

INTERNAL REVENUE SERVICE
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10/21/98

LEGEND

A =
B =
D =
F =
G =
H1 =
H2 =
I =
K =

M =
R =
X =
Z =

Dear :

In a letter dated , you requested rulings regarding your purchase of gas properties. The transaction was later modified as described in a letter dated September 30, 1998. You represented that:

A entered into agreements to purchase certain gas interests in I from B. Production from the subject interests includes gas produced from the Devonian shale 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 Contingent Promissory Note, a Non-Recourse Promissory Note and a volumetric production payment retained by B. The Non-Recourse Promissory 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 Non-Recourse Promissory 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 payments required under the production payment are M% of the gross proceeds from the sale of hydrocarbons from the subject interests during the Payment Period less amounts due under the Non-Recourse Note and expenses listed in the purchase agreement.

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. It is anticipated that the Non-Recourse Promissory 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 Non-Recourse Promissory 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 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.

The Contingent Promissory Note for any Payment Period 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. The payments are adjusted yearly to K% of the actual credit earned.

B was granted an option to re-acquire the subject interests for fair market value. The repurchase option is exercisable between H1 and H2.

A has also entered into a Management Agreement with B. The management agreement is typical of those within the industry.

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 of the Code.

3. The Contingent Promissory Note is not an economic interest in the properties.
4. The Non-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 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 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 Contingent Promissory Note is to be paid from sources other than the subject properties. Having an alternate source of income, the note cannot be an economic interest following Anderson. Likewise the Non-Recourse Promissory 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 of B in the transferred properties 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 Contingent Promissory Note is not an economic interest in the properties.
4. The Non-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 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 Non-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,
Assistant Chief Counsel (Passthroughs
and Special Industries)

By _____
Joseph H. Makurath
Senior Technician Reviewer
Branch 7