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Bonus, Delay Rental, and Minimum Royalty - Treatment and Distinctions for Tax Purposes

Peter C. Maxfield

University of Wyoming

College of Law

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Mineral law draws conceptual distinctions between bonus, delay rental, and minimum royalty. Nevertheless, the federal income tax consequences to lessees and lessors of mineral interests blur and confuse these substantive distinctions. In this article Professor Maxfield attempts to resolve much of the confusion in the income tax treatment of bonus, delay rental, and minimum royalty.

BONUS, DELAY RENTAL, AND MINIMUM ROYALTY --- TREATMENT AND DISTINCTIONS FOR TAX PURPOSES

*Peter C. Maxfield**

ALTHOUGH the courts have settled some of the questions involving bonus, rental and minimum royalty which in the past have perplexed taxpayers engaged in the mineral industry, problems remain concerning precise differences between and treatment of such payments. The following article is broken into four sections. The first three involve definitions of the above payments relevant to their appropriate tax treatment. The fourth section attempts a delineation of the distinctions and a resolution of the problems in treatment for tax purposes.

I. BONUS

When the owner of a mineral fee executes a lease and retains a nonoperating interest which will exist for the life of

*Assistant Professor of Law, University of Wyoming; A.B. 1963, Regis College; J.D. 1966, University of Denver; LL.M. 1968, Harvard University; Member of the Colorado and Wyoming Bars.

the lease, such as a royalty or net profits interest, any consideration received by such owner-lessor from the lessee in the form of an initial payment for the execution of the lease is generally described as bonus. Often a lessee assigns his lease retaining an overriding royalty or net profits interest and receives in addition a bonus in the form of a cash payment. Also, a cash payment made to a mineral fee owner for an option to lease has been held to be regarded for tax purposes as an additional form of bonus.[1]

A. Payee's Tax Treatment

The die is cast as to a payee's tax treatment of bonus received. The Supreme Court has concluded that bonus is in the nature of advance royalty and thus depletable despite even the lack of any reasonable assurance of obtaining production.[2] If, however, the lease or sublease expires, terminates, or is abandoned in a subsequent tax year without any production under the lease, the recipient of the bonus must restore the depletion deduction previously taken to income in the year in which the lease or sublease is terminated or abandoned.[3] The payee in such case may restore to his basis in the property any amount previously deducted because of depletion taken on the bonus.[4] Where the deduction for depletion exceeds the amount of the basis, clearly the payee may only restore to his basis the original amount thereof since otherwise the requirement to restore would be rather fatuous to the extent of the excess of depletion taken over the amount of the basis. Also the requirement to restore has been determined to exist despite the lack of tax benefit from the original deduction.[5] If the lease or sublease terminates, expires, or is abandoned without any production in the tax year in which

1. Commissioner v. Pickard, 401 F.2d 615 (10th Cir. 1968).
2. Herring v. Commissioner, 293 U.S. 322 (1934); Burnet v. Harmel, 287 U.S. 103 (1932); *see also* Treas. Reg. § 1.612-3(a, d) (1960). For the underlying basis for depletable ordinary income rather than capital gain treatment, see G.C.M. 22730, 1941-1 CUM. BUL. 214. See Freling, *Bonus Payments Through the Looking Glass*, P-H NATURAL RESOURCES TAXES, ¶ 2027 (1968) for an excellent critical appraisal of the somewhat anamalous tax treatment given bonus payments.
3. Treas. Reg. § 1.612-3(a)(2) (1960).
4. *Id.*
5. Douglas v. Commissioner, 322 U.S. 275 (1944).

the bonus was paid, the payee is precluded from taking a depletion deduction on the bonus.[6]

Serious doubt about the need to restore exists, however, if some marginal production is obtained. Where marginal production is obtained and sold, the regulations would appear to not require restoration.[7] The Board of Tax Appeals in *Delores Crabb*[8] held that a lessor-taxpayer who received $36.98 as his royalty did not have to restore the $4,125 depletion deduction taken by him on a $15,000 bonus since there was some commercial production. However, the Tax Court in 1963 in *Seth Campbell*[9] held that depletion was not allowable on a bonus paid where 15 barrels of oil were produced, the lessor was paid $1.84 as his share of production but none of the production was marketed, and the lease was abandoned in the same year in which it was given. The *Crabb* case discussed above was distinguished on the fact that no production was marketed and on the ground that here the lease was given and abandoned in the same tax year and therefore restoration was not an issue. Although the latter distinction seems questionable, the fact that no oil was marketed would have clearly defined the limits of the restoration requirement but for a concurring opinion which cast doubt on the future precedential value of the *Crabb* case where only minimal production was marketed. Additionally, Revenue Service has changed its position on the *Crabb* case and is now nonacquiescing in the holding.[10] In order to reconcile the nonacquiescence in *Crabb* with the regulations wherein, as above noted, the requirement to restore applies only if no income is "derived from the extraction of minerals,"[11] one would have to conclude that minimal income from extraction is no income at all. However,

6. *See* Seth Campbell, 41 T.C. 91 (1963).
7. Treas. Reg. § 1.612-3(a)(2) (1960).
If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination or abandonment.
8. 41 B.T.A. 686 (1940), *aff'd*, 119 F.2d 772 (5th Cir. 1941).
9. 41 T.C. 91 (1963).
10. 1968-2 CUM. BUL. 3.
11. Treas. Reg. § 1.612-3(a)(2) (1960).

the lessor's position was confirmed by a decision from the Northern Federal District of Texas, wherein the regulations were construed as not requiring a commercially profitable well in order to avoid restoration but rather production and marketing of some oil.[12]

The application of a prorata restoration requirement such as exists with minimum royalties[13] seems to this author the best solution. It avoids the enlargement of depletable gross income possibility which is inherent in the present requirement and which in effect has been prescribed by the Supreme Court in another context.[14] It replaces the rather fatuous determinant applied in *Crabb* with one that is more consonant with the purposes for the depletion allowance and more economically realistic where there is insufficient actual production.

