

INTERNAL REVENUE SERVICE
Index No.: 0029.00-00

Number: **199926015**
Release Date: 7/2/1999

CC:DOM:P&SI:7-PLR-114297-98

March 26, 1999

LEGEND

A =
B =
D =
E =
F =
G =
H =
I =
L =
R =
X =
Z =

Dear _____ :

In a letter dated _____, _____, you requested rulings regarding your purchase of oil and gas properties.

You represented that:

E had a number of interests in oil and gas properties that it wanted to sell. Production from some of the interests includes gas produced from tight formations which is a qualified fuel under section 29(c) of the Internal Revenue Code of 1986, as amended. B wanted to purchase the properties but could not utilize the section 29 credits and therefore would not be able to bid as much as potential buyers that could use the credits. B approached A who could utilize the section 29 credits. Together they worked out an arrangement whereby E's properties were acquired by B and the properties whose production qualified for the section 29 credits would be subsequently sold to A. B retained the bulk of the properties, which did not generate the credit.

A paid cash equal to D. A will also be obligated to pay a

Credit Payment Amount, a Recourse Note and a volumetric production payment retained by B. The Recourse Note is in the principal amount of R and bears interest at the rate of Z%. Payments of principal and interest are made in accordance with a schedule. The entire balance of the Recourse Note, including unpaid interest, is due and payable in full on X. Prior to maturity and notwithstanding the payment schedule, payments are to be made out of actual net proceeds received from sale of minerals produced from the properties. Any amounts due but unpaid will be paid in succeeding months.

The production payment is payable solely out of the gross proceeds from the sale of hydrocarbons from the subject interests. The payments required under the production payment are the lesser of (a) the Measurement Amount for the current Payment Period and (b) the Gross Proceeds from the sale of hydrocarbons ("gross income from the property" within the meaning of section 613 of the Code) from the subject interests during the Payment Period. The Measurement Amount is determined by reference to an amount in the Net Profits Account (NPA). The NPA amount equals the sum of (i) any unpaid Measurement Amount carried forward from a prior Payment Period, and (ii) the balance in the NPA for the current Payment Period. Any measurement Amount in excess of Gross Proceeds is carried forward to the succeeding Payment Period.

The NPA amount will be calculated for each Payment Period by deducting the total debits from the total credits made to the NPA during such Payment Period. The NPA is credited with the Gross Proceeds and any other consideration received during the Payment Period with respect to the Subject Interests. All expenses paid during the Payment Period with respect to the ownership and operation of the Subject Interests are debited to the NPA, including all amounts of principal and interest under the Recourse Note.

The production payment will terminate when the production from the subject interests equals F percent of the current (at the time of creation of the production payment) estimate of the economically recoverable reserves in the subject interests. It is anticipated that the Recourse Note will terminate before the volumetric production payment. When the production payment was created the estimated present value of the production from the subject interests after the production payment and the Recourse Note terminate was greater than 5% of the present value of the entire production stream from all the subject interests.

Following termination of the production payment, A will be entitled to 100% of the income from production attributable to the subject interests. As part of the agreement, B has an

interest (the Contingent Interest) in any reserves that might exist after production of 100% of the reserves currently estimated to exist.

Under the Credit Payment Amount, A will pay the Credit Payment Amount to B after the total amount of the Credit Payment Amount exceeds the prepaid Credit amount of \$L. The Credit Payment Amount is payable each calendar quarter and is defined as G% multiplied by the dollar amount of the estimated Section 29 credits attributable to sales of qualified fuels from the subject interests until the payments equal \$R.

B was granted an option to re-acquire the subject interests for fair market value. The repurchase option is exercisable before H. If B purchases the properties before certain dates, B must pay specified penalties.

The rulings requested are:

1. A has acquired the entire economic interest of B in the transferred properties.
2. The volumetric production payment is properly characterized as a purchase money mortgage loan under section 636(b) of the Code.
3. The right to receive the Credit Payment Amount is not an economic interest in the properties.
4. The Recourse Promissory Note is not an economic interest in the properties.
5. Any Section 29 credit attributable to production from the properties after their sale to A is attributable to A.

