

sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise allocated) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the taxable income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9421, May 25, 1971]

MINERAL PRODUCTION PAYMENTS

§ 1.636-1 Treatment of production payments as loans.

(a) *In general.* (1)(i) For purposes of subtitle A of the Internal Revenue Code of 1954, a production payment (as defined in paragraph (a) of § 1.636-3) to which this section applies shall be treated as a loan on the mineral property (or properties) burdened thereby and not as an economic interest in mineral in place, except to the extent that § 1.636-2 or paragraph (b) of this section applies. See paragraph (b) of § 1.611-1. A production payment carved out of mineral property which remains in the hands of the person carving out the production payment immediately after the transfer of such production payment shall be treated as a mortgage loan on the mineral property burdened thereby. A production payment created and retained upon the transfer of the mineral property burdened by such production payment shall be treated as a purchase money mortgage loan on the mineral property burdened thereby. Such production payments will be referred to hereinafter in the regulations under section 636 as carved-out production payments and retained production payments, respectively. Moreover, in the case of a transaction involving a production payment treated as a loan pursuant to this section, the produc-

tion 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. For the definition of the term *transfer* see paragraph (c) of § 1.636-3.

(ii) The payer of a production payment treated as a loan pursuant to this section shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income and *gross income from the property* (see section 613(a)) for the taxable year so applied. The payee shall include in his gross income (but not *gross income from the property*) amounts received with respect to such production payment to the extent that such amounts would be includible in gross income if such production payment were a loan. The payer and payee shall determine their allowable deductions as if such production payment were a loan. See section 483, relating to interest on certain deferred payments in the case of a production payment created and retained upon the transfer of the mineral property burdened thereby, or in the case of a production payment transferred in exchange for property. See section 1232 in the case of a production payment which is originally transferred by a corporation at a discount and is a capital asset in the hands of the payee. In the case of a carved-out production payment treated as a mortgage loan pursuant to this section, the consideration received for such production payment by the taxpayer who created it is not included in either gross income or *gross income from the property* by such taxpayer.

(2) If a production payment is treated as a loan pursuant to this section, no transfer of such production payment or any property burdened thereby (other than a transfer between the payer and payee of the production payment which, if the production payment were a loan, would extinguish the loan) shall cause it to cease to be so treated. For example, A sells operating mineral interest X to B for \$100,000, subject to a

\$500,000 retained production payment payable out of X. Subsequently, A sells the production payment to C, and B sells X to D. C and D must treat the production payment as a purchase money mortgage loan.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. On December 22, 1972, A, a cash-basis calendar-year taxpayer who owns operating mineral interest X, carves out of X a production payment in favor of B for \$300,000 plus interest, payable out of 50 percent of the first oil produced and sold from X. In 1972, A treats the \$300,000 received from B for the production payment as the proceeds of a mortgage loan on X. In 1973, A produces and sells 125,000 barrels of oil for \$373,500. A pays B \$186,750 with respect to the production payment, \$168,750 being principal and \$18,000 being interest. In computing his gross income and *gross income from the property* for the year 1973, A includes the \$373,500 and takes as deductions the allowable expenses paid in production of such mineral. A also takes a deduction under section 163 for the \$18,000 interest paid with respect to the production payment. For 1973, B would treat \$18,000 as ordinary income not subject to the allowance for depletion under section 611.

Example 2. Assume the same facts as in example 1 except that the principal amount of the production payment is to be increased by the amount of the ad valorem tax on the mineral attributable to the production payment which is paid by B. Under State law, the ad valorem tax with respect to the mineral attributable to the production payment is a liability of the owner of the production payment. For 1973, B includes the amount received with respect to such taxes as income and takes a deduction under section 164 for the taxes paid by him. Since the ad valorem taxes paid by B are his liability under State law, A may not take a deduction under section 164 for such taxes.

