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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Production Payment Substantiation

This Field Service Advice responds to your memorandum dated October 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =

SC =

Field 1 =

Field 2 =

Field 3 =

Year 1 =

X =

ISSUE

Whether taxpayer has substantiated that it's investment must be treated as an economic interest in minerals in place, rather than as a loan, in accordance with Treas. Reg. § 1.636-1(b) and the "pool of capital" doctrine.

CONCLUSION

Taxpayer has substantiated its entitlement to treat its investment as an economic interest in minerals in place rather than as a loan.

FACTS

Between Year 1 and Year 3, Taxpayer entered into three separate production payment agreements with a sister corporation ("SC") and claimed depletion on the production payments received. Taxpayer and SC are related entities, both being owned by the same parent corporation. The production payments pertain to certain SC interests located in X.

Under the first agreement, Taxpayer was to advance SC money in exchange for the production payments. Under the agreement, Taxpayer was entitled to be repaid out of production for the amounts that it advanced plus an accrued interest equivalent amount. The payments due to Taxpayer from SC were equal to a percentage of the gross proceeds of sale of the subject mineral, not to exceed a certain amount per calendar quarter, together with an interest component. If SC's obligation to Taxpayer was not discharged within a specified time period from the date of the first production payment, or if at any time the remaining estimated recoverable reserves fell below 50% of the original estimated recoverable reserves, then this limitation would not apply.

Under the second agreement, Taxpayer was to advance SC money in exchange for the production payment from SC. Taxpayer was entitled to be repaid out of production for the amounts that it advanced plus an accrued interest equivalent amount.

Under the third agreement, Taxpayer was to advance SC money in exchange for the production payment from SC. Taxpayer was entitled to be repaid out of production for the amounts that it advanced plus an accrued interest equivalent amount.

The IRS requested documentation from Taxpayer which, among other things, would show the advance payments from Taxpayer to SC and the application of such to the exploration and development costs for all of the fields. Taxpayer provided documentation which did not detail the manner in which the money forwarded through Taxpayer's and SC's affiliates was ultimately credited to SC accounts, and thereafter used for development expenditures from these accounts.

Taxpayer argues, however, that the IRS is attempting to force it to "trace" each dollar of the advance payments to qualify for the Treas. Reg. Sec. 1.636-1(b) exception, and has declined to provide the IRS with such matching information. According to the taxpayer, each production agreement bound SC to use the funds received from Taxpayer for development of the particular field to which the agreement related, and Taxpayer monitored SC's expenditures to make certain that the amounts of pledged money actually were spent on exploration and development pursuant to 636(a).

Taxpayer, therefor, maintains that it only must document that the production agreements were contractual obligations to fund the exploration and development of the related fields, and that it need not submit actual proof that SC applied the advances to the specific exploration and development activities pursuant to section 636(a). Taxpayer relies on Treas. Reg. Sec. 1.636-1(b)(i) through (iv) for this position. That regulatory provision in summary provides: (i) that a production payment shall not be considered as carved out for exploration or development to the extent that the consideration for the production payment is not <u>pledged</u> for use in the future exploration or development of the mineral property (or properties) which is burdened by the production payment; (ii) may be used for the exploration or development of any other property or for any other purpose; (iii) does not consist of a <u>binding obligation</u> of the payee of the production payment to pay expenses of the exploration or development; or (iv) does not consist of a <u>binding obligation</u> of the payee of the production payment to provide services, materials, supplies, or equipment for the exploration or development of the property. (Emphasis supplied). Taxpayer contends that the language of the agreements satisfy these requirements. Taxpayer argues that the legislative history of section 636 and administrative rulings support its position that production payments containing a contractual obligation to use the proceeds for exploration or development of the mineral property are not to be treated as loans.

Taxpayer contends, however, that it did more than merely passively include language in the production agreements in satisfaction of Treas. Reg. Sec. 1.636-1(b): Taxpayer states that SC was required to devote substantial efforts to ensure that the funds were in fact expended for development activities. The parties began this process by identifying the expenditures that qualified as development expenditures under section 636(a). Each of the authorizations for expenditures (AFE's) was examined by Taxpayer to determine whether it involved qualifying expenditures, non-qualifying expenditures, or a combination thereof. SC only billed Taxpayer for the qualifying expenditures. Taxpayer, in turn, monitored the billings and, when necessary, SC adjusted the billings at Taxpayer's request so that all of the expenditures met the requirements of section 636(a). For example, in one instance where the funds were not properly billed, SC refunded the excess amounts to Taxpayer.

As a consequence of Taxpayer's failure to provide the additional documentation requested, the district has proposed adjustments: 1) increasing Taxpayer's taxable income by the interest equivalent amounts that accrued under the three production agreements in the years of accrual; 2) reducing Taxpayer's gross income by the amounts it reported under two agreements (no income was reported with respect to the field covered by the third agreement; and 3) disallowing Taxpayer's depletion deductions claimed with respect to some of the fields.

