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The Pool of Capital Doctrine
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G.C.M. 22730, 1941-1 C.B. 214, provided that the receipt of an interest in a drilling venture in return for capital and services furnished by a driller and equipment supplier was not taxable on receipt. This ruling provided for the "pool of capital" doctrine that is widely quoted in oil and gas tax law. Similar reasoning had been extended to geologists, petroleum engineers, lease brokers, accountants, and lawyers who receive an interest in an oil or gas drilling venture in return for services rendered. This extended reach of the pool of capital doctrine has been reversed without sufficient explanation, which has now brought into question the core or unextended pool of capital doctrine itself.

Law Developed Before G.C.M. 22730

The oil and gas sharing arrangement, was first recognized in 1925, when the IRS ruled that the assignor of a fraction of a working interest, in return for the assignee's promises to drill a free well, realized no gain or loss. It was recognized that the drilling of the well was a benefit to the assignor, but that the benefit was represented merely by an appreciation in the value of the property he owned. No taxable income or loss would be recognized until such appreciation was realized. SM 3322, IV-1 CB 112 (1925), obs. Rev. Rul. 70-277, 1970-1 CB 280.

The assignee's position in the sharing arrangement was covered in 1927 when the IRS ruled that costs incurred by the assignee were capital in nature, that such costs represented his investment in the property, and, by implication, that he had acquired a property interest. G.C.M. 932, VI-1 CB 241(1927), obs. Rev. Rul. 67-123, 1967-1 CB 383. When the assignee drilled a well in consideration of an interest in a property, it was held by the courts that he did not realize taxable income to the extent of the value of the interest received, but rather had made an investment in the oil and gas in place. *Dearing v. Commissioner*, 102 F.2d 91, (5th Cir. 1939), aff'g 36 BTA 843 (1937) acq., 1940-2 CB 2.

If the value of some or all of the assets received by a seller cannot be ascertained with reasonable accuracy, the computation with respect to those assets for income tax purposes is held "open," for income[1] tax purposes under *Burnet v. Logan*, 283 U.S. 404 (1931) until they are sold, collected, or otherwise reduced to property of ascertainable

[1] The receipt of an obligation to pay "60 cents for each ton of ore" received in exchange for stock was valued by the IRS and that value was accepted for estate tax purposes but not for income tax purposes. "This probably was necessary in order to ascertain the mother's estate….The liability for income for income tax ultimately can be fairly determined without resort to mere estimates, assumptions, and speculation…. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one." *Id.* at 412-413.

value. Such a delay will affect the year in which the gain or loss is recognized and it may also affect the characterization of the gain or loss.[2]

In *Burnet v. Harmel*, 287 U.S. 103 (1932) the Supreme Court summarized the risks which are inherent in every oil and gas leasing transaction and concluded that "the lessee had acquired merely the privilege of exploiting the land…" and that "such operations…resemble a manufacturing business … to which the passing of title of the minerals is <u>but an incident</u>, rather than a sale of the land or of any interest … in its mineral content."

Based on this analysis, the Court determined that the lessor had not parted with any interest, which conveyed economic value, in that the lessor's retained royalty, free of the costs and burdens of developing the lease, was equal in value to his entire interest prior to the transfer. Therefore, the cash payment received could not be for the sale or exchange of the property interest but must instead represent an advance royalty.

In the landmark case of *Palmer v. Bender* 287 U.S. 551 (1933) the Court (in deciding whether a sublessor was entitled to the depletion deduction on its retained overriding royalty interest) concluded that "oil in the ground represented a reservoir of the capital investment of the various parties…" and that the subleasing transaction itself was merely a means of acquiring an interest in such a reservoir which was "capable of realization as gross income…" only by the subsequent "production and sale of the oil…" which would in turn result in the "return of capital invested."

Net profits interests were not economic interests in the mineral property. *Helvering v. O'Donnell*, 303 U.S. 370 (1938). It was not until 1946 that net profits interests were determined to be economic interests in the mineral property. *Burton-Sutton Oil Co., Inc. v. Comm'r*., 326 U.S. 25 (1946).

A current deduction for intangible drilling and development costs was allowed by administrative ruling beginning in 1916. However, prior to 1943 under the "obligation well" doctrine whenever drilling a well was undertaken in consideration for the assignment of operating or royalty rights in a property, the entire cost of drilling the well was capitalized as an acquisition cost of the assignee. *F.H.E. Oil Co. v. Comm'r*., 147 F.2d 1002 (5th Cir. 1945).

