Land & Water Law Review

Volume 22
Issue 2 *Symposium: Western Water Rights*

Article 10

1987

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LAND AND WATER LAW REVIEW

VOLUME XXII 1987 NUMBER 2

Coping With Revenue Ruling 83-46: Exploring Alternatives to the Pool of Capital Theory

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The current depression in the oil and gas industry is having a severe impact upon small independent oil companies and wildcatters. By issuing Revenue Ruling 83-46, the Internal Revenue Service is adding to their difficulties by challenging the long-standing common law doctrine that a contributor of services to the acquisition or development of an oil and gas prospect in return for an economic interest does not realize income until and unless production is attained. In this article the author examines the possibilities for mitigation or circumvention of the Ruling through the use of alternative business associations. The article specifically focuses upon the partnership relation and concludes that it is feasible to form partnerships under the Uniform Partnership Act and sufficient for purposes of Subchapter K of the Internal Revenue Code which would bypass the Ruling's tax consequences. The article then offers specific recommendations on how to structure the partnership deal.

Revenue Ruling 83-46[1] has caused widespread concern in the oil and gas industry because it purports to include the value of overriding royalty[2] interests in gross income in three situations where the venerable "pool

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1. Rev. Rul. 83-46, 1983-1 C.B. 16.

2. An "overriding royalty" is created from the working interest and entitles the owner to a specified fraction of production without the burden of development or operation costs. The term of the overriding royalty is co-extensive with the term of the working interest. F. Burke & R. Bowhay, Income Taxation of Natural Resources ¶ 2.05 (1982) [hereinafter Burke & Bowhay].

of capital" doctrine seems applicable. Under that judicially-created doctrine,[3] one who contributes services or property[4] to the acquisition, exploration or development of a mineral prospect in return for an economic interest[5] in the mineral in place does not realize income immediately upon receipt of that interest provided that he looks only to production from that specific prospect for a return on his investment. Rather, the contributor realizes taxable income only if production is attained and after his capital has been returned. The common law thus comports with the layman's common sense view of what "income" truly is—namely, profit[6] —but in relation to service providers, to many the concept of acquiring an "interest" for a "contribution" smacks too heavily of a carved-out exception to the general rule that income includes compensation for services.[7] The doctrine is of immense historical importance to the development of the petroleum industry in the United States.[8] Its continued vitality re-

3. The pool of capital doctrine originated with the Supreme Court decision of Palmer v. Bender, 287 U.S. 551 (1933). The I.R.S. fully adopted the doctrine in Gen. Couns. Mem. 22, 730, 1941-1 C.B. 214, and has reaffirmed it on numerous occasions, notably in Rev. Rul. 69-352, 1969-1 C.B. 34; Rev. Rul. 77-176, 1977-1 C.B. 77; and Gen. Couns. Mem. 38,906 (Oct. 6, 1982).

4. "Property" in this context includes money.

5. Treas. Reg. § 1.611-1(b)(1) (as amended in 1965) defines "economic interest" as follows: "An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . . to which he must look for a return of his capital."

6. The concept that the recipient of an economic interest does not immediately have income but only potentially has income was cogently stated by the Fifth Circuit in *Estate of Weinert v. Comm'r:*

> This opportunity of converting a right to develop the possibility of oil into property is the only ownership of minerals that has tax significance; bare ownership in place of minerals 12,000 feet underground, or perhaps not there at all, or if there perhaps not exploitable, has little if any real meaning—or should have little meaning for income tax purposes. It is the development of this opportunity into producing wells having a present economic usefulness that results in income values.

294 F.2d 750, 762 (5th Cir. 1961).

7. I.R.C. § 61(a) (1982 & Supp. III 1985); Treas. Reg. §§ 1.61-2(a) to -2(d)(1) (1960); *see* Parker, *Contribution of Services to the Pool of Capital: General Counsel Memorandum 22730 to Revenue Ruling 83-46*, 35TH INST. ON OIL & GAS L. & TAX'N 313 (1984). In Gen. Couns. Mem. 22730, the I.R.S. nevertheless generally included service providers to be covered by the doctrine:

> If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deduction, and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished.

1941-1 C.B. 214, 221-22.

8. Arrache, in his article, *Is Revenue Ruling 83-46 a "Duster" for Service Contributors Seeking "Tax Free" Pool of Capital Treatment?* 24 SANTA CLARA L. REV. 857 (1984) states:

> [I]n the early days of the industry, in oil and gas producing states such as Oklahoma, Texas, and California, the person with a little cash, the prospector with a little knowledge of geology, and the driller who owned a cable tool rig, would come together to discover and to develop oil and gas producing wells. All of them would share the joy of discovery or alternatively, the disappointment of loss in having produced a 'dry hole.'
>
> As time went on, more and more specialists contributed their services, as did the cash and equipment investor, to the 'pool of capital.' Added to the

mains of crucial importance to hundreds of the small independent oil companies and wildcatters whose numbers comprise roughly 98% of the industry.[9]

The pool of capital doctrine was engendered by the courts to reflect the economic realities attendant to drilling for oil and gas.[10] A drilling venture is inevitably a highly expensive undertaking, fraught with danger and uncertainty. Oil and gas deposits have always been extraordinarily difficult to forecast and hence economic interests pertaining thereto are enormously difficult to value prior to actual discovery. One who contributes to the formation of a reservoir of capital to permit the venture to go forth will probably lose his investment.[11] To require such a person to immediately pay a tax liability on the basis of a value somehow attributed to his economic interest would be to discourage investment and stifle production in an already depressed but most vital industry.

