

Internal Revenue Service

Department of the Treasury

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Telephone Number:

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Date:

October 1, 2001

LEGEND

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

Dear

In a letter dated March 13, 2000, you requested rulings regarding your purchase of oil and gas properties.

You represented that:

A agreed to purchase certain interests in oil and gas producing properties and related production equipment from B. Production from the interests includes gas produced from the C formation which are qualified fuels under section 29(c) of the Internal Revenue Code of 1986, as amended. A 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.

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 time denominated 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 when the total amount paid equals R. The time denominated production payment entitles B to S% of the net proceeds less amounts paid to satisfy the dollar denominated production payment. The time denominated production payment terminates on H. In addition A is required to make payments to B equal to G% of the value of the section 29 credits generated by the

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subject interests (Recourse Promissory Note).

When the time denominated production payment terminates the production from the subject interests is expected to equal 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 options to re-acquire the subject interests for greater of \$T or fair market value during four different time windows or circumstances.

A entered into a management agreement with B for it 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. 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.

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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 time cut off based on a 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 payments meet the requirements of § 1.636-3(a)(1) and are treated as purchase money mortgage loans. 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

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continuing interest.

The Recourse Promissory Note is to be paid from sources other than the subject properties. Following Anderson, because the Recourse Promissory Note is 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. 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 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.

Sincerely,
Joseph H. Makurath
Senior Technician Reviewer
Branch 7