The Revenue Service has ruled that a lessor may avoid the necessity of restoration by making a complete disposition by sale or gift of the property in question, *i.e.,* his retained mineral interest, prior to the termination of the lease.[15] Thus with planning the requirement to restore may be avoided readily.

Depletion on the bonus and the restoration requirement are both applied on a "property" basis as the latter term is defined by section 614 of the Code.[16] Therefore, if a lease is granted on a single section 614 "property" in consideration for a bonus and royalty, no portion of the depletion taken on the bonus need be restored if there is the requisite production from the property even if the lessee has released or surrendered a portion of the acreage thereof. If the lease covers several properties, *e.g.,* one lease given on two noncontiguous tracts, then the bonus is allocated between the properties ratably on an acreage basis unless the parties have demonstrated that the bonus was intended to be received on other

12. Sloan v. United States, 69-1 U.S. Tax Cas. ¶ 9355 (N.D. Tex. 1969).

13. *See* text accompanying notes 51, 52 *infra.*

14. Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934); *see* INT. REV. CODE OF 1954, § 611.

15. Rev. Rul. 60-336, 1960-2 CUM. BUL. 195.

16. Norman Freeman, 48 T.C. 96 (1967).

than an acreage basis.[17] Then the rules above apply to each property with its allocated portion of the bonus.

The taxpayer may take either cost or percentage depletion, whichever is greater, with respect to bonus income.[18] As a practical matter cost depletion is seldom available to the landowner because typically the landowner has little or no basis in his mineral fee. The regulations preclude an allocation of any amount to the basis of the minerals which represents the value of the land for other purposes.[19] Probably, therefore, in situations where the land is acquired and a new basis, *i.e.,* not a transferred basis, attaches, unless the cost of or value attached to the land is at least partially the result of the minerals, little or none of such cost or value would be allocable to the basis of the mineral interest acquired. However, cost depletion of the bonus in many cases will be more advantageous than statutory depletion where a mineral lessee, who already has paid a bonus for the lease, assigns it to another for a cash consideration and an overriding royalty or net profit interest.

Cost depletion with respect to bonus income is computed by multiplying the taxpayer's basis for depletion in the mineral property involved by a fraction, the numerator of which is the amount of the bonus and the denominator of which is the sum of the bonus and the royalties expected to be received.[20] Percentage depletion is computed by multiplying the amount of the bonus by the appropriate percentage depletion rate, which resulting amount cannot exceed fifty percent of taxable income from the property in question.[21]

> *Example* (1): A, the owner in fee of the surface and mineral rights in a tract of land, gives an oil and gas lease to the EZ Oil Company during tax year 1971, retaining a 1/8 royalty and receiving a bonus of \$10,000 for the lease. A has no cost basis in the minerals as such. A should report the \$10,000 as income and take a statutory or percentage depletion deduction of \$2,200 in 1971. In the event that suffi-

17. *Id.*
18. Treas. Reg. § 1.612-3(a,d) (1960).
19. Treas. Reg. § 1.612-1(b)(1)(ii) (1960).
20. Treas. Reg. § 1.612-3(a)(1) (1960).
21. Treas. Reg. § 1.612-3(d) (1960).

cient production is obtained under the lease, A need make no further adustjments. If, however, in 1972, EZ Oil Company surrenders the lease without sufficient production, A must restore the $2,200 depletion deduction taken in 1971 by reporting it as income in the return he files for 1972 whether or not a tax benefit resulted from the deduction in 1971. If A had made a complete disposition of his retained oil and gas rights in the tract prior to the surrender, A would have avoided the need to restore.

Example (2): B acquired an oil and gas lease on a tract for which he paid $10,000. He immediately assigned the lease to the EZ Oil Company for $15,000 plus a 1/16 overriding royalty. The estimated recoverable reserves from the property are 3,200,000 barrels of which 100,000 barrels are attributable to B's 1/16 overriding royalty interest. The posted field price of the oil is $3.50 per barrel. B's cost depletion deduction is computed by multiplying his basis of $10,000 by the fraction 15,000/(15,000 + 350,000), *i.e.*, $411. B's statutory depletion deduction is computed by multiplying the $15,000 by 22%, *i.e.*, $3,300. Accordingly, B will report the $15,000 bonus as income and take as a deduction from income the statutory depletion deduction of $3,300 since it exceeds cost depletion.

If the bonus is a substantial one, a cash basis taxpayer might consider spreading the income received over a period of years by entering into an agreement under which the lessee or sublessee agrees to pay the bonus in a series of annual installments. The Revenue Service has ruled that an accrual basis taxpayer will be required to include in income the total amount of the installment bonus contract in the year in which the lease contract is executed.[22] However, the fact that the lessee is prepared to pay an initial lump sum bonus would probably not preclude the cash basis lessor from entering into an arrangement under which the bonus is payable in a series of annual installments.[23] If, though, the bonus obligation is unconditionally payable by a solvent obligor whose credit is unquestionable under an enforceable contract, the

22. Rev. Rul. 68-606, 1968-2 CUM. BUL. 42.

23. Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

rights thereunder being freely transferable and readily saleable, the fair market value of the promise must be included in income in the year in which the lease contract is executed.[24] A restriction against assignment of the right to receive the bonus might preclude immediate valuation; however, absent a business reason, it would probably be attacked on a tax evasion theory. The provisions permitting income averaging may provide some relief in this situation.[25] If the cash basis taxpayer is required to immediately report the fair market value of the installment obligation, there is a danger that the total depletion deduction will be reduced since the difference between the fair market value of the obligation and its face value may be regarded as interest income and therefore not depletable.[26]

