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DISPOSITION OF MINERAL PROPERTIES – A REAPPRAISAL OF TAX CONSEQUENCES ON INCOMPLETE DISPOSITIONS

HAROLD S. BLOOMENTHAL*

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INTRODUCTION

In *Griffith v. United States*[1] the United States District Court for the District of Wyoming permitted capital gains treatment to the taxpayer with respect to payments characterized by the appropriate instruments as "royalty payments." Several instruments were involved, but essentially they included the same terms and provided in effect that the transferee of certain bentonite properties would pay the taxpayer-transferor a specified amount (20¢ per ton under certain instruments and 65¢ per ton under others) for each ton of bentonite removed from the premises and specifying for minimum amounts of bentonite to be removed or paid for each year. Properties involved were known to contain bentonite but the exact amount was unknown and, as construed by the Court, the transferee was required to remove all of the bentonite from the tracts involved. The Commisioner contended that the payments were royalty payments and as such ordinary income subject to the depletion deduction. The Court, relying on a number of decisions in other Circuits involving sand and gravel, sustained taxpayers treatment of the proceeds from these payments as subject to the capital gains provisions. Since the decision of the *Griffith* case and the several decisions in other Circuits relied on as precedent appear to be inconsistent with the law that has developed in connection with similar oil and gas transatcions, a careful examination of these cases and a reappraisal of the oil and gas decisions appear to be in order.

We are concerned for the most part in this article with transfers of mineral properties which involve something less than a complete disposition by the transferor. We are particularly concerned with those instances in which the transferor disposes of a mineral property for a cash consideration and retains a royalty in the usual form, net profit interest, a production payment, fixed unit price "royalty" or a combination of same in the transferred properties. Tax implications involve appropriate treatment from the standpoint of both transferor and transferee as to (1) monies paid to the transferor at the time of the transaction and (2) deferred payments to the transferor based on production attributable to his retained interest. Tax consequences in this area, as is shown in this article, are determined largely by the sale versus lease dichotomy. However, the economic interest concept, the sharing arrangement concept and anticipation of income theory all play subsidiary roles.

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Summary of Tax Consequences Based on Classification

In the event a transaction involving an incomplete disposition of the type described is characterized as a sale, the cash consideration received by the transferor at the time of the transaction is ordinarily subject to capital gain or Section 1231 tax treatment.[2] The transferee-vendee, in such event, capitalizes as acquisition costs all amounts paid by him to the transferor-vendor.[3] The deferred out of production payment to the transferor, may, depending upon their classification of an "economic interest," be regarded as ordinary income to the transferor subject to depletion,[4] or additional proceeds from the sale.[5] In the event the deferred payments are regarded as ordinary depletable income to the transferor, they are excluded from income by the transferee-vendee for all purposes,[6] whereas in the event such payments are regarded as additional consideration for the sale they must be included as income by the transferee-vendee and capitalized by him as part of his acquisition costs.[7]

If the transaction is characterized as a lease or sublease, proceeds received by the transferor-lessor at the time of the transaction are ordinary income[8] subject to the depletion deduction.[9] The transferee-lessee, on the other hand, must capitalize all such bonus payments as his acquisition costs recoverable through depletion[10] and must exclude a proportionate part of such bonus payments from his gross income for the purpose of determining his depletion deduction,[11] but not for the purpose of computing his gross income.[12] The foregoing is subject to the caveat that if the dictum of the *Jefferson Lake* case[13] is followed the transferee-lessee may be able to exclude such bonus payments from his gross income. The deferred payments are ordinary income subject to depletion to the transferor-lessor and are excludable from gross income for all purposes by the transferee-lessee.[14]

Competing Considerations in Classification

The transferor ordinarily desires the transaction to be regarded as a disposition of capital assets or Section 1231 assets and most of the recent litigation in this area represents an effort on the part of Internal Revenue

[1] 180 F .Supp. 454 (D.C. Wyo. 1960).
[2] Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936); G.C.M. 22730, 1941-1 Cum. Bull. 214.
[3] Int. Rev. Code of 1954, § 1012.
[4] If an economic interest, the transferor reports such proceeds as depletable income. Thomas v. Perkins, 301 U.S. 655 (1937). See discussion commencing at text related to note 26 infra.
[5] If not an economic interest, such proceeds are part of the sales price. Anderson v. Helvering, 310 U.S. 405 (1940).
[6] Thomas v. Perkins, supra note 4.
[7] Anderson v. Helvering, supra note 5.
[8] Burnet v. Harmel, 287 U.S. 103 (1932).
[9] 26 C.F.R. § 1.612-3(a)(1) (1961); Herring v. Commissioner, 293 U.S. 322 (1934).
[10] 26 C.F.R. § 1.612-3(a)(3) (1961).
[11] 26 C.F.R. § 1.613-2(c)(5)(ii) (1961).
[12] Sunray Oil Co. v. Commissioner, 147 F.2d 962 (10th Cir. 1945); Canadian River Gas Co. v. Higgens, 151 F.2d 954 (2d Cir. 1945).
[13] Lambert v. Jefferson Lake Sulphur Co., 236 F.2d 542 (5th Cir. 1956).
[14] See discussion commencing at text related to note 26 infra.

Service to frustrate this objective.[15] If transferor can achieve capital gain treatment for both the cash proceeds received at the time of the transaction and the deferred payment, he has achieved a taxpayer's Valhalla. The reasons for seeking these objectives are not difficult to find.

First, as to long-term capital gain, taxpayer has in effect a 50% deduction whereas the deduction for depletion is 27.5% in the case of oil and gas and in the case of other minerals is, at best, 23%. Second, in a capital gains transaction only the excess of the proceeds over taxpayer's adjusted basis is taxed. On the other hand, bonus income received in a leasing or subleasing transatcion is taxed in its entirety. Third, taxpayer may be able to eliminate from his taxable income the entire long-term capital gain by careful planning which results in taking offsetting capital losses. Fourth, the depletion deduction taken with respect to the consideration received from a leasing or subleasing transaction will have to be restored to income in the event that the lease or sublease is terminated without production.[16]

The objective of the transferee, on the other hand, is to place expenditures for mineral "acquisitions" in the category of deductible expenses or income exclusions rather than capital items. The reasons are more compelling than than in the case of depreciable property as all amounts capitalized for the acquisition of mineral rights must be amortized through cost depletion.[17] In view of the fact that statutory depletion frequently exceeds cost depletion, in many instances the transferee will derive no additional tax benefit by capitalizing acquisition costs.

The transferee is seldom concerned as to whether the transaction is characterized as a sale or lease as to the initial payment (bonus) in that under prevailing notions he will have to capitalize cash amounts paid the transferor at the time of the transatcion regardless of characterization. However, if the dictum of the *Jefferson Lake* case should be adopted, it would then be advantageous from the transferee's standpoint for a transaction to be regarded as a lease in that the taxpayer would then be permitted to either deduct or exclude such amount from income. It is generally advantageous from the transferee's standpoint for the deferred out of production payment to be regarded as income paid to the holder of an

[15] For an illustrated discussion of the advantages to the transferor of capital gains treatment see Bloomenthal, "Tax Advantages of Oil and Gas Operations," P-H *Tax Ideas Service,* ¶ 8013.5 (2). The ambivalence of the Commissioner as between capital gain and depletable income during those early tax years (1924-1934) as contrasted to the Commissioner's present day preference for the lease approach results from the different nature of the early day capital gain provisions, the comparatively low surtax rates and some special advantages deriving from the now obsolete discovery depletion. The policy of taxing only a portion of capital gains was not initiated until 1934 and then not on the present basis of taxing only 50% of net long term capital gains until 1938. Rather prior to 1934 all net capital gains were taxed at the flat rate of 12½%. Accordingly, whether capital gain or depletable income resulted in the more favorable tax treatment depended upon the particular transaction and taxpayer. In addition there has been a tendency to overlook the tax implications of the transaction viewed as a whole.

[16] Douglas v. Commissioner, 322 U.S. 275 (1944); 26 C.F.R. § 1.612-3.