Example 3. On December 31, 1974, C, a calendar-year taxpayer and owner of the operating mineral interest Y, sells Y to D for \$10,000 cash and retains a \$40,000 production payment payable out of Y. At the time D acquires the property, it is estimated that 500,000 tons of mineral are recoverable from the property. In 1975, D produces a total of 50,000 tons from the property. D's cost depletion for 1975 is \$5,000 determined as follows:

Basis in property:	\$50,000
Total recoverable units:	500,000
Rate of depletion per ton:	\$0.10
	(\$50,000÷500,000)
Cost depletion for year:	\$5,000
	(\$0.10 × 50,000)

(b) *Exception.* (1) A production payment carved out of a mineral property (or properties) for exploration or development of such property (or properties) shall not be treated as a mortgage loan under section 636(a) and this section to the extent *gross income from the property* (for purposes of section 613) would not be realized by the taxpayer creating such production payment, under the law existing at the time of the creation of such production payment, in the absence of section 636(a). See section 83 and the regulations thereunder, relating to property transferred in connection with the performance of services. For purposes of section 636(a) and this paragraph, 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 incidental to and necessary for the preparation of a deposit for the production of mineral. However, an expenditure which relates primarily to the production of mineral (as, for example, in the case of a pilot water flood program with respect to the secondary recovery of oil) is not for exploration or development as those terms are used in section 636(a) and this paragraph. Whether or not a production payment is carved out for exploration or development shall be determined in light of all relevant facts and circumstances, including any prior production of mineral from the mineral deposit burdened by the production payment. However, a production payment shall not be treated as carved out for exploration or development to the extent that the consideration for the production payment:

(i) Is not pledged 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 than that described in subdivision (i) of this subparagraph;

(iii) Does not consist of a binding obligation of the payee of the production payment to pay expenses of the exploration or development described in subdivision (i) of this subparagraph; or

(iv) Does not consist of a binding obligation of the payee of the production

payment to provide services, materials, supplies, or equipment for the exploration or development described in subdivision (i) of this subparagraph.

(2) In the case of a carved-out production payment only a portion of which is subject to the exception provided in this paragraph, the rules contained in paragraph (a) of this section with respect to the treatment of income and deductions where a production payment is treated as a loan shall apply to the portion of the taxpayer's income or expenses attributable to the production payment which bears the same ratio to the total amount of such income or expenses, as the case may be, as the amount of the consideration for the production payment which would have been realized as income in the absence of section 636(a), by the taxpayer creating such production payment, bears to the total consideration to the taxpayer for the production payment. For example, A, owner of a mineral property, carves out a production payment in favor of B for \$600,000 plus interest in return for \$600,000 cash. A pledges to use \$400,000 for the development of the burdened mineral property. In each of the payout years loan treatment applies to one-third of the income and expenses of A and B attributable to the production payment.

(c) *Treatment upon disposition or termination of mineral property burdened by production payment.* (1)(i) In the case of a sale or other disposition of the mineral property burdened by a production payment treated as a loan pursuant to this section, there shall be included in determining the amount realized upon such disposition an amount equal to the outstanding principal balance of such production payment on the date of such disposition. However, if such a production payment is created in connection with the disposition, the amount to be so included shall be the fair market value of the production payment, rather than its principal amount, if the fair market value is established by clear and convincing evidence to be an amount which differs from the principal amount. See section 1001 and the regulations thereunder. In determining the cost of the transferred mineral property to the transferee for purposes of section 1012, the out-

standing principal balance of the production payment shall be included in the cost.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A, the owner of mineral property X which is burdened by a carved-out production payment to which section 636(a) applies having an outstanding principal balance of \$10,000, sells property X to B, an individual, for \$100,000 cash. The amount realized by A on the sale of property X is \$110,000. B's basis in property X for cost depletion and other purposes is also \$110,000.

Example 2. Assume the same facts as in example 1 except that the production payment is retained by A in connection with the sale of property X to B, that section 636(b) applies to the production payment, that the production payment includes, in addition to the \$10,000 principal amount, an additional amount equivalent to interest at a rate which precludes application of section 483, and that the fair market value of the production payment is \$9,000. The amount realized by A on the sale of property X is \$109,000. B's basis in property X for cost depletion and other purposes is \$110,000. A's basis in the retained production payment is \$9,000. If the production payment is paid in full, A realizes income of \$1,000 plus the amount equivalent to interest, which income is includible in A's gross income at the time when such amounts would be so includible if such production payment were a loan.

