

# Tulsa Law Review

---

Volume 5 | Number 3

---

1968

## Capital Gains Assignment of Production Payments

J. S. Keil

Follow this and additional works at: <https://digitalcommons.law.utulsa.edu/tlr>



Part of the [Law Commons](#)

---

### Recommended Citation

J. S. Keil, *Capital Gains Assignment of Production Payments*, 5 Tulsa L. J. 321 (1968).

Available at: <https://digitalcommons.law.utulsa.edu/tlr/vol5/iss3/7>

This Casenote/Comment is brought to you for free and open access by TU Law Digital Commons. It has been accepted for inclusion in Tulsa Law Review by an authorized editor of TU Law Digital Commons. For more information, please contact [megan-donald@utulsa.edu](mailto:megan-donald@utulsa.edu).

## INCOME TAX — CAPITAL GAINS ASSIGNMENT OF PRODUCTION PAYMENTS

### ORDINARY INCOME AND CAPITAL ASSET CONCEPTS APPLICABLE TO ASSIGNMENTS OF MINERAL INTERESTS

The income tax law provides preferential tax treatment to gains realized from the sale or exchange of capital assets.<sup>1</sup> Although the present provisions constitute just one of the many methods employed by the government in taxing such gains, some concession or preference in tax has been accorded capital gains since the Revenue Act of 1921.<sup>2</sup> It has been made quite clear, however, that in affording taxpayers preferential capital gains treatment the courts will narrowly construe the extent to which such provisions may be applied.<sup>3</sup>

Many of the present controversies which arise between the Internal Revenue Service and taxpayers claiming capital gain treatment are in part due to the fact that the 1954 Code defines "capital asset" in the negative, that is by stating that it consists of all property which does not fall within specified categories.<sup>4</sup> The Supreme Court, in refusing to provide relief to this dilemma, has stated that there is no implication in the federal revenue law that state law should govern whether a particular property interest represents a capital asset.<sup>5</sup> There has been, however, some clarification provided by the courts with regard to transactions involving mineral rights.

<sup>1</sup> INT. REV. CODE of 1954, § 1201.

<sup>2</sup> 1921 REV. ACT, § 206. *See generally*, 3B MERTENS L. FED. INC. TAX. § 22.01 (1966).

<sup>3</sup> *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955).

<sup>4</sup> *See* INT. REV. CODE of 1954, § 1221.

<sup>5</sup> *Burnet v. Harmel*, 287 U.S. 104 (1932).

An owner of the fee interest in land who grants to another the underlying minerals is normally held to have received ordinary income to the extent of the cash received so long as the grantor retains a royalty interest<sup>6</sup> and the grantee contractually agrees to develop the minerals.<sup>7</sup> Where the grantee undertakes no obligation to develop the property there is authority that the grantor may treat the transaction as a sale of a capital asset.<sup>8</sup> A subsequent bona fide conveyance of all or an undivided interest in the royalty interest retained by the grantor constitutes a sale giving rise to a capital gain or loss.<sup>9</sup>

If a production payment<sup>10</sup> is retained upon a conveyance of the mineral rights by an owner of developed property, the conveyance of the mineral right represents a sale of a capital asset so long as it can be shown that there are sufficient mineral reserves available to satisfy the production payment prior to exhaustion of such minerals.<sup>11</sup> Where it is obvious from the facts known at the time of the conveyance that the retained production payment will not pay out and that payments will continue over the productive life of the property, the interest retained is considered an economic interest

<sup>6</sup> A royalty interest is a right to receive a specified percentage of all oil and gas produced and lasts during the entire term of the lease. *Anderson v. Helvering*, 310 U.S. 404, 410 (1940).

<sup>7</sup> *Burnet v. Harmel*, 287 U.S. 103 (1932); *West v. Commissioner*, 150 F.2d 723 (5th Cir. 1945); *Berg v. Commissioner*, 33 F.2d 641 (D.C. Cir. 1929).

<sup>8</sup> *United States v. White*, 311 F.2d 399 (10th Cir. 1962).

<sup>9</sup> *R. R. Ratliff*, 36 B.T.A. 762 (1937); G.C.M. 12118, XII-2 CUM. BULL. 119 (1933).

<sup>10</sup> A production payment is the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced. *Anderson v. Helvering*, 310 U.S. 404, 410 (1940).