[17] United States v. Dakota-Montana Oil Co., 288 U.S. 459 (1933).

economic interest as he will be permitted to exclude such payments from his gross income for all purposes, whereas in the event such payments are characterized as additional consideration, it will be necessary for the transferee to take such payments into his gross income subject to the depletion deduction and to capitalize the payments as additional acquisition costs.[18]

SALE-LEASE DISTINCTION AND CRITERIA DEVELOPED IN OIL AND GAS CASES

In all of the incomplete dispositions discussed in this article, the transferor disposes of a portion of the bundle of rights that he owned in the mineral property. This probably would be regarded by many people as a "sale" in the ordinary connotation of that term although the Supreme Court has concluded otherwise. The law in this area developed primarily in connection with oil and gas leases which unfortunately are characterized as "leases" although they are in fact *sui generis.*[19] Unlike an ordinary lease, typical oil and gas leases, in the event of discovery, continue throughout the productive life of the property and involve a complete consumption of the mineral property. The tax doctrines that have evolved in this area are the result of litigation extending o\er a period of years commencing even before the adoption of the Sixteenth Amendment and are based on distinctions that are more historical and fortuitous than logical.[20]

It is, nonetheless, possible as the result of considerable litigation in the oil and gas area to reduce much of the law in this area to a neat formula: If the transferor reserves an economic interest in the minerals that will continue during the entire productive life of the property, the transaction is a lease or a sublease and not a sale. If the transferor reserves no economic interest or an economic interest which is certain to terminate prior to the end of the productive life of the property, the transaction is a sale.[21] Accordingly, a cash consideration received for executing a mineral lease (or for the assignment of a lease) with the reservation of a royalty (or overriding royalty, as the case may be) is a leasing or subleasing transaction and the cash consideration received by the taxpayer is ordinary depletable income.[22] If, on the other hand, the taxpayer reserves a production payment which will terminate and no other interest, the transaction involves a sale and the initial consideration received is subject to capital gains or Section 1231 treatment.[23] However, if the taxpayer reserves an override and a production payment, he has reserved an economic interest that will continue during the productive life of the property and the entire transaction is for tax purposes—a sublease rather than a sale.[24]

[18] See discussion commencing at text related to note 26 infra.

[19] However, for the role played by mining leases in the early development of tax law in this area see Bloomenthal, *Acquisition and Disposition of Mineral Interests,* 5 AMERICAN LAW OF MINING § 28.104.

[20] For a discussion of the historical development of tax doctrines in this area see Ibid.

[21] Burnet v. Harmel, 287 U.S. 551 (1933); Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936); G.C.M. 22730, 1941-1 Cum. Bull. 214.

[22] Murphy Oil Co. v. Burnet, 287 U.S. 299 (1932); Herring v. Commissioner, 293 U.S. 322 (1934).

[23] Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936).

[24] Palmer v. Bender, 287 U.S. 551 (1933).

TAXATION OF THE DEFERRED PAYMENT—HEREIN OF THE ECONOMIC INTEREST CONCEPT

In the event a transaction is characterized as a leasing transaction, proceeds of the retained deferred payment out of production (royality, overriding royalty or net profit interest) are taken into income by the owner of the retained interest (the transferor) and are depletable.[25] the transaction is characterized as a sale despite the retention of a deferred payment out of production, the fixed initial payment is subject to the capital gains provisions, but the appropriate treatment of the deferred payment depends upon classification as an economic interest. In the event characterized as an economic interest the share of proceeds attributable to such interest is regarded as the depletable income of the owner of the interest (the transferor) and excluded from income by the transferee.[26] If not classified as an economic interest the proceeds attributable to the interest are depletable income to the transferee, an additional part of the purchase price to the transferor and capitalized as part of the acquisition cost of the transferee.[27]

The "economic interest" concept has played multiple roles in oil and gas tax characterization. Determining whether an economic interest has been retained is the first step in determining whether a transaction is a sale or lease. This concept also controls the allocation of the depletion deduction among competing taxpayers claiming the depletion deduction on the same income.[28] The Supreme Court has said that economic interest "issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."[29] The approach of the Supreme Court in determining to whom the income from the deferred payment is to be taxed has been to determine whether the owner of the deferred interest is entitled to the depletion deduction which in turn depends upon whether the interest is an economic interest in the mineral. In the event the deferred payment is an economic interest the payor-operator excludes it from his income as it is taxable to the payee; if it is not an economic interest the payor-operator includes it in his income and capitalizes it as part of his acquisition costs.[30]

In order for the deferred payment to constitute an economic interest it must (1) represent an interest in which taxpayer has a capital investment and (2) the taxpayer must depend solely upon production to recover his capital investment.[31] It is apparent, however, from the decisions that it is not necessary in all instances for the taxpayer to have a capital investment in the sense of a basis in the property and on the other hand satis-

[25] G.C.M. 22730, 1941-1 Cum. Bull. 214.

[26] Thomas v. Perkins, 301 U.S. 655 (1937).

[27] Anderson v. Helvering, 310 U.S. 405 (1940).

[28] Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934).

[29] Anderson v. Helvering, 310 U.S. 405, 407 (1940).

[30] Anderson v. Helvering, supra note 29; Thomas v. Perkins, 301 U.S. 655 (1937); Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936).

[31] Palmer v. Bender, 287 U.S. 551 (1933).

faction of the second requirement alone may not be sufficient.[32] In applying these doctrines to deferred payments, the Supreme Court has held that a retained production payment payable only out of production is an economic interest and hence excludable from income by the payor.[33] If, on the other hand, payment of the production payment is guaranteed, or represents a claim against the general credit of the payor, or is payable from any source other than production it is not an economic interest and is part of the payor's taxable income. These decisions are the basis for the ABC transaction and suggest to the creative tax practitioners some important tax planning alternatives by varying the nature of the production payment.[35]

Helvering v. Elbe—Maverick or Pathfinder?

No discussion of the sale-lease dichotomy and economic interest concept is complete without consideration of *Helvering v. Elble Oil Land Development Co.*[36] in which an assignment of an oil and gas lease was made for a cash consideration, provision for fixed installment payments and a deferred net profit interest. Despite the retention of the net profit interest the Supreme Court held, sustaining the Commissioner, that the transaction was a sale stating as follows: "We agree with the conclusion of the Board of Tax Appeals that the contract between the respondent and the Honolulu Company provided for an absolute sale of all the properties in question, including all oil and gas in place, and that respondent did not retain any interest for investment therein. The aggregate sum of two million dollars was paid as an agreed purchase price to which was to be added the one-third of the net profits payable on the condition specified. We are unable to conclude that provision for this additional payment qualified in any way the effect of the transaction as an aboslute sale or was other than a personal covenant with the Honolulu Company. . . ."[37] The immediate issue in this case involved the appropriate treatment of the bonus and the fixed installment payments, the taxpayer attempting to take depletion. Attempts have been made to explain this case by its reliance on *Helvering v. O'Donnell*[38] in which the Supreme Court held that a so-called disassociated net profit interest was not an economic interest in oil and gas in place. However, in fact, the net profit interest here was not disassociated from the property in the same sense as it was in *Helvering v. O'Donnell* and subsequent cases have held that a disassociated net profit interest may be an economic interest in place.[39]

In the *Elbe* case, the instrument in question expressly provided as follows:[40]

[32] Parsons v. Smith, 359 U.S. 215 (1959).
[33] Thomas v. Perkins, 301 U.S. 655 (1937).
[34] Anderson v. Helvering, 310 U.S. 405, 407 (1940).
[35] See Bloomenthal, op. cit. supra note 19 at § 28.109.
[36] 303 U.S. 372 (1938).
[37] Helvering v. Elbe Oil and Development Co., 303 U.S. 372, 375 (1938).
[38] 303 U.S. 370 (1938). See discussion infra at note 42.
[39] Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956).
[40] Helvering v. Elbe Oil and Development Co., 303 U.S. 372, 374 (1938).

"Anything in this agreement contained to the contrary notwithstanding, it is the intention of the parties to this agreement that the full ownership, possession and control of all the properties the subject of this agreement, and of all the personal property acquired and/or used on and in connection with the operation or development of the properties, the subject of this agreement, shall be vested in [purchaser] and [seller] shall have no interest in or to said properties . . . or in or to the salvage of any thereof, ..." It is this language which the Court in the *Burton-Sutton* case, distinguishing *Elbe,* regarded as a "provision for the transfer of all interest of the assignor."[41] This distinction may be of some significance in explaining the cases involving minerals other than hydrocarbons discussed below in which lower courts have reached a sale conclusion despite the retention by "vendor" of a deferred payment out of production with an indefinite duration.

