

Internal Revenue Service

Department of the Treasury

Number: **200240036**
Release Date: 10/4/2002
Index Number: 636.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B07-PLR-123132-02

Date:

June 27, 2002

A =
B =
C =
d =
e =
f =
g =

Dear :

A acquired oil and gas working interests in leases located in the C and equipment from the predecessor of B. The consideration A paid included (i) an initial cash payment and (ii) additional payments pursuant to a Recourse Promissory Note payable based on the actual Section 29 credits produced plus interest.

Prior to the assignment of the Assets to A, B transferred two carved-out production payments burdening the Subject Interests to an affiliate of B. The Senior Production Payment was dollar denominated and the Junior Production Payment was volumetric. Also, B agreed to manage the Subject Interests pursuant to a Management Services Agreement. The Senior Production Payment terminated on d. A and B expect that the Junior Production Payment will terminate in e.

B will purchase from A a volumetric production payment burdening the Subject Interests pursuant to the terms of the purchase and sale Agreement. The parties will agree to several changes to the documents from the original transaction in order to accommodate the creation of the Production Payment.

The closing date of the Production Payment will occur after a number of conditions precedent have been satisfied, including the receipt of a favorable private letter ruling in response to this request. The Production Payment will be a volumetric production payment entitling B, as owner, to 100% of the monthly net profits attributable to the Subject Interests, beginning at 7:00 a.m. on the day the Junior Production

PLR-123132-02

Payment ends, through the hour of the day on which MMBtu's have been produced and sold from the Subject Interests from April 1, 1998. As consideration for the Production Payment, B has agreed to pay A at closing a purchase price equal to \$g plus an adjustment amount that is a function of natural gas prices. The Production Payment will be payable solely from production attributable to the Subject Interests and not from any other source. The estimated present value of the production attributable to the Subject Interests after the expiration of the Production Payment will represent approximately 56% of the present value of the entire production from the Subject Interests as of April 1, 2002. The 2002 Production Payment is limited by a quantum of mineral (a specified amount of production equal to 17.9% of the estimated recoverable reserves as of April 1, 2002).

On the basis of the foregoing facts, you requested the following rulings:

- (1) The purchase of the Production Payment by B and the amendments to the 1998 Transaction agreements do not affect A's ownership of the entire economic interest in the Subject Interests for purposes of Sections 29(d)(3) and 611 of the Code and the Treasury Regulations (the "Regulations") thereunder.
- (2) The Production Payment is properly characterized as a mortgage loan for purposes of Section 636 and the Regulations thereunder.
- (3) A will continue to be entitled to claim all Section 29 tax credits attributable to the Subject Interests.

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.

Section 636(a) and § 1.636-1(b)(2) provide that a carved out production payment is treated as a 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

PLR-123132-02

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 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.

In this case, A will carve out a production payment that is limited to a stated percentage of the reserves currently known to exist at the time the transaction is consummated.

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. Accordingly, based on the information submitted and the representations made, the production payment meets the requirements of § 1.636-3(a)(1) and is treated as a mortgage loan.

Since a production payment is treated as a loan A has not disposed of its economic interest in the property. Therefore the production from the properties will be attributable to A.

Based on your representations we conclude that:

- (1) The purchase of the Production Payment by B and the amendments to the 1998 Transaction agreements do not affect A's ownership of the entire economic interest in the Subject Interests for purposes of Sections 29(d)(3) and 611 of the Code and the Treasury Regulations (the "Regulations") thereunder.
- (2) The Production Payment is properly characterized as a mortgage loan for purposes of Section 636 and the Regulations thereunder.
- (3) A will continue to be entitled to claim all Section 29 tax credits attributable to the Subject Interests.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

PLR-123132-02

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Joseph H. Makurath

Senior Technician Reviewer

Office of Associate Chief Counsel

(Passthroughs and Special Industries)