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COMMENTS

THE OIL AND GAS INSTALLMENT BONUS AND CAPITAL GAINS TREATMENT — A CRITIQUE

Rice M. Tilley Jr.

Obtaining capital gains through the use of an oil and gas installment bonus involves a two step transaction, *viz.*, the recipient of a bonus arranges for its payment in installments and then assigns this right to the installment payments treating the proceeds received as a gain on the sale of a capital asset. Each step in the transaction will first be discussed separately and then in relationship to each other.

I. PAYMENT OF THE BONUS IN INSTALLMENTS

When an oil and gas lease is granted in exchange for both a cash bonus and a retained royalty, the payment of the bonus by the lessee constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit and is recoverable through the higher of cost or percentage depletion.¹ To the lessor the bonus represents advance royalty and is thus ordinary income in the year of receipt subject to the higher of cost or percentage depletion.²

The receipt by a lessor of a cash bonus has always assured him at the time of the execution of the lease of an economic benefit which would otherwise not have been available until actual production in paying quantities resulted in royalty payments. However, this lump sum bonus payment ordinarily has not been satisfactory because it was wholly taxed in that year at ordinary income tax rates. As a result, it became popular to arrange for the payment of the bonus in deferred annual installments with each payment being subject to a depletion deduction³ in the year received. Such pay-

¹ Treas. Reg. § 1.612-3(a)(3) (1960).

² Treas. Reg. § 1.612-3(a), (d) (1960). These same principles apply to the analogous sublease situation in which the owner of a working interest transfers it but retains an overriding royalty. For purposes of clarity in terminology, the term "lessor" will denote any assignor of a lease and the term "lessee" will indicate the assignee.

³ These installments are payable in any event and cannot be avoided by drilling or by a surrender of the lease. Fiske, *Federal Taxation of Oil and Gas Transactions* § 2.06 (1960). Just as is the case with a normal lump sum bonus, if the lease is abandoned at some subsequent time with no drilling, the lessor must report as income an amount equivalent to the depletion which was previously allowed or allowable on the prior bonus installments received. Treas. Reg. § 1.612-3(a)(2) (1960). Of course, if any of the installment payments are received after the abandonment, no depletion deductions may be taken since they are only conditional allowances granted in anticipation of production from the property, and relinquishment of the lease terminates any such anticipation. *Douglas v. Commissioner*, 322 U.S. 275 (1944).

ments were treated as advance royalties paid in addition to the royalties dependent upon production since their essential character was fixed at origin and was not changed by deferment.⁴ This had the obvious advantage of spreading the lessor's bonus over several taxing periods. On the other hand the lessee was unaffected because he could only capitalize the bonus as part of the leasehold cost regardless of whether it was payable in a lump sum or in installments.⁵ Certainly there was no legal reason why bonus payments could not continue to be made after income began to accrue by means of the royalty stemming from a share of actual production. What such a situation amounted to was that the owner of the economic interest represented by the royalty was receiving income out of current or anticipated production equal to his fractional interest in production *plus* the amount of the installment payment.⁶

The prerequisite to the lessor's being allowed to report as income only the bonus installment payment received each year was that the obligation of the lessee to make the installment payments had to be secured *only* by an executory contract with no notes, bonds or other evidences of indebtedness being given.⁷ Consequently, the contract would have no fair market value and no tax liability could arise until an actual payment was made.⁸

This result clearly followed so far as cash basis taxpayers were concerned.⁹ Nothing taxable was *actually* received because all that was transferred to the lessor was an executory contract which, it was settled, had no fair market value.¹⁰ Nothing was *constructively* received because the lessor had no right to demand the payments until they became due each year.¹¹

⁴ 1 Oil & Gas Tax Q. 10 (1951).

⁵ Breeding & Burton, *Income Taxation of Oil and Gas Production* § 4.08 (rev. ed. 1961).

⁶ See Kent, *Tax Problems Affecting Lessors and Royalty Owners*, *Southwestern Legal Foundation First Inst. on Oil and Gas L. & Tax.* 355, 393 (1949).