DISPOSITION OF STOCK WITH PURCHASE PRICE CONTINGENT UPON PRODUCTION

In the event the mineral properties are owned by and are the only asset of a corporate entity, a possible alternative to the taxpayer is to dispose of all of the stock in the corporation and to provide for a purchase price that in some manner is contingent upon the extent of the ultimate production. In the event the taxpayer is expecting ultimately to dispose of mineral properties he may want to consider utilizing corporate ownership either at the time of the property acquisition or well in advance of the time of the disposition. From any realistic standpoint the disposition of the stock is no different from a disposition of the mineral property itself with a deferred contingent payment out of production. However, since a sale of corporate security is involved the possibility of obtaining capital gain treatment may be better than in the comparable disposition of the mineral property. *Helvering v. O'Donnell*[42] involved essentially this type of situation, the taxpayer disposing of his stock to a purchaser who agreed to pay him as partial consideration one-third of the net profit from the operation of corporate mineral property. The Supreme Court, sustaining the Commissioner, held that the taxpayer-vendor could not take depletion with respect to the net profits received by him as the result of this transaction.[43] The other side of this tax coin under such circumstances, as previously noted[44] is that such proceeds are included in the transferee's income, are capitalized by the transferee and are an additional part of the purchase price received by the transferor for the sale of the stock.

In *Burnet v. Logan*[45] taxpayer sold stock in a corporation for a specified consideration plus 60 cents for each ton of ore produced from the properties involved. The Supreme Court held that the transaction involved a sale and emphasized the fact that "the 1916 transaction was a

[41] Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 36 (1946).

[42] 303 U.S. 370 (1938).

[43] Ibid.

[44] See text at note 29 supra.

[45] 283 U.S. 404 (1931).

sale of stock—not an exchange of property." In this case the corporation did not produce the ore (coal) or own the mineral property but had the right to purchase specified percentages of the coal produced by certain mines which it used as a source of supply for its steel operations. Accordingly, it was apparent that taxpayer had no economic interest in the coal property. In a recent Tax Court decision[46] taxpayer sold her stock in an oil company for $1,090 per share in cash plus 50 cents per barrel of reserves in excess of 4½ million barrels to be determined by a subsequent estimate of reserves. Internal Revenue Service conceded capital gain treatment on the entire proceeds, the only question being the tax treatment by taxpayer of the cost incurred by her in connection with the estimation of the reserves. However, it should be noted that here the purchase price did not depend upon actual production, but merely depended upon the preparation of a disinterested estimate of reserves, which estimate was to be made well in advance of final production.

SALE-LEASE DISTINCTION IN CASES NOT INVOLVING HYDROCARBONS

There has developed a separate line of authority relating to minerals other than hydrocarbons which departs from the pattern previously outline as to hydrocarbons to such an extent that one commentator has inquired as to whether the criteria applied to oil and gas are also applied to other minerals.[47] These transactions have generally been cast in the mold of a purported sale with language of sale being used rather than leasing language, the instrument emphasizing that an absolute transfer has been made of all of the minerals in place. Typically, such arrangements provide that a portion of the consideration shall be paid as the mineral is produced on the basis of a fixed price for each unit of the mineral produced. A substantial number of cases have been litigated in recent years in this area, all below the Supreme Court level, with many courts characterizing such transactions as sales, permitting capital gain treatment not only for the initial consideration but for the deferred payment out of production as well. As we shall note below it is difficult to reconcile these cases; their rationale is not entirely clear and in some instances appear to be inconsistent. Perhaps, to a large extent, these cases represent dissatisfaction with the sale-lease and economic interest pattern outlined above and a common sense connotation of the term sale. Internal Revenue Service can be expected to continue to refuse to acquiesce in these decisions although to date it has not elected to take any of these cases to the Supreme Court. Ironically these decisions conform to the position unsuccessfully argued by the Commission in *Thomas v. Perkins* and successfuly in *Helvering v. Elbe.*[48]

[46] Estate of Bessie Machris, 34 T.C. 827 (1960).

[47] *Contingent Deferred Payments: A Study in Contradictions,* X Oil and Gas Tax Q. 117.

[48] See discussion at text related to notes 29 and 36 supra. The Commissioner has always regarded contingent fixed unit price deferred payments as a royalty in the usual form. See G.C.M. 22730, 1941-1 Cum. Bull. 214, where, among other things, it is stated as follows: "The cited cases show that the stated basic principles apply equally to mineral deposits and to oil and gas."

The Courts in reaching a capital gain conclusion in these transactions have frequently emphasized the parties' intention to make a sale. If intention in the subjective sense is controlling in this area all the parties need do is provide that "the parties hereto intend for this transaction to be regarded as a sale."[49] It is obvious that the Courts are not relying on this type of subjective intention in reaching the sale conclusion, but rather have in mind, as is discussed below, the fact that the transaction is more characteristic of what they regarded as a sale rather than a leasing transaction or sharing arrangement.

The cases in this area have also relied in large part on the fact that the deferred production payment is measured in terms of a fixed price per unit (e.g., 25 cents per ton) rather than a percentage of the gross proceeds from production.[49a] This feature has permitted the Circuit Court to distinguish *Burnet v. Harmel*[50] and other cases developing the lease-sale distinction. As is noted below, the fact that the deferred payment is based on a fixed price per unit may be of real significance in this context.

Some of these decisions have relied on the fact that the purported instrument of sale required certain periodic minimum payments and on this basis have analogized the transaction to an installment sale.[51] These decisions appear to overlook the fact that unlike an installment sale there is no terminal price and these payments are indistinguishable in this aspect from a typical minimum royalty payment.[52] On one hand many of these cases have stressed the fact that development is not a dominating motive[53] and on the other hand some of the cases have emphasized the fact that there is a legal or practical assurance that all of the mineral that is subject to the conveyance will be produced.[54] In addition, in the sand and gravel cases, some significance has been attached to the fact that the "purchaser" has acquired the mineral for its own use and not for the resale to others.[55]

All the cases finding capital gains treatment in this area have emphasized the fact that language of sale was used and a purported absolute conveyance was made.[56] In those instances in which lease language has

[49] Cases emphasizing the intention of the parties include Barker v. Commisisoner, 250 F.2d 195 (2d Cir. 1957); Crowell Land and Mineral Corporation v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Griffith v. United States, 180 F. Supp. 454 (D.C. Wyo. 1960). White v. United States, 14 Oil & Gas Rep. 875 (D.C. Colo. 1961).

[49a] See particularly Linehan v. Commissioner, _F.2d_ (1st Cir. 1961), 8 A.F.T.R.2d 5947.

[50] 287 U.S. 103 (1932).

[51] Barker v. Commissioner, supra note 49; Crowell Land and Mineral Corporation v. Commissioner, supra note 49. Cf., Gowans v. Commisioner, 251 F.2d 163 (9th Cir. 1957).

[52] Cf., Kittle v. Commissioner, 229 F.2d 313 (9th Cir. 1956).

[53] Crowell Land and Mineral Corporation v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Maude W. Olinger, 27 T.C. 93 (1956).

[54] Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Gowans v. Commissioner, 251 F.2d 163 (9th Cir. 1957); Griffith v. United States, 180 F. Supp. 545 (D.C. Wyo. 1960).

[55] Barker v. Commissioner, supra note 54; Robert M. Dann, 30 T.C. 499 (1958). Cf., Gowans v. Commisioner, supra note 54.

