January 1966

A Guide to Federal Mineral Income Taxation - Part II

Harold S. Bloomenthal

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LAND AND WATER
LAW REVIEW

VOLUME I  1966  NUMBER 2

The following materials are Part II, and the concluding part, of
Professor Bloomenthal's Guide to Federal Mineral Income Taxation, Part
I of which appeared in Volume I, Number 1.

A GUIDE TO FEDERAL MINERAL
INCOME TAXATION -- PART II

Harold S. Bloomenthal*

TABLE OF CONTENTS—PART II

Page

Introduction ........................................................................................................ 380

Capital Gains and Losses—

Disposition of Mineral Properties ................................................................. 380

(1) Sale or Lease — Oil and Gas ................................................................. 381

(2) Sale or Lease—Minerals Other Than Oil and Gas .......................... 383

(3) Tax Advantages and Disadvantages of Sale ..................................... 385

(4) Section 1231 Assets, Capital Assets, Stock in Trade Distinguished ..... 390

(5) Determining the Holding Period ......................................................... 391

(6) Allocating Basis .................................................................................... 392

(7) Carved-Out Production Payments ..................................................... 396

(8) Acquiring Production—The ABC Transaction ................................ 399

Non-Taxable Exchanges and Sharing Agreements ...................................... 404

Form of Business Organization ..................................................................... 406

(1) Corporations ....................................................................................... 406

(2) Co-Owners ........................................................................................ 409

(3) Partnerships ....................................................................................... 412

Unitization .................................................................................................... 417

Forms ........................................................................................................... 420

Conclusion .................................................................................................... 422

* Professor of Law, University of Wyoming; LL.B. 1947, Duke University;
J.S.D. 1950, Yale University. Member Massachusetts, Colorado and Wyoming Bars.
In Part I of this Article, published in the previous issue, we were concerned primarily with tax deductions—depletion, exploration and development, depreciation and for losses—as peculiarly applicable to mineral operations. In Part II we are primarily concerned with the disposition of mineral properties and the form of business organization employed for carrying on mineral operations. There is necessarily some overlapping since the separate mineral property concept discussed in Part I is relevant to both the deductions and to disposition of mineral properties; since many of the *sui generis* arrangements for carrying on mineral activities such as the carried interest arrangement discussed in Part I in the context of deductions is in many respects a substitute for a more formal type of business association, and since the line between lease (discussed in Part I) and sale (discussed in Part II) is for some purposes the line between depletion (discussed in Part I) and capital gain treatment (discussed in Part II). As in Part I as a matter of convenience the EXAMPLES refer to oil and gas transactions, but unless otherwise indicated are applicable to transactions involving other minerals as well. The footnote numbering continues from Part I and for most purposes it is essential that the reader consider the two parts as one integral article.

**Capital Gains and Losses—Disposition of Mineral Properties**

As is well known a taxpayer whether an individual or corporation, is, in effect, taxed on not more than 50 per cent of the excess of the net long-term capital gain over the net short-term capital loss and can in no event incur a tax that exceeds 25 per cent of such excess. A long-term capital gain results from the sale of a capital asset that has been held longer than six months. Long-term capital losses and net short-term capital losses can be offset against long-term capital gains and, in the case of an individual, applied against up to $1,000 of ordinary income. To the extent not so used such losses can be carried over indefinitely in the case of an
individual, and to the five succeeding tax years in the case of a corporation and offset against subsequent gains and, in the case of an individual against $1,000 of ordinary income. The loss carried over becomes a short-term capital loss in the year to which it is carried. Because of the aforementioned rules governing limitations on the taxation of long-term capital gains, it is always advantageous to a taxpayer to have income regarded as capital gain rather than ordinary income. On the other hand, because of the limitations noted with respect to deducting capital losses it is generally desirable for losses to be incurred as ordinary losses.

(1) Sale or Lease—Oil and Gas

There can be no capital gain unless the property involved is a capital or Section 1231 asset (see infra, p. 390) and unless there is a sale or exchange. Assuming taxpayer can avoid dealer classification, an interest in a mineral property is generally a capital asset or Section 1231 asset. See Part I, supra, p. 170. Generally with respect to a complete disposition of such assets there is no problem in obtaining capital gain treatment. However, transactions involving an incomplete disposition of oil and gas properties have given rise to considerable litigation. A number of transactions that would appear to be sales have for tax purposes been deemed to be subleases or leases because the "vendor" retained an interest (royalty, overriding royalty, etc.). As noted in connection with the discussion of depletion allowance, the consideration ("bonus") received for a lease or sublease (as distinguished from a sale) is considered an advance royalty taxable as ordinary income but with respect to which a depletion deduction can be taken. See Part I, supra, p. 86.

If the "vendor" disposes of a mineral property reserving an economic interest in the oil or gas, which interest will continue during the entire productive life of the property, the transaction is a lease or sublease and not a sale. Accordingly, if the fee owner receives a cash consideration for executing an oil and gas lease and reserves a royalty or, if an oil and gas lessee assigns his lease for a cash consideration, reserv-
ing an overriding royalty\textsuperscript{326} or net profit interest,\textsuperscript{327} a lease or sublease rather than sale is involved and the consideration received by the taxpayer is taxed as ordinary depletable income. If, on the other hand, the taxpayer reserves an oil payment and no other interest, the transaction involves a sale subject (as to the cash consideration received) to capital-gain treatment (other requirements thereof being present) in that the taxpayer has not reserved an economic interest that will continue during the entire life of the lease.\textsuperscript{328} Amounts received as oil payments would, however, be ordinary income, subject to depletion. If the taxpayer reserves an override and an oil payment, he has reserved an economic interest that will continue during the productive life of the property and the entire transaction is for tax purposes a sublease rather than a sale.\textsuperscript{329} Further, if the taxpayer is unable to establish that the oil payment will pay out either because of its amount or because of the unproven nature of the property involved, it will be regarded as the equivalent of an override and the transaction will be treated as a leasing transaction.\textsuperscript{330}

In order for the transaction to be a lease or sublease the economic interest retained by the taxpayer must be in the nature of a “royalty” or comparable interest against which the cash received as consideration may be regarded as an advance. If the taxpayer sells all or a part of a royalty,\textsuperscript{331} of a lease\textsuperscript{332} of a net profit interest,\textsuperscript{333} or of a participating interest,\textsuperscript{334} the transaction involves a sale rather than a lease or sublease in that, even if the taxpayer retains a part of his original interest, any income accruing thereunder results from his ownership of such interest and not from the “royalty” or other comparable payments created as a result of the con-

\textsuperscript{327} Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946).
\textsuperscript{328} Hammonds v. Commissioner, 106 F.2d 420 (10th Cir. 1939); Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936); G.C.M. 22730, 1941-1 Cum. Bull. 214.
\textsuperscript{330} United States v. Morgan, 321 F.2d 781 (5th Cir. 1963).
\textsuperscript{331} Bankers Mortgage Co., 1 T.C. 698, aff’d, 141 F.2d 357 (4th Cir. 1944), cert. denied, 323 U.S. 727.
\textsuperscript{332} Badger Oil Co. v. Commissioner, 118 F.2d 791 (5th Cir. 1941).
\textsuperscript{334} Rawco, Inc., Ltd., 37 B.T.A. 128 (1938).
veyance. A conveyance of an undivided part of the mineral rights would also fall within the foregoing classification and as such involve a sale; however, if the grantee of such rights obligates himself to drill a well or wells, the transaction has many of the characteristics of an oil and gas lease and the court may find that the transaction is in substance a lease rather than a sale of the minerals.\(^{335}\)

(2) Sale or Lease—Minerals Other Than Oil and Gas

Several decisions have held that a transaction involving minerals other than oil and gas in which the "vendor" reserves an interest in the form of "vendee’s" promise to pay a fixed price per unit produced over the life of the property is a sale rather than a lease.\(^{336}\) If, \textit{e.g.}, the vendee should agree to pay the vendor a consideration at the time of the transaction and ten cents for every cubic yard of gravel produced, the transaction in the light of these holdings may possibly be a sale rather than a lease. Not only has the consideration received at the time of the transaction been accorded capital gain treatment, but the fixed unit price as paid has been accorded the same treatment.\(^{337}\) This would be a distinct advantage to the "vendor" over a reservation of a production payment which, although regarded as a sale as to the initial consideration, involves receipt of depletable income as payments are received from the production payment. The cases in this area are difficult to reconcile even within the same Circuit and, insofar as the fixed unit price is a factor appear to be in conflict with a Supreme Court decision.\(^{338}\) The cases have usually been argued in terms of


\(^{336}\) United States v. White, 311 F.2d 399 (10th Cir. 1962), \textit{non-acq.}, 1963-1 \textit{CUM. BULL.} 141; Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Crowell Land & Mineral Corp. v. Commissioner, 242 F.2d 864 (6th Cir. 1957); Ah Pah Redwood Co. v. Commissioner, 251 F.2d 163 (9th Cir. 1957); Gowans v. Commissioner, 246 F.2d 448 (9th Cir. 1957); Robert M. Dann, 30 T.C. 499 (1958); Maude W. Olinger, 27 T.C. 95 (1956); Commissioner v. Remer, 260 F.2d 337 (6th Cir. 1958). \textit{Contra:} Kittle v. Commissioner, 229 F.2d 313 (9th Cir. 1956); Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957); Laudenslager v. Commissioner, 305 F.2d 686 (3d Cir. 1962). For a discussion of these cases see Bloomenthal, \textit{supra} note 329.


whether the vendor has reserved an economic interest and, in reaching the capital gain conclusion, have relied in different instances on (a) the lack of the usual development requirement of a lease and other typical lease provisions,\(^\text{339}\) or (b) the fact that the vendee could not avoid the obligation by relinquishment and hence the payments could be regarded as a deferred payment of the purchase price.\(^\text{340}\) This latter rationale would appear applicable only with respect to a well-defined mineral deposit and covenants to produce or pay a minimum royalty. The cases have generally related to minerals other than oil and gas and at least one such holding specifically excluded oil and gas properties from its rationale.\(^\text{341}\) One Tax Court decision did involve oil and gas as well as other minerals.\(^\text{342}\) If this rationale should become applicable to payments made pursuant to a reserved oil payment, such payments could not be excluded from income by the vendee and the basic reason for the ABC transaction discussed at infra, p. 399, would be destroyed. Taxpayers relying on the fixed unit approach should use sale terminology rather than lease terminology.

