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COMMENTS

INCOME TAXATION OF MINERAL SHARING ARRANGEMENTS: THE POSSIBILITY OF BONUS TREATMENT FOR CASH PAID TO THE TRANSFEROR

This article concerns the federal income taxation of cash payments in the context of mineral property sharing arrangements.[1] Specifically, the article covers the uncertain tax status of unfettered cash paid to a transferor of mineral rights in sharing arrangements other than traditional leases.

In a traditional lease situation, up-front cash paid unconditionally to the lessor constitutes a "bonus" and for tax purposes receives special treatment. As it will be seen, bonus tax treatment is generally undesirable from the lessee's viewpoint, and often from the lessor's viewpoint as well.[2] This may create a dilemma where parties to a contemplated mineral transaction wish to avoid these tax consequences but otherwise find the lease form suitable to their needs.

Apparently, it has been widely assumed that bonus treatment applies in traditional leases and nowhere else. If this were so, it would be possible to obviate all possibility of bonus treatment by structuring a sharing arrangement to avoid one or more traditional lease features. In many cases the sharing arrangement could be tailored to retain those lease characteristics desired by the parties while doing away with the undesired tax consequences. In other words, in relation to the dilemma just described, the parties could "have their cake and eat it too."

However, in several unsettling cases, taxpayers have been disappointed in their efforts to avoid bonus treatment by departing slightly from traditional lease models. In these cases, the courts treated the transactions as leases anyway, and applied bonus tax treatment. The cases may imply the appropriateness of bonus treatment for cash payments in a wide variety of sharing arrangements; very little contrary authority exists to restrict this spill-over from the taxation of traditional

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1. Coal and iron ore transactions are beyond the scope of this article because of their special treatment under I.R.C. § 631(c).
2. *See* notes 26-30 and accompanying text *infra*.

leases. As a result, parties to a contemplated sharing arrangement undertake a measure of insecurity in providing for an unconditioned cash payment to the transferor. To plan the transaction as effectively as possible for their tax purposes, they need to know the potential for bonus treatment and the factors relevant to its avoidance. With a view to this need, the present article will detail the principles and authorities involved and offer theoretical analysis of the problem.

DEFINITION OF SHARING ARRANGEMENT; EXAMPLES

A sharing arrangement may be defined as "a transaction wherein one party makes a contribution to the acquisition, exploration, or development of a mineral property and receives as consideration an interest in the property to which the contribution is made."[3] This basic sharing formula may be cast in a number of forms. For example, all of the following transactions are sharing arrangements:

(1) R, owner of a mineral property, transfers all of the operating rights in the property to E, reserving a royalty and obtaining a promise from E to develop the property.

(2) R transfers the entire operating rights to E, providing that E will develop the property and recoup his development costs from production, whereupon a percentage of the operating rights will revert to R.

(3) R transfers a percentage of operating rights to E in return for E's agreement to develop the property; however, R also gives E a production payment out of R's retained interest, to repay E for a share of the development costs.

(4) R transfers a percentage of operating rights to E in return for E's agreement to develop the property, and also assigns to E all production from the property until E has recouped his costs, after which the parties share production in accordance with their interests.

(5) R transfers a percentage of operating or nonoperating rights to E in consideration for a cash payment which R pledges to the development of the property.

3. BURKE & BOWHAY, INCOME TAXATION OF NATURAL RESOURCES 7.01 (1980).

(6) R transfers a percentage of operating rights to E in return for E's agreement to hire R as a mining or drilling contractor to develop the property.

Example (1) above is a "lease;" examples (2), (3) and (4) are "carrying arrangements;" (5) is a "pledged funds" transaction; and (6) is a "turnkey" arrangement.[4] Throughout the remainder of this article, these examples will be referred to as representative of the various sharing arrangements discussed.

Despite the differences of form, each of these sharing arrangements accomplishes substantially the same result: 1) the transferee makes a contribution to the acquisition, exploration or development of a mineral property, and 2) he receives an interest in the property to which the contribution is made.

