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A CAPSULE VIEW OF THE HISTORY AND IMPORTANCE OF THE ECONOMIC INTEREST CONCEPT IN MINERAL TAXATION*

Martin J. McMahon, Jr.†

I. THE IMPORTANCE OF THE ECONOMIC INTEREST CONCEPT

The "economic interest" concept is the linchpin of the system of special rules and principles governing federal income taxation of natural resources. Understanding the "economic interest" concept is crucial to understanding mineral taxation for several reasons. First, the right to claim the depletion allowance under section 611 of the Internal Revenue Code[1] (the Code) depends on the taxpayer's possession of an economic interest with respect to the mineral property in question.[2] This aspect of the economic interest doctrine is most significant when a taxpayer receives income from a mineral deposit in which the taxpayer has no basis. Even though cost depletion is unavailable because the taxpayer has no

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1. I.R.C. § 611 (1988).

2. Treas. Reg. § 1.611-1(b)(1) (as amended in 1973). For a general discussion of the depletion allowance, see BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶¶ 13.1-.3 (1988) and Martin J. McMahon, Jr., *Fundamentals of Federal Income Taxation of Natural Resources*, 3 J. MIN. L. & POL'Y 225, 233-46 (1988) [hereinafter McMahon, *Fundamentals*].

basis, percentage depletion remains available.[3] Allowance of percentage depletion after basis has been exhausted, or even if the taxpayer never has any basis in the deposit, is due to the dual nature of the depletion allowance, which is in part a cost recovery mechanism and in part an incentive for the development and extraction of mineral deposits.[4]

Second, a corollary of the right of a holder of an economic interest to claim depletion is that royalty payments to other holders of an economic interest in the same property are excluded or deducted in computing taxable income[5] and must be excluded from "gross income from the property" in computing the payor's percentage depletion allowance.[6]

Third, the economic interest concept is critical in determining whether a transfer of an interest in a mineral property is a sale or exchange versus a lease.[7] Characterization of the conveyance under local law is irrelevant.[8] If the transferor has retained an economic interest while conveying an economic interest to the transferee, the transaction is treated as a lease. Both the transferor and the transferee will realize ordinary income from extraction of minerals and be entitled to a depletion allowance.[9] If the transferor has not retained an economic interest, the conveyance will be taxed as a sale.[10] Gain or loss will be characterized with reference to the purpose for which the taxpayer holds the property and installment sale treatment may be available.[11]

Finally, holding an economic interest is a prerequisite for claiming other important deductions, namely oil and gas intangible drilling and development costs (IDC) under section 263(c) of the Code,[12] solid mineral exploration expense deductions under section 617 of the Code,[13] and solid mineral development expense deductions under section 616 of the Code.[14] But to claim these deductions the taxpayer must have more than

3. Treas. Reg. § 1.611-2(b)(2) (as amended in 1972).

4. *See generally* Martin J. McMahon, Jr., *The Coal Depletion Allowance Deduction*, 85 W. VA. L. REV. 581, 584-85 (1983).

5. *See, e.g.*, Thomas v. Perkins, 301 U.S. 655 (1937).

6. I.R.C. § 613(a) (West Supp. 1991).

7. *See, e.g.*, O'Connor v. Commissioner, 78 T.C. 1 (1982).

8. *See* Burnet v. Harmel, 287 U.S. 103 (1932).

9. The transferor and transferee will be entitled to a depletion allowance except to the extent that § 631(c) of the Code prescribes § 1231 treatment for the lessor of a coal or iron ore deposit. *See generally* McMahon, *Fundamentals*, *supra* note 2, at 352-63.

10. *See, e.g.*, *O'Connor*, 78 T.C. 1.

11. *See* Rev. Rul. 73-428, 1973-2 C.B. 303; Rev. Rul. 68-226, 1968-1 C.B. 362.

12. I.R.C. § 263(c) (West Supp. 1991).

13. *Id.* § 617 (West Supp. 1991).

14. *Id.* § 616 (West Supp. 1991).

a mere economic interest; the interest must be a "working" or "operating" interest.[15]

II. DEFINING ECONOMIC INTEREST

A. *Judicial Origin and Regulatory Adoption*

The Internal Revenue Code does little to help identify who is entitled to the depletion allowance. Section 611(b)(1) of the Code provides that depletion should be equitably apportioned between the lessor and lessee; section 611(b)(2) provides that a life tenant is entitled to the entire allowance, to the exclusion of remaindermen; and section 611(b)(3) and (4) provide for apportionment of the allowance among trust and estate beneficiaries. But no guidance is provided with respect to the various interests into which mineral properties uniquely can be divided. Determination of the various interests entitled to depletion has been left to the courts and the Internal Revenue Service.

Originally the Internal Revenue Service and the courts limited the depletion allowance to taxpayers with a legal interest in the mineral deposit. Thus, even before the economic interest concept was coined or the Internal Revenue Code expressly provided for apportionment of the depletion allowance between lessors and lessees, the Supreme Court held that a lessee of a mineral deposit was entitled to claim the depletion allowance.[16]

1. *Palmer v. Bender*

The Supreme Court devised the "economic interest" concept in *Palmer v. Bender*[17] in the course of resolving whether the assignor of an oil and gas lease who had retained an overriding royalty realized gain from the sale of property or ordinary income subject to depletion. Holding that the overriding royalty payments were ordinary income subject to depletion, the Court found it immaterial whether the conveyance was an assignment of a lease or a sublease. The formal attributes and characterization under local law of the interest obtained by the taxpayer did not

15. *See* Treas. Reg. § 1.612-4(a) (1965); Rev. Rul. 77-308, 1977-2 C.B. 208. Some cases dealing with IDC deductibility, such as Marathon Oil Co. v. Commissioner, 838 F.2d 1114 (10th Cir. 1987), have confused the two concepts.

16. Lynch v. Alworth-Stevens Co., 267 U.S. 364 (1925).

17. 287 U.S. 551 (1933).

control.[18] Instead, the Court formulated the now classic test for determining whether a taxpayer's interest in a mineral deposit gives rise to ordinary income and entitles the taxpayer to the depletion allowance:

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. . . . In the present case the two partnerships acquired, by the leases to them, complete legal control to the oil in place. Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute.[19]

2. Treasury Regulations

Together with some gloss from two subsequent Supreme Court cases,[20] the *Palmer v. Bender* definition of an economic interest is incorporated in Treasury Regulation, section 1.611-1(b)(1), 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. . . . A person who has no capital investment in the mineral deposit . . . does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction . . . does not convey a depletable economic interest.[21]

B. *Supreme Court Analysis of the Economic Interest Concept*

The definition of "economic interest" provided by Treasury Regulation, section 1.611-1(b)(1), does not begin to capture the wealth of complexity in the development of the economic interest concept. Twelve more Supreme Court decisions, handed down over the next fifty years, along with a plethora of lower court decisions, flesh out the parameters

18. *Id.* at 557-58.
19. *Id.*
20. *See infra* parts II.B.3, II.B.10.
21. Treas. Reg. § 1.611-1(b)(1) (as amended in 1973).

of the concept.[22]

1. *Helvering v. Twin Bell Oil Syndicate*

The year after *Palmer v. Bender*[23] was decided, the Supreme Court had an opportunity to apply the economic interest concept in *Helvering v. Twin Bell Oil Syndicate*.[24] Twin Bell Oil Syndicate, the assignee of an oil and gas lease, was required to pay the assignor cash royalties. The issue was whether the lessee's gross income from the property for purposes of computing percentage depletion had to be reduced by the cash royalties paid to the assignor of the lease.[25] Even though no provision of the Code then expressly required that the lessee exclude royalties paid to the lessor from gross income from property, the Supreme Court held that such an exclusion was required when computing percentage depletion.[26] The Court reasoned that "[s]uch an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowance."[27] Thus, the economic interest concept prevents percentage depletion from being claimed by multiple persons having interests in the deposit with respect to aggregate income in excess of total production from the property.

2. *Thomas v. Perkins*

Three years later in *Thomas v. Perkins*,[28] the Supreme Court held that a retained production payment was an economic interest.[29] Perkins had acquired an oil and gas lease for $155,000 from a transferor who retained a production payment of $395,000 to be paid out of one-fourth of production. The issue was whether Perkins was required to include in gross income the amount paid to the assignor-production payment holder by the purchasers of oil from Perkins. Citing *Palmer* and *Twin Bell Oil Syndicate*, the Court held that Perkins was not required to include the amounts paid to the assignor because the assignor was entitled to depletion on the amounts received as its share of production.[30]

22. For a thorough discussion of the myriad of early cases, see Joseph T. Sneed, *The Economic Interest—An Expanding Concept*, 35 TEX. L. REV. 307 (1957).
23. *See supra* part II.A.1.
24. 293 U.S. 312 (1934).
25. *Id.* at 315.
26. *Id.* at 321. This rule now is expressly provided in I.R.C. § 613(a).
27. *Id.*
28. 301 U.S. 655 (1937).
29. *Id.* at 663.
30. *Id.*

Although the statement of the facts indicates that the provision for payment only in kind and the absence of an obligation to pay the assignor cash were important, the Court found that it was irrelevant whether a royalty was paid in cash or in kind, thus reaffirming the holding in *Twin Bell Oil Syndicate*.[31] The crucial factor in *Perkins* was the assignor's failure to obtain a lien for payment of the $395,000, indicating that payment was to be made only from oil produced.

3. *Helvering v. Bankline Oil Co.*

In 1938 the Supreme Court handed down three decisions limiting the scope of the economic interest concept. In the first case, *Helvering v. Bankline Oil Co.*,[32] the taxpayer operated a casinghead gasoline plant. Pursuant to contracts with the producer of natural gas, Bankline Oil Company installed pipelines to transport wet gas from the wellhead to its plant where it extracted casinghead gasoline from wet gas, paying the producer thirty three and one-third percent of the proceeds of the sale of the gasoline so extracted; the dry gas was disposed of in a variety of ways. The taxpayer claimed percentage depletion on the amount by which the fair market value of the wet gas at the wellhead exceeded the price it paid the producer for the gas. The Internal Revenue Service disallowed the claimed depletion, and the Supreme Court agreed. Finding that Bankline Oil Company had a "mere economic advantage derived from production, through a contractual relation to the owner," not a "capital investment in the mineral deposit,"[33] the Court concluded that Bankline Oil Company had not acquired an economic interest. Accordingly, the Court disallowed the claimed depletion allowance.[34] The Court's reasoning emphasized that, apart from the contracts, the taxpayer was granted no interest in the mineral in place; under the contracts the taxpayer was merely a processor entitled to delivery at the wellhead, with no control over production.[35]

4. *Helvering v. O'Donnell*

On the same day *Bankline Oil Co.* was decided, the Court handed

31. Subsequently, in Anderson v. Helvering, 310 U.S. 404 (1940), the Supreme Court reaffirmed that a production payment could qualify as an economic interest even though it was payable in cash, not in kind.
32. 303 U.S. 362 (1938).
33. *Id.* at 367.
34. *Id.* at 368.
35. The holding of *Bankline Oil Co.* now is expressly incorporated into Treas. Reg. § 1.611-1(b)(1) (as amended in 1973).

down *Helvering v. O'Donnell.*[36] In *O'Donnell*, the taxpayer owned one-third of the stock of San Gabriel Company, which owned oil and gas properties. He transferred that stock to Midway Petroleum Company in exchange for a promise of payments equal to one-third of Midway's net profits from subsequent operation of the San Gabriel properties. In denying the taxpayer a depletion allowance with respect to payments from Midway, the Court concluded that the agreement was "a personal covenant and did not purport to grant [the taxpayer] an interest in the properties themselves."[37] If Midway realized no net profits, there would be no payments. Prior to the exchange, the taxpayer did not have an investment or interest in the oil and gas properties as a result of his ownership of the shares of stock. As a result of the transaction, the taxpayer had merely obtained an "economic advantage" in exchange for his shares. He did not have an economic interest.[38] *O'Donnell* is no longer considered good law, having been overruled, *sub silentio*, by the subsequent Supreme Court decision in *Burton-Sutton Oil Co. v. Commissioner.*[39]

5. *Helvering v. Elbe Oil Land Development Co.*

In the third 1938 case, *Helvering v. Elbe Oil Land Development Co.*,[40] the Supreme Court held that sale treatment was to be accorded to the conveyance of oil and gas leases, prospecting permits, drilling agreements, and equipment in consideration of five specified installments of fixed cash amounts, plus one-third of the transferee's net profits from production and operation, after the transferee had recovered its expenditures for acquisition and development.[41] Accordingly, the stipulated fixed cash payments were found not to be a bonus, and the transferor-payee was denied percentage depletion on them.