G.C.M. 22730

In what was described as "leasing transactions":
A the fee owner leases to B for:
i) $100,000;

[2] One court noted that the pool of capital "doctrine reflects the inequity of taxing the recipient on the speculative value of an economic interest in a pre-production mineral investment, deferring taxation until that interest yields income." *Zuhone v.Comm'r*., 883 F.2d 1317 (7th Cir. 1989).

ii) $100,000 payable out of a 1/16 royalty interest (an oil payment interest which does not by its terms extend throughout the lease term – old law); and,
iii) 1/8 royalty interest.
A recognizes ordinary income for the bonus payment of $100,000 subject to depletion. Proceeds paid to A for production are ordinary income subject to depletion.

B assigned the lease to C for:
i) $200,000; and,
ii) $100,000 payable out of a 1/16 royalty interest (an oil payment interest which does not by its terms extend throughout the lease term – old law).
B recognizes $200,000 as sales proceeds (old law). The retained oil payment is ordinary income subject to depletion.

C assigned a 50% of the lease interest to D who agreed to develop and operate the property for:
i) 50% net profits interest (NPI was not an economic interest –old law).
C has a sale for a nondepletable contract right.

D conveyed an oil payment to E for drilling an oil well:
i) $25,000 payable out of a 1/8 royalty interest.
E has a depletable economic interest for its capital investment in drilling and equipping the well.

D conveyed an oil payment to F for $15,000, which was covenanted to use in developing the lease:
i) $25,000 payable out of a 1/8 royalty interest (an oil payment interest which does not by its terms extend throughout the lease term – old law).
F has a depletable economic interest for its capital investment pledged for development.
D has an economic interest in the property less the interests agreed upon by him or his predecessors. D's invested capital does not include the sums contributed by E or F.

The IRS in G.C.M. 22730 determined that a driller or equipment dealer's investment in return for an interest in the property does not represent payment in property for services rendered or supplies furnished. The same treatment was accorded to the acquisition of an oil payment right pledged for such development of the property.

This is indicated by the following excerpts therefrom:

> Such language (referring to the *Palmer* case) indicates that the Court regarding the contracts between the interested parties as dividing the property rights in oil and gas in place in accordance with their respective shares upon production. That is, the lessor by lease terms **reserving royalties**, merely grants to the lessee

> exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a **value equivalent** to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, **is regarded as not having disposed of a capital asset**. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest, which carries the risks and burdens attending exploitation. *** So considered, the view that a **lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee, acquires a capital interest** upon the execution or assignment of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or proceeds realized therefrom with him. ***. **The lessor does not sell an interest to the lessee. Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property**.
>
> If the **driller or equipment dealer** is making an investment by which he acquires an economic interest in the oil and gas in place, expenditures made by him represent **capital expenditures returnable tax-free through the depletion allowance** rather than by way of expense deduction, and the oil payment rights acquired **<u>do not represent payment in property for services rendered or supplies furnished.</u>** Similarly, one who, in return for an oil payment right, furnishes money which the lessee is **pledged** to use in developing the property would be **regarded as making an investment representing an addition to the reservoir of capital investments in the oil and gas in place*****.
> (Emphasis added.)

Post G.C.M. 22730 developments for production payments

Until 1946 the IRS treated the issuance of a production payment (not pledged for development) as generating long-term capital gain. In 1946 the IRS ruled that "consideration (not pledged for development) received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands." G.C.M. 24849, 1946-1 C.B. 66, 69.

In 1950 the IRS dropped the short-lived limitation, "the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it was carved, is essentially the assignment of expected income from the property interest. Therefore…results in the receipt of ordinary income…." However this holding "will not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property." I.T. 4003, 1950-1 C.B. 10, 11.

In 1958 the Supreme Court agreed with the IRS that amounts received for the transfer of oil payment rights was an ordinary income subject to depletion (i.e., an anticipatory assignment of depletable income). *Comm'r. v. P.G. Lake, Inc*., 356 U.S. 260 (1958). This however was a pyrrhic victory for the IRS because taxpayers were now free to avoid the percentage depletion net income limitation by selling production payments (not pledged for development). The IRS turned to the Congress to legislatively overturn the *P.G. Lake* decision.

