Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200645026**

Release Date: 11/10/06
CC:PSI:B07:
POSTF-126103-05

UILC: 611.01-00

date: April 27, 2006

to:

from:

---

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer

a

B

b

Field

c

C

d

e

D

E

f

F

G

g

h

i

j

k

l

m

n

o

p

q

r

s

t

ISSUES

1) For purposes of valuing land pursuant to § 21(c) of the Alaska Native Claims Settlement Act (ANCSA), as amended by § 1408 of the Alaska National Interest Lands

Conservation Act (ANILCA), is the time of first commercial development the first day of the taxable year in which commercial development begins or the date when commercial development actually begins?

2) Is the interest to be valued at the time of first commercial development the fee interest conveyed to Taxpayer pursuant to ANSCA or the royalty interest Taxpayer held on the date of first commercial development?

CONCLUSIONS

1) Under ANILCA, the taxpayer is permitted to value the interest in the lands received pursuant to ANCSA at either the time of receipt or the time of first commercial development. For purposes of valuation, the time of first commercial development is the date when commercial development actually begins.

2) The interest to be valued at the time of first commercial development is the fee interest conveyed to Taxpayer pursuant to ANSCA, subject to the leases that burdened the Field when it was conveyed to Taxpayer.

FACTS

On a, Taxpayer was incorporated to manage funds and land granted to B under the Alaska Native Claims Settlement Act, Pub. L. 92-203, 85 Stat. 713 (December 18, 1971) (ANCSA), as amended by the Alaska National Interest Lands Conservation Act, Pub. L. 96-487, 94 Stat. 2371 (December 2, 1980) (ANILCA). Taxpayer is one of twelve Regional Corporations established under ANSCA. The purpose of ANCSA was to settle and extinguish Alaska Natives' aboriginal land claims by conveying to Regional Corporations and village corporations, over a number of years, land and other consideration.

In b, Taxpayer completed its land selection process and received the bulk of its land. The final conveyance of the Field to Taxpayer was not completed until c, however, because of competing claims between Taxpayer, C, and the

.

Taxpayer received a d percent fee interest in the Field unburdened, with a few limited exceptions, by oil and gas leases. A small portion of the Field was already subject to oil and gas leases when it was conveyed to Taxpayer. Taxpayer agrees that this burden should be reflected in the tax basis of the Field.

In e, following the conveyance of the Field, Taxpayer, C, and the ("Lessors") jointly leased the Field to D (succeeded by E in f), F, and G ("Lessees"). The Lessors granted the Lessees a g percent working interest (D held an h percent interest). The Lessors jointly retained shared royalty interests varying from i percent to j percent (depending upon the lease). Taxpayer holds a k percent royalty interest in the Field.

Between l and m, the Lessees engaged in an exploration program that led to the discovery and commercial development of oil and gas. First commercial development occurred on n.

The taxpayer valued its interest in the Field based on the d percent fee interest that it held in c when the interest was conveyed. This valuation resulted in a net present value of $o. Based on that valuation, Taxpayer claimed cost depletion deductions of $ p in tax year q, and $ r in tax year s.

BACKGROUND

There are several types of ownership interests of mineral properties. These interests are distinguished by their terms of creation, rights, responsibilities, and duration. IRC § 614(d) and Treas. Regs. § 1.614-2(b) define the term "operating interest" to include any interest that must take the cost of production into account in computing the taxable income limitation for percentage depletion under IRC § 613, or would be so required if the mine, well, or other natural deposit were in production stage. An operating mineral interest bears the costs and responsibilities of operating the property. The owner of an operating interest usually has the right to conduct exploration activities, control drilling operations, and share in production.

Conversely, the term "non-operating mineral interest" includes only interests that are not operating interests. IRC § 614(e)(2); Treas. Regs. § 1.614-5(g). There are several types of nonoperating interests, for example, royalty interests and overriding royalty interests. A royalty interest is usually retained by the landowner when the operating rights to the property are leased. An overriding royalty, on the other hand, generally either is retained on the transfer of the operating interest, or it is carved out of the operating interest. The owner of a royalty interest bears none of the costs or responsibilities of operating the property, but simply receives a specified part of the gross production or income from the property. The owner of an overriding royalty usually is responsible for his or her share of production or severance taxes, but does not bear the costs of exploration, development, or operation. A royalty results in ordinary income, subject to the depletion allowance, to the lessor. The lessee excludes from its "gross income from the property" an amount equal to royalties paid to the royalty owner. Treas. Regs. § 1.613-2(c)(5)(i).

