Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201520004**
Release Date: 5/15/2015

CC:PSI:B06
POSTF-137295-12

[Third Party Communication:
Date of Communication: Not Applicable

UILC: 611.02-04, 9411.05-00

date: January 14, 2015

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subject: Request for Advice -— TAXPAYER

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

TAXPAYER =

COUNTRY =

FIRM =

LAW =

DEPOSIT =

FIRM SUB1 =

FIRM SUB2 =

C1 =

C2 =

C3 =

C4 =

AGREEMENT =

TAXPAYER SUB1 =

TAXPAYER SUB2 =

TAXPAYER SUB3 =

TAXPAYER SUB4 =

YEAR 1 =

YEAR 2 =

YEAR 3 =

YEAR 4 =

YEAR 5 =

YEAR 6 =

YEAR 7 =

YEAR 8 =

YEAR 9 =

YEAR 10 =

X =

Y =

Z =

ISSUE

Should TAXPAYER’s AGREEMENTS be treated for United States federal income tax purposes as leases of mineral interests or as sale transactions.

CONCLUSION

For all taxable years involved (YEAR 4, YEAR 5, YEAR 6, YEAR 7, YEAR 8, AND YEAR 9), TAXPAYER’s AGREEMENTS are correctly treated as leases of mineral interests for federal income tax purposes.

FACTS

TAXPAYER is a energy company with worldwide operations in many countries, including COUNTRY. As explained below, TAXPAYER conducts its business in COUNTRY through wholly-owned subsidiaries that are members of TAXPAYER’s affiliated group.

FIRM is a corporation established by LAW, and is responsible for all phases of the oil and gas industry in COUNTRY. FIRM manages operations on behalf of the government of COUNTRY, .

In YEAR 1, DEPOSIT was discovered in COUNTRY. FIRM devised a plan to produce from DEPOSIT, and market the product to markets. The operations and activities of FIRM’s endeavor in DEPOSIT were accomplished, in part, through FIRM SUB1 and FIRM SUB2.

FIRM SUB2 is a COUNTRY joint venture company established to produce and sell hydrocarbons from DEPOSIT. Furthermore, FIRM SUB2 serves as an operating company on behalf of the owners of certain exploration and development rights in DEPOSIT. The owners include companies C1, C2, C3 and C4 (collectively, the companies). These companies were formed under AGREEMENTS among COUNTRY, FIRM and TAXPAYER which granted FIRM and TAXPAYER permission to develop the resources of certain areas in exchange for the payment of royalties to COUNTRY. The companies are characterized as foreign partnerships for U.S. income tax purposes.

C1, C2 and C3 are owned by FIRM (roughly X%) and TAXPAYER (roughly Y%) through TAXPAYER SUB1, which is an affiliated member of TAXPAYER’s consolidated group. TAXPAYER SUB1’s Z% interest in C1 and Y% interest in C2 is directly owned, while it owns its Y% in C3 through TAXPAYER SUB2, a disregarded foreign entity.

C4 is owned by FIRM (majority shareholder), TAXPAYER, and various other foreign minority shareholders. C4 is treated as a partnership for U.S. tax purposes.

TAXPAYER owns its interest in C4 through TAXPAYER SUB3, an affiliated member of Taxpayer's consolidated income tax return. TAXPAYER SUB3's interest in C4 is in turn owned through TAXPAYER SUB4, a disregarded foreign entity.

The companies entered into Agreements (" As") with FIRM. The As establish the rights, responsibilities, terms and conditions that govern each party's conduct and operations in the development of COUNTRY's DEPOSIT under the applicable AGREEMENTS, including royalties payable in cash to COUNTRY. The first royalty payments made to COUNTRY by C1, C2, C3 and C4 occurred, respectively, in YEAR 2, YEAR 3, YEAR 7 and YEAR 7.

From their inception, TAXPAYER has treated the AGREEMENTS as oil and gas leases for United States federal income tax purposes. Accordingly, TAXPAYER has recognized its share of production from properties subject to the AGREEMENTS as gross income, and claimed its share of the royalty payments on such production which the companies made to the government of COUNTRY as deductions or through cost of goods sold (Lease Method).

