

**INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

JAN. 15, 1999

Index (UIL) No.: 611.02-04  
CASE MIS No.: TAM-117321-98  
Number: **199918002**  
Release Date: 5/7/1999

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No.:  
Years Involved:  
Date of Conference:

**LEGEND:**

A =  
C =  
D =  
E =  
G =  
i =  
j =  
M =  
n =  
o =  
P =  
country =

**ISSUE:**

Is the net profits royalty interest which E corporation received from C an economic interest under section 611 of the Internal Revenue Code.

**CONCLUSION:**

The net profits royalty interest is an economic interest.

## FACTS:

G held an interest in the n project which produced gas and condensate from certain mineral properties in country. M agreed to purchase G's interest in the n project. Both parties are controlled by A. G received money and retained a "net profits royalty interest" equal to o% of the income from liquified natural gas (LNG) less certain specified expenditures. G received no income from gas delivered to P ( an agency of country), nor from the sale of condensate from the project properties. The instrument creating the "net profits royalty interest" provides that the payments may not exceed the "gross income from the property". For this purpose, the term "gross income from the property" is defined by reference to section 613(c) of the Code

G sold its retained "net profits royalty interest" to C for i. C entered into an exchange with E in which C received D and E received the "net profits royalty" in addition to j land.

## LAW AND ANALYSIS

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 Section 636, production payments.

In Kirby Petroleum v. Commissioner, 326 U.S. 599, 66 S. Ct. 1946, the Supreme Court considered a case in which the owner of fee simple lands leased the property for the production of oil and gas. The taxpayer received a cash bonus, a royalty and a share of the net profits realized by the lessee from their operation under the lease. The Court determined that the taxpayer had retained an economic interest in the property stating " The lessor's economic interest in the oil is no less than when his right is to a share a net profit from its sale than when it is to share the gross receipts." The Court thus views a net profits interest as representing a share of the "gross income from the property" that is measured by net profits.

In Anderson v. Helvering, 310 U.S. 404 (1940), Oklahoma City Co. ("OCC") conveyed various mineral interests to Anderson for a total of \$160,000 in return for a cash payment of \$50,000, and \$110,000 payable from one-half of the production from the property, with one-half of any proceeds from the sale of the land itself to be applied in repayment of any unpaid balance otherwise payable from production. Anderson attempted to exclude from its taxable

income the share of income from production paid to OCC under the theory that OCC had retained an economic interest in the minerals, and therefore, OCC should be taxable on its share of the production from the property. The Court ruled that Anderson should report all of the income, and that the payments to OCC were payments for the purchase of the property from OCC. The Court held that OCC's reservation of an interest in the land, where it had reserved the right to receive a portion of the proceeds of any sale of the fee interest in the land, changed the character of the interest it retained. Therefore, OCC did not have an economic interest in the mineral interests conveyed to Anderson, because OCC had reserved the right to look to a source of income other than from the extraction and sale of the minerals in place.

Similarly, the Fifth Circuit held in Christie v. Commissioner, 436 F.2d 1216 (5<sup>th</sup>. Cir. 1971), that the holder of a production payment did not have an economic interest in the minerals, because he had the option of having proceeds from the sale of equipment applied to repay any outstanding balance on the production payment.

Under both Anderson and Christie the courts have denied economic interest treatment where there is a possibility of sharing in income not solely derived from extraction.

In addition, to Kirby the Courts have ruled in numerous other cases involving net profits interests (e.g., Burton-Sutton Oil Co., Inc. v. Commissioner of Internal Revenue, 328 U.S. 25, 66 S. Ct. 861, 90 L. Ed. 1062 (1946), Commissioner of Internal Revenue v. Southwest Exploration Co., 350 U.S. 308, 76 S. Ct. 395, 100 L. Ed. 347 (1956), Callahan Mining Corporation v. Commissioner, 51 T.C. 1005., Byron H. Fawell v. Commissioner, 35 TC. 454). A review of the factors used to determine the amount of the net profits in these cases shows that those factors vary from case to case and in Callahan Mining the interest even changes over time.

In this case G initially held an economic interest (as defined in section 1.611-1(b)(1) of the regulations). G disposed of a portion of that interest while retaining a "net profits royalty interest". The "net profits royalty interest" is equal to 0% of the income from LNG less stated expenditures. Because the LNG, when sold, had value added by the liquefaction process, the argument is made that G traded its economic interest for an interest in an enterprise whereby G looked to sources other than the mineral property for a return of its capital. Accordingly, applying the reasoning of Anderson and Christie, the "net profit royalty interest" would not constitute an economic interest in the minerals in place. However, under the instrument creating the "net profit royalty interest", payments may not exceed the "gross income from the property" attributable to the project properties. Thus, the instrument provides for payment of a variable portion (up to 100%) of the "gross income from the property", but does not permit payment that would be derived from income beyond that generated by the project properties. Therefore, there

is no alternate source of recoupment of E's investment in the project properties and Anderson and Christie have no application. E's "net profits royalty interest" is an economic interest within the meaning of section 611 of the Code.

**CAVEAT(S)**

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.