Land & Water Law Review

Volume 3 | Issue 1 Article 8

1968

Oil and Gas Federal Income Taxation--1967 Edition, by Kenneth G. Miller

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OIL AND GAS FEDERAL INCOME TAXATION—1967 EDITION, by Kenneth G. Miller. Illinois: Commerce Clearing House, 1967. Pp. 470.

THIS book, published under the authorship of Kenneth G. Miller, was written under Mr. Miller's directorship by a group associated with Arthur Young and Company. This is a reference book which many lawyers and accountants concerned about oil and gas income taxation problems will want to have in their libraries. The book is comprehensive in its coverage and exhaustive in its case references. As a result of its comprehensive coverage, the book may be particularly valuable in helping with relatively obscure problems when they do arise. The book is also valuable in that it sets forth many of the unpublished informal staff positions of the Internal Revenue Service which are available only to those having frequent contact with the Service. The book also includes many helpful illustrations; those accounting oriented (for example, allocation of overhead for the purpose of determining the 50 percent of taxable income limitation on statutory depletion at pages 164-165) are particularly good.

This book does not, however, accomplish all that one might hope for with respect to a one-volume oil and gas income tax source book. The organization of the book is such that there is an unusual amount of duplication and repetition and at the same time there is a failure to correlate varying aspects of the same general problem. To illustrate the repetition involved—various types of oil and gas interests are discussed in a chapter dealing with "economic interests;" are again discussed in a chapter entitled "Allowance of Depletion Deduction;" are further discussed in the "Lease and Sale" chapter and are also discussed in six separate chapters, each of which deals with a particular type of oil and gas interest. The failure to correlate varying aspects of the same problem is illustrated by the treatment of bonus payments from the standpoint of the lessee. At page 228 we learn that such bonus payments must be capitalized by the lessee; at page 105 we learn that the lessee in calculating his deduction for depletion must exclude from gross income for this purpose an allocated portion of the bonus payment, and at page 125 we learn that the lessee cannot make a similar exclusion for the purpose of determining his taxable gross income from the property. It would take one familiar with the particular tax principles and all their implications to realize that these three separate discussions are actually related to each other.

Too much of the book consists of a stringing together of excerpts from cases without adequate correlation of the materials and without adequate analysis of the cases in terms of the overall problems involved. For the most part the technique employed is to use a separate caption indicating a very narrow phase of the problem and under that caption reference is then made to one or two cases which are summarized very briefly and the court's holding then reflected by short and usually relevant quotations from the case. The result is much what one might expect in the way of data retrieval when and if law books are published by computers. A stringing together of cases permits inconsistent cases to exist side by side without much, if any, explanation. In those few instances in which the authors choose to deal with a systematic presentation of the problems involved and particular areas rather than individual cases, as they do in Chapter 27 relating to depreciation and a few other instances, the quality and cohesiveness of the presentation is much improved.

This book will be of some help in planning oil and gas transactions but less than what one would hope for or expect. A separate chapter (Chapter 29) is devoted to strategy and planning suggestions and is good insofar as it goes. The weakness from the planning standpoint is the failure to indicate in many contexts the practical implication of various holdings and the failure to emphasize alternative methods of handling the same problems so as to achieve desired objectives. This is partially a result of the authors' propensity to refer to all the cases that have been decided in a particular area, stringing the cases together without discrimination. Thus, the chapter dealing with the carried interest arrangement overemphasizes the present-day significance of *Abercrombie*[1] and underemphazises *Weinert*[2] and the informal position of the Internal Revenue Service as reflected by the

1. Commissioner v. J. S. Abercrombie Co., 162 F.2d 338 (5th Cir. 1947).
2. Weinert v. Commissioner, 294 F.2d 750 (5th Cir. 1961).

proposed[3] (but since withdrawn[4]) regulations. From a tax planning standpoint the objectives of the parties in this area are usually to have income during payout taxable to the carrying party and for the carrying party to take the deduction for intangibles. This objective can usually be achieved by adopting a so-called *Manahan*[5] tyep carried arrangement since it is consistent with the general objectives of the Internal Revenue Service in this area. Further, a partnership arrangement is a feasible alternative to *Manahan* and may have some other advantages; while this is mentioned in the chapter dealing with partnerships, it is not referred to or cross-referenced in the chapter dealing with carried interest arrangements.