The Code now expressly provides with respect to coal and iron deposits held for more than six months for tax treatment consistent with the foregoing cases. The "royalties" received pursuant to the retained interest are subject to capital gain treatment on the difference between the royalty owners' proceeds and adjusted depletion basis in the coal or iron.\(^\text{343}\) Initial payments received are also subject to capital gain treatment if in the form of advance royalty or minimum royalties to be applied on coal or iron ore subsequently mined\(^\text{344}\) or if in the form of a bonus to the extent

\(^{339}\) See, e.g., Maude W. Olinger, 27 T.C. 93 (1954).

\(^{340}\) See, e.g., Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957).

\(^{341}\) Ibid.


\(^{343}\) INT. REV. CODE OF 1954, § 631. See also INT. REV. CODE OF 1954, § 272 which disallows certain expenditures relating to such royalties as deductions, but permits them to be added to the royalty owner's depletion basis thus reducing the amount of gain. It, of course, also follows that such royalty owners cannot take a deduction for depletion.

\(^{344}\) Treas. Reg. § 1.631-3(c)(1) (1965). If the right to mine coal or iron ore under the contract ("lease") expires, terminates or is abandoned before advance or minimum royalties have been recovered, taxpayer must recompute his tax liability for the year in which such payments were received by treating such unrecovered payments as ordinary income. Treas. Reg. § 1.631-3(c)(2) (1965).
attributable to coal or iron ore held for more than six months.\(^{545}\)

A 1965 Supreme Court decision in the Brown case\(^{546}\) not directly related to mineral transactions may have a significant impact on the sale-lease distinction. The case involved a sale of stock the purchase price of which was to be paid in installments out of the earnings of the business. The Commissioner relying on the economic interest cases\(^{547}\) that are the basis for the sale-lease distinction in oil and gas transactions asserted that the transaction could not be treated as a sale resulting in capital gain treatment because the entire risk of the transaction remained on the sellers. The Court rejected this contention as being contrary to the policy reasons for the capital gain provisions which the Court viewed as being designed to ameliorate the bunching of income resulting from appreciation which accrued over a substantial period of time. Rather the Court relied upon the ordinary connotation of the term “sale” as the transfer of property for a fixed price in money or its equivalent. While the Court suggested that the oil and gas cases might stand on a different basis, the case could constitute a departure from the economic interest concepts that have heretofore dominated oil and gas taxation and buttress the holdings of the fixed unit price cases.\(^{548}\) The Brown decision is consistent with some earlier decisions\(^{549}\) of the Court involving the sale of stock a portion of the consideration to be paid out of the proceeds from mineral production in which the Court regarded the transaction as a sale.

(3) Tax Advantages and Disadvantages of Sale

It is generally advantageous to the vendor for a transaction to be regarded as a sale subject to long-term capital gain treatment rather than as a lease or sublease. There are several reasons why this is true:

First, the tax on a long-term capital gain cannot exceed 25 percent whereas the bonus income received in connection

\(^{545}\) Treas. Reg. § 1.631-3(c) (3) (1965).


\(^{547}\) Thomas v. Perkins, 301 U.S. 655 (1937).

\(^{548}\) For a critical analysis of the role of the economic interest concept in this context, see Bloomenthal, supra note 329, at 11.

with a lease or sublease is taxed to the full extent of the consideration received, except to the extent that a statutory or cost depletion deduction can be taken. Long-term capital gain treatment as a minimum amounts to a 50 percent deduction, whereas statutory depletion is a 27\% percent deduction in the case of oil and gas and a lesser deduction in the case of other minerals.

Second, the taxpayer may be able to eliminate from his taxable income the entire long-term capital gain by careful planning which results in the taking of capital losses in the appropriate year in which such losses can be offset against capital gains.

Third, the depletion deduction taken with respect to the consideration received in connection with a lease or sub-lease will have to be restored to income in the event the lease or sublease is terminated without production.

Fourth, in the event the transaction is regarded as a lease or sub-lease, the tax will be computed on the entire consideration received, whereas in the case of a capital gain the tax will be imposed only to the extent to which the consideration received exceeds the taxpayer’s adjusted basis in the property sold.

The foregoing principles are illustrated by the following examples:

**EXAMPLE (1):** Adams owns a producing oil and gas lease and is offered $20,000 for an assignement of the lease by the ABC Oil Co. with the right to reserve either a 2 percent overriding royalty or an oil payment of $150,000 payable out of 5 percent of the oil produced. If Adams elects to reserve an override, the transaction will be regarded as a sublease; if he elects to reserve an oil payment, it will be regarded as a sale. Adams is married, files a joint return and has no other income. His exemptions are $1,200 and his deductions (other than for depletion) total $2,300. The oil and gas lease was acquired several years previously by Adams, qualifies as a capital asset, and has an adjusted basis of zero. The tax consequences depending upon whether Adams reserves an override or an oil payment are as follows:
### Example (2):

Assume the same facts as in example (1) except Adams has an adjusted basis of $5,000 in the oil and gas lease.

If he reserves an oil payment, he must allocate his basis for the lease between the lease and the oil payment according to their respective values. Adams will realize capital gain in the amount by which the $20,000 cash payments exceed the portion of basis allocated to the lease. The portion of basis allocated to the oil payment becomes his basis therefor and is recoverable through depletion.

If, on the other hand, he reserves an override, the fact that he had a basis in the oil and gas lease will have no effect in determining his taxable income, but will merely become his basis in the overriding royalty retained. This basis will have to amortized through depletion deduction and as noted in Part I, supra, p. 9, frequently will not result in any additional tax benefit.

### Example (3):

Assume the same facts as in example (1) except that Adams owns securities in the XYZ Corporation which he has held for several years and which have a cost basis of $5,000. The present market value of the securities is $1,000 and XYZ Corporation’s business prospects appear very dim. If Adams sells these securities during the same taxable year, he will have a long-term capital loss which can be offset against his long-term capital gain. Accordingly,

<table>
<thead>
<tr>
<th>(A) Reserves Overriding Royalty</th>
<th>(B) Reserves Oil Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less long-term capital gain</td>
<td></td>
</tr>
<tr>
<td>adjusted income</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less exemptions &amp; deductions</td>
<td></td>
</tr>
<tr>
<td>(Other than depletion)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Adjusted income</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less statutory depletion</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>$16,500</td>
<td>$6,500</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>$11,000</td>
</tr>
<tr>
<td>(27 1/2% x $20,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>$5,500</td>
<td></td>
</tr>
</tbody>
</table>
if Adams reserves an oil payment he can offset this loss in full against the $20,000 received. If, on the other hand, he reserves an overriding royalty, only $1,000 of the loss can be offset against current income and the balance must be carried over to succeeding tax years to be offset against $1,000 of ordinary income or against capital gains incurred in those years.

**EXAMPLE (4):** Assume the same facts as in example (1) except that the property is not productive and, after 2 years, the ABC Oil Co. surrenders the lease. If Adams reserved an overriding royalty, he will have to restore to income, in the year in which the lease is surrendered, the $5,500 previously taken as a depletion deduction. However, as to the tax treatment of reserved oil payments with respect to non-productive property, see WARNING below.

