Federal Tax Aspects of Financing Techniques for the Development of Natural Resources

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FEDERAL TAX ASPECTS OF FINANCING TECHNIQUES FOR THE DEVELOPMENT OF NATURAL RESOURCES

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The acquisition, exploration, and development of properties for the production of oil, gas, coal, and other natural resources require the investment of considerable capital and often involve the assumption of considerable risk, particularly with respect to previously undeveloped properties. The owners and operators of such properties, particularly oil and gas properties, have utilized a variety of techniques (in addition to the usual debt financing) for financing the development of the properties and for spreading the associated risk. For several decades, the enactment of federal income tax legislation by Congress and favorable interpretations of those laws by the Treasury Department have provided various incentives for the exploration and development of domestic natural resources.¹

The selection of the particular financing technique involves considerations of tax, economic, and other factors. Of course, the tax considerations can affect materially the anticipated income to be realized on the investment of capital, and often determine the form and feasibility of the particular investment in the property. While a comprehensive treatment of the federal income tax aspects of natural resources is beyond the scope of this article, it is necessary to summarize briefly some of the principal deductions and exclusions from income that are considered in the financing of the acquisition, exploration, and development of the properties.²

TAX BENEFITS

Depletion of Properties

Oil, gas, coal, and other minerals in place are wasting assets, which are physically consumed or exhausted by development of, and production from, mineral properties. In addition to the depreciation

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1. Recent legislation and administrative interpretations seem to exhibit a negative attitude toward the oil and gas industry. See, e.g., I.R.C. §§ 4986-98 & 613A; Rev. Rul. 77-176, 1977-1 C.B. 77.

2. This discussion of principal deductions and exclusions does not apply with respect to timber.

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allowance for the use of physical properties, the Internal Revenue Code\(^3\) provides for an annual allowance in determining the owner's taxable income for the depletion of the mineral reserves; the depletion allowance is intended to return the capital investment in the reserves consumed in the production of income.

The courts long have recognized that several persons may have an interest in the production of minerals from the property, and have required that the taxpayer have an economic interest in the minerals in place, rather than legal title under state property law, in order to qualify for the depletion allowance.\(^4\) The Code merely provides for the deduction of a reasonable depletion allowance, which is to be made under regulations prescribed by the Treasury, and states that, in the case of a lease, the deduction shall be apportioned equitably between the lessor and lessee.\(^5\) The regulations provide that annual depletion deductions are allowed to the owner of an economic interest in mineral deposits under a lease or other contract providing for the sharing of economic interests; an economic interest consists of an interest, acquired by investment in the minerals in place, entitling the owner to income derived from the extraction of the minerals, to which he must look for a return of his capital.\(^6\)

For example, if a landowner grants a mineral lease on his land for an initial cash payment (referred to as a "bonus") and reserves a royalty of one-eighth of the minerals produced from the property or their value, both the lessee (the owner of the seven-eighths operating rights or working interest) and the lessor (the owner of the one-eighth royalty) have economic interests in the minerals in place, and are entitled to depletion allowances on their respective shares of the gross income from the minerals produced and sold.\(^7\) In the event the lessee subsequently should assign his operating or working interest for a cash "bonus" and reserve an overriding royalty of one-sixteenth of the seven-eighths operating or working interest, the additional royalty carved out of the operating or working interest would be a depletable economic interest in the minerals in place.\(^8\) The cash bonuses received by the lessor and sublessor have

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3. The Internal Revenue Code of 1954 will hereinafter be referred to as the Code in both the text and the notes.
5. I.R.C. § 611(a).
6. A person who does not invest in the mineral deposit, but merely enters into a contract to purchase or process the product or to receive compensation for extraction, does not have a depletable economic interest. Treas. Reg. § 1.611(b)(1) & (c)(2) (1965).
been held to be advance royalties from future production from the property and, therefore, constitute ordinary income subject to deple-
tion.9

The amount of the depletion allowance is either (1) an allocated portion of the adjusted basis of the mineral property (usually the cost), which is based on the number of units produced and sold during the taxable year in relation to the total estimated recoverable reserves (cost depletion);10 or (2) a statutory percentage of the gross income from the mineral property (excluding rents or royalties paid or incurred) during the taxable year, but not in excess of 50 percent of the taxable income before depletion from the mineral property for the year (known as percentage depletion),11 whichever allowance is greater.12 Congress has repealed percentage depletion with respect to oil and gas properties, except for certain fixed-price and regulated gas contracts, geothermal deposits, geopressured brine, and limited quantities of domestic oil and gas production for taxpayers who are not large retailers or refiners.13 The amount of percentage depletion is determined without reference to, but reduces, the basis of the property, and any excess depletion over the adjusted basis of the property at the end of the taxable year is considered to be an item of tax preference subject to the minimum tax.14

Intangible Drilling Costs (Oil and Gas)

As an exception to a provision15 disallowing the deduction of certain capital expenditures, the Code states that the Treasury may grant the option to a taxpayer to deduct as expenses the intangible drilling and development costs for oil and gas wells.16 The regulations provide that the owner of an operating or working interest may take advantage of this option. Intangible expenditures are for

