



TABLE OF CONTENTS

BUSINESS LAW1
Marcellus Shale Gas Leads to Litigation and Legislation1

TAX TAKES.....2
Tax Benefits for Businesses under the American Recovery and Reinvestment Tax Act of 2009.....2

ENVIRONMENTAL REALM.....4
Regulatory Powers and the Control of Pollution in the Chesapeake Bay.....4

BUSINESS LAW

Marcellus Shale Gas Leads to Litigation and Legislation

The Marcellus Shale is a deep rock formation underlying much of western and northern Pennsylvania, southern New York, West Virginia, and parts of Ohio and Virginia. Recent technological advances in gas drilling and recovery have made up to 500 trillion cubic feet of natural gas recoverable from the Marcellus Shale, to the delight of many upstate landowners now faced with the possibility of leasing their lands for gas exploration and development.

While Marcellus Shale has led to unexpected revenues, landowners who have entered into leases with gas production companies sometimes face legal uncertainties, which are exacerbated by the rush to lease and the paucity of Pennsylvania case law setting the ground rules on interpreting leases in the modern era. In addition, the few statutes that have been enacted in Pennsylvania sometimes provide more questions than answers.

One statutory example is the 1979 Minimum Royalty Act, which provides:

A lease or other such agreement conveying the right to remove or recover oil, natural gas or any other designation from lessor to lessee shall not be valid if such lease does not guarantee the lessor at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property.

While this provision appears straight-forward, a flurry of lawsuits have erupted over the issue of whether post-production costs can be deducted from the minimum royalty payment required by this statute, leading to confusing results. In March 2009, the Susquehanna County Court of Common Pleas held that the Minimum Royalty Act did not allow the gas company to deduct these costs. In April 2009, in another case, the U.S. District Court for the Middle District of Pennsylvania came to the opposite conclusion. Both cases are currently moving through their respective appeals process.

While the courts are witness to battles over the money now flowing, Congress is examining whether the federal government needs to regulate the environmental impacts of gas production. On June 9, 2009, companion bills were introduced in the U.S. Senate and House of Representatives to eliminate the exemption to the Safe Drinking Water Act for gas wells. Without this exemption, the injection of fracturing (“frac”) fluids into these wells would make them “injection wells” under the Safe Drinking Water Act. In addition, the bills would require more public disclosure of the makeup of the frac fluids, which may contain chemicals such as 2-butoxyethanol,



formaldehyde, sodium hydroxide, glycol ethers, and naphthalene. The Pennsylvania Department of Environmental Protection, on the other hand, has created an expedited permitting process to move gas wells into production more quickly.

The form leases often bandied about oversimplify very complex subjects, and the ambiguity rarely works to the landowners' advantage. Because the first wave of leasing has largely been completed, those landowners

that have not entered into leases have more leverage to negotiate favorable terms in their leases, so long as they remain wary of the legal terms offered by the gas companies.

The litigation and legislation involving the Marcellus Shale will likely increase over the next few years, as the lands currently under lease are developed and the profits start flowing. If a lease is drafted with these considerations in mind, perhaps the worst of it can be avoided.

TAX TAKES

Tax Benefits for Businesses under the American Recovery and Reinvestment Tax Act of 2009

President Barack Obama signed the American Recovery and Reinvestment Tax Act of 2009 on February 17, 2009. While the Recovery Act was signed several months ago and much has been written about it, we felt a refresher of the significant tax benefits (and costs) of the Recovery Act was important.

Net Operating Loss Carry-backs. Prior to passage of the Recovery Act, most net operating losses ("NOLs") could only be carried back two years. The Recovery Act allows small businesses, which are businesses with average gross receipts of \$15 million or less, to elect to carry-back NOLs incurred in any single tax year that begins or ends in 2008 for either a three, four, or five year carry-back period.

Business Expense Deductions. In 2008, Congress passed the Economic Stimulus Act and amended the Internal Revenue Code to

allow businesses to take a deduction worth up to \$250,000 of the cost of "qualified property" placed into service during taxable years beginning in 2008. The \$250,000 deduction was set to expire in 2009, in which case the maximum allowable deduction for qualified property placed into service during taxable years beginning in 2009 would have been \$125,000. The Recovery Act extends the \$250,000 deduction to qualified property placed into service during taxable years beginning in 2009. "Qualified property" is new or used depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

There are two limits to the \$250,000 deduction: (1) the allowable deduction is decreased by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000; and (2) the amount deducted cannot exceed the taxable income for the taxable year that is derived from the active conduct of the trade or business for which the qualified property is used. Nevertheless, any amount that cannot



be deducted because of this second limitation may be carried forward to future tax years.

Accelerated Cost Recovery.

Bonus Depreciation. As part of the 2008 Economic Stimulus Act, Congress amended the Internal Revenue Code to allow businesses to take a bonus depreciation deduction worth 50% of the cost of qualified property placed into service during 2008 and, in certain circumstances, during 2009. This 50% depreciation deduction is in addition to the regular depreciation deduction a business can take when it places qualified property into service. The Recovery Act extends this bonus depreciation through 2009 and through 2010 for property with a recovery period of ten years or longer and for certain transportation property.

Refundable Credits. Businesses eligible for bonus depreciation may choose instead to claim refunds for the value of accumulated alternative minimum tax or research and development credits for eligible qualified property placed into service after March 31, 2008 and before December 31, 2009. While this option was included in the 2008 Economic Stimulus Act, the Recovery Act extends the option to tax years beginning in 2009. Refundable credits claimed in lieu of bonus depreciation are increased by the “bonus depreciation amount,” which equals 20% of the difference between depreciation claimed on eligible property with and without bonus depreciation. Of note, the “bonus depreciation amount” is limited to the lesser of the following: (1) \$30 million; or (2) eligible refundable credits accumulated for

tax years prior to January 1, 2006.

Estimated Tax Payments. Generally, taxpayers make quarterly estimated payments based on their “required annual payment,” which is the lesser of 90% of the current year’s tax or 100% of the tax liability shown on the previous year’s return (or 110% if the tax shown on the previous year’s return exceeds \$150,000).

The Recovery Act provides that the “required annual payment” for a “qualified individual” in 2009 may be based either on 90% of the current year’s tax or 90% (instead of 100% or 110%) of the tax liability shown on the previous year’s return. A “qualified individual” is a person whose adjusted gross income on the previous year’s tax return was less than \$500,000 (or \$250,000 if married and filing separately), and who is able to certify that at least 50% of the previous year’s adjusted gross income was earned from a small trade or business. A small trade or business is one that employs an average of no more than 500 persons during the previous tax year.

Small Business Stock Gains Exclusion.

Prior to passage of the Recovery Act, individuals could exclude 50% of the gain from the sale of qualified small business stock acquired at original issue and held for five years or more. Under the Recovery act, this exclusion is increased to 75% of the gain from the sale of such stock issued after February 17, 2009 and before January 1, 2011. The sale of such stock qualifies for the exclusion if, when the stock is issued, the business is active and has \$50 million or less in gross assets.

**Shorter S-Corporation Built-In Gain**

Holding Period. The Internal Revenue Code requires S corporations (which do not pay corporate level tax) that once operated as C corporations (which do pay corporate level tax) to pay a 35% tax on gains from the sale of appreciated assets if the assets are sold within ten years of the date upon which the business converted to an S corporation and the assets were originally acquired when the business was operating as a C corporation.

The Recovery Act shortens the ten year “built-in gain period” to a seven year period for C corporations that convert to S corporation status in tax years beginning in 2009 and 2010.

Cancellation of Indebtedness. The Recovery Act allows businesses that issue debt instruments in connection with the conduct of a trade or business to defer the recognition of income from reacquiring its own debt instruments if the reacquisition

occurs after December 31, 2008 and before January 1, 2011. Businesses that reacquire their own debt instruments can defer the resulting income for a five-year period beginning in 2014. “Debt instruments” include bonds, notes, debentures, certificates, and any other contractual arrangement constituting indebtedness.

COBRA. Generally, COBRA-eligible individuals are responsible for paying their own premiums for continued coverage. However, the Recovery Act requires businesses to pay 65% of the premium for COBRA-eligible individuals involuntarily terminated between September 1, 2008 and December 31, 2009. Businesses are reimbursed for the 65% premium by taking a credit against income and payroll tax withholding liability. If premium subsidies exceed a business’s income and payroll tax withholding liability, the excess premium subsidies the business paid will be reimbursed directly by the IRS.

ENVIRONMENTAL REALM

Regulatory Powers and the Control of Pollution in the Chesapeake Bay

As those that visit it regularly can attest, the Chesapeake Bay has lost vitality over the past twenty years, primarily due to the inflow of nutrients (specifically nitrogen and phosphorus) and sediments from its feeding rivers. Pennsylvania’s rivers are a major factor in the Bay, with the Susquehanna River alone contributing approximately half of the freshwater that flows into the Bay.

Pennsylvania has agreed to limit the amount of nitrogen, phosphorus, and sediment that

enter the Bay through its waters, primarily from discharges from treatment plants and runoff from farm fields.