⁷ This is to be distinguished from § 453, Int. Rev. Code of 1954, which specifically allows the use of the installment method, since § 453 applies only to sales, and an oil and gas lease is not a sale for federal taxation purposes. *Burnet v. Harmel*, 287 U.S. 103 (1932); see Kent, *op. cit. supra* note 6.

⁸ There was a failure to act pursuant to this technique in *Harry Leland Barnsley*, 31 T.C. 1260 (1959). Accordingly, since the lessor received a right to installment bonus payments represented by *negotiable* notes, it was held that the notes were the equivalent of cash, and therefore the full fair market value of the lease was taxable to the lessor as ordinary depletable income in the year of the execution of the lease.

⁹ The Regulations provide that a cash basis taxpayer is taxable only for items of income which are actually or constructively received within the tax year. Treas. Reg. § 1.446-1(c)(1)(i) (1957).

¹⁰ *Alice G. K. Kleberg*, 43 B.T.A. 277 (1941); *R. B. Cowden*, 9 CCH Tax Ct. Mem. 1148 (1950). See also *Bedell v. Commissioner*, 30 F.2d 622 (2d Cir. 1929).

¹¹ The Regulations provide that income will be constructively received by the taxpayer in the year in which it is credited to his account or set apart for him so that he may draw upon it at any time. See Treas. Reg. § 1.451-2(a) (1957).

As might be expected, the problem became more difficult when accrual basis taxpayers entered the picture.¹² Nevertheless, an accrual basis taxpayer in *C. W. Titus*¹³ was allowed to report the installment bonus payments when they were actually received. This conclusion was based on the fact that the executory contract indicated merely a conditional or contingent liability since nothing in the contract itself provided when, if ever, the assignee would become bound to make the payments. Accordingly, the assignor had nothing more than an account receivable. Although the *Titus* case has been criticized,¹⁴ its holding can probably be justified on the basis of the particular fact situation involved, *viz.*, the inconclusive terminology in the contract constituted a sufficient contingency to prevent the obligation from becoming fixed.

That the payment to be received is a *true* installment bonus may for purposes of this Comment be assumed; however, care should be taken to prevent a possible contention by the Commissioner that it is actually a delay rental. This is important because a lessor must report delay rentals as ordinary income not subject to depletion.¹⁵ Furthermore, the lessee will undoubtedly claim that any questionable payment is a delay rental, because the Revenue Service has taken the position that delay rentals are not materially different from carrying charges on non-productive property. Thus, unlike bonus payments, the lessee has an option either to expense¹⁶ or to capitalize¹⁷ them. However, as long as the lessee is committed to make annual payments and cannot avoid the payments by abandoning the lease, commencing drilling operations, or obtaining production from the property, the payments will be regarded as a lease bonus payable in installments and not as a delay rental.¹⁸ Moreover, any payment which continues a lease in force for more than one year will probably be treated as being in the nature of a bonus.¹⁹ A slightly different problem arises where payments are made to a lessor to defer production from a lease after a well has been drilled and found to

¹² The Regulations provide: "Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.446-1(c)(1)(ii) (1957).

¹³ 33 B.T.A. 928 (1936).

¹⁴ See Breeding & Burton, *op. cit. supra* note 5, at § 4.08.

¹⁵ Treas. Reg. § 1.612-3(c)(2) (1960).

¹⁶ Int. Rev. Code of 1954, § 162(a)(3); Treas. Reg. § 1.612-3(c)(2) (1960).

¹⁷ Int. Rev. Code of 1954, § 266; Treas. Reg. § 1.266-1(b)(1)(i) (1959).

¹⁸ *Bennett v. Scofield*, 170 F.2d 887 (5th Cir. 1948). See Ervin, *The Bonuses, Minimum Royalties and Delay Rentals*, Southwestern Legal Foundation Fifth Inst. on Oil and Gas L. & Tax. 529, 544 (1954).