B. Payor's Tax Treatment

Since, as discussed above, the bonus is considered as being in the nature of advance royalty to the payee and therefore depletable, the payor (lessee) is required to exclude a prorata portion of the bonus from gross income from property in each taxable year before computing percentage depletion.[27] A failure to so exclude would result in either an expansion over actual production of depletable income or else double depletion on the same income. Both results are contrary to the Code as it has been construed.[28] The amount of the exclusion is determined by taking that percentage of the bonus that is the percentage of total estimated mineral reserves sold during the tax year.[29]

> *Example:* A gives an oil and gas lease to B in 1970 for a cash payment of $50,000 and a 1/8 royalty. In 1971 a single well is drilled on the leasehold with estimated recoverable reserves of 1,000,000 barrels of oil. 100,000 barrels are produced and sold. The amount

24. Rev. Rul. 68-606, 1968-2 CUM. BUL. 42; Norman Freeman, 48 T.C. 96 (1967).
25. INT. REV. CODE OF 1954, §§ 1301-05.
26. Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962); Herbert's Estate v. Commissioner, 139 F.2d 756 (3rd Cir. 1943).
27. Treas. Reg. § 1.613-2(c)(5) (1960).
28. INT. REV. CODE OF 1954, § 611; Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934).
29. Treas. Reg. § 1.613-2(c)(5)(ii) (1960); *see also* Quintana Petroleum Co. v. Commissioner, 143 F.2d 588 (5th Cir. 1944).

of bonus to be excluded by B from gross income from property for purposes of computing depletion is \$5,000, *i.e.,* (100,000 barrels sold/1,000,000 barrels recoverable) x \$50,000 bonus. Assuming oil sells for \$3.50 per barrel, B's gross income from property would be \$350,000, minus 12½% thereof, and minus \$5,000, *i.e.,* \$301,250.

Although no judicial determination has been made, it appears that the amount of bonus excluded in determining gross income from property may not be added back in determining taxable income from property for purposes of the 50% limitation. The final regulations provide, "The term 'taxable income from property (computed without allowance for depletion)' as used in section 613 and this part means 'gross income from the property' . . . less allowable deductions."[30] Since, according to the final regulations, the allocable portion of bonus is excluded in determining "gross income from property,"[31] this author has little doubt about the above conclusion. On the other hand, for purposes of determining section 63 taxable income, neither all nor an allocable portion of the bonus payment is deductible.[32]

The regulations provide that a lessee or sublessee paying a bonus must capitalize the bonus expenditure and recover it through depletion.[33] Where statutory depletion exceeds cost depletion, of course, the lessee will derive no tax advantage from capitalizing such expenditures unless the lease is abandoned or sold with some remaining depletable basis. Although this treatment of bonus payments generally has been accepted by the courts,[34] in *Lambert v. Jefferson Lake Sulphur Com-*

30. Treas. Reg. § 1.613-4(a), T.D. 6955, 1968-1 CUM. BUL. 295. The proposed draft of the regulations contains the same prescriptions. Proposed Treas. Reg. § 1.613-5(a), 36 Fed. Reg. 19264 (1971).
31. Treas. Reg. § 1.613-2(c)(5)(ii) (1960).
32. Treas. Reg. * 1.613-2(c)(5)(ii) (1960); Shamrock Oil & Gas Corp. v. Commissioner, 346 F.2d 377 (5th Cir. 1965), *cert. denied,* 382 U.S. 892 (1965); Murphy Oil Corp. v. United States, 230 F. Supp. 583 (D.C. Ark. 1964), *aff'd,* 337 F.2d 677 (8th Cir. 1964); Sunray Oil Co. v. Commissioner, 147 F.2d 962 (10th Cir. 1945).
33. Treas. Reg. § 1.612-3(a)(3) (1960).
34. Shamrock Oil & Gas Corp. v. Commissioner, 346 F.2d 377 (5th Cir. 1965), *cert. denied,* 382 U.S. 892 (1965); Murphy Oil Corp. v. United States, 230 F. Supp. 583 (D.C. Ark. 1964), *aff'd,* 337 F.2d 677 (8th Cir. 1964); Canadian River Gas Co. v. Higgins, 151 F.2d 954 (2d Cir. 1945); Sunray Oil Co. v. Commissioner, 147 F.2d 962 (10th Cir. 1945); Baton Coal Co. v. Commissioner, 51 F.2d 469 (3rd Cir. 1931).

pany[35] the Federal District Court of Louisiana by its holding and the Fifth Circuit Court of Appeals in *dictum*[36] adopted the position that bonus payments do not have to be capitalized into depletable basis by the payor but rather are deductible from section 61 gross income in computing section 63 taxable income. The reasoning was simply that if, as the Supreme Court has held,[37] a bonus payment is advanced royalty to the payee-lessor then the payor-lessee should likewise so regard it. However, in 1965 the Fifth Circuit repudiated its prior *dictum* in *Jefferson Lake* and adopted the view set forth in the regulations.[38] One result, in effect, is that the greater the initial capital investment, the greater the payor's tax burden since the statutory depletion deduction is reduced because of the bonus exclusion requirement. Relative to the treatment of capital costs elsewhere in the Code, this result seems somewhat anomalous to this author.

> *Example:* A gives an oil and gas lease to B for a cash payment of $50,000 and a 1/8 royalty. The total proceeds from production, after royalties, are $3,062,500. B's total percentage depletion over the life of the property is $662,750 (22% of $3,012,500, gross proceeds less bonus). B cannot exclude bonus in computing section 63 taxable income and therefore his section 61 gross income from the lease actually subject to tax is $3,062,500. The percentage depletion allowance of $662,750 absorbs the capitalized bonus and B pays a tax on $2,399,750 ($3,062,500 minus $662,750). If B could have excluded the bonus payment from section 61 gross income in computing section 63 taxable income, he would pay a tax on $2,349,750 ($3,012,500 minus $662,750). If B had paid no bonus whatsoever, his total statutory depletion deduction would have been $673,750 and his total section 61 taxable income (assuming no other deductions) would be $2,388,750 ($3,062,500 minus $673,750).