6. *Anderson v. Helvering*

Two years later, the Supreme Court further restricted the economic interest concept in *Anderson v. Helvering.*[42] Anderson acquired oil and gas properties, including fee interests, from the Oklahoma Company in

36. 303 U.S. 370 (1938).
37. *Id.* at 372.
38. *Id.*
39. *See infra* part II.B.8.
40. 303 U.S. 372 (1938).
41. *Id.* at 375.
42. 310 U.S. 404 (1940).

consideration of a $50,000 bonus plus $110,000 payable from one-half of the proceeds of the oil and gas produced from the property or from a sale of the fee interest. Anderson excluded payments from production delivered to the Oklahoma Company from gross income on the theory that the transferor's production payment was an economic interest under *Thomas v. Perkins*.[43] The Commissioner argued that the Oklahoma Company did not have an economic interest because the production payment was payable in cash, not in kind. The Supreme Court rejected this argument, yet held that an economic interest had not been retained.[44] Thus, Anderson was required to include the full proceeds from the sale of production as income. *Thomas v. Perkins* was inapposite because the Oklahoma Company, Anderson's transferor, reserved an interest in the fee in addition to an interest in the minerals. Reservation of the additional security destroyed the economic interest because the transferor could be paid from a sale of the fee interest. Therefore, the Oklahoma Company could look to a source other than extraction of minerals for a return of its investment.[45] If the transferor was allowed depletion and was paid from proceeds of the sale of the fee, depletion ultimately would be allowed with respect to income in excess of the gross proceeds from extraction, contrary to the holding of *Twin Bell Oil Syndicate*.[46]

7. *Kirby Petroleum Co. v. Commissioner*

In 1946, the Supreme Court decided two important cases that effectively, although not expressly, overruled *O'Donnell*[47] and *Elbe Oil Land Development Co.*[48] *Kirby Petroleum Co. v. Commissioner*[49] dealt with a taxpayer who held the fee interest in oil and gas properties. He leased the properties for a bonus, a fractional royalty, and a net profits interest. The Commissioner conceded that bonus payments and royalty payments received by the taxpayer were depletable because the taxpayer had an economic interest, but argued that the net profits interest was a mere economic advantage as in *O'Donnell* and *Elbe Oil Land Development Co.* The Supreme Court held for the taxpayer, because the net profits payments "flow[ed] directly from the taxpayers' economic interest in the oil

43. *See supra* part II.B.2.
44. *Anderson*, 310 U.S. at 412-13.
45. *Id.*
46. *See supra* part II.B.1.
47. *See supra* part II.B.4.
48. *See supra* part II.B.5.
49. 326 U.S. 599 (1946).

and par[took] of the quality of rent rather than of a sale price."[50] The Court distinguished both *O'Donnell* and *Elbe Oil Land Development Co.* on the basis that *O'Donnell* involved a taxpayer who was a stranger to the lease receiving a net profits interest, and *Elbe Oil Land Development Co.* involved a net profits interest which was disassociated from an economic interest thus not entitling the holder to depletion. These distinctions made the result in *Kirby Petroleum Co.* appear to turn on the presence of a royalty interest in addition to the net profits interest.

8. *Burton-Sutton Oil Co. v. Commissioner*

In *Burton-Sutton Oil Co. v. Commissioner*,[51] decided less than four months later, the Supreme Court examined the treatment of interests created by a sublease where the sole consideration payable to the lessor was fifty percent of the sublessee's net profits from production. The taxpayer-sublessee had excluded from gross income the amounts paid to the sublessor on the theory that the sublessor had retained an economic interest. The Commissioner, however, treated the entire sales proceeds of production as income of the sublessee, arguing that a net profits interest was not an economic interest unless, as in *Kirby Petroleum Co.*, the holder of the interest also was entitled to a royalty.

The Supreme Court rejected the Commissioner's argument and held that a naked retained net profits interest retained by a lessor or a sublessor, was an economic interest, excludable by the holder of the burdened interest and depletable by the holder of the net profits interest. The Court stated:

> [T]he assignor of the petitioner before assignment had an economic interest in the oil in place through its control over extraction . . . . [T]he petitioner looked to the special depletion allowances . . . to return whatever capital investment it had. The cost of that investment to the beneficiary of the depletion . . . is unimportant. Depletion depends only upon production. It is the lessor's, lessee's or transferee's "possibility of profit" from the use of his rights over production, "dependent solely upon the extraction and sale of the oil," which marks an economic interest in the oil.[52]

The Court attempted to distinguish *Elbe Oil Land Development Co.*[53] as a case involving a transfer of all interest of the assignor in the properties

50. *Id.* at 607.
51. 328 U.S. 25 (1946).
52. *Id.* at 34-35 (citing Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 604 (1946)).
53. *See supra* part II.B.5.

by way of "absolute sale" and concluded that *Elbe Oil Land Development Co.* should not be extended.[54] Mr. Justice Frankfurter, in a separate opinion, noted that *Elbe Oil Land Development Co.* was indistinguishable. The eloquent language of his dissent captures the elusiveness of the economic interest concept:

> Nothing better illustrates the gossamer lines that have been drawn by this Court in tax cases than the distinction made in the Court's opinion between *Helvering v. Elbe Oil Land Co.* . . . and this case. To draw such distinctions, which hardly can be held in the mind longer than it takes to state them, does not achieve the attainable certainty that is such a desideratum in tax matters, nor does it make generally for respect of law.[55]

9. *Commissioner v. Southwest Exploration Co.*

Ten years passed before another significant Supreme Court case applying the economic interest concept was decided. *Commissioner v. Southwest Exploration Co.*[56] dealt with a carved-out net profits interest. Southwest Exploration Company held offshore leases in California. State law required either whipstock drilling or drilling from filled land and required evidence of ability to furnish a drilling site as a condition precedent to consideration of bids to lease oil properties from the state. There were no suitable filled lands from which to develop the deposit on which Southwest Exploration Company was bidding. However, the Huntington Beach Company owned ocean-front land, and in order to bid on leases, which it subsequently obtained, Southwest Exploration granted Huntington Beach Company twenty-four percent of its net profits from sale of the oil in exchange for rights to whipstock drill from Huntington Beach land. The agreement specified that Huntington Beach Company did not acquire any share in the lease or deposit by virtue of the net profits payment.

Despite the contract provision expressly limiting Huntington Beach Company's interest in the lease or lease deposit, the Supreme Court held that the contractual right to a share of the profits from the extracted oil carved out of its leasehold interest by Southwest Exploration Company and granted to Huntington Beach Company, constituted an economic

54. *Burton-Sutton Oil Co.*, 328 U.S. at 36-37.
55. *Id.* at 38 (citation omitted).
56. 350 U.S. 308 (1956).

interest held by Huntington Beach Company.[57] The Court acknowledged that this was the first case in which it found a claimant outside the chain of title to the fee or lease of the deposit to have economic interest. But the Court stated, the law deals with "economic realities, not legal abstractions."[58] Without the agreement of the upland owners, Southwest Exploration Company could not obtain a lease or drill. Huntington Beach Company made an "indispensable contribution" to the drilling in exchange for a net profits interest in the mineral deposit.[59] The proximity of Huntington Beach Company's land to the oil and gas deposit in conjunction with state law, made the upland owners "essential parties to any drilling operations."[60] Huntington Beach Company could have sold the land and realized the enhanced value resulting from its controlling position with respect to the deposit, but chose instead to exchange the land for a share of the operating profits. Contribution of the land for drilling was an "investment" in the deposit; Huntington Beach Company's income was dependent upon production, and the value of its interest decreased with each barrel of oil produced. In a final paragraph, the Court attempted to limit its decision to the particular facts, stating that its decision did not necessarily apply to other "instances of 'strangers disassociated from the lease' who may have contributed an essential facility to the drilling operation in return for a share of the net profits."[61] The lower courts and the Internal Revenue Service, however, have given *Southwest Exploration Co.* an expansive application.[62]

10. *Parsons v. Smith*

Most of the preceding cases focused on whether certain nonoperating interests were economic interests entitling the holder to depletion. In 1959, the Supreme Court first examined the economic interest concept in the context of operating interests. The issue in *Parsons v. Smith*[63] was whether contract miners who extracted minerals for the lessee in consideration of a specified dollar amount per ton had obtained an economic interest under the contract mining agreement. Parsons was a road building contractor who agreed, under an oral contract, to strip mine coal owned by Rockhill Coal Company in consideration of a fixed dollar

57. *Id.* at 316.
58. *Id.* at 315.
59. *Id.* at 317.
60. *Id.* at 316.
61. *Id.* at 316-17.
62. *See infra* text accompanying notes 92-95, 116-117.
63. 359 U.S. 215 (1959).

amount per ton, subject to adjustment for cost increases.[64] Parsons provided, at his expense, all equipment and labor to remove overburden and extract the coal. All of the extracted coal was delivered to Rockhill for sale by Rockhill; Parsons was not entitled to keep any of the coal, and his right to payment was not conditioned on Rockhill's sale of the coal. Either party was entitled to terminate the arrangement on ten days' notice, subject to Parson's right to complete extraction of any coal with respect to which he had removed the overburden. Parsons invested substantial amounts in movable equipment and operated under the agreement for eight years. When he quit, large amounts of strippable coal remained.

The Court characterized the rights of the contract miners as a "mere economic advantage," not an economic interest.[65] The contract miners simply provided the use of equipment and services in exchange for a fee paid by the mineral owners. Nothing indicated that the contract miners made any investment in the mineral deposit or that the mineral owners had transferred any interest to the miners. The miners's claim that the contract right constituted an investment in the mineral deposit was dismissed as a legal fiction. The Court summarized its reasoning as follows:

> To recapitulate, the asserted fiction is opposed to the facts (1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was . . . agreed to be in "full compensation for the full performance of all work and for the furnishings of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts. The agreement of the landowners to pay a fixed sum per ton for mining and delivering the

64. A companion case involved a written contract terminable on thirty day's notice. The contract miner in that case operated under the agreement until most of the strippable coal had been extracted. *Id.* at 218-19.

65. *Id.* at 224.

coal "was a personal covenant and did not purport to grant [petitioners] an interest in the [coal in place]."[66]

Nothing in the Court's opinion provided any significant clues regarding the relative importance of the seven factors.

11. *Paragon Jewel Coal Co. v. Commissioner*

Six years later, the Supreme Court reaffirmed the result and clarified the scope and reasoning of *Parsons. Paragon Jewel Coal Co. v. Commissioner*[67] dealt with whether contract miners who were engaged in underground mining (drift mining) had an economic interest in the deposit. Paragon, the lessee of coal properties, entered into oral contracts with various firms under which contract miners mined coal on Paragon's property at the miner's expense. All of the contracts were for an indefinite period and did not refer to termination. Paragon was to pay the miners a fixed fee for each ton of coal delivered. The fee would be varied to reflect the market price of coal; any changes in the fee were prospective only. The contract miners did not specifically share in the proceeds of the coal delivered and sold at the market price. Because the coal was extracted by drift mining, the contract miners expended substantial time and money for mine development in driving tunnels.

The Tax Court found that the contracts were terminable at will, and that all seven *Parsons* factors were present. Thus, the court denied the contract miners an economic interest. The court of appeals reversed, finding that under state law the contract miners had an implied right to mine to exhaustion.[68] The Supreme Court reversed again, agreeing with the Tax Court that the contracts were terminable at will and that *Parsons* controlled.[69] The Court held that the contract miners did not have an economic interest. In explaining its reasoning, the Court shed additional light on the *Parsons* factors. Although the Court found the contracts terminable at will, it went on to state that "[i]n any event the right to mine to exhaustion, without more, does not constitute an economic interest."[70] The determinative factor in *Paragon* was that the fee received by contract miners was not directly related to the sales price of the coal that they mined. The owner was free to sell at any price and retain entire proceeds in excess of the agreed upon fee, indicating that the contract

66. *Id.* at 225 (citing Helvering v. O'Donnell, 303 U.S. 370, 372 (1938)).
67. 380 U.S. 624 (1965).
68. *Id.* at 633-34.
69. *Id.* at 634.
70. *Id.*

miners had no interest in the coal in place and did not look to extraction and sale of the mineral for a return of any investment. The Court stated that:

> Paragon was bound to pay the posted fee regardless of the condition of the market at the time of the particular delivery and thus the contract miners did not look to the sale of the coal for a return of their investment, but looked solely to Paragon to abide by its covenant.[71]

12. *United States v. Swank*

As a result of the decisions in *Parsons* and *Paragon Jewel Coal,* the Internal Revenue Service took the position that a lessee under a lease terminable on short notice did not hold an economic interest in the deposit and was not entitled to depletion.[72] The Tax Court upheld the Commissioner's position,[73] but the Commissioner's position was rejected by the Fifth Circuit and Court of Claims.[74]

The Supreme Court resolved the controversy in favor of the lessees in its most recent economic interest pronouncement, *United States v. Swank.*[75] In *Swank,* the taxpayer leased coal deposits under leases terminable by the lessors without cause on thirty days' prior notice. However, the lessee-taxpayer actually extracted coal for several years without interruption. The Internal Revenue Service denied the lessee any depletion deduction on the grounds that short notice terminability of the lease was fatal to the claim of an economic interest relying on *Parsons* and *Paragon Jewel Coal.* The government argued that because of the termination clause, the lessee taxpayer had a mere economic advantage, not an economic interest. As a matter of "practical economics," the government argued, the lessor had the only significant interest in the coal in the ground.

The Court rejected the government's arguments noting that *Swank,*

71. *Id.* at 635. The holdings in *Parsons* and *Paragon Jewel Coal* now are incorporated expressly in Treas. Reg. § 1.611-1(b)(1) (as amended in 1973).

72. *See, e.g.*, Rev. Rul. 77-341, 1977-2 C.B. 204 (holding that a lessee under an oral lease, which was terminable at will because it did not meet the requirements of the statute of frauds, did not have an economic interest), *revoked by* Rev. Rul. 83-160, 1983-2 C.B. 99. *See generally* Martin J. McMahon, Jr., *Defining the "Economic Interest" in Minerals After* United States v. Swank, 70 KY. L.J. 23, 52-60 (1981-82) [hereinafter McMahon, *Defining the "Economic Interest"*].

73. *See* Weaver v. Commissioner, 72 T.C. 594 (1979); Mullins v. Commissioner, 48 T.C. 571 (1967), *acq. in result,* 1970-2 C.B. xx. See Whitmer v. Commissioner, 443 F.2d 170 (3d Cir. 1971) for Third Circuit treatment of the issue.

74. *See* Swank v. United States, 602 F.2d 348 (Ct. Cl. 1979), *aff'd,* 451 U.S. 571 (1981); Winters Coal Co. v. Commissioner, 496 F.2d 995 (5th Cir. 1974); Bakertown Coal Co. v. United States, 485 F.2d 633 (Ct. Cl. 1973).

75. 451 U.S. 571 (1981).

unlike *Parsons* and *Paragon Jewel Coal,* dealt with whether *anyone* could claim depletion, not *who* could claim it. *Parsons* and *Paragon Jewel Coal* were distinguished on the grounds that short notice terminability of the agreements was not the determinative factor. Rather, the Court stated that the key factor in both cases was that the contract miners merely were to mine the coal for delivery to the owners at a fixed price. The miners had no rights in the coal before extraction nor rights to sell it or share in the proceeds of its sale after extraction. Thus, the miners looked to a personal covenant for their income.

