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ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING 94-006

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TO:

FROM: Commissioner of Revenue (Acting)
ALABAMA DEPARTMENT OF REVENUE

DATE: June 10, 1994

SUBJECT: Income and Franchise Taxation of Proposed Royalty Trust to be Organized as a Fixed Investment Trust to Acquire Overriding Royalty Interest in Alabama Coalbed Methane Properties

ISSUES AND FACTS

The facts as represented by requestor are as follows:

Company A (the "Company") owns certain proved developed natural gas properties lying in Location A. (the "Underlying Properties"). The Underlying Properties were originally developed by Company B for the production and sale of coalbed methane gas from the Location A. The Company proposes to convey a X% overriding royalty interest in these coalbed methane properties (the "Royalty Interest") to Trust A (the "Trust"), which will be a fixed investment trust organized under the Delaware Business Trust Act, commonly known as a "royalty trust". The Royalty Interest will be a nonoperating interest and will bear only expenses relating to property, production and related taxes (including Alabama severance taxes).

In return for the Royalty Interest, the Trust will issue X amount of units of beneficial interest (the "Units") to the Company, which will then dividend the Units to its ultimate parent company, Company C. The Units will then be offered for public distribution pursuant to the Prospectus originally filed with the U.S. Securities and Exchange Commission on Date X, bearing registration Number X.

The Trust will be a passive entity formed for the single purpose of holding the Royalty Interest. Although formed under the Delaware Business Trust Act, the limited purpose of the Trust and the strict limitations on the powers of the Trustees will result in the Trust being treated as a fixed investment trust for federal and Delaware income tax purposes. The Trust is strictly prohibited from engaging in business. The Trustees have no discretionary authority and are authorized to take only such actions as specifically set forth in the Trust Agreement. Accordingly, the Trustees have no power to vary the investment of the Trust and are prohibited from causing the Trust to receive any assets other than an initial cash deposit, the Royalty Interest, and the temporary investments of cash proceeds from the Royalty Interest.

The Trust will receive quarterly payments based on the revenues received from the sale of natural gas produced from the Underlying Properties attributable to the Royalty Interest. The cash proceeds from the payments made to the Trust (net of Trust administrative expenses) will then be distributed to the Unitholders on a quarterly basis with respect to periods prior to termination of the Trust. In addition, the federal income tax credit granted by section 29 of the Internal Revenue Code will be allocated quarterly to the Unitholders through Date X.

The net proceeds of the offering of the Units will be paid entirely to Company C and the Trust will not receive any of the proceeds. The Underlying Properties are presently operated by Company D, an unrelated corporation, and the parties intend that relationship to continue. The coalbed methane gas presently being produced from the Underlying Properties is sold to Company E pursuant to a gas purchase agreement that extends as long as reserves on the Underlying Properties produce natural gas in certain quantities. The Royalty Interest will entitle the Trust to receive X% of the gross proceeds of the production and sale from the subject gas to Company E. It is intended that Company E will make periodic payments to the Company for the gas produced from the Underlying Properties and the Company will, in turn, remit X% of those proceeds to the acting trustee of the Trust, Trustee A, headquartered in Location B. The Trust will not be entitled to receive a specific quantity of gas in-kind but only the sale proceeds of the gas first remitted to the Company by Company E.

Apart from its ownership of the Royalty Interest, the Trust will have no connection with Alabama. The Trust will maintain no office, telephone number or postal address within Alabama and a substantial number, if not the majority, of the Unitholders will be nonresidents. The trust instrument forming the Trust will be executed and delivered outside of Alabama and provides that all meetings of the Trustees and Unitholders will be held exclusively outside of Alabama. Both Trustees of the Trust will be nonresidents of Alabama. The Trust will contract with third parties for the performance of all administrative services

necessary for its operation and all contracts to which the Trust will become a party will be executed outside of Alabama. The principal books and records of the Trust will be located outside of Alabama. The Trust will not have any employees. The Units will not be registered as "capital stock" with the SEC. Based on the facts set forth above, the Trust does not intend to qualify to do business in Alabama.

The Department assumes, for purposes of this ruling, that the discussion in the Prospectus entitled "Federal Income Tax Consequences -- Classification of the Trust" to the effect that the Trust will be classified as a trust for federal income tax purposes is correct and properly reasoned.

The issues are as follows:

(1) Will the Trust be classified as a trust for Alabama income tax purposes?

