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Advance Sales of Future Mineral Production May Be Taxed Sooner than You Think

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New rules on advance payments could change when payments for future mineral production are subject to tax. After considering the differences between the old and new rules, taxpayers should review agreements to determine if there is a shift in the accrual timing.

On September 9, 2019, the IRS issued proposed regulation section 1.451-8[1] to clarify new section 451(c).[2] New section 451(c) changed the timing of taxation for certain advance payments, including advance payments for future mineral production and delivery. A taxpayer using the accrual method of accounting that receives any advance payment during the year generally includes the advance payment in gross income for the tax year of receipt. Receipt for purposes of new section 451(c) means actual or constructive receipt and encompasses situations in which an item is due and payable to the taxpayer. Certain advance payments for future mineral deliveries that previously could have been deferred to subsequent tax years under the old law may no longer be eligible for deferral treatment. However, the proposed regulations under section 451(c) allow an exclusion for certain defined forward sales of goods.

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 Passed under the Tax Cuts and Jobs Act, P.L. 115-97 (the "TCJA").

This article examines four types of advance mineral payments for federal income tax purposes; new section 451(c) does not affect the first two, but it may change when income related to an advance sale of minerals to be produced and delivered in the future or an advance sale of inventoriable goods is included in taxable income. These variations on advance payments for future mineral deliveries are discussed below.

Sale of a Royalty Interest

The owner of a mineral operating interest may carve out a royalty interest (a nonoperating interest) and sell it. When the royalty interest is carved out, the owner will treat the royalty conveyance as a sale of real property and will split its adjusted tax basis in the mineral property between the retained operating rights and the conveyed royalty. The adjusted tax basis in the mineral property under section 1016 is apportioned based on the fair market values of the two interests on the sale date.[3] The proceeds received less the adjusted tax basis of the royalty interest determines the gain or loss for the seller. The seller would likely have either section 1231 loss or gain subject to section 1254(a)(2)(A) ordinary income recapture. Alternatively, the buyer could purchase a mineral lessor's retained royalty interest, and the seller would likely have either section 1221 loss or gain subject to section 1254(a)(2)(B) ordinary income recapture.

The royalty interest buyer will receive a fractional interest share of any future production from the mineral property, either in cash or in kind. When the royalty owner receives royalty income, it is subject to depletion.[4]

Volumetric Production Payments

A mineral operating interest owner or a royalty interest owner may carve out a volumetric (i.e., a volume of minerals to be delivered in the future) production payment burdening one or more mineral properties and sell it to a buyer. A carved-out production payment must be an economic interest in the minerals in place and have a shorter life than the life of the mineral property it burdens.

Revenue Procedure 97-55[5] provides a safe harbor if it is reasonably expected, at the time the production payment right is created, that:

- The right will terminate upon the production of not more than 90 percent of the reserves then known to exist, and
- The present value of the production expected to remain after the right terminates is five percent or more of the present value of the entire burdened mineral property.

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[3] Section 1.614-6(a)(2)(i)(a).

[4] Sections 611, 613, or 613A.

[5] Rev. Proc. 97-55, 1997-2 C.B. 582.

The safe harbor treats carved-out production payments (not pledged for exploration or development of the burdened property under section 636(a)) as a purchase money mortgage loan generating interest expense and a repayment of principal by the burdened mineral property owner, and interest income and a repayment of principal to the production payment buyer.

However, if the production payment proceeds are pledged for exploration or development of the burdened mineral property, then the burdened mineral property owner is treated as conveying an economic interest in the mineral property to the buyer in a "pool of capital" transaction.[6] The pledged production payment seller does not have any income from the sales proceeds applicable to the pledged production payment and does not receive any deductions for its expenditure of the pledged funds. The pledged production payment buyer receives income from the property that qualifies for depletion.

Advance Sale of Minerals to Be Produced and Delivered in the Future

The owner of an operating or royalty interest in mineral property may receive advance proceeds for a volume of minerals that are expected from the mineral property and will be delivered to a buyer if, as, and when produced. New section 451(c) may change when the advance proceeds received are subject to tax. The term "streaming agreement" is in general an advance sale of minerals that are when produced, refined, and delivered.

Old Rules

Prior to January 1, 2018, the general rule was that under the accrual method of accounting, income was includible in gross income when all the events occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy.[7]

Thus, when a taxpayer received a payment for goods prior to providing those goods, the advance payment would, as a default matter, be included in income upon receipt. However, prior section 1.451-5 allowed advance payments for goods to be reported in the tax year during which the payments were properly accruable for tax purposes (i.e., when the goods are shipped, delivered, or accepted), but no later than the tax year in which those amounts were taken into account for financial reporting purposes, unless an inventoriable goods exception applied (the general deferral method).

Prior section 1.451-5(c) limited deferral of payments under the general deferral method. Recognition of advance payments could be deferred until the end of the second tax year following the year the

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[6] GCM 22730, 1941-1 C.B. 214 (1941 WL 77257). GCM 38883 (July 26, 1982) generally obsoleted all General Counsel Memoranda (1-28099) issued prior to enactment of the 1954 Code (Aug. 16, 1954) except those published in the Internal Revenue Bulletin. GCM 38906 (Oct. 13, 1982) noted, in part, that GCM 22730 had been published in the Internal Revenue Bulletin and was "still current." *See also* CCA 20150004 (May 18, 2015).