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9. Herring v. Commissioner, 293 U.S. 322 (1934). If the lease terminates or is abandoned before any income is derived from production, the lessor and sublessor must restore the amount of the depletion deductions to income and the basis of the property at that time. Douglas v. Commissioner, 322 U.S. 275 (1944); Treas. Reg. § 1.612-3(a)(1) & (2) (1977).
11. I.R.C. § 613. Gross income is the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well or sells the solid minerals prior to the application of non-mining processes (including non-mining transportation). Treas. Reg. §§ 1.613-3(a), 1.613-4(a), (c) & (g) (1972). See United States v. Cannelton Sewer Pipe Co., 364 U.S. 76 (1960).
13. I.R.C. § 613A.
14. I.R.C. §§ 56(a) & 57(a)(8).
15. I.R.C. § 263.
wages, fuel, repairs, hauling, supplies, and other items, which are incidental to, and necessary for, the drilling and the preparation of wells for the production of oil or gas. The option applies only to those items that, in themselves, do not have a salvage value; but the option covers expenditures for the clearing of ground and geological work in preparation for the drilling of the wells, and such expenditures incurred in the construction of derricks, tanks, pipelines, and other physical structures as are necessary for drilling and the preparation of the wells for production. These expenditures usually constitute the major part of the costs of drilling an oil or gas well prior to completion.

With respect to taxpayers other than corporations, the amount by which the "excess intangible drilling costs" exceed the taxpayer's net income from oil, gas, and geothermal properties for the taxable year constitutes an item of tax preference subject to the minimum tax. The "excess intangible drilling costs" are the excess of intangible drilling costs for producing wells over the amount that would have been allowable for the taxable year, if such costs had been capitalized and amortized over a period of 120 months from the date production commenced, or, if the taxpayer so elects, over the period that may be used to determine cost depletion.

In the event of the disposition of the property, all taxpayers (including corporations) are required to recapture as ordinary income (but not in excess of the gain realized) the aggregate amount of intangible drilling expenditures deducted for productive wells after December 31, 1975, less the amount that would have been deducted as cost depletion if the expenditures had been capitalized as part of the adjusted basis of the property.

**Exploration Costs**

The Internal Revenue Service has ruled that geological and geophysical exploration costs associated with mineral properties constitute capital expenditures. The costs of preliminary geological and geophysical surveys in a single, integrated project area must be

17. Treas. Reg. § 1.612-4(a) (1972). The option is exercised by deducting intangible drilling costs on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs such costs. The election is binding for subsequent years. If the taxpayer fails to deduct such costs, he is deemed to have elected to capitalize such costs and will recover them through depletion of the leasehold and depreciation of physical properties.


19. I.R.C. § 1254. Dispositions by gifts, transfers at death, and certain non-taxable transactions are not subject to the recapture provisions. I.R.C. § 1245(b).
allocated equally among the various areas of interest. The areas of interest are the separate non-contiguous portions of the project area selected for further extensive exploration. In the event the taxpayer acquires leases within an area of interest, the costs of the additional, detailed surveys of the particular area of interest, and the preliminary survey costs allocated to that area, then are allocated on a net acreage basis to the properties acquired as the result of the surveys. Such preliminary and direct costs are capitalized as part of the leasehold costs and are recoverable through the allowance for depletion. With respect to the exploratory work in connection with those areas of interest as to which no leases are acquired, the taxpayer may deduct the costs as losses from the abandonment of the properties. The costs of geological work in determining the location of an oil or gas well and in preparing for drilling are included within the option to deduct intangible drilling and development expenditures.

With respect to mines other than oil and gas wells, the Code specifies that the taxpayer may elect to deduct expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any domestic deposit of ore or other mineral, provided that such costs are paid or incurred before the beginning of the development stage. The provision does not apply to expenditures for the acquisition or improvement of property that is subject to depreciation, but allowances for depreciation are considered as exploration expenditures. The development stage of the mine begins when deposits of ore or other minerals are disclosed in sufficient quantity and quality to justify reasonably commercial exploitation by the taxpayer.

If the taxpayer elects to deduct exploration expenditures when paid or incurred, such expenditures are subject to recapture when the mine reaches the producing stage or when the property is transferred. A mine is considered to have reached the producing stage when:

22. The total deduction is limited to $400,000 for exploration expenditures for minerals located outside the United States.
23. I.R.C. § 617(a) & (h)(1). A taxpayer may exercise this election by deducting such costs in his return for the first year in which he desires to do so, or in an amended return which is filed before the expiration of the period for filing a claim for credit or refund of income tax for such year. The election is binding for all exploration costs in subsequent years, unless revoked with the consent of the commissioner. I.R.C. § 617(a)(2)(B); Treas. Reg. § 1.617-1(c)(1) & (2) (1972).
25. I.R.C. § 617(b) & (d).
workings other than those opened for the purpose of development; or (2) the principal activity of the mine is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.\textsuperscript{26}