[56] Barker v. Commissioner, supra note 49; Crowell Land and Mineral Corporation v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Gowans v. Commissioner, supra note 51; Commissioner v. Remer, 260 F.2d 337 (8th Cir. 1958); Maude W. Olinger, 27 T. C. 93 (1956).

been used, the use of such language has, with one exception, been regarded as fatal and has resulted in a leasing conclusion.[57] In the *Griffith* case[58] the Court found for capital gain treatment despite the use of the term "royalty." In some of the cases the only issue involved was the appropriate treatment of the initial consideration paid upon execution of the instrument.[59] In most of the cases, however, the Court also found for capital gains treatment with respect to the deferred payments out of production.[60] In several of the cases a reversionary interest in the event of default was retained by the tranferor and such retention was not regarded as fatal, being deemed essentially a security arrangement.[61]

In some of the cases the arrangement involved no obligation relating to the development of the property except to the extent that the inclusion of the minimum royalty payment might be deemed such an obligation.[62] In other cases as construed by the Court there were development requirements. Such requirements in each instance pertained to known ore bodies and did not involve exploratory type development.[63] The cases generally were characterized by the fact that they involved properties with proven ore bodies, the reserves being developed, fixed and known with a reasonable degree of accuracy in some of the cases.[64] In other instances the reserves were fully developed, but the exact quantity of reserves were indeterminable, unknown or disputed.[65] Several of the courts have been careful to emphasize that their decisions do not necessarily have application to oil and gas or have otherwise distinguished the oil and gas cases.[66]

Do we have one approach for hydrocarbons and another approach for other minerals? Is this merely an elevation of form over substance? Is one commentator correct in his conclusion that these cases were erroneously decided and in the interest of uniformity the pattern developed in connection with oil and gas should always be applied?[67] A careful reading

[57] Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957); Kittle v. Commissioner, 229 F.2d 313 (9th Cir. 1956). Linehan v. Commissioner, — F.2d — (1st Cir. 1961), 8 A.F.T.R.2d 5974, cf. White v. United States, 14 Oil & Gas Rep. 875 (D.C. Colo. 1961).

[58] Griffith v. United States, 180 F. Supp. 454 (D.C. Wyo. 1960).

[59] Maude W. Olinger, 27 T.C. 93 (1956).

[60] Crowell Land and Mineral Corporation v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Commissioner v. Remer, 260 F.2d 337 (8th Cir. 1958); Gowans v. Commissioner, 251 F.2d 163 (9th Cir. 1957); Griffith v. United States, 180 F. Supp. 454 (D.C. Wyo. 1960). Linehan v. Commissioner, — F.2d — (1st Cir. 1961), 8 A.F.T.R.2d 5974, White v. United States, 14 Oil & Gas Rep. 875 (D.C. Colo. 1961).

[61] Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Crowell Land and Mineral Corporation v. Commissioner, supra note 49. But cf. Albritton v. Commissioner, supra note 52.

[62] Crowell Land and Mineral Corporation v. Commission, supra note 49; Commissioner v. Remer, 260 F.2d 337 (8th Cir. 1958); Maude W. Olinger, 27 T.C. 93 (1956).

[63] Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Gowans v. Commissioner, 251 F.2d 163 (9th Cir. 1957); Griffith v. United States, 180 F. Supp. 454 (U.S.D.C. Wyo. 1960).

[64] Commissioner v. Remer, 260 F.2d 337 (8th Cir. 1958); Gowans v. Commissioner, supra note 63.

[65] Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Crowell Land and Mineral Corporation v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Grififth v. United States, 180 F. Supp. 454 (D.C. Wyo. 1960); Maude W. Olinger, 27 T.C. 93 (1956).

[66] Barker v. Commissioner, supra note 65; Crowell Land and Mineral Corporation v. Commissioner, supra note 65.

[67] *Contingent Deferred Payments: A Study in Contradictions,* X Oil and Gas Tax Q 117, 140.

of these cases suggests that these cases may be different, or, at least, that the lease-sale dichotomy and economic interest concepts as developed in the oil and gas cases have failed to take into account certain considerations less apparent in the oil and gas area and highlighted by the type of transactions involved in these cases.

The difference, it is suggested, may be found in the fact that these cases involve proven properties with fully or substantially fully developed reserves. The transaction may contemplate development in terms of production of these reserves. The transaction does not contemplate the exploratory type of deevlopment. The significance of these facts necessitates an appraisal of the sale-lease distinction and the economic interest concept.

THE SALE—LEASE DICHOTOMY AND THE ECONOMIC INTEREST CONCEPT—AN APPRAISAL

Development of the sale-lease distinction and related concepts were not the out-growth of an overall consistent framework of reference but were rather the outgrowth of strategical considerations based on the assumed impact on tax revenues and it has been this approach that has been largely responsible for the development of distinctions which defy rationalization. Such an approach not only disregards the fact that the over-all impact varies depending upon the tax structure at any particular time, but, and more important, even assuming a given tax structure, the over-all tax impact is unpredictable because of the many variables involved. The problem in this regard is much more complex than is generally realized,[68] depending as it does on looking at the tax impact in terms of all of the parties affected by the transaction and not as Internal Revenue Service has so often done in the past—merely looking at the tax implications of one side of the transaction. Involved are the tax brackets of the particular taxpayers, the complex interrelationship of the depletion and capital gains provisions, the adjustments to and allocation of basis, and the special impact of percentage depletion. It would require no less than a number of arbitrary assumptions and an electronic computer to begin to estimate the impact of these doctrines on total tax revenues. Further, the present system of fine distinctions permits the taxpayer with astute counsel to cast a transaction in a favorable tax mold and in this sense encourages tax avoidance.

It will be helpful in appraising the doctrines and case law in this area to refer on occasions to the terminology and approach developed by a study group of the American Law Institute which to the extent relevant are outlined in the note relating to this text.[69] The draft study produced

[68] See note 15 and related text.

[69] AMERICAN LAW INSTITUTE, DRAFT OF A STUDY OF DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION (1950). This draft study carries neither the approval nor the disapproval of the American Law Institute but was merely prepared for consideration by that organization. The analysis set forth in this article parallels in many respects the approach but not necessarily the conclusions of the study group.

by this group (hereinafter the ALI Study Group) attaches significance to a certain extent to some of the policy factors emphasized by the Supreme Court in the past in applying the capital gains provisions, although the study group isolates these factors more sharply and applies its own terminolgy.

Inasmuch as frequent references are made to the approach of the American Law Institute Study Group throughout the body of the article, it may be helpful at the outset to summarize the study group's approach and conclusions.

The draft study takes the form of a suggested revision of the present statutory provisions relating to capital gains taxation. The study assumes the continuance of a preferential statutory treatment of capital gains but premises such continuance on attempting to achieve the basic policy considerations associated with capital gain treatment. The three basic policies factors that are relevant to mineral taxation and that are taken into consideration by the study group as as follows (at pp. 6-14):

1. Providing relief against the effect of an asset transfer on the rate of tax; that is relief against imposition of high surtax rates because of realization of all the income in the year of sale. This is referred to as "the bunching aspect" and there is both a forward bunching aspect which relates to the fact that the sale of a capital asset has the effect of accelerating the receipt of future income that would otherwise have been received over a number of subsequent years, and the backward bunching aspect which refers to the fact that frequently a sale results in the realization of income in one year which reflects appreciation in value that has actually occurred over a number of prior years. The draft proceeds on the view that preferential treatment accorded by the capital gain treatment does not bear any particular relationship to the tax hardship caused by the bunching and, accordingly, attempts to provide tax relief in this area through special tax provisions especially adopted to this problem rather than through the capital gains provisions.

2. Providing relief against the tax impediment to the conversion of assets resulting from the fact that the taxpayer by avoiding conversion can defer realization of the gain for a substantial and in some instances indefinite period of time. This is referred as as the "locked-in" aspect and if the locked-in effect relates to a substantial period of time, it is regarded as an appropriate consideration for determining the application of the capital gain provisions. In this respect, the estimated length of the future life of an asset is employed as a criterion for capital asset clasification of mineral interests, but not as to many other assets.

3. Capital gains provisions are designed to encourage risk taking; this is referred to as the "incentive aspect." Accordingly, if the inherent nature of the asset is such that its acquisition does not characteristically involve an outlay of funds or commitment of credit, the asset is not regarded as a capital asset. Further, the general policy of encouraging investment or risk taking is to allow capital treatment with respect to appreciation that has accrued at the time when there is a termination of the taxpayer's investment risk in the appreciated asset. Accordingly, if at the time of disposition the transferor reserves an interest so that his investment is still at risk, such transfer does not form the basis for capital gains treatment. The study group concludes "until the outcome of that risk is finally determined, capital gains treatment is inappropriate."

