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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-160707-04

Date:
May 04, 2005

Legend:

Company =

State =

Dear :

This responds to your request for a ruling dated November 18, 2004, submitted on behalf of Company. Company requests a ruling that income and gains from certain net profits and overriding royalty interests are qualifying income under section 851(b)(2) of the Internal Revenue Code of 1986, as amended ("Code").

FACTS

Company is organized as a State corporation and has elected to be treated as a business development company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the 1940 Act). Company will be classified as a closed-end, non-diversified management investment company under the 1940 Act.

Company has elected under section 851(b)(1) of the Code to qualify as a regulated investment company ("RIC") for federal income tax purposes.

Company intends to use the proceeds of its initial public offering to make Vertical Loans and Mezzanine Loans, as described below, to small and mid-size energy companies. These loans provide for a relatively high degree of risk. The loans bear interest and may also entitle Company to receive additional compensation in the form of warrants, options to purchase equity securities of the borrower or the right to convert

into equity securities of the borrower, or a property-based equity interest in the borrowing companies.

Company represents that it will not enter into Vertical Loans or Mezzanine Loans, nor detach and sell an overriding royalty interest or net profits interest attached thereto, with a speculative purpose or expectation of profiting from market fluctuations in the price of oil or gas.

Vertical Loans

A Vertical Loan will consist of a senior secured loan and a subordinated loan with respect to a single facility. The senior tranche will produce a current cash yield and typically will be secured by a first lien on cash flow producing assets. The subordinated loan tranche typically will include a current cash yield component coupled with a property-based equity interest in the form of an overriding royalty interest or a net profits interest. The subordinated loan generally will be secured by the same lien as the senior tranche on the borrower's assets (assuming that the Company is the borrower's only secured creditor). In some cases, Company may receive from the borrowing company either a warrant or an option to purchase equity securities of the borrower, or the right to convert into such equity securities either in addition to, or in lieu of, an overriding royalty interest or a net profits interest.

In addition, a Vertical Loan may contain covenants that prohibit additional liens on the borrower's assets, limit additional debt, or require maintenance of minimum loan-to-collateral value ("asset coverage") ratios. Company anticipates that Vertical Loans usually will have a term of three to five years, but expects that in many cases, the Vertical Loans will be prepaid before maturity. Vertical Loans may bear interest at either a fixed or floating rate.

Mezzanine Loans

A Mezzanine Loan will generally take the form of subordinated debt coupled with an overriding royalty interest or net profits interest. The term may also be used to refer to preferred equity, such as redeemable preferred stock, that bears a coupon interest rate. In some cases, Company may receive from the borrowing company either a warrant or an option to purchase equity securities of the borrower or the right to convert into such equity securities either in addition to, or in lieu of, the overriding royalty interest or net profits interest. Company anticipates that Mezzanine Loans usually will have a term of three to five years, but expects that in many cases, Mezzanine Loans will be prepaid before maturity. Mezzanine Loans may bear interest at either a fixed or floating rate.

Property-based Equity Interests

A property-based equity interest appended to a Vertical Loan or Mezzanine Loan may take the form of either a net profits interest or an overriding royalty interest. These property-based equity interests are a customary form of consideration for loans made to small and mid-size energy companies.

An overriding royalty interest entitles the holder to a specified percentage of a borrower's oil and gas production under a lease free of any expense for exploration, drilling, development, operating, and other costs incident to the production and sale of oil and gas produced from the lease.

A net profits interest entitles the holder to a stated percentage of the net profits from the operation of the borrower's property. Unlike an overriding royalty, the income accruing to the net profits interest is reduced by specified development and operating costs to the extent of its share of the income.

Both an overriding royalty interest and a net profits interest entitle the holder to receive additional payments on a regular basis based upon the performance of specific assets of the borrower. Both are carved out of a working interest. The holder of either interest has no right to develop or operate the borrower's property. Rather, the holder is a passive investor entitled only to a stream of income.