That is precisely the result promoted by Revenue Ruling 83-46, and the entities standing to suffer most are the small operators. As a matter of public policy, it is certainly arguable that whether the small operators sink or swim should be a function of the market. It is also arguable that it is not the proper province of the Internal Revenue Service to unilaterally change that market and that, indeed, it is a proper function of the government to encourage private enterprise. The proclivity of the I.R.S. to exact its tax revenues early may in the long run be counterproductive to the promotion of a vigorous economy.

This article discusses Revenue Ruling 83-46 and explores possibilities for the mitigation or circumvention of its tax effects through interpretations of section 83 and the use of alternative business associations such as corporations and partnerships. The article specifically analyzes the potential of the partnership relation in the light of current case law and statutory authority and concludes that it is feasible to form partnerships under the Uniform Partnership Act and sufficient for purposes of Subchapter K which would bypass the effect of the Ruling. Provided that such business associations are otherwise formed for legitimate business purposes and not merely to avoid taxes, they should be afforded full recognition by the Commissioner of Internal Revenue and the courts. Until the

list of types of contributors were the services of the independent geologist/prospector, independent geologist/drilling advisor, geologist/corporation, petroleum engineer, driller/drilling corporation, tax shelter promoter, attorney, accountant, landman/independent contractor, landman/employee, and the corporation executive. Each contributed his services and each received an economic interest in the property rather than a cash payment.

9. *See* Comm'r v. Engle, 464 U.S. 206, 218 n.16 (1984). Large oil companies are not, relatively speaking, lacking in resources to conduct drilling projects. Typically, their preference is to purchase numerous oil and gas leases and select the time for drilling during the various lease terms. It is salutary to reflect that the pool of capital doctrine antedates many of the "Seven Sisters" who comprise the giants of the industry and actually assisted in their growth.

10. The doctrine applies to the extractive industries generally, but the vast bulk of case law emanates from the oil and gas field.

11. Some estimate that on average, fewer than one in thirty exploratory wells are productive. *See* Friske, *Revenue Ruling 77-176 Revisited*, 28 OIL & GAS TAX Q. 147, 154 (1979).

courts pass upon the ultimate validity of Revenue Ruling 83-46, oil and gas lawyers would do well to consider alternatives to the nonrealization of income within the pool of capital.

I. THE SUBSTANCE OF THE RULING

Revenue Ruling 83-46 describes three fact situations and holds that the fair market value of overriding royalties received by the taxpayer in each situation is included in gross income under section 83 of the Internal Revenue Code and its supporting relations. The Ruling also cites Revenue Ruling 67-118[12] for the proposition that an overriding royalty constitutes an economic interest in oil and gas. The fact situations involve a corporate promoter, an attorney, and an employee of a closely-held corporation.

In the first situation, a corporation syndicated partnerships that acquired interests in oil and gas properties. The corporation entered into an agreement with one such partnership which provided that the corporation would acquire a royalty in consideration for its services in locating available oil and gas properties for the partnership. Under the agreement, the corporation received several such royalties in oil and gas to be produced from leases acquired by the partnership.

In the second situation, an attorney is retained by a corporation in connection with its acquisition of oil and gas properties. The attorney examined titles to the properties and drafted lease agreements under which the corporation acquired the minerals in place. The attorney and the corporation agreed that for each such lease that the corporation so acquired, the attorney would receive a royalty in the oil and gas to be produced under the lease.

In the third situation, an employee of a closely-held corporation was responsible for corporate administrative and policy matters. His duties included arranging financing to acquire and develop oil and gas properties located by the corporation's technical staff and overseeing the operations in developing the properties. For these services, the employee received a salary and a royalty in the oil and gas being produced from each such lease acquired by the corporation.

Conspicuously absent from the Ruling is any reference to the pool of capital doctrine or any I.R.S. authority interpreting it. Such absence was intentional[13] and is especially significant coming on the heels of Revenue

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12. Rev. Rul 67-118, 1967-1 C.B. 163.

13. *See* Parker, *supra* note 7, at 339 (citing Background Information Note (Dec. 16, 1982). This Note is available by request under the Freedom of Information Act and states:

> In view of the length of time G.C.M. 22730 and Rev. Rul. 77-176 have been outstanding, it would not be feasible to revoke them. Reference to G.C.M. 22730, Rev. Rul. 77-176, and the pool of capital doctrine, has been intentionally omitted in the proposed revenue ruling in favor of related factual situations, though sufficiently distinct from the G.C.M. and Rev. Rul. 77-176. It is believed that this approach is the most effective way to accord compensatory arrangements relating to the acquisition and development of oil and gas properties the same tax treatment under Sections 61 and 83 of the Code as other compensatory arrangements in which property interests are received.

Ruling 77-176[14] and a series of letter rulings in which the Service continued to hold that the doctrine does apply to the receipt of an economic interest in return for the provision of services.[15] Through careful delineations of the bounds of the doctrine, the Service conceivably could have achieved the same result in relation to the three fact situations discussed in the Ruling.[16]

We are therefore left to speculate upon the Service's ultimate design. At present it seems possible that the I.R.S. proposes to remove from pool of capital treatment economic interests received by purely service providers to the *acquisition* of oil and gas prospects,[17] since all three Revenue Ruling 83-46 taxpayers contributed services relating to acquisition as

14. Rev. Rul. 77-176, 1977-1 C.B. 77.

15. "[I]f an economic interest is received in a transmission that meets the requirements of G.C.M. 22730, neither Section 61 nor Section 83 requires the inclusion of gross income of the value of the economic interest received." Priv. Ltr. Rul. 8,047,005 (July 24, 1980); Priv. Ltr. Rul. 8,129,006 (Mar. 30, 1981); Priv. Ltr. Rul. 8,137,006 (July 23, 1981).