Translating these general guides into concrete provisions and particularly with respect to mineral interest the recommendations of the ştudy group would accomplish the following results:

1. A mineral would not be classified as a capital asset unless its acquistion characteristically involved the substantial outlay of cash or its equivalent. On this basis, it appears that the disposition by a typical land owner of his mineral rights would not involve the sale of a capital asset. (pp. 20, 52).

2. The mineral interest would not be deemed a capital asset unless its expected life would cover a substantial period of years or is unascertainable. This is advanced as a tentative recommendation with respect to mineral interests since it does not take care of the undeveloped mineral interest very well, presumably because of the fact that the expectd life of such interest is almost always unascertainable. (pp. 22, 53-58).

3. A capital gains transaction is not involved even though a capital asset is present unless a complete disposition of that asset is made by the taxpayer. The approach of the draft study is to replace the sale-lease distinction and the economic interest concept by prescribing reasonably objective methods of determining whether a disposition is complete or incomplete. This involves two aspects,

One of the policy factors stressed by the ALI Study Group relates to providing incentives for risk-taking. Based on this policy consideration, the study group would not regard an asset as a capital asset unless its acquisition characteristically involved the substantial outlay of cash or its equivalent. It was suggested earlier that the execution of a typical oil and gas lease by the landowner involves a sale in the ordinary connotation of that term in that the landowner had disposed of a portion of the bundle of rights owned by him.[70] However, the Supreme Court regarded this disposition as an "incidental transfer" and concluded "it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act."[71] It is apparent from other langauge in this case that the Court was dealing with unproven, wildcat acreage and that it was influenced in its thinking by such fact.[72] In the case of the typical oil and gas lessor (but not necessarily in the case of the typical lessor under other mineral leases) the lessor seldom has a separate basis in oil and gas rights in that they are not characteristically acquired apart from the surface

the method of payment and the factor of the carving out of an interest, discussed below. (pp. 27-30, 72-78):

1. Method of Payment:

(a) A disposition is regarded as complete if the total amount of payments are fixed even though payments are due periodically (that is, in installments) and even though the amount of specific payments is contingent on the productivity, profitability, use of disposition of the asset. Accordingly, transfers in return for payments the total amount of which is fixed and assured are transfers involving a complete disposition, even though the time at which the payments are due is tied to production, profitability, use of disposition of the asset. If, on the other hand, the agreement provides for payments that are contingent but which may not exceed a fixed maximum amount the payments are to be treated as contingent and the disposition incomplete. But see subparagraph (d) below.

(b) If payments are contingent upon productivity, profitability, use or disposition of the asset, the disposition is not complete and such payments are not subject to capital gains treatment. For this purpose, payments are regarded as contingent if determined by the quantity of future production (a fixed price per unit), the value of future production (the percentage of proceeds from production, future profits from production (net profit interest) or from the resale of the asset.

(c) If the disposition involves a fixed single or installment payment plus contingent payment, the disposition is treated as a complete disposition as to the payments that are not contingent and incomplete as to the other. The result is to provide capital gains treatment for the fixed payment and ordinary income treatment to the contingent payment. However, this recommended provision is further qualified in that the disposition of this type which results in gains with respect to which a percentage depletion allowance is available, no part of the disposition is to be treated as complete. If combined treatment is indicated, the draft study would apply taxpayer's basis first against the fixed payments.

(d) A disposition is regarded as complete even though the payments are contingent, provided such payments are to be made within a future period of not more than five years or one-half of the future period during which the asset is expected to have substantial value, whichever is the lesser.

2. Dispositions by Carving Out:

(a) Such dispositions aer incomplete if a non-wasting asset is involved.

(b) In the case of a wasting asset the disposition is complete if the rights to future income transferred are for a period equal to at least one-half of the period during which the asset can be expected to have value; otherwise, the disposition is incomplete.

[70] See text commencing at note 19 supra.

[71] Burnet v. Harmel, 287 U.S. 103, 106 (1932).

[72] "Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee . . ." Ibid.

rights and expressly for their value as mineral rights. The Supreme Court in *Burnet v. Harmel,*[73] which is the leading case establishing the sale-lease distinction, was influenced in part by the fact that lessor had taken no risks for which he should be rewarded through the capital gains provisions. In the case of the transfer of properties involving proven mineral reserves, the incentive factor is a substantial factor and this has undoubtedly influenced the ocurts in reaching the capital gains conclusion in the cases previously discussed.[74]

Under the ALI Study Group approach the fact that characteristically the owner of the asset has a substantial investment in the asset is only one aspect of the problem, since it merely determines that a capital asset is involved and it does not necessarily follow that capital gains treatment will be appropriate with respect to all dispositions of such assets. The study isolates as another important policy factor of the capital gains provisions the desire to provide relief against bunching of income in a tax year. This policy factor of the capital gains provision is also referred to by the Court in *Burnet v. Harmel.*[75] The Court emphasized the fact that the capital gains provisions were designed to provide relief in a situation in which income that otherwise would accrue over a long period of time becomes taxable in a single year. This is what the study group refers to as the forward bunching of income, that is the realization of income in one year that would otherwise be received over a period of several years. Both *Burnet v. Harmel* and the study group regard typical royalty payments as involving no hardship in this respect since they are paid over a period of time coterminous with the period in which income would have been realized by the transferor even in the absence of the transatcion.[76] The Court in the *Burnet* case[77] also recognized the policy consideration referred to the fact that the capital gains provisions were designed to provide relief from the taxation of gains in a single year that actually represent the accural of appreciation that has taken place over a period of years. The Court, however, did not regard this consideration as applicable to the facts of the particular case, possibly, because it was dealing with unproven properties as to which the appreciation in value did not occur over a period of years and was not the result of the efforts of the lessor, but occurred more or less immediately and was the result of fortuitious circumstances. In the type of mineral case previously discussed[78] the backward bunching effect of income is pronounced as to the initial consideration in that proven properties generally involve development efforts of the transferor extending over a number of prior years.[79]

An additional policy factor relating to the capital gains provisions

[73] 287 U.S. 103, 106 (1932).
[74] See text commencing at note 49 supra.
[75] 287 U.S. 103, 106 (1932).
[76] See note 69.
[77] 287 U.S. 103, 106 (1932).
[78] See text commencing at note 49 supra.
[79] See note 69.

isolated by the study group is referred to as the "locked-in aspect."[80] The Court was aware of this consideration in *Burnet v. Harmel* as the Court referred to the capital gains provisions as designed "to remove the deterrent effects [of described burdens] on . . . conversions [of capital investments]" and held that the taxation of an initial bonus "as ordinary income does not act as a deterrent upon conversion of capital assets, any more than the taxation" of an unusually large rental for the first year under a typical real estate lease.[81] This conclusion is undoubtedly correct if applied to the execution of an oil and gas lease by a typical land owner in that to the extent the property has appreciated in value for minerals, the appreciation cannot ordinarily be realized by the land owner without development of the property and hence taxing the bonus income as ordinary income will not deter the land owner from entering into an oil and gas lease. If, on the other hand, proven properties were involved, which would be a typical with respect to oil and gas lessor but not an oil and gas sublessor or a mining lessor, the "lessor" may be in position to develop such properties and ordinary income treatment for the bonus consideration would constitute a deterrent to conversions.

The lock-in effect relates to the extent to which the taxpayer can defer the imposition of tax by producing the property rather than by selling the property. The ALI Study Group regards as a controlling consideration in this area the period of years over which the imposition of the tax can be deferred which in turn depends upon the approximate economic life of the asset in question. The study group recommendations approach this problem primarily in terms of classification of assets which are capital assets and by providing that mineral interests which are limited duration assets are not capital assets. A limited duration asset is defined as one which will have substantial value for less than a number of specified years. In case of mineral interests, it obviously requires some refinement in that an undeveloped asset conceivably could have substantial value for a longer period of years than a completely developed mineral property. Inasmuch as many developed mineral properties can be produced within a relatively short number of years, this approach would exclude many proven mineral properties from classification as a capital asset. The rationalization for this position is that capital gains provisions permit taxation of 50% of the gain even though such gain could otherwise be deferred indefinitely and hence that the capital gains provision should be applicable only if the locked-in effect is the equivalent to at least 50% of the locked-in effect in the case of assets as to which the tax on the appreciated value could be postponed indefinitely.[82] The draft study approach is in terms of devising

[80] See note 69.

[81] 287 U.S. 103, 106 (1932).

[82] AMERICAN LAW INSTITUTE, DRAFT OF A STUDY OF DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION (1960) at 8-9. Although not phrased in these terms the absence of a substantial locked-in aspect appears to have been a factor in the Court's decision in Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958). The A.L.I. draft study as noted accepts a 50% locked-in effect since the present impact of the capital gains provision is to tax 50% of the gain even though tax on the appreciated

an ideal statutory scheme whereas we are concerned with the existing statutory provisions. Inasmuch as the present capital gains provisions provide for relief in respect to locked-in effect generally, the percentage of locked-in effect is relative only to the extent of determining that this locked-in effect is substantial and significant.

There is a locked-in aspect arising out of the statutory depletion deduction that is peculiar to the disposition of mineral properties which the ALI Draft Study completely overlooks. Statutory depletion is computed as a percentage of gross income and is limited to 50% of net income from the property. It is a reasonable assumption with respect to proven properties that the price to be paid for the property will approximate the parties estimate of the discounted present value of the net return to be derived from the property over its productive life. This will also be true but with a greater degree of approximation in dispositions involving contingent deferred payments. In the event mineral properties are not to be regarded as capital assets and the proceeds received by the transferor are to be taxed as ordinary depletable income, the transferor will, in effect, be computing statutory depletion as a percentage of net income rather than as a percentage of gross income. Under such circumstances the taxpayer will save substantial amounts in taxes by producing the property. In fact, if statutory depletion is equal to 50% of net income (which may be unusual in oil and gas operations but not in a mining operation) a taxpayer with no or little basis in the property who is in the 50% or less bracket (which for practical purposes includes all corporations) will achieve substantially as favorable or better tax results by operating the property than by the realization of capital gains on disposition.

Under the case law developed in the oil and gas cases and previously discussed,[83] retention of an economic interest may or may not characterize the transaction as a sale or a lease. In the event the economic interest continues through the productive life of the lease the transaction is a leasing transaction; whereas, if it will terminate prior to the end of the productive life of the lease the transatcion is a sale and the initial or

value might be postponed indefinitely. The percentage of locked-in effect is determined by first assuming that the value of the right to postpone a tax indefinitely is equal to the value of the tax itself and then computing the value of the right to defer the tax for a limited period in relationship to the value of the right to defer indefinitely by assuming various after-tax rates of return. Thus, in order for an asset to have a 50% locked-in effect, on an assumed 5% rate it must have a future life of 30 years; on an assumed 6% rate it must have a future life of 26 years, and on an assumed 8% rate a future life of 19 years. American Law Institute, op. cit. supra note 69 at 8-9. This analysis overlooks the importance of the incentive aspect, uncertainties involved in determining future life and the role of inflation, the business cycle, management and public taste in determining the extent of appreciation and the extent to which realization of the appreciated value can be deferred. For example, a stock may have increased in value because of inflation and the assumption (made by the Draft Study) that realization of the appreciation can be postponed indefinitely may be quite unrealistic. Yet a sale of the security would be subject to capital gain despite the fact that appreciation resulted from inflation rather than the taking of risk and despite the fact that the appreciated value of the security may disappear the following day.

[83] See text commencing at note 19 supra.

bonus consideration (although not the deferred payments from production) are subject to capital gain treatment. The property involved in the leading case of *Fleming v. Commissioner* was obviously a proven and producing property, and accordingly, where the parties had provided for an initial consideration of a million dollars in cash the Court had no difficulty in concluding:[84]

"Very clearly, his interests were sold and transferred, and the cash on payment of which conveyances were to be made (and we suppose were made) was purchase money. The making of the sale depleted nothing. The money paid did not come actually or in anyone's contemplation from the production of oil, but was the purchaser's independent capital invested by him in the oil lease. If he in turn should sell to another the next day, gain or loss might be realized, but no depletion allowance could be claimed. A number of such transactions might occur during the taxable year having no reference to the removal of oil and involving no depletion."

The same remarks could, of course, be appropriately made with respect to all bonus payments irrespective of the nature of the retained economic interest. The distinction between the economic interest retained in the form of production payment and that retained in the form of a royalty must arise from some different source. It is suggested this source is the fact that as to the initial consideration the transferor was selling a known quantity of oil in the ground (as distinguished from the right to look for oil) and to the extent of this payment the purchaser had assumed all of the risk. Because of the known presence of oil in the ground the transfer of ownership was not regarded as incidental. In the case of the execution of an oil and gas lease something is transferred; to-wit, the right to explore and develop and a share of the proceeds from production but this transfer is regarded only as incidental for the reasons heretofore noted.[85]

The foregoing explanation, however, will not account for the decision in *Palmer v. Bender*[86] involving the disposition of proven properties and the retention of an overriding royalty in which the Supreme Court held the transaction a lease rather than a sale of capital assets. This case, however, was argued in the context of whether the taxpayer was entitled to depletion, and not in the context of the appropriateness of capital gain treatment. The government conceded that if the transferor retained a reversionary interest in the property against which depletion could be allowed that the transaction was a lease. The Supreme Court had no difficulty in concluding that the transferor retained an economic interest, and if a lessor is allowed depletion on the bonus under the regulations, as the government conceded, there was no reason to deny depletion to a sublessor. In short, the Court never considered the capital gain argument as there was no one to make the argument; the taxpayer desired depletable

[84] Commissioner v. Fleming, 82 F.2d 324, 327 (5th Cir. 1936).

[85] See discussion at note 70.

[86] 287 U.S. 551 (1933).

income treatment and the Commission could not afford to jeopardize the basis for its own regulations.

To the extent the fixed unit price cases involve a substantial initial consideration and proven properties, it is suggested that the oil payment cases support the capital gain position irrespective of the fact that the reserved deferred payment out of production does not terminate until production is exhausted.[87] This is suggested because on examination it appears in the context of this particular problem that it is the nature of the transaction and the interest retained rather than its duration that provides the more significant distinction. It is not surprising, therefore, that the lower courts have invariably sustained capital gain treatment for an initial consideration related to the calculation of ore reserves particularly in those instances in which it is problematical that there are sufficient reserves to ever result in deferred production payments.[88] This analysis suggests, however, that the draftsman would be well advised to relate the initial payment to a specific quantity of reserves at the fixed unit price.

There is another feature of the incentive aspect in relationship to the capital gains provision stressed by the draft study. The study group regards the incentive aspect as significant only if as a result of the transaction the transferor has completely terminated his investment risk.[89] Although never characterized in precisely this manner, this factor has undoubtedly been an important consideration in the development of the present-day law in this area. In fact, this is essentially what the argument is all about although it is usually framed in terms of whether the deferred payment out of production is an "economic interest." Unfortunately the Supreme Court has generally approached this problem by regarding legal consequences in this area as controlled by the depletion deduction. The Court has determined who is entitled to depletion (which frequently is not directly in issue) as the basis for its decision as to the appropriate tax treatment of the bonus consideration and of the deferred payments from production.[90] This approach has resulted in emphasis on finding the inherent characteristics for tax purposes of an economic interest and since it serves as the touchstone for the solution of many different problems this approach tends to obscure policy considerations. It is suggested that the problem be approached from the standpoint of whether the transaction involves a sale of a capital asset with emphasis on the policy considerations underlying the capital gains provisions and any other policy consideration that may be pertinent.

There are, as noted earlier, in the incomplete dispositions two issues—appropriate tax treatment of the initial or bonus payment and appropriate

[87] See note 69.
[88] Commissioner v. Remer, 260 F.2d 337 (8th Cir. 1958); Maude W. Olinger, 27 T.C. 93 (1956); Cf., Helvering v. Elbe Oil Land Development Co., 303 U.S. 372 (1938).
[89] See note 69.
[90] See text commencing at note 29.

tax treatment of the deferred payment out of production. The Supreme Court had at an early date characterized mining as an income producing operation resembling "a manufacturing business carried on by the use of the soil."[91] Viewing mineral production as a business, it is a fair conclusion that the lessor under a typical mineral lease is a part of the venture and participating in the fruits of the venture to the extent that it is a successful one. The lessor in effect is a peculiar type of partner in the venture, sharing proceeds and contributing his property in return for the contribution of capital and management.[92] He is not, of course, the traditional type of partner in that his risks are limited and his return is measured in terms of percentage of the gross as a rule rather than a percentage of the net but nonetheless he has many of the characteristics of a participant in a business venture. The taxpayer's investment, applying the approach of the ALI Study Group, is still at risk. Accordingly, proceeds from the lessor's royalty are appropriately regarded as ordinary income subject to the depletion allowance.[93]

The production payment cases, some of which involve decisions of the Supreme Court, are inconsistent with lower court treatment in fixed unit price cases of the proceeds from retained deferred production payments. Under appropriate Supreme Court constructions involving oil and gas production payments the proceeds from production are treated as ordinary depletable taxable income to the owner of the deferred production payment. However, analysis of these cases suggests that the issue is not as clear in this regard as many persons have assumed. The deferred oil production payment cases generally arose in the context of the operator holding a lease subject to production payments attempting to exclude the amount of such payments from its income. The leading and oft cited case of *Thomas v. Perkins*[94] involved a production payment retained on the disposition of unproven acreage; hence, the party retaining the production payment from the standpoint of participating in the venture was in a position substantially identical to that of a lessor retaining a royalty payment in its usual form except for the fact that the production payment was limited in amount.[95] In the light of this it is not surprsing that the Court in effect treated the production payment as would a royalty holding that the proceeds are taxable to the holder of the production payment and excludable from income by the operator. Faced with the same problem in the context of a producing property the Court purported to resolve the issue by determining whether the transferor could take depletion on the production payment. Since the production payment was payable out of either production or the proceeds from the resale of the transferred prop-

[91] The quoted language is from Anderson v. Helvering, 310 U.S. 405, 407-408 (1940), but appears to be a paraphrase of language from Stratton's Independence v. Howbert, 231 U.S. 399, 414 (1913).

[92] G.C.M. 27322, 1952-2 Cum. Bull. 62.

[93] Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934).

[94] 301 U.S. 655 (1937).

[95] See text at note 25 supra.

erty it was apparent to the Court that depletion could not be taken on the proceeds from a resale. The Court, accordingly, held that the retained interest was not subject to depletion; hence, income attributable to this interest could not be excluded by the transferee but became part of his acquisition costs.[96] Even though the Court distinguished *Thomas v. Perkins,* it apparently felt sufficiently troubled by its decision in that case to take the unusual step of providing the following belated rationalization:[97]

> "Thomas v. Perkins . . . relied upon by petitioners, presented the issue whether the right to oil payments—that is, the right to a specified sum of money, payable out of a specified percentage of the oil . . . should be treated for tax purposes like the right to oil royalties or like the right to cash payments upon a sale . . . the holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place. The value of the right, *even though dependent upon the extent of the oil reserves,* is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments. *Yet it does depend upon the production of oil,* ordinarily can be realized upon only over a period of years, and permits a simple and convenient allocation between lessor and lessee of both the gross income derived from production and the allowance for depletion. . . . Accordingly, this Court in *Thomas v. Perkins* decided that the provision in the lease for payment solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties. The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for the payments of that type." [Emphasis supplied.]

The Court in striving to explain *Thomas v. Perkins* suggests that the deferred production payment is still at risk as its payment depends upon the extent of the oil reserves. This was stated more directly by the Fifth Circuit Court in the *Fleming* case.[98] "If the oil ran short or proved non-existent, the taxpayer was a proportional loser." Yet the Court in *Helvering v. Anderson* permitted capital gain treatment[99] under circumstances in which the transferor's investment was still subject to a degree of risk being payable out of production or the proceeds from a resale, neither of which absolutely assured eventual payment. The ALI Study Group apparently

[96] Anderson v. Helvering, 310 U.S. 405 (1940).

[97] Anderson v. Helvering, supra note 96 at 409-410.

[98] Commissioner v. Fleming, 82 F.2d 324, 327 (5th Cir. 1936).

[99] Although the immediate issue in Anderson v. Helvering, 310 U.S. 405 (1940) involved the right of the transferee to exclude the proceeds from the contingent payment from income, it is clear that in taxing the income to the transferee the court was impliedly holding that the proceeds to the transferor represented part of the sales price subject to capital gains treatment. Cf., Commissioner v. Fleming, supra note 98.

reaches a compromise solution applying capital gains treatment if the production payment will pay out in five years or within half of the remaining life of the property, whichever is the lesser.[100] Although involving a carved-out production payment, the Supreme Court has recognized the fact that production payments can be engineered so that there is no substantial risk involved in their payout.[101]

The determination of whether the transfer terminates the transferor's investment risk in the typical mineral conveyance involving a retained deferred payment out of production based on a fixed unit price requires a close look at the transaction. Assuming a property with well defined reserves, the parties in determining a price in this situation will consider the value of the mineral in the ground, that is, the relationship of the gross value based on current or expected prices for the mineral as against the cost of producing and marketing the mineral. In this bargaining process the parties are likely to consider a rough approximation of values in the ground; for example, a dollar for each barrel of oil reserve or $1.50 for each pound of uranium. If the parties agree as to the reserves, calculation of price is readily determinable by multiplying number of barrels or the number of pounds of uranium as the case may be by the agreed upon valuation for the mineral in the ground. In order to provide for the financing of the acquisition the parties might provide that a portion of the total purchase price thus calculated shall be payable in installments. The purchaser may, as he frequently does in any acquisition, depend on the proceeds from the enterprise (here proceeds from production) to pay off in part the purchase price and may attempt to arrange the installment payments to coincide in this regard with his projected production payment schedule.[102] The parties may provide that a portion of the purchase price may be paid out of production with a further provision that not less than a specified amount shall be paid during a specified period and with a provision limiting the total payment in connection with the transaction. Although Internal Revenue Service chose to challenge an arrangement similar to that last described it is reasonably clear that all of these transactions would be regarded as a sale.[103] The total consideration to be paid is fixed, the outer limits of time within which the consideration is to be paid is also fixed and the purchased has assumed none of the risk and participates in none of the benefits of the enterprise.

The negotiations leading to the transaction may result in agreement as to the value of a barrel of oil or pound of the mineral in the ground, but a substantial disagreement as to the total reserves underlying the tract in

[100] See note 69. However, if the entire expected duration of the mineral property is a relatively short one the asset might be classified as a limited duration asset and hence not a capital asset.

[101] Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 265 (1958).

[102] Capital gains tratment would be appropriate under the A.L.I. Study Group approach for installment sales of capital assets (See note 69) as it is under existing law. Int. Rev. Code of 1954, § 1001(d).

[103] Irma Mines Corp., 32 T.C. 1360 (1959).

question. This disagreement may arise out of (1) difference in engineering standards applied in the determination of reserves or (2) the fact that additional drilling or other development work is necessary in order to determine more exactly the extent of known reserves or (3) out of the fact that there are additional exploratory opportunities available as to the particular property. In any of these situations it is not unlikely that the parties will agree on a purchase price to be determined on the basis of an agreement upon fixed unit price applied to actual production. This agreement may involve no initial down payment or on the other hand may involve a substantial initial down payment based in part on the agreed minimum reserves, it may involve a provision for ultimate termination of payment upon receipt of a specified amount or such payments may continue throughout the entire productive life of the property. Assuming the first situation, that is reserves that differ because of a difference in engineering standards and an arrangement that provides for fixed unit payment throughout the productive life of the property, the parties are in a sense merely deferring the caluculation of the purchase price until proven reserves are tested against actual produtcion. Unlike the typical royalty situation there will be no variation as the result of variations over a period of time in the market price of the mineral involved and although there is a possible variation in the final price, this variation will be confined within certain narrow limits. It cannot, however, be said that the party disposing of the mineral interest has disposed of all of his interest in the venture in that he shares in and is the beneficiary to a limited extent of the risk involved in producing the property and in determining reserves. As we go from the first to the third category the extent of his participation in the venture and the extent of his risk and benefit sharing obviously increases. These variations may call for some refinements that impose difficulties from the standpoint of practical administration; however, the necessity for such refinements should not in themselves be decisive in finding against the sale conclusion.