Whether the conveyance of an interest in a mineral property is classified as a lease or as a sale or exchange depends upon whether the transferor retains an interest in the mineral property and the nature of the interest, if any, retained by the transferor. When the transferor assigns all of his or her interest in a mineral property or a fractional interest that is identical to the interest retained, or when a transferor assigns a continuing nonoperating interest and retains a working interest, the conveyance is classified as a sale. On the other hand, when the transferor assigns the operating rights and retains a continuing nonoperating interest the conveyance is classified as a lease or sublease.

It is the Service's longstanding position that in a leasing transaction, the lessor merely grants to the lessee exclusive exploitation privileges. The lessor retains a share of the oil and gas in place, free of the burdens of development and operating costs, and that retained share has a value equivalent to the value of the entire interest subject to such burdens. The lessor is not regarded as having disposed of a capital asset. Rev. Rul. 69-352, 1969-1 C.B. 34. Furthermore, a lessor's basis in the mineral reserves on its leased property becomes the basis of the non-operating interest or retained royalty. Treas. Regs. § 1.612-1(b).

In this case, Taxpayer received a fee interest in the Field upon its conveyance under ANCSA in c. While Taxpayer entered into oil and gas leases with unrelated parties, it merely leased the rights to exploit the mineral reserves. Taxpayer has not disposed of its fee interest in the Field. In return for the taxpayer leasing these rights to the working interest owners it currently receives a royalty interest in the production stream created by the efforts of the working interest owners.

Furthermore, while it is not clear how the received an overriding royalty in the working interest, it is clear that the % value derived from this interest is measured by in the production stream created by the working interest owner, not the value of the royalty held by the taxpayer.

Most importantly, the value of the fee interest held by the taxpayer cannot be derived from the values of the working interest or the overriding royalty, but only from the estimated mineral reserves of the Field.

LAW AND ANALYSIS

Section 21(c) of ANCSA provides that:

> The receipt of land or any interest therein pursuant to this Act or of cash in order to equalize the values of properties exchanged pursuant to subsection 22(f) shall not be subject to any form of Federal, State, or local taxation. The basis for computing gain or loss on subsequent sale or other disposition of such land or interest in land for purposes of any Federal, State, or local tax imposed on or measured by income shall be the fair value of such land or interest in land at the time of receipt.

The provisions of ANCSA were clarified by Congress in 1980 when ANILCA was enacted. Section 1408 of ANILCA amended § 21(c) of ANSCA to provide that:

> (c) The receipt of land or any interest therein pursuant to this Act or of cash in order to equalize the values of properties exchanged pursuant to subsection 22(f) // 43 USC 1621. // shall not be subject to any form of Federal, State, or local taxation. The basis for determining gain or loss

> from the sale or other disposition of such land or interest in land for purposes of any Federal, State, or local tax imposed on or measured by income shall be the fair value of such land or interest in land at the time of receipt, adjusted as provided in section 1016 of the Internal Revenue Code of 1954, // 26 USC 1016. // as amended: *Provided, however, That the basis of any such land or interest therein attributable to an interest in a mine, well, other natural deposit, or block of timber shall be not less than the fair value of such mine, well, natural deposit, or block of timber (or such interest therein as the Secretary shall convey) at the time of the first commercial development thereof*, adjusted as provided in section 1016 of such Code. For purposes of this subsection, the time of receipt of land or any interest therein shall be the time of the conveyance by the Secretary of such land or interest (whether by interim conveyance or patent)." (emphasis added).

By enacting ANCSA, Congress expressed its intent that in exchange for the surrender of land claims by Alaska Natives, the U.S. would transfer land to Alaska Natives under ANSCA tax-free. Furthermore, under this provision lands were conveyed to Alaska Natives with the highest possible tax basis or a “fresh start basis,” to prevent income tax liability from arising if the lands were later converted into cash or other property.

ANILCA clarified ANCSA § 21(c) by creating a “modified fresh start basis” rule to allow Alaska Natives to receive lands with mineral reserves with a basis that is not less than the fair market value of the land when the true commercial value of the mineral reserves is ascertained, that being the time of first commercial development.

Congress’ intent in enacting ANILCA § 1408 is further explained by S. Rep. No. 96-413, 96th Cong., 1st Sess. 1979, which provides:

> ...The purpose of the provision is to eliminate an ambiguity in the language of section 21(c) of the Alaska Native Claims Settlement Act as to precisely which date is intended by the term 'time of receipt', and also to eliminate a potential inequity in the tax treatment accorded different native corporations. The effect of the Amendment is to require the basis of land received under the Act to be determined on one of two dates. The general rule is that the basis of land received shall be the fair market value (FMV) at the time of receipt. The Amendment provides that the time of receipt shall be defined as 'the time of the conveyance' by the secretary of the interior, regardless of whether the title document is a patent or an interim conveyance.
>
> The Amendment also provides that the basis of mineral deposits and timber shall be the FMV at the time of first commercial development.