¹⁹ *Houston Farms Dev. Co. v. United States*, 131 F.2d 577 (5th Cir. 1942). See Judge, *Tax Considerations of the Oil and Royalty Owner*, 31 *Taxes* 828, 832 (1953).

be productive. "Shut-in" payments which are not recoverable from future production and which must be paid to prevent a termination or forfeiture of the lease are treated as delay rentals and not entitled to a depletion deduction. A recent decision has even taken this position in a situation where the lease continued whether or not the payment was made and even though the right to extract the minerals remained with the lessee.²⁰

II. CAPITAL GAINS TREATMENT OF THE PROCEEDS RECEIVED FROM THE ASSIGNMENT OF A RIGHT TO INSTALLMENT BONUS PAYMENTS

Assuming that a taxpayer-lessor successfully arranged for the payment of installment bonus payments over a period of years and was thus subject to taxation only in the year a payment was actually received, the receipt of the amount of the bonus was effectively spread over a period of several years. Nevertheless, there was still a failure to obtain the substantially more advantageous capital gains treatment. The obvious solution to this problem was for the lessor to sell his right to receive the installment payments and, if he had owned the leased land for six months, treat the amount received as proceeds from the sale of a capital asset.

The landmark case dealing with this tax minimization technique was *Alice G. K. Kleberg*²¹ (hereinafter referred to as the first *Kleberg* case). Here, the taxpayer-lessors, who were on the cash basis, were the owners of a fractional interest in the mineral rights of a substantial land acreage in Texas. In 1933 the entire tract was leased by the owners, including the taxpayers, to a large oil company for installment bonus payments extending over a period of twenty years and a $\frac{1}{8}$ royalty interest in all oil and gas produced. In the same year the taxpayers assigned their portion of the right to receive these installment payments to the other owner of the property, the King estate, for cash, payable one-half in 1933 and the other half in 1934. The reason for the split payments was that the King estate was unable to pay the entire lump sum in 1933. The Commissioner contended that the taxpayers had merely sold their right to receive future installment payments and were thus simply anticipating ordinary income in 1933 in the amount of both payments. In adopting the taxpayer's position the court held that there had been a sale of a capital asset, *i.e.*, a royalty interest, since a bonus is an *advance* royalty. However, the court found that, other than the

²⁰ *Johnson v. Phinney*, 287 F.2d 544 (5th Cir. 1961).

²¹ 43 B.T.A. 277 (1941).

1933 payment itself, nothing was received in that year except a contractual promise to pay in 1934 an equal amount which was not evidenced by any note, bond, or other instrument of indebtedness. Accordingly, the court cited the *Titus*²² case and concluded that the promise to make the 1934 payment had no fair market value in 1933 and therefore the taxpayers were taxable only in 1933 to the extent of the actual payment received in that year.²³ The court then went on to hold that the taxpayers were not entitled to any depletion deduction on the payments received by them since they had *sold* their economic interest to the purchaser who then became the only one entitled to the depletion deduction. However, the taxpayers were, of course, allowed to recover their cost basis in computing gain on the transaction.

A subsequent related case, *Alice G. K. Kleberg*²⁴ (which was a continuation of the first *Kleberg* case and will be hereinafter referred to as the second *Kleberg* case), added one important additional point: the holding period (for purposes of capital gains taxation) of the capital asset transferred by the Klebergs began at the time when the taxpayers first acquired their interest in the property rather than, as the Commissioner had contended, at the time taxpayers sold their right to receive the installment payments. After first stating that oil and gas in place in *Texas* are a part of the realty, susceptible of ownership and conveyance, the court then reasoned that "the sale of the right to receive the rents from the [taxpayer's] interest in the . . . lease to the King estate did not create any new right to the minerals in the [taxpayer] . . . it merely changed the form in which the proceeds from the sale of the original mineral rights were to be received."²⁵

It is interesting to note that the Revenue Service acquiesced in both the first²⁶ and second²⁷ *Kleberg* cases but subsequently withdrew these and substituted non-acquiescences in the early 1950's.²⁸

This "sale" language was again emphasized in a more recent case, *R. B. Cowden*²⁹ (hereinafter referred to as the first *Cowden* case).

²² 33 B.T.A. 928 (1936).

²³ This conclusion was based on the relevant statutory language which stated that: "The amount realized from the sale . . . of property shall be the sum of any money received plus the *fair market value* of the property (other than money) received." (Emphasis added.) Revenue Act of 1932, ch 209, § 111(b), 47 Stat. 196.