1969 Tax Reform Act

The 1969 Tax Reform Act contained two seemingly contradictory provisions. Under new Section 636(a) the carving out of a production payment, is treated as the making of a mortgage loan on the property and not as a grant of an economic interest <u>unless</u> that production payment was not treated as income from services under prior law (i.e., G.C.M. 22730 - pledged for development of the property). New Section 83 dealt with property transferred in connection with the performance of services. That section created numerous rules dealing with property received for services but did not its taxability under Section 61.

In Section 636(a) Congress implicitly recognized as to D the continued validity of G.C.M. 22730 and cases supporting the non-taxability of D by excepting sharing arrangements from mortgage loan treatment generally applicable to carved out production payments; the language of the new Section 636(a) did not attempt to distinguish between capital and services as consideration furnished to D, nor did court decisions supporting the non-taxability of D. In addition, to hold the G.C.M. inapplicable to D as to services performed by E would ignore the fact that if D were to obtain a cash contribution from "F" in exchange for an economic interest in a sharing arrangement with "F" and were then to pay the case to E for services, D would realize no income; the fact that D deals with one person and not with two should not change the result.

Congress can be said to have adopted indirectly the pool of capital investment doctrine in 1969 in Code Sec. 636 (a) where certain production payments retain an economic interest status.

Rep. No. 91-552, 91st Cong., 1st Sess., p. 185. The following extract from this committee report explains the exception contained in Code Sec. 636(a):

> For example, under existing law if A, the owner of a lease, carves out a production payment in favor of X in consideration of the drilling by X of a well on the lease owned by A, gross income is not realized by A on this transaction and A is not entitled, of course, to deduct the drilling costs incurred by X. Similarly, if A carves out a production payment for $100,000 and sells it to X for $90,000 and agrees to use the proceeds in drilling development wells on the lease to which the carve-out relates, the $90,000 is not income to A under existing law and A cannot, of course, deduct the $90,000 spent in drilling the development wells. Thus, the bill would not treat the production payment as a loan in the case of either of the above examples, and in each case the production payment held by

> X would continue to be treated as an economic interest in his hands. See also Reg. § 1.636-1(b)(1).

In *James A. Lewis Engineering, Inc. v. Comm'r,* 339 F.2d 706 (5th Cir. 1964) Lewis rendered services installing and operating a secondary recovery program in exchange for an interest in the property. The Fifth Circuit concurred with the Tax Court that the services rendered "did not fall within the concept of development so fully treated in G.C.M. 22730" – and thus not within the purview of the general rules as they existed before 1964. However, the Court volunteered the following dictum:

> Unless a careful analysis of the reasons underlying the issuing of G.C.M. 22730 compelled it, the Court would have great difficulty accepting a construction of the Code that would fly in the face of the general provisions of the tax laws to the effect that compensation for services must be returned as part of gross income. Sec. 61(a)(1).

In the 1974 cases of *Diamond v. Comm'r*, 492 F.2d 286 (7th Cir. 1974) and *Vestal v. United States*, 498 F.2d 487 (8th Cir. 1974) the Seventh and Eighth Circuits held that partnership interests received by the contributors of services were compensation and, thus, taxable income. In *Diamond*, a non-oil and gas case, the court held that a contribution of services to a partnership didn't qualify for the same tax-free treatment under the Regulations as a contribution of property. It found that the partnership profit-share interest had a determinable market value, and so was taxable in the year received.

In *Vestal*, a cash-basis taxpayer provided services to the investors in a limited partnership, and in return was given contract rights to receive a future fractional partnership interest in an oil and gas field. The Eighth Circuit said that the rights were taxable compensation. However, it also said that the taxable event was the actual acquisition of the joint venture interest, not the receipt of the contract rights (which occurred in an earlier year). Therefore, the court held that the compensation for services wasn't taxable until the partnership sold its interest in the field, since until then Vestal's right to participate in future profits was conjectural, and his share of the partnership interest had no ascertainable market value.

