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June 2, 2000

LEGEND

A =
A1 =
B =
C =
C1 =
D =
E =
F =
F1 =
G =
G1 =
H =
I =
I1 =
J =
K =
X =
X1 =
Y =

Dear :

In a letter dated February 4, 2000, you requested rulings regarding your purchase of oil and gas properties.

You represented that:

A and C are limited partnerships whose sole general partner is A1 and C1 respectively. J is the sole member of both A1 and C1.

A and C agreed to purchase certain interests in oil and gas producing properties (and all rights and obligations of the seller under gas balancing agreements, etc) from B. Production from the interests includes gas produced from tight formations which are qualified fuels under section 29(c) of the Internal Revenue Code of 1986, as amended. A and C will claim the credit under section 29 only with respect to production from wells which have been determined to produce qualified fuel by the applicable regulatory authorities in accordance with the Natural Gas Policy Act of 1978.

During negotiations with J, B determined that a substantial number of the properties could not be transferred without obtaining consents from unrelated co-owners. To avoid delaying the sale J and B agreed to close the transaction in two parts with A getting the properties where no consent was needed from third parties and C getting the remainder. A paid cash equal to D. C paid cash equal to K. A and C will each also be obligated to pay a Contingent Promissory Note, a Non-recourse Promissory Note, and a production payment retained by B.

The Contingent Promissory Note for A is for G% multiplied by the dollar amount of the estimated Section 29 credits attributable to sales of qualified fuels from the subject interests. In the case of C the Contingent Promissory Note is for G1% of the tax credits.

The Non- Recourse Promissory Note of A is for $X and bears interest at the rate of Y%. The Non- Recourse Promissory Note of C is for $X1 and also bears interest at the rate of Y%. Each note is paid out of net proceeds according to a schedule. The notes are due and payable on I in the case of A and I1 in the case of C.

The production payments are payable solely out of the gross proceeds from the sale of hydrocarbons from the subject interests. The payments required are essentially equal to the gross proceeds from the subject interests less the operating expenses and payments on the Non-Recourse Promissory Notes.

The production payment will terminate when the production from the subject interests equals, in the case of A, F percent (in the case of C, F1 percent) of the current (at the time of creation of the production payment) estimate of the economically recoverable reserves in the subject interests. When each of the production payments was created the estimated present value of the production from the subject interests after the production payment terminates 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 and C will be entitled to 100% of the income from production attributable to their 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.

B was granted options to re-acquire part or all the subject interests at fair market value. The repurchase option is exercisable effective H .

A and C have also entered into Management Agreements with B. The management agreements are typical of those within the industry.

The rulings requested are:

1. A and C have acquired the entire economic interest in the properties transferred to them.

2. The production payments are properly characterized as purchase money mortgage loans under section 636 of the Code.

3. The Non- Recourse Promissory Notes are not economic interests in the properties.

4. The Contingent Promissory Notes are not economic interests in the properties.

5. Any Section 29 credit attributable to production from the properties after their sale to A and C is attributable to A and C.

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 Section 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 could 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 solely to 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 this 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 § 483 of the Code. Section 483, in turn, refers to § 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 conterminous with the productive life of the transferred property.

In this case, B will retain production payments that are 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 payments are 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 interests 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 production payments meet the requirements of § 1.636-3(a)(1) and are treated as purchase money mortgage loans.

The Contingent Promissory Amounts are to be paid from sources other than the subject properties. Having an alternate source of income, the Notes cannot be economic interests following Anderson.

Likewise the Non- Recourse Promissory Notes must be paid off on I and I1 (if not already paid off) from sources other than the subject properties and thus cannot be economic interests.

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

1. A and C have acquired the entire economic interest in the properties transferred to them.

2. The production payments are properly characterized as purchase money mortgage loans under section 636 of the Code.

3. The Non- Recourse Promissory Notes are not economic interests in the properties.

4. The Contingent Promissory Notes are not economic interests in the properties.

5. Any Section 29 credit attributable to production from the properties after their sale to A and C is attributable to A and C.

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 notes or 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 mean of § 29(c). However, we do point out that following True Oil Company v. Commissioner of Internal Revenue, No. 97-9029 (10th Cir. March 23, 1999), production from any well which lacks a Determination by a jurisdictional agency or review of such Determination by FERC does not qualify for the credit under § 29.

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