<sup>11</sup> *Hammonds v. Commissioner*, 106 F.2d 420 (10th Cir. 1939); *Commissioner v. Fleming*, 82 F.2d 324 (5th Cir. 1936); G.C.M. 22730, 1941-1 CUM. BULL. 214.

in the property and ordinary income has been realized to the extent of cash consideration received for such conveyance.<sup>12</sup> A taxpayer who assigns a production payment carved from any type of depletable interest has realized ordinary income to the extent of the consideration received for such assignment.<sup>13</sup>

The position taken by the Internal Revenue Service,<sup>14</sup> and upheld by the courts,<sup>15</sup> with regard to assignments of mineral rights therefore appears to have provided a rule which turns on the question of whether the assignor has retained in the property assigned an economic interest continuing over the life of the property. If no economic interest has been retained, the assignment is properly classified as a sale. If the taxpayer has retained an economic interest, the consideration received for the assignment results in the immediate recognition of ordinary income.

*Wiseman v. Barby*<sup>16</sup>

During 1947 Barby, who owned certain land in fee, granted a mineral lease for a term of ten years. During 1956, while the minerals were still undeveloped, a new lease superseding the 1947 lease, was granted to the same lessee. In consideration for the 1956 grant, Barby received cash as well as retaining a one-eighth royalty interest and a \$300,000 production payment. Subsequently a fifty percent interest in the production payment was sold to a third party with

<sup>12</sup> *United States v. Morgan*, 321 F.2d 781 (5th Cir. 1963).

<sup>13</sup> *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958).

<sup>14</sup> G.C.M. 24849, 1946-1 CUM. BULL. 66; G.C.M. 27322, 1952-2 CUM. BULL. 62; Rev. Rul. 63-120, 1963-1 CUM. BULL. 141.

<sup>15</sup> *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946); *United States v. Morgan*, 321 F.2d 781 (5th Cir. 1963); *McLean v. Commissioner*, 120 F.2d 942 (5th Cir. 1941); *Cullen v. Commissioner*, 118 F.2d 651 (5th Cir. 1941).

<sup>16</sup> *Wiseman v. Barby*, 380 F.2d 121 (10th Cir. 1967), *rev'd per curiam*, 390 U.S. 339 (1968).

the remaining one-half interest being sold to another party in the following taxable year.

The consideration received from the sales of each of the interests in the production payment was reported as proceeds from the sale of a capital asset by the taxpayer in each of the taxable years in which the sales occurred. The commissioner sought to treat the proceeds from these sales as ordinary income, asserting that it was not a conveyance of a capital asset but rather an assignment of the right to receive future ordinary income.

The Court of Appeals for the Tenth Circuit held that, although both the royalty interest and the production payment had been retained from the entire interest in the oil and gas in place prior to the granting of the lease, the production payment was wholly separate and distinct from the royalty interest, neither being dependent upon, carved out of, or affected by the other.<sup>17</sup> Therefore the sale of each undivided half of the production payment constituted a complete disposition of the property interest therein and was a sale of the capital asset.

In order to determine that the interest conveyed constituted a capital asset, the court not only had to find that a production payment is capable of representing a property interest but also that such an interest may be separate and distinct from a longer lived interest retained as a part of the same transaction as that which created the production payment. While there is general acceptance of the fact that a production payment may represent a property interest,<sup>18</sup> the determination of the second conclusion was more difficult and certainly more critical to the final holding. To have held that the production payment was not a property interest distinct from the royalty also retained would have apparently lead

<sup>17</sup> *Id.* at 123.

<sup>18</sup> *Tennant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53 (1937); *see, e.g., Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 264 (1958).

to the conclusion that the production payment was in actuality carved out of the single interest retained.

In reversing the judgment of the Tenth Circuit, the Supreme Court held that the transaction resulted in the assignment of income rather than the sale of a separate and distinct capital asset.<sup>19</sup> This decision was reached by applying the holding in *Commissioner v. P. G. Lake, Inc.*<sup>20</sup> that ordinary income results from the carving out of a depletable interest from a longer lived asset.<sup>21</sup> The holding in the instant case appears to have established the rule that, although a taxpayer purports to retain multiple interests, in reality only a single property interest may be reserved and retained as a result of a transaction in which a portion of a previously held property interest is conveyed.

J. S. Keil

<sup>19</sup> *Wiseman v. Barby*, 390 U.S. 339 (1968).

<sup>20</sup> 356 U.S. 260 (1958).

<sup>21</sup> The holding in the *Barby* case upheld an earlier determination by the Fifth Circuit that the transfer of a production payment right resulted in assignment of income. *United States v. Foster*, 324 F.2d 702 (5th Cir. 1963); *Floyd v. Commissioner*, 309 F.2d 95 (5th Cir. 1962).