SHARING ARRANGEMENT AS NON-TAXABLE EVENT

According to the Revenue Service's ruling in G.C.M. 22730,[5] the formation of a sharing arrangement is not a taxable event because it involves no sale or exchange. Rather, the owner of the mineral property allows the transferee to make a capital investment in that property, thereby expanding the pool of capital which it represents. The resultant production accruing to the transferee derives entirely from his own investment. And, even though transferee acquires a capital interest in the property, the transferor does not part with one, because transferor's interest, now partially or wholly relieved of the cost and risk of development, is worth exactly what it was worth before the transaction.[6]

A sharing arrangement may thus be distinguished from any transaction in which transferee makes no capital investment in the property. For example, if transferor gives transferee a fractional interest in the mineral property in return for an unconditioned cash consideration alone, the whole cash payment is taxable sale proceeds.[7] This result follows from the rationale of G.C.M. 22730.[8] Since the money is not pledged to the acquisition, exploration or development of

4. *See* MAXFIELD & HOUGHTON, TAXATION OF MINING OPERATIONS, ch. 9 (1981).
5. G.C.M. 22730, 1941-1 C.B. 214.
6. *Id.* at 216-18.
7. Vern W. Bailey, 21 T.C. 678 (1954); Rawco, Inc., 37 B.T.A. 128 (1938).
8. G.C.M. 22730, *supra* note 5.

the mineral property received by the transferee, transferor's interest remains burdened by those costs as it was before the transaction. Therefore, transferor's interest must be worth less by the amount of property transferred, and transferor has thus parted with a capital asset in exchange for the cash, *i.e.*, a sale has occurred.

In sharing arrangements like example (5) above, transferee's capital investment consists of a cash payment to transferor which is pledged to development of the property. Here, the cash payment is non-taxable to the extent it is actually applied according to the pledge.[9] In this regard it is important that the funds be pledged to *pre-production* costs such as acquisition, exploration or development. Cash dedicated only to the operation of a producing property does not qualify as a non-taxable contribution to capital.[10] This limitation is compatible with the G.C.M. 22730 rationale; a contribution to the operation of a property does not relieve the cost or, especially, the risk of developing the property in the first place.

UNCONDITIONED CASH PAYMENT TO TRANSFEROR

In the context of a sharing arrangement, an unconditioned cash payment to transferor could arise in several ways. For example, the parties might provide for an outright cash payment as an additional consideration to transferor for entering into the transaction. Or, in a "pledged funds" transaction (example (5)) the parties might provide that transferor may keep any excess of the funds over the amount actually used in the acquisition, exploration or development of the property. Similarly, in a "turnkey" arrangement (example (6)), the amount paid to hire transferor as a mining or drilling contractor may exceed the reasonable costs of mining or drilling so that in effect transferor has received an excess cash payment.

In any of these cases transferor ends up with surplus cash not subject to any conditions or restrictions. This result then poses the question of how the parties should treat the excess cash payment for tax purposes. Regarding the traditional lease

9. Rawco, Inc., *supra* note 7; Trans California Oil Co., 37 B.T.A. 119 (1938), *nonacq.*, 1942-1 C.B. 30.

10. James A. Lewis Engineering, Inc. v. Commissioner, 339 F.2d 706 (5th Cir. 1964); Rev. Rul. 74-549, 1974-2 C.B. 186; Treas. Reg. § 1.636-1(b)(1) (1973).

(example (1)) the question is settled in favor of the special treatment for lease bonuses, which is described under the next heading. In the context of other sharing arrangements, however, the treatment is uncertain. Two alternatives appear most logical: 1) treat the cash as proceeds of a sale, or 2) treat the transaction as a lease, and the cash as a lease bonus. These possibilities will be considered in detail below, following the review of lease/bonus treatment in the next section.

UNCONDITIONED CASH PAYMENT IN LEASE TRANSACTION

As previously indicated, an unconditioned lump sum paid to a lessor at the inception of a lease constitutes a "bonus."[11] The peculiar but now established mode of taxing bonus income originated in the United States Supreme Court case of *Burnet v. Harmel.*[12] There the Court denied the benefits of the capital gains deduction to the recipients of a lease bonus, for two main reasons.

First, the Court said that by enacting the capital gains provisions, Congress intended to relieve taxpayers of the tremendous tax burdens incidental to the conversion of capital assets. However, the Court found this policy inapplicable to the oil and gas lease because the lessor's gains on the transaction would be spread out over the term of the lease.[13] In this regard, the Court noted that "[t]he payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease."[14]

Second, the Court distinguished a mineral lease from an ordinary sale by analogizing the mining or drilling operation to "a manufacturing business carried on by the use of the soil, to which the passing of title of the minerals is but an incident. . . ."[15] The Court held that the lessor realized ordinary income on receipt of the bonus, but could take the depletion deduction on that income.[16]

11. MAXFIELD & HOUGHTON, *supra* note 4, § 3.02[1].
12. 287 U.S. 103 (1932).
13. *Id.* at 106.
14. *Id.*
15. *Id.* at 107.
16. *Id.* at 111-12.