Example 3. C, the owner of mineral property Y, sells the mineral property to D for \$500,000 cash. Property Y is burdened by a carved-out production payment with an outstanding principal balance of \$600,000, 40 percent of the consideration for which was pledged for the development of property Y. The amount realized by C on the sale is \$860,000 (\$500,000 plus \$600,000 × .60). D's basis in property Y for cost depletion and other purposes is \$860,000.

(2) In the case of the expiration, termination, or abandonment of a mineral property burdened by a production payment treated as a loan pursuant to this section, for purposes of determining the amount of any loss under section 165 with respect to the burdened mineral property the adjusted basis of such property shall be reduced (but not below zero) by an amount equal to the outstanding principal balance of such production payment on the date of such expiration, termination, or abandonment. Thus, in example 2 in subparagraph (1)(ii) of this paragraph, if B abandons the mineral property at a

time when \$5,000 of the principal amount of the production payment remains unsatisfied, B's adjusted basis immediately before the abandonment would be reduced by \$5,000 for determining his loss on abandonment under section 165.

(3) In the case of a transfer of a portion of the mineral property burdened by a production payment treated as a loan pursuant to this section, such production payment shall be apportioned between the transferred portion and the retained portion by allocating to such transferred portion that part of the outstanding principal balance of the production payment which bears the same ratio to such balance as the value of such transferred portion (exclusive of any value not related to the burdened mineral) bears to the total value of the burdened mineral property (exclusive of any value not related to the burdened mineral).

(4) In general, the entire amount of gain or loss realized pursuant to this paragraph shall be recognized in the taxable year of such realization. See section 1211 for limitation on capital losses. This subparagraph shall not affect the applicability of rules providing exceptions to the recognition of gain or loss which has been realized (e.g., a transfer to which section 351 or 1031 applies). However, see section 357(c) with respect to the assumption of liabilities in excess of basis in certain tax-free exchanges. Furthermore, in the case of a transaction which otherwise qualifies, gain realized on a transfer of a mineral property to which section 636(b) applies may be returned on the installment method under section 453.

[T.D. 7261, 38 FR 5463, Mar. 1, 1973]

§ 1.636-2 Production payments retained in leasing transactions.

(a) *Treatment by lessee.* In the case of a production payment (as defined in paragraph (a) of § 1.636-3) which is retained by the lessor in a leasing transaction (including a sublease or the exercise of an option to acquire a lease or sublease), the lessee (or his successors in interest) shall treat the retained production payment for purposes of subtitle A of the Code as if it were a bonus granted by the lessee to the lessor payable in installments. Accord-

ingly, the lessee shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income for the taxable year so applied. The lessee shall capitalize each payment (including any interest and any amounts added on to the production payment other than amounts for which the lessee would be liable in the absence of the production payment) paid or incurred with respect to such production payment. See paragraph (c)(5)(ii) of § 1.613-2 for rules relating to computation of percentage depletion with respect to a mineral property burdened by a production payment treated as a bonus under section 636(c) and this section.

(b) *Treatment by lessor.* The lessor who retains a production payment in a leasing transaction (or his successors in interest) shall treat the production payment without regard to the provisions of section 636 and § 1.636-1. Thus, the production payment will be treated as an economic interest in the mineral in place in the hands of the lessor (or his successors in interest) and the receipts in discharge of the production payment will constitute ordinary income subject to depletion.

(c) *Example.* The provisions of this section may be illustrated by the following example:

Example. In 1971, A leases a mineral property to B reserving a one-eighth royalty and a production payment (as defined in § 1.636-3(a)) 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 (subject to proper adjustment under section 1016) 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 (subject to proper adjustment under section 1016) 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