**EXAMPLE (5):** Assume the same facts as in example (1) except Adams' other income is $100,000, the cash consideration is $100,000 and the transaction occurs in 1965. In the event the transaction involves a capital gain it will now be advantageous to use the alternative method of determining the tax relating to such gain. The tax consequences depending upon whether Adams reserves an override or oil payment are as follows:

(A)

**Reserves an Override**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$200,000</td>
</tr>
<tr>
<td>Less exemptions and deductions</td>
<td></td>
</tr>
<tr>
<td>(other than depletion)</td>
<td>3,500</td>
</tr>
<tr>
<td></td>
<td><strong>$196,500</strong></td>
</tr>
<tr>
<td>Less statutory depletion ($27\frac{1}{2}% \times$100,000)</td>
<td>27,500</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$169,000</td>
</tr>
<tr>
<td>One-half of taxable income for married taxpayer filing joint return</td>
<td>$ 84,500</td>
</tr>
<tr>
<td>Tenative tax</td>
<td>$ 44,850</td>
</tr>
<tr>
<td>Actual tax liability (2 × $44,850)</td>
<td>$ 89,700</td>
</tr>
</tbody>
</table>
(B)

Reserves an Oil Payment

<table>
<thead>
<tr>
<th>Gross income</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less long-term capital gain</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less exemptions and deductions</td>
<td>$3,500</td>
</tr>
<tr>
<td></td>
<td>$96,500</td>
</tr>
</tbody>
</table>

One-half of $96,500 for married taxpayer filing joint return $48,250
Tenative tax $21,740
Partial tax (2 x $21,740) $42,480
Add: 25 percent of excess of net long-term capital gain over net short-term capital loss $25,000
Total tax $67,480

**WARNING**—If the oil payment is so large that there is little if any likelihood that it will be paid off during the productive life of the property, the Internal Revenue Service will regard the oil payment as the equivalent of a reserved override and tax the consideration received as ordinary depletable income. With respect to producing properties, termination of the oil payment prior to depletion of the reserves can be assured by providing that, regardless of the amount of the oil payment, it shall terminate at any time the value of the estimated remaining reserves is less than, for example, 150% of the unpaid balance of the oil payment. However, with respect to non-producing properties, it is impossible to adopt mechanics which will assure the termination of the oil payment prior to termination of the economic life of the leasehold. The reservation of an oil payment on the assignment of non-producing wildcat acreage probably involves a leasing transaction and not a sale although the Fifth Circuit has refused to find as a matter of law that payout cannot reasonably be expected as to wildcat acreage. A fortiori payout as to non-producing but proven acreage might be reasonably expected under certain circumstances.

Except for the ABC transaction discussed below, prior to Jefferson Lake, Part I, supra, p. 90, it ordinarily made no difference to a lessee or assignee of a lease as to whether the transaction was classified as a sale or a lease. In either event the vendee had to capitalize the amount paid and recover it through depletion. If, however, the view of the Jefferson Lake case should prevail, which now appears unlikely, the vendee would ordinarily find it advantageous to have the transaction regarded as a leasing transaction, in that such bonus expenditure would either be deductible or excludable from income.

(4) Section 1231 Assets, Capital Assets, Stock in Trade Distinguished

Mineral interests can be capital assets, stock in trade, or property used in the taxpayer's trade or business. If they are capital assets, any sale results in capital gain or loss. If they are stock in trade, any sale results in ordinary gain or loss. If they are real property used in the taxpayer's trade or business, they are Section 1231 assets. Sales of such assets, held for 6 months or less, result in ordinary gain or loss. In sales of such assets held for more than six months, gains and losses are set off against each other; a net gain is treated as a capital gain and a net loss is an ordinary loss. The distinction between capital assets and Section 1231 assets is discussed in Part I, supra, p. 170. In addition, it is also necessary to determine whether mineral interests are acquired for resale as part of a business, for, if they are, such assets are stock in trade.351

The acquisition of federal non-competitive oil and gas leases is a popular investment for high bracket taxpayers since the filing fee and advance rentals are deductible. (See Part I, supra, p. 84). However, as a result of such deductions the taxpayer typically will have no basis in such leases and if he resells them on a scale that results in dealer classification the entire gain may be taxable as ordinary income. Under these circumstances, the taxpayer may prefer to retain an override in an effort to achieve subleasing classification in

which event he could take statutory depletion on the proceeds but at the risk of having to restore the deduction to income in some subsequent year if the leases terminate without production. (See Part I, supra, p. 66). It may become important to such taxpayers to make an effort to have his leases (or some of them) developed. The Fifth Circuit has held that one generally subject to dealer classification may as to a particular lease obtain Section 1231 treatment upon a showing that such lease was acquired for development.352

(5) Determining the Holding Period

Several problems arise in determining the holding period of mineral properties in connection with the sale of capital assets and Section 1231 assets. The Tax Court has held that the holding period of a lessor's royalty interest begins on the date on which he acquired the mineral rights rather than the date on which the lease creating the royalty was executed.353 The rationale of these decisions is that the taxpayer is, in effect, selling part of his original mineral rights. Applying this rationale to other situations in which the assignor retains an interest leads to the conclusion that the holding period of such interests (overriding royalty, production payment, net profit, interest, etc.) runs from the date the original mineral interest was acquired rather than the date on which the retained interest was created. The acceptance of this rationale is critical to the typical ABC transaction tax consequences discussed at infra, p. 399.

The holding period of a mineral lease subject to an escrow agreement does not begin to run until the conditions of the escrow agreement are complied with.354 The decision, so holding, indicated that, if the escrow condition was the beginning of the drilling of a well, that the holding period would begin with the commencement of drilling operations and the acquisition of the lease. However, a Fourth Circuit decision held with respect to a producing lease that the hold-

354. Howell v. Commissioner, 140 F.2d 765 (5th Cir. 1944).
The rationale of the decision is that the taxpayer acquires a different property when production is obtained and that it is the new property that he sold rather than the original property.

—SUGGESTION—The Fourth Circuit decision referred to, which was at the instance of a taxpayer, appears to be clearly erroneous and has been criticized by a number of tax commentators. However, until clarified the cautious taxpayer may wish to refrain from selling productive properties until more than 6 months after production is obtained.

As previously noted (Part I, supra, p. 174), Section 614 of the 1954 Code permits a taxpayer, under certain limited circumstances, to combine separate mineral properties as a single property for all tax purposes including the determination of gain or loss on a sale or exchange. In the event an aggregated property is sold and some of the constituent properties were held for less than six months, the aggregate adjusted basis is apportioned in proportion to the relative fair market values of the properties held less than six months to those held six months or more as of the date of sale to determine the amount of income represented by the sale of property held for six months or less.\(^\text{356}\)

(6) Allocating Basis

Assuming that a sale of an oil and gas property, including the lease equipment, involves the sale of a capital asset or a Section 1231 asset, the taxpayer, in determining the gain or loss, will have two cost bases to take into consideration: (1) the acquisition cost of the lease and (2) the acquisition cost of the lease equipment. These cost bases will be identical to those used for determining cost depletion and depreciation, respectively. The initial cost basis must in each instance be adjusted by reducing it by the amount of allowable depreciation or depletion or by allowed depreciation or depletion if the latter is greater. If allowed depreciation or depletion


\(^{356}\) Treas. Reg. § 1.614-6(b) (1961).
exceeds allowable depreciation or depletion, the taxpayer now reduces his basis only to the extent that he derived a tax benefit from the excess of allowed over allowable.\textsuperscript{357}

If the taxpayer sells his entire interest in the property, it will probably be regarded as two separate sales—(1) a sale of the well equipment and (2) a sale of the oil and gas interest. If the taxpayer retains a royalty or other continuing economic interest, he has made a sale of the well equipment and has subleased the oil and gas rights. If, on the other hand, the taxpayer retains only an oil payment, he has made a sale of the equipment and a sale of the oil and gas rights. In all three situations it is necessary to determine what part of the purchase price represents the price of the equipment and what part represents the sales price (or bonus, as the case may be) of the oil and gas rights. In all three situations reasonable allocations in the contract of sale will probably be determinative. If, however, the contract does not make an allocation, the taxpayer in the past has been allowed to recover from the purchase price the amount of his unrecovered basis in the well equipment and regard the balance of the purchase price as payment for the oil and gas interest.\textsuperscript{358} To the extent amounts allocated to the equipment exceed the vendor's adjusted basis the gain is subject to the recapture as ordinary income provisions of Section 1245 to the extent of prior depreciation deductions. See Part I, \textit{supra}, p. 151. Under these circumstances it is advantageous to the taxpayer vendor to allocate to the purchase price of the equipment relatively small amounts. However, Internal Revenue Service can be expected to carefully scrutinize allocations and will probably insist on allocating the purchase price to equipment and leasehold upon the basis of their relative fair market value. In a leasing transaction (reservation of an override) the "vendor" must allocate all of his basis in the oil and gas interest to the interest retained. In a sale with a retained interest (oil payment), the vendor allocates his basis in the oil and gas interest between the interest disposed of and the

\textsuperscript{357} \textit{INT. REV. CODE OF 1954, § 1016.}

\textsuperscript{358} \textit{Louisiana Land & Exploration Co., 6 T.C. 172 (1946), acq., 1946-1 CUM. BULL. 3.}
interest retained in accordance with their relative fair market values.\footnote{Columbia Oil & Gas Co. v. Commissioner, 118 F.2d 459 (5th Cir. 1941).}

\textit{EXAMPLE:} Adams owns an oil and gas lease with respect to which his adjusted basis in the oil and gas rights is $20,000 and in the depreciable equipment is $50,000. He sells the property, including the equipment, for $75,000, reserving a 2 percent overriding royalty. Adams can apply $50,000 of the purchase price to depreciables thereby recovering his entire basis in depreciables. The balance ($25,000) of the purchase price is a bonus paid for a sublease of the oil and gas rights. The bonus is ordinary depletable income and subject to the tax treatment heretofore outlined. The adjusted basis in the oil and gas rights ($20,000) becomes the taxpayer’s basis in the retained overriding royalty. If the transaction involved the retention of an oil payment rather than royalty and hence classifiable as a “sale,” the consideration received would be allocated in the same manner between the equipment and the leasehold but taxpayer would allocate his basis in the leasehold between the interest sold (assume $15,000 so allocated) and the oil payment retained (assume $5,000) based upon their relative fair market values. The taxpayer’s gain from the sale of the leasehold would be $10,000. In both situations, if Section 1245 were applicable Internal Revenue Service might insist on an allocation of additional amounts to the equipment.