16. In adopting the pool of capital doctrine in G.C.M. 22730, the I.R.S. set forth various requirements which must be met before an economic interest transferred in exchange for services can qualify for nonrealization treatment. They may be summarized as follows:

> (1) The economic interest transferred must be in the identical property to which the services relate;
> (2) Such services must perform functions which otherwise would have to be performed or paid for by the lessee;
> (3) Prior to the performance of the services, the parties must agree that the services represent a contribution of capital and that an economic interest, not compensation or satisfaction of a liability, is expected in return. Title of the interest itself need not be transferred at the outset if evidence of such an agreement is provided;
> (4) The provider of funds, materials, or services must look only to his economic interest for any possibility of recoupment or profit. If an alternative means otherwise guarantees payment should the property fail to produce as desired, no risk is involved and the resemblance to a true investor disappears;
> (5) The nature and extent of the services to be provided must be definite and determinable. If services are required on a continuing basis after the property is developed, the interest received takes on the appearance of compensation.

See Parker, *supra* note 7, at 330; Hall, *Contribution of Services to the Pool of Capital: Defining the Boundaries*, 30 OIL & GAS TAX Q. 442, 445 (1982); *see also* Kirgis & Wilson, *Tax Aspects of Co-Ownership Interest in Oil and Gas Property Received for Services: Terminal (?) Condition of G.C.M. 22730, Part 1*, 25 OIL & GAS TAX Q. 251, 254 (1977). In the case of the corporate promoter, the I.R.S. could, for example, have reasoned that its services did not relate to the acquisition of any specific property and hence were not definite and determinable. As for the attorney, perhaps the services he performed were not of the sort which the lessee would otherwise have had to perform himself in developing the property. The employee, for his part, is arguably not acting at his own risk because of the employment relation.

17. Conceivably supportive of this possible trend is *Cline v. Comm'r*, 617 F.2d 192 (6th Cir. 1980) (royalties received by taxpayers as compensation for services in negotiating coal leases acquired by mining company taxable as ordinary income and not capital gain despite a subsequent contract purporting to sell the interests in the coal to which the royalties pertained back to the company) (Note: Nonrealization within the pool of capital was not a litigated issue); Priv. Ltr. Rul. 8,520,004 (Jan. 30, 1985) (Five percent working interest received by geologist engaged in generating oil and gas prospects was subject to § 83 where he received the interest as a result of the performance of services for others.). If the I.R.S. is indeed intending to remove contributions to the acquisition as opposed to the exploration or development of oil and gas prospects, such would do violence to the doctrine's history. *See* Shelton, *The Taxation of Oil and Gas Interests Received in Payment for Property or Services*, 5TH INST. ON OIL & GAS L. & TAX'N 385 (1954).

opposed to development or exploration. More fundamentally, it seems plausible that the I.R.S. is reconsidering its position taken in G.C.M. 22730 with respect to services generally.[18] Since the Revenue Ruling 83-46 service providers are not drillers or equipment dealers, perhaps the I.R.S. is moving toward the position that service providers who are not directly enough associated with the actual extractive processes cannot qualify for nonrealization treatment. If so, such a distinction might also exclude from pool of capital treatment the services of the geologist who surveys the land, the accountant who sets up the books, or the petroleum engineer who plans the project. It is also possible, of course, that the ruling is at the vanguard of a movement to do away with the doctrine altogether.[19]

If upheld by the courts, Revenue Ruling 83-46 will drastically affect traditional means by which owners of oil and gas prospects have secured the performance of services essential to the development of oil and gas wells. The "corporate promoter" treated in the first fact situation bears very close resemblance to the familiar lease broker who assembles the blocks of leases, thus enhancing the value of the individual included leases and maximizing the potential of obtaining drilling services. Attorneys, for their part, for many years have not charged fees from relatively unmoneyed operators but instead have rendered services such as title clearing and lease negotiation in return for economic interests.[20] Admittedly, the propriety of the doctrine's application in the employment context is less certain but at least two commentators have endorsed its practice.[21] Surely, nevertheless, one however situated who makes a contribution to the "pool" and profits only if production is attained must be distinguished from one who receives an interest in property in discharge of a money obligation. The latter person expects to be compensated for his services irrespective of the success or failure of the drilling venture. The courts will uphold his right to payment and will award a money judgment if he is not paid. The former person, by contrast, only shares "ownership in place of minerals 12,000 feet underground . . . perhaps not there at all."[22]

II. THE SCOPE OF SECTION 83

Under the pool of capital concept, the receipt of an economic interest for services is neither a sale or exchange nor compensation income. The service provider is properly viewed as a risk-sharer and investor as opposed to a worker for hire. Nevertheless, Revenue Ruling 83-46 seems to

18. *See generally* Parker, *supra* note 7.

19. It is the writer's observation that students of the pool of capital doctrine tend to polarize into two factions: The "Linden" school and the "Dumas" school. William M. Linden's article, *Income Realization in Mineral Sharing Transactions: The Pool of Capital Doctrine*, 33 TAX LAW. 115 (1979) is essential reading, for it most ably advances the thesis that the doctrine is entirely in consonance with general principles of income realization. The opposite view is well presented by Bethany Dumas in her Comment, *The Pool of Capital Doctrine in Oil and Gas Taxation: Its Status Under Revenue Ruling 83-46*, 52 TENN. L. REV. 291 (1985).