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In later cases, the Supreme Court has elaborated upon the *Burnet v. Harmel* view of bonus income. In *Palmer v. Bender*[17] the Court stated: "The bonus received [is] a return *pro tanto* of the [lessor's] capital investment in the oil, in anticipation of its extraction, resulting in a corresponding diminution in the unit depletion allowance upon the royalty oil as produced."[18] This language makes explicit the notion implicit in *Burnet v. Harmel* that the bonus is in substance an advance payment on what would otherwise be royalty income to the transferor. The Court confirmed this in *Herring v. Commissioner*,[19] finding that "[a] bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income. As such it is part of the 'gross income from the property.' "[20]

In G.C.M. 22730,[21] the Revenue Service attempted to reconcile the Supreme Court's characterization of bonus with the general theory of sharing arrangements, as follows:

> A cash bonus . . . is not a division of products or proceeds therefrom. Nor, as already noted, does it represent proceeds from the sale of a capital asset. . . .
>
> * * *
>
> As the mineral in place is a reservoir of the capital investments of the parties returnable through the depletion allowance, and as the bonus payment results in a reduction in the lessor's capital investment to the extent of the depletion allowable thereon, it follows that such payment is a contribution by the lessee to such reservoir of capital investments which is substituted for the capital thereby withdrawn by the lessor. Such shifting of capital investment is attended by a corresponding shift in the value of the respective capital interests or share rights of the parties. That is, a bonus payment diminishes the value of the lessor's mineral interest by reducing his royalty share in future production. The depletion allowance on his bonus income is designed to compensate him for such diminution in value of his interest thereby sustained. Correspondingly, the bonus payment enhances the value of the lessee's interest by

17. 287 U.S. 551 (1933).
18. *Id.* at 559.
19. 293 U.S. 322 (1934).
20. *Id.* at 324.
21. G.C.M. 22730, *supra* note 5.

> giving him a larger share of the minerals produced, or the proceeds therefrom, by reason of his bonus investment.[22]

This rationale is paradoxical; it seems to say that although the lessee acquires a greater interest in the minerals by paying transferor a bonus, no sale or exchange occurs. This is made possible by a fictional "shifting" in the shared "reservoir of capital investments." However, in the same ruling the Service muddies the water by suggesting that a similar rationale applies in a "sale" of a mineral interest:

> A cash payment representing proceeds from the sale of an economic interest also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes a capital gain or loss measured by the difference between cost allocable to the interest sold and the proceeds received.[23]

Apparently the "shifting of capital investments" theory applies whether the cash payment is a lease bonus or simply the proceeds from a sale. If so, the theory does not help to justify the distinction between bonus and sales treatment, although it does have the advantage of leaving room for both possibilities consistent with the underlying theory of sharing arrangements.

The Supreme Court's characterization of bonus income has resulted in a distortion, for tax purposes, of the economic reality of the transaction. Since a bonus is never recouped from production,[24] the depletion allowed on it is in effect a depletion unrelated to extraction. If the parties to the lease could continue to take full depletion on all subsequent production throughout the life of the lease, the total depletion allowed would necessarily exceed the amount of depletion attributable to production. To avoid this gratuitous depletion allowance, the regulations provide for a compensating reduction in depletion allowed to the lessee upon production.[25]

The lessee's tax treatment of the bonus payment may be summarized as follows:

22. *Id.* at 216-17.
23. *Id.* at 218.
24. *See* MAXFIELD & HOUGHTON, *supra* note 4, §§ 3.02[1], 3.03[3][a].
25. Treas. Reg. §§ 1.612-3(a)(3), 1.612-2(c)(5)(ii), T.D. 6446, 1960-1 C.B. 208.

1) Lessee must allocate a specific portion of the bonus to each tax year, and exclude that amount from his base for depletion in that year.

2) He capitalizes the amount of the bonus payment into his basis for the mineral property acquired in the lease.