\textit{SUGGESTION—}The allocation of the purchase price between the equipment and the oil and gas rights should be made in the contract and, if taxpayer has a gain in a subleasing transaction from his standpoint as large a part thereof as is reasonably possible should be allocated to the purchase price of the equipment provided taxpayer has not taken a substantial amount of depreciation in prior years subject to recapture under Section 1245. The gain on the sale of the equipment in such event will ordinarily be subject to capital gain or Section 1231 tax treatment which, as already noted, is always preferable to having the income received regarded as a bonus. However, if a substantial amount of depreciation subject to recapture has been allowed (or was allowable) in
prior years, it would be preferable from the standpoint of
the vendor both in a subleasing transaction and a sale to limit
the allocation of the consideration received to equipment to
the adjusted basis of the equipment. Otherwise, such excess
to the extent of depreciation taken in prior years will be tax-
able as ordinary income. As noted above, Internal Revenue
Service may attempt to allocate additional amounts to equip-
ment.

If the taxpayer in an incomplete disposition disposes of
the equipment at a loss, and if the contract of disposition
clearly provides that the vendor is selling all of his interest
in the equipment, the litigated cases have permitted the tax-
payer to take such loss, despite the contention of the Revenue
Service that the amount of the loss cannot be deducted but
rather should be allocated as part of his basis in the retained
oil and gas interest.360

EXAMPLE: Adams owns a producing oil and gas lease;
his adjusted basis in the equipment is $50,000 and zero in
the leasehold. Adams disposes of the equipment and lease
for $30,000 retaining an oil payment. According to the litig-
gated cases taxpayer has a $20,000 loss on the equipment;
according to Internal Revenue Service361 taxpayer cannot
take a loss but must regard the unrecovered loss as part of
his basis in the retained interest whether a retained override
or oil payment, thus converting depreciable basis into deple-
table basis.

If a portion only of an aggregated property unit (See
Part I, supra, p. 174) is disposed of in a sale, the taxpayer
does not utilize the original basis of the constituent parts,
but allocates the total basis for the aggregated property unit
between the portion sold and the portion retained upon the
basis of their relative fair market values.362

The purchaser in all three situations, in the absence of
contractual allocation, should determine his basis in the

360. Choate v. Commissioner, 324 U.S. 1 (1945); Kline v. Commissioner, 268 F.2d
854 (9th Cir. 1959); Megert v. Campbell, 12 Am. Fed. Tax R.2d 5913 (D.
Tex. 1966). Compare holding that in the event of gain the taxpayer need
allocate no part of his equipment basis to the retained oil payment. Thomas
v. Peckham Oil Co., 115 F.2d 685 (5th Cir. 1940).
property acquired by allocating the sales price to depreciable equipment and depletable oil and gas rights respectively according to their relative fair market value. The purchaser ordinarily is interested in allocating as much of the purchase price as is possible to the equipment and thus if the recapture provisions of Section 1245 are applicable there may be a conflict of interest in this regard as between the seller and purchaser.

While the problems discussed in this subsection could under unusual circumstances be applicable to minerals other than oil and gas, the discussion is limited to oil and gas operations since it is primarily in this type of operation that the depreciable equipment and the mineral interest become so inextricably bound together that they are likely to be sold as a unit.

(7) Carved-Out Production Payments

Production payments are frequently created as the result of an assignment of a mineral property in which the assignor reserves a specified production payment. As already noted the consideration received by the assignor in this situation is regarded as the sales price of mineral interest and well equipment (if any) and is subject to capital gain or Section 1231 tax treatment. (See supra, p. 382). In some instances the lessee (or royalty owner) carves out (that is, grants) a production payment from his lease (or royalty) either as the subject matter of a sale or of a gift, and retains the remainder of his interest. Carved-out payments may be used as vehicles to finance the drilling of a well either by the sale of such payments for cash with the proceeds pledged for the development of a well or in exchange for services and/or equipment employed in the drilling of a well. In the event the proceeds from the sale are pledged to the development of a well or if given in exchange for services or equipment employed in the drilling of a well, the transaction is not taxable and the taxpayer merely reduces his development costs by the amount of cash, services, or equipment received. The taxpayer’s

364. C.C.M. 24849, 1946-1 CUM. BULL. 66. See also Weinert v. Commissioner, 294 F.2d 760 (5th Cir. 1961).
principal problem in connection with production payments created for development purposes is establishing that he was obligated to use such proceeds in the development of a particular well and that the proceeds were, in fact, used for this purpose. Taxpayers on frequent occasions have been unable to sustain the burden of proof on these issues because of loosely or improperly drawn agreements or because of failure to maintain adequate records. \(^{365}\)

The taxpayer may carve out a production payment in order to realize cash to be used for purposes other than the development of a well or may assign a carved-out production payment as a gift to a family member or to a charity and it is in these situations that the Commissioner and the taxpayers had been doing battle for several years. The conflicting viewpoints advanced concerning the tax consequences of such transactions including the following:

(1) The Internal Revenue Service position has been that a carved-out production payment is an attempt to anticipate income and that the consideration received by the assignor is to be regarded as ordinary income subject to depletion. \(^{366}\) With respect to the gift situation, under this view the donor must continue to report the income payable to the holder of the production payment as income subject to the depletion allowance and at the time of the donor’s death the production payment is regarded as part of the donor’s estate. In the case of a gift to a charity the donor cannot deduct the production payment as a charitable contribution in the year of its creation, but at the time of the receipt of income from the production payment can deduct the amount of such income as a charitable contribution for that particular year. \(^{367}\)

(2) The position of most taxpayers has been that the creation of a carved-out production payment is either a sale or a gift, as the case may be, of a capital asset. In the sale situation any consideration received is subject to capital gain treatment. In the gift situation, income received from the production payment is taxable to the donee and the production payment is not part of the donor’s estate. In the case

\(^{365}\) See, e.g., Rogan v. Blue Ridge Oil Co., Ltd., 83 F.2d 420 (9th Cir. 1936).


\(^{367}\) Ibid.
of a gift to a charity the taxpayer deducts the value of the production payment as a charitable contribution in the year in which it is created.

The Supreme Court in the Lake case resolved the conflict that has existed among and within Circuit Courts of Appeals with the viewpoint of the Internal Revenue Service prevailing.\textsuperscript{368} Although the cases before the Court involved the sale situation, they appear to decide the gift situation as well, in that they rely on gift-of-income cases as the basis for the holding.\textsuperscript{369} The Court emphasized the fact that the period of time in which the production payment would pay out could be predicted with a reasonable degree of accuracy, and that the consideration paid was approximately the discounted value of the oil payment based on such payout period. Undoubtedly an effort will be made by some persons to vary the characteristics of the particular production payment sufficiently to distinguish it from the foregoing facts; however, the prospects for obtaining capital gain treatment are poor.

—\textit{SUGGESTION}—An operator with a substantial net operating loss carry forward might rely on the Lake decision so as to anticipate income by the sale of a carved out production payment and thereby avoid the expiration of the net operating loss carry over. The Lake case did not actually decide the tax year in which such anticipated income was realized, but a District Court has held that the amounts received from the sale of the production payments were taxable as income in the year of receipt and were not to be spread out over the years in which the mineral is produced.\textsuperscript{370}

Internal Revenue Service appears to be determined to exploit every possible advantage of the Lake decision. It is understood to be taking the position, for example, that the Lake decision precludes the use of short term trusts conforming to the Clifford regulations in the event the corpus of the trust is a mineral interest.\textsuperscript{371} There appears, however, to be no policy reason as to why mineral interests should not be


\textsuperscript{371} Helvering v. Clifford, 309 U.S. 331 (1940); INT. REV. CODE OF 1954, §§ 671-78 and the regulations adopted thereunder.
subject to the same treatment that is presently provided under the Clifford regulations with respect to short term trusts generally. In fact, since in the case of producing mineral properties a portion of the corpus will be consumed during the life of the trust there appears to be a real basis for viewing the transfer as more than a gift of income.

(8) Acquiring Production—The ABC Transaction

Production payments are frequently used to finance the acquisition of producing properties. The tax advantages are better understood by comparing the mechanics employed with orthodox loan financing. A is the seller of a productive property, B is the purchaser and C finances the transaction. In the orthodox loan transaction, B pays part of the purchase price with his own funds and borrows the balance from C, giving C an interest bearing note secured by a lien on the property. In the ABC transaction A sells the entire working interest for a specified amount in cash representing the amount B would ordinarily pay with his own capital, and A reserves an oil payment in the amount plus interest that ordinarily would have been financed. The oil payment is then sold to C for the amount that otherwise would have been financed, usually as a result of a prearranged plan. The tax consequences of the orthodox loan transactions are as follows:

(1) A realizes capital gain treatment on the purchase price.

(2) C realizes taxable income on repayment of loan and interest only to extent of the interest.