20. Read: "Have worked for nothing on the long chance that oil might be discovered."

21. *See* Hall, *supra* note 16, at 464-66; Glancy, *Compensating Key Employees in the Oil and Gas Business*, 33D INST. ON OIL & GAS L. & TAX'N 369, 373 (1982).

22. Weinert v. Comm'r, 294 F.2d 750, 762 (5th Cir. 1961).

reflect the aim of the Internal Revenue Service to eclipse that view through the medium of section 83. Under that section, the fair market value of property received for services performed is included in the taxpayer's gross income in the first taxable year in which the property is transferable or no longer subject to a substantial risk of forfeiture.

At the outset, there is some question as to whether the Service's reliance upon section 83 to accomplish the results announced in Revenue Ruling 83-46 is justified for reasons of legislative history. Section 83 was enacted as part of the Tax Reform Act of 1968 and was impelled by confusion associated with restricted stock plans used as deferred compensation arrangements. Stock transferred to employees would be subject to a substantial risk of forfeiture and thus be virtually non-transferable because it would revert to the employer if the employment relation ended before a certain date.

By enacting section 83, Congress has ensured that the value of such stock will be taxed when such restrictions are removed. However, the legislative process has yielded a statute with broad-sweeping language not apparently confined to restricted stock plans.[23] Assuming that the statute is nevertheless applicable in the context of oil and gas sharing arrangements,[24] the lawyer should be cognizant of two concepts subsumed within section 83 which, as appropriate, may operate either to defer or accelerate the inclusion of gross income of the value of interests received for services contributed to an oil and gas prospect.

A. *"Substantial Risk of Forfeiture"*

Under section 83(a), income is included only when any restrictions which constitute a substantial risk of forfeiture are removed. Section 83(c)(1) specifically defines a substantial risk of forfeiture to exist where

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23. See Anders, *Section 83 as an Alternative,* 23 OIL & GAS TAX Q. 67, 77 (1974), for a discussion of the evolution of the present statute. Section 83(a) provides:

> If in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—
> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having a beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
> (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

I.R.C. § 83(a) (1982).

24. A "sharing arrangement" is a transaction where one party contributes 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. *See* BURKE & BOWHAY, *supra* note 2, ¶ 7.01.

the taxpayer's rights to full enjoyment of the property depend upon the future performance of substantial services by any individual. In other cases, the question of whether there is a substantial risk of forfeiture depends upon the surrounding facts and circumstances.[25]

Legitimate questions may be raised regarding whether the overriding royalties received by the Revenue Ruling 83-46 taxpayers are subject to a substantial risk of forfeiture. On the one hand, the taxpayers clearly received present interests which presumably are in turn alienable. On the other hand, valuing those interests is extraordinarily difficult because the overwhelming statistical probability is that any given oil drilling venture will not be commercially successful.[26] *Arguendo,* to the extent that an overriding royalty or other fractional working interest represents an interest which likely will never be taken in kind, such an interest seems decidedly subject to a substantial risk of forfeiture and hence should not be taxed until the drilling project proves successful. It would seem, however, that from the standpoint of the Service such a classification would be redolent of the disfavored "open transaction" doctrine.[27]

B. The Section 83(b) Election

Assuming that such a high likelihood of commercial failure does constitute a substantial risk of forfeiture, one option available to the taxpayer would be to elect to be taxed currently under section 83(b). This election must be made within 30 days of receiving the property interest and enables the taxpayer to include in gross income the value of property measured at the time he receives it irrespective of the substantial risk of forfeiture. The mitigating effect of exercising the election is at once apparent should the oil prospect turn out to be productive, because any appreciation in value subsequent to the election would be taxable only when the taxpayer disposes of the property.[28] The value of an economic interest almost always will be lower *prior* to oil or gas discovery.

On the other hand, a potential disadvantage to the taxpayer is that, should the interest indeed prove worthless and hence forfeited, no deduction is allowed in respect of such forfeiture.[29] Moreover, an election once

25. H.R. REP. No. 91-413, 91st Cong., 1st Sess. 88, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1735; S. REP. No. 91-552, 91st Cong., 1st Sess. 121, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2152-53.

26. As an illustration, 7,090 of the 9,242 exploratory wells drilled in 1975 were dry holes. DAILY EXEC. REP. (BNA) 85, at G-5 (Apr. 30, 1976).

27. Burnet v. Logan, 283 U.S. 404 (1931), is the seminal case of the "open transaction" doctrine. In this case, the Supreme Court held that where the consideration in the sale of stock was based upon amounts of iron ore to be mined in the future, the value of that consideration could not be determined with "fair certainty." Hence, the taxpayer did not need to report income upon the payments he received until the amount of the payments in the aggregate exceeded his basis in the stock. The stated preference of the I.R.S. today is to arrive at some present value. *See* Rev. Rul. 58-402, 1958-2 C.B. 15.

28. Treas. Reg. § 1.83-2(a) (1978). The character of the taxed appreciation would be capital gain, but with the repeal of former I.R.C. § 1202, the 1986 Code has eliminated the tax advantage formerly given to capital gains as opposed to ordinary income.

29. I.R.C. § 83(b)(1) (1982).

made may not be revoked except with the consent of the Commissioner.[30] The election could therefore visit a particular hardship upon a taxpayer whose interest becomes worthless when the drilling enterprise fails but who is unable to take a loss deduction.