> The determination of the basis of mineral deposits and timber is postponed until first commercial development, because the existence or the extent and quality of a mineral deposit may not be known at the time of receipt. The uncertainty as to the existence of a mineral deposit or as to extent and quality of a deposit would be a significant effect on value...

The legislative history of ANSCA and ANILCA indicates that Congress clearly intended that Alaska Natives be able to value land conveyed under ANCSA at either the time of conveyance or the time of first commercial development. Furthermore, the Senate Report clarifies that the basis of mineral deposits must be valued at the time of first commercial development once any mineral reserves are ascertained. Thus, the intention of Congress in enacting ANCSA and ANILCA is to grant Alaska Natives the highest possible basis in the land and attached mineral reserves that they receive under ANCSA.

However, the Senate Report does contain the following language regarding the meaning of "first commercial development":

> ... For these purposes, the time of first commercial development shall be the first day of the taxable year in which, (1) a deduction for depletion is allowed or allowable, (2) gain or loss is realized from a disposal of minerals or timber with a retained economic interest, or (3) minerals in place or standing timber are sold or exchanged....

The Service has taken the position that this language is not to be interpreted as defining the time of first commercial development as the first day of the taxable year, but rather as the date that first commercial development actually begins. PLR 9147002.

In the instant case, the language of ANCSA § 21(c) makes it is clear that Taxpayer may value the Field on either the date of conveyance (c) or at the time of first commercial development (n). Taxpayer has selected the time of first commercial development as the date of valuation for the Field. It is also clear under ANCSA that Taxpayer's basis in the Field is the higher of the value of the Field on either the date of conveyance or the time of first commercial development.

Treatment of ANSCA by the Service:

TAM 8412008 addressed the issue of determining a taxpayer's basis in standing timber on land received under ANCSA. The taxpayer entered into contracts with unrelated parties to dispose of the standing timber. The Service found that under ANCSA, "[t]he basis for computing gain or loss on subsequent disposal of the property for purposes of federal tax imposed on income was to be the fair value of this land or interest in the land at the time of receipt."

Furthermore, the Service interpreted the amendments made to ANCSA by

ANILCA as allowing Alaska Natives to value lands received under ANCSA at the fair market value at either the time of receipt or the time of first commercial development. The Service interpreted ANILCA as allowing Alaska Natives to choose the greater of these two values as the unadjusted basis of the land received. The TAM also commented that, "one reason for providing an alternative valuation date for establishing unadjusted basis in a block of timber is because of difficulties in determining the FMV of the timber at the time of receipt." Importantly, the Service ruled in the taxpayer's favor and concluded that, "the unadjusted basis in timber received by X and Z under [ANCSA] is to be determined as though it were in their hands at the time of first commercial development."

TAM 8417001 addressed the issue of the determination of a taxpayer's basis in standing timber on lands received under ANCSA. Similarly, the taxpayer had disposed of timber rights in the lands it received under ANCSA.

The Service observed that at the time of receipt ANCSA "provided that the receipt of this property was not to be subject to any form of federal taxation." Furthermore, ANCSA states that "the basis for computing gain or loss on subsequent disposal of the property for purposes of federal tax imposed on income was to be the fair value of this land or interest in the land at the time of receipt."

However, the TAM also notes that the amendment of ANCSA § 21(c) by ANILCA provides "that the basis of any such land or interest therein attributable to an interest in a block of timber must not be less than the fair value of the block of timber (or interest therein as the Secretary of the Interior conveys) at the time of first commercial development thereof, adjusted as provided in section 1016 of the Code." Hence, the amended statute, "provides in effect that the unadjusted basis in timber received by a village corporation is the fair value of the timber at the time of receipt unless the fair value of a block of timber at the time of first commercial development of the block is greater, in which case the fair value of the block at the time of first commercial development would constitute the unadjusted basis of the block of timber. Thus, the greater of the two values would be the unadjusted basis in a block of timber."

In ruling for the taxpayer, the Service echoed the conclusion of TAM 8412008 that "the unadjusted basis in timber received by X and Z under [ANCSA] is to be determined as though it were in their hands at the time of first commercial development."

Finally, TAM 9147002 addressed the issue of computing cost depletion on mineral received pursuant to a conveyance of land under ANCSA. The more specific issue raised in the TAM is the interaction between IRC § 612 and its associated regulations, and the basis provisions of ANCSA § 21(c). The TAM asserted that because the lands received by the taxpayer were conveyed under ANCSA, that provision governs the determination of the taxpayer's basis in those lands.