In YEAR 9 and YEAR 10, TAXPAYER submitted to Examination affirmative adjustments with regard to the following entities and taxable years: C1 and C2 (YEAR 4, YEAR 5, YEAR 6, YEAR 7), C3 (YEAR 7), and C4 (YEAR 7) (hereinafter the "Claims"). The adjustments in the Claims propose to change the U.S. income tax treatment of the AGREEMENTS from the Lease Method to a sale method.

LAW AND ANALYSIS

In 1941, the Internal Revenue Service prepared G.C.M. 22730, 1941-1 C.B. 214,[1] an opinion that embodied most of the basic principles governing transactions in the oil and gas industry. The factual scenario presented in the request was quite complex, involving six separate parties. The opinion methodically applied the then-recent high court decisions to the complexities of the facts before it, and held that five of the six parties retained economic interests in the transaction. The opinion noted that "a sale of capital assets is not involved in a lease agreement in which the lessor, in consideration of a bonus or lump sum cash payment made at the time the lease was executed … and stipulated royalties measured either by a percentage of production under the lease or by a stated sum per unit extracted and sold … which are payable over the entire lease life, grants a lessee the right to enter upon and use the land for purposes of exploitation," citing Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1933), and Burnet v. Harmel, 287 U.S. 103 (1932).

[1] G.C.M. 38883 (July 26, 1982) generally obsoleted all General Counsel Memoranda issued prior to enactment of the Internal Revenue Code of 1954 (August 16, 1954) except those published in the Internal Revenue Bulletin. G.C.M. 38906 (October 13, 1982), noted, in part, that G.C.M. 22730 had been published in the Internal Revenue Bulletin and was "still current."

Thus, generally, whether a transaction is classified as a sale or exchange or as a lease or sublease depends on the nature of the interest transferred and the interest retained. Burnet, 287 U.S. at 111. Under a lease, the lessee acquires merely the privilege of exploiting the land for the production of oil and gas for a certain period. *Id*. The lessor parts with no capital interest in the oil and gas in place (although the lessee acquires a capital interest upon the execution or assignment of a lease). G.C.M. 22730, 1941-1 C.B. at 216. The lessor does not sell an interest to the lessee. G.C.M. 22730, 1941-1 C.B. at 217. Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property. *Id*.

A few years prior to the issuance of G.C.M. 22730, the Supreme Court in Palmer v. Bender, 287 U.S. 551 (1933,) addressed the question of how to determine whether a given transaction involved a sale or a lease of natural resources. In that case, the Court refused to distinguish between lessors and sub-lessors or assignors of leasehold interests who, by stipulation for royalty payments, reserved an interest in production coextensive with the leasehold life. The Court held that the bonus payment, oil payments, and royalty payments involved in the case were all ordinary income to the sub-lessor or assignor subject to the depletion allowance, rather than proceeds from the sale of capital assets. *Id*. at 559. The Court also refused to distinguish between leases governed by varying state laws, which apply different rules as to when technical title to oil and gas passes to the lessee, on the ground that the economic consequences to the lessor are the same in all cases, that is, the value of the lessor's interest is lessened by the extraction of oil. The Court stressed the general view that each person having a right to share in the oil produced or the proceeds from its sale, irrespective of the legal form of the interest in the property, has an economic interest in the oil and gas in place to which the depletion provisions are applicable. *Id*. at 557.

Likewise, the right to depletion figured prominently in many of the early Supreme Court oil and gas cases. The Court in Palmer v. Bender noted that there was nothing in the statute or regulations providing for depletion that confined the depletion allowance to those who are technically lessors. *Id*. at 556. "The language of the [depletion] statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital…. [T]he lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if by virtue of the leasing transaction he has retained a right to share in the oil produced. If so, he has an economic interest in the oil, in place, which is depleted by production." *Id*. at 557. See also Treas. Reg. § 1.611-1(b)(1) of the Income Tax Regulations.