III. ALTERNATIVE BUSINESS ASSOCIATIONS

In relation to service providers, then, we should examine whether alternatives exist within the Internal Revenue Code to achieve the *nonrecognition* of income which apparently would be *realized* under the authority of section 83 and Revenue Ruling 83-46. The most eligible candidates are the provisions of Subchapter C relating to corporations and Subchapter K dealing with partnerships.

A. Corporations

We might entertain the possibility that the service provider could contribute his services to a section 351 controlled corporation in return for stock or securities of a value commensurate with the economic interest he would otherwise receive. If feasible, the value of such stock or securities would be received tax-free.

Section 351(a) provides that:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

The control test under section 368(c) and its supporting regulations is that following the exchange the "control group" must own 80% of the stock possessing at least 80% of the total combined voting power of all voting stock and at least 80% of the total shares of all other stock. Unfortunately, section 351(d) specifically provides that, "[f]or purposes of this section, stock or securities issued for services . . . shall not be considered as issued in return for property." Hence, since a contribution of *services* does not qualify as *property* under section 351(a), the service provider will recognize as income the value of the shares received for services contributed to a controlled corporation. Moreover, section 351(f)(4) states as follows: "For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation . . ., see section 61(a)(1)." Section 61(a)(1) is the provision including into gross income compensation for services. The corporation is therefore not available as an adequate substitute for the pool of capital doctrine in relation to the service provider. Income will be immediately realized upon his receipt of stock.[31]

30. *Id.* § 83(b)(2).

31. *See* James v. Comm'r, 53 T.C. 63 (1969) (*Held*, value of stock received for service to a controlled corporation taxable to recipient; concurrent transfer of property by another person also taxable because he failed the 80% control test).

B. Partnerships

During the previous major assault upon the pool of capital citadel namely, Revenue Ruling 77-176,[32] the partnership device was widely employed and generally viewed as the only effective vehicle by which the effects of that ruling could be entirely circumvented.[33] In Revenue Ruling 77-176, the I.R.S. reaffirmed the pool of capital doctrine but restricted its application in "obligation well farm-out" transactions: Where a driller agrees to drill a well upon a lessee's land in return for an assignment of the working interest, Revenue Ruling 77-176 holds that nonrealization of income results only with respect to the drill site acreage as defined by state law but not the surrounding ("outside") lease acreage. Similarly, it would seem that, if a partnership valid for purposes of Subchapter K could be formed to include the promoter, attorney, or employee, the effects of Revenue Ruling 83-46 could be avoided. The parties would then allocate items of income and deduction among themselves in accordance with their partnership agreement.[34]

It must be observed, however, that the taxpayers featured in Revenue Ruling 83-46 are very differently situated from the driller taxpayer involved in Revenue Ruling 77-176. First, they may fairly be classified as "pure" service contributors; the driller, by contrast, contributes not only his services but also considerable equipment and typically all drilling expenses. Also, notwithstanding that an overriding royalty is an interest carved out of the working interest,[35] it is not *itself* a working interest and is of a sort often exchanged for services rendered and hence arguably smacks of a compensatory arrangement. Finally, the holder of a royalty oil interest for services is not a party to the joint cooperating agreement as between driller and lessee; hence, he could not be a member of the tax partnership[36] created by the joint operating agreement.

32. Rev. Rul. 77-176, 1977-1 C.B. 77.

33. *See* Linden & Manford, *How to Avoid the New Ruling Which May Currently Tax Oil and Gas "Farmout" Deals,* 47 J. TAX'N 76, 79 (1977); *see also* Burke, *Taxation of Natural Resources: Evaluation of Recent Changes and Projection for the Future with Special Emphasis on Oil and Gas Transactions,* 14 HOUS. L. REV. 1075, 1080 (1977).

34. Allocations must pass the "substantial economic effect" test of I.R.C. § 704(b)(2) (1982). Under the doctrine of Orrisch v. Comm'r, 55 T.C. 395 (1970), an allocation of a deduction to a partner has substantial economic effect only if he ultimately bears the economic burden of the cost giving rise to the deduction. The subject of allocations is beyond the scope of this article. The new Treasury Regulations under § 704(b) are extraordinarily detailed, and a helpful reference to understanding how they operate is Professor Alan Gunn's article, *The Character of a Partner's Distributive Share Under the "Substantial Economic Effect" Regulations,* 40 TAX LAW. 121 (1986).

35. BURKE & BOWHAY, *supra* note 2, ¶ 2.05.

36. A "tax partnership" refers strictly to a partnership created solely for tax purposes. When a lessee and a driller join together to exploit an oil and gas prospect, a joint operating agreement results. Such agreements constitute tax partnerships (sometimes called "partnerships by default") under I.R.C. § 7701(a)(2) (1982) unless an election is made under § 761(a) and Treas. Reg. § 1.761-2(a) to be excluded from the application of the provisions of Subchapter K. Lessees and drillers who wish to avail themselves of pool of capital treatment typically make this "election out."

Section 761(a) provides that the members of an unincorporated organization may, under regulations prescribed by the Secretary, elect to be excluded from the provisions of Subchapter K, provided the organization is availed of "for investment purposes only and not

If the partnership alternative is available to the taxpayers treated in Revenue Ruling 83-46 (as well as various other types of service providers to an oil and gas prospect[37]) it would seem that a legal partnership as formed in accordance with the Uniform Partnership Act would be preferable to the tax partnership. By means of formal instruments creating the partnership entity with its own set of books, transferring all subject oil and gas properties to it, and providing for capital accounts, liquidation rights, and special allocations, such arrangements could help solidify a taxpayer's position under I.R.S. scrutiny. The question remains, however, whether this alternative is available.

