization must be the likely or actual rental income a property owner may generate when the use of mineral interests is leased to third parties rather than the income generated by oil and gas extraction activities themselves.

If these issues are not addressed legislatively, they seem certain to generate significant amounts of litigation and increase the administrative burdens imposed on counties. In the absence of legislative guidance, the owners of mineral interests subject to assessment will also need to carefully analyze and review how county assessors establish income amounts subject to capitalization.

As is the case with selecting a proper discount rate, avoiding value-in-use assessment is similarly critical for the assessment of other types of mineral interests. While these topics have previously not been a source of major controversy for tax assessment purposes in Pennsylvania, the debate and attention being given to House Bill 10 and similar proposals may result in a greater focus on the proper assessment of other types of mineral interests.

### **Properly Considering Depletion**

Just as House Bill 10 provides for the discounting of income to present value, it also recognizes that once resources are extracted from a property, the value of the remaining mineral reserves will decline due to depletion.

Unfortunately, the approach taken by House Bill 10 is to allow adjustments for depletion through reassessment initiated by county assessment offices at their discretion. A more rational and desirable approach would be to require that whenever the value of mineral interests is assessed, the assessments must include a depletion factor to annually or on some other fixed periodic schedule automatically reduce values as the available resources are used up. Because counties are unlikely to undertake reassessments on their own that reduce the value of property, as drafted, the legislation will force property owners to periodically petition for reassessments. This approach is not only burdensome for property owners, but will also substantially increase

administrative and legal costs that counties must incur.

### **Avoiding Constitutional Litigation**

The Uniformity Clause of the Pennsylvania Constitution requires all taxes to be uniform upon the same class of subjects within the territorial limits of the authority levying the tax. The Pennsylvania Constitution further specifies circumstances in which exemptions or special provisions for taxation of property are permissible, and provides that all laws exempting property from taxation other than those specifically enumerated by the Constitution “shall be void.” Various provisions of the U.S. Constitution further impose limitations upon state taxes, including the due process and equal protection requirements of the 14<sup>th</sup> Amendment and the Commerce Clause.

House Bill 10 would allow counties to change the value of oil, gas, and coal bed methane mineral interests whenever events significantly affect the valuation of the property. This procedure contrasts with existing Pennsylvania law that authorizes the reassessment of properties only pursuant to countywide reassessments or in the event of subdivisions, the construction of new improvements, or as necessary to correct errors and omissions in a county’s assessment records. As a result, significant questions will arise regarding whether, in the context of tax assessments statutorily required to be determined based upon a common base year, establishing different reassessment schedules for certain types of property violates uniformity and equal protection requirements.

Similarly, House Bill 10 deviates substantially from existing law by taxing mineral interests severed from fee-simple title by a lease or other agreement, but exempting the same mineral interests if retained by

the landowner. It is difficult to identify a rational basis for exempting from taxation mineral interests held by fee-simple landowners, but imposing taxes on identical mineral interests severed from the remaining interests in the property, other than a patently discriminatory intent to impose taxes primarily upon businesses engaged in interstate commerce that focus their efforts upon mineral development and to confer benefits upon the owner occupants of properties located within Pennsylvania.

Finally, because liquid and gaseous minerals may not be confined to specific locations, substantial issues exist regarding whether such fugacious mineral interests constitute real property owned by a person with the right to conduct drilling at a specific location. Real property by definition constitutes a class of assets that are permanent, fixed and immovable. In contrast, oil and gas may migrate within geological formations and may in many circumstances be completely recovered by drilling conducted from different locations. As a result, while oil and gas after extraction constitute personal property owned by a person with a right to conduct drilling, prior to extraction, these mineral resources may be deemed to lack the fundamental characteristics that allow them to be assessed as a form of real property.

If these issues posed by House Bill 10 are not addressed and resolved, and the legislation is enacted into law, it may take years to resolve the numerous constitutional issues raised by the legislation. The result is likely to be the creation of substantial uncertainty and the imposition of significant costs upon mineral developers, landowners, and local governments, the ultimate impact of which may be to retard mineral development in Pennsylvania.

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