In contrast, the lessee in *Swank* had a legal interest in the coal both before and after it was extracted and was free to sell the coal at the market price. The Court found no statutory requirement of a minimum duration for the interest. It rejected the government's argument that the practical economics of the deal assured that the lessor would terminate the lease if the price of coal rose, thus making the lessee's interest in the coal too tenuous to justify a depletion allowance. The government's argument that the lessor could, and presumably would, renegotiate a more favorable lease if the price of coal rose was not a certainty because other factors in addition to royalty level influenced whether the lease remained advantageous. For example, the quantity of coal actually mined by the lessee was also influential. That the leases were continued over a number of years despite the increased value of the coal in the ground was cited as evidence of the Court's conclusion.

Furthermore, the Court concluded it would be unfair to deny depletion to a lessee who in fact had extracted minerals over a long period merely because he incurred the risk of termination of the lease as a result of unequal bargaining power.[76] Finally, the Court could find no rational basis for linking depletion with the period of time that the taxpayer operates a mine. If percentage depletion is sound policy, it is equally sound whether one taxpayer operates a mine over an extended period or several taxpayers operate a mine over successive shorter periods.[77]

C. *Elaboration of the Theoretical Definition*

The lower courts and the Internal Revenue Service have added further gloss to the definition of the economic interest concept developed by the Supreme Court by synthesizing and reconciling some of the apparent conflicts in the Court's opinions. Furthermore, Congress has intervened

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76. *Id.* at 584-85.

77. *See generally* McMahon, *Defining the "Economic Interest," supra* note 72.

to alter statutorily the treatment accorded to production payments.[78]

1. Alternative Source of Payment Rule

Anderson v. Helvering held that if the holder of a nonoperating interest had a source of payment other than from extraction and sale of minerals, the interest was not an economic interest.[79] This limitation, developed in *Anderson*, was applied by the Fifth Circuit in *Christie v. United States*[80] to deny an economic interest to the holder of a production payment that could have been satisfied either from production or from salvage of well equipment. The rule proscribing any alternative source of payment for an economic interest was strictly applied, negating the existence of an economic interest, even though the burdened property was already producing at a rate indicating that the production payment would be paid in full within one or two months.[81]

On the other hand, in *Standard Oil Co. (Indiana) v. Commissioner*,[82] the Seventh Circuit Court of Appeals refused rigidly to apply the alternative source of payment rule. Standard Oil Company assigned to Pacific Northwest Pipeline Company interests in a number of oil and gas leaseholds that Standard Oil previously had acquired. Originally, Standard Oil retained a royalty interest in produced gas, subject to a minimum royalty. Subsequently, the assignment was modified to impose a ceiling on the total amount due to Standard Oil, thereby converting Standard Oil's retained interest to a production payment, and to provide that the reserved production payment was payable not only out of proceeds from the sale of produced gas, but also from proceeds of any sale of the assigned leasehold interest to a third party by Pacific Northwest. Standard Oil's purpose in modifying the assignment to include the provision for satisfaction of the production payment from the proceeds of a sale of the lease specifically was to preclude treatment of its retained interest as an economic interest, thereby characterizing the assignment as a sale and entitling it to report the proceeds at the then highly advantageous long term capital gains rates.

The government contended that the taxpayer had received ordinary

78. *See* discussion *infra* part II.C.7.
79. *See supra* part II.B.6.
80. 436 F.2d 1216 (5th Cir. 1971).
81. *Id.* at 1220-21.
82. 465 F.2d 246 (7th Cir. 1972).

income subject to depletion. The court of appeals agreed with the government, citing two reasons for distinguishing *Anderson*.[83] First, unlike *Anderson* where the alternative source of payment was a sale of the fee, in *Standard Oil* the alternative source of payment was limited to sales proceeds of the mineral reserves. Second, because the production payment in *Standard Oil* was large but was interest free, and numerous exceptions existed to transfers that would trigger payment (e.g., corporate reorganizations or mergers), it was unlikely that anyone would purchase the reserves in a transaction that would trigger payment from the alternative source. Thus, the possibility of payment from the alternative source was too remote to be considered. Although the court did not rely on the taxpayer's motive in reaching its conclusion, it is worth noting that the transaction was fraught with tax avoidance. Originally structured definitively as a lease, the transaction was modified three years later in an effort to use *Anderson* as a sword to obtain the capital gains preference.

Application of the alternative source of payment rule to production payments currently is of diminished importance because section 636 of the Code now treats most production payments as loans.[84] Generally, even if the transaction fails the economic interest test, a purported production payment will be treated as a loan.

Nevertheless, the alternative source of payment rule remains important. In certain instances, the alternative source of payment rule may apply to royalties. *Cline v. Commissioner*[85] involved a taxpayer who held overriding royalty interests on coal leases. He exchanged the royalties, acknowledged as economic interests by the Tax Court, for a royalty interest in all coal processed through the tipple owned by the lessee of the burdened properties. The Tax Court found that the new royalty was not an economic interest because payment was not dependent on extraction of coal from any particular lease. In contrast, the Internal Revenue Service treats as an economic interest a net profits interest that burdens multiple properties and is computed with reference to the combined net income of the properties (i.e., a "basket net profits interest"), even though such an interrelationship arguably may run afoul of the alternative source of payment proscription.[86]

83. *Id.* at 253.
84. *See* discussion *infra* part II.C.7.a.
85. 67 T.C. 889 (1977), *aff'd*, 617 F.2d 192 (6th Cir. 1980).
86. *See* Gen. Couns. Mem. 38,907 (Oct. 8, 1982); Priv. Ltr. Rul. 85-43-030 (July 26, 1985).

2. Overriding Net Profits or Royalty Interest Acquired by Persons with No Prior Interest in the Deposit

Standing alone, the Supreme Court decisions defining economic interest do not deal definitively with treatment of carved-out royalty and net profits interests. This is due in part to the Court's attempt to limit the scope of its decision in *Southwest Exploration Co.* Recall that in *O'Donnell*[87] the Supreme Court held that a corporate shareholder who sold oil company stock in consideration of a profits interest in the company's oil and gas properties did not acquire an economic interest in the deposits. The precise rationale for the result was unclear. If the rationale was that a net profits interest is a personal covenant, under which the holder is not looking to extraction and sale of the minerals for income, it was overruled, *sub silentio*, by *Burton-Sutton Oil.*[88] Alternatively, if the rationale was that the claimant of the economic interest was outside the chain of title, it was seriously undermined by *Southwest Exploration Co.*[89] In any event, *O'Donnell* is largely devoid of precedential value.

Neither the courts nor the Internal Revenue Service now even consider applying *O'Donnell* to similar fact patterns, and carved-out interests in minerals generally are treated as economic interest if they otherwise qualify. *Beach Petroleum Corp. v. Commissioner*[90] involved the treatment of a carved-out net profits interest in oil and gas properties that was distributed by the corporation holding the working interest in the properties. The Commissioner, citing *O'Donnell,* argued that the shareholders were not entitled to depletion. The Tax Court rejected the application of *O'Donnell,* finding *Kirby Petroleum*[91] and *Burton-Sutton Oil Co.* to be controlling. The court concluded that the shareholders had obtained an economic interest. The key to an economic interest, the court reasoned, is not any particular form of ownership or any real cash investment, but only a right to income entirely dependent on production.

Subsequently, in *Alexander v. Commissioner,*[92] the Tax Court held that a vendor of corporate stock who received an overriding royalty in exchange had acquired an economic interest, without ever discussing *O'Donnell.* In *Warren v. United States,*[93] the Court of Claims reached

87. *See supra* part II.B.4.
88. *See supra* part II.B.8.
89. *See supra* part II.B.9.
90. 5 T.C.M. (CCH) 638 (1946).
91. *See supra* part II.B.7.
92. 34 T.C. 758 (1960), *acq. in result,* 1961-1 C.B. 3.
93. 171 F. Supp. 846 (Ct. Cl. 1959), *cert. denied,* 361 U.S. 916 (1959).

the same result with respect to other shareholders involved in the transaction.

The principles of these lower court cases appear to be well accepted. In General Counsel Memorandum 38,907 and Private Letter Ruling 85-43-030, the Internal Revenue Service accepted the holding of *Beach Petroleum* and extended it to basket net profits interests covering multiple properties.[94] Furthermore, Revenue Ruling 67-118 holds that a donative transfer to a trust of an overriding royalty carved out of the working interest by the lessee is a transfer of an economic interest.[95]

3. Leases Terminable on Short Notice

In Revenue Ruling 83-160, the Internal Revenue Service expanded the principle of *Swank*[96] somewhat beyond its precise facts, holding that the terminability of a mineral lease at the will of the lessor "is not an essential criterion that, by itself, will preclude a taxpayer from having an economic interest."[97] Accordingly, the Service revoked four previous rulings which denied an economic interest to lessees operating under leases subject to short notice termination.[98] Two other rulings were modified to eliminate the factor that the leases were not terminable on short notice without cause as a reason that the lessees held an economic interest.[99]

One revoked ruling is particularly worth noting. Revenue Ruling 77-341 held that a lessee of a coal deposit in Kentucky under an oral lease did not have an economic interest because the lease was unenforceable under the statute of frauds.[100] The revocation of this ruling does not necessarily mean that the Internal Revenue Service now views a lessee under an oral or otherwise unenforceable lease as having an economic interest. The Service continues successfully to assert that licensees do not have an economic interest,[101] and a lessee under an unenforceable lease generally is considered a licensee.[102]

94. Gen. Couns. Mem. 38,907 (Oct. 8, 1982); Priv. Ltr. Rul. 85-43-030 (July 26, 1985).

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

96. *See supra* part II.B.12.

97. Rev. Rul. 83-160, 1983-2 C.B. 99, 100.

98. Rev. Rul. 74-506, 1974-2 C.B. 178; Rev. Rul. 74-507, 1974-2 C.B. 179; Rev. Rul. 77-341, 1977-2 C.B. 204; Rev. Rul. 77-481, 1977-2 C.B. 205.

99. Rev. Rul. 72-477, 1972-2 C.B. 310; Rev. Rul. 73-32, 1973-1 C.B. 301.

100. Rev. Rul. 77-341, 1977-2 C.B. 204.

101. *See* Missouri River Sand Co. v. Commissioner, 83 T.C. 193 (1984), *aff'd*, 774 F.2d 334 (8th Cir. 1985).

102. *See* 3 THE AMERICAN LAW OF MINING § 16.17, at 269-70 (Rocky Mountain Mineral Law Foundation ed., 1982).

4. Contract Miners

The Supreme Court clearly stated in *Paragon Jewel Coal* that contract miners are denied an economic interest primarily because they receive a fixed fee for extracting the coal rather than relying on a sale at the market price for their income.[103] Adjusting the fixed price periodically to reflect labor and other costs or general market price trends does not change the result. The contract miner still is viewed as earning its profits from the personal covenant of the mineral owner.[104]

Not all contract miners, however, are denied an economic interest. A contract miner who receives a percentage of net proceeds from the sale of extracted minerals may have an economic interest even if the contract miner never obtains title to the minerals or the right to sell the minerals for his own account. In *Ruston v. Commissioner*[105] and *Brown v. Commissioner*,[106] decided prior to *Parsons* and *Paragon Jewel Coal*, the Tax Court held that contract miners who were entitled to a fixed percentage of the net profits realized by the lessee-mineral owner upon sale of the extracted minerals had an economic interest in the mineral deposit and were entitled to the depletion allowance. In both cases the contract miner had the exclusive right to mine the deposits and the agreement was not terminable without cause. Thus, *Parsons* and *Paragon Jewel Coal* are distinguishable from *Ruston* and *Brown*. Nevertheless, in *Utah Alloy Ores v. Commissioner*,[107] decided after *Parsons*, the Tax Court held that a percentage of sales contract miner did not have an economic interest.

The Internal Revenue Service has announced, however, that on limited facts it will follow *Ruston* and *Brown*, not *Utah Alloy Ores*. Revenue Ruling 84-88 reaffirmed that a percentage of sales contract miner may have an economic interest.[108] The facts of the ruling, however, appear to

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103. *See supra* part II.B.11.

104. *See* Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624, 628 (1965) (fixed contract price varied "depending somewhat on the general trend of the market price for the coal over extended periods and to some extent on labor costs"); Costantino v. Commissioner, 445 F.2d 405, 406 (3d Cir. 1971) (contract miner frequently was paid more per ton than contract price); McCall v. Commissioner, 312 F.2d 699, 700 (4th Cir. 1963) (fixed contract price subject to change as market price fluctuated); United States v. Stallard, 273 F.2d 847, 849 (4th Cir. 1959) (fixed contract price subject to change as market price fluctuated); Adkins v. Commissioner, 51 T.C. 957, 966 (1969) (contract price to be adjusted in comparable ratio to substantial change in general price level), *acq. in result*, 1970-1 C.B. xv; Denise Coal Co. v. Commissioner, 29 T.C. 528, 547 (1957) (fixed contract price subject to change if market price of lawful maximum price increased), *aff'd in part, rev'd in part*, 271 F.2d 930 (3d Cir. 1959).

105. 19 T.C. 284 (1952).

106. 22 T.C. 58 (1954), *acq.*, 1954-2 C.B. 3.

107. 33 T.C. 917 (1960).

108. Rev. Rul. 84-88, 1984-1 C.B. 141.

be intended to limit its application. Not only does the ruling emphasize that the contract miner had the *exclusive* right to extract the mineral for sale by the owner, but, in contrast to the treatment of lessees in Revenue Ruling 83-160,[109] also specifically states that the contract miner had the right to mine the deposit to exhaustion. On the other hand, the Service appears to have been generous to the contract miner by holding that the presence of a guaranteed minimum payment from the mineral owner did not negate the economic interest under the alternative source of payment rule.[110] Clearly there existed at least a theoretical possibility that the contract miner could be paid more than one-hundred percent of the sales price of the extracted mineral. Why the possibility that the contract miner could be paid more than the sales price of the mineral does not violate the alternative source of payment rule is a mystery.

