

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

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hands of A in the years of receipt of such amounts by A.

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### § 1.636-3 Definitions.

For purposes of section 636 and the regulations thereunder:

(a) *Production payment.* (1) The term *production payment* means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. 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 right to mineral in place which 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 only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term *production payment* includes payments which are commonly referred to as *in-oil payments*, *gas payments*, or *mineral payments*.

(2) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. An example of an interest which is to be treated as a production payment under this subparagraph is

that portion of a *royalty* which is attributable to so much of the rate of the royalty which exceeds the lowest possible rate of the royalty at any subsequent time (disregarding any reductions in the rate of the royalty which are based solely upon changes in volume of production within a specified period of no more than 1 year). For example, assume that A creates a royalty with respect to a mineral property owned by A equal to 5 percent for 5 years and thereafter equal to 4 percent for the balance of the life of the property. An amount equal to 1 percent for 5 years shall be treated as a production payment. On the other hand, if A leases a coal mine to B in return for a royalty of 30 cents per ton on the first 500,000 tons of coal produced from the mine in each year and 20 cents per ton on all coal in excess of 500,000 tons produced from the mine in each year, the fact that the royalty may decline to 20 cents per ton on some of the coal in each year does not result in a production payment of 10 cents per ton of coal on the first 500,000 tons in any year. Another example of an interest which is to be treated as a production payment under this subparagraph is the interest in a partnership engaged in operating oil properties of a partner who provides capital for the partnership if such interest is subject to a right of another person or persons to acquire or terminate it upon terms which merely provide for such partner's recovery of his capital investment and a reasonable return thereon.

(b) *Property.* The term *property* has the meaning assigned to it in section 614(a), without the application of section 614 (b), (c), or (e).

(c) *Transfer.* The term *transfer* means any sale, exchange, gift, bequest, devise, or other disposition (including a distribution by an estate or a contribution to or distribution by a corporation, partnership, or trust).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

### § 1.636-4 Effective dates of section 636.

(a) *In general.* Except as provided hereinafter in this section, section 636 and §§ 1.636-1, 1.636-2, and 1.636-3 apply to production payments created on or after August 7, 1969, other than production payments created before January