However, in 1977, the IRS added a new element. In Revenue Ruling 77-176, it ruled that a driller "X", who drilled an oil and gas well at a designated location on a leased tract of land in return for an assignment from the owner "Y" of the entire working interest in the drill site *and* an undivided fraction in the remainder of the tract, realized ordinary income for services.[3] Reason: The driller received a fractional interest in the tract, outside the

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[3] As a practical matter the conveyance likely gave X a 50% working interest in the entire lease and a payout from the from Y's interest in the drill site. Y would have retained a 1/16th overriding interest in the well site that converted to a 50% working interest at payout. *See* Rev. Ruls. 69-332, 71-207 and 75-446. Y's lease was on a single tract of land. Query, why were all of X's operating interests in that tract not combined and treated as one property under Section 614(b)(1)?

drill site. The IRS said that to come within G.C.M. 22730, the economic interest acquired must be in *the same* property as that for the development of which the materials and services are contributed, and "property" meant each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

Despite the court decisions outlined above, the IRS confirmed the viability of the pool-of-capital doctrine in a number of rulings.

PRIVATE LETTER RULINGS – Expansion of the POC

TAM 8047005 held that the receipt of overriding royalty interests and reversionary operating interests by a corporate taxpayer for services rendered in **acquiring working interests for promoted investments** for joint ventures as an agent and for limited partnerships where it was the general partner but was acting outside the scope of the partnership, qualified for nontaxable treatment under the "pool of capital" doctrine. TAM 8129006 held that the receipt of overriding royalty interests by an **independent geologist** engaged in the business of generating oil and gas prospects for independent oil companies qualified for nontaxable treatment under the "pool of capital" doctrine. TAM 8137006 held that the acquisition of an overriding royalty interest by a corporate taxpayer, convertible under certain circumstances to a working interest, for services in **acquiring properties for itself and other participants** qualifies for nontaxable treatment under the pool of capital doctrine.

In each of these TAMs the IRS reasoned, "As used in G.C.M. 22730, services for development of the property include drilling prior to discovery of oil and gas, **<u>and also, services performed prior to the value of the property being known</u>**." (Emphasis added.) In G.C.M. 22730 the services rendered were for drilling and equipping a well on a non-producing lease. So while it is true that the drilling and equipping[4] services in G.C.M. 22730 were rendered prior to the value of the lease being known, it is certainly an expansion of the pool of capital doctrine to include services rendered prior to drilling, at least to the extent that those services are rendered by someone not in the prior chain of title to that property (i.e., TAM 8129006).

In TAM 8047005 the IRS clearly understood that its determination "depends upon whether G.C.M. 22730 applies to P's receipt of the economic interests or do either section 61 or section 83 apply." In each of these TAMs the IRS reasoned "**if an**

[4] There was some initial concern over equipment under the section 636(a). However, in *Anderson v. Commissioner*, 446 F2d 672 (5th Cir. 1971), the court stated: "according to established principles of oil and gas taxation, when taxpayers assign production payments in exchange for funds pledged in advance for the purchase of equipment on the leases, they realized no gain on the transaction." Revenue Ruling 92-38 concluded that a carved-out production payment to finance equipment used to develop a mine qualifies as a development carve-out if no consideration passes between the parties to a sharing arrangement except a contribution to, or assumption of, some portion of the development obligation, neither grantee nor grantor realizes taxable income or loss from the transaction.

economic interest is received in a transaction that meets the requirements of G.C.M. 22730, neither section 61 nor section 83 requires the inclusion in gross income of the value of the economic interest received." In TAMs 8129006 and 8137006 the IRS specifically acknowledged the continuing viability of the pool of capital doctrine, "Where an economic interest is received by a taxpayer for the contribution of services to a reservoir of capital under circumstances that meet the requirements of G.C.M. 22730, the **economic interest received does not represent compensation or payment in property for services**." In TAM 8047005 the IRS specifically found that "P's services are performed for the development of a pool of capital and **are not services rendered to the coowners**…."

Even under this expanded view of the pool of capital doctrine corporate employees did not qualify. TAMs 8146006 and 8152001 held that the receipt of an overriding royalty interest by an exploration manager and land manager of a corporation did not qualify for nontaxable treatment under the pool of capital doctrine. The IRS reasoned that "X is a company employee who entered into an employee incentive arrangement to increase his compensation in the form of an ORR interest….Such an arrangement is not a contribution in the form of services rendered to the pool of capital within the meaning of G.C.M. 22730." TAM 8014024 held that services of a chief executive officer relating to administrative matters such as personnel and policy decisions and fund-raising activities was an arrangement "to increase his salary by compensation in the form of an ORR interest…." The IRS found that the CEO's services do not constitute "services rendered to the development of any particular property."