Although the Internal Revenue Service has not stated clearly that it does not consider *Swank*[111] applicable to contract miners, every indication is that the Service takes this position. Notwithstanding the ambiguity of the Service's position on this point, there is a possibility that a percentage of sales contract miner with a contract term of one year or more arguably may have an economic interest. Prior to *Parsons*, the Internal Revenue Service took the position that even a fixed fee contract miner with a contractual right to mine the deposit for one year or more had obtained an economic interest from the mineral owner.[112] In light of *Swank* and Revenue Ruling 83-160, it is possible that the Internal Revenue Service and the courts might consider reviving this standard in the future. Because the question in contract mining cases is *who claims* depletion, not the amount of income from the property subject to depletion, any such change should be prospective only.[113]

5. Licensees

Except in rare circumstances, licensees generally are found not to have acquired an economic interest in a mineral deposit by virtue of the license to extract. Lack of a formal interest or enforceable exclusive rights to the mineral in the ground is considered to be fatal to the claim. In *Holbrook v. Commissioner*,[114] the Tax Court held that a taxpayer

109. Rev. Rul. 83-160, 1983-2 C.B. 99.
110. Rev. Rul. 84-88, 1984-1 C.B. 141.
111. *See supra* part II.B.12.
112. *See* Gen. Couns. Mem. 26,290, 1950-1 C.B. 42, 45-46.
113. *See generally* Martin J. McMahon, Jr., *The Coal Depletion Allowance Deduction*, 85 W. VA. L. REV. 581, 593-605 (1983) [hereinafter McMahon, *Coal Depletion*].
114. 65 T.C. 415 (1975).

holding a nonexclusive, nontransferable license to extract coal, subject to termination on ten days' notice, was not entitled to claim percentage depletion. The licensee's freedom to sell the coal on his behalf, acquisition of title on extraction, expenditure of time and money in developing the underground mine, and operation under the license for four years, were considered insufficient to confer an economic interest.[115] Despite the licensee's operation of a deposit for several years, the inherently nonexclusive and terminable nature of a license generally is found to preclude a licensee from acquiring an economic interest.

In contrast, relying on *Southwest Exploration Co.*,[116] in two cases the Tax Court has found that a licensee effectively holding the sole ability to exploit a deposit acquired an economic interest in the deposit even without possessing an exclusive legal right to extract the deposit.[117] The cases involved sand and gravel dredging where the taxpayer owned the only riparian land allowing access to the desired sand and gravel deposits. Exclusive physical access coupled with the license sufficed to give rise to an economic interest.

Neither the Internal Revenue Service nor the courts appear to have reconsidered their general treatment of licensees in light of *Swank* and Revenue Ruling 83-160. Since 1983, the Internal Revenue Service has successfully denied percentage depletion to licensees operating under nonexclusive licenses.[118] However, the policy based analysis of the Supreme Court in *Swank*, allowing percentage depletion to lessee's under short-notice termination leases, indicates that there may be some reason critically to reexamine the disallowance of percentage depletion to licensees because their rights are not exclusive. The Supreme Court emphasized the incentive aspect of depletion, not its cost recovery aspect, in holding that terminability of a lease on short notice did not preclude an economic interest. Because percentage depletion serves an incentive purpose, not an income measurement purpose, the Court saw no reason why the availability of the allowance should depend on whether one lessee mined over a long period or several lessees extracted the minerals over

115. *Id.*; *accord*, Rissler & McMurry Co. v. United States, 480 F.2d 684 (10th Cir. 1973) (oral license to remove sand and gravel from gravel pit), *aff'g* 342 F. Supp. 43 (D. Wyo. 1972).

116. *See supra* part II.B.9.

117. *See* Victory Sand & Concrete, Inc. v. Commissioner, 61 T.C. 407 (1974), *acq. in result*, 1976-2 C.B. 3; Oil City Sand & Gravel Co. v. Commissioner, 32 T.C. 31 (1959), *nonacq.*, 1965-1 C.B. 5; *see also* Weaver v. Commissioner, 72 T.C. 594 (1979).

118. Missouri River Sand Co. v. Commissioner, 83 T.C. 193 (1984) (licensee extracting gravel from river under nonexclusive license), *aff'd*, 774 F.2d 334 (8th Cir. 1985); Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296, (Cl. Ct. 1984) (licensee extracting gravel from river under nonexclusive license).

successive shorter periods, thus weakening the exclusivity requirement.[119] Furthermore, the Court distinguished its earlier cases denying contract miners an economic interest on the grounds that those cases involved allocating the depletion allowance among the various parties with an interest in the deposit, whereas *Swank* involved an instance where one could claim depletion on the operator's gross income from mining if the lessee-operator was denied the allowance.[120]

As did its position in *Swank*, the Internal Revenue Service's position with respect to licensees limits the total income on which depletion is allowed to the royalties paid to the deposit owner; the holder of the working interest is denied any depletion. Licenses now present the only instance in which this situation results.[121]

Furthermore, the Internal Revenue Service has not consistently applied the exclusivity requirement that it employs to deny licensees an economic interest. Revenue Ruling 70-499 held that lessees under a "joint and several" lease possessed an economic interest where the lease was "exclusive" with respect to nonlessees, even though the lessees operated independently, enjoyed no exclusive rights among themselves, and were not entitled to any minimum portion of the deposit.[122] Nevertheless, there may be some historical basis for requiring exclusivity of rights as a prerequisite for an economic interest. Percentage depletion was first introduced as an administratively convenient substitute for discovery value depletion.[123] Under discovery value depletion, which served the same incentive function as percentage depletion, exclusivity of rights to the deposit could have been viewed as necessary; it would have been impossible to compute the depletion allowance in the absence of exclusive rights because there would have been no clearly fixed amount of the deposit over which the operating licensee could allocate the value of the deposit to arrive at a dollar per unit depletion rate.[124]

6. Operating Agreements with Foreign Governments

Arrangements permitting an American company to extract mineral deposits in another country are not always easily analyzed under the

119. United States v. Swank, 451 U.S. 571, 585 (1981).

120. *Id.* at 583.

121. *See generally* Martin J. McMahon, Jr., *Licensees and Economic Interest in Minerals After* Swank *and Revenue Ruling 83-160,* 72 KY. L.J. 787 (1983-84).

122. Rev. Rul. 70-499, 1970-2 C.B. 132.

123. *See* McMahon, *Defining the "Economic Interest," supra* note 72, at 30-33.

124. *See id.* For the cost depletion formula, of which discovery depletion was a variant, see Treas. Reg. § 1.611-2(a) (as amended in 1972).

traditional economic interest test. The traditional test may be difficult to apply in this context because the foreign government may retain all forms of technical ownership of the mineral until it is produced. Such a problem was presented in *Gulf Oil Corp. v. Commissioner.*[125] In *Gulf,* the issue was whether Gulf Oil Corporation had an economic interest in oil and gas deposits in Iran under a 1973 agreement with Iran and the National Iranian Oil Corporation (NIOC).

In 1954, a consortium of oil companies, including Gulf, entered into an agreement with NIOC under which an operating company funded by the consortium produced crude oil on behalf of Iran, which retained title to the oil in place. Trading company subsidiaries of the consortium members purchased crude oil from NIOC at the wellhead at a price equal to twelve and one-half percent of the posted price. Oil and gas retained by NIOC for Iranian domestic use was refined by another operating company capitalized by the consortium. The trading companies funded all assets and facilities used for operations and reimbursed the operating companies for the expenses of exploration, development, and operations; NIOC paid expenses and fees for production and refining for Iranian domestic consumption. Because the Internal Revenue Service concluded that the arrangement had "all the essential characteristics of a lease," it ruled that under the agreement Gulf held an economic interest in the minerals in place.

In 1973, the original agreement was replaced by a new agreement under which a joint stock company formed by the consortium, but funded by NIOC, replaced the operating companies. The joint stock company drilled and produced oil under NIOC's direction. The trading companies annually advanced a specified percentage of NIOC's budgeted operating expenditures. These advances were amortized over ten years as a set-off against payments due to NIOC. NIOC and the trading companies annually agreed on the amount of crude oil that would be produced. Production in excess of Iran's needs was purchased by the trading companies. If production was insufficient, the trading companies received less. NIOC received a wellhead price equal to the sum of its extraction costs, twelve and one-half percent of the applicable posted price, and certain additional amounts. In addition to the set-off for advances, the trading companies set off the unrecovered 1973 book value of the operating companies' assets. The Internal Revenue Service asserted that under the 1973 agreement Gulf and other consortium members had

125. 86 T.C. 115 (1986), *aff'd,* 914 F.2d 396 (3d Cir. 1990).

a mere economic advantage, not an economic interest, and disallowed Gulf's claim for percentage depletion and certain foreign tax credits.

The Tax Court concluded that Gulf held an economic interest under the 1973 agreement. Prefacing its analysis with the statement that "[t]he [economic interest] test under [the regulations] requires first that there be an 'investment,' which requires that the payments must be in exchange for the receipt of minerals and that there must also be an investment in the production,"[126] the court continued by acknowledging that legal title is not necessary. According to the court, "The 'investment' test requires only an economic commitment to look to production of the mineral for income."[127] Ultimately, the standard employed by the court required "a clear capital interest in the mineral which diminishes as the mineral is extracted, and [that] the taxpayer must share directly in the economic productivity of the minerals and the market risk upon sale of the minerals."[128]

On appeal, the Tax Court's decision was affirmed, but the reasoning of the court of appeals differed from that of the Tax Court.[129] The court of appeals purported to apply the two part test for an economic interest found in Treasury Regulation, section 1.611-1(b), but appears in fact to have fashioned its own somewhat amorphous test that is in part inconsistent with *Swank*.[130] Under the first prong of the economic interest test, the court analyzed whether Gulf had "acquired, by investment, any interest in the oil in place."[131] First, the court acknowledged that the absence of legal title to the mineral in place did not preclude an economic interest. Then, after stating that the "factors" employed in cases such as *Paragon Jewel Coal Co. v. Commissioner*,[132] *Parsons v. Smith*,[133] and *Freede v. Commissioner*[134] "are simply considerations that we may examine in determining the existence of an economic interest in a particular case,"[135] the court applied what it characterized as the "*Paragon Jewel Coal Company* factors," which actually are the *Parsons* evidentiary considerations, as determinative. Apparently without appreciating the conflict with *Swank*, the court noted that the most important factor was

126. *Gulf Oil Corp.*, 86 T.C. at 133.
127. *Id.* at 134 (citing Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956)).
128. *Id.* (citing Weaver v. Commissioner, 72 T.C. 594 (1979)).
129. Gulf Oil Corp. v. Commissioner, 914 F.2d 396 (3d Cir. 1990).
130. *Id.* at 418.
131. *Id.* (quoting Palmer v. Bender, 287 U.S. 551, 557 (1933)).
132. *See supra* part II.B.11.
133. *See supra* part II.B.10.
134. *See infra* text accompanying notes 196-208.
135. *Gulf Oil Corp.*, 914 F.2d at 419.

whether the taxpayer had the right to exhaust the mineral deposit or whether the taxpayer's rights were terminable.[136]

According to the court, the first negative factor, "the miner's investments were in movable equipment rather than in the coal in place,"[137] was not present in *Gulf* because the taxpayer and the other consortium members had invested substantial capital in immovable Iranian plant and facilities that had not been fully depreciated. Thus, the first factor did not disqualify Gulf from holding an economic interest. Next, without clearly stating which *Paragon Jewel Coal* factor it was applying, the court stated that, because the consortium members held the exclusive right to sell the produced oil through the trading companies, the members clearly had a right to share in the produced oil. Presumably, this conclusion overcame the fifth, sixth, and seventh *Paragon Jewel Coal* negative factors, namely:

> (5) the landowners owned the coal at all times, even after it was mined, precluding the miners from keeping or selling any of it; (6) the landowners retained all proceeds from the sale of the coal; and (7) the miners could look only to the landowners for all sums due under their contracts.[138]

Finishing its application of the *Paragon Jewel Coal* factors, the court observed that the contract was long term, lasting twenty years, not terminable-at-will.

The Commissioner's argument that the first prong of the test of the Regulation was not met, because under *Bankline Oil Co.*[139] Gulf had a mere economic advantage with respect to the deposit, was rejected. The court's conclusion was grounded on Gulf's unrecovered investment in plant assets and facilities as well as the trial court's finding that Gulf "had made and was continuing to make investments in the production of minerals."[140]

The second prong of the economic interest test requires that the taxpayer "secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."[141] The court concluded that this prong was satisfied because Gulf's

136. *Id.*
137. *Id.*
138. *Id.* (quoting Parsons v. Smith, 359 U.S. 215, 225 (1959)).
139. *See supra* part II.B.3.
140. *Gulf Oil Corp.*, 914 F.2d at 420.
141. *Id.* at 418 (quoting Palmer v. Bender, 287 U.S. 551, 557 (1933)).

"profits [were] made by way of purchase at the wellhead, which depended on extraction of the oil."[142] Because the trading companies could set off against payments due to NIOC the operating companies' unrecovered cost of plant and equipment, the court concluded that under *Southwest Exploration Co.*,[143] Gulf had an economic commitment to look to the production of oil for a return of its investment.