LAW AND ANALYSIS

The substantive issue

A "production payment" is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when the production occurs. Treas. Reg. § 1.636-3(a). The owner of an operating interest in mineral rights creates a "carved out" production payment when it transfers limited rights to production in exchange for cash or other consideration. The payment is secured by an interest in the minerals, the right to the production is for a period shorter than the expected life of the property, and the payment must be satisfied from production. See id. The payee of a production payment thereby acquires an "economic interest" in the mineral in place similar in treatment to a joint venture interest. Historically, the payee of the production payment took that share of production into income and claimed depletion on the share. Conversely, the owner of an operating interest creating the production payment did not take that share of production into income and could not claim depletion on the production.

Section 636 changed the treatment of production payments in some circumstances. The first sentence of section 636(a) mandates that a carved out production payment shall be treated as a mortgage loan and not as an economic interest in mineral property. The result is that the creator of the production payment must take the periodic payments into income and pay tax on them. The case law, regulations and the legislative history of section 636 make clear that Congress considered creation of the production payment to be in the nature of a loan and intended to prevent the creator from paying such indebtedness with pretax dollars taxable to the payee. Congress did not intend, however, to treat a production payment as valid indebtedness for all purposes under the Internal Revenue Code. See Brountas v. Commissioner, 692 F.2d 152, 160 (1st Cir. 1981); Gibson v. U.S., 81-1 U.S.T.C. 86,425 P 9213. See also H. Rep. 91-413, 1969-3 C.B. 288 and S. Rep. 91-552, 1969-3 C.B. 540. See also Guardian Investment Corp. v. Phinney, 253

F.2d 326, 331 (5th Cir.1958) ("mortgage loan" is not "an indebtedness" within the meaning of the Code"). Cf. Treas. Reg. 1.636-1(a)(1)(i).[1]

Congress also excepted from mortgage loan treatment "a production payment carved out for exploration or development of mineral property," to the extent such production payments would not be taxable to the creator of the production payment in the absence of the first sentence of section 636(a). This exception from mortgage loan treatment incorporates the preexisting law that held, under the "pool of capital doctrine," that a production payment in exchange for a pledge to pay for drilling and developing activities provided the payee of the production payment with an economic interest in mineral in place.

Under the "pool of capital doctrine" money advanced or exchanged for future payments from mineral production was considered a capital investment in the development and production of oil and gas property (analogous to a capital contribution to a partnership). Thus, the payee reports his share of production as income and claims depletion on this income to recover his capital investment. The payee is accorded this treatment, however, only if the payee has acquired an "economic interest" in the minerals in place, that is only if the payee has pledged the money advanced to the payor for exploration and developed activities.

In order to have the requisite "economic interest" in the property, the payee must acquire "by investment," an interest in the oil in place, and secure, by any form of legal relationship, income derived from the extraction of oil, to which he must look for a return of capital. Treas. Reg. § 1.611-1(b); Palmer v. Bender, 287 U.S. 551, 557 (1933)[2]. The rationale for finding that a taxpayer has an economic interest in mineral in place in this circumstance is that the oil in the ground represents "a reservoir of capital investment" that can be recovered only through production. Id. at 558.

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[1]This regulation provides in part:

> in the case of a transaction involving a production payment treated as a loan pursuant to this section, the production payment shall constitute an item of income (not subject to depletion), consideration for a sale or exchange, a contribution to capital, or a gift if in the transaction a debt obligation used in lieu of the production payment would constitute such an item of income, consideration, contribution to capital, or gift, as the case may be.

[2]In Palmer v. Bender, the taxpayer explored and developed the subject property, transferred it to a producer, and retained a production payment.

Treas. Reg. § 1.636-1(b) endorses preexisting law and further provides that "[w]hether or not a production payment is carved out for exploration or development shall be determined in light of all relevant facts and circumstances." The regulation points out that a production payment "shall not" be treated as carved out for exploration or development to the extent that the consideration for the production payment is not pledged for use in future exploration or development, may be used for another purpose, or the recipient does not have a binding obligation to use the funds for exploration or development. These same requirements are reflected in the legislative history of section 636[3] and GCM 22730, 1941-1 C.B. 214.

Substantiation

We conclude that Taxpayer has sufficiently substantiated that an interest in oil in place was acquired "by investment" pursuant to the second sentence of section 636. Taxpayer appears to have provided the relevant records in its possession that show actual monies devoted to the requisite exploration and development activities. Moreover, it appears that Taxpayer monitored SC's billings to ensure that the pledged funds were expended only for appropriate activities. Our limited review of a sample billing and reconciliation statements, provided by your office, indicates further that actual development expenditures occurred. Accordingly we believe no further substantiation is required or under current legal principals can be required.

HAZARDS OF LITIGATION AND INSTRUCTIONS TO THE FIELD

[redacted]

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[3] H. Rep. 91-413, 1969-3 C.B. 288 and S. Rep. 91-552, 1969-3 C.B. 540.

[4] [redacted]

[redacted]

Please call if you have any further questions.

By: ______________________________
PATRICK PUTZI
Special Counsel (Natural Resources)