[7] Section 1.451-1(a).

taxpayer received the payment (i.e., a maximum two-year deferral) if the payment had not already been included in income under the taxpayer's accrual accounting method and:

- The taxpayer was deferring prepayments on the sale of goods under section 1.451-5;
- The taxpayer had received "substantial advance payments" (the total of the advance payments received on the future sales of inventoriable goods equaled or exceeded the total estimated cost of goods to be sold under the sale agreement); and
- The taxpayer had goods of a substantially similar kind on hand (or available during the year through the normal source of supply) in sufficient quantity to satisfy the sale agreement.

In an advance sale of minerals to be produced in the future, the third requirement was usually not met because the mineral reserves had not yet been produced or refined. As a result, the advance payments were not considered to be substantial advance payments, and this inventoriable-goods exception did not apply. After the law changed, the IRS proposed removing section 1.451-5(c) as obsolete because it was supplanted by section 451(c).[8]

New Rules

For periods after 2017, new section 451(c) requires an accrual-method taxpayer that receives any advance payment during the tax year to include the advance payment in gross income for that tax year, unless the taxpayer elects to include in gross income the amount included in its financial statements and include the remaining portion of the advance payment in gross income in the succeeding tax year.

Proposed Regulation Section 1.451-8 under the New Rules

The advance sales of inventoriable goods generally follow the new section 451(c) rules. The sales proceeds received in streaming agreements are typically required to be used for exploration and development of a specified mineral property.

The agreement may give the buyer the right to receive refined minerals, the volume of which is determined by a percentage of the mineral volume extracted from the specified mineral property. However, there is generally no requirement for the refined minerals delivered to the buyer to have been extracted from the specified mineral property. The purchase of refined mineral volumes is a derivative covenant, which does not purport to grant the buyer an economic interest in the specified mineral property. The delivery for the refined mineral is often by London Metal Exchange (LME) or Commodity Exchange Inc. (COMEX) warrants.

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[8] Preamble, REG-104872-18, 83 *Fed. Reg.* 51904 (Oct. 15, 2018).

Treasury and the IRS determined that an exclusion is appropriate for certain goods on which a taxpayer requires a customer to make an upfront payment under the contract[9] if:

- The contracted delivery month and year of the goods occurs at least two tax years after an upfront payment,
- The taxpayer does not have the goods or a substantially similar goods on hand at the end of the year the upfront payment is received, and
- The taxpayer recognizes all revenue from the sale of the goods in its AFS (applicable financial statement) in the year of delivery.

A taxpayer may rely on these proposed regulations for tax years beginning after December 31, 2017, provided that the taxpayer applies all portions of the applicable rules contained in the proposed regulations and consistently applies the proposed regulations to all advance payments.[10] Treasury and the IRS employed the authority granted to the Secretary[11] to exclude certain payments, in a limited manner, that would otherwise constitute advance payments within the meaning of section 451(c)(4)(A), in response to proposals described in comments to the proposed regulations.

Other Considerations

Percentage depletion under section 613 for minerals other than oil and gas should be claimed when the depletable income is paid or accrued.[12] For tax years after 1986, percentage depletion on oil and gas may be claimed only when produced and paid.[13]

In *Freede*,[14] the court noted that a buyer of gas had "no legal title or leasehold interest in the gas or the gas-producing property." In fact, the contracts stated specifically that title to the gas passed from seller to buyer at the point of delivery, "which occurs at the wellhead or at the outlet of the well separator, if any."

Prepaid income can create a potentially severe mismatch between the recognition of the income and the ability to claim a deduction for cost of goods sold ("COGS") other than depletion (except for oil and gas). The preamble to the advance payment regulations under proposed section 1.451-8 pointedly rejected public comments that such a mismatch is inappropriate and that an acceleration of the income

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[9] Proposed section 1.451-8(b)(9).

[10] Section 7805(b)(7).

[11] Section 451(c)(4)(B)(vii)

[12] Malloy & Co. v. Commissioner., 33 B.T.A. 1130 (1936), *acq. in result*, 1964-2 C.B. 3 (lump-sum consideration received by the taxpayer for the sale of its entire gas production over the life of the field constituted depletable "gross income from the property" for the tax year of receipt).

[13] Section 613A(d)(5).

[14] H.J. Freede v. Commissioner., 864 F.2d 671, 673 (10th Cir. 1988) (see also Coleman v. United States, 388 F.2d 337 (Ct. Cl. 1967) (gas sales agreement for the entire life of the reserves did not convey an economic interest to the gas purchaser).

under the new section 451 rules should allow a COGS offset in the same year. Instead, Treasury and the IRS took the position that the rules for income and the rules for deductions/COGS are separate provisions of the Code, and that the TCJA's amendment of the income provisions to accelerate income to match book accrual did not affect the provisions governing deductibility of performance costs.

Observations

Considering the changes to when advance payments for future mineral production are subject to tax, taxpayers should review their agreements to determine if there is a change to the accrual timing under new section 451(c) and guidance under the proposed regulations.