The court of appeals' opinion is confusing for two reasons. First, the court treated Gulf's investment in immovable equipment as a positive factor. Numerous judicial decisions, including *Paragon Jewel Coal*, establish that the proper question is not whether the taxpayer has invested in immovable property, but whether the taxpayer invested in minerals. An investment in depreciable production facilities does not give rise to an economic interest in the mineral deposit.[144] Second, the conclusion that Gulf's "profits [were] made by way of purchase at the wellhead, which depended on extraction of the oil," does not establish that Gulf's profits were from extraction and sale in the sense required by Treasury Regulation, section 1.611-1(b). Purchasers who cannot earn a profit "but for" extraction, such as a utility company having a long term output contract with a mineral owner, or a gas purchaser under a take-or-pay contract, generally are not considered to have an economic interest.[145] Alternatively, if the court meant that Gulf's profits were derived by a bargain purchase at the wellhead, *Bankline Oil Co.* is directly contrary precedent notwithstanding that the court did not find it so. The facts of *Bankline Oil Co.* clearly reveal that Bankline Oil Company purchased gas at the wellhead for a bargain price. Nevertheless, the Supreme Court held that the company did not hold an economic interest and denied it the right to claim percentage depletion on the income attributable to the bargain purchase.[146]

Even though *Bankline Oil Co.* supports the argument that Gulf did

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142. *Id.* at 420.

143. *See supra* part II.B.9.

144. *See, e.g.*, Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624, 628 (1965) (tipple, power line, and railroad siding); Denise Coal Co. v. Commissioner, 271 F.2d 930, 939 (3d Cir. 1959) (buildings). *But see* Food Mach. & Chem. Corp. v. United States, 348 F.2d 921 (Ct. Cl. 1965) (holding that a depreciable plant involved economic interest when constructed to process minerals purchased from owner; without construction of plant near deposit it would not have been economically feasible to extract minerals).

145. *See* Freede v. Commissioner, 864 F.2d 671 (10th Cir. 1988) (purchaser under take-or-pay contract), *rev'g* 86 T.C. 327 (1986), *cert. denied*, 493 U.S. 810 (1989); Douglas Coal Co. v. United States, 429 F. Supp. 322, 338-39 (N.D. W.Va. 1977) (utility with supply contract); Rev. Rul. 80-48, 1980-1 C.B. 99 (purchaser under take-or-pay contract).

146. Helvering v. Bankline Oil Co., 303 U.S. 362, 369 (1983).

not acquire an economic interest in the deposit under the 1973 agreement, the result in *Gulf* nevertheless is consistent with the Supreme Court's decision in *Swank*[147] allowing percentage depletion to a lessee under a lease terminable on short notice. Focusing on the policy basis for percentage depletion, encouraging production of minerals, *Swank* eschewed reliance upon the technical definition of an economic interest in favor of an analysis based primarily on whether the taxpayer shared in the proceeds from extraction and sale as an entrepreneur. Under the policy based analysis of *Swank*, Gulf should have had an economic interest because it made a substantial financial commitment to production, received from the owner of the deposit the right to acquire produced crude oil at a bargain price, and was entitled to resell that oil in the first open market sale.

This conclusion, reached by applying *Swank*, finds some support in Revenue Ruling 73-470,[148] in which the Internal Revenue Service found that an oil company prohibited by law from obtaining legal title to either the mineral deposit in the ground or produced hydrocarbons nevertheless had obtained an economic interest in the mineral deposit. Under an agreement with a foreign country, the oil company at its own risk provided necessary funds for exploration, development, and production of oil and gas. All produced oil and gas was to be delivered to the foreign government, which paid the oil company the competitive world market price. The agreement was subject to termination by the foreign government at any time, but if the government terminated the agreement, it was obligated to pay the oil company an amount equal to the company's contractual share of the value of the remaining reserves. Because the oil company bore the risk that its advances for exploration and development would not be recouped except out of production, the Service found that the oil company held an economic interest.[149]

7. Production Payments

a. *Treatment*

Historically, under *Thomas v. Perkins*, a production payment was an economic interest in the mineral deposit and the holder realized ordinary income subject to depletion upon receipt of payments.[150] Concomitantly,

147. *See supra* part II.B.12.
148. Rev. Rul. 73-470, 1973-2 C.B. 88.
149. *Id.* at 89.
150. *See supra* part II.B.2.

the owner of the burdened mineral interest could exclude the production payment from gross income under section 61 of the Code or claim a deduction for amounts paid to the holder. This basic rule largely has been supplanted by section 636 of the Code,[151] which was enacted in 1969 to counteract perceived tax avoidance spawned by treating production payments as economic interests in mineral deposits rather than as loans.

Section 636 of the Code treats production payments differently depending on the nature of the transaction in which the production payment was created. Both carved-out production payments[152] under section 636(a), and production payments retained in a conveyance in which the holder retains no other economic interest under section 636(b), are treated as mortgage loans.[153] An exception is provided for carved-out production payments if the proceeds are pledged to exploration or development of the property. Where the exception is met, the production payment continues to be treated as an economic interest, entitling the holder to depletion and the owner of the burdened property to exclude the payment from income.[154]

Because section 636 of the Code generally treats a carved-out production payment as a mortgage loan from the buyer to the seller, the holder realizes ordinary income only to the extent of the interest component of payments received. In computing the interest component of each payment in liquidation of the production payment, the original issue discount rules or unstated interest rules of sections 1272 through 1275[155] or section 483[156] respectively, must be taken into account to the extent applicable. The holder does not claim depletion. Consonantly, the owner of the burdened interest (the payor) includes the full payment in gross income but deducts the interest element,[157] subject to any applicable limitations on interest deductions.[158]

A carved-out production payment pledged to exploration or development is an economic interest and the holder realizes ordinary income

151. I.R.C. § 636 (1988).

152. For examples of carved-out production payments, see Treas. Reg. § 1.636-1(a)(3) Ex. 1 (1973) and Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958).

153. See *supra* part II.B.2 for discussion of prior law. *See also* Martin J. McMahon, Jr., *A Production Payment Primer*, 4 NAT. RESOURCES TAX REV. 331 (1991) [hereinafter McMahon, *Production Primer*].

154. *See* Treas. Reg. § 1.636-1(a)-(b).

155. I.R.C. §§ 1272-1275 (West Supp. 1991).

156. *Id.* § 483 (1988).

157. *See* Treas. Reg. § 1.636-1(a)(1), (3) Ex. 1.

158. For example, passive activity loss rules act as limitations on interest deductions. I.R.C. § 469 (West Supp. 1991).

subject to depletion.[159] Where the production payment has been acquired for cash, rather than by providing services, cost depletion invariably will be claimed.[160] If the production payment was received in consideration of services for exploration or development, under the pool of capital doctrine the holder does not realize any income upon receipt of the right to the production payment.[161] Thus, the holder will not have any basis or will have a very low basis. Upon receipt of payments, the holder will realize ordinary income and claim percentage depletion. Accordingly, the owner of the burdened property (the payor) excludes the production payment from gross income, and may not deduct expenses funded by the proceeds from the sale of the payment.[162]

The distinction between exploration and development activities and production activities is crucial in applying section 636(a). Carved-out production payments to finance production activities are treated as mortgage loans.[163] In Revenue Ruling 74-549,[164] the Internal Revenue Service held that a carved-out production payment sold to finance production stage removal of overburden to increase mine efficiency, but which benefitted only minerals directly underlying removed overburden, was not sold to finance development. Accordingly the carved-out production payment was not within the exception to mortgage loan treatment in section 636(a).

Although removal of large quantities of overburden benefitting the deposit generally is considered a development activity under section 616 of the Code,[165] only depreciation on the equipment is a development expense, not its acquisition cost.[166] Prior to the enactment of section 636, however, carved-out production payments used to finance the acquisition of development equipment qualified as economic interests. Under the pool of capital doctrine the carved-out production payment did not give

159. *See* Treas. Reg. § 1.636-1(b).

160. Under Rev. Rul. 65-10, 1965-1 C.B. 254, the holder of a production payment may elect between alternative methods of computing the depletion unit for cost depletion.

161. *See* Gen. Couns. Mem. 22,730, 1941-1 C.B. 214. *See generally* William M. Linden, *Income Realization in Mineral Sharing Transactions: The Pool of Capital Doctrine*, 33 TAX LAW. 115 (1979); Emily A. Parker, *Contribution of Services to the Pool of Capital: General Counsel Memorandum 22,730 to Revenue Ruling 83-46*, 35 INST. ON OIL & GAS L. & TAX'N 313 (1984).

162. *See* Anderson v. Commissioner, 446 F.2d 672 (5th Cir. 1971).

163. Treas. Reg. § 1.636-1(b).

164. Rev. Rul. 74-549, 1974-2 C.B. 186.

165. *See* Rev. Rul. 86-83, 1986-1 C.B. 251 (finding that removal of overburden making minerals accessible over long period of time was development cost).

166. Treas. Reg. § 1.616-1(b)(2).

rise to income for either the transferor or transferee.[167] If this rule survived the enactment of section 636, a carved-out production payment, the proceeds of which are pledged to acquisition of development equipment, would qualify for treatment under the exception to section 636(a). However, the language of Treasury Regulation, section 1.636-1(b), can be read to prescribe a more restrictive definition of exploration and development under which carved-out production payments that finance the acquisition of equipment are treated as mortgage loans.[168] Accordingly, Revenue Ruling 74-549 held that a production payment sold to finance the acquisition of depreciable equipment used to remove overburden in the development stage of a mine, was not carved-out for development and thus was treated as a mortgage loan.[169]

The decision in *James A. Lewis Engineering, Inc. v. Commissioner*[170] illustrates the difference between development and production with respect to oil and gas. In *Lewis,* the court held that services provided to implement a waterflood secondary recovery program constituted production activity, not development activity.[171]

Section 636(b) treats a production payment retained in a sale of a mineral property, when the transferor retains only the production payment and no royalty or net profits interest, as a purchase money mortgage loan. Thus, the holder is treated as having no economic interest in the deposit. Instead, the holder is treated in much the same manner as the holder of a carved-out production payment. However, because the retained production payment arose from a sale or exchange of property, the holder recognizes gain upon receipt of the right to the payment. Installment reporting under section 453 of the Code may be available to defer recognition of gain, if the sale qualifies.[172] As with carved-out production payments, the original issue discount and unstated interest rules must be taken into account in determining the extent to which the stated payments are principal or interest.

Section 636(c) treats a production payment retained in a lease as a bonus payable in installments. This rule applies where, in addition to the production payment, the transferor retains a fractional, percentage, or fixed sum per unit royalty or a net profits interest. Under section 636(c),

167. *See* Anderson v. Commissioner, 446 F.2d 672 (5th Cir. 1971).

168. Treas. Reg. § 1.636-1(b).

169. Rev. Rul. 74-549, 1974-2 C.B. 186. *Contra* Mapco, Inc. v. United States, No. 84-C-256-E (N.D. Okla. March 17, 1987).

170. 339 F.2d 706 (5th Cir. 1964).

171. *Id.* at 710.

172. I.R.C. § 453 (West Supp. 1991).

the lessor realizes ordinary income subject to depletion as payments are received.[173] The lessee may not exclude the payments from gross income under section 61, or deduct the payments, but must capitalize the full amount of the production payment into depletable basis.[174] Nevertheless, the lessee must exclude the amount of the production payment from gross income from the property under section 613 of the Code in computing percentage depletion for the year of extraction of the minerals to which the bonus payments relate.[175]

b. Definition

(1) Generally

In capsule form, Treasury Regulation, section 1.636-3(a), defines the term "production payment" as a right to a share of minerals or proceeds from the sale of the minerals produced from a property meeting the definition of an economic interest, but which has "an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby."[176] Production payments may be expressed in terms of a dollar amount of the proceeds from the sale of extracted minerals or a specified quantity of minerals to which the holder is entitled. Production payments frequently are described in terms of a royalty that is extinguished after a specific amount, often including additional interest on the principal amount, has been paid. However, if an ordinary and prudent person dealing in mineral properties could not reasonably expect, at the time the production payment was created, that it would be paid off before the economic life of the burdened mineral property or termination of the lease, or the taxpayer himself does not have such a belief, the interest will be treated as a royalty, not a production payment.[177]

The requirement that the interest be expected to terminate prior to exhaustion of the deposit in order to qualify as a production payment

173. Note, however, that in the case of an oil and gas lease, § 613A(d)(5) of the Code prescribes percentage depletion but not cost depletion for bonuses, and in some cases, § 631(c) of the Code prescribes § 1231 treatment of gains, supplanting ordinary income subject to depletion, with respect to lessors of coal or domestic iron ore.

174. Treas. Reg. § 1.612-3(a)(3) (as amended in 1977).

175. I.R.C. § 613 (West Supp. 1991); Treas. Reg. § 1.613-2(c)(5)(ii) (as amended in 1977); Rev. Rul. 79-73, 1979-1 C.B. 218.

176. Treas. Reg. § 1.636-3(a) (1973).

177. United States v. Morgan, 321 F.2d 781 (5th Cir. 1963); Yates v. Commissioner, 92 T.C. 1215 (1989), *aff'd*, 924 F.2d 967 (10th Cir. 1991); Watnick v. Commissioner, 90 T.C. 326 (1988).

presents problems in creating production payments with respect to nonproducing properties. If the property is in the exploration or development stage, it may be difficult to predict the economic life of the deposit. Revenue Ruling 86-119[178] held that if an investor advances money to an oil and gas operator in consideration of the right to receive from production the lesser of twice the amount advanced or a specified percentage of the net proceeds from the sale of produced hydrocarbons, and the only indication that hydrocarbons will be produced from the property is favorable geological and geophysical reports, the interest obtained will be a royalty and not a production payment. The ruling distinguished *United States v. Foster*,[179] in which the court found that an interest in a nonproducing property could be a production payment. In *Foster*, production from an adjacent tract indicated both that there would be production from the burdened property and that the expected life of the production payment was less than the expected producing life of the burdened property.[180]

Yates v. Commissioner[181] dealt with a careful attempt to create a production payment burdening wildcat oil and gas properties. The taxpayer acquired oil and gas leases in a federal lottery and assigned the leases to an operator for substantial cash payments totalling $675,000 plus a production payment in the form of an overriding royalty equal to five percent of the proceeds from production "until such time as estimated recoverable reserves . . . are 10% or less." On the theory that the right to the $675,000 was a production payment reserved in a sale subject to section 636(b), the taxpayer reported gain realized on the transaction as capital gain in an installment sale. The Commissioner asserted that the transaction was a lease and that the fixed sum payments were lease bonuses, reportable as ordinary income subject to depletion.