(3) B must report as income all the proceeds from production including that portion used in the repayment of the loan. B, in computing his taxable income, deducts statutory or cost depletion, whichever is the greater. The tax consequences of the ABC transaction are as follows: (1) A realizes capital gain treatment both with respect to the consideration received for the working interest and the consideration received for the oil payment provided he sells the entire oil payment. It is extremely important that the oil payment be reserved rather than carved-out by B after the conveyance in order to avoid the anticipated income theory discussed above. (2) C recovers the amount paid for the oil payment through cost depletion and is taxed only on the amount actually received over the amount
advanced, such excessive amount being comparable to interest payments. (3) B, the purchaser, realizes the principal tax advantage from this transaction in that the amount payable to C under the oil payment is excluded from B’s income whereas in the orthodox loan transaction such amounts would be included in B’s income even though applied on the loan. Although the amount of the loan in the orthodox loan transaction would be recovered through cost depletion, it would have to be amortized over the entire productive life of the property, whereas use of the oil payment method in effect permits amortization of the “loan” over the payment period of the oil payment. In addition, after the oil payment has terminated B can take statutory depletion which will offset in part at least the cost depletion he could have taken if an orthodox loan had been used, and as a result, ordinarily the total taxable income to B over the entire productive life of the property is less in the ABC situation.

There has been a tendency to oversimplify the tax advantages of the ABC transaction to the purchaser. It is sometimes assumed that, inasmuch as the entire amount of the oil payment is excluded from his income, there is a tax saving to B equivalent to the tax on the amount of such excluded income. This, of course, is not correct in that this analysis disregards the impact of the cost depletion deduction that would be available if the transaction had been handled as an orthodox loan. Irrespective of over-all tax saving, the ABC transaction always has the effect of accelerating the amortization of the purchaser’s investment and may result in an over-all tax saving as well. In order to result in an over-all tax savings, statutory depletion (27 1/2 percent in the case of oil and gas) must exceed cost depletion as a percentage of total gross income over the life of the property attributable to the interest acquired by the purchaser under the proposed ABC arrangement. This has been demonstrated at length elsewhere.872 It is possible to calculate by formula the principal amount of production payment necessary to reduce the ratio of the purchaser’s cost to gross income precisely to the statutory depletion rate. Production payment in this

amount is the critical production payment in that to achieve an over-all income tax savings a production payment in excess of this amount must be retained, and as the production payment increases above the level of the critical amount the purchaser increases over-all tax savings. The maximum benefit of an ABC transaction occurs when cost depletion on the straight purchase arrangement does not exceed the statutory depletion rate times the gross income from the property over its entire productive life. In this event the critical oil payment level is zero, and an oil payment retained in any amount will produce an over-all income tax saving to the purchaser.

The ABC tax treatment is predicated on the holding in *Thomas v. Perkins*,\(^373\) that a reserved oil payment is an economic interest and the amounts received are taxable to the recipient assignor (A) as depletable income and excluded from income by the assignee (B). The Internal Revenue Service in the past has issued favorable rulings in connection with ABC transactions sustaining the tax treatment indicated above.\(^374\) The Service subsequently announced that it would no longer issue such rulings pending further study of the problem,\(^375\) then withdrew this announcement but indicated that it was continuing to study the problem and that it invited comment from interested parties.\(^376\)

The Fifth Circuit\(^377\) in a case in which the taxpayer in effect argued for a reversal of *Thomas v. Perkins*, made it clear in no uncertain terms that this holding was the basis of many oil and gas transactions and it would not upset precedent that had been relied upon to this extent, stating: "The transaction here was the precise application of the classic production payment device. Developed and approved in a succession of court decisions primarily in the oil and gas field, it has come to be a vital and important part of that business . . . The production payment is certain in its application and tax consequences. Uncertainty in a transaction so precisely constructed as this one was not to be imported on

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\(^373\) 301 U.S. 655 (1937). See also Anderson v. Helvering, 310 U.S. 404 (1940).
\(^377\) United States v. Witte, 306 F.2d 81 (5th Cir. 1962).
anything as equivocal as that urged here—the misplaced hope of Taxpayer that the transaction was to be treated as a capital gain. 378 The Court was talking about the situation in which a production payment was reserved without being part of an ABC transaction, but then went on to state: "Indeed, the transaction was perfectly constructed for capital gains, and to achieve them all the Taxpayer had to do was to sell the production payment." 379 However, the Court still hedged somewhat on whether it would sustain the ABC tax consequences described above, for in a footnote explanation at this particular point it stated: "The production payment retained by A, the seller, may be sold to C as an isolated unplanned, subsequent transaction and when sold it constitutes capital gains . . . ." (emphasis supplied) In the same footnote the court stated: "Another approach concerning which there is is a considerable body of tax literature is the more intricate structure of the so-called ABC deal . . . ." The Court left the matter there without any further discussion. In Pan American Petroleum Corp. v. Long, 380 in a footnote explaining the ABC transaction Mr. Justice Brown, who also wrote the opinion in the Witte case, stated: "A secondary purpose, with regard to the production payments, was to exploit for the mutual and legitimate benefit of all parties the economic advantages flowing from the unique tax advantages of this type of transaction. See United States v. Witte . . . ."

Although Internal Revenue Service has indicated that it is concerned with the tax consequences to all participants to the ABC transaction, the main attention has been focused on the appropriate tax treatment to A, the seller. In particular, concern has been expressed over the possibility that Internal Revenue Service will regard the sale by A of the reserved oil payment as an anticipation of income, despite the fact that A has made a complete disposition of the oil payment. In this regard it is suggested that production payment is still a production payment irrespective of whether it is created by grant or reservation, and concern is expressed

378. Id. at 87-88.
379. Id. at 88.
380. 340 F.2d 211, 221 n.29 (5th Cir. 1964).
over the following language of the Supreme Court in the Lake case.\textsuperscript{381}

"The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property."

Referring to the above quotation from the Lake case, it could just as well be said of the sale of the reserved production payment that the substance of what was received was the present value of the income which the recipient would otherwise obtain in the future. However, there is a significant difference, between the context of the situation in which as in Lake, the party selling the oil payment retains control over the property, and the retained payment situation in which he has made a complete disposition of his interest in the property. Viewing the ABC transaction as a whole, from the seller's standpoint (assuming that the contemporaneous sale of the oil payment is part of the same transaction) the consideration paid is "for an increase in the value of the income-producing property."

In view of the decisions it is apparent that care should be taken that the production payment in an ABC transaction is reserved rather than carved out in advance. In addition, there is a real danger in attempting to reserve two production payments because of the fact that two lending institutions may be involved or because of other aspects of the transaction in that if such payments are to run consecutively, Internal Revenue Service and the Tax Court regard the sale as a carved-out oil payment with the proceeds from the "sale" being taxed as ordinary income on the "anticipation of income" theory.\textsuperscript{382} A District Court before Lake held otherwise in a situation in which the production payments run concurrently,\textsuperscript{383} but the Fifth Circuit apparently would apply the anticipation of income theory to this situation if the pay-out

\textsuperscript{382} Estate of O. W. Killam, 33 T.C. 345 (1959).
of the production payment can be predicted with reasonably accuracy.  

The ABC transaction has been utilized primarily in connection with the disposition of oil and gas properties. Presumably, the same principles would be applicable to other minerals, but as noted at supra, pp. 383-85, another line of authority has developed with respect to non-hydrocarbons which is inconsistent with the rationale upon which the ABC transaction is based.

**Non-Taxable Exchanges and Sharing Agreements**

Exchanges of property held for productive use in trade or business, or for investment, for property of a like kind are non-taxable.  The Supreme Court has held, reversing the Fifth Circuit, that an exchange of a carved-out oil payment for urban real estate was not an exchange of property of a like kind, but an exchange of anticipated ordinary income from oil leases for real estate. The Court reached this conclusion after conceding that the carved-out oil payment was an interest in real property. In the light of this decision, a number of lower court decisions, pertaining to exchanges including the following, may now be of questionable authority:

1. The Fifth Circuit has held that the exchange of a fee interest in the minerals for an oil payment is a tax-free exchange.

2. The exchange of non-productive acreage for productive acreage has been held to be a tax-free exchange.

3. The exchange of an oil and gas interest for urban real estate has been held to be a tax-free exchange.

—**OBSERVATION**—The property exchanged must be held for productive use in business, or for investment. Stock

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384. United States v. Foster, 324 F.2d 702 (5th Cir. 1963), in which taxpayer retained an override and an oil payment subsequently disposing of the oil payment. The Court held that the taxpayer had in effect carved out the oil payment from a larger interest and denied capital gain treatment on the consideration received.


387. Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953).


389. Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941).
in trade is expressly excluded and hence persons classified as dealers in oil and gas interests could not exchange interests in a tax-free exchange. Stock in a corporation is also excluded and hence the exchange of stock in two oil corporations would be taxable.\textsuperscript{390}

If the promoters of a corporation transfer mineral properties to a corporation which they control in exchange for stock, the exchange is not taxable.\textsuperscript{391} However, "control" for this purpose requires that the transferors own 80 percent of the voting stock and 80 percent of all other classes of stock of the corporation after the completion of the transaction.\textsuperscript{392}

The assignment of an oil and gas interest in exchange for equipment to be used in drilling a well on the same property or in return for an agreement on the part of the assignee to drill a well is a non-taxable sharing arrangement.\textsuperscript{393} In connection with such transactions, the assignor may be able to allocate part of his basis in the oil and gas rights to the depreciable equipment in which he acquires an interest,\textsuperscript{394} although there is no direct authority and the Revenue Service would probably take issue with such allocation. See Part I, \textit{supra}, pp. 131-37, for discussion of other aspects of such sharing arrangements.