35. 236 F.2d 542 (5th Cir. 1956), *aff'g* 133 F. Supp. 197 (D.C. La. 1955).
36. 236 F.2d 542, 546, (5th Cir. 1956).
37. Herring v. Commissioner, 293 U.S. 322 (1934).
38. Shamrock Oil & Gas Corp. v. Commissioner, 346 F.2d 377 (5th Cir. 1965).

II. DELAY RENTAL AND SHUT-IN ROYALTY

Delay rental is defined in the regulations as "an amount paid for the privilege of deferring development of the property and which could be avoided by abandonment of the lease, by commencement of development operations, or by obtaining production."[39] The payee (lessor) receiving delay rentals must report such as ordinary income and cannot take depletion thereon.[40] The payor (lessee) incurring delay rental expense has the option to regard such as either current expense or capital cost recoverable through the depletion allowance. In order to capitalize delay rentals, the taxpayer must so elect in a statement filed with his return. A new election may be made each year and is available apparently as to each separate property.[41] Only where cost depletion will exceed percentage depletion by an amount greater than the amount of the delay rental payment made in a particular year on a particular mineral property will it be beneficial to capitalize such payments. Since usually cost depletion will not so exceed percentage depletion, it is generally preferable to treat delay rental payments as current expense inasmuch as the rental payment is then recoverable from section 61 gross income as an independent deduction and not by amortization through the statutory depletion allowance.

The Revenue Service in 1956 adopted the view that initial payments, even though labeled delay rental, which were made on competitive federal and state leases and on all private leases were to be given bonus treatment.[42] However, in 1967 the Revenue Service relented by concluding that first year delay rental payments on competitive federal and state leases and on private leases may be expensed or capitalized at the option of the lessee.[43] Payments which are rental in form but bonus in substance will be given bonus treatment according to the ruling. However, it should be possible to cast at least

39. Treas. Reg. § 1.612-3(c) (1960).
40. Treas. Reg. § 1.612-3(c)(2) (1960); Commissioner v. Wilson, 76 F.2d 766 (5th Cir. 1935).
41. INT. REV. CODE OF 1954, § 266; Treas. Reg. § 1.266-1(c) (1958); Treas. Reg. § 1.612-3(c)(2) (1960); Rev. Rul. 55-118, 1955-1 CUM. BUL. 320; Rev. Rul. 67-25, 1967-1 CUM. BUL. 157.
42. Rev. Rul. 56-252, 1956-1 CUM. BUL. 210; *see also* United States v. Dougan, 214 F.2d 511 (10th Cir. 1954); Olen F. Featherstone, 22 T.C. 763 (1954).
43. Rev. Rul. 67-25, 1967-1 CUM. BUL. 156.

part of the consideration agreed upon as rental paid for deferring the development obligation under the lease. To accomplish this, the lease should provide for a first-year rental payment in advance which, like subsequent rental payments, defers the obligation to commence drilling a well for a period of 12 months. If the initial payment is disproportionate in amount to subsequent payments, the Revenue Service is likely to recast such payment as bonus.

Since the Revenue Service's expressed position above described is limited to delay rentals paid on unproductive properties, where payments labeled delay rental are allocable in part to a tax year(s) in which the property is producing, such payments might arguably be characterized by the taxpayer as part of the sharing arrangement and therefore additional royalty to the extent that the production income is sufficient to cover them.[44]

Oil and gas leases frequently provide for the continuation of the lease through the payment of shut-in royalties when a well has been shut-in for some reason such as the lack of a market. The Fifth Circuit has held that such payments should be accorded delay rental treatment by the lessee since they "were made neither in return for the extraction of oil or gas nor in contemplation of that event"[45] and hence not within the depletion concept which is an allowance for the exhaustion of a wasting asset.

Sometimes, because of excessive production of salt water, a well(s) must be shut in with an allowable for other wells set by the state conservation commission because of the shut-in. If the lessee transfers the allowable to another of his leases (assuming a different lessor) and pays his lessor of the shut-in well a substitute royalty based on a per unit of production formula in order to continue the lease with the shut-in well, such payments will probably be accorded delay rental treatment since the payee (lessor of shut-in lease) has been held by the Tax Court to not own an economic interest in the

44. *See* pp. 362-64 *infra*.

45. Johnson v. Phinney, 287 F.2d 544, 546 (5th Cir. 1961), *rev'g* 181 F. Supp. 315 (D.C. Tex. 1960).

mineral property to which the allowable is transferred.[46] For the same reason, where the lessee transfers to another operator-lessee (rather than to a different lease owned by him) the allowable in consideration for a certain amount per unit of production in one case and a lump sum payment in the other, the Court of Claims held that the transferee-payor was not required to reduce his gross income from property in computing statutory depletion.[47] Thus delay rental treatment probably should be given such payments. Although if a lump sum is paid for the transfer or for the substitute royalty, the payor may be required to amortize such payment over the life of the transferred allowable.[48] The above holdings by the Court of Claims were based on a presumption that the transferee of the oil allowable was producing oil derived from his own leasehold. The court noted that such presumption could be rebutted if the following showing was made: (1) oil production pursuant to the allowables doesn't deplete the transferee's oil; (2) oil underlying the transferor's lease decreased during the life of the allowables; and that (3) it was the transferee's production pursuant to the allowables that caused such decrease.[49]

III. MINIMUM ROYALTIES

In most respects the appropriate tax treatment for minimum royalties[50] is relatively clear provided that the particular arrangement in question can be characterized as advance or minimum royalty. In the event of such classification, the payee can take depletion on the payment received even to the extent that it exceeds the actual production allocable to him in the year of payment. However, in the event the working in-

46. P.G. Lake, Inc., 24 T.C. 1016 (1955).

47. Tidewater Oil Co. v. United States, 339 F.2d 633 (Ct. Cl. 1964); Getty Oil Co. v. United States, 399 F.2d 222 (Ct. Cl. 1968).