In the Tax Court, the taxpayer argued that the retained interest should not be classified as a royalty because the terms of the production payment required that it terminate when ten percent of original reserves remained, thus assuring that the interest inherently met the definition of a production payment in Treasury Regulation, section 1.636-3(a)(1). The Commissioner argued that under *United States v. Morgan*[182] and

178. Rev. Rul. 86-119, 1986-2 C.B. 81.
179. 324 F.2d 702 (5th Cir. 1963).
180. *Id.* at 709.
181. 92 T.C. 1215 (1989), *aff'd*, 924 F.2d 967 (10th Cir. 1991).
182. 321 F.2d 781 (5th Cir. 1963).

Watnick v. Commissioner[183] the retained interest could not qualify as a production payment. Any well drilled on the property would be an exploratory "wildcat" well and the most probable duration of production from a "wildcat" well is zero. Because there is no expectation of production from a "wildcat" well, the life of the retained interest and the lease are coextensive.

The Tax Court restated the issue as whether there was a reasonable prospect that the retained share of proceeds from the oil produced from the subject properties, up to the time that ninety percent of the recoverable reserves had been extracted, would in substance be paid out prior to extraction of one-hundred percent of recoverable reserves. After finding as a matter of fact that there was only a one in five likelihood of obtaining any production from the burdened property, the Tax Court concluded that such a probability of production "cannot fairly be characterized as an expectation that the difference between 100 percent and 90 percent of future production would be cognizable."[184] Thus the interest was a royalty and the transaction was a lease, not a sale.

On essentially the same reasoning, the court of appeals affirmed the Tax Court's decision, adding a few embellishments.[185] The court of appeals concluded that the language of Treasury Regulation, section 1.636-3(a), requires that a production payment "possess 'an expected economic life'," and that "[t]he use of the word 'expected' as used in the regulation neither connotes nor means a mere possibility of production. Some reasonable degree of certainty, but less than absolute, is thus required."[186] After examining the relevant circumstances, such as available geologic and seismic data, costs of exploration and drilling, the price of oil and transportation, the probable pay-out, the price received by the taxpayer, and the proximity of production, the court of appeals concluded that the Tax Court's finding was not erroneous.[187] In rebuttal to the taxpayer's argument that under the court's analysis a production payment never could be created to burden a non-producing property, the court stated, "There can be little doubt that a taxpayer who attempts to create a 'production payment' from a non-developed property bears a difficult burden of persuasion; however, it is not an impossible burden."[188]

183. 90 T.C. 326 (1988); *see supra* text accompanying note 177.
184. *Yates*, 92 T.C. at 1229.
185. Yates v. Commissioner, 924 F.2d 967, 972 (10th Cir. 1991).
186. *Id.* at 970.
187. *Id.* at 972.
188. *Id.*

Application of *Yates* as a precedent is not universally government favorable. The result in *Yates* may produce more favorable tax treatment for Yates' assignee than would the characterization for which Yates argued. Since the transaction was a lease, not a purchase, payments on the overriding royalty are excludable or deductible by the lessee, rather than a capital expenditure added to the basis of the deposit. The fixed-sum cash installments, however, still must be capitalized under Treasury Regulation, section 1.612-3(a)(3), as a bonus.

(2) Blanket Production Payments

Treasury Regulation, section 1.636-3(a)(1), provides that a production payment may burden more than one property. This provision cannot be read too broadly, however. *Lehigh Portland Cement Co. v. United States*[189] held that if two or more production payments are "cross-guaranteed" with successive payouts, the production payments will not be treated as an economic interest because the alternative source of payment rule has been violated.[190] The Internal Revenue Service, however, treats a production payment that burdens all deposits underlying a single tract, which are multiple properties under section 614 of the Code,[191] but were not multiple properties when General Counsel Memorandum 22,730[192] was promulgated, to qualify as an economic interest.[193] But if the production payment burdens more than one tract or parcel, then it is not an economic interest and cannot qualify for the exception.[194] In cases where the holder of the operating interest is seeking to avoid the exception, in order to deduct expenses paid with funds acquired by the sale of the production payment, this last stated rule may be taxpayer advantageous.

(3) Take-or-Pay Contracts

The Internal Revenue Service maintains that excess payments by a purchaser under a take-or-pay contract, entitling the payor to recoupment out of future production of the mineral, typically gas, do not create a carved-out production payment that will be treated as a mortgage loan. Instead, the Service treats payments under take-or-pay contracts as

189. 433 F. Supp. 639 (E.D. Pa. 1977).
190. *Id.* at 642.
191. I.R.C. § 614 (West Supp. 1991).
192. Gen. Couns. Mem. 22,730, 1941-1 C.B. 214.
193. Gen. Couns. Mem. 32,478 (Jan. 3, 1963) (holding that a blanket production payment is a single economic interest).
194. *See* Gen. Couns. Mem. 36,663 (March 26, 1976).

amounts received pursuant to a contract under which the pipeline company purchases minerals upon production. Thus, it treats the seller as receiving ordinary income subject to depletion in the year payment under the take-or-pay contract is received.[195]

The Internal Revenue Service's position has met with mixed success in litigation. In *Freede v. Commissioner*,[196] the taxpayer was the owner of a working interest in a gas property who received advance payments from a gas pipeline company pursuant to a take-or-pay contract. If payments exceeded the amount attributable to gas taken in the year, the pipeline company was entitled to an offset for gas taken in future years in excess of the amount of gas attributable to the minimum payment in the future year. The pipeline company had no other right to recoup excess payments. Freede treated the amounts received in excess of payments for gas taken as nontaxable mortgage loan proceeds received from the gas pipeline company as a lender. In a reviewed opinion, the Tax Court upheld Freede's treatment of receipt of the funds as a loan under section 636(a). The court concluded that by virtue of the payments in excess of the gas taken, which entitled the pipeline company upon future production to take gas without further payment, the payor-gas pipeline company made an investment in the minerals in place that could be recovered only through production.[197] In addition, the Tax Court concluded that the contract gave the pipeline company a right to compel production from which it could recoup its advance payments. Accordingly, the pipeline company had acquired an economic interest, and since the pipeline company's rights were limited to a specified volume of gas that was less than the remaining reserves, it had acquired a carved-out production payment subject to the general rule of section 636(a).

The decision for the taxpayer was reversed on appeal.[198] In applying the two part test of *Palmer v. Bender*[199] and Treasury Regulation, section 1.611-1(b)(1), the Tenth Circuit attempted to enumerate factors that bear upon whether the taxpayer possesses an "interest . . . in the minerals in place" under the first part of the test.[200] The factors used by the court, which unlike the *Parsons*[201] factors are positive factors, were: (1) the degree of the claimant's legal interest in the minerals; (2) whether

195. Rev. Rul. 80-48, 1980-1 C.B. 99.
196. 86 T.C. 340 (1986), *rev'd*, 864 F.2d 671 (10th Cir. 1988).
197. *Id.* at 350.
198. Freede v. Commissioner, 864 F.2d 671 (10th Cir. 1988).
199. *See supra* part II.A.1.
200. *Freede*, 864 F.2d at 673-74.
201. *See supra* part II.B.10.

the claimant has significant control over the deposit; (3) the extent of the claimant's contribution to development or operation; (4) whether the claimant bears a risk of loss with respect to the deposit; and (5) whether the claimant's interest is depleted as the mineral is extracted. Neither the presence nor absence of any one factor, the court stated, was determinative.[202]

Examining the facts to determine whether the pipeline company had an interest in the minerals in place, the court found that the company met only the second and fourth factors. The company had acquired some significant control over the deposit and it bore a risk of loss. For example, the company could not recoup its investment if production ceased because of inadequate pressure. Rather than determining whether this was sufficient to meet the first half of the test, however, the court of appeals ducked the issue and proceeded to find that the pipeline company failed the second half of the test for an economic interest. The court's reasoning on this point is a bit confusing. It concluded that the pipeline company failed the second half of the test because the company made no investment in the gas-producing enterprise and did not look solely to extraction and sale for a return of its investment. The court found *Bankline Oil Co.*[203] to be controlling, describing the pipeline company's interest as an economic advantage.[204] Finally, the court of appeals concluded that the pipeline company did not have an economic interest because it was "not seeking, through its recoupment right, a profit from the extraction of gas."[205] If the company recovered its prepayment in a future year, it simply received produced gas it had already paid for. Profits would be derived solely from the remarketing of the gas.

Although the court of appeals began its analysis of the second half of the economic interest test with some confusion, its ultimate rationale has some merit. The initial part of the analysis imported the illusory "investment" requirement of the first half of the test into the second half of the test. In continuing, however, the court applied *Bankline Oil Co.* by focusing on language in *Kirby Petroleum Co.*[206] and *Burton-Sutton Oil Co.*[207] describing the hallmark of an economic interest as looking to extraction for the possibility of profit, as opposed to looking to extraction

202. *Freede*, 864 F.2d at 674.
203. *See supra* part II.B.3.
204. *Freede*, 864 F.2d at 676-77.
205. *Id.* at 677.
206. *See supra* part II.B.7.
207. *See supra* part II.B.8.

for a return of capital. Because the percentage depletion allowance in fact has little to do with capital recovery, focusing on extraction as a source of profit, as opposed to a source of recovery of capital, may make some sense. Further, because the pipeline company in *Freede* presumably paid Freede a price that reflected the market price for produced gas immediately upon production, not the value of gas in the ground, no unrealized appreciation inhered in the gas owned by the pipeline company; the gas would have a value greater than the price paid for it only after transportation. The pipeline company thus is distinguishable from a producer, who seeks a profit through the appreciation in the value of the mineral realized by the act of production.

On the other hand, the test for an economic interest under *Palmer v. Bender* and Treasury Regulation, section 1.611-1(b)(1), does not require that the taxpayer look to extraction and sale for a *profit*, but rather for a *return of capital*.[208] Thus, unless the test has metamorphosed over the years, strictly construing the definition of an economic interest would result in the pipeline company having acquired an economic interest. Perhaps in altering the test for an economic interest to deny Freede the loan treatment he sought, the court of appeals was seeking a result consistent with normal business practice, under which the industry views payments under a take-or-pay contract as advance payments for gas, even though the court was unable or unwilling to articulate this basis for its conclusion. At the root of the problem is an almost irreconcilable tension between section 451 of the Code, which generally treats advance payments for goods as income in the year of receipt, and section 636(a), which sets up a contrary rule with respect to advance payments for minerals in the ground.

III. Selected Transactional Problem Areas

A. *Distinguishing Leases from Sales*

The economic interest test is used to distinguish a lease of a mineral property from a sale of a mineral property for federal income tax purposes. If the transferor has not retained an economic interest in the deposit, other than a retained production payment, then the transaction is taxed as a sale. If the transferor retains an economic interest in the deposit, the transaction is a lease and the transferor will realize ordinary

208. *See supra* part II.A.

income subject to depletion in the case of leases of oil and gas, solid minerals other than coal or iron ore, and coal or iron ore not subject to section 631(c) of the Code.[209] Coal and iron are not subject to section 631(c) if either the holding period requirement of that section has not been met or if the transferor's tax rate on ordinary income does not exceed its tax rate on capital gains (as is true for all taxpayer's other than high-income individuals).[210] In the case of a disposition of coal or iron ore in which the transferor retains an economic interest because the lease meets the requirements of section 631(c) and the lessor is not entitled to any capital gains preference, the lessor receives section 1231 treatment.[211]

If the *only* retained economic interest in a transfer is a production payment under section 636(b),[212] the transaction will be treated as a sale with a purchase money mortgage loan and the transfer will not be treated as having an economic interest.[213] Regardless of whether a deferred payment sale is evidenced by a recourse or nonrecourse obligation, a mineral property may be sold in an installment sale under section 453 of the Code. If, however, the deferred payments are neither subject to a fixed ceiling nor payable over a limited time, the transaction may be recharacterized as a lease and the payments treated as royalties.[214] Such a recharacterization is unlikely, however, if the purchase money indebtedness is a *bona fide* recourse obligation.

The numerous cases dealing with whether the taxpayer has retained an economic interest in a purported sale transaction have focused on a variety of factors. *O'Connor v. Commissioner*[215] is a fairly recent exposition by the Tax Court of the test for distinguishing sales from leases based upon a "risk analysis" determination of whether the taxpayer retained an economic interest. In Revenue Ruling 69-352 and Revenue Ruling 69-466, the Internal Revenue Service ruled that the intent of the parties to characterize the transaction as either a sale or a lease was not relevant; whether the transferor retained an economic interest was the

209. *See* I.R.C. § 631(c) (1988); Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946); Herring v. Commissioner, 293 U.S. 322 (1934); Murphy Oil Co. v. Burnet, 287 U.S. 299 (1932); Burnet v. Harmel, 287 U.S. 103 (1932); Rev. Rul. 69-352, 1969-1 C.B. 34.

210. *See* I.R.C. §§ 1(a), (h), 11 (West Supp. 1991).

211. *Id.* § 1231 (1988). *See generally* John C. Coggin, III, *Dispositions of Coal Interests: Section 631(c)*, 29 TAX LAW. 95 (1975).

212. *See supra* part II.C.7.a.

213. *See* Treas. Reg. § 1.636-1(a)(1), (c) Ex. 3 (1973).

214. *See* Temp. Treas. Reg. § 15A.453-1T(c)(4) (as amended in 1981).