1. "Capital" vs. "Profits" Interests. Section 721(a) is the "nonrecognition" statute for partnerships which is analogous to section 351 relating to controlled corporations. This statute provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."

Again, "property" under this statute does not include services—presumably because services are ephemeral and difficult to recognize as representing an identifiable continuing investment in the business of the partnership. But section 1.721-1(b)(1) of the Regulations features the following language:

> To the extent that any of the partners gives up any part of his right to be repaid his contributions *(as distinguished from a share in partnership profits)* in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.[38]

This provision is frequently cited for the proposition that there is a distinction for tax purposes between a capital interest in a partnership

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for the active conduct of a business" or "for the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted." I.R.C. §§ 761(a)(1), -(2) (1982).

Treas. Reg. § 1.761-2(a) specifies that:

> (1) the participants must own the property, as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights;
> (2) the participants must reserve the right to take separately their shares of production in kind, though each may delegate authority to sell his share of production for the time being for his account, but not for a period of time in excess of the minimum needs of the industry and in no event for more than one year; and
> (3) the organization must not have as one of its principal purposes cycling, manufacturing or processing for nonmembers.

See Treas. Reg. § 1.761-2(a) (1972). The election is made by attaching a statement to the partnership return for the first taxable year for which exclusion from Subchapter K is desired. *See id.* § 1.761-2(b)(2).

37. Each partner to a partnership must contribute either "capital or services." Comm'r v. Culbertson, 337 U.S. 733, 740 (1949).

38. Treas. Reg. § 1.721-1(b)(1) (1960) (emphasis added).

and a profits interest.[39] One who receives a capital interest in a partnership in exchange for services past, present or future is being compensated and realizes ordinary income per section 61(a). He would take a cost basis in the partnership interest equal to the amount he includes in gross income, and such compensation would be treated by the partnership as a guaranteed payment under section 707(c).[40] However, the parenthetical language "as distinguished from a share in partnership profits" suggests by negative implication that one who contributes services for a *profits* interest *will* qualify for nonrecognition treatment. This interpretation is justifiable on practical considerations:

> First, the valuation of a profits interest would be a particularly difficult task, similar in many respects to valuation problems which Congress, the courts, and the Service have carefully avoided in other contexts. Furthermore, if a service partner were taxed upon the receipt of a profits interest, he might be taxed again on the same profits as they are realized by the partnership and included in his distributive share. Of course, the income taxed to the service partner on the receipt of his profits interest would be includible in the basis of his interest, but there is no recognized procedure for amortizing this basis, or otherwise recovering it, prior to the dissolution of the partnership or the sale of the interest. Thus, the service partner might wait years to recover his basis.[41]

Taxpayers arguing this position, however, are only able to cite as primary authority the dictum found in a footnote in the 1965 Tax Court case of *Hale v. Commissioner:* "Under the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability."[42] *Hale* itself did not deal with the receipt of a partnership profits

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39. The distinction between an interest in profits and an interest in capital was given by the Advisory Group on Subchapter K: "An interest in the capital of a partnership can be distinguished from a profits interests in that the former conveys a right to receive a specific share of the partnership property in a distribution of property upon liquidation of the partnership operation." *Hearing on Advisory Group Recommendations on Subchapters C, J and K of the Internal Revenue Code Before the House Comm. on Ways and Means,* 86th Cong., 1st Sess. 54, 141 (1959).

40. I.R.C. § 707(c) provides:

> GUARANTEED PAYMENTS—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

I.R.C. § 707(c) (1982). Where a partner contributes capital or basic services, he may not be satisfied with a mere share of partnership profits or losses but may want a fixed payment. Under this provision, he would include the amount of that payment under § 61(a) and the partnership would deduct it per § 162(a).

41. W. MCKEE, W. NELSON, & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 5.05[2], at 5-24 (1977).

42. 24 T.C.M. 1497, 1502 n.3 (1965) (citing Treas. Reg. § 1.721-1(b)(1)). They should also, however, give serious thought to citing the U.S. Solicitor General's statement in his opposition to the petition for certiorari filed in the Supreme Court in United States v. Frazell, 339

interest but rather with its sale, which was deemed to result in ordinary income to the taxpayer because the consideration received was merely in anticipation of future ordinary income.[43] Nevertheless, scholars for years have assumed that a partnership profits interest can be acquired for services without tax consequences.[44] The service partner was thought to recognize income only as his distributive share of partnership profits was earned by the partnership. Two cases have cast some doubt upon this proposition, however.

2. *United States v. Frazell.* In this first case, *United States v. Frazell*,[45] the taxpayer, a geologist, contracted in 1951 to contribute exploration services and maps to an oil company partnership and another investor in return for a monthly salary, expenses, and stated interests in oil and gas properties after the properties had been developed and after the partnership and individual investors had recouped their costs and expenses. Prior to recoupment, the original contract was terminated and the parties transferred their interests to a new corporation. Frazell in 1955 was issued about 13% of the stock of this corporation, worth $91,000.[46]

Frazell contended that the stock was either received in a tax free exchange to a controlled corporation per section 351 or, in the alternative, received tax free in accordance with the pool of capital doctrine. The Fifth Circuit rejected both contentions, citing section 1.721-1(b)(1) of the Treasury Regulations, which provides that "the value of an interest in such partnership capital . . . transferred to a partner as compensation for services constitutes income to the partner under Section 61."[47] The court's rationale was that Frazell had in substance received a 13% partnership interest in return for his services, which interest either became possessory immediately upon termination of the original contract in 1955 or else the stock was issued to him for the partnership interest "originally contemplated."[48] Either interpretation results in ordinary income to the taxpayer.