48. *See* Treas. Reg. § 1.162-11(a), T.D. 6520, 1961-1 CUM. BUL. 52; Harry W. Williamson, 37 T.C. 941 (1962); Rev. Rul. 68-2 CUM. BUL. 76. *But see* John D. Fackler, 39 B.T.A. 395 (1939), *nonacquiescing* 1968-2 CUM. BUL. 3; Court Holding Co., 2 T.C. 531 (1943), *nonacquiescing* 1968-2 CUM. BUL. 3.

49. Tidewater Oil Co. v. United States, 339 F.2d 633 (Ct. Cl. 1964); Getty Oil Co. v. United States, 399 F.2d 222 (Ct. Cl. 1968).

50. The regulations describe them as "advance" royalties. Treas. Reg. § 1.612-3(b) (1960). However, this may be misleading in light of the treatment the Revenue Service will probably accord a lump sum initial payment in advance to lessor for production. *See* text accompanying notes 63, 64 *infra*.

terest against which the minimum royalties are applied expires, terminates, or is abandoned before the minimum royalty payments have been recouped out of production, the payee must adjust his capital account by restoring the depletion deduction taken in prior years on account of any units paid for in advance but not extracted.[51] A corresponding amount must be returned as income for the year of such expiration, termination, or abandonment.[52]

If the depletion deduction taken on the minimum royalty payment exceeded the payee's basis on the property, to what extent should the payee-lessor make restoration thereto? The problem is slightly different from the bonus restoration question since depletion taken on a minimum royalty is restored *pro tanto.* It clearly would be preferable from the taxpayer's point of view to adjust the now zero basis by adding whatever total amount is being restored. However, inasmuch as presumably any amount in basis will at least eventually reduce income, whether ordinary or capital gain, the requirement that the payee-lessor also restore to income would be rather fatuous to the extent of the excess of the amount of the original deduction over the former basis. Thus, as in the case of bonus restoration, probably the payee-lessor may only restore to his basis to the extent of his former basis. Additionally, restoration to basis probably may only be made to the extent that the amount required to be restored exceeds depletion taken on a zero basis. This would appear to be the appropriate treatment since otherwise there would be at least partially a doube recovery of basis, *i.e.,* when depletion was taken and later after restoration when the property was sold or abandoned.

The payor of the minimum royalty may deduct the amount of the payment from his section 61 gross income either when it is paid or when it is recouped.[53] Additionally, the payor in computing statutory depletion shall exclude from gross income from property the amount deducted from section 61 gross income in the tax year when the latter deduction is

51. Treas. Reg. § 1.612-3(b)(2) (1960).
52. *Id.*
53. Treas. Reg. § 1.612-3(b)(3) (1960).

made.[54] The payor must make an election as to the treatment of all advance royalties in his return for the first taxable year in which such payments are made, and the election is binding on the payor for all properties and for all subsequent years.[55] If no election is made, the payor will be held to have elected to deduct in the year in which the payment is recouped.[56]

By deferring the deduction of the payments from section 61 gross income and from section 613 gross income from property until such payments are earned, the payor will have an increased total statutory depletion deduction. However, his total taxable income will be increased by the amount of the deferred and unrecouped payments unless, when the mineral property becomes worthless or is abandoned, he may deduct such total deferred amount from his section 61 gross income. Although serious problems concerning the appropriate year for a section 165 worthlessness deduction can arise,[57] assuming the appropriate tax year, this author can see no theroetical problem with the deduction of such excess payments, *i.e.,* such excess is an otherwise unrecovered cost. However, a lack of any guidance on this question should prompt the cautious planner to consider applying for a ruling.

> *Example:* A gives an oil and gas lease to B reserving 1/8 royalty. The lease further provides that B will, at the commencement of each year, pay a minimum royalty of $20,000 to be applied on the royalty payable and to the extent in any year that the amount of actual production attributable to A's 1/8th royalty is less than $20,000, such excess minimum royalty payment shall be recouped in subsequent years out of production attributable to A's 1/8th royalty to the extent that such production exceeds the minimum royalty payment made in such year(s). Assume that in each of the first two years total actual production is $120,000 and the lease is surrendered in the third year.

54. Treas. Reg. § 1.613-2(c)(5)(iii) (1960).
55. Treas. Reg. § 1.612-3(b)(3), T.D. 6841, 1965-2 CUM. BUL. 200.
56. *Id.*
57. *See* Bloomenthal & Maxfield, *Tax Advantages of Oil and Gas Operations,* P-H FEDERAL TAX IDEAS, ¶ 17,011.5 (1970).

In each of the first and second years A will report $20,000 as section 61 gross income and take a statutory depletion deduction of $4,400 (22% x $20,000). In the third year A will probably be required to restore to income the depletion deduction taken in the first and second years to the extent of the insufficiency of actual production attributable to the royalty interest, *i.e.,* $2,200 must be restored (depletion was taken on $40,000 and actual production attributable to the royalty interest over the two years amounted to $30,000 and therefore depletion taken on the excess $10,000 must be restored). Based on the discussion below on distinctions between the various payments, it would appear reasonably arguable that inasmuch as total production in the first two years exceeded the minimum royalty payments, no restoration need be made by A because to the extent that the minimum royalty payments exceeded the production attributable to the ⅛th royalty, the parties have simply varied the sharing agreement. The regulations, however, appear to preclude such treatment.[58] If the amounts received by A had been in the form of bonus, there would be no necessity of restoring any part of the depletion deduction.