(2) Will the nonresident Unitholders be subject to Alabama income taxation on their distributive share of the Trust's net income?

(3) May the Department lawfully enter into the proposed composite income tax return agreement with the Trust on behalf of itself and the nonresident Unitholders?

(4) Will the Trust be classified as a trust, rather than as a corporation, for purposes of the foreign franchise tax?

LAW AND ANALYSIS

ISSUE (1)

For State of Alabama income tax purposes, a business trust is taxed as an ordinary trust in accordance with §40-18-25. See §19-3-67. Thus, the income of the Trust will be taxed in the same manner as that of an ordinary trust.

ISSUE (2)

Royalty interest income derived from an overriding royalty interest in coalbed methane properties located in Alabama constitutes income from sources within the State of Alabama. Therefore, a nonresident of the State of Alabama is subject to Alabama income tax on income arising therefrom.

Nonresident beneficiaries of a trust are subject to Alabama income taxation on their distributive share of trust income attributable to Alabama sources. See Section 40-18-25(d) and Department Regulation 810-3-25-.05(1)(b). Thus, each

nonresident Unitholder is subject to Alabama income tax on their distributive share of the Trust's net income.

ISSUE (3)

No statutory provision specifically authorizes the Department to enter into a composite income tax return agreement with The Trust on behalf of itself and the nonresident Unitholders. The Department will in this case, as a matter of administrative policy, allow The Trust to file a composite return on behalf of itself and the nonresident Unitholders.

The Composite income tax return will avoid the need to list the names and addresses of all nonresident Unitholders but will provide for only one personal exemption (presently, $1500), to be claimed by the Trust on behalf of all Unitholders who are nonresidents, as described above. A deduction for depletion will be allowed on the composite income tax return based on the combined factors for the nonresident Unitholders. Under the composite income tax return the Department will be allowed to collect any Alabama income tax owed by the nonresident Unitholders directly from the Trust as if it were the taxpayer.

ISSUE (4)

Article XII of the Constitution of Alabama of 1901 pertains to corporations. Section 241 defines "corporation" to include all joint stock companies, and all associations having any of the powers or privileges of a corporation, not possessed by individuals or partnerships. A business trust will be treated as an association if its corporate characteristics are such that it more nearly resembles a corporation than a trust. See Morrissey et al. v. Commissioner, 296 U.S. 344 (1935). As a general rule, most business trusts are treated as associations taxable as corporations. There are exceptions, however, either because of statutory authority to the contrary or because the business trust is properly classified as a trust due to its retaining the traditional characteristics of a trust.

The Trust in this case is prohibited from engaging in business, a fundamental requirement of a business trust or association. See Morrissey, 296 U.S. at 356 (an association "implies the entering into a joint enterprise . . . for the transaction of business"). The purpose of the Trust in this case is to conserve and protect the assets of the Trust for the benefit of the Unitholders, traditional characteristics of a trust. The Trustees in this case are prohibited from varying the investment of the Trust. Thus, the Trust properly is classified as a trust, not an association or business trust. See Chase National Bank v. Commissioner, 122 F.2d 540 (2d Cir. 1941) (fixed investment trust was treated as a trust and not an association where, for the purpose of conserving trust property,

the trustee had ministerial functions of holding corpus and distributing income and sales proceeds, and had no power to direct investments); Royalty Participation Trust v. Commissioner, 20 T.C. 466 (1953) (an oil royalty investment trust was treated as a trust and not an association where no power was granted to the trustee beyond those necessary for the preservation of trust property and the collection and distribution of income therefrom); Treas. Reg. §301.7701-4(c) (an investment trust with a single class of beneficial interests will be classified as a trust if there is no power under the trust agreement to vary the interests of the certificate holders). Thus, the Trust will not be classified as a "corporation" under section 241 of our Constitution; therefore it will not be subject to the foreign franchise tax.

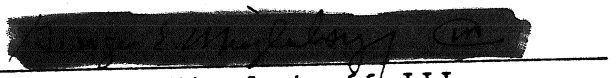
HOLDINGS

(1) The Trust will be classified as a trust for Alabama income tax purposes.

(2) The nonresident Unitholders will be subject to Alabama income tax on their distributive share of the Trust's net income.

(3) The Department will allow, as an administrative policy, the Trust to file a composite return on behalf of itself and the nonresident Unitholders.

(4) The Trust will not be classified as a corporation under §241 of the Ala. Const.; therefore, it will not be subject to the foreign franchise tax.



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