When the mine reaches the producing stage, the taxpayer may elect to recapture the exploration expenditures by including an amount equal to the "adjusted exploration expenditures" in income (but not depletable income) for the taxable year. The amount included in income is treated as expenditures incurred at the time the mine reaches the producing stage, and such expenditures are capitalized as additional basis of the property recoverable through depletion. If the taxpayer does not elect to include the expenditures in income, the taxpayer's deduction for depletion with respect to the property is disallowed until the amount of depletion otherwise allowable equals the amount of the "adjusted exploration expenditures" with respect to the mine. The basis of the property is not reduced by the depletion otherwise allowable.\textsuperscript{27} The "adjusted exploration expenditures" with respect to a mine are the aggregate amount of the expenditures allowed as deductions to the taxpayer, reduced by the excess of (1) the amount of percentage depletion that would have been allowable (except for the deduction of such expenditures in determining the 50 percent of net income limitation), over (2) the amount allowable for depletion.\textsuperscript{28}

If the property is disposed of (except by gift, transfer at death, or certain non-taxable transactions), the lower of (1) the "adjusted exploration expenditures" with respect to the property, or (2) the excess of the amount realized from the sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition) over the adjusted basis of the property, shall be treated as ordinary income not subject to depletion.\textsuperscript{29}

\textit{Development Costs (Mines)}

The Code provides that a taxpayer may deduct all expenditures paid or incurred during the taxable year, and after the determination

\textsuperscript{26} Treas. Reg. § 1.617-3(c)(2) (1972).
\textsuperscript{27} I.R.C. § 617(b)(1) & (e)(1); Treas. Reg. § 1.617-3(a)(2) (1972). The election to include the "adjusted exploration expenditures" in income applies to all mines reaching the producing stage during the taxable year, and the taxpayer exercises the election by a clear indication on his return for such year not later than the time prescribed for filing the return (including extensions). A taxpayer is entitled to a new election with respect to such expenditures in each year. I.R.C. § 617(b)(1) & (2); Treas. Reg. § 1.617-3(b) (1972).
\textsuperscript{28} Treas. Reg. § 1.617-3(d)(1) (1972).
\textsuperscript{29} I.R.C. § 617(d)(1).
of the existence of ores or minerals in commercially marketable quantities, for the development of a mine (other than an oil or gas well). The provision does not apply to expenditures for the acquisition or improvement of property that is subject to depreciation, but allowances for depreciation of such property are considered as development expenditures.\textsuperscript{30} The Internal Revenue Service has ruled that the expenditures are those directly resulting from physical operations, such as the driving of shafts, tunnels, or galleries, and similar operations undertaken to make ore or minerals in place accessible for production.\textsuperscript{31} The taxpayer may elect to defer the deduction of the expenditures in any year with respect to a particular mine, and deduct such expenditures ratably when the units of produced ores or minerals are sold.\textsuperscript{32}

The taxpayer may deduct development expenditures, whether or not such expenditures are made in the development or production stage of the mine or other natural deposit. While the mine is in the development stage, the election applies only to that portion of the development expenditures which is in excess of the net receipts from the mine or deposit. The mine or deposit will be considered to be in a producing stage when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or deposit is the production of the developed ores or minerals rather than the development of additional ores or minerals for mining.\textsuperscript{33}

\textbf{FINANCING TECHNIQUES}

The owners of operating rights or working interests in minerals have availed themselves of a variety of techniques to finance the cost and spread the risk of exploration and development, particularly in the oil and gas industry.

\textsuperscript{30} I.R.C. § 616(a).
\textsuperscript{32} I.R.C. § 616(b). The election to defer development expenditures applies only to expenditures for the mine in that taxable year, is binding with respect to the expenditures, and cannot be revoked. The election is exercised by a clear indication on the return not later than the time prescribed for filing the return (including extensions) for the taxable year. Treas. Reg. § 1.616-2(a) & (e) (1960). The deferred expenditures are considered in determining the adjusted basis of the mine or deposit except for the purpose of determining depletion. I.R.C. § 616(c).
\textsuperscript{33} Treas. Reg. §§ 1.616-1(a) & 1.616-2(b) (1960).
Assignment of Interest

If the owner decides not to develop the property, possibly because of unfavorable geological data or lack of funds, he could sell the operating or working interest under the lease to another party; if the owner had held the property for more than one year, he probably would realize long-term capital gain or ordinary loss on the transaction to the extent the consideration received exceeds or is less than his basis in the property.\textsuperscript{34}

If he believes the property has potential for production but he does not wish to bear the cost and risk of development, he could "farm-out" the property; that is, he could assign the interest to another party, subject to the obligation to develop the property within a specified period, and reserve a non-operating interest which continues for the life of the lease (such as an overriding royalty). The operating or working interest may be assigned when the contract is entered into or when the obligation to develop the property is satisfied. This transaction is considered a sublease (except with respect to certain coal and iron ore properties), and the sublessor's basis in the leasehold becomes the basis of the retained interest. The sublessor realizes ordinary income, subject to the depletion deduction, on any proceeds realized from his share of production of the minerals.\textsuperscript{35} If the assignor reserves an interest in the minerals that does not continue for the life of the lease (such as a production payment limited to a specific quantity or amount), the transaction is considered to be a sale of the operating or working interest in the lease.\textsuperscript{36} Since the assignee or sublessee owns the entire operating or working interest under these sale and lease arrangements, he is entitled to deduct all of the intangible drilling and development costs of an oil or gas well, or he may deduct expenditures for exploration (subject to recapture) and development of a mine.\textsuperscript{37}