B, the lessee, has the option (assuming no prior election) to deduct such payments currently or to deduct them as earned from section 61 gross income and from section 613 gross income from property for depletion purposes. If B elects to deduct currently, the following is his income picture for tax purposes for the three years:

	1st yr.	2nd yr.	3rd yr.	Total
Section 61 Gross Income less royalty and minimum royalty	$100,000	$100,000	— 0 —	$200,000
Section 613 Gross Income from Property	100,000	100,000	— 0 —	200,000
Statutory Depletion Deduction	22,000	22,000	— 0 —	44,000
Section 63 Taxable Income	78,000	78,000	(20,000)	136,000

58. Treas. Reg. §§ 1.612-3(b)(2); 1.612-3(b)(4) Ex. 1 (1960).

If B elects to defer the deduction until earned, the following is his income picture for tax purposes for the three years:

	1st yr.	2nd yr.	3rd yr.	Total
Section 61 Gross Income less deductible royalty and minimum royalty	$105,000	$105,000	— 0 —	$210,000
Section 613 Gross Income from Property	105,000	105,000	— 0 —	210,000
Statutory Depletion Deduction	23,100	23,100	— 0 —	46,200
Section 165 Deduction	— 0 —	— 0 —	30,000	30,000
Section 63 Taxable Income	81,900	81,900	(30,000)	133,800

Assuming the deductibility in the third year under section 165 of the excess minimum royalty payment over the amount of production allocable to A's 1/8 royalty, B has $2,200 less in total section 63 taxable income by electing to defer.

A rather anamolous consequence of B's electing to deduct currently in the above example is the loss for depletion purposes of a total of $10,000 in depletable gross income from property. This results from B's exclusion of $40,000 from his section 613 gross income from property and A's inclusion after restoration of $30,000 in his section 613 gross income from property. The regulations thus permit depletion to be taken only on $230,000 of the total of $240,000 actual production in the example above. This anomaly which is contrary to the spirit if not the letter of the statutory depletion provisions[59] would be resolved as suggested in the example above by requiring the payee to restore only if total production (rather than production attributable to the lessor's retained royalty) is less than the payments made to the lessor. As noted above and discussed below, the excess of the payments over production attributable to the lessor's royalty could simply be treated as a variation in the sharing arrangement.

59. INT. REV. CODE OF 1954, § 613(a).

IV. DISTINCTIONS

The regulations in describing the tax treatment to be given minimum or advance royalties use the example of a per-unit type which is recoupable out of production in future years and avoidable by the obligor through surrender or termination of the lease.[60] Also the regulations refer to such royalties as "advanced royalties."[61] However, it would appear since an annual payment not based on production is contemplated that such could also be described as "minimum royalties." The problems of distinguishing minimum or advanced royalty from bonus and rental arise when the pattern set forth in the regulations is varied. If the parties to the lease provide for a minimum royalty coupled with a percentage type royalty clause as contrasted with a per-unit type, the arrangement rather clearly should still warrant minimum royalty treatment.[62]

If what purports to be a minimum royalty is payable unconditionally and not avoidable by surrender or termination of the lease, the payment will be given bonus treatment by the Revenue Service.[63] Additionally, a lump sum paid in the first year even though characterized as advanced or minimum royalty will probably be given bonus treatment by the Revenue Service.[64] There may be some limited opportunity for obtaining minimum or advanced royalty treatment for some of the negotiated initial consideration for the lease

60. Treas. Reg. § 1.612-3(b)(4) (1960):

> B leased certain mineral lands from A under a lease in which A reserved a royalty of 10 cents a ton on minerals mined and sold by B. The lease also provided that B had to pay an annual minimium royalty of $10,000 representing the amount due on 100,000 tons of the particular mineral whether or not B mined and sold that amount. It was further provided that, if B did not mine and sell 100,000 tons in any year, he could mine and sell in any subsequent year the amount of mineral on which he had paid the royalty without the payment of any additional royalty. However, this right of recoupment was limited to minerals mined and sold in any later year in excess of the 100,000 tons represented by the $10,000 minimum royalty required to be paid for that later year.

61. Treas. Reg. § 1.612-3(b) (1960).
62. *See* Rev. Rul. 70-22, 1970-1 CUM. BUL. 204.
63. Rev. Rul. 69-467, 1969-2 CUM. BUL. 142.
64. *Minimum Royalties*, 10 OIL AND GAS TAX QUARTERLY 1, 13 (1960); *see also* Churchhill Farms, Inc., ¶ 69,192 P-H MEMO T.C., wherein amounts paid by the lessee to the lessor pursuant to the lease as reimbursement for legal fees incurred by the lessor in the negotiation of the lease were accorded bonus treatment.

where a regular annual minimum royalty is agreed upon. In a recent ruling the Revenue Service gave minimum royalty treatment to payments so labeled in the lease of $1,500 in the first year and $1,000 per year thereafter.[65]

As noted above, the regulations provide the example of a minimum royalty which is recoupable in subsequent years to the extent that the minimum payment is not recouped in the year made. If the minimum royalty payments are only recoupable in the year made, minimum royalty treatment will probably still be accorded the payments, assuming no bonus characteristics exist such as an unconditioned or unavoidable obligation to pay. The Tax Court in the *McFaddin*[66] case held that such a payment warrants minimum royalty treatment by the payee-lessor even though production attributable to the payee's interest in the year in question is insufficient to permit a complete recoupment by the lessee-payor. The taxpayer-lessor in that case reserved a one-eighth royalty and a $25,000 per year minimum royalty recoupable only in the year paid. For the tax year in question, production amounted to approximately $32,000. Thus the lessee recouped only $4,000 of the $25,000 minimum royalty payment out of production attributable to the lessor-taxpayer's interest. The Commissioner argued unsuccessfully that the taxpayer could not take depletion on the unrecouped portion of the minimum royalty payment, *i.e.,* $21,000, but rather in effect that delay rental treatment was appropriate because of the failure to recoup.