²⁴ 2 T.C. 1024 (1943).

²⁵ *Id.* at 1031.

²⁶ Acq., 1941-1 Cum. Bull. 6.

²⁷ Acq., 1944 Cum. Bull. 16.

²⁸ Acq. withdrawn and non-acq. substituted, 1951-1 Cum. Bull. 5 (first *Kleberg* case); acq. withdrawn and non-acq. substituted, 1952-1 Cum. Bull. 5 (second *Kleberg* case).

²⁹ 9 CCH Tax Ct. Mem. 1148 (1950), remanded on stipulation, 202 F.2d 748 (5th Cir. 1953). Apparently a dollar compromise of the deficiencies was reached.

In this case the lessors were also cash basis taxpayers residing in Texas. Leases were executed with separate supplementary agreements providing for unconditional installment bonus payments on specific future dates. On the day following the execution of the leases, the lessors assigned the bonus agreements without recourse to several banks. When the lessors reported the proceeds of the sales in the year of the assignment as proceeds from the sales of capital assets held for more than six months (since the land had been acquired several years previously), the Commissioner contended that the deferred payments were taxable income in the year the property was leased. The court relied on the first *Kleberg* case to hold that even though the promises to make future installment payments were unconditional, since they were not evidenced by notes, bonds, or other evidences of indebtedness, the contractual promises had no *fair market value* when executed. Therefore, the lessors received no taxable income until the payments were actually made. The court then held that since oil and gas in Texas are part of the realty, capable of conveyance, the execution of the lease by the lessors actually constituted a *sale* of portions of their realty with the consideration being the right to receive installment bonus payments. Thus, the sale of the right to the installment bonus payments merely changed the form of the proceeds realized from the original sale of the realty,³⁰ *i.e.*, changed it from ordinary income to gain on the sale of a capital asset.

Strong support can be found for the position that the reasoning used by the court, in reaching its conclusion that capital gains treatment will apply when rights to installment bonus payments are assigned, was based on a legal fallacy.³¹ It is true as the court stated that in Texas the execution of an oil and gas lease constitutes the conveyance of realty. But it is equally true that local law does not control the timing and tax result so far as federal taxing statutes are concerned.³² It would thus appear that the court in the second *Kleberg* and first *Cowden* cases applied the "sale" language of the

³⁰ The court paraphrased that portion of the second *Kleberg* case which was quoted *supra* in the discussion of that case. 9 CCH Tax. Ct. Mem. at 1150.

³¹ See 2 Oil & Gas Tax Q. 219 (1953).

³² See e.g., *Burnet v. Harmel*, 287 U.S. 103, 110 (1932), where the Court answered the contention of a Texas lessor-taxpayer that capital gains treatment should be given to a bonus received upon the execution of an oil and gas lease by stating that:

For the purpose of applying this section to the particular payments now under consideration, the Act of Congress has its own criteria, irrespective of any particular characterization of the payments in the local law. . . . The state law creates legal interests but the federal statute determines when and how they shall be taxed. We examine the Texas law only for the purpose of ascertaining whether the leases conform to the standard which the taxing statute prescribes for giving the favored treatment to capital gains.

first *Kleberg* case (which was therein applied only to the sale of a *royalty interest, i.e.,* installment bonus payments³³) too liberally when discussing the tax consequences of a taxpayer-lessor's *execution* of an oil and gas lease. Therefore, to the extent the first *Cowden* case views an oil and gas lease as an instrument of sale and applies capital gains treatment to the proceeds received for the assignment of the right to future bonus installments, it appears to be at variance with the legal principles established by the Supreme Court and recognized by the Bureau and independent practitioners for many years. Accordingly, it is submitted that the application of these long accepted legal principles to the transaction here in question would completely nullify the basis upon which the courts in the second *Kleberg* case and in the first *Cowden* case derived the conclusion that capital gains treatment would be accorded the assignment of rights to future bonus installment payments.