We must therefore question whether *Frazell* refutes the proposition that a profits interest can be transferred tax free. The authorities have split, but perhaps Kirgis and Wilson have the true moral of this story:

> [T]here is a difference in opinion as to what rights Frazell actually had. Some have determined that Frazell's interest was a profits interest. Others would say that you must distinguish between a present transfer of an interest in property subject to certain restrictions and a future transfer of an interest in property upon

F.2d 885 (5th Cir. 1964). In arguing that the taxpayer did not receive income in a certain year, the Solicitor General, representing the I.R.S., advocated that the receipt of an interest in partnership profits is not taxable. *See infra* note 50.

43. 24 T.C.M. at 1503.

44. *See, e.g.*, 1 A. WILLIS, J. PENNELL, & P. POSTLEWAITE, PARTNERSHIP TAXATION § 27.02 (3d ed. Supp. 1986).

45. 335 F.2d 487 (5th Cir. 1964).

46. *Id.* at 488-89.

47. *Id.* at 489 (citing Treas. Reg. § 1.721-1(b)(1)).

48. *Id.* at 490.

> fulfillment of certain conditions. . . . [A]nd while *Frazell* probably reached the right result, the decision necessarily leaves tax advisors in a quandry. Careful draftsmanship will be necessary to insure that the interest intended to be transferred is actually transferred in the view of the Service and the courts. Only this can circumvent the potential ability to recast the transfer in a light less favorable to the taxpayer.[49]

It would seem that Frazell's interest did not become possessory until 1955, at which time it suddenly attained an ascertainable value. If the partnership had become a formal partnership in 1951 with Frazell acquiring his (profits?) interest at that point, it is possible that a different result would have been reached.[50] But perhaps an even greater obstacle to the tax-free receipt of a partnership profits interest for services is represented by Sol Diamond's clumsy attempt to convert ordinary income into capital gain on a routine real estate transaction.

3. Diamond v. Commissioner. In this case,[51] Diamond was a mortgage broker who agreed to obtain a mortgage loan for the full price of a building to be purchased by Kargman. In exchange for his services he was to receive a 60% share of the profit or loss derived from the ownership or sale of

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49. Kirgis & Wilson, *Tax Aspects of Co-Ownership Interest in Oil and Gas Property Received for Services: Terminal (?) Condition of G.C.M. 22730, Part 2,* 25 OIL & GAS TAX Q. 441, 447 (1977).

50. *See* Burke, *How Should An Economic Interest Acquired for Services be Treated After Rev. Rul. 83-46?* 58 J. TAX'N 352, 353 (1983). Frazell petitioned unsuccessfully to the Supreme Court for certiorari. In a footnote in his opposing brief, the Solicitor General expanded on the meaning of Treas. Reg. § 1.721-1(b)(1) in its application to Frazell:

> Moreover, even if the taxpayer had only a net profits interest, that would still not shield him from taxation on the transfer of that interest to the W.W.F. corporation in exchange for its stock. *The most it would mean is that Frazell would not have been taxed on the net profits interest at the time he "received" it* (November 1955, the end of the payout period), *but only as the partnership profits were actually earned over a period of time.* But while the receipt of a bare right to future income (*i.e.*, the net profits interest) may not be a taxable event, the present realization of that income through an anticipatory sale of the right plainly is such an event. Accordingly, the value of the W.W.F. stock is no less taxable when received by the taxpayer in exchange for a net profits interest in the partnership than it would be when received in exchange for an executory interest in the partnership capital, as discussed above.

Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case,* 27 TAX L. REV. 161, 184 (1972) (quoting Brief for the United States in Opposition at 10 n.3, United States v. Frazell, 335 F.2d 487 (5th Cir. 1964) (No. 20758) (emphasis added)). Cowan remarks as follows:

> If Frazell had had a profits interest as he claimed and if it were taxable when he received it, the government could have lost the case, because the taxable event would have occurred several years prior to the one before the court and at a time when Frazell's interest had little or no value in excess of what he paid for it. By arguing that a profits interest was not taxable when received, the Solicitor General was attempting to convince the Supreme Court that Frazell's claim to a profits interest was irrelevant to the proper disposition of the case.
>
> Thus, the Solicitor General, representing the Internal Revenue Service before the Supreme Court, adopted the consensus viewpoint.

Id. at 184-85.

51. Diamond v. Comm'r, 56 T.C. 530 (1971), *aff'd,* 492 F.2d 286 (7th Cir. 1974).

the building. Diamond arranged for the financing and shortly afterward sold his interest to Kargman for $40,000, which he reported as a short term capital gain. This gain was offset by unrelated short term capital loss, and hence Diamond ostensibly had no tax consequences on the sale. The Tax Court, however, rejected his claim that the parenthetical language of section 1.721-1(b)(1) made this a non-taxable event and found that the interest on date of sale had a market value of $40,000. Stating that the parenthetical language was not explicit enough ("opaque") to give operation to the section 721 nonrecognition provision, the court also asserted, "[W]hat is plain is that the regulations do not call for the applicability of section 721 where a taxpayer has performed services for someone who has compensated him therefor by giving him an interest in a partnership that came into being on a later date."[52]

The Seventh Circuit affirmed.[53] Although noting "a startling degree of unanimity" among the commentators that a partnership profits interest in return for services was not taxable at the time of conferral and expressing concern that