The assignment of an interest in an exploratory mineral property in exchange for geological, legal, or other services rendered in connection with the exploration or development of such property at one time was regarded as a sharing arrangement and non-taxable.\textsuperscript{395} However, Internal Revenue Service now takes the position that the sharing arrangement rationale has no application to an exchange of a mineral interest for personal services and recent Fifth Circuit Court decisions have cast considerable doubt on the appropriateness

\textsuperscript{390} Int. Rev. Code of 1954, § 1031(a).

\textsuperscript{391} Int. Rev. Code of 1954, § 331.

\textsuperscript{392} Int. Rev. Code of 1954, § 388(c).

\textsuperscript{393} Treas. Reg. § 1.612-4(a) (1965); S.M. 3322, IV-1 Cum. Bull. 112 (1925); G.C.M. 22730, 1941-1 Cum. Bull. 214. For an excellent discussion see Shelton, \textit{The Taxation of Oil and Gas Interests Received in Payment for Property or Services}, 5 Oil & Gas Inst. 385 (Sw. Legal Fdn. 1954).


\textsuperscript{395} Based on the assumption that G.C.M. 22730, 1941-1 Cum. Bull. 214 which sets forth the sharing arrangement rationale is applicable to all services related to the development of a mineral property since it expressly encompasses services rendered by a driller.
of this tax treatment. The Fifth Circuit has concluded that the services rendered by a petroleum engineer in planning a secondary recovery program were not rendered in connection with "the acquisition, exploration or 'development'" of the mineral property and hence did not have to reach this issue. However the Court did state: "Unless a careful analysis of the reasons underlying the issuing of GCM 22730 compelled it, the court would have great difficulty accepting a construction of the Code which would fly in the face of the general provisions of the tax laws to the effect that compensation for services must be returned as a part of gross income ...." Further in the Frazell case (discussed at infra, p. 413) in which the parties appeared to have in mind a sharing arrangement involving services the Court reached the conclusion that the property interest received for services was taxable as income but did so in the context of a partnership approach and without referring to the sharing arrangement rationale or GCM 22730.

FORM OF BUSINESS ORGANIZATION

The selection of the form of business organization for the purpose of carrying on mineral ventures, in addition to the usual considerations, presents a number of peculiar problems which are emphasized herein. These problems reflect in part the variety and complexity of financing and operating arrangements employed in the development of mineral properties, such arrangements frequently being characterized by multiple ownership of the mineral property. A comprehensive discussion of the factors involved in the selection of the form of business organization, is beyond the scope of this analysis.

(1) Corporations

The corporate form frequently has been avoided in the past by mineral operators for reasons that have been eliminated in part by the ability to form Subchapter S corporations which can elect to be taxed as a partnership and other amendments to the tax laws. The disadvantages of the cor-

396. James A. Lewis Eng'r, Inc. v. Commissioner, 339 F.2d 706 (5th Cir. 1964).
397. Id. at 709.
398. United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), on rehearing, 339 F.2d 885, cert. denied, 380 U.S. 961.
porate form and the impact of Subchapter S are noted below:

1. A corporation is taxed on its taxable income and the shareholders are taxed on a large part of the same income when distributed as dividends. For eligible small business corporations with 10 or fewer shareholders making an appropriate election under Subchapter S, double taxation can now be avoided.399

2. The corporation may have substantial losses (particularly if it has expensed intangibles) and no income against which to offset such losses. Shareholders in an electing small business corporation can now offset their pro rata share of such losses to the extent of the adjusted basis in the stock of such corporation and the corporation’s indebtedness to them.400

3. The loss incurred by a shareholder of a corporation on the sale of stock or upon stock becoming worthless is ordinarily a capital loss which can be only offset against capital gains and limited amounts of ordinary income. Shareholders in a corporation with limited capital and meeting specified statutory requirements can in any one year deduct losses from the sale of stock or arising from worthlessness up to $25,000 ($50,000 on a joint return) as an ordinary loss.401 To the extent such ordinary loss deduction may now be available, the position of such shareholders is more advantageous than the comparable position of a co-owner in or sole proprietor of mineral property who can deduct loss for worthlessness as an ordinary loss but must treat a loss on sale or exchange as a capital loss unless the mineral property is classified as a Section 1231 asset.

4. At one time corporations whose principal assets consisted of mineral properties which had appreciated in value were particularly vulnerable to the collapsible corporation provisions.402 If a natural resource corporation and its 20 percent shareholders can avoid classification as a dealer,
the collapsible corporation provisions under the 1958 amendments will seldom be applicable.\textsuperscript{403}

5. A distribution by a corporation out of depletion reserves to the extent based upon cost depletion is not taxable as a dividend to the extent of shareholder’s basis in the stock but reduces the shareholder’s basis in his stock and is taxable as a gain on the sale of property (ordinarily a capital gain) to the extent the distribution exceeds his basis in the stock. In addition, to the extent a distribution from the reserve for depletion represents the excess of statutory over cost depletion, the distribution is taxable as a dividend.\textsuperscript{404} In effect, a portion of the income otherwise tax free because of the statutory depletion deduction becomes subject to taxation and this has been one of the principal motivations for attempting to avoid corporate tax treatment for mineral operations. An election under Subchapter S is of no help here; the effect of such an election is to eliminate the corporate tax and not the tax on dividends.\textsuperscript{405} Such depletion reserves can, however, be accumulated by an electing small business corporation and are not part of the corporation’s undistributed taxable income for the purpose of determining the shareholders’ gross income.\textsuperscript{406}

Because of the limitations noted above with respect to the distribution of depletion reserve, Subchapter S will probably not be availed of by natural resource enterprises to the extent that many have predicted. Each situation requires careful analysis in the light of the foregoing factors and other appropriate considerations. In addition, Subchapter S elections are unavailable if one of the participants is a corporation or a trust or to corporations failing to meet the other qualifications of a small business corporation. Co-owners constituting an association under the rules hereafter noted are a corpora-

\textsuperscript{403} INT. REV. CODE OF 1954, § 341(e), as added by 72 Stat. 1615 (1958).
\textsuperscript{404} Treas. Reg. § 1.316-2(e) (1955).
\textsuperscript{405} INT. REV. CODE OF 1954, § 1372(b).
\textsuperscript{406} INT. REV. CODE OF 1954, §§ 1373(c), (d).
tion as defined by Section 7701 (a)(3) and can elect Subchapter S treatment if otherwise qualified.

(2) Co-Owners

Mineral properties and in particular oil and gas properties frequently are developed by co-owners (tenants in common). The tax status of such enterprises depends upon the provisions of the operating agreement and the making of appropriate elections. Depending upon such provisions and elections, the enterprise may have the tax consequence of an individual, partnership or corporation.

The owners of fractional undivided interests in a productive oil and gas lease (and presumably as to other mineral leases as well) according to Internal Revenue Service rulings, are an association taxable as a corporation under the following circumstances:

1. If the co-owners irrevocably authorize another co-owner or agent with like powers of agency from another co-owner to act as their agent in selling their share of production or in granting options to purchase their share of production.

2. If the co-owners grant revocable-at-will authority to a common agent to enter into contracts of sale or to grant options to purchase for a period longer than a year, or, if less than a year, for a period longer than reasonably required by the minimum needs of the industry under the circumstances.

The fractional undivided interest owners are not an association taxable as a corporation under the following circumstances:

1. The co-owners reserve the right to take their share of the production in kind.

2. The co-owners reserve the right to direct the sale of their share of production by individually entering into a purchase agreement or granting an option to purchase. It is immaterial in this respect that other co-owners enter into similar contracts provided they each enter into the contract as an individual and not through a common agent.

3. The co-owners individually grant irrevocable agency powers to dispose of their share of production provided the individual co-owner’s agent is not another co-owner or an agent with like powers of agency from another co-owner.

4. The co-owners grant revocable-at-will authority to a common agent to enter into a sales agreement or grant an option to purchase for such reasonable periods of time as are consistent with the minimum needs of the industry under the circumstances, but in no event to exceed one year.

—SUGGESTION—To assure that the interest holders are not regarded as an association taxable as a corporation, the operating agreement should provide that the interest holders reserve the right to take their share of production in kind, but in the event they do not elect to do so, the operator can dispose of their share of production currently or can enter into a contract of sale or grant an option to purchase for a period of time consistent with the minimum needs of the industry but in no event for in excess of one year.

—OBSERVATION—A corporation, as the owner of a fractional undivided interest in mineral lease, can become a member of a separate association taxable as a corporation. If a corporation enters into an operating agreement that is improperly drawn in this respect, the proceeds relating to the particular lease will be taxed as that of a separate corporation. If this should occur, part of the income received from the venture would be taxed three times—(1) the income would be taxed to the association, (2) 15 percent of the income received by the corporation would be subject to the corporate tax, and (3) all but $100 of the income distributed to the stockholders as dividends would be subject to the personal income tax.

—CAVEAT—In United States v. Stierwalt, the Internal Revenue Service successfully taxed as a corporation co-owners complying with the foregoing rulings except for a failure to limit the duration of the sales agreements entered into by the common agent to a period not exceeding one year.

The Court's opinion does not refer to the duration factor and suggests that the criteria of the rulings are artificial and that such arrangements may in any event be taxable as a corporation.