Revenue Ruling 83-46 – Reversing the expansion of the POC

ISSUE

Whether Section 83 requires taxpayers to include in gross income overriding royalty interests received under the situations described below.

FACTS

Situation (1): X corporation syndicates partnerships that acquire interests in oil and gas properties and take advantage of the intangible drilling and development costs deduction. X entered into an agreement with one such partnership, PRS, which provides that X will receive an overriding royalty interest (as described in Rev. Rul. 67-118) in consideration for its services in locating available oil and gas properties for PRS. Under the agreement, X received, in 1983, several such overriding royalty interests in oil and gas to be produced from leases acquired by PRS.

Situation (2): A, an attorney, is retained by Y corporation, in connection with Y's acquisition of oil and gas properties. In 1983, A conducted title examinations for oil and gas properties and drafted a number of lease agreements under which Y acquired the minerals in place. A and Y agreed that for each such lease Y acquired, A would receive, in 1983, an overriding royalty interest (as described in Rev. Rul. 67-118) in the oil and gas to be produced under the lease.

Situation (3): B, an employee of Z, a closely held corporation, is responsible for the administrative and policy matters of Z. B's duties include arranging financing for the acquisition and development of oil and gas properties located by Z's technical staff and overseeing the operations of Z in developing the properties. For these services, in 1983, B received from Z a salary plus an overriding royalty interest (as described in Rev. Rul. 67-118) in the oil and gas to be produced from each lease acquired by Z.

LAW AND ANALYSIS

Section 83(a) of the Code and the regulations thereunder provide that, if in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of the property at the first time the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for the property, is included on the gross income of the person who performed the services. The taxable year of inclusion is generally the first taxable year in which the rights of the person receiving the property are substantially vested, i.e., transferable or not subject to a substantial risk of forfeiture. See Section 1.83-3(b) of the regulations.

Rev. Rul. 67-118 provides that an overriding royalty interest may be defined as an economic interest of oil and gas in place, created from the working interest that entitles its owner to a specified fraction of gross production, free of operating and development costs. The term of an overriding royalty interest is coextensive with the term of the working interest from which it was created. Thus, the transfer of an overriding royalty is an assignment of a property interest and is not an anticipatory assignment of income.

In the above situations, X, A, and B have each received property interests in the form of overriding royalties for the services each performed in connection with the oil and gas leases acquired and/or developed by PRS, Y, and Z.

HOLDINGS

In 1983, X, A, and B must include in gross income the fair market value of each overriding royalty interest received pursuant to Section 83 of the Code.

Perhaps the best way to view Rev. Rul. 83-46 is that it was simply reversing the prior TAMs that expanded the pool of capital doctrine to pre-drilling and equipping services, especially since the promoter X does not appear to be in the prior chain of title for the properties. But the absence of any discussion of G.C.M. 22730 was cause for concern. Background information notes relating to the issuance of Rev. Rul. 83-46, obtained under the Freedom of Information Act, contain the following:

> In view of the length of time G.C.M. 22730 and Rev. Rul. 77-176 have been outstanding, it would not be feasible to revoke them. Reference to GC.M. 22730, Rev. Rul. 77-176, and the pool of capital investment doctrine, has been intentionally omitted in the proposed revenue ruling in favor of related factual situations, though sufficiently distinct from the G.C.M. and Rev. Rul. 77-176. It is believed that this approach is the most effective way to accord compensatory arrangements relating to the acquisition and development of oil and gas properties the same tax treatment under sections 61 and 83 of the Code as other compensatory arrangements in which property interests are received.

In *Zuhone v.Comm'r.*, 883 F.2d 1317 (7th Cir. 1989) the Court of Appeals affirmed the Tax Court and refused to apply the pool of capital investment doctrine to royalty interests granted to the president and virtually the sole shareholder of the transferor corporation for services provided in the acquisition, drilling and operation of wells. The court determined that the "continued viability of the pool of capital doctrine was threatened by Rev. Rul. 83-46" and in reviewing the development of the IRS's position in Rev. Rul. 83-46, and in spite of the IRS's defense of the pool of capital doctrine in its brief, the Court stated:

> In this 1983 revenue ruling, the IRS, although not formally rejecting G.C.M. 22730, has indicated its disfavor with the exception therein by severely limiting the application of the pool of capital investment doctrine. We likewise express doubt as to the wisdom of judicially endorsing this exception to sections 61 and 83 of the Code for the oil and gas industry in the absence of legislative intent. For the purposes of this appeal, however, it is unnecessary to reject the doctrine under all factual circumstances, since taxpayer does not meet the exception.