The problem which remains unresolved by the *McFaddin* case is the appropriate treatment to be given the minimum royalty payment to the extent that it exceeds in amount the total production for the year in question.

> *Example:* If in the *McFaddin* case total production had been $16,000 instead of $32,000, the *McFaddin* rationale would permit minimum royalty treatment as to $16,000 of the $25,000 minimum royalty payment even though the lessee would actually have recouped only $2,000 of the payment out of production

65. Rev. Rul. 70-20, 1970-1 CUM. BUL. 144.
66. James Lewis Caldwell McFaddin, 2 T.C. 395 (1943).

allocable to lessor. However, what treatment should be given the excess of $9,000 of the minimum royalty payment over the amount of actual production for the year?

Although clearly the *McFaddin* case relied on the variation of the sharing arrangement theory for its result, *i.e.,* in the year in question the lessee paid the lessor $25,000 of the $32,000 production, the question is whether each tax year must be treated as a separate unit or whether the parties can retrospectively look at the entire producing life of the property to determine whether production is sufficient. Some commentators appear to have concluded that the former is the proper view.[67] It might be argued that the regulations are also in accord with this former view in requiring restoration, "[i]f the right to extract minerals . . . against which the advanced royalties may be applied expires, terminates, or is abandoned before all such minerals or timber have been extracted or cut."[68] A close reading of the regulations indicates to this author support for the Commissioner's unsuccessful position in *McFaddin.* An example given in the regulations looks solely to production allocable to the lessor's retained interest to determine whether restoration must be made, *i.e.,* the regulations do not appear to incorporate the sharing arrangement variation theory which permits an examination of total production accruing to the lessee and the lessor in determining whether restoration must be made.[69] However, the *McFaddin* case does employ the variation in sharing arrangement theory, and in 1943 the Revenue Service acquiesced in the case.[70] Thus, given the applicability of the variation theory, there is nothing in the *McFaddin* case or in the regulations to indicate that each year should be considered separately. On the contrary, the Tax Court's reliance on *Herring v. Commissioner*[71] would indicate that the appropriate treatment is to await the termination of the lease to determine whether restoration must be made. In the *Herring* case, the

67. BREEDING & BURTON, P-H 1971 INCOME TAXATION OF NATURAL RESOURCES, ¶ 15.08.
68. Treas. Reg. § 1.612-3(b)(2) (1960); *see also* Treas. Reg. § 1.612-3(b)(4) Ex. 1 (1960).
69. Treas. Reg. § 1.612-3(b)(4) Ex. 1 (1960).
70. 1943 CUM. BUL. 16.
71. 293 U.S. 322 (1934).

Supreme Court held that bonus is depletable by the payee irrespective of whether there was any production in the year of payment.

Another possibility on the recoupability variable (assuming, again, no bonus characteristics such as an unconditional or unavoidable obligation to pay) is for the payments to be completely nonrecoupable. The questions here which are related to those raised above are twofold. First, are such payments under any circumstances variations in the sharing arrangement with the consequence of depletability to the payee and the payor's requirement of exclusion from section 613 gross income from property, or should such payments be treated as delay rental, *i.e.,* nondepletable ordinary income to the payee and deductibility from section 61 gross income to the payor? Second, assuming the variation theory applies, must there be sufficient production in the year of payment attributable to the lessee-payor's interest to warrant the lessor-payee's taking depletion on the payment, or may the parties await the termination of the lease to make the determination whether to restore?

As to the first question, the answer appears well settled. The courts[72] and the Revenue Service[73] have concluded in the analogous situation of the lessee's paying the ad valorem and severance tax obligations of the lessor that such amounts paid by the lessee constitute depletable income to the lessor, at least where in the year of payment there is sufficient production allocable to the lessee-payor's interest to equal the amount of such payments. The courts regard such payments as a variation in the sharing arrangement on the ground that, if the lessee had not agreed to pay the lessor's taxes, the lessee would have had to pay a larger royalty and that such payments are in effect a part of the total production package which is the basic economic return to the lessor for executing the lease.[74] The Second Circuit recently raised one conceptual

72. Handelman v. United States, 357 F.2d 694 (Ct. Cl. 1966); Louisiana Land and Exploration Co. v. Donnelly, 394 F.2d. 273 (5th Cir. 1968); John W. McLean, 54 T.C. 569 (1970).
73. Rev. Rul. 64-91, 1964-1 CUM. BUL. 219, *modifying* Rev. Rul. 16, 1953-1 CUM. BUL. 173.
74. Handelman v. United States, 357 F.2d 694 (Ct. Cl. 1966).

problem with the application of the "variation in sharing" theory in this context.[75] The court noted that there was something "essentially grotesque" in the idea that the sharing arrangement perforce changes as the state increases its taxes. However, the weight of precedent was determinative in the decision.

The answer to the second question, *i.e.*, must be the determination as to sufficiency of production be made yearly, is considerably more unsettled. The Revenue Service has through two rulings clarified its position somewhat. In Revenue Ruling 16,[76] published in 1953, the Revenue Service concluded that ad valorem tax payments made before production should be given delay rental treatment whereas such payments made subsequent to production are additional royalty, and therefore variations in the sharing arrangement provided total production from the lease is sufficient to cover the amount paid on behalf of the lessor. However, if production is insufficient, then to the extent of such insufficiency the payment is to be given delay rental treatment. In 1964 the Revenue Service modified its position by concluding that whether a lessee's agreement to pay the lessor's ad valorem tax obligation should be treated as part of the arrangement between the parties for the sharing of production or proceeds therefrom should not depend (contrary to the view set forth in Revenue Ruling 16) on whether the production income at any particular time is insufficient to cover the lessor's taxes paid by the lessee.[77] Thus the timing of the payment of taxes relative to the time when production is obtained is ruled insignificant. However, the ruling does not indicate when there must be sufficient production, *i.e.*, at the end of the tax year or at the termination of the lease.

The two courts which have spoken on the question have split. The Court of Claims appears to have concluded that the calculation as to the sufficiency of production should be made annually.[78] The Tax Court, on the other hand, has concluded

75. United States Steel Corp. v. United States, 445 F.2d 520 (2d Cir. 1971), *aff'g* 316 F. Supp. 990 (S.D.N.Y. 1970).
76. Rev. Rul. 16, 1953-1 CUM. BUL. 173.
77. Rev. Rul. 64-91, 1964-1 CUM. BUL. 219.
78. Handelman v. United States, 357 F.2d 694 (Ct. Cl. 1966).

that the calculation may be deferred until termination of the lease.[79] Because of the fluctuations that occur in amounts of production from year to year, the lessor-payee would undoubtedly prefer the Tax Court solution that a larger total amount in depletion would be allowable where insufficient production in some years is balanced by surplus production in other years.

In light of the Tax Court's position on ad valorem tax payments where in a particular year there is insufficient production allocable to the lessee-payor's interest, consistency would require that payments purporting to be minimum royalty which are either non-recoupable or only recoupable in the year of payment be given the same treatment, *i.e.,* the determination as to the sufficiency of production would be deferred until the termination of the lease. *Dictum* in the Tax Court decision referred to immediately above would appear to support this conclusion.[80] This would appear to be a correct result if one accepts the well-settled principle which is basic to the lessor's treatment of bonus and minimum royalty, *i.e.,* that payments which are unrelated to production can be depletable as constituting an advance to the payee on his share of production and an increase in his share of production over the amount allocable to him because of his retained interest in the mineral property. From the lessee's point of view, the excess of the payment over production in a particular year is not an isolated event. Rather, such is a setback in a continuum, the life of the lease, which may be recouped in effect by a surplus of production at anytime later in the life of the lease. This is simply a conclusion that economically it is more representative of reality to attend the termination of the lease to determine sufficiency of production than it is to make the determination annually.

As to the payor-lessee, where payments warrant minimum royalty treatment which are either nonrecoupable or only recoupable in the year of payment, the option to defer the deduction from section 61 gross income will probably not be

79. John W. McLean, 54 T.C. 569 (1970).
80. *Id.* at 576.

available. The payor-lessee simply excludes or deducts from his section 61 gross income and from section 613 gross income from property the amount of the payment in the year of payment.[81] The regulations make express provision for the availability of the option to defer only where the payor-lessee may recoup in future years.[82]

In all three minimum royalty situations, *i.e.*, payments nonrecoupable, payments recoupable in the year of payment only, and payments recoupable in future years (where an election to deduct currently has been made), a problem arises when production from the property in question in a particular year does not at least equal the amount the lessee-payor subtracts in determining his own section 613 gross income from property (*i.e.*, either the amount of minimum royalty payment to the lessor where such is recoupable or the amount of the minimum royalty payment plus the amount of royalty paid to the lessor where the minimum royalty payment is not recoupable). In effect, the aggregate amount of section 613 gross income from property reported by both parties over the life of the property on which depletion has been taken will exceed the total amount of actual production accruing from the property over its life. However, the example given in the regulations raises the problem and no exception is made for the situation.[83] If the payor deducts the amount of the payment from his section 61 gross income in the year paid, in order to avoid depletion taken on an amount which exceeds the amount of actual production, the payor-lessee might be required to carry over to future years the amount of excess minimum royalty payment. The regulations would appear to preclude this, however, by requiring that the deduction from section 613 gross income from property occur in the year in which the payor deducts the payment from his section 61 gross income.[84] The Court of Claims' solution, which requires the payee to compute annually the sufficiency of production,[85]

81. *See* United States Steel Corp. v. United States, 270 F. Supp. 253, 264 (S.D.N.Y. 1967), *aff'd* 445 F.2d 520 (2d Cir. 1971).
82. Treas. Reg. §§ 1.612-3(b)(3), T.D. 6841, 1965-2 CUM. BUL. 200; 1.613-2(c)(5)(iii) (1960).
83. Treas. Reg. §§ 1.612-3(b)(4) Ex. 2 (1960); 1.613-2(c)(5)(iii) Ex. (1960).
84. *Id.*
85. Handelman v. United States, 357 F.2d 694 (Ct. Cl. 1966). *See* text accompanying note 78 *supra*.

resolves the problem but, as noted above, is disconsonant with other relevant considerations. If the decreased complication of like deductions for purposes of section 61 and section 613 is desired, perhaps the regulations should be revised so as to provide for a carryover of both deductions to the extent of the excess of the minimum royalty payment over actual production.

To summarize, tax consequences vary rather radically depending on the classification of a payment as bonus, minimum royalty, or delay rental. If the payment is bonus or minimum royalty, the payee may take depletion theron; but if the payment is characterized as delay rental, the payee may not take depletion thereon. If the payment constitutes bonus, restoration is only necessary if there is no commercial production; whereas if the payment is minimum royalty, the payee must make a pro-rata restoration. If the payment is bonus, the payor must capitalize it into depletable basis; and, although he is required to reduce his section 613 gross income from property by the amount of the bonus in computing depletion, he may not reduce his section 61 gross income in computing his section 63 taxable income. On the other hand, if the payment constitutes minimum royalty, the payor reduces both his section 613 gross income from property and his section 61 gross income; and the amount of the payment is not capitalized into depletable basis. If the payment is characterized as delay rental, the payor at his election may deduct the same from his section 61 gross income in the year of payment without the necessity of reducing his section 613 gross income from property, or he may capitalize the payment into his depletable basis. Obviously, the payee-lessor would prefer ordinary income which is depletable and which involves the least risk of the necessity of restoration, *i.e.,* bonus. The payor-lessee on the other hand, would prefer a characterization which reduces his section 61 gross income but not his depletion allowance, *i.e.,* delay rental. The unhappy compromise is minimum royalty.