3) He does not deduct any part of the bonus payment from his Section 61 gross income.[26]

This summary shows the undesirability of a bonus payment from the lessee's viewpoint. First, lessee loses the depletion allowance on a certain portion of production each year, without a corresponding reduction in Section 61 gross income. Second, he gets no benefit from the increase in basis, except in the rare case when he uses cost depletion because it exceeds statutory ("percentage") depletion.[27]

From the lessor's viewpoint, the tax treatment of bonus as depletable ordinary income may or may not be undesirable. For example, if the cash could be treated as sale proceeds, it might qualify for the sixty percent capital gains deduction in lessor's hands.[28] The maximum deduction under statutory depletion is twenty-two percent;[29] obviously, a sale characterization could save lessor a lot of tax dollars. In some instances, though, a lessor might not be able to get any capital gains benefit on the sale. For example, this might be the case if lessor's gain would be short term, or if lessor were a dealer in the property.[30] Then lessor would probably be happy with the depletion deduction, although given a high enough basis in the transferred property he might still prefer sale treatment.

NON-LEASE SHARING ARRANGEMENTS; CASH PAYMENT AS SALE PROCEEDS

If a non-lease sharing arrangement provides for an unconditioned cash payment to the transferor, one might reasonably conclude that the cash should be treated as taxable sale proceeds. This conclusion comports with the general sharing

26. I.R.C. § 61. For a full computational treatment of bonus payments, *see* MAXFIELD & HOUGHTON, *supra* note 4, ch. 3; BURKE & BOWHAY, *supra* note 3, ch. 4.
27. *See generally* MAXFIELD & HOUGHTON, *supra* note 4, ch. 2; BURKE & BOWHAY, *supra* note 3, ch. 8.
28. I.R.C. § 1202; *see* MAXFIELD & HOUGHTON, *supra* note 4, § 8.02.
29. I.R.C. § 613.
30. *See* I.R.C. §§ 1202, 1221, 1222.

theory discussed above:[31] the receipt of excess cash by the transferor would seem to indicate that an extra portion of transferor's mineral interest is flowing to transferee, beyond the interest transferee acquires by assumption of some or all of the development burden. In other words transferor's interest in the property diminishes in value by an increment exchanged to transferee for cash. Under this view the transaction is divided into parts: 1) a non-taxable sharing arrangement as to a certain extent of the mineral interest transferred, and 2) a sale as to the rest.[32] The sale portion then merits the same treatment given to a transfer of minerals for unfettered cash alone.[33]

In spite of the apparent logic of the above rationale, there is little authority to support it. And, the rationale is rendered less persuasive by its repudiation in the lease context, because it is as appropriate to leases as it is to other forms of sharing.

Two cases from the Ninth Circuit suggest sales treatment for excess cash paid to the transferor in "pledged funds" sharing arrangements (example (5)). These cases, *Rogan v. Blue Ridge Oil Co.*,[34] and *United States v. Knox-Powell-Stockton Co.*,[35] involved essentially the same facts: in each case the owner of mineral rights transferred fractional interests in production in exchange for funds which were not pledged to development but were in fact partially expended in development. While such a transaction would not normally constitute a sharing arrangement because of the unpledged funds,[36] the court explicitly found an implied pledge in *Rogan*,[37] and may have assumed the same in the companion case. The court held that the excess of funds over the cost of drilling was income to the transferor. In so holding, the court seemed to assume that the transactions involved were "sales" of the fractional interests, although in neither case did the court address the issue explicitly, and in neither was there any mention of capital gain treatment as opposed to bonus treatment. Still, these cases might serve as some authority for sales treatment of an excess cash payment to transferor in a sharing arrangement involv-

31. *See* note 5 and accompanying text *supra*.
32. BURKE & BOWHAY, *supra* note 3, at 7.06.
33. *See* note 7 and accompanying text *supra*.
34. 83 F.2d 420 (9th Cir. 1936), *cert. denied*, 299 U.S. 574 (1937).
35. 83 F.2d 423 (9th Cir. 1936), *cert. denied*, 299 U.S. 573 (1937).
36. *See* note 7 and accompanying text *supra*.
37. Rogan v. Blue Ridge Oil Co., *supra* note 34, at 422.

ing pledged funds, like example (5) above. To the extent the remaining examples could be analogized to this type of transaction, sale treatment might follow, except of course in the first example, which is a lease.

The Tax Court case of *Charles M. Bernuth,*[38] affirmed by the Second Circuit, involved an excess cash payment analogous to the surplus of pledged funds just discussed. The transaction was a "turnkey" arrangement similar to example (6). In *Bernuth,* the taxpayers acquired fractional working interests in a mineral property as part of a "package deal;" as part of the deal, the taxpayers participated in the development of the property under a contract by which the transferor agreed to drill wells for a fixed price. The question in the case was the extent to which the taxpayers could deduct the contract fee as intangible drilling and development costs. The court agreed with the Commissioner that only a certain portion of the fee represented a reasonable cost for drilling the wells. The balance of the cash payment was denominated "capital expenditures to acquire interests in the oil wells in question."[39] While this characterization equally suits bonus and sale proceeds, the Commissioner did not argue for bonus treatment, and there is no indication that bonus treatment was accorded. On appeal, the Court of Appeals for the Second Circuit treated the overall deal as a "purchase" of a package, apparently viewing the "capital expenditures" as sale money.

