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November 27, 1998

LEGEND

A =
B =
C =
D =
F =
G =
Q =
R =
S =
T =

Dear _____ :

_____, you requested rulings regarding your purchase of gas properties.

The facts are understood to be as follows.

A entered into an agreement to purchase certain gas operating interests and certain net profits interest from B. Production from the subject interests includes gas which is a qualified fuel under section 29(c) of the Internal Revenue Code of 1986, as amended.

As consideration for the subject interests, A will pay B cash equal to D. A will also be obligated to pay a dollar denominated production payment and a volumetric production payment retained by B. The dollar denominated production payment is payable solely out of Q% of the net proceeds from the sale of hydrocarbons from the subject interests and will terminate the earlier of when the total amount paid equals R plus interest at G% per annum or when the volumetric production payment terminates. The volumetric production payment entitles B to S% of the net proceeds less amounts paid to satisfy the dollar denominated production payment. In addition A is required to make payments to B equal to T% of the value of the section 29 credits generated by the subject interests (Credit Payment Amounts).

The volumetric 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. When the production payment was created the estimated present value of the production from the subject interests after both of the production payments terminate was greater than 5% of the present value of the entire production stream from all the subject interests.

Following termination of the production payments, A will be entitled to 100% of the income from production attributable to the subject interests. As part of the Assignment, B reserved an interest (the Contingent Interest) in any reserves that might exist after production of 100% of the reserves currently estimated to exist.

B was granted an option to re-acquire the subject interests for fair market value. The repurchase option is exercisable before C and provides penalties if the option is exercised before certain dates.

A entered into a management agreement with a company wholly owned by B for which the company will be compensated. The agreement is typical of those in the industry.

The rulings requested are:

1. A has acquired the entire economic interest of B in the transferred properties.
2. The production payments are properly characterized as purchase money mortgage loans under section 636 of the Code.
3. The Credit Payment Amount is not an economic interest.
4. 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.

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 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.

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 may 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 payer 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 production payments that are limited to a specified dollar amount and 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 payments are payable solely from production from the burdened

properties and have economic lives of shorter duration than the economic lives of the burdened properties. Accordingly, based on the information submitted and the representations made, the production payment meets the requirements of § 1.636-3(a)(1) and is treated as a purchase money mortgage loan. 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.

The Credit Payment Amounts are to be paid from sources other than the subject properties. Following Anderson, because the Credit Payment Amounts are payable from sources other than the subject properties, the right to receive such payments does not constitute an economic interest.

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

1. A has acquired the entire economic interest of B in the transferred properties.
2. The production payments are properly characterized as purchase money mortgage loans under section 636 of the Code.
3. The Credit Payment Amount is not an economic interest.
4. Any Section 29 credit attributable to production from the properties after their sale to A is attributable to A, unless and until B reacquires the properties 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 the interest or principal pursuant to the production payments.

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,
Assistant Chief Counsel (Passthroughs
and Special Industries)

By _____
Joseph H. Makurath
Senior Technician Reviewer
Branch 7