Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
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Telephone Number:

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Date:
September 22, 2009

LEGEND:

Taxpayer:

X:

State 1:

State 2:

b:

Dear :

This is in reply to a letter dated March 25, 2009, in which you request that the transfer of working interests from Taxpayer to X, and the reservation of a net profits interest by Taxpayer, would be treated for federal income tax purposes as a sublease rather than as a sale or exchange of assets.

The facts and representations submitted are summarized as follows:

Taxpayer is a State 1 corporation and at all times relevant to this request has been taxed as an S Corporation under Subchapter S of the Internal Revenue Code. Taxpayer is the owner of working interests in various domestic oil and gas properties in several states, and qualifies for percentage depletion on its production under § 613A(c) of the Code. Taxpayer participates with X, an unrelated State 2 corporation, in exploring and developing the working interests. The working interests are properly characterized as a form of operating interest in the oil and gas properties.

Taxpayer seeks to convert a portion of these operating interests into passive, nonoperating royalty interests for the purpose of contributing them by way of gift to one or more charitable organizations. To accomplish this, Taxpayer proposes to transfer and assign to X certain operating interests, and to reserve for itself a net profits interest equal to b percent of the net proceeds of the hydrocarbons in the affected properties.

The net profits interest retained by Taxpayer would be a nonoperating interest, and requires that certain costs be taken into account in computing the return on the retained interest. The payments under the net profits interest will not be in excess of revenue. The assignment of the operating interest and a reservation of net profits interest continue for the terms of the underlying leases. Taxpayer will receive no cash consideration as part of the transaction.

Section 1001(c) provides that, in general, the entire amount of gain or loss on the sale or exchange of property shall be recognized as taxable income by the taxpayer.

Section 1.611-1(b)(1) of the Income Tax Regulations provides, in part, that an economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place and secures, by any form of legal relationship, income derived from the extraction of the mineral to which the taxpayer must look for a return of capital.

Section 1.614-1(a)(2) defines the term “interest” as an economic interest in a mineral deposit. It includes working or operating interests, royalties, overriding royalties, net profits interest, and to the extent not treated as loans under section 636 of the Code, production payments.

Section 1.614-2(b) defines, in part, the term “operating mineral interest” to mean a separate mineral interest described in section 614(a), in respect of which the costs of production are required to be taken into account by the taxpayer for purposes of the 50 percent of the taxable income from the property in determining the deduction for percentage depletion computed under section 613, or such costs would be so required to be taken into account if the mine, well, or other natural deposit were in the production stage. The term does not include royalty interests or similar interests, such as production payments or net profits interests.

Section 614(e)(2) of the Code and section 1.614-5(g) of the Income Tax Regulations define the term “nonoperating mineral interests” to include only interests described in section 614(a) which are not operating mineral interests within the meaning of section 1.614-2(b).

Anderson v. Helvering, 310 U.S. 404 (1940) involved the sale of oil properties, including fee interests, for cash and one-half of the proceeds from the production of oil and gas from the properties and/or proceeds from the sale of the fee of any of the land

conveyed. The retained interest was not an economic interest because it could be satisfied other than by the production of oil and gas from the properties.

The issue to be determined in this case is whether the proposed transaction will constitute a lease or a sale. A transaction is classified as a lease, rather than a sale, in any case in which the owner of a fee interest or operating interest assigns all or a part of the interest and retains a continuing nonoperating interest.

In this case, Taxpayer represents that it is merely giving X the right to exploit the oil and gas on the leased properties, but retaining for itself a nonoperating interest in the form of a net profits interest. The only source of payment for Taxpayer is the production or sale of oil and gas from the burdened properties. Taxpayer's retained interest in the property continues for the term of the underlying leases.

Based on your representation, we conclude that the transaction in this case is properly described as a sublease and not as a sale or exchange of a capital asset for purposes of federal income taxation.

Except as specifically set forth above, we express or imply no opinion concerning the federal income tax consequences of the transaction described above under the cited provisions or any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with a power of attorney on file in this office, a copy of this letter is being furnished to your authorized representatives.

Sincerely,

Jaime C. Park
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

cc: