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his capital investment and a reasonable return thereon.

(b) *Property*. The term *property* has the meaning assigned to it in section 614(a), without the application of section 614 (b), (c), or (e).

(c) *Transfer*. The term *transfer* means any sale, exchange, gift, bequest, devise, or other disposition (including a distribution by an estate or a contribution to or distribution by a corporation, partnership, or trust).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

§ 1.636-4 Effective dates of section 636.

(a) *In general*. Except as provided hereinafter in this section, section 636 and §§1.636-1, 1.636-2, and 1.636-3 apply to production payments created on or after August 7, 1969, other than production payments created before January 1, 1971, pursuant to a binding contract entered into before August 7, 1969.

(b) *Election*. Under section 503(c)(2) of the Tax Reform Act of 1969, if the taxpayer so elects, section 636(a) of the Code and §§1.636-1 and 1.636-3 apply to all production payments carved out by him after the beginning of his last taxable year ending before August 7, 1969, including such production payments created after such date pursuant to a binding contract entered into before such date. No interest shall be allowed on any refund or credit of any overpayment of tax resulting from an election under section 503(c)(2) for any taxable year ending before August 7, 1969. The provisions of this paragraph may be illustrated by the following example:

Example. A, a fiscal-year taxpayer whose taxable year ends on October 31, carved out and sold (from a producing property) production payments on October 1, 1967, and on July 9, 1969. On August 1, 1969, A entered into a binding contract to create another carved-out production payment (from a different producing property) and the production payment was carved out on December 22, 1969. If A elects under section 503(c)(2), the production payments carved out on July 9, 1969, and December 22, 1969, are treated as mortgage loans under section 636(a). The production payment carved out on October 1, 1967, is not treated as a mortgage loan under section 636(a) because it was carved out before the beginning of A's last taxable year ending before August 7, 1969.

(c) *Time and manner of making election*. (1) Any election under section

503(c)(2) of the Tax Reform Act of 1969 must be made not later than May 30, 1973.

(2) An election under section 503(c)(2) shall be made by a statement attached to the taxpayer's income tax return (or amended return) for the first taxable year in which the taxpayer created a production payment (i) to which the election applies, and (ii) which, in the absence of section 636, would not have been treated as a loan. A statement shall also be attached to an amended return for each subsequent taxable year for which he has filed his income tax return before making the election, but only if his tax liability for such year is affected by the election. Each such statement shall indicate the taxpayer's election under section 503(c)(2), and shall identify by date, amount, parties, and burdened mineral properties all production payments described in subdivisions (i) and (ii) of this subparagraph which have been created by the date on which the statement is filed. However, a taxpayer who, prior to the date on which permanent regulations under this section are published in the FEDERAL REGISTER, made a valid election under section 503(c)(2) pursuant to §§301.9100-17T and 301.9100-18T of this chapter are not required to amend statements previously furnished which meet the requirements of §301.9100-17T(b)(1)(ii) of this chapter unless requested to do so by the district director. In applying the election to the taxable years affected, there shall be taken into account the effect that any adjustments resulting therefrom have on other items affected thereby and the effect that adjustments of any such items have on other taxable years. In the case of a member of a consolidated return group (as defined in paragraph (a) of §1.1502-1), section 503(c)(2) and paragraphs (b), (c), and (d) of this section shall be applied as if such member filed a separate return.

(d) *Revocation of election*. A valid election under section 503(c)(2) shall be binding upon the taxpayer unless consent to revoke the election is obtained from the Commissioner. The application to revoke such election must be made in writing to the Commissioner of Internal Revenue, Washington, D.C.

20224, not later than May 30, 1973. Such application must set forth the reasons therefor and a recomputation of the tax reflecting such revocation for each prior taxable year affected by the revocation, whether or not the period of limitations for credit or refund or assessment and collection has expired with respect to such taxable year. Consent shall not be given in any case in which the revocation would result in an increase in the taxpayer's tax liability for a taxable year for which such period of limitations has expired unless the taxpayer waives his right to assert the statute of limitations.

(e) *Special rule.* (1) Except as provided in subparagraph (2) of this paragraph, in the case of a taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, section 636 of the Code applies to production payments carved out during the taxable year which includes August 7, 1969, as provided in paragraph (a) of this section, only to the extent that the aggregate amount of such production payments exceeds the lesser of:

(i) The excess of:

(a) The aggregate amount of production payments carved out and sold by the taxpayer during the 12-month period immediately preceding his taxable year which includes August 7, 1969, over

(b) The aggregate amount of production payments carved out and sold before August 7, 1969, by the taxpayer during his taxable year which includes such date, or

(ii) The amount necessary to increase the amount of the taxpayer's gross income within the meaning of chapter 1 of subtitle A of the Code, for his taxable year which includes August 7, 1969, to an amount equal to the amount of his deductions (other than any deduction under section 172) allowable for such year under such chapter

In applying the preceding sentence, production payments carved out for exploration or development are to be taken into account only to the extent, if any, that *gross income from the property* (for purposes of section 613) would have been realized by the taxpayer creating such production payment under the law existing at the time of the cre-

ation of such production payment, in the absence of section 636(a).

(2) Subparagraph (1) of this paragraph shall not apply for any taxable year for purposes of determining the amount of any deduction for cost or percentage depletion allowable under section 611 or the limitation on any foreign tax credit under section 904.

(3) The application of this paragraph may be illustrated by the following examples:

Example 1. (a) A, a calendar-year taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, carves out and sells on December 31, 1968, a \$500,000 production payment. Further, A carves out and sells on March 4, 1969, a \$300,000 production payment, and on November 14, 1969, a \$150,000 production payment. None of the production payments are carved out for exploration or development. During 1969, A has gross income of \$600,000 (determined initially for this purpose by treating the \$150,000 production payment carved out on November 14, 1969, as a loan) and allowable deductions of \$700,000.

(b) The provisions of section 636 do not apply to a portion of the November 14, 1969, production payment for purposes other than section 611 and section 904 of the Code, determined as follows:

(1) Amount of production payment carved out in 1969 on or after August 7, 1969	\$150,000
(2) Amount of production payment carved out during 1968	500,000
(3) Amount of production payment carved out during 1969 taxable year before August 7, 1969	300,000
(4) Item (2) minus item (3)	200,000
(5) Excess of allowable deductions over gross income for 1969	100,000
(6) Amount of production payment carved out in 1969 on or after August 7, 1969, to which section 636 does not apply (lesser of items (1), (4), and (5))	100,000

Thus, A will not treat \$100,000 of the consideration received for the production payment carved out on November 14, 1969, as a loan and as a result his gross income for 1969 will be \$700,000. However, in computing percentage depletion, A will not include the \$100,000 in *gross income from property* and in computing cost depletion A will not include the mineral units attributable thereto. Nor, will A include the \$100,000 in determining the limitation on foreign tax credit under section 904.

Example 2. Assume the same facts as in example 1 except that for taxable year 1969 A's gross income (determined initially for this purpose by treating the November 14, 1969, production payment as a loan) exceeds the amount of his allowable deductions under

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chapter 1 of subtitle A of the Code. The entire amount of the November 14, 1969, production payment is treated as a mortgage loan under section 636(a).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

CONTINENTAL SHELF AREAS

§ 1.638-1 Continental Shelf areas.

(a) *General rule.* For purposes of applying any provision of chapter 1, 2, 3, or 24 (including section 861(a)(3), 862(a)(3), 1441, 3402, or other provisions dealing with the performance of personal services), with respect to mines, oil and gas wells, and other natural deposits:

(1) *United States and possession of the United States.* The terms *United States* and *possession of the United States* when used in a geographical sense include the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States or such possession and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources. The terms *Continental Shelf of the United States* and *Continental Shelf of a possession of the United States*, as used in this section, refer to the seabed and subsoil included, respectively, in the terms *United States* and *possession of the United States*, as provided in the preceding sentence.

(2) *Foreign country.* The term *foreign country* when used in a geographical sense includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which such foreign country has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources, but this sentence applies only if such foreign country exercises, directly or indirectly, taxing jurisdiction with respect to such exploration or exploitation. The term *foreign continental shelf*, as used in this section, refers to the seabed and subsoil described in the preceding sentence. A foreign country is not to be treated as a country contiguous to the United States by reason of the application of section 638 and this section.

(b) *Exercise of taxing jurisdiction.* For purposes of paragraph (a)(2) of this section, the exercise, directly or indirectly, of taxing jurisdiction with respect to the exploration for, or exploitation of, natural resources is deemed to include (but is not limited to) those cases in which a foreign country:

(1) Imposes a tax upon assets, equipment, or other property connected with or income derived from such exploration or exploitation, or

(2) Requires natural resources referred to in paragraph (a)(2) of this section to be transported to points within its landward boundaries and then levies a tax upon such natural resources or upon the income derived from the sale thereof

A foreign country which, for purposes of paragraph (a)(2) of this section, exercises taxing jurisdiction by the imposition of tax upon any person, property, or activity engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section, or the income therefrom of any taxpayer, is deemed to exercise taxing jurisdiction over all such persons, property, and activities and over all income therefrom of all such taxpayers; thus, for example, a foreign country which imposes tax upon a person engaged in exploitation of oil and gas wells in its seabed and subsoil referred to in paragraph (a)(2) of this section is deemed to exercise taxing jurisdiction over property related to exploration for other natural deposits in such seabed and subsoil. A foreign country is deemed to be imposing tax upon a person, property, activity, or income described in the preceding sentence if such foreign country exempts such person, property, activity, or income from tax for a period not in excess of 10 years from the commencement of such exploration or exploitation. Except in the case of a foreign country which is deemed under the preceding sentence to impose tax by virtue of an exemption for a period not in excess of 10 years, a foreign country which exempts all persons, property, and activities engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of