Where, as in *Bernuth,* the parties each bear a full share of development and operating costs, in proportion to their working interests, it may be argued that sale classification is the only possibility, because the sharing theory of G.C.M. 22730 does not apply. Even though the total development cost to transferor is reduced by the transfer, his retained interest must be worth less as a result. For example, if transferor's interest is originally worth X dollars subject to the total costs, a retained 1/3 interest subject to 1/3 of the costs must be worth 1/3 • X dollars. And, transferor must part with a capital asset in giving up the proportionately burdened 2/3 interest. Where he

38. 57 T.C. 225 (1971), *aff'd,* 470 F.2d 710 (2d Cir. 1972).
39. *Id.* at 234.

receives cash in return, as in *Bernuth,* the transaction must constitute a sale.[40]

The lack of any discussion of bonus treatment in the above cases may reflect the assumption that bonus treatment applies in traditional leases and nowhere else. However, the cases discussed under the next heading indicate that it may apply in a much wider variety of transactions.

MARGINAL SALE/LEASE CASES

A number of cases have resulted in bonus treatment for cash payments in transactions departing slightly from the traditional lease model illustrated in example (1) above. In example (1) the transferee bore all of the costs and risks incident to development and operation, whereas in these marginal cases, some of the costs and risks were retained by the transferor. Allowing sales treatment here would open the door to converting bonus into sale proceeds by the simple expedient of allocating some costs to the transferor. However, in each of the cases to be discussed, the court held that the transaction was in substance a lease and treated the cash payment as a bonus. This expansion of the scope of bonus treatment indicates that any sharing arrangement which is substantially equivalent to a lease may be treated as such. The question, then, is what factors will determine whether a given sharing transaction is deemed a lease or a sale.

In the Tax Court case of *Harold E. Jahn,*[41] affirmed by the Sixth Circuit, the taxpayers transferred a 3/8 interest in oil and gas, retaining 5/8. Transferee agreed to undertake the development of the property, but the taxpayers retained an obligation to pay 5/8 of the cost of operating completed wells. In addition, transferee paid the taxpayers a lump sum consideration. The issue in the case was whether the lump sum was a lease bonus or the proceeds from an outright sale. The Tax Court called the transaction a lease and treated the cash payment as a bonus, relying for its decision on certain formal aspects of the conveyance (*e.g.*, the form of the granting

40. In Rogan v. Blue Ridge Oil Co., *supra* note 34, and United States v. Knox-Powell-Stockton Co., *supra* note 35, the facts are unclear as to whether the transferors bore any costs. Thus it remains an open question whether the cases stand for any broader application of sale treatment than the *Bernuth* case. *See* note 42 and accompanying text *infra.*
41. 58 T.C. 452 (1972), *aff'd,* 475 F.2d 1140 (6th Cir. 1973).

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clause), and, more importantly, on the location of the development burden.

The court in *Jahn* did not enunciate a test for distinguishing between leases and sales. However, discounting the formal elements relied on and using the location of the development burden as the test, one might conclude that *Jahn* requires bonus treatment for cash payments in any sharing arrangement wherein transferee relieved transferor's retained interest of the development burden. This would include any "carried" arrangement, such as, for instance, any of examples (2), (3), and (4) above, because transferee, in advancing costs subject to recoupment only upon production, shoulders the entire risk that production may never occur. Also, bonus treatment would follow from sharing arrangements like examples (5) and (6), provided that the transferee undertook the entire development cost. Perhaps, then, sale treatment would be appropriate where the transferor retained a proportionate part, or at least some portion, of the risk and expense of development. This result would be consonant with *Bernuth,*[42] where the transferor had participated in the drilling costs, and the court apparently treated the excess cash payment as the "purchase" of an interest.

In *Westates Petroleum Co.,*[43] the Tax Court reached a result similar to the *Jahn* result. In *Westates,* the transferor, owner of certain oil and gas leases, gave the transferee an option to acquire a 75% interest. Transferee paid a lump sum consideration and agreed to bear the cost of exploration and the drilling of a test well. If the first well produced oil or gas, transferor was to pay 25% of pumping equipment and operating costs and receive 25% of production. If the well proved dry, the transferee could either reassign his interest to transferor or drill a second well. If this second well was productive, the transferee was to continue developing the property. Transferor agreed to pay 25% of the cost of drilling the

42. *See* note 38 and accompanying text *supra.* However the *Jahn* case may well be inconsistent with Rogan v. Blue Ridge Oil Co., *supra* note 34, and United States v. Knox-Powell-Stockton Co., *supra* note 35, depending on one's construction of the facts in those two cases. If the transferees there bore all of the drilling costs, *Jahn* would indicate lease treatment, but the Ninth Circuit apparently viewed the transactions as sales. As authority counter to *Jahn,* the cases are unpersuasive because 1) the court did not address the sale/lease issue, and 2) the facts are equivocal as to whether or not transferees bore all of the drilling costs.

43. 21 T.C. 35 (1953).

second and all subsequent wells, and in return was to receive as his share of production from these wells a 5% net profits interest and a 20% "carried working interest."[44]

Again, the issue in the case was whether the initial cash payment constituted bonus or sale proceeds. The Tax Court concluded that the transaction was a lease, saying that the transferor "did not sell or otherwise dispose of its interest in the oil and gas in place while assigning the right for a limited time to explore and drill for the oil and gas."[45] Thus the court treated the cash as a bonus. From the rest of the court's opinion it is hard to discern the underlying reasoning; however, the above-quoted language seems to indicate that the court considered most relevant 1) the transferor's retention of an economic interest in the property, and 2) transferee's exclusive right to explore and obligation to drill a test well. Of these two considerations, the second must have been crucial, since the retention of an economic interest by the transferor, standing alone, is clearly not enough to invoke lease treatment. For example, when an owner of a mineral estate transfers a fractional interest or carved out royalty for cash alone, he retains an economic interest in the property; but, as previously noted, the transaction is a sale because the theory of sharing arrangements cannot apply.[46]

The division of risks and obligations are similar in *Westates* and *Jahn*. Regarding the first well in *Westates*, the arrangement was practically identical to the *Jahn* arrangement: transferee assumed the entire burden of exploration and development, but upon production the parties shared proportionately the operating expense. In *Westates* the facts are not clear regarding the second and subsequent wells. While the parties agreed that transferee would "charge"transferor with 25% of the drilling costs, transferor was also said to have retained a 5% net profits interest and a 20% "carried working interest."[47] This apparently means that transferee was to pay the out-of-pocket costs and then recoup the "charges" from transferor's 20% share of production. After the payout of all

44. *Id.* at 37, 39.
45. *Id.* at 39.
46. *See* note 7 and accompanying text *supra*. For a discussion of the "economic interest" concept, *see generally* MAXFIELD & HOUGHTON, *supra* note 4, § 1.04.
47. Westates Petroleum Co., *supra* note 43, at 37.

the carried costs, the 20% of production and a proportionate part of subsequent operating expenses would revert to the transferor.[48] If this interpretation is correct, the result after the reversion is essentially the same as the *Jahn* transaction; transferor bears a proportionate part of the operating costs, while transferee has borne the risk and cost of development. Thus in holding the transaction to constitute a lease, the *Westates* case is fully in accord with *Jahn.*

In *Campbell v. Fasken,*[49] the taxpayers transferred interests in a large number of tracts to several transferees. In each transaction, the taxpayers retained a 55% fractional interest, and received a cash payment and a promise by the transferee to drill and complete one well. Taxpayers agreed that on completion of a producing well they would pay $25,000 as their share of the drilling cost. It was agreed that if a well was not completed as a producer, the taxpayers would pay 55% of the costs, but not to exceed $25,000. Further, the taxpayers were to pay 20 cents per barrel as their share of operating costs unless the price of oil dropped below $1.01 per barrel, in which case they were to pay 55% of the operating costs.

The case initially went to court over a dispute about the deductibility of the taxpayers' expenses. However, on appeal, the Commissioner argued that the transactions were actually leases rather than sales. The Court of Appeals for the Fifth Circuit agreed with the Commissioner on this issue, relying on the "substance over form" principle.[50] The court therefore treated the cash payments as bonus income.

Fasken repudiates, or at least modifies, the test suggested by *Jahn.* In *Fasken,* the transferors retained not only a portion of the operating costs, but also a substantial portion of the development obligation. In this respect the *Fasken* transactions diverged more radically from a traditional lease than did the *Jahn* transaction. Still, the divergences did not suffice to save the *Fasken* transactions from lease treatment.

48. *See generally* MAXFIELD & HOUGHTON, *supra* note 4, § 9.04[4].
49. 267 F.2d 792 (5th Cir. 1959).
50. *See also* West v. Commissioner, 150 F.2d 723 (5th Cir. 1945), *cert. denied,* 326 U.S. 795 (1946).

Fasken differs from *Jahn* in the degree to which the transferors carried their share of operating expenses. In *Jahn*, the transferor agreed to pay a full proportionate share of actual operating costs, whereas in *Fasken*, transferor's contribution was in practical effect limited to 20 cents per barrel. This limited contribution might well be viewed as a formality (a simple and regular deduction from transferor's share of production), and not substantially burdening transferor's interest. In this respect, then, the *Fasken* transactions diverged less from the traditional lease than did the *Jahn* transaction.

It is not clear to what extent the *Fasken* court regarded as significant the $25,000 per well limit on the transferor's share of drilling costs. Practically speaking, this limitation could have reduced considerably the risk attending a full 55% development obligation. To the degree transferor's risk was so reduced, it was shifted to the transferee, as it would be in a leasing transaction. Thus the limitation tends to justify the court's conclusion that the transaction was a lease. On the other hand, the limitation did not wipe out transferor's $25,000 per well gamble, which, it must be conceded, was hardly *de minimis*. The implication may be that for the *Fasken* court, no amount of transferor's contribution to development would prevent a sharing arrangement from being recast as a lease. Read more conservatively, the case holds that nothing short of a fully proportionate contribution will prevent lease treatment.

One commentator has suggested, in response to the *Fasken* case, that the expense of development borne by transferor can be viewed as a reduction of transferor's economic interest in the property.[51] This constitutes a kind of reverse version of the "shifting of capital investments" theory discussed above.[52] The idea is to impute to the transferee the entire assumption of the development burden, leaving transferor with a reduced but fully unburdened interest in the property. This rationalization of the result in *Fasken* is unsatisfactory because it ignores the economic significance of the risks actually allocated to transferor. Pushing the rationaliza-

51. Note, *Taxation: Sale of Mineral Interest: Ordinary Income or Capital Gain*, 7 U.C.L.A. L. REV. 404 (1960).
52. *See* note 22 and accompanying text *supra*.

tion a bit further, one might conclude that transferor's interest is equally unburdened *before* the transfer—it is simply viewed as being reduced by the total cost of development. The frivolity of this line of reasoning should be obvious.

PRE-PRODUCTION COSTS

As noted, *Jahn* and *Westates* may imply a sale/lease test based on the location of the development burden, regardless of who bears the cost of operation. *Fasken* goes farther to find a lease where transferor has retained a substantial, but not fully proportionate, share of the development burden. However, these cases say nothing about why the development burden may be so important, or why the operational expense should be so unimportant.

In the context of sharing arrangements generally, a distinction may be made between pre-production expenditures as *capital* in nature, and operational expenditures as *non-capital* in nature. It has already been seen that sharing theory requires a contribution to pre-production costs by transferee, because it is this assumption of pre-production risk by transferee which expands the "pool of capital" and allows transferee to acquire a capital interest without transferor's having to give one up.[53] A contribution to operational expense alone does not expand the "pool of capital." For example, if a transferee receives a fractional interest in oil and gas in exchange for cash and his (the transferee's) promise to bear part of the cost of operating completed wells, the transaction can not be a sharing arrangement. The obligation to pay operating expenses, while reducing transferee's net proceeds from production, does not serve to unburden transferor's interest at all. Transferee has not expanded the "pool of capital," so therefore the interest he acquires must flow from transferor in exchange for the cash payment. In other words the transaction must be a sale.

What if, instead, transferee assumes the entire development burden as in *Jahn*? Once the property has reached the production stage, the greater part of the investment risk has passed. At that point, the payment of a portion of operating

53. *See* note 10 and accompanying text *supra*.

costs by the transferor represents simply a reduction in transferor's net proceeds from existing production. The parties probably anticipated during negotiation the amount of this reduction and adjusted transferor's interest upward to compensate; the net effect would be to give transferor a royalty. The transaction then looks very much like a lease, with transferee undertaking the entire investment risk, and transferor taking a share of the proceeds.

