Presented:
11th Biennial Parker C. Fielder Oil Gas and Tax Conference
October 27-28, 2011
Houston, TX

Production Payments:
Concepts, Economics and Taxation

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GENERAL EXPLANATION
OF THE
TAX REFORM ACT OF 1969

H.R. 13270, 91ST CONGRESS, PUBLIC LAW 91-172

PREPARED BY THE

STAFF OF THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION

DECEMBER 3, 1970

Revenue effect.—The immediate revenue effect of this provision will be negligible because there is no significant production of oil from oil shale at the present time. However, as technological problems are solved and shale oil is produced in quantity, there will be a corresponding increase in the loss of revenue.

4. Mineral Production Payments (sec. 503 of the Act and sec. 636 of the code)

Prior law.—A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when that production occurs. The payment is secured by an interest in the minerals, the right to the production is for a period of time shorter than the expected life of the property, and the production payment usually bears interest. Depending on how a production payment is created, it may be classified as a carved-out production payment or a retained production payment which may then bo used in a so-called A-B-C transaction.

A carved-out production payment is created when the owner of a mineral property sells—or carves out—a portion of his future production. A carved-out production payment is usually sold for cash and, quite often, to a financial institution. Under prior law, the amount received by the seller of the carved-out production payment generally was considered ordinary income subject to depletion in the year in which received. The purchaser of the production payment treated the payments received as income subject to the allowance for depletion (almost always cost depletion) and thus generally paid no tax on those amounts (except on that portion of the payments which is in the nature of interest). The amounts utilized to pay the production payment were excluded from income by the owner of the property during the payout period, but the expenses attributable to producing the income were deducted by him in the year they were incurred.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under prior law the owner of the retained production payment received income for which percentage depletion could be taken during the payout period, or period during which he received a part of the production (or a payment based on production). The purchaser of the working interest excluded the amounts used to satisfy the production payment during the payout period, but deducted the cost of producing the minerals subject to the production payment-

The so-called A-B-C transaction is the same as a retained production payment case, except that after selling the working interest, the initial owner then sells the "retained production payment." Thus, in an A-B-C transaction, the owner of the mineral property, A, sells it to a second person, B, and reserves a production payment (bearing interest) for a major portion of the purchase price. He then sells the production payment to a third party, C, which is usually a financial institution, or, perhaps, a tax-exempt organization.

General reasons for change.—The treatment of mineral production payments under prior law resulted in what were essentially two problems, one relating to carved-out production payments and one relating to retained production payments and A-B-C transactions. In the case of the carved-out payments, by advancing the time income (but not the related expense) was reported for tax purposes, taxpayers were

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First appeared as part of the conference materials for the
11th Biennial Oil and Gas Tax Conference session
"Production Payments: Concepts, Economics and Taxation"