Section 1.611-1(b)(1) of the Income Tax Regulations provides that an economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which the taxpayer must look for a return of the taxpayer's capital.

Section 1.614-1(a)(2) provides that the term "interest" means an economic interest in a mineral deposit within the meaning of § 1.611-1(b)(1). The term includes working or operating interests, royalties, overriding royalties, net profits interests, and, to the extent not treated as loans under § 636, production payments.

In Anderson v. Helvering, 310 U.S. 404, 409, the taxpayer received payments which had to be satisfied out of any sale of the fee simple title of the land as well as production of the oil. Because the taxpayer was not looking entirely upon the oil production for a return on his investment, the court found he did not have an economic interest.

Section 636(a) and § 1.636-1(a) provide that a production payment created and retained upon the transfer of the mineral property burdened by the production payment is treated as a purchase money mortgage loan on the burdened mineral property.

Section 1.636-3(a)(1) defines the term "production payment" to mean a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from the production. The right must be an economic interest in the mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. The right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the burdened mineral properties. A right to mineral in place that can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment must be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby if the right may not reasonably be expected to extend in substantial amounts over the entire productive life of the mineral property.

Section 1.636-1(a)(1)(ii) of the regulations states that the payor and payee shall determine their allowable deductions as if the production payment were a loan and refers to section 483 of the Code. Section 483, in turn, refers to sections 1272 through 1275 for the treatment of original issue discount instruments.

Section 29(a), provides a credit for qualified fuel (as defined in § 29(c)) sold by the taxpayer to an unrelated person during the taxable year, the production of which is attributable

to the taxpayer.

A transaction will be classified as a sale or exchange of a mineral interest in cases in which the owner of a continuing property interest assigns that interest and retains a non-continuing interest in production (economic interest), that is, an interest that is not coterminous with the productive life of the transferred property.

In this case, B will retain a production payment that is limited to a specified number of units of mineral based on a stated percentage of the reserves currently known to exist at the time the transaction is consummated. If additional reserves are found to exist after all reserves currently known to exist have been produced, B will acquire a contingent interest which is a specified percentage of any such additional reserves.

The production payment is payable solely from production from the burdened properties and has an economic life of shorter duration than the economic life of the burdened properties. Because the interest B retained in any additional reserves does not come into being unless and until the additional reserves (not at present believed to exist) are determined to exist, it is not a continuing interest.

Accordingly, based on the information submitted and the representations made, the volumetric production payment meets the requirements of § 1.636-3(a)(1) and is treated as a purchase money mortgage loan.

The Credit Payment Amount is to be paid from sources other than the subject properties. Having an alternate source of income, the right to receive the Credit Payment Amount cannot be an economic interest following Anderson. Likewise the Recourse Note cannot be an economic interest since it must be extinguished on X from sources other than the subject properties.

Based solely on the representations made and the information submitted, we conclude that:

1. A has acquired the entire economic interest in the properties transferred to it until and unless B repurchases the property or the contingent interest arises.
2. The volumetric production payment is properly characterized as a purchase money mortgage loan under section 636 of the Code.

3. The right to receive the Credit Payment Amount is not an economic interest in the properties.

4. The Recourse Note is not an economic interest in the properties.

5. Any Section 29 credit attributable to production from the properties after their sale to A is attributable to A until and unless B repurchases the property or the contingent interest arises.

No opinion is expressed or implied regarding the determination of the buyer's basis in the subject interests. No opinion is expressed or implied regarding the determination of amounts attributable to interest or principal pursuant to the Recourse Note or the production payment.

Except as ruled above, we express or imply no opinion as to the federal tax consequences of this transaction under any other provision of the Code. Specifically, we express or imply no opinion whether any fuel produced from the properties is qualified fuel within the meaning of §29(c).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this ruling should be attached to your tax return filed for the year in which the transaction covered by this ruling was consummated. A copy is enclosed for this purpose.

Sincerely yours,

By _____
Joseph H. Makurath
Senior Technician Reviewer
Branch 7
Assistant Chief Counsel (Passthroughs and
Special Industries)