To achieve Pennsylvania’s commitments, the Department of Environmental Protection (“DEP”) has issued a series of guidance documents. These guidance documents include an overall Strategy, two implementation plans (one governing water discharge permits and the other addressing sewerage planning) and a Nutrient Trading Policy. The Nutrient Trading Policy attempts to create a market system for the sale and purchase of pollution prevention credits.



Under this system, a farmer can implement measures to control runoff and receive credits that can be sold to wastewater treatment plants, which use the credits to offset reductions that would have been otherwise required. These credits must be certified by DEP and DEP takes a “share” of the pollution, meaning that the certified credits that can be sold are less than the amount of pollution actually prevented by the measures implemented.

DEP’s Strategy has recently been challenged by a group of municipalities and municipal authorities, which assert that it constitutes an unpromulgated regulation, not mere policy. Recently, the Commonwealth Court held that the case could proceed over DEP’s objection, moving the case into discovery as to how the Strategy has been implemented. If the Strategy is rejected, all of the guidance documents will likely fail as well. This would mean that the guidance documents will have to be approved taken through the regulatory process, which would delay DEP’s efforts by several years. The sum total is that either a legislative fix will be necessary, or DEP will be forced into a settlement that endangers the achievement of the state’s commitments.

On the federal level, President Obama recently issued an Executive Order creating a Federal Leadership Committee to address the Chesapeake Bay issue, made up of representatives of impacted federal agencies. The Committee is directed to examine available legal tools, develop a strategy to use those tools, and present a report for the implementation of the strategy. The Committee is to coordinate its efforts with the affected states and the District of Columbia. The Executive Order symbolizes that the federal government will now take a leading role in finding a solution to the Bay’s woes, but at this point it is impossible to foretell whether this symbolism will result in any action.

Locally, the real world impact of these efforts is felt by the municipal sewage plants, which are seeing reductions in their water discharge permit limits. As the federal government examines its legal options, however, actors whose discharges are not currently regulated may find themselves under more pressure to control their impact. Protection of the Bay, while obviously laudable, could result in an expansion of the power currently afforded to the federal government, which many would not find desirable.



KKAG SPEAKING OUT...

- ◆ Mark Grimm and Pat Zaepfel co-authored the Pennsylvania Bar Institute book “*Buying and Selling a Business (6th Edition)*.”
- ◆ On September 16, 2009, Mark Grimm and Jason Confair will be presenters at the Lancaster Chamber of Commerce and Industry’s Small Business Summit on business law topics.
- ◆ Mark Grimm is a faculty member of the Pennsylvania Bar Institute’s (Philadelphia) seminar “Buying and Selling a Business,” which will be held on July 27, 2009.



- ◆ On June 4, 2009, Jason Confair gave a seminar at the Lancaster County Bar Association entitled “The Pennsylvania Home Improvement Consumer Protection Act: The Good, The Bad, and The Ugly.”
- ◆ On September 12, 2008, Mark Grimm gave a presentation entitled “An Overview of Buying and Selling a Business” for Accountant CPE.
- ◆ On May 21, 2008, Mark Grimm gave a presentation entitled “Business Succession Planning” to the Vistage Group.
- ◆ In June 2008, Rhonda Lord gave a presentation to the Pennsylvania Association of School Business Officials (“PASBO”) on 409A – New Deferred Compensation Regulations.
- ◆ In Harrisburg on November 6, 2008 and in Scranton on November 12, 2008, Pat Zaepfel gave a presentation entitled “Environmental Issues in Real Estate Transactions” at the Advanced Real Estate Issues course sponsored by the National Business Institute.

We hope you find this issue of the Business Law Watch helpful and informative. If you have any questions regarding any of the subjects covered or other business law matters, please do not hesitate to call or e-mail Mark Grimm (e-mail: grimm@kkaglaw.com), Clarence Kegel (e-mail: kegel@kkaglaw.com), Rhonda Lord (e-mail: lord@kkaglaw.com), Patrick Zaepfel (e-mail: zaepfel@kkaglaw.com), or Jason Confair (e-mail: confair@kkaglaw.com) at 717-392-1100.



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KKAG has a substantial business law practice, representing businesses of all sizes.

KKAG advises businesses on mergers and acquisitions, business formation, general contracting and business counseling, financing, distribution and trade regulation, tax, technology law issues, environmental issues, as well as a full range of other legal areas faced by businesses.

D. Mark Grimm, Jr., Clarence C. Kegel, Jr., Patrick H. Zaepfel and Jason T. Confair are the primary lawyers in our business law group. Other lawyers are involved in business law work as appropriate based on their areas of expertise.

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