In 1941, the Internal Revenue Service issued a comprehensive ruling on the status of oil and gas leasing transactions, the acquisition and assignment of interests in mineral properties, and the division of income among the parties. The ruling considered the "farm-

\textsuperscript{34} I.R.C. § 1231(a).
\textsuperscript{35} Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25 (1946); Rev. Rul. 69-352, 1969-1 C.B. 34. See Treas. Reg. § 1.612-4(a) (1972). With respect to coal and iron ore, the royalty owner will realize long-term capital gain or ordinary loss on the disposal thereof after a period of more than one year. I.R.C. §§ 631(c) & 1231(a).
\textsuperscript{36} Cullen v. Commissioner, 118 F.2d 651 (5th Cir. 1941); Hammonds v. Commissioner, 106 F.2d 420 (10th Cir. 1939); Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936). See I.R.C. § 636(b).
out” arrangement, and reasoned that the assignor (or sublessor) “has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person.”38 The assignee (or sublessee) has contributed to the “reservoir of the capital investments of the several parties entitled by agreement to share in the oil and gas produced under the lease.”39 Therefore, neither the sublessor nor the sublessee realized gain or loss on the assignment. The principles apply equally to similar transactions involving other natural resources.40

In some situations the owner retains the operating interest, but assigns non-operating interests to third parties in consideration of the furnishing of materials, services, or funds for the development of the property. Subsequently interpreting its earlier ruling, the Service recently stated that

when drillers or equipment suppliers and investors contribute materials and services in connection with the development of a mineral property in exchange for an economic interest in such property, the receipt of the economic interest does not result in realization of income. The contributors are viewed as not performing services for compensation, but as acquiring capital interests through an undertaking to make a contribution to the pool of capital . . . . With respect to the transferor of the economic interest . . . such transferor has parted with no capital interest but has merely given the transferee (driller, equipment supplier, or investor) a right to share in production in consideration of an investment made.41

In the event the owner wished to retain part of the operating or working interest, he could transfer a fraction of the interest to another party and enter into an agreement providing for the joint development and operation of the property and the proportionate sharing of the resulting income and costs. The transaction is considered as a sale of an undivided fractional interest in the minerals; the seller may realize long-term capital gain or ordinary loss to the extent the consideration received exceeds or is less than the basis

38. G.C.M. 22730, 1941-1 C.B. 214, 221.
39. Id. at 216.
40. Id. at 219. See Dearing v. Commissioner, 102 F.2d 91 (5th Cir. 1939).
41. Rev. Rul. 77-176, 1977-1 C.B. 77, 78. The reaffirmation of G.C.M. 22730 by the Service is interesting in view of the fifth circuit’s decision in United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), which resulted in confusion as to the taxability of an interest in mineral property received for a contribution of services, particularly with respect to an interest in a partnership. See Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).
allocated to the transferred interest, provided that the property has been held for more than one year. The parties can elect out of the partnership provisions of the Code, and thus individually report their respective shares of income and expenses for federal income tax purposes.

In some situations the agreement may provide that the assignee of an undivided fraction of the operating or working interest under the lease shall pay all of the costs of drilling and completing the initial well or developing the first mine on the property, or an amount of the costs that is more than the assignee's proportionate interest in the property. The assignor's interest is thus "carried." When the assignee of an operating or working interest "carries" the assignor for some or all of the costs of developing and operating the property attributable to the assignor's interest, the Internal Revenue Service takes the position that the "carrying party," the assignee, can deduct only his share of the intangible drilling and development costs and the depreciation of equipment for an oil or gas well or the development and depreciation costs for a mine; he must capitalize the excess of such costs over the costs attributable to his interest in the property as part of the cost of acquiring the leasehold interest.

However, the assignor may assign all of the operating or working interest to the assignee, or a fraction proportionate to the share of the costs to be borne by the assignee, until the assignee recovers his development and operating costs from the production from the property, at which time a fraction of the working interest reverts to the assignor; in this situation the assignee may deduct his intangible drilling and development costs and operating costs of an oil or gas well, or the development and operating costs of a mine, during the complete payout period. For example, if the assignee is to bear all of the intangible drilling and development costs and to furnish all of the equipment for an oil and gas well, and the assignor assigns all of the working interest to the assignee until he recovers his development and operating costs, at which time one-half of the working interest reverts to the assignor, the assignee would be entitled to deduct all of the costs incurred, since he owned the entire working interest during the complete payout period.