Generally, tax problems are not analyzed in depth; hence, one concerned with persuading courts will find this book helpful primarily as an index to the cases. This lack of analysis in depth also leads to some confusion in exposition. In the sale-lease distinction area, for example, the usual formula is outlined and subscribed to. Under this formula, the retention of an economic interest, such as an overriding royalty, the life of which is co-extensive with the productive life of the property transferred results in a leasing or subleasing transaction; whereas, the retention of an economic interest, such as a production payment, that will terminate prior to the expiration of the life of the interest transferred results in a sale subject to capital gain treatment as to the initial consideration. In both instances, the deferred payment out of production received by the holder of the retained interest is taxable to him as ordinary depletable income and excluded by the operator-assignee from his income. There is a whole line of cases involving minerals other than hydrocarbons which do not make this distinction, at least if a transaction is cast in the form of a sale and other factors are present. Under this line of authority the transaction is a sale and both the initial payment and deferred payments out of pro-

3. Proposed Treas. Reg. § 1.612-4(a) as proposed on April 29, 1960, 25 Fed. Reg. 3761 (1960).

4. Withdrawn by T.D. 6836 on June 15, 1965, 30 Fed. Reg. 8902 (1965), INT. REV. BULL. No. 34, at 19. Although withdrawn as acknowledged by the authors (p. 212) generally the proposed regulations reflect the current philosophy of the Service.

5. Manahan Oil Co., 8 T.C. 1159 (1947). Under this arrangement the owner of the lease assigns the entire lease to the operator with a provision to the effect that upon complete payout a one-half interest in the lease will revert to the assignor.

duction are part of the consideration for the sale.[6] Since the Supreme Court's decision in *Helvering v. Elbe*[7] reached a sale conclusion in a transaction involving a reserved net profit interest and since this case has been distinguished but not overruled, courts have on occasion relied on this case with respect to incomplete dispositions in reaching a sale conclusion. The most recent instance of this being the decision of the Tax Court in the *Pickard* case.[8] This case appears to have significance to the general problem of distinguishing between lease and sale; however, the authors choose to treat it as reviving *Helvering v. Elbe* and limit its application to a reserved net profit interest, which also raises the possibility that such a reserved net profit interest may not be an economic interest for depletion purposes (see page 224). Since the interest reserved in *Pickard* was a royalty and the Court expressly refused in this context to distinguish between a reserved royalty interest and a net profit interest, the authors' conclusions seem to be a peculiar reading of the significance of this decision.

Admittedly, the sale-lease cases are difficult to reconcile among themselves. The more recent cases involving incomplete dispositions and reaching a sale conclusion have emphasized the fact that the assignor had no reversion rights and the assignee had no obligation to develop.[9] This is also the basis of the *Pickard* case which incidentally involved an oil and gas property. The law, however, in this area is a morass. There is not likely to be clarification until the courts come to grips with the basic problems in terms of the policy considerations relating to capital gain treatment. This in fact has been the approach of the Supreme Court in a non-mineral

6. Reference is briefly made by the authors to this line of cases at p. 242. For a discussion of these cases *see* Bloomenthal, *Disposition of Mineral Properties—A Reappraisal of Tax Consequences on Incomplete Dispositions*, 16 WYO. L.J. 1 (1961).