If transferor retains a proportionate part of the obligation to develop, it would be less sensible to cast his retained interest as a royalty, because his interest remains burdened by the possibility of no production after substantial expenditures. No matter how the parties may have adjusted transferor's share of production to account for his expenditures, the adjustment will fail unless production is attained. It is clear that to the extent transferor's interest remains burdened by the pre-production risk, the sharing theory of G.C.M. 22730 does not apply. When transferor retains a fully proportionate share of pre-production costs, it is hard to see how the sharing theory could apply at all; even though the total development cost to transferor is reduced by the transfer, his retained interest must be worth less, as well.[54]

The suggestion here is that lease treatment cannot logically be extended to a transaction wherein the parties agree to bear *pro rata* the pre-production costs. As seen above, the post-production expenses do not have the same degree of economic significance, because they do not substantially affect the allocation of risk between the parties. Thus in distinguishing sales and leases, the allocation of post-production costs between the parties might well be ignored.

Bonus Treatment

Where the parties have split the pre-production costs in proportion to their interests, an unconditioned cash payment to the transferor should not be accorded bonus treatment. First, since the transaction does not relieve transferor's interest of the development risk, from transferor's point of view the transaction does not differ from any other disposition

54. *See* note 40 and accompanying text *supra*, for a discussion of the analogous situation where transferor has also retained proportionate operating costs.

of a capital asset. Therefore, as a practical matter, the policies behind the capital gains deduction are as applicable here as they are to, say, the sale of an apartment building.[55] Second, the notion of bonus as an advance payment on production[56] is wholly inapplicable here. Transferee has acquired his interest through an exchange reducing transferor's interest, rather than by assuming the obligation to develop transferor's interest. Transferor's share of production is then completely accounted for by his retained operating interest; therefore an advance payment on that share of production could not logically be coming from the transferee.

It can be argued that bonus treatment is, economically speaking, so fundamentally unsound that it should be limited to traditional leases and nothing else.[57] Adoption of this viewpoint involves the rejection of *Jahn, Westates,* and *Fasken* as wrongly decided because they expand the contexts in which cash will be deemed bonus. However, if bonus treatment is with us to stay, it should be given effect, at most, in those transactions which are substantially identical to leases. *Jahn* and *Westates* involved transactions differing from traditional leases only in the allocation of operating expenses; since, as discussed above, the allocation of operating expenses lacks real economic significance, the conclusion that the two transactions were leases seems justified.

The *Fasken* case is much harder to rationalize; even though transferor's share of pre-production costs was limited by a $25,000 ceiling, it still had substantial impact on the economics of the transaction. Arguably, the *Fasken* court should have given some effect to transferor's contribution, perhaps by allocating part of the cash payment to bonus and part to sales price. For example, the court might have prorated the cash according to the percentage which transferor's actual share of pre-production costs bore to a fully proportionate share. Such an approach would have the advantages of 1) allowing the parties the tax benefit of transferor's investment in pre-production costs, and 2) still preventing the easy conversion of bonus into sale proceeds by a nominal allocation of costs

55. *See* text accompanying notes 12-14 *supra*.
56. *See* text accompanying notes 17-20 *supra*.
57. *See* MAXFIELD & HOUGHTON, *supra* note 4, §§ 3.02[2][a], 8.01, 8.03[2][c].

to transferor. However, *Fasken* seems to hold that unless transferor bears a full *pro rata* share of costs, *all* of the cash payment will constitute bonus. In this regard, *Fasken* has not been followed in any other case; perhaps it has been regarded as an aberration in the tax law, and therefore to be ignored.

CONCLUSION

It is unclear to what extent *Jahn, Westates,* and *Fasken* call for bonus treatment in other types of sharing arrangements. It has been seen that in all cases there is a sound logical basis for sale treatment. However, the supportive authority is scant. *Jahn* and *Westates* certainly indicate that a retention of operating costs by transferor will not suffice to avoid bonus treatment. The question remains to what degree a retention of pre-production costs will work. *Fasken* suggests the solution of treating any sharing arrangement as a lease unless transferor retains a full proportionate share of pre-production costs. However, where transferor has retained a lesser share, it still might be feasible to treat some of the cash payment as sale money and some as bonus. In any event, parties desiring sale treatment will need to carefully consider all of the above factors in planning their transaction. Unfortunately, it remains uncertain exactly how these factors may ultimately affect the tax treatment given. The best that can be said is that the parties undertake a certain risk when they count on avoiding bonus treatment by resort to non-lease sharing arrangements.

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