42. Badger Oil Co. v. Commissioner, 118 F.2d 791 (5th Cir. 1941).
43. I.R.C. § 761(a).
44. Treas. Reg. §§ 1.612-4(a) (1972); 1.616-1(b)(3) (1960); 1.617-1(b)(3) (1972).
45. Rev. Rul 71-207, 1971-1 C.B. 160; 69-332, 1969-1. The assignor acquires an interest in the equipment at the time of reversion, but has no basis for a depreciation deduction. G.C.M. 22730, 1941-1 C.B. 214. It would appear that the assignee could amortize the basis of the reversionary interest in equipment over the life of the property, rather than adding the amount to the depreciable basis of the leasehold interest. See Choate v. Commissioner, 324 U.S. 1 (1945).
An oil and gas lease (or leases) often covers a significant number of acres on which the drilling of several wells may be contemplated. In such cases the lessee, in consideration for the drilling and completion of the initial well to a specified depth at a designated location, frequently assigns to another party the entire working interest in the spacing unit assigned to the well by the state regulatory body, subject to the reservation of an overriding royalty interest in the property, and also assigns an undivided one-half of the working interest in the remaining acreage under the lease (or leases). The overriding royalty in the drill site may be converted by the assignor to an undivided one-half of the working interest, after the assignee has recovered his costs of drilling, completing, and operating the well out of the proceeds from the entire working interest.

Consistent with its previous position on "farm-out" arrangements, the Internal Revenue Service recently ruled that, since the assignee receives the entire working interest in the drill site during the complete payout period, he may deduct all of the intangible drilling and development costs, depreciation of the equipment, and operating costs incurred during this period. Neither the assignor nor the assignee realizes any income from the assignment, since the assignee merely has contributed to the pool of investment capital in the property, and the assignor has not disposed of a capital interest but simply has reduced the required investment and the risks related to the development of the drill site. The doctrine providing for the non-taxability of such a transaction is referred to appropriately as the "pool of capital" concept.

However, in a radical departure from previous interpretations, the Service also ruled that the working interest in the acreage outside the drill site is a separate property; since the drilling of the well does not represent a capital investment in the development of this separate property, the federal income tax consequences are not determined under the "pool of capital" concept. The assignor is considered to have sold the undivided one-half interest in this property for its fair market value on the date of transfer, and to have paid the cash proceeds to the assignee as compensation for the development by the assignee of the drill site. If the property has been held for a period of more than one year, the assignor probably will realize long-term capital gain or ordinary loss to the extent the fair market value of the interest on the date of transfer exceeds or is less than the adjusted basis allocated to the interest. The assignee has received compensation in the form of property for the development of the drill site. Since the rights to receive the assignment of the working interest were conditioned upon the abandonment or completion of the well, the fair market value of the working interest, determined as of the date of transfer, is includible in the gross
income of the assignee in the year the well was completed or when the working interest was received, whichever is earlier.

To lessen the harsh tax consequences of this recent ruling, it may be advisable for the assignor to assign the interest prior to the development of the property in order to minimize any possible appreciation in the property's fair market value. The assignor's adjusted basis in the overriding royalty interest reserved in the drill site should be increased by the fair market value of the undivided one-half working interest in the acreage exclusive of the drill site on the date of the transfer of the working interest to the assignee.

Production Payment

One of the most widely utilized techniques for the financing of the development of natural resources is the assignment by the owner of the operating or working interest of a production payment from the property. A production payment is the right to a specific share of the production from minerals in place (if, as, and when produced) or the proceeds from such production. Such 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 mineral properties burdened thereby. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time.

The production payment is a non-operating interest, which is not burdened with the costs of development and production, created out of a larger operating or non-operating interest. A production payment is similar to a royalty interest, except that its duration is shorter than the economic life of the property, and it is usually for a primary sum plus interest at a specified rate on the unpaid balance.

The owner of a mineral interest may assign the mineral interest to another party, subject to the reservation or retention of a production payment in the property, or he may create or carve a production payment out of a larger interest and assign this payment to another party for a consideration.

Prior to the Tax Reform Act of 1969, the production payment was considered to be an economic interest in the minerals in place, provided that it was not guaranteed by a party to the transaction and that it could not be satisfied from any source other than the production from the particular property. The production payment

was considered as a limited royalty interest; therefore, the amount realized from production and applied to satisfy the production payment was excluded from the gross income of the owner of the operating or working interest and was ordinary depletable income to the owner of the production payment.

The exclusion from income made possible the acquisition of the operating or working interest in substantial, valuable properties for a considerably smaller investment ("front-end" money), subject to the reservation of a substantial production payment. Since the proceeds applicable to the production payment were excluded from the gross income of the working interest owner, the satisfaction of the production payment (and the financing of the acquisition) could be accomplished with the use of pre-tax income. If the transferor wished to convey the entire property, he could convey the production payment simultaneously to another party (a "middle-man"), who usually would finance the purchase with a loan from a lending institution; as a result the transferor probably would realize capital gain to the extent the total consideration received exceeded the adjusted basis in the mineral property.49

When a production payment was carved out of a larger property interest and conveyed to another party for consideration (usually cash), the United States Supreme Court upheld the position of the Internal Revenue Service to the effect that the transaction was the anticipation of future ordinary income from the property subject to the depletion deduction in the taxable year of the transfer.50 The sale of carved-out production payments frequently was employed by taxpayers to anticipate ordinary income in order to utilize expiring net operating losses and to maximize the percentage depletion deduction for a property in a particular year when the 50 percent of net income limitation on percentage depletion otherwise would be applicable.