Furthermore, the Service opined on Congress' intent in enacting and later amending ANCSA:

> This special basis treatment was accorded to mineral and timber rights because Congress felt that it was inequitable to require the Native Corporations to value these rights on the date of conveyance as their value might not be ascertainable on that date. It was reasoned that mineral rights valuation should be postponed until the date of first commercial development because the existence or the extent and quality of a mineral deposit may not be known at the time of receipt. The uncertainty as to the existence of a mineral deposit or as to extent and quality of a deposit has a significant effect on value. S. Rep. No. 96-413, 96th Cong., 2nd Sess. at 256-7.

Ultimately, the holding of TAM 9147002 turned on the valuation date of the mineral rights attached to the taxpayer's lands. The Service held that the taxpayer was entitled to a cost depletion deduction, but directed the taxpayer to compute the deduction based upon an estimate of the mineral reserves and to amend its returns at the time of first commercial development when its basis could be finalized.

The TAMs discussed above reflect the Service's interpretation of ANCSA. Specifically the TAMs illustrate the Service's position that a taxpayer receiving land under ANCSA may choose to value the land at either the time of receipt or the time of first commercial development, whichever date will yield the higher valuation. However, it is important to remember that the asset to be valued remains the same.

Judicial Interpretation of ANSCA:

In Klukwan, Inc. and Subs. v. C.I.R., the Tax Court considered the issues of determining the fair market value of standing timber on land received by a taxpayer under ANCSA and determining the allowable depletion deductions resulting therefrom. T.C. Memo 1994-102, 68 T.C.M. (CCH) 446 (1994). The Service determined that under the terms of ANCSA § 21(c), the taxpayer's basis in the land and timber that it received was either the fair market value on the date of conveyance or at the time of first commercial development. The taxpayer chose to value its interests on the date of conveyance.

The taxpayer submitted a valuation report to the Service, valuing the standing timber as of the date of conveyance. The Service disputed the taxpayer's method of valuing the standing timber on this date. In ruling for the taxpayer, the Tax Court determined that the interest to be valued was "the fee ownership timber interest acquired by [the taxpayer] on June 5, 1980."

Klukwan reflects the issues of the present case. Both the Taxpayer and the Service agree that the Taxpayer's land may be valued at the time of first commercial

development, . However, the Service disputes the Taxpayer's assertion that the interest to be valued on is the same interest that was conveyed to the Taxpayer under ANCSA in 1991. The holding of Klukwan and the plain meaning of ANCSA, as amended by ANILCA, confirm the Taxpayer's position.

In Old Harbor Native Corp. v. C.I.R., the Tax Court interpreted ANCSA § 21(h) to determine the tax treatment of payments received by the Native Corporation from unrelated parties interested in developing mineral reserves on lands received under ANCSA. 104 T.C. 191, 199 (1995). The Court observed that "ANCSA legislation generally exempted from taxation the regional and village corporations' initial receipt of rights in the Government-owned land." 104 T.C. at 199 *citing* 43 U.S.C. 1620. The Tax Court reasoned that because "Congress did not specify the exact manner of taxing the revenues subsequently generated from these rights," such determination must be made by first interpreting ANCSA, "as the statute that extinguished the aboriginal land claims of the Alaskan natives." 104 T.C. at 199 *citing* 43 U.S.C. 1620.

In Old Harbor the Tax Court noted that it does not read ANCSA as narrowly as the Service, in fact, the Court stated, "we read ANCSA broadly and in the light most favorable to Alaskan natives, the intended beneficiaries of ANCSA." 104 T.C. at 204 *citing* Bryan v. Itasca County, 426 U.S. 373, 392 (1976); Squire v. Capoeman, 351 U.S. 1, 7 (1956); Alaska Pacific Fisheries v. U.S., 248 U.S. 78, 89 (1918); Chugach Alaska Corp. v. U.S., 34 F.3d 1462 (9th Cir.1994). Ultimately, the Tax Court found that the payments received by the taxpayer are subject to Federal income taxation. 104 T.C. at 203.

While case law interpreting ANCSA is hardly voluminous, each Court that has interpreted this statute has applied an Indian canon of statutory interpretation to rule "in the light most favorable to Alaskan natives." Klukwan, Inc. and Subs. v. C.I.R., T.C. Memo 1994-102, 68 T.C.M. (CCH) 446 (1994); Paul v. C.I.R., 77 T.C. 755 (1981); Doyon, Ltd. v. U.S., 214 F.3d 1309 (2000). The Service's position and the judicial interpretation of ANCSA agree.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views. Please call (202) 622-3120 if you have any further questions.