INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

JAN 29 1999

Index (UIL) No.: 611.00-00
Case Mis No.:
CC:Dom:P&SI:B07
TAM-116007-98

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

A =
B =

c =

ISSUE(S): Does A have an economic interest in the minerals in place?

CONCLUSION: A does have an economic interest.

FACTS:

B, an electric utility, had plans to build an electric power plant. As part of their plans B acquired nearby lignite reserves through a combination of ownership and leases.

B then entered into two agreements with A. Under the Grant of Operating Rights A had the exclusive right to mine the property. A would pay a royalty to B. A was entitled to sell the lignite to third parties but B retained the right of first refusal on any lignite mined. The Grant of Operating Rights states that the purpose of the grant is to transfer an economic interest to A. B

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claims depletion or treatment under section 631 of the Internal Revenue Code with respect to royalty amounts it receives from A. A claims depletion with respect to amounts received from sale of lignite to B, excluding amounts paid to B as royalties.

Under the Lignite Mining Agreement, A agreed to mine and sell lignite to B. Under the agreement, the price of the lignite was determined by a formula. B determined the tonnage of lignite it would buy each year, subject to upper and lower limits, prescribed by the agreement, on what that tonnage would be. The mining agreement also had a clause that in the event that B was unable to accept delivery of the lignite, because of Force Majeure, B (after a specified lapse of time and for the duration of the existence of the Force Majeure) would pay to A, c% of the current selling price of the lignite contracted for, but not accepted.

LAW AND ANALYSIS:

Section 611(b)(1) of the Code provides that in the case of a lease, the allowance for depletion shall be equitably apportioned between the lessor and lessee.

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 Anderson v. Helvering, 310 U.S. 404 (1940), the 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.

In Christie v. Commissioner, 436 F.2d 1216 (5th. Cir. 1971), the Fifth Circuit held 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.

The Anderson and Christie cases thus lead to the conclusion that where a taxpayer acquires a mineral property but can look to a source of income other than the extraction of mineral for recovery of the taxpayer's investment, the taxpayer does not have an economic interest.

In contrast, sections 1.612-3(b)(2) and 1.631-3(c)(2) of the regulations provide for a restoration to ordinary income of amounts taken as depletion (capital gains in the case of coal and iron ore) on advanced royalties when units paid for are not extracted before termination of the lease. Although the regulations do not allow depletion on income from mineral not extracted, the regulations do not void the taxpayer's economic interest for having received income not directly attributable to those units.

In Freede v. Commissioner, 864 F.2d 671 (10th. Cir. 1988), the purchaser agreed to pay for a specified minimum quantity of gas each year, without regard to whether it took physical delivery of the gas. If the amount of gas paid for under the take-or-pay provision exceeded the amount of gas actually taken from Freede's wells, the purchaser had the right to credit the excess payment against extra gas taken in later periods. The purchaser, however, would lose the benefit from any excess payments that it did not recoup by taking extra gas within the required period. The court likened the excess payments to pre-determined damages payable to the producer for gas that was not taken as expected.

The court refused to hold that payments made pursuant to a sales contract created production payments for purposes of section 636(a) of the Code. Instead, the court required the taxpayer receiving the excess payments (which are the amounts attributable to volumes paid for but not taken; i.e., amounts received by the holder of the economic interest other than for the production of minerals) to report such amounts as income. There was no question raised as to whether receipt of payments under the take-or-pay contract negated the seller's retained economic interest.

Considering the provisions of the regulations regarding advanced royalties and the conclusion of the court in Freede, we conclude that Anderson and Christie may not be interpreted

as necessarily voiding an economic interest in every case where the owner of a mineral property may receive payment not directly attributable to extraction. An economic interest is not voided, for instance, where the taxpayer is merely selling mineral under a requirement that the buyer make specified minimum payments.

In Revenue Ruling 72-477, 1972-2 C.B. 310, a taxpayer leased coal land from a utility and entered into a contract to sell coal to that utility in a situation very similar to the present case. The Service ruled that the taxpayer had acquired an economic interest. Unlike the present case, the situation described in the revenue ruling does not mention a Force Majeure clause. Nevertheless, the revenue ruling recognizes that a lessee may enter into a contract for sale of mineral to the lessor without voiding the lessee's economic interest.

If the Grant of Operating Rights and the Lignite Mining Agreement are considered as parts of one transaction, the potential for income from implementation of the Force Majeure clause could be viewed as an alternate source of income and, following Anderson and Christie, A would not have an economic interest.

If the two transactions are viewed as separate (or if A had contracted to sell lignite to a third party) A would be in a situation similar to the taxpayer in Freede, that is, being paid for units of mineral not produced.

Under the facts and circumstances of this case, we conclude that the Grant of Operating Rights and the Lignite Mining Agreement provide for a fair apportionment of the depletion allowance between lessor and lessee (within the meaning of section 611(b)(1) of the Code) in a manner similar to the situation described in Rev. Rul. 72-477 in which the lessee merely contracted for the sale of mineral to the lessor. Accordingly, we conclude that A has acquired an economic interest with respect to the subject mineral property.

CAVEAT(S)

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