In order to prevent the satisfaction of a production payment with "tax-free dollars" and "the avoidance of the limitation on percentage depletion deductions,"51 Congress amended the Code to provide that, with respect to production payments created after August 7, 1969, a production payment carved out of a mineral property, or a production payment retained on the sale of a mineral property, shall be treated as if it is a mortgage loan on the property, and will not qualify as an economic interest in the property for

49. The three-party transaction is commonly referred to as the "ABC transaction."
purposes of the depletion deduction. The net effect of the provision is that the purchaser of mineral property subject to a retained production payment cannot exclude from his gross depletable income the proceeds of production from the property accruing to the owner of the production payment. Such proceeds relate to the payment of a loan secured by production rather than the share of production attributable to an economic interest in the property. As a consequence, the purchaser will satisfy the production payment loan with after-tax income.

Also, the seller of a carved-out production payment will realize proceeds from a loan secured by the production from the property rather than anticipated ordinary depletable income therefrom. The owner of the operating or working interest can deduct the interest element of the production payment and all costs of operating the property. The owner of mineral property, who transfers the property for a consideration and retention of a production payment, probably will realize long-term capital gain to the extent the consideration received (including the value of the production payment) exceeds his adjusted basis in the property, provided that he has held the property for a period in excess of one year. He will realize ordinary interest income on the collection of any proceeds in excess of the value of the production payment loan. The purchaser of a carved-out production payment also will realize interest income on the payment in excess of the principal amount of the production payment.

The Code provides for two significant exceptions to the treatment of production payments as loans on the property. A production payment carved out of a mineral property or properties for the exploration or development of such property will not be treated as a mortgage loan to the extent gross income from the property would not be realized by the taxpayer creating the production payment, in the absence of this provision in the Code. It has long been recognized that the assignment of a production payment to another party to develop the property, or to finance the acquisition of the equipment for the completion of a well, or for a specified sum of money pledged by the assignor for the development of the property, does not result in gross income to the grantor under the sharing arrangement; he has not parted with any capital but merely has given the driller, supplier, or investor the right to share in the production in consideration of a contribution to the pool of capital invested in the

52. I.R.C. § 636(a) & (b); Treas. Reg. § 1.636-4(a) (1973).
53. I.R.C. § 1231(a). The seller may qualify for the installment method of reporting the income from the sale. I.R.C. § 453.
54. I.R.C. § 636(a).
An expenditure is for exploration or development to the extent that it is necessary for ascertaining the existence, location, extent, or quality of any deposit of mineral, or is incident to and necessary for preparation of a deposit for the production of minerals, as distinguished from production from the property. In these situations involving the development of the property, the production payment continues to be treated as an economic interest in the property rather than a mortgage loan secured by production.

If the owner of the operating or working interest assigns a production payment to another party for the drilling and completion of an oil and gas well or for the development of a mine, the assignee does not realize income but acquires an economic interest in the property. The basis of the production payment is the cost of the services and equipment which are furnished by him. The proceeds that the assignee realizes from the production payment constitute gross income from the property subject to percentage or cost depletion, whichever is applicable in the particular year. The assignee is not entitled to a deduction for the intangible drilling costs of the well, the exploration and development costs of the mine, or the depreciation of the equipment, but has to recover his investment through the deduction for depletion.

The assignor has not parted with any capital, but simply has given the assignee the right to production by contributing a capital investment in the property. The assignor, therefore, is not entitled to the above-mentioned deductions for expenditures not paid or incurred by him, but he excludes from his gross income the share of the proceeds from production that accrue to the owner of the production payment. If the assignor should receive a sum of money that is pledged to and utilized in the development of a well or mine, he would reduce his expenses by that amount.

The second exception to the treatment of a production payment as a mortgage loan is the retention of a production payment on the lease of mineral property. A production payment retained in a mineral property by the lessor in a leasing transaction shall be treated, insofar as the lessee is concerned, as if it were a bonus, payable in installments, granted by the lessee to the lessor. The

57. Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943); Treas. Reg. § 1.612-4(a) (1972). The assignor is not entitled to the investment credit on the equipment. Anderson v. Commissioner, 446 F.2d 672 (5th Cir. 1971).
lessee shall include the proceeds from the minerals produced and applied to the satisfaction of the production payment in his gross income (with no related allowance for depletion) for the taxable year; he shall capitalize each payment (including any interest element) with respect to the production payment as an additional basis in the property. However, the lessor who retains a production payment in a leasing transaction (or his successor in interest) shall treat the production payment without regard to the provision in the Code; that is, he has a economic interest in the minerals in place, and the proceeds received in discharge of the production payment constitute ordinary income subject to depletion.\(^5\)

The provisions are illustrated in the following example in the regulations:

In 1971, A leases a mineral property to B, reserving a one-eighth royalty and a production payment . . . with a principal amount of $300,000 plus an amount equivalent to interest. In 1972, B pays to A $60,000 with respect to the principal amount of the production payment plus $16,350 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1972 and subsequent years will include . . . the $76,350 paid to A. In 1973, B pays to A $60,000 with respect to the principal amount of the production payment plus $12,750 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1973, and subsequent years will include . . . the $72,750 paid to A. The $76,350 received by A in 1972, and the $72,750 received by A in 1973, will constitute ordinary income subject to depletion in the hands of A in the years of receipt of such amount by A.\(^6\)

This principle has the illogical result of increasing the basis and cost depletion of the property in the hands of the lessee in the later years of the lease.