The Seventh Circuit's statement is dicta because it had determined that Zuhone did not meet the pool of capital standards that he had asserted to the court. "Here taxpayer did not look solely to the mineral interests for his possibility of profit….as an employee of the corporation, taxpayer received a salary from the corporation as partial compensation for his services."

IRS Current Position[5]?

The status of G.C.M. 22730 is unclear at this time. It has not been revoked although it seems to have been partially superseded by the 1954 Code, case law, and the 1969 Tax Reform Act.

Generally, for the pool of capital doctrine to apply, all of the following must occur:

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[5] The IRS position under this heading is taken primarily from the IR Manual 4.41.1 (07-31-2002).

1. The contributor of services must receive a share of production, and the share of production is marked by an assignment of an economic interest in return for the contribution of services.
2. The services contributed may not in effect be a substitution of capital.
3. The contribution must perform a function necessary to bring the property into production or augment the pool of capital already invested in the oil and gas in place.
4. The contribution must be specific to the property in which the economic interest is earned.
5. The contribution must be definite and determinable.
6. The contributor must look only to the economic interest for the possibility of profit.

The only exception to the general rule is a production payment carved out of a mineral property that is pledged for exploration or development of such property (Treas. Regs. 1.636-1). The Regulations are very specific that certain conditions must be met before the production payment will qualify as a true production payment (Treas. Regs. 1.636-1).

A production payment shall not be treated as carved out for exploration or development to the extent that the consideration for the production payment:

a. Is not pledged for use in the future exploration or development of the property or properties which are burdened by the production payment
b. May be used for the exploration or development of any other property, or for any other purpose than that described in (a) above
c. Does not consist of binding obligation of the payee of the production payment to provide services, materials, supplies, or equipment for the exploration or development described in (a) above
d. Does not consist of a binding obligation of the payee of the production payment to pay expenses of the exploration or development described in (a) above

Whether a production payment meets the criteria of being "pledged for development" is a question of fact to be determined in light of all relevant information that should be considered. Three factors should be verified in each case of a production payment allegedly pledged for development.

a. The development must relate to the property burdened by the production payment.
b. The proceeds must be used for exploration and development, not for the production of minerals. The Regulations indicate that one of the tests that should be applied is whether or not there has been any prior production from the mineral deposit burdened by the production payment. If there has been production, it may not meet the exception of Treas. Regs. 1.636-1(b) as production payment pledged for development.

c. Repayment of the production payment must be only from the property involved and not from other leases or by a guaranty letter. See *Brountas v. Commissioner*, 73 T.C. No. 42 (1979).

To be classified as a production payment, there must be sufficient anticipated reserves to "pay off" the production payment. (Note that this was not a requirement in G.C.M. 22730.)

Example: On wildcat (untested) leases, reserves (if any) are not known. Any future wells drilled may be dry holes. Regulation 1.636-3(a) states that a production payment "right to a mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby."

Today's Paradigm

It is rather rare in today's oil and gas industry for an oil company[6] to own drilling rigs and to drill and equip a well for an economic interest in that property. Instead the oil company pays a drilling service company to drill and equip the well. So the drilling company, which performs the services, receives cash, not an economic interest in the property. It is the oil company whose cash was used to drill and equip the well that receives an economic interest in that property. Has the oil company's cash been essentially pledged for development?

Using the construct of Rev. Rul. 77-176, does the oil company (i.e., X) perform any "services" by paying cash to the drilling company? If X performs no services does Section 83 apply? Is X's operating interests in the tract acreage outside of the drill site and its operating interest in the tract acreage inside the drill site aggregated under Section 614(b)(1)? If not, does X have income from the receipt of the tract acreage outside of the drill site, or does X have to allocate some of its cash paid to the driller as basis in the tract acreage outside of the drill site or is X covered by the pool of capital doctrine?

[6] In rare circumstances a small drilling company may receive an economic interest in certain shallow wells that it drills.