—OBSERVATION—The Revenue Service rulings are not entirely consistent with some of the litigated cases which have held that interest owners are not an association taxable as a corporation even though they granted irrevocable authority to dispose of their share of production to a common agent, where they have failed to attain limited liability and other incidents of the usual corporation (e.g., an elected management) were not present.410

If the co-owners do not constitute a corporation, are they taxable as individuals or as a partnership? Because a partnership has a separate election with respect to the deduction of intangible drilling and development costs, it is important for this purpose and for other purposes to determine this question. An early Revenue Service ruling regarded such arrangements (assuming that they are not associations taxable as a corporation) as creating a "qualified partnership."411 The Tax Court has held that co-owners did not constitute an association taxable as a corporation, relying in large part on the fact that each co-owner disposed of his own share of production, and found that they constituted a partnership with a separate election as to the deduction of intangibles where they had consistently filed a partnership return of income.412

Section 761(a) of the 1954 Code permits such organizations to elect (see infra, p. 421, for manner of making election) to be treated as joint owners, taxed individually, and not as partners, providing:

1. The organization is availed of for investment purposes only; or

2. The organization is availed of for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted.

However, the income of the members must be capable of being adequately determined without computation of partnership taxable income.

(3) Partnerships

Co-owners, if they choose, may for tax purposes be treated as a partnership. However, rather than developing properties pursuant to an operating agreement, the parties in interest may deliberately employ the more orthodox business forms of partnership, limited partnership or corporation. A partnership and a limited partnership generally have the same tax consequences as a proprietorship. However, separate elections and permissible allocations of basis and losses may give a partnership more flexibility than a proprietorship or co-ownership arrangement (see Part I, supra, pp. 137-39).

The use of a limited partnership may achieve the objective of limiting the liability of certain participants and preserving the tax advantages of a proprietorship. Under current regulations the typical limited partnership organized under the Uniform Limited Partnership Act is not an association taxable as a corporation. However, these regulations appear to be motivated by a desire to deny professional associations corporate status for tax purposes and a careful practitioner may wish to adopt additional safeguards in drafting the limited partnership agreement so as to avoid having the partnership classified as an association taxable as a corporation. It is believed that the inclusion of the following provisions will be helpful for this purpose:

(1) Termination of the partnership within a specified period of time, e.g., after one year. This may be coupled with a provision that the partnership shall continue on a year-to-year basis with the general partners having the right to terminate at the end of each year upon giving of notice within specified time prior to end of such year period.

(2) Termination of the partnership in the event of death, insanity, withdrawal, or bankruptcy of a general partner. This may be coupled with a provision that with unanimous

consent of special and general partners the partnership may continue.

(3) The right of a general partner to withdraw at any time. This is an aspect of (2) above.

(4) Termination of the partnership upon assignment of the interest of a general partner. This may be coupled with a provision that such assignment may be made with unanimous consent.

The purpose of the foregoing provisions obviously is to preclude the partnership from having perpetual existence. Practitioners will differ as to the extent they regard it necessary to include all of the foregoing provisions.

The partnership alternative avoids the taxability of distributed statutory depletion reserves as in the case of a corporation. First, partnership distributions in excess of basis are taxed but only at capital gain rates.\(^4\) Secondly, and most important, each partner's basis in the partnership is increased pro-ratably to the extent statutory depletion exceeds cost depletion\(^5\) and accordingly the distribution of depletion reserves ordinarily merely reduces the basis by a corresponding amount and hence is not taxable.

The partnership arrangement may also permit a partner to contribute services to the partnership without resulting taxable income. The \textit{Frazell} case,\(^6\) which has been much criticized, is viewed by many as precluding this consequence but in this author's judgment the decision in that case was a result of the fact that the taxpayer planned a sharing arrangement and was trapped into a partnership rationale which was not applicable to the particular facts. The key to the decision in the \textit{Frazell} case it is believed is the Court's statement\(^7\) (apparently correct on the particular facts) that the amounts recovered by the other partners represented a "skimming of profits" rather than a return of capital and hence the service partner received an interest in the other partner's capital accounts. Appropriate draftmanship of the partnership

agreement limiting the service partner to a share of the profits and his own capital account and precluding any portion of the other partner's capital accounts from becoming vested in the service partners should bring the arrangement within the provisions of Reg. Sec. 1.721-b(1) and avoid the *Frazell* result. Any preference of the contributing partners should be in the form of a return of their capital contributions or out of a disproportionate allocation of profits. The price of this approach to the service partner is taxability on his share of the profits during a period of time in which all partnership distributions (as a return of capital) are being made to the other partners. This could be alleviated in part by providing for a deferral of a portion of the other partners' distributions.

A preferable alternative might be to avoid the use of a partnership and to give the person contributing services a carried interest in the property. If the usual sharing arrangement rationale were applicable, the receipt of the interest would not be taxable and during payout all of the income would be taxable to the parties receiving the income. However, in view of the serious question that exists as to whether the sharing arrangement rationale is applicable to personal services (see *supra*, p. 406) this approach invites an attack by the Commissioner.

The foregoing principles are illustrated by the following necessarily oversimplified examples:

**EXAMPLE:** Able and Baker organize a partnership to acquire and develop an oil property—Able to contribute $100,000 and Baker to contribute geological services. The partnership agreement provides that Able's capital account upon the formation of the partnership shall be $100,000 and Baker's shall be zero and that each partner shall share equally in partnership profits and the excess of statutory depletion reserves over cost depletion. Assume that at the end of the first year's operation the partnership has $50,000 in taxable income and that statutory depletion exceeds cost depletion (which is zero) by $50,000. (1) Each partner reports his distributive share ($25,000) of partnership profits as taxable income. (2) Each partner's basis in the partnership is in-
increased by a corresponding amount plus his distributive share ($25,000 each) of the excess of statutory depletion. As a result Able’s basis and capital account is now $150,000. (His original basis of $100,000 plus his distributive share of profits and excess statutory depletion.) Baker’s basis and capital account is $50,000 (original basis of zero plus his distributive share of profits and excess statutory depletion). (3) The partnership distributes $50,000 to each partner thereby reducing Able’s basis and capital account to $100,000 and Baker’s basis to zero. The distribution is not taxable as it does not exceed the partners’ respective bases. Able’s original capital contribution is intact and Reg. 1.721-b(1) should be applicable despite Frazell.

EXAMPLE: Assume the same facts as in the previous example except the partnership agreement provides that the partnership will return Able’s original capital contribution before any distribution is made to Baker. The tax and other consequences are the same through (2) of the previous example. The partnership distributes $100,000 to Able and nothing to Baker. The effect of this distribution is to reduce Able’s basis and capital account to $50,000 and at this point both Able and Baker have identical capital accounts in the partnership. Frazell should not be applicable as Baker has received no part of Able’s initial capital contribution. However, Baker will have paid taxes on $25,000 of partnership income and will have received no distribution from the partnership.

EXAMPLE: Assume the same facts as are set forth in the first example above to (1) except the agreement provides that Able is to receive a distribution of the initial $100,000 of profits and thereafter the partners are to own partnership assets and to share partnership profits equally. Assume further that the results of the second year’s operations are identical to the first. The profits in both years will be taxable only to Able. At the end of the second year Able’s basis and capital account is $250,000 (initial capital of $100,000, all of both years’ profits and his distributive share of statutory depletion) and Baker’s basis and capital account is $50,000, (zero initial capital, zero profits plus his distributive share of statutory depletion). The initial $100,000 of profits are
distributed to Baker in accordance with the partnership agreement thereby reducing his capital account and basis to $150,000. At this point Baker under the agreement becomes an equal partner not only as to future profits, but also as to partnership capital. Accordingly Able's capital account is reduced to $100,000 and Baker's increased to $100,000—Baker has received a part of Able's original capital contribution and to this extent has received taxable income. This is Frazell.

EXAMPLE: Instead of organizing a partnership the parties agree that Able will advance the $100,000 and Baker contribute services under an arrangement pursuant to which Able is to own the entire interest in the oil and gas property until complete payout of his initial $100,000 contribution and thereafter each will own an equal interest in the property. To the extent of the $100,000 advanced by Able the parties have created a Manahan type carried interest arrangement. If GCM 22730 (see supra, p. 405) and Manahan (see Part I, supra, p. 134) are applicable, the initial arrangement is not taxable as it is a sharing arrangement, Able deducts all of the intangibles and reports as depletable income the return of his original contribution of $100,000. However, as noted at supra, p. 406, Internal Revenue Service denies the applicability of the sharing arrangement rationale to this type of situation.

-OBSERVATION—The practical tax result of the second and third example above may be substantially the same but with more flexibility in the arrangement involved in the second example and perhaps a difference in the timing (year) of the tax impact. The complex inter-relationship of the depletion deduction (statutory v. cost), the depreciation deduction, the deduction for intangibles, determining to whom income is taxed during payout and other tax factors necessitates extreme care in planning this type of transaction.

-WARNING—At times the Court in the Frazell case seemed to be equating the capital contribution of partners advancing money with the assets acquired with such capital contributions. In such event, the foregoing analysis of Frazell is not correct and in the second example above Baker might
be taxed to the extent he acquired as a partner an interest in partnership properties.