7. Helvering v. Elbe Oil Land Dev. Co., 303 U.S. 372 (1938).

8. Anne Pickard, 46 T.C. 597 (1966).

9. *See* United States v. White, 311 F.2d 399 (10th Cir. 1962); White v. United States, 254 F. Supp. 894 (D. Colo. 1966). However, there have also been a number of recent cases involving sand and gravel in which the Courts often rejecting their own precedents in the non-hydrocarbon cases have reached a leasing rather than sale conclusion. *See, e.g.*, Wood v. United States, 337 F.2d 300 (5th Cir. 1967); Royalty Stone Corp. v. Commissioner, 379 F.2d 298 (2d Cir. 1967).

case[10] involving similar issues. The Supreme Court there emphasized capital gains as providing relief for the bunching of income in one year reflecting appreciation in value which has taken place over a period of several years. The Court did not regard as critical the fact that the deferred payments to the seller were at the seller's risk, which appears to be the keystone to the application of the economic interest concept in the context of mineral transactions. It should also be noted that the transaction involved in this case provided for an end price.

One of the other areas in which the authors attempt to analyze the problem in some depth is the area in which professional services (legal, geological, etc.) are rendered in exchange for an interest in a property in connection with the acquisition, exploration, or development of such property. This analysis challenges the dicta of the *Lewis*[11] case which questions the sharing arrangement or pool of capital concept previously thought to be controlling in this area. Basically, the authors argue that since the drilling of a well (which in part involves the services of a drilling contractor in exchange for an interest in the property drilled) is recognized as a non-taxable pooling of capital, the same result should be followed with respect to the contribution of other services. This type of analysis represents a form of special pleading which is not likely to be successful in the long run; since one rendering professional services in all other areas in exchange for an interest in property has taxable income, it seems inevitable that courts will examine carefully the pooling of capital rationalization in this context. This suggests that the most desirable alternative in this area is the partnership route with reliance on the provisions of Reg. § 1.721-b(1) which permits a service partner to escape taxation on the organization of a partnership provided he does not receive an interest in the other partners' capital contributions. *Frazell*[12] is not inconsistent with this, since under the assump-

10. Commissioner v. Brown, 380 U.S. 563 (1965). This 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 Court held that the deferred payments were subject to capital gain treatment. For an attempt at a policy oriented approach *see* Bloomenthal, *supra* note 6, at 11.
11. James A. Lewis Eng'r, Inc. v. Commissioner, 339 F.2d 706, 709 (5th Cir. 1964).
12. United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), *on rehearing,* 339 F.2d 885, *cert. denied,* 380 U.S. 961.

tions that were made by the Court, and not really refuted, the service partner did acquire an interest in capital accounts of the other partners.[13] Appropriate drafting can avoid this by limiting the service partner to an interest in partnership profits. There are alternative ways of accomplishing this, each of which has varying economic and tax consequences that must be carefully considered.[14]

Despite the foregoing criticism, this book will be useful to practitioners for many purposes, some of which have been referred to in the introductory paragraph of this review. Its sheer comprehensiveness assures that it will have some relevance to practitioners or accountants dealing with oil and gas income tax problems. In some areas analysis is good, as is the case in the chapter dealing with minimum royalties which is a troublesome area. In many other areas although the analysis is incomplete, the materials will serve at least as a point of departure. The book should also be helpful in the preparation of tax returns with respect to routine oil and gas tax problems. Perhaps, these are sufficient objectives for a one-volume reference book.

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13. Since the arrangement permitted the other "partners" to recover their investment from the first available funds without regard for their source and after recovered the service partner received an interest in the entire venture this conclusion would necessarily follow. While the parties apparently intended a sharing arrangement rather than a partnership, the case (apparently, with acquiescence of counsel) was decided on the basis of a partnership approach. Particularly significant in the reviewer's judgment is the statement of the Court that the amounts recovered by the other partners represented a "skimming of profits" rather than a return of capital. United States v. Frazell, 339 F.2d 885, 886 (5th Cir. 1964).
14. The reviewer has discussed some of the alternatives in Bloomenthal, *A Guide To Federal Mineral Income Taxation*, 1 LAND & WATER L. REV. 80, 413 (1966).

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