In those situations in which there remains additional opportunities for exploration, deferred production payments are not unlike typical royalties. However, in situations in which the only contingency is the extent of known reserves from the standpoint of the incentive aspect there appears to be little reason why the deferred payments should be treated different from installment payments. The purpose of requiring termination of the taxpayer's investment risk as a prerequisite to capital gains treatment is to assure that the taxpayer does not receive capital gains treatment for what is essentially his share of income from a business enterprise.[104] In the hypothetical situation the vendor's interest is substantially

[104] Compare Comment, Gowans v. Commissioner. Crowell Land and Mineral Corp. v. Commissioner, 71 Harv. L. Rev. 376 (1957). This position also finds some support in the cases that characterize a leasing transaction as one the predominant motive of which is development. Wesley W. West, 3 T.C. 431, aff'd, 150 F.2d 723 (5th Cir. 1945) cert. denied, 326 U.S. 795; Arthur N. Trembley, 7 T.C.M. 972 (1948). It is clear from the facts of these cases that the development motivation referred

fixed at the time of the transaction. The holder of the deferred payments is not a substantial participant in the continuing enterprise and the deferred payments are essentially a means of providing a reasonable method for calculating the purchase price rather than a sharing arrangement in a common enterprise.[104a] This was apparent to the Supreme Court when the deferred payment per unit was based on the amount of tons acquired rather than produced.[105] The Circuit Courts have almost uniformly regarded the proceeds from such deferred payments as additional consideration for the sale of the mineral interest where there was assurance that all of the mineral would be produced, the known reserves had all been developed, and the only contingent factor was the precise extent of such reserves.[106] There may be those who disagree with these conclusions[107] but this, at least, appears to be the level at which argument should be pursued rather than some metaphysical concept of what constitutes an "economic interest."

In view of the fact that a "sales" price characteristically has an "end price," draftsmen relying on this analysis would be well advised to provide a definite end price at which the deferred production payments will terminate. This price should be reasonably related to reserve estimates and the instrument in any event should contain provisions that assure that the payments will terminate prior to the exhaustion of the minerals.[108] As an alternative the agreement might provide for payment of the balance of the purchase price to be made on the basis of a deferred calculation of reserves.[109]

to is of the exploratory type. The Internal Revenue Service rebuttal that the typical oil and gas lease does not include development requirements (G.C.M. 27322, 1952-2 Cum. Bull. 62) is not realistic. While oil and gas leases seldom contain firm drilling provisions, the usual bonus payments, delay rental termination clauses, short primary terms and requirement for production to extend the lease and the implied covenants against drainage and of development combine so as to effectively result in exploration and, if warranted, development. The net profit cases even with respect to proven properties are distinguishable as this is the clearest type of continued participation in all the risks and benefits of the enterprise. See J. Bryant Kasey, 33 T.C. 656 (1960).

[104a] This in essence is the rationale of Linehan v. Commissioner, __F.2d__ (1st Cir.1961), 8 A.F.T.R. 2d 5974, decided since this was written. See also Robert M. Dann, 30 T.C. 499,505 (1958).

[105] Burnet v. Logan, 283 U.S. 404 (1931). See text at note 45 supra.

[106] See cases cited in notes 49, 51, 53 and 56 supra.

[107] See note 67 and related text. The argument against capital gains treatment applying this approach would be as follows: First, there is no forward bunching aspect involved since payments relate to production and extend over the entire productive life of the property. Second, for the same reason there is no locked-in effect. Third, if the expected productive life (as to known reserves) is comparatively short, for example five years, taxpayer is to convert what would have been realized as income in a short period into capital gains realized over the same period. Fourth, from an administrative standpoint it will be difficult to separate known reserves from those subsequently developed. Fifth, transferor's investment is still at risk as production may result in considerably less or considerably more than the estimated reserves. However, as to the locked-in effect see note 82 and related text, supra. The position assertd in th text conceivably could sound the death knell for the so-called ABC transaction. See Bloomenthal, op. cit. supra note 19 at § 28.109. The tax implications of the ABC transaction are presently under study by the Internal Revenue Service. T.I.R.-326, July 17, 1961 and T.I.R.-338, September 15, 1961. For an argument on behalf of the present assumed tax treatment for ABC transactions see, *The Case for ABC,* XI Oil and Gas Tax Q. 1.

[108] These provisions would lessen the impact of arguments first, second and fifth set forth in note 107.

On the Supreme Court level *Thomas v. Perkins*[110] and the dictum of *Anderson v. Helvering*[111] conceivably may be regarded as inconsistent with these decisions.[112] In addition, the Supreme Court did not regard a fixed price per unit royalty as a distinguishing characteristic in holding that the royalty was taxable as ordinary depletable income.[113] The instrument involved used lease language and no emphasis was placed on the fixed unit price aspect of the case. The taxpayer based its case on the conceptual argument that under the law of West Virginia the transaction involved a sale of minerals in place. Also of some significance is the fact that if regarded as a sale, the transaction would have completely escaped taxation as the transaction (but not the royalty payments) took place before the adoption of the Sixteenth Amendment. The *Sargent Land Co.* case[114] involving the Corporation Excise Tax of 1909 is contra to the Circuit Court decisions involving fixed unit price deferred production payments. On the other hand, the *Elbe* case[115] which appears to support these decisions although it may elevate form over substance, did not involve the appropriate treatment of the deferred payment out of production, and may have been effectively overruled by subsequent decisions.[116]

CONCLUSION

The decision of the United States District Court for the District of Wyoming in the *Griffith* case and the decisions of other Circuits on which the Wyoming Court relied are inconsistent with the prevailing doctrine that has developed in connection with similar oil and gas problems. Although there appears to be no basis for developing different principles outside of the oil and gas area, it does not necessarily follow that the oil and gas decisions are as clear in this regard as is generally assumed and further, on analysis, there appears to be much to recommend the approach adopted by the Court in the *Griffith* type case in connection with both hydrocarbons and other minerals. In order to achieve capital gains treatment for the transferor the following drafting suggestions appear advisable:

1. The instrument should be styled a sale and should purport to be an absolute conveyance of all minerals in place. Lease and royalty language should be avoided at all cost.

2. All deferred payments should be based on a fixed price per unit of produtcion (e.g., 25 cents per ton produced).

3. The initial consideration should be related to a specified number of units of the particular mineral involved. If, for example, the per unit

[109] Cf., Estate of Bessie E. Machris, 34 T.C. 827 (1960). See also possibilities involved in selling an incorporated mineral property discussed at text commencing at note 42 supra.
[110] 301 U.S. 655 (1937).
[111] 310 U.S. 405 (1940).
[112] See discussion commencing at note 94.
[113] Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932).
[114] Von Baumbach v. Sargent Land Co., 242 U.S. 503 (1917).
[115] Helvering v. Elbe Oil and Development Co., 303 U.S. 372 (1938). See text at note 36 supra. See in addition for support of this position cases referred to in note 104 supra.
[116] Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956).

price is 25 cents per ton for deferred payments, the instrument should recite that the initial consideration of $25,000 is based on the first 100,000 tons to be produced.

4. The deferred payment relating to production should contain a terminal price as, for example, 25 cents for each additional ton produced in excess of 100,000 tons until transferor has received a total of $500,000.

5. Appropriate provisions should be included to assure that the deferred payment will terminate well in advance of the exhaustion of the particular mineral to be removed.

6. A provision should be included to the effect that the transferee will pay annually for a minimum number of units irrespective of actual production, or, in lieu thereof, the transferee should be required to agree to continuously mine, produce and market minerals from the property until the full purchase price has been paid the transferor. Neither of these requirements should be avoidable by the transferee although the transferor probably can safely retain a reversionary interest in the event the transferee is in default.

In the event the foregoing arrangement is not in accord with the agreement of the parties some of the foregoing provisions may have to be eliminated, but to the extent they are eliminated, the likelihood of the transferor obtaining capital gain treatment will be reduced. Counsel to the transferee should recognize that it is advantageous from the transferee's standpoint for the payments to be regarded as ordinary depletable income to the transferor and hence excludable from income by the transferee, accordingly, the transferee will be interested in an arrangement of this type only when it otherwise facilitates the completion of the transaction.