The cases dealt with under this heading have concerned only cash basis taxpayers. However, a strong argument may be made for the proposition that insofar as the *Kleberg* and *Cowden* cases were valid, accrual basis taxpayers could also plan their leasing and subleasing transactions in a manner which would result in capital gains treatment of the proceeds received from assigned rights to installment payments. It will be remembered that the court in the first *Kleberg* case refused to consider the deferred payments as income realized upon the execution of the lease because, as the court pointed out, a promise to pay evidenced only by a contract, unsupported by notes, bonds or other evidences of indebtedness, has no *fair market value*. In so stating, the court made reference to the *Titus*³⁴ case which dealt with an accrual basis taxpayer and which held that a taxpayer's accounting method was not determinative of whether a contract had a *fair market value*.³⁵ Consequently, it appears that accrual basis taxpayers should be entitled to the same capital gains treatment as the cash basis taxpayers involved in the *Kleberg* and *Cowden* cases.

The first *Kleberg* case also dealt with a particular transaction

³³ 43 B.T.A. at 288:

It is our opinion that the respondent is correct in his contention that the transaction between petitioners and the representatives of the King estate was a sale. . . . The thing the absolute or general property in which was transferred from petitioners to the King estate was petitioners' right to receive 20 annual rental payments. . . . The price in money paid or promised was . . . cash paid upon the execution of the agreement, and a promise to pay . . . cash [in the following year]. Thus all the elements of a sale are present.

³⁴ 33 B.T.A. 928 (1936).

³⁵ *Id.* at 929: "We now think that we were in error in holding that the fact that the taxpayer kept its books on the accrual method of accounting was determinative of the issue"

which is quite similar to those which have just been discussed, but which must be distinguished from them. One of the two taxpayer-lessors involved in the Kleberg cases had received a separate tract of land which was her separate property. She leased this land also and received as consideration the usual $\frac{1}{8}$ royalty and an agreement by the lessee to pay her a stated amount in two installments, this amount being calculated on the basis of certain annual payments for twenty years discounted at their present value. The court held³⁶ that the exchange with the lessee of the twenty annual installment payments for a lump sum payment in the year of the exchange plus another lump sum in the following year did not constitute a sale. Further, the two lump sum payments were in the nature of a bonus and the lessor was thus entitled to a depletion deduction on the amount of each of the two payments when received. This transaction was essentially different from the situation in the first *Kleberg* case which has been previously discussed. There, a sale resulting in capital gains treatment was effected by the assignment to a *third party* of the right to installment bonus payments in exchange for two lump sum payments to be made in the year of the exchange and in the following year. Here, these two steps were shortened into one which resulted in a different tax consequence. Thus, the *same individual* who was obligated to make the installment payment was the one who exchanged them for the two lump sum payments. This, rather than effecting a sale (and capital gains treatment), merely brought about an acceleration of the payment of the bonus.³⁷

III. THE SECOND COWDEN CASE

Prior to 1959 there had been implicit faith in the use of the installment bonus as a safe and effective method of preventing the concentration of income in one tax year. But there was substantially less confidence on the part of tax planners in regard to the sale of rights to receive future bonus installments in order to obtain capital gains treatment of the proceeds received. Even though the *Kleberg* and first *Cowden* cases favored the taxpayer, the Internal Revenue Service continued to maintain its adverse position.³⁸

Accordingly, there was an understandable sense of shock on the part of those accustomed to utilizing the installment bonus as a tax minimization technique when the Tax Court in *Frank Cowden*,

³⁶ 43 B.T.A. 277 (1941).

³⁷ See Kent, *op. cit.* supra note 6, at 394.

³⁸ This position became even more formidable after the decision in *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958). See text accompanying note 82 *infra*.

Sr.³⁹ (hereinafter referred to as the second *Cowden* case) attacked, not the use of the installment bonus as a capital gain device, but the installment bonus itself.