The Supreme Court has indicated that while the economic interest test was developed to determine whether a taxpayer was entitled to a deduction for depletion, the same test applies for determining whether proceeds are taxable as capital gains or as ordinary income. Burton-Sutton Oil v. Commissioner, 328 U.S. 25 (1946). Because these early

Supreme Court oil and gas tax cases often addressed which person or entity was entitled to claim depletion on a certain economic interest, this analysis helps glean whether proceeds are taxable as capital gains or as ordinary income and, thus whether transactions involve sales or leases of the oil and gas property.

One such early Supreme Court case was Anderson v. Helvering, 310 U.S. 404 (1940). In Anderson, the real question before the Supreme Court was who had a capital investment in the oil and gas in place and what was the extent of their interest. The Court addressed a sale of Oklahoma reserves in the ground and fee interests in land for $160,000, of which $50,000 was to be paid in cash and $110,000 to be paid by either the taxpayer-buyer making payments in kind of oil production to the seller or by the taxpayer-buyer selling some of the fee interests. The seller in Anderson was not dependent entirely upon the production of oil for the deferred payments. The payments could have been derived from the sales of the fee title to the land conveyed, and it is clear that payments derived from such sales would not be subject to an allowance for depletion of the oil reserves because no oil would have been severed from the ground. An allowance for depletion upon the proceeds of such a sale would result in a double depletion deduction, first to the seller, then to the buyer-taxpayer, upon production of the oil. Therefore, the seller did not retain an economic interest; the transaction was a sale.

The taxpayer-buyer in Anderson attempted to rely on a similar case of Thomas v. Perkins, 301 U.S. 655 (1937), where the assignor (seller) of certain oil leases had the right to a specified sum of money payable out of a specified percentage of oil, or the proceeds received from the subsequent sale of such oil, if, as and when that oil was produced. The question in Perkins was whether the taxpayer-assignee (buyer) had to report as its own income a total of $395,000 to be paid to the assignor (seller) of the leases in question through the specified oil production. The Supreme Court in Perkins decided that the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments and should be given the same consequences as a provision for oil royalties, and not be considered income to the taxpayer-assignee. In Perkins, the Court held that the arrangement is equivalent to a provision for royalties based on reservation of an economic interest. Therefore, the transaction involved a lease.

The difference in the results in Perkins and Anderson came down to the presence in Anderson of the reservation of an additional type of security for the deferred payments, notwithstanding the fact that the parties in Anderson had agreed that the only income from the properties in dispute was actually derived from oil production. In the instant case, payments cannot be made from future sales of the fee interest as well as from production. There are no guarantees of what the oil payments will total in the future. Consequently here, as in Perkins, the arrangement is equivalent to a provision for royalties based on reservation of an economic interest, which is present in a lease transaction.

Thus, the substance of the AGREEMENTS, as well as their form, supports continued use of the Lease Method. The government owns all the minerals in the ground in COUNTRY. In order to reach that mineral wealth, a lessee must contract with the government. The form of the contractual relationship is a lease, meaning that the government is giving up a portion of its rights to the mineral production in order to secure substantial development and operational activity in the subject properties.[2] In return, the government receives cash royalties on all and produced pursuant to each AGREEMENT and, in the case of C3 and C4, royalties on as well.

Furthermore, the Internal Revenue Service has already ruled that similar arrangements in another country should be treated as leases for income tax purposes. Rev. Rul. 76-215, 1976-1 C.B. 194, addresses production sharing contracts that a taxpayer entered into with Pertamina, the Indonesian national oil company. The ruling involved several production sharing contracts under which Pertamina and the taxpayer divided production in a 70/30 ratio. Pertamina would then pay 60 of its 70 percent share into the Indonesian Treasury, retaining 10 percent. In addition, the taxpayer was required to make certain exploration investments in each of the first six years of the contract; pay Pertamina a signing bonus upon execution of the contract; make various charitable contributions; and pay Pertamina a production bonus when production reached a certain level. The taxpayer would also have to pay for all equipment used in the operations and all expenses incurred in exploration, development, extraction, production, transportation, and marketing. To recover the foregoing expenditures, the taxpayer must look solely to the extraction of oil or gas or the income therefrom.