If the owner of the coal (including lignite) and domestic iron ore, held for a period in excess of one year, disposes of the minerals under any form of contract and retains an economic interest, he is considered to have made a sale of property used in a trade or business; he will realize long-term capital gain for the difference between the amount realized from the disposal of the coal or iron ore and the adjusted depletion basis (cost depletion) plus certain disallowed deductions in connection with the contract. The owner, of course, is not entitled to percentage depletion with respect to such coal and iron ore. The date of disposal is determined to be the date


\(^{59}\) Treas. Reg. § 1.636-2(c) (1973).
on which the coal or iron ore is mined. The owner is any person, including a sublessor, who owns an economic interest in the coal or iron ore in place. Therefore, since a production payment retained on a lease of mineral property continues to be considered as an economic interest to the owner, a lessor of coal or iron ore property, who retains a royalty and a production payment, apparently will realize capital gain on the initial consideration and on the payments of the royalty and the production payment. The lessee will treat the share of the production attributable to the production payment as an installment payment of bonus, and will exclude the share attributable to the royalty interest from his gross depletable income.

**Parties**

Recognizing that many persons enter into joint ventures for the development and production of natural resources and that these unincorporated organizations may be classified as partnerships for federal income tax purposes, the Code provides that such organizations may elect to be excluded from the application of the partnership provisions of the Code, provided that the income of the members can be determined adequately. The regulations require that the agreement provide that each participant reserves the right to take his share of the production in kind; any delegation of authority to sell a product for a participant’s account must be only for such reasonable periods of time as is consistent with the minimum needs of the industry under the circumstances, but not for a period in excess of one year.

While most joint ventures elect out of the partnership provisions of the Code, many ventures find that it is advantageous to be considered as a partnership for federal income tax purposes. A partnership is not subject to the federal tax on its income, and each partner reports separately his distributive share of certain items of income and expenses and the remaining taxable income or loss of the partnership. A partner’s distributive share of such items and the taxable income or loss of the partnership is determined in accordance with his interest in the partnership, unless the partnership agreement provides for a special allocation and the allocation under the agreement has substantial economic effect. The regulations provide that

60. I.R.C. §§ 631(c) & 1231(a); Treas. Reg. § 1.631-3(a) (1965). “Owner” does not include a partner or principal in the mining of the coal or iron ore.
61. I.R.C. § 761(a).
62. Treas. Reg. § 1.761-2(a) (1972). These provisions usually are incorporated in such partnership agreements in order to avoid the classification of the organization as an association taxable as a corporation.
63. I.R.C. §§ 701-02.
64. I.R.C. § 704 (a) & (b).
the allocation of a particular item to a partner has substantial economic effect if it "may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences." The examples in the regulations indicate that, if an item of deduction is allocated to one partner and an equivalent amount of another deduction is allocated to another partner, the special allocation will not be recognized, since its sole purpose is to reduce the taxes of certain partners without actually affecting their respective shares of partnership income.

However, assume that one partner contributes $2,500 cash and agrees to render services to a partnership to develop and market electronic devices, and the other partner agrees to contribute $100,000 cash and to obtain a loan for the partnership of any additional capital needed. The regulations recognize the special allocation under the partnership agreement for the full amount of any research and experimental expenditures and interest on partnership loans to the investor partner, and the provision that he would be entitled to 90 percent of the partnership income or loss before such expenditures, until all loans have been repaid and he has recovered the amount of such expenditures and his share of any partnership operating losses, at which time the partners would share profits and losses equally. Since all of the research and experimental expenditures and interest specially allocated to the investor partner are in fact borne by him, the allocation will be recognized in the absence of other circumstances.

The owners of operating or working interests in mineral properties frequently enter into partnership agreements with investors that provide for the operators to contribute the leases and the funds for the acquisition of any equipment to the partnership, and for the investors to contribute the necessary capital to develop the property. All of the deductions for the intangible drilling costs for an oil and gas well or the development costs for a mine are allocated to the investor partners, and any deductions for the leases and depreciation of the equipment are allocated to the other partners. Since the partnership owns the entire operating or working interest, the partnership can deduct the items of expense; the allocation of such items to the contributing partners appears to have substantial economic effect, since, for example, the drilling and development costs are borne by the investor partners.

66. Id.
The Internal Revenue Service consistently has taken the position that, when one person assigns a fractional operating or working interest to another person in consideration for the development of the property, the assignee is entitled to deduct only the share of the costs attributable to his fractional interest and must capitalize the costs of development and equipment attributable to the fractional interest held by others as the depletable cost of the fractional interest in the acquired lease. Of course, the agreement could provide that the assignee would be entitled to all of the income from the property until he had recovered his costs of developing, equipping, and operating the property; since he would own the entire operating or working interest during the complete payout period, he would be entitled to deduct the costs. In the event, however, that the assignor wishes to participate in the production upon completion of the well and is not agreeable to the payout provision (otherwise known as a "free well" arrangement), the parties can agree to a partnership arrangement and provide for special allocations to the partners by the partnership to accomplish the desired results.