215. 78 T.C. 1 (1982).

only relevant inquiry.[216] Some older cases have distinguished sales from leases based on the parties' intent[217] while more recent cases expressly adopt the economic interest test.[218]

The presence and structure of complicated advance minimum royalty provisions also may influence whether a transaction is a sale or a lease. In *Deskins v. Commissioner*,[219] the taxpayer disposed of coal pursuant to a document entitled "Coal Lease." Under the "lease," the taxpayer was to receive an annual minimum royalty of $430,000 for ten years. The royalty was recoupable by the lessee and total royalties were limited to $4.3 million over the life of the lease. The taxpayer retained no reversionary interest in any of the minerals, even if minerals remained unmined at the end of ten years. Because the transferor was entitled to receive exactly $4.3 million regardless of the amount of coal mined by the transferee, she had not retained an economic interest. Accordingly, the Tax Court held that the transaction was a sale, not a lease.[220] Thus, under section 483 of the Code, interest was to be imputed on the deferred payments; the imputed interest was taxable as ordinary income, and only the remainder of the "royalties" were treated as an amount realized on the sale of a capital or section 1221 asset, which would be accorded a preferential tax rate.[221] If the transaction had been a lease under section 631(c) as in effect for the year in question, all payments would have been treated as amounts realized on the sale of section 1231 property.[222]

B. *Distinguishing Contract Miners from Lessees*

Sometimes the owner of a mineral deposit leases the deposit to another person to operate, but the lessee concurrently agrees to sell all or a portion of the mine output to the lessor or to meet the lessor's requirements for mineral supplies. In such a case it may be difficult to determine whether the lease is a true lease or whether the lease and the output or requirements contract combined amount in substance to a contract mining arrangement. Cases confronting this problem consider all of the

216. Rev. Rul. 69-352, 1969-1 C.B. 34; Rev. Rul. 69-466, 1969-2 C.B. 140; *see also* Rev. Rul. 82-221, 1982-2 C.B. 113.
217. *See, e.g.*, West v. Commissioner, 150 F.2d 723 (5th Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); Jahn v. Commissioner, 58 T.C. 452 (1972), *aff'd*, 475 F.2d 1140 (6th Cir. 1973).
218. *See, e.g.*, Whitehead v. United States, 555 F.2d 1290 (5th Cir. 1977); O'Connor v. Commissioner, 78 T.C. 1 (1982).
219. 87 T.C. 305 (1986).
220. *Id.* at 323.
221. *Id.* at 322-24.
222. *Id.* at 322-23.

facts and circumstances surrounding the transaction. The following cases are illustrative.

In *Adkins v. Commissioner*,[223] a purported lessee was held actually to be a contract miner. The taxpayer leased coal under a series of one year renewable leases. The leases provided that no royalties were due on coal sold to the lessor. Concurrently, the lessee executed an output contract under which the lessee agreed to sell all of the extracted coal to the corporate parent of the lessor corporation at a fixed price per ton, subject to certain adjustments if there was a significant change in the market price of coal. Either party could terminate the contract if they failed to agree on the price. The lessor paid all real estate taxes, royalties, and mine engineering costs. The Tax Court found *Paragon Jewel Coal*[224] controlling and held that the taxpayer was a contract miner.[225] The determinative facts that the lessee was in reality a contract miner were that the "lessee" was not required to pay any royalties on coal sold to the lessor's corporate parent and that all of the extracted coal, except for *de minimis* amounts sold to lessee's employees, was sold to the lessor's corporate parent.

A similar result was reached in *Bolling v.Commissioner*.[226] The taxpayer-lessee entered into a lease of indefinite term, subject to termination on thirty days notice. Fixed sum royalties were due to the lessor on all coal extracted, but the parties simultaneously entered into a requirements contract under which the lessor had an option to purchase the mine output at "a price or prices to be agreed upon."[227] In practice the price paid more nearly reflected the lessee's extraction costs than it did the market price for the extracted coal. Although the lessee was required to purchase the surface rights because the lessor held only mineral rights, that purchase was not considered to be sufficient to give him an economic interest by analogy to *Southwest Exploration Co.*[228] The court concluded that *Parsons*[229] controlled, stating that the cost of the surface rights could be deducted.

Thornberry Construction Co. v. United States,[230] which reached the opposite conclusion from *Adkins* and *Bolling*, indicates that the price

223. 51 T.C. 957 (1969), *acq. in result*, 1970-1 C.B. xv.
224. *See supra* part II.B.11.
225. *Adkins*, 51 T.C. 967-68.
226. 37 T.C. 754 (1962).
227. *Id.* at 757.
228. *See supra* part II.B.9.
229. *See supra* part II.B.10.
230. 576 F.2d 346 (Ct. Cl. 1978).

structure of the arrangement may be an important element in finding a true lease as opposed to a contract mining arrangement. The lessor, which was in the business of operating coal properties, owned a coal deposit it did not want to operate and which it leased to the taxpayer on the condition that the taxpayer execute requirements contracts with valued customers of the lessor. The lease called for fixed royalties, but was terminable if the output was not sold to the designated customers. The customers, however, were unrelated to the lessor, and the lessee independently negotiated the sales contracts with the customers. The lessee bore all development and operating costs, including the acquisition of certain surface rights. The arrangement was held to be a true lease, not a contract mining agreement, because the lease "conferred upon [the lessee] the rights to mine coal and to sell that coal, *at whatever price it could obtain therefor*, to an independent, unrelated third party (albeit a valued customer of [the lessor]) and not to [the lessor] itself."[231]

Notwithstanding that the opinion in *Thornberry Construction* cites both the price structure and the independence of the purchaser from the lessor as factors important to finding a true lease, there is a basis for concluding that the price structure may be the single most important factor. In Revenue Ruling 72-477,[232] the Internal Revenue Service held that a lessee acquired an economic interest in a mineral deposit despite a contemporaneous agreement to sell a portion of the output to the lessor. The mining company leased a coal deposit from a utility company for a term of twenty-one years, subject to the lessee's right to extend the lease for ten years if the coal was not worked-out at the end of the initial term. The lessee was required to pay royalties at a fixed amount, which was stated in the ruling to be reasonable, subject to adjustment to reflect changes in the Wholesale Price Index. Contemporaneously, the lessee agreed to sell and the lessor-utility agreed to purchase a specified amount of coal annually, but the utility company retained the right to increase the amount. The price of the coal was determined under a formula based on the mining company's costs, excluding the royalties, plus an administrative charge and a profit factor, subject to adjustment to reflect changes in the Wholesale Price Index. The ruling states that the price was "substantially equivalent to the open market price of coal."[233] The supply agreement, like the lease, was for a twenty-one year term, but could be

231. *Id.* at 353.
232. Rev. Rul. 72-477, 1972-2 C.B. 310, *modified*, Rev. Rul. 83-160, 1983-2 C.B. 99.
233. *Id.* at 311.

extended by the utility company if the lease was extended. The lessee had the right to sell any extracted coal in excess of the amount required under the sales contract. Nevertheless, the Internal Revenue Service concluded that the agreements were not coterminous because the supply agreement could terminate prior to termination of the lease. On these facts the Service concluded that the mining company-lessee had acquired an economic interest because "the compensation [it] received from the utility company represents a share of the coal or proceeds of its sale."[234]

Revenue Ruling 86-81[235] is a further indication that the Internal Revenue Service views the price structure as the key to determining the presence of an economic interest. The ruling held that a lessee, under a lease requiring a reasonable royalty, but who was obligated to sell the entire output to the lessor, had acquired an economic interest where the sale of the extracted coal was to be at market price and the lessee had the right to mine to exhaustion or for a longer term. The lessor, who purchased the coal unprocessed and applied processes that would be considered mining processes if applied by the taxpayer, was found to have retained no economic interest other than the right to royalties.[236]

Revenue Ruling 73-32,[237] however, injects some confusion into the criteria for distinguishing leases from contract mining agreements. A power company leased a coal deposit to a joint venture, consisting of a subsidiary of the power company and an unrelated mining company, for sixteen years. Royalties were due on all coal mined from the property. The parties simultaneously executed a contract under which the lessee dedicated reserves sufficient to supply the power company-lessor's needs, although the lessee was permitted to sell a limited amount of coal on the market annually. The only information that the ruling provides regarding the price to be paid to the joint venture by the power company was that "[t]he price paid by the power company for coal supplied by the joint venture was stated in the coal supply agreement."[238] The joint venture transported the coal to the power company facilities where it was processed. The power company's subsidiary provided all of the equipment, the mining company provided the management, and each joint

234. *Id.* at 312.

235. Rev. Rul. 86-81, 1986-1 C.B. 249.

236. *Id.* at 250. It is worth noting that although the ruling does not specify whether the "lessee" was a true lessee or a percentage of sales contract miner, the conclusion that the lessor was not entitled to treat income from the sale of the coal as gross income from mining compels the conclusion that the lessee was a true lessee.

237. Rev. Rul. 73-32, 1973-1 C.B. 301.

238. *Id.*

venturer provided one half of the working capital. Under the joint venture agreement, the power company's subsidiary received a fixed fee per ton for the use of its equipment and the mining company received a fixed fee per ton for its management; remaining profits were divided equally.

On these facts, the Service held that the joint venture had acquired an economic interest in the coal deposit because the lease was not terminable on short notice and the joint venture looked "for its compensation solely to the extraction and sale of the coal."[239] Nevertheless, the facts of this ruling may more closely resemble those in *Adkins* and *Bolling* than those in *Thornberry Construction*, Revenue Ruling 72-477, and Revenue Ruling 86-81. Any meaningful analysis or application of Revenue Ruling 73-32 is impossible because of the lack of detail regarding the price structure.

C. *Joint Ventures*

Occasionally the form of a joint venture raises questions regarding which of the joint venturers has an economic interest and is entitled to depletion. Making this determination is not usually difficult because joint ventures are partnerships for tax purposes,[240] and if the partnership is a bona-fide lessee, the partnership will have an economic interest and allocate depletion among the partners.[241] Thus, Revenue Ruling 77-1 held that a partnership or corporation operating a "captive mine" holds the economic interest and is the proper taxpayer to claim the depletion allowance.[242]

However, section 761(a) of the Code permits certain partnerships to elect out of Subchapter K, which governs taxation of partnerships and partners.[243] If such an election is made, the joint venturers are treated for most purposes as if they were not partners but were co-owners of the deposit. To make this election the partners must reserve the right to take production in kind, must not actually jointly sell production, and it must

239. *Id.* at 302.

240. *See* Bentex Oil Corp. v. Commissioner, 20 T.C. 565 (1953) (holding that an oil and gas joint operating agreement is a partnership); PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS 19 (1991).

241. *See* I.R.C. §§ 701-704 (West Supp. 1991). Under current law, oil and gas partnerships allocate depletable basis and the partners compute depletion independently. *See* I.R.C. §§ 613A(c)(7)(D), 703(a)(2)(F) (West Supp. 1991).

242. Rev. Rul. 77-1, 1977-1 C.B. 161.

243. I.R.C. § 761(a) (1988).

be possible to compute taxable income without reference to the partnership rules.[244] Although some joint ventures may escape initial partnership classification because of unique arrangements, such occurrences are rare.

Revenue Ruling 74-469 held that both *X* Corporation and *Y* Corporation held an economic interest in a mineral deposit that they operated under a joint venture arrangement.[245] *X* Corporation, which held certain mineral leases, granted to *Y* Corporation the right to mine the leased deposits to exhaustion. *Y* obtained all permits in *X*'s name. *X* paid all royalties and conducted all extraction activity, processing, and storage. Under the agreement, however, title to the minerals was vested in *X* and *Y* in specified shares, and each sold its share separately through an independent agent. Whether *X* Corporation should be treated as holding an operating interest or a royalty payable in kind is not clear from the ruling.

IV. Treatment of Payments Between Holders of Different Economic Interests in the Same Property

Except for the treatment of contract miners and licensees, and to a limited extent lessees under short-notice terminable leases, the economic interest concept has focused primarily on identifying those nonoperating interests in mineral properties that give rise to depletable income. A corollary of the recipient's right to claim depletion with respect to a payment from the holder of a working interest is the denial of depletion to the holder of the working interest with respect to that payment. This section summarizes the treatment of both the payor and payee, including eligibility for percentage depletion, with respect to amounts paid or received pursuant to mineral leases.[246]

A. *Royalties*

Royalties received by a lessor or sublessor are depletable income, whether reserved as a royalty in a prime lease or as an overriding royalty upon a sublease of assignment of the lease.[247] A carved-out overriding

244. *See* Treas. Reg. § 1.761-2 (1972). *See generally* Martin J. McMahon, Jr., *The Availability and Effect of Elections Out of Partnership Status Under Section 761(a)*, 9 VA. TAX REV. 1 (1989).
245. Rev. Rul. 74-469, 1974-2 C.B. 178.
246. Determination of the amount of depletable income realized from operations by the holder of a working or operating interest is beyond the scope of this article. For discussion of this topic, see McMahon, *Coal Depletion*, *supra* note 113, and McMahon, *Fundamentals*, *supra* note 2.
247. Palmer v. Bender, 287 U.S. 551 (1933).

royalty is depletable without regard to the nature of the consideration paid for the royalty.[248] Similarly, a royalty received in consideration of wheelage or surface rights is an economic interest entitling the holder to depletion.[249] A net profits interest in a mineral deposit is an economic interest, whether retained on assignment of the lease or in a sublease or carved out, for example, as a dividend by a corporation to its shareholders. Receipts by the holder of the interest are depletable by the holder of the net profits interest and excludable by the owner of the working interest.[250]

A royalty expressed as a fixed sum per unit of mineral extracted from the property is an economic interest.[251] This is true even though the lessor's income does not vary with the market price. However, *Parsons v. Smith*[252] and *Paragon Jewel Coal Co. v. Commissioner*[253] might indicate that where income from extraction varies only with the number of units extracted, without reference to price or value fluctuations, income from the interest is not depletable.[254]

Some cases indicate that when a royalty is paid in kind, or, in the case of oil and gas, when the royalty is paid directly to the lessor by the purchaser pursuant to a division order, the lessee excludes the amount of the royalty from gross income for purposes of section 61 of the Code.[255] A number of other cases, however, indicate that when the lessee receives a cash payment for the full price of the mineral and remits the royalty in cash, the lessee should take the full sales price into account as cost of goods sold in the case of an operating interest, or gross income in the case of a sublessor, and then take depletion into account as part of cost of

248. *See* Rev. Rul. 83-46, 1983-1 C.B. 17 (holding that receipt of a carved-out royalty received for services rendered to a mineral owner other than in development or exploration of the deposit is income when received because it is an economic interest, which is a property right for tax purposes); Rev. Rul. 77-84, 1977-1 C.B. 173 (holding that a carved-out royalty with respect to mineral property received in consideration of rendering services in connection with the acquisition of a second property, was an economic interest in the first property); Rev. Rul. 73-80, 1973-1 C.B. 308 (holding that a royalty received in exchange for assignment of an outstanding option to purchase a mineral property is an economic interest).