A. *The Tax Court Decision*

In the unique facts of this case, a taxpayer-lessor on the cash basis had contracted with an oil company for the sale of oil and gas leases. Part of the consideration for the leases was the execution by the oil company of unsecured non-negotiable agreements to pay the lease bonus in three installments. The oil company was willing and able to pay the bonus immediately but acquiesced in the lessor's demand for a deferment of the bonus payments. The bank to whom the lessor assigned the installment payment rights had obtained an opinion from its counsel that the obligations represented thereby were bankable. Although such transactions were not considered commonplace, the bank had, over several years, acquired a number of other such obligations in like manner. Consequently, the bank was willing to purchase the agreements at a nominal discount. Further, even the lessor believed that the agreement had a fair market value. Prior to the actual payment of each installment the lessor would sell the contract to the bank for cash. The lessor relied on the usual argument that his right to receive future bonus payments had no fair market value and therefore could not result in the realization of taxable income to him upon the execution of the agreement. Nevertheless, the court held that the installment bonus contract had a fair market value and was thus taxable as gross income in the year in which the contract was made. The court pointed out that, "we are convinced from the particular facts of this case that . . . here the bonus payments were not only readily but immediately convertible to and were the *equivalent of cash* and for that reason had a *fair market value* in their *face amounts*. This value, less depletion allowances, represents ordinary income to the [lessor] upon the date of execution and delivery of the leases. . . ."⁴⁰ (Emphasis added.)

Unfortunately, it is difficult to discern the true basis for the Tax Court's decision. The dissent criticized the majority view on the grounds that it dangerously extended the doctrine of constructive receipt,⁴¹ however, the Tax Court opinion also appears to have relied to some extent on the "equivalent of cash" concept.

³⁹ 32 T.C. 853 (1959); noted, 59 Colum. L. Rev. 1237 (1959); 58 Mich. L. Rev. 480 (1960).

⁴⁰ 32 T.C. at 858, 859.

⁴¹ Id. at 861:

Thus, the result reached by the majority can only be based upon the pro-

1. *The Constructive Receipt Argument*

Constructive receipt is a fiction used to determine *when* certain income is realized.⁴² In essence, this doctrine treats income which is unqualifiedly available to a cash method taxpayer as though it had been received at the time it became available.⁴³ Emphasis had been placed on the extent to which the taxpayer had unfettered command⁴⁴ over the funds, whether the transaction was negotiated at arm's length,⁴⁵ and whether the taxpayer turned his back on income to which he had a present legal right.⁴⁶ The doctrine, however, has not been applied in cases (such as the second *Cowden* case) where the taxpayer did not have an existing right to the money when the cash offer was made.⁴⁷ With these factors in mind, it appears unlikely that the Tax Court decision in the second *Cowden* case was based on constructive receipt. The court apparently recognized that the lessor had no existing right to the installment bonus payments at the time of the execution of the lease because it did not even mention the doctrine of constructive receipt. Of those factors mentioned by the majority as being decisive in framing their decision,⁴⁸ only one—that the lessor refused the lessee's continual offer

position that [the oil company] would have as willingly paid the bonuses in cash on execution of the lease and therefore [this] cash basis [taxpayer was] in constructive receipt of the cash. . . . In my view this is a far reaching and dangerous extension of the doctrine of constructive receipt.

⁴² The Regulations provide: "Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or *constructively* received." (Emphasis added.) Treas. Reg. § 1.446-1(c)(1)(a) (1957).

⁴³ E.g., *Ross v. Commissioner*, 169 F.2d 483 (1st Cir. 1948).

⁴⁴ "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

⁴⁵ E.g., *Glenn v. Penn.*, 250 F.2d 507 (6th Cir. 1958); *Howard Veit*, 8 T.C. 809 (1947).

⁴⁶ E.g., *Hamilton Nat'l Bank*, 29 B.T.A. 63 (1933) (holder of promissory note refused to accept early payment when maker had a right to pay before the due date).

⁴⁷ E.g., *Richards' Estate v. Commissioner*, 150 F.2d 837 (2d Cir. 1945); *J. D. Amend*, 13 T.C. 178 (1949). These cases are based on reasoning exemplified by Treas. Reg. § 1.451-2(a) (1957) which provides:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

⁴⁸ The factors were:

- 1) The lessor believed that the agreement had a fair market value.
- 2) The bank was willing to purchase the agreements at a nominal discount.
- 3) The bank considered the rights to be bankable and to represent direct obligations of the payor.
- 4) The bank generally dealt in such contracts where it was satisfied with the financial responsibility of the payor and looked solely to it for payment without recourse to the lessor.
- 5) The oil company lessee was willing to pay the face amount of the obligations

to make immediate payment of the obligations—indicates that the doctrine of constructive receipt could have been applicable.