The partnership arrangement also could be utilized to avoid the unfavorable effects of the recent ruling by the Service in the situation in which an assignee agrees to drill an initial well on a property and receives the entire working interest in the drill site, subject to the reservation of a royalty therein, and receives a fractional interest in the acreage exclusive of the drill site.

The Code provides that a partner's distributive share of partnership loss in a particular year shall be allowed only to the extent of the adjusted basis of his interest in the partnership at the end of the partnership year. Any excess loss is carried over to subsequent years. A partner's basis for his interest in the partnership consists of any money and the basis of any property contributed by him, less any distributions to him, adjusted for his distributable share of the taxable income or loss and certain other items of the partnership during each taxable year. Any increase or decrease in a partner's share of the liabilities of the partnership is treated as a contribution to or distribution from the partnership and, therefore, increases or decreases a partner's basis in his partnership interest. The regulations provide that the partner's share of liabilities is determined in accordance with the ratio for sharing losses under the partnership agreement, but the share of a limited partner cannot exceed his con-
tributions to the partnership. However, if none of the partners has any personal liability for a partnership liability (as in the case of property acquired without assumption of any liability), all of the partners, including limited partners, are considered to share such liability in the same proportion as they share the profits of the partnership.74

Formerly, partnerships developing mineral properties could obtain non-recourse loans for the development of the properties, increasing the basis of all partners (including limited partners) in their partnership interests, and then allocate substantial losses to the limited investor partners to shelter their other income from federal taxes.75 Congress amended the Code to limit the deduction of such losses to the amount which the taxpayer is "at risk" for the particular activity at the close of the taxable year.76 Generally, a taxpayer is considered to be "at risk" for an activity in the amounts of money and adjusted basis of property contributed by him to the activity and the amounts borrowed for such activity, to the extent that he is personally liable for the repayment of such amounts or has pledged property as security for such amounts.77

CONCLUSION

The assignment of operating or non-operating interests in mineral properties, with the resulting tax advantages, has been utilized extensively in the oil and gas industry for many years to finance the acquisition, exploration, and development of oil and gas properties. The tax principles involved are equally applicable to the financing of the acquisition and development of other mineral properties.

The limited partnership arrangements, which were employed extensively to allocate substantial income and deductions to certain partners, particularly the investors in relatively high income tax brackets who furnish substantial funds for drilling, have been curtailed to some extent by recent legislation and restrictive requirements for advance rulings by the Service.78 However, general partnerships, particularly those joint ventures that do not exercise the election out of the partnership provisions of the Code, still are used frequently for special allocations of income and deductions from oil and gas properties to various partners in excess of their

75. See I.R.C. §§ 702-04.
76. I.R.C. § 465.
77. I.R.C. § 465.
78. I.R.C. § 465.
proportionate interests in the properties. The partnership documents should be drafted carefully in order to assure partnership treatment; the Service, in view of the negative attitude toward the oil and gas industry, is scrutinizing the arrangements closely.

While recent legislation has reduced considerably the tax advantages of retained and carved-out production payments, these devices still serve as primary sources of financing in the oil and gas industry. The production payment has been utilized to finance development of other minerals; but, in those industries in which the production from the mine requires additional processing in order to produce a marketable product, the Service takes the position that gross income from the property for purposes of percentage depletion should be based on the first marketable product. Considerable controversy has resulted between taxpayers and the Service in determining the "cut-off" point for gross income from the property for percentage depletion and in determining the mining processes and transportation which should be considered in determining the income for this purpose.79 The Code does not define gross income from the property for oil and gas wells, but contains an extensive definition of gross income from mining and the treatment processes which will be considered as mining for this purpose.80 The regulations simply define gross income from oil and gas properties as (1) the amount for which the taxpayer sells the product in the immediate vicinity of the well; or (2) the amount equivalent to the representative market or field price of the product prior to conversion or transportation, if no sales occur on the premises or the product is transported from the premises prior to sale.

However, the regulations contain comprehensive and complex provisions, which have undergone extensive revisions from time to time, relative to gross income from mining.81 The Code provides that, for coal, the mining processes shall include cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment. If the coal customarily is sold in the form of a crude mineral product; the mining processes also shall include "sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form."82 With respect to coal that does not

80. I.R.C. § 613(c).
82. I.R.C. § 613(c)(4)(A) & (C).
undergo significant processing other than the mining processes enumerated in the Code, gross income from mining usually would be the amount for which the taxpayer sells the coal, less any cash or trade discounts that may be allowed to the customers.\textsuperscript{83}

The percentage depletion provisions of the Code are still applicable to the coal industry and to those production payments that may qualify as economic interests. Production payments have been utilized by the coal industry in the past. It is anticipated that, particularly with the need to acquire and develop additional coal reserves to supplement oil and gas as a source of energy, production payments will increase dramatically in future years as a method to finance the acquisition and development of coal properties and to spread the risks inherent in the development of previously undeveloped properties.

\textsuperscript{83} Treas. Reg. §§ 1.613-4(b)(ii); 1.613-4(e)(i); 1.613-4(f)(3)(iv) (1972).