UNITIZATION

Unitization, which is peculiar to oil and gas operations, raises myriads of tax problems, some of which have not been definitely resolved. It is the position of the Revenue Service that the typical unit agreement results, in effect, in exchanging an oil and gas interest in a specifically described tract for a lesser interest of the same type in a larger tract. The transaction so viewed essentially involves the exchange of property of a like kind and as such is a non-taxable exchange.418 It is the position of the Tax Court, on the other hand, that "unitization amounts to no more than a production and marketing arrangement as between owners of oil production or property rights."419 In the view of the Fifth Circuit, whether or not an exchange is effected depends on local law,420 a view since rejected by the Tax Court.421 Some of the differences in consequences resulting from this conceptualistic difference are listed below:

(1) Expenses involved in effecting the unitization are, in the view of Internal Revenue Service, acquisition costs that must be capitalized. Not so, says the Fifth Circuit—they are expenses incident to the operation of the property and deductible.422

(2) The taxpayer, according to the Commissioner, obtains a new mineral property as a result of unitization and, in the event he commits two separate properties to the unit, the basis in both is combined in the interest he obtains in the unit and depletion is computed based on his unitized mineral interest which is one property. Not so, says the Tax Court—he continues to have two separate properties and computes depletion on both and may use cost depletion on one and percentage depletion on the other. The amount of production to

418. Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941); E. C. Laster, 43 B.T.A. 169 (1940), acq., 1941-1 CUM. BULL. 7; I.T. 4093, 1952-2 CUM. BULL. 130. See also Hill, Tax Problems Arising Out of Unitization Agreements, OIL & GAS INST. 427 (Sw. LEGAL FDN. 1952).
420. Whitwell v. Commissioner, 257 F.2d 548 (5th Cir. 1958).
422. Campbell v. Fields, 229 F.2d 197 (5th Cir. 1956).
be allocated to each is dependent upon prior production history of both tracts or, in the absence of production, possibly on a relative acreage basis.\textsuperscript{423} The Ninth Circuit concurred with the Tax Court but observed that an unitization agreement might be drafted in a manner necessitating an exchange of interest conclusion.\textsuperscript{424} The immediate problem has been resolved prospectively by a 1964 amendment to the Code\textsuperscript{425} which provides that all of a taxpayer’s operating mineral interests in a unit plan of operation shall be treated as constituting a single mineral property although in the case of voluntary unitization (or pooling) such results follow only if the tracts are contiguous or in close proximity and are in a single deposit or two or more deposits logically developed or produced together. These amended Code provisions will also affect the determination of the 50 percent of taxable income limitation on the statutory depletion deduction. (See Part I, \textit{supra}, p. 107). See also discussion of separate mineral properties at Part I, \textit{supra}, p. 171.

Unitization of producing properties frequently results in adjustments of various types to compensate some participants on the comparative basis of the acreage and equipment contributed. In the event the adjustment is in the form of cash, the Internal Revenue Service regards the cash as boot received in a tax-free exchange and as such subject to capital gain treatment. Where those contributing more are compensated by an oil payment to reflect the difference, the Commissioner and the Tax Court agreed, but for different reasons, that the proceeds derived from the oil payment are ordinary depletable income and not capital gain.\textsuperscript{426} However, the Fifth Circuit in the \textit{Whitwell} case reversed the Tax Court, holding the proceeds from the oil payment a return of capital tax-free to the extent of basis and capital gain as to any excess.\textsuperscript{427} Internal Revenue Service has taken the position\textsuperscript{428} that it will follow \textit{Whitwell} only if the amount of the oil payment is guaranteed so that it is not a true oil payment. Otherwise,
the Service will regard the oil payment as an economic interest and the proceeds received therefrom will be taxable as depletable income and not as capital gain.

Viewing the two transactions involved in Whitwell from the other side of the tax coin other problems present themselves. Under the doctrine adopted in Whitwell, from the standpoint of the other unit participants making the production payment, presumably the amount of such production payment will have to be capitalized and recovered through cost depletion, generally an undesirable consequence. Under the Internal Revenue Service theory, on the other hand, if viewed as an oil payment the amount of such payment could be excluded by the unit contributors from their income. Accordingly, it would appear that under Whitwell the recipient of equalization payments benefits tax-wise at the expense of the other unit participants. However, these tax consequences would probably also follow if instead of using an oil payment the equalization for prior development was made by cash contributions. The other unit participants might protect themselves if an oil payment is to be used by a contractual understanding that the recipient will report the oil payments as depletable income; since this accords with the Service position if the payments are not guaranteed no difficulty should be encountered in obtaining a favorable ruling.

In the event of unitization of producing properties, the exchange can, if appropriate safeguards are not adopted, result in converting a depreciable basis into depletable basis, generally an undesirable consequence. Assuming, as is very often the case, that intangibles have been deducted and the taxpayer’s basis in the property being transferred to the unit is largely in depreciables, if the unit agreement fails to separately exchange the mineral interest and the interest in equipment, the taxpayer’s combined basis will be allocated to the interest acquired on the basis of the relative fair market value of the property (equipment and interest) received under the unit agreement. In view of the Laster case and attitude of Internal Revenue Service it is obviously imperative to separate the “exchange” of equipment phase of the

transaction from the exchange of mineral interest phase. In such event, prior to the 1962 amendments there were no particular problems under the exchange theory if the depreciables were so severed; Internal Revenue Service regarded the exchange as a tax-free exchange and any cash payments made for equalization purposes as "boot" subject to capital gain treatment with the payor entitled to capitalize such equalization payments (as he did in the Whitwell case) as part of his depreciable basis and recover same through depreciation. However, the investment credit provisions of the Revenue Act of 1962 and the amendments to the depreciation provisions included in that Act, which require in the event of sale of the taxation of gain as ordinary income to the extent depreciation has previously been taken, may pose some complications under the "exchange" theory.

Operations pursuant to a unit operating agreement pose the same problem with respect to possible tax classification as a corporation involved in operations generally under co-ownership arrangements considered at supra, p. 409. Reliance is generally placed on I.T. 3930 and 3948 under the unit operating agreement as it is under other operating agreements with the usual provision being made permitting each working interest participant to take his share of production in kind and granting only limited and revocable authority to market oil and gas to the operator. In addition, the typical unit operating agreement retains more control by the non-operators over the operator than is the case with respect to other operating agreements which may tend to negative the existence of representative centralized management.

**Forms**

A taxpayer claiming a deduction for depletion and/or depreciation with respect to a mineral property must keep accurate accounts recording the cost or other basis of the mineral deposit, the plant and equipment, and showing subsequent allowable capital additions and all other required adjustments. The taxpayer must also submit with his return

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480. See discussion at Part I, supra, p. 150.
481. See discussion at Part I, supra, p. 151.
482. For a further exposition of these problems see Hill, *Tax Problems Related to Unitization*, 14 OIL & GAS INST. 445, 463-64 (SW. LEGAL FDN. 1963).
detailed data relating to depletion and/or depreciation; the information required with respect to depletion data relating to oil and gas properties can be furnished on Form O and as to other mineral properties on Form M which can be obtained by request from the office of any District Director of Internal Revenue. If a taxpayer takes a deduction for worthless mineral rights, he should submit Form 927, Proof of Worthlessness of Mineral Rights.

The usual income tax forms are used by a taxpayer reporting income from oil and gas properties and the form used in this respect depends upon whether the return is being filed by an individual, partnership, fiduciary or corporation.

Any unincorporated organization (including co-owners) desiring to be excluded from all partnership provisions must make such election in a statement attached to a Partnership Return, Form 1065. The name or other identification and address of the organization is the only information required on Form 1065 itself.

The statement attached to the return must contain the following information:

(1) The name and address of all members of the organization.

(2) A statement that the organization qualified under subdivisions (i) and either (ii) or (iii) of Regulations Section 1.761-1(a)(2).

(3) A statement that all members of the organization elect to be excluded from the partnership rules.

(4) A statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained).

Form 1065 is filed only in the initial year in which the election has to be made. Thereafter, the “organization” files a Form 1096 and also a Form 1099 is filed for each co-owner. Forms 1096 and 1099 are filed with the taxpayer’s particular regional Service Center. If one co-owner is a member of several organizations having a common operator, the operator can file one Form 1099 for such co-owner, listing all of the

organizations in which such co-owner has an interest.\textsuperscript{434}

Although the election to be excluded from the partnership provisions must be unanimous, any co-owner who fails to advise the Commissioner within 90 days of the formation of the organization that he desires the partnership provisions to apply and has so advised the other co-owners by registered or certified mail is deemed to have elected to be excluded from such provisions.\textsuperscript{435} The election of an organization to be excluded is not affected by a subsequent transfer of a co-owner’s interest.\textsuperscript{436}

Although any co-owner can file the appropriate Forms, the operating agreement should specifically place that burden on the Operator. If the co-owners desire to be excluded from the partnership provision, the operating agreement should so provide and should further provide that each co-owner covenants not to do anything inconsistent with such election. To assure compliance with such provision it may be advisable to provide for payment of liquidated damages in the event of breach.

If the co-owners desire to be taxed as a partnership, an appropriate election should be made within 90 days of the formation of the organization. In such event, the partnership will complete and file annually Form 1065 and such form should include an appropriate election to deduct intangibles. Out of an abundance of caution, co-owners electing to be excluded from the partnership provisions may, in the initial Form 1065, include a statement to the effect that if it should be determined that such election is not available and/or not properly exercised, that the resulting partnership elects to deduct intangibles.

\textbf{Conclusion}

This Article in two parts has attempted to canvass the entire field of federal mineral income taxation. We end as we began with a word of caution—the complexity of mineral taxation is such that (1) careful tax planning is essential, and (2) such planning must be comprehensive and in depth. Hopefully, the basis for such planning may be found in this Article.