> [s]urely in many if not the typical situations it (a profits interest) will have only speculative value, if any.[54]
>
> . . . .
>
> But in the absence of regulation, we think it sound policy to defer to the expertise of the Commissioner and the Judges of the Tax Court, and to sustain their decision that the receipt of a profit-share with determinable market value is income.[55]

Diamond has been roundly criticized,[56] but the lawyer seriously considering the partnership vehicle for purely service providers to oil and gas prospects must take care to distinguish his clients' situations from that

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52. *Id.* at 546.
53. Diamond v. Comm'r, 492 F.2d 286 (7th Cir. 1974).
54. *Id.* at 290.
55. *Id.* at 291.
56. Probably no commentator had any greater contact with the case than Martin B. Cowan, who, while associated with the New York City firm of Wien, Lane & Malkin, personally observed the metamorphosis of *Diamond,* as it proceeded through the courts and who discussed the case with the lawyers involved:

> Unfortunately, the Seventh Circuit rationale is as difficult to justify as the Tax Court's. None of the parties had pointed out to the Tax Court in their briefs the position of the Solicitor General in *Frazell,* the prior statement of the Tax Court in its own *Hale* decision, the apparent conflict in result between *Hale* and *Diamond,* or the unanimity of opinion among the commentators (including some who were known to have participated in drafting the regulation). However, the Seventh Circuit did have this information before it when it rendered its decision, and one hardly can accept at face value the Seventh Circuit's assertion that the Government had *never* taken a contrary position. The statement of the Solicitor General in a brief filed with the United States Supreme Court on behalf of the Internal Revenue Service by itself stands witness to the contrary.
>
> Moreover, it was apparent to those familiar with the internal workings of the agencies involved that the IRS did not arrive at its position in the *Diamond* case through any pre-planned review of policy. The main thrust of the

case. Hopefully, the *Diamond* result will obtain only in situations where, as in the case itself, services are performed *prior* to the formation of the partnership and before the profits interest has a clearly ascertainable market value[57]—as Diamond's was when he actually sold it. Regrettably, the Treasury Department has not yet deigned to promulgate new regulations under section 721 which would clarify the situation.

C. A Prescription

Based upon the present state of the law, it would seem that the current taxation of overriding royalty interests received in return for services invested in oil and gas prospects could be avoided by forming partnerships including the service provider if the following constraints are observed.

First, partnerships thus formed should be created by written instruments which clearly detail the subjects of capital accounts, liquidation rights, and allocations of income and deduction. The partnership entity should have its own accounting books. Rigorous adherence to these formalities will amplify the parties' intent to be a partnership for tax and all other purposes.

Second, the partnership interest conveyed to a service provider should be a profits interest only, as the rules are explicit that the transfer of a capital interest will yield recognition of income.[58]

Third, the partnership should be formed *before* completing surveys, negotiating leases, or acquiring oil and gas properties. By doing so, the taxpayer should be able to discourage I.R.S. assertions that the partnership is merely a device designed only to thwart Revenue Ruling 83-46.

Fourth, the service partner's services should be performed *subsequent* to the creation of the partnership, but his profits interest should be conveyed to him *before* acquiring property because, at that time, the profits interest should have an unascertainable value. Also, if the profits interest is received after performance of services, it arguably takes on the appearance of compensation. Moreover, the service provider should be cognizant that an attempt to quickly alienate his interest could suddenly result in that interest attaining an ascertainable market value—especially if he actually sells it as did Sol Diamond.

> IRS in the Tax Court was that the arrangement in *Diamond* was not a bona fide partnership, but an association, trust, or other relationship. The attorney who made the argument in the Tax Court appeared to have thrown the profits interest point into his brief as an afterthought, in the heat of battle and without a thorough job of research. . . . And during the pendency of the appeal in *Diamond*, this writer personally discussed the issue with the various Treasury Department representatives, . . . who denied that the issue had ever been specifically considered by the Treasury Department.

Cowan, *G.C.M. 22730 and Subchapter K: What Choice for the Driller?* 26TH INST. ON OIL & GAS L. & TAX'N 353, 380-81 (1975) (emphasis in original) (footnote omitted).

57. *See* Burke, *supra* note 50, at 354.

58. Treas. Reg. § 1.721-1(b)(1) (1983).

Lastly, it would seem that the service provider's services should be of a continuous rather than fleeting sort in order to indicate his continuing interest in the partnership. Indeed, by requiring him to provide continuing services, the profits interest could become subject to a substantial risk of forfeiture, thus deferring the tax under section 83 in any event.[59]

IV. CONCLUSION

It is dubious whether machinations such as those described above can work a satisfactory alternative to the time-tested and -proven pool of capital doctrine. Nevertheless, this article has attempted to suggest that it is possible to thread the needle between *Frazell* and *Diamond* to achieve nonrecognition treatment on the assignment of a partnership profits interest. The oil and gas lawyer might consider this alternative in an appropriate case.

Happily, the Internal Revenue Service has not yet indicated an intent to challenge the pool of capital doctrine as it relates to contributions of cash and equipment to exploration and development in exchange for economic interests. Moreover, a partnership capital or profits interest conveyed in exchange for cash or equipment would, under section 721, receive nonrecognition treatment as well. Where possible, service contributors should consider escalating their contributions to include cash or equipment.

59. *See* I.R.C. § 83(c)(1) (1982); *cf.* Arrache, *supra* note 8, at 897: "[I]n abundance of caution, one might structure the partnership interest of the service contributor to contain restrictions which provide for 'substantial risks of forfeiture' and against transfer in accordance with the guidelines of section 83 and the Treasury Regulations."