From a more conceptual perspective, the constructive receipt doctrine presupposes a situation in which an obligation is due and payable, and for payment thereof the “debtor” has made funds available which are refused by the “creditor.”⁴⁹ Since this is entirely different from the situation in which the debtor is willing and able to repay the debt, it would be logical to surmise that the Tax Court did not reach its conclusion on grounds of constructive receipt because of the lack of an immediate obligation to pay.

Another interesting consideration is the fact that, if the Tax Court did rely on constructive receipt, its decision is in direct conflict with a recent Revenue Ruling,⁵⁰ which was published after the decision was announced in the second *Cowden* case. The Ruling indicated that the doctrine of constructive receipt would not be used to tax a contract providing for deferred payments, and further stated without qualification that the income tax statutes “cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment.”⁵¹

A further ground for criticism may be based on the fact that the doctrine of constructive receipt is applicable only to cash basis taxpayers.⁵² In this connection it is appropriate to note the statement by the Tax Court that:

The fact that [the lessor] reported [his] taxable income on the cash basis of accounting is of *no consequence* here for no matter on what basis income is reported where, as here, an immediate payment in money or its equivalent is made a consideration for the execution of a lease, that payment constitutes taxable income under *any* accounting and reporting method.⁵³ (Emphasis added.)

Clearly, if the Tax Court’s conclusion was reached without regard for the accounting and reporting method used by the taxpayer-lessee, then that conclusion could not have been grounded on the doctrine of constructive receipt which is applicable *only* to cash basis taxpayers.

immediately and at all times prior to the due dates and the only reason this was not done was due to the lessor’s refusal to receive such payments.

⁴⁹ See 9 Oil & Gas Tax Q. 122, 126 (1960).

⁵⁰ Rev. Rul. 60-31, 1960 Int. Rev. Bull. No. 5, at 174. This ruling clearly demonstrates that the Service will not apply the doctrine of constructive receipt to unfunded contracts even in the absence of any provisions in the contract that condition the taxpayer’s right to the deferred compensation.

⁵¹ *Ibid.*

⁵² *Harbor Plywood Corp. v. Commissioner*, 14 T.C. 158 (1950), *aff’d*, 187 F.2d 734 (9th Cir. 1951); Treas. Reg. § 1.446-1(c)(1)(i) (1957).

⁵³ 32 T.C. at 859.

It must be pointed out that if the courts were to view this decision as the dissent apparently did, (*viz.*, as the finding of constructive receipt based on the fact that the taxpayer insisted on the deferred payment), it could be extended to make taxable in the year of the making of the contract all income to be received through the use of deferred payment contracts which are now widely used by authors, entertainers, and business executives as a technique for spreading income over several taxable years. Such an extension would seem wholly unwarranted in view of the fact that, since such contracts are usually arm's length transactions, a serious departure from present tax policy in this field would result. Further, such a finding could constitute a precedent for the finding of constructive receipt even in a situation where a land vendor desiring periodic payments was unfortunate enough to receive a cash offer. Surely, requiring tax liability to depend solely upon whether the taxpayer had sufficient foresight to warn the promisor not to mention cash is a tenuous distinction which borders on the ridiculous.

Finally, if it be assumed that the Tax Court relied upon the fact that the lessee would have paid the bonuses in cash just as willingly at the time of execution of the lease, the decision conflicts with income tax fundamentals. A taxpayer should be taxed on the basis of the transaction into which he actually entered. As the dissent pointed out, "It has been axiomatic that a taxpayer is free to cast his transactions in any manner he may choose, and the tax consequences of such transactions are to be based on what he did, not what he could or might have done, the only qualification being that he must in fact have done what he claims, not merely appear to have done so."⁵⁴

2. *The Equivalent of Cash Argument*

Although a cash basis taxpayer who has a right to receive benefits in the future from an unfunded contract may not, under the doctrine of constructive receipt, realize income at the time the contract is made, he may be said to realize income on the contract by applying the cash equivalent doctrine. Unlike constructive receipt, which determines *when* certain income is realized, cash equivalent deals with one aspect of the general problem of *what* non-cash benefits constitute income, and any contract rights with a fair market value are treated like property and taxed when received. Under the equivalent of cash method, the taxpayer is taxed on the income received in cash or its equivalent within the taxable year.⁵⁵ For

⁵⁴ *Id.* at 861.