When combined with a loan, these interests are intended to compensate Company for a lower coupon interest rate. The taxpayer represents that the coupon interest rate on a loan coupled with an overriding royalty interest or a net profits interest is significantly lower than it would be for the same loan without such an interest attached. The use of an overriding royalty interest or net profits interest in combination with a loan helps ensure that Company receives a rate of return appropriate to the risk undertaken in making the Vertical or Mezzanine Loan.

The use of an overriding royalty interest or net profits interest in combination with a loan mitigates the borrower's cash burden if its exploration and production activities are less successful than expected. Conversely, Company shares in the profits through the use of these property-based equity interests if the borrower's activities are more successful than expected.

Alienability of Property-based Equity Interest

Company will have the right to detach an overriding royalty interest or net profits interest that has been issued in combination with a Vertical Loan or Mezzanine Loan from the corresponding loan only in very limited circumstances. In general, the interest will be sold back to the borrower when the loan is repaid. Company may, however, detach the interest and sell it to a party other than the borrower within twelve months before or twelve months after the loan is paid or prepaid. This will afford Company adequate time to market the interest, permitting it to weather, for example, potential

temporary downturns in the market, or to give it time to effectuate necessary sale documents.

Company's ability to sell an interest to a third party will be further subject to the borrower's right of first refusal. The right of first refusal would allow the borrower to purchase the interest on the same terms and in the same manner as the offer from a third party. Company's ability to market and sell the detached interest to a third party is intended to help ensure that Company can negotiate a fair price from the borrower. If Company has not sold the interest within twelve months after the corresponding loan is paid or prepaid, the borrower will be required to purchase it at a formula price agreed to by the borrower and Company at the time the loan is made.

Finally, Company will have the right to detach the interest from the corresponding loan and sell it to a third party in the event that borrowing company is in default, as defined in the loan documents.

LAW AND ANALYSIS

Section 851(a)(1)(B) defines a RIC, in part, as a domestic corporation that has in effect an election under the 1940 Act to be treated as a business development company.

Section 851(b) limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(b)(2)(A) provides that, to qualify as a RIC, at least 90% of its gross income must be derived from dividends, interest; payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the 1940 Act), or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies.

Section 2(a)(36) of the 1940 Act defines the term "security" to include, inter alia, "any note, bond, debenture, or evidence of indebtedness". Vertical Loans and Mezzanine Loans are issued together with overriding royalty interests and net profits interests as investment units. The loan portion of such an investment unit is an evidence of indebtedness and thus is a security as described in this section of the 1940 Act. As 1940 Act securities, the loans are securities within the meaning of the phrase "stock or securities" in section 851(b)(2)(A).

Preferred equity, such as redeemable preferred stock, also falls within the meaning of the phrase "stock or securities" in section 851(b)(2)(A).

The overriding royalty interests and net profits interests are combined with Vertical Loans and Mezzanine Loans and are received by Company as additional consideration for the making of these loans. These interests compensate Company for a lower coupon rate of interest on the loans and are customary forms of consideration for loans made to small and mid-size energy companies such as the borrowers.

Company will not hold these interests independently of the loans for which they constitute consideration, except in the very limited circumstances previously described, nor will it have the right to sell these interests independently of the loans to which they relate, except in the very limited circumstances previously described. Company will not detach and sell an overriding royalty interest or net profits interest attached to a Vertical Loan or Mezzanine Loan with a speculative purpose or expectation of profiting from market fluctuations in the price of oil or gas. The overriding royalty interests and net profits interests are received, held, and sold by Company, therefore, in direct connection with its business of investing in stock or securities within the meaning of section 851(b)(2)(A).

CONCLUSION

In accordance with the foregoing, we rule that Company shall treat income and gains from the overriding royalty interests and net profit interests received by Company in combination with and as consideration for the making of Vertical Loans and Mezzanine Loans to borrowing energy companies, under the circumstances described in this letter, as other income derived with respect to its business of investing in stock or securities, for purposes of determining its qualification as a RIC under section 851(b)(2) of the Code.

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code and regulations.

No opinion is expressed concerning whether Company otherwise qualifies as a RIC under subchapter M, part I of the Code.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Susan Thompson Baker
Susan Thompson Baker
Assistant to the Branch Chief, Branch 2
(Financial Institutions & Products)