While Rev. Rul. 76-215 primarily addresses whether the portion of Pertamina's share of production that was transferred to the Indonesian Treasury can be considered creditable foreign taxes, another underlying issue, namely, the nature of the amounts transferred to the Indonesian Government, dictates the answer. The ruling notes that the Indonesian Government has legal title to all oil located in Indonesia. Further, the Indonesian Government must look solely to a percentage of production under the production sharing contracts for compensation for the exhaustion of its oil deposits. Thus, the ruling concludes, the Indonesian Government's share of production is a royalty, not a tax.

The word "royalty" as used in an ordinary oil and gas lease generally refers to "a share of the product or profit reserved by the owner for permitting another to use the property." Sneed v. Commissioner, 33 B.T.A 478, 482 (1935) citing Hill v. Roberts, 284 S.W. 246; National Gas Co. v. Stewart, 90 N.E. 384. "It is compensation for the privilege of drilling and producing oil and gas and consists of a share in the product." Sneed, 33 B.T.A. at 482 citing Bellport v. Harrison, 255 Pac. 52. Unlike rent, it represents a division or sharing of the production or its proceeds. G.C.M. 22730. Such a royalty is gross

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[2] At one time, the presence of a dominating purpose of the parties to a transaction to secure development and operation of the property was a determining factor on the question of lease versus sale, but that is no longer the case. See Rev. Rul. 69-352, 1969-1 C.B. 34, superseding G.C.M. 27322, 1952-2 C.B. 22.

income taxable in the hands of the lessor upon which the lessor is entitled to a reasonable allowance for depletion. Treas. Reg. §1.613-2(c)(5)(i). The lessee, on the other hand, does not include the amount of the lessor's royalty in the lessee's own gross income, nor does he include the royalty amount in the "gross income from the property" upon which the lessee's own statutory depletion allowance is based. *Id*. It is axiomatic that there can be only a single allowance for depletion on a given barrel of oil. Helvering v. Twin Bell Syndicate, 293 U.S. 312 (1934). In contrast to a lease, proceeds realized from a sale of oil and gas properties or an interest therein are not subject to the depletion allowance since such proceeds are not derived from the production and sale of oil and gas. Anderson, 310 U.S. at 412.

TAXPAYER's case and Rev. Rul. 76-215 are very similar in that the government has legal title to all oil located in COUNTRY; the government must look solely to a percentage of production under the AGREEMENTS for compensation for the exhaustion of its oil deposits; and the government's share of production in substance represents a royalty. Since a royalty is clearly an economic interest, it follows that the AGREEMENTS should all be considered leases for income tax purposes and follow Taxpayer's established Lease Method.

Lastly, when determining whether a given transaction involves a sale or a lease, the sale and lease labels placed on a transaction by its participants are not necessarily dispositive. The case of Rutledge v. United States, 428 F.2d 347 (5th Cir. 1970), provides one such example. The court in Rutledge said that the proper application of the economic interest test under the circumstances of that case required that it look beyond the language of the agreements in issue. The court concluded that the purported conveyance of sand and gravel in place, under the circumstances in that case, was in substance nothing more than a grant of operating rights to mine hard minerals at a fixed unit price for materials removed. Consequently, the taxpayer retained an economic interest in the minerals in place in the two tracts. It was not, for tax purposes, a sale of capital assets.

Therefore, an oil and gas leasing transaction occurs when the taxpayer, as owner of the operating rights, assigns all or part of such rights to another person for no immediate consideration, or for cash or its equivalent, and retains a continuing non-operating interest in production. It does not matter if the operative documents are entitled AGREEMENTS or leases. It does not matter if the rights involved are described as royalties or production payments; both are economic interests. None of the AGREEMENTS mention the word "lease," but that does not mean that they are not treated that way for income tax purposes. The substance of the AGREEMENTS clearly requires that they be treated as leases and their operations should be reported in accordance with the Lease Method for United States federal income tax purposes.

Accordingly, the AGREEMENTS should be reported by TAXPAYER in accordance with the Lease Method because the substance of the AGREEMENTS supports treatment under the Lease Method, and the substance of the AGREEMENTS does not support treatment as sales transactions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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