249. Omer v. United States, 329 F.2d 393, 395 n.2 (6th Cir. 1964).

250. Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Beach Petroleum Corp. v. Commissioner, 46 T.C.M. (P-H) 654 (1946); Gen. Couns. Mem. 38,907 (Oct. 8, 1982).

251. Bankers' Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932); *see also* Treas. Reg. § 1.613-2(c)(5) (as amended in 1977).

252. 359 U.S. 215 (1959).

253. 380 U.S. 624 (1965).

254. *See* discussion *supra* parts II.B.10, II.B.11.

255. *See, e.g.*, Thomas v. Perkins, 301 U.S. 655 (1937).

goods sold or a deductible expense, as appropriate.[256] However, in determining the lessee's "gross income from the property" for purposes of depletion, royalties are excluded whether paid in cash, in kind, or pursuant to a division order.[257]

B. *Advance Minimum Royalties, Bonuses and Delay Rentals*

1. Generally

Advance minimum royalties received with respect to solid minerals are includable in income and subject to depletion by the lessor in the year of receipt or accrual, even though not earned.[258]

Bonus payments received by a lessor are also depletable.[259] If a production payment is retained in a sublease or assignment of a lease together with a royalty or net profits interest, under section 636(c) the production payment is treated as a lease bonus payable in installments, and the payments will be eligible for depletion by the lessor.[260] Option payments received with respect to a lease or assignment of a lease are depletable as a bonus.[261] If a bonus is received in connection with the transfer of a working property, including depreciable equipment and structures, a portion of the bonus will be treated as an amount realized upon the sale of the depreciable property.[262]

Pursuant to section 613A(d)(5) of the Code, bonuses, advance royalties, or any other amount payable without regard to production that are received with respect to an oil or gas property after August 16, 1986, in a taxable year ending after that date, are not eligible for *percentage* depletion.[263] Advance royalties and bonuses received with respect to oil and

256. *See* Commissioner v. Jamison Coal & Coke Co., 67 F.2d 342 (3d Cir. 1933) (advance minimum royalties); Ramsay v. Commissioner, 83 T.C. 793, 810 (1984) (purported advance minimum royalties); Buffalo Eagle Mines, Inc. v. Commissioner, 37 B.T.A. 843, 850 (1938) (royalties); *see also* Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(K) (1987) (requiring treatment of depletion as an inventory cost for any producer of minerals, oil or gas).

257. I.R.C. § 613(a) (West Supp. 1991); Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934).

258. Treas. Reg. § 1.612-3(b)(1), (d) (as amended in 1991); Commissioner v. Engle, 464 U.S. 206 (1984); Herring v. Commissioner, 293 U.S. 322 (1934); McLean v. Commissioner, 54 T.C. 569 (1970), *nonacq.*, 1972-2 C.B. 4; Handelman v. United States, 357 F.2d 694 (Ct. Cl. 1966); Rev. Rul. 72-165, 1972-1 C.B. 177.

259. Treas. Reg. § 1.612-3(a)(1), (d); *see Engle*, 464 U.S. at 227; Murphy Oil Co. v. Burnet, 287 U.S. 299 (1932); Burnet v. Harmel, 287 U.S. 103 (1932).

260. Treas. Reg. § 1.636-2(b) (1973).

261. Westates v. Commissioner, 21 T.C. 35 (1953).

262. Choate v. Commissioner, 324 U.S. 1 (1945). For application of this principle, see, e.g., Kline v. Commissioner, 268 F.2d 854 (9th Cir. 1959), and Louisiana Land & Exploration Co. v. Commissioner, 6 T.C. 172 (1946).

263. I.R.C. § 613A(d)(5) (1988).

gas properties continue to be eligible for cost depletion.[264]

Merely possessing an economic interest does not assure that all receipts of a lessor or sublessor will be entitled to depletion. Only receipts related to production or, as is the case with advance royalties and bonuses, receipts that are viewed in lieu of, rather than in addition to, production royalties are depletable. Accordingly, no depletion is allowed with respect to delay rentals, which are more commonly associated with oil and gas leases than solid mineral leases.[265] "A delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production."[266] Thus, delay rentals are unrelated to production; they are related to nonproduction.

2. Recapture of Depletion on Bonuses and Advance Royalties

Allowance of depletion upon receipt of payments in advance of production does not assure permanent allowance of depletion with respect to the payment. If a lease is surrendered by the lessee prior to any production, cost or percentage depletion previously claimed with respect to a bonus must be recaptured in the lessor's income.[267] Even slight commercial production prevents recapture.[268] Furthermore, if a lessor receives a bonus and disposes of the entire leasehold interest prior to abandonment, the recapture rule does not apply.[269] If, however, the lessor disposes of only an undivided fractional interest in the lease prior to its abandonment by the lessee, recapture will be required.[270]

In contrast to recapture of depletion on bonuses, which is an all or nothing proposition, recapture of depletion on advance royalties is more precise. Depletion claimed by a lessor with respect to advance royalties is subject to recapture if the lease is abandoned prior to extraction of all of the minerals to which the advance royalties relate.[271] Only depletion

264. For computation of cost depletion on bonus and advance royalty payments, see Treas. Reg. § 1.612-3.

265. *Id.* § 1.612-3(c)(2).

266. *Id.* § 1.612-3(c)(1). *See* White Castle Lumber & Shingle Co. v. United States, 481 F.2d 1274, 1279 (5th Cir. 1973) (treating acreage selection bonuses as delay rentals).

267. Treas. Reg. § 1.612-3(a)(2); Douglas v. Commissioner, 322 U.S. 275 (1944).

268. Crabb v. Commissioner, 41 B.T.A. 686 (1940), *nonacq.*, 1968-1 C.B. 3, *and aff'd*, 119 F.2d 772 (5th Cir. 1941). *But see* Campbell v. Commissioner, 41 T.C. 91, 93-94 (1963) (questioning *Crabb*).

269. Rev. Rul. 60-336, 1960-2 C.B. 195.

270. *See* Waggoner v. Commissioner, 47 B.T.A. 699 (1942).

271. Treas. Reg. § 1.612-3(b)(2).

on advance royalties relating to minerals for which royalties have been paid, but which remain in the ground upon abandonment, are recaptured. As a result of recapture, the lessor increases the depletable basis of the deposit *pro tanto*.

3. Lessee's Treatment of Advance Royalties and Bonus Payments

a. Advance Royalties

Advance royalties paid by a lessee are excluded from gross income from the property in computing the lessee's depletion allowance and are deducted from gross income in computing taxable income in the year of sale of the mineral to which the royalties relate, rather than in the year of payment or accrual.[272] At the lessee's election, however, advance royalties paid under a lease provision requiring substantially uniform minimum royalties over a period of at least twenty years, or, if less, the life of the lease, including renewals, may be deducted in the year of payment or accrual when computing taxable income under section 63 of the Code.[273] Notwithstanding that Treasury Regulation, section 1.613-2(c)(5)(iii), provides that advance royalties are excludable from gross income from the property in computing depletion in the same year they are deducted—in this case in the year paid or accrued—Revenue Ruling 79-386 held that the lessee must exclude substantially uniform advance minimum royalties from gross income from the property in the year of sale of the mineral to which the royalties relate, even though the lessee has made a valid election to deduct such royalties in the year paid or accrued.[274]

b. Bonus Payments

Lease bonus payments are treated similar to advance royalties in computing the depletion allowance. Each year the lessee excludes from gross income from the property the portion of the bonus allocable to minerals sold during that year.[275] This allocation spreads the lease bonus over the estimated reserves in a manner similar to the formula for cost depletion.[276]

Although a lease bonus is excluded from gross income from the

272. *Id.* §§ 1.613-2(c)(5)(iii), 1.612-3(b)(3).
273. *Id.* § 1.612-3(b)(3).
274. Rev. Rul. 79-386, 1979-2 C.B. 246.
275. Treas. Reg. § 1.613-2(c)(5)(ii); Rev. Rul. 79-73, 1979-1 C.B. 218.
276. *See* Treas. Reg. § 1.613-2(c)(5)(ii) Ex. 1.

property under section 613(a) for purposes of computing the depletion allowance, when computing the lessee's taxable income, the bonus allocable to the year of sale is neither excluded from gross income under section 61[277] nor deductible under any other Code section in determining taxable income.[278] The bonus is a capital expenditure, added to the lessee's depletable basis of the mineral deposit and recovered through depletion.[279] Nevertheless, the bonus payment must be excluded from the lessee's gross income from the property because it is depletable to the lessor.[280] The effect of requiring capitalization by the lessee of lease bonus payments is to deny the lessee any effective tax recovery of the bonus expenditure when percentage depletion is claimed.

C. *Carved-Out Production Payments*

Because of the unique treatment accorded to payments from one holder of an economic interest to another, Congress has statutorily modified the treatment of production payments. Only carved-out production payments the proceeds of which are pledged to, and used for, exploration or development of the burdened property constitute an economic interest. Payments in liquidation of such a production payment are depletable to the holder and excludable by the owner of the working interest.[281] If the proceeds of a production payment were not pledged to exploration or development of the burdened property, or were used for any other purpose, such as to finance production, the carved-out production payment is treated as a mortgage loan.[282]

V. CONCLUSION

The economic interest concept never has been easy to understand or apply. This difficulty is attributable in part to its gradual development as a judicial doctrine, with its parameters being defined on a case-by-case

277. I.R.C. § 61 (West Supp. 1991).

278. Treas. Reg. § 1.612-3(a)(3); Shamrock Oil & Gas Corp. v. Commissioner, 346 F.2d 377 (5th Cir.), *cert. denied*, 382 U.S. 892 (1965); Sunray Oil Co. v. Commissioner, 147 F.2d 962 (10th Cir.), *cert. denied*, 325 U.S. 861 (1945); Rev. Rul. 79-73, 1979-1 C.B. 218.

279. Treas. Reg. § 1.612-3(a)(3); *see* Murphy Oil Corp. v. United States, 337 F.2d 677 (8th Cir. 1964), *cert. denied*, 380 U.S. 979 (1965).

280. *See* Treas. Reg. § 1.612-3(a). Thus, an oil and gas lessee must exclude bonuses and advance royalties on which the lessor may not claim percentage depletion, because the lessor may claim cost depletion.

281. *See* I.R.C. § 636(a) (1988); Treas. Reg. § 1.636-1(b) (1973).

282. *See generally* McMahon, *Production Primer*, *supra* note 153.

basis. Another factor contributing to the doctrine's ambiguity is its application to both operating (or working) interests and nonoperating interests, which constitute significantly different bundles of rights and obligations and are created in significantly different manners. A third reason for continuing difficulty in applying the economic interest doctrine is that the classic test for an economic interest is formulated with reference to an "investment" in the deposit and "return of capital." Because both operating and nonoperating interests in mineral deposits often are acquired without making any investment in a tax sense, i.e., the owner of the interest has not made any expenditure capitalized into the basis of the deposit, the formal test is in fact nonsensical. In practice, the Internal Revenue Service and the courts both have been compelled to examine the issue by putting the cart before the horse; that is, analyzing on a policy basis whether on all the facts the taxpayer putatively holding an economic interest ought to be allowed percentage depletion and finding that the taxpayer holds an economic interest if that question is answered in the affirmative. *United States v. Swank* illustrates this backward reasoning better than any other case.[283]

As a matter of historical analysis, certain broad generalizations can be deduced from the pattern of the cases. Any person owning the fee or leasehold interest in a mineral deposit has an economic interest. On the other hand, the right to gross production, less a royalty paid, is not necessarily an economic interest if the interest is not formally a lease. Licensees generally are denied an economic interest, apparently because their interests in the deposit are too tenuous. However, a person having a right to a fractional share of gross production for the life of the deposit, such as an overriding royalty, has an economic interest, apparently whether the right is created by deed or otherwise.

Rights to a fixed sum of money for every unit of mineral extracted from deposit, however, are not necessarily an economic interest. The passive holder of a fixed-sum-per-unit royalty has an economic interest, while the miner who actively extracts minerals on behalf of the lessee or owner in consideration of a fixed sum for every unit of extracted mineral, i.e., a contract miner, does not have an economic interest. In the abstract, this distinction makes no sense, but when the question is considered in context, the distinction may be reasonable.

The status of a right to a share of the profits from a mineral deposit is not always as easily categorized. A deeded net profits royalty, for

283. *See supra* part II.A.12.

whatever reason created, always should be an economic interest. But a net profits interest created by contract may be subject to a facts and circumstances scrutiny, such as that in *Commissioner v. Southwest Exploration Co.*,[284] and if the holder of the right had no prior connection with the deposit, the interest may not be an economic interest.

Whenever a unique arrangement is examined, the policy behind the percentage depletion allowance always looms as an influential, even though sometimes hidden, factor in the analysis. Thorough examination of the development of the economic interest doctrine reveals that the words of the definition long ago lost their plain meaning. The regulatory definition of economic interest as a whole, and its individual component words, have become abstract terms of art. Applying these abstract terms of art, however, requires careful attention to both the formalism and real substance of the arrangement under scrutiny.

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284. *See supra* part II.A.9.