⁵⁵ See *John B. Atkins*, 9 B.T.A. 140, 150 (1927), *aff'd*, 36 F.2d 611 (D.C. Cir. 1929) ("in the case of one reporting income on the receipts and disbursements basis only cash or its equivalent constitutes income."); Int. Rev. Code of 1954, §§ 61, 451.

example, a negotiable note received by a cash basis taxpayer in payment of an obligation is the equivalent of cash⁵⁶ and the taxpayer realizes income to the extent of the fair market value⁵⁷ of the note when he receives it. However, realization of income through the application of the cash equivalent doctrine is not limited to situations where the taxpayer actually receives cash or a negotiable note, for the doctrine has been extended to include any *economic benefit*⁵⁸ derived by the taxpayer.⁵⁹

Of those factors listed by the majority opinion as being determinative of the decision reached,⁶⁰ all but one indicate that the court's decision was based wholly on this economic benefit aspect of the equivalent of cash doctrine. But here, the property interest received by the taxpayer was only an unsecured executory contract for future payments, and the courts had never before held that the economic benefit concept could be extended to such unfunded contractual arrangements.⁶¹ Accordingly, the value of an unfunded contract to receive benefits in the future has never been taxed at the time the contract was made.⁶² The basis for this has been that, as a matter of law, an unfunded contract to receive benefits in the future can have no fair market value.⁶³ Only where the right to

⁵⁶ *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Cherokee Motor Coach Co. v. Commissioner*, 135 F.2d 840 (6th Cir. 1943); *Harry Leland Barnsley*, 31 T.C. 1260 (1959). See also *Treas. Reg. § 1.61-2(d)(4)* (1959).

⁵⁷ The interest rate and the solvency of the parties liable on the note will largely determine the fair market value. *Paul M. Potter*, 15 P-H Tax Ct. Mem. 114 (1946).

⁵⁸ E.g., *Helvering v. Eubank*, 311 U.S. 122 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940).

⁵⁹ See Comment, 1960 *Duke L.J.* 436.

⁶⁰ See note 48 *supra*.

⁶¹ The most emphatic statement to this effect was rendered by Judge Learned Hand in *Bedell v. Commissioner*, 30 F.2d 622, 624 (2d Cir. 1929):

If a company sells out its plant for a negotiable bond issue payable in the future, the profit may be determined by the present market value of the bonds. But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language when calculating profits under the income tax [I]t is absurd to speak of a promise to pay a sum in the future as having a "market value," fair or unfair. Such rights are sold, if at all, only by seeking out a purchaser and higgling with him on the basis of the particular transaction.

See also *United States v. Christine Oil & Gas Co.*, 269 Fed. 458 (1920); *C. Florian Zittel*, 12 B.T.A. 675 (1928); *Branscomb*, *Recent Developments in Oil and Gas Taxation*, Southwestern Legal Foundation Eleventh Inst. on Oil and Gas L. & Tax. 615, 652 (1960).

⁶² *C. W. Titus*, 33 B.T.A. 928 (1936) (deferred payment contract for the sale of oil and gas leases held not to have a fair market value); *J. Darsie Lloyd*, 33 B.T.A. 903 (1936) (noncommercial annuity contract held not to have a fair market value); *Charles C. Ruprecht*, 16 B.T.A. 919 (1929), *aff'd*, 39 F.2d 458 (5th Cir. 1930) (contract held to be a mere noninterest bearing account receivable).

⁶³ See *Appleman*, *Current Developments in Oil and Gas Tax Law*, Univ. of Tex. Seventh Inst. on Current Tax Law Developments 136, 144-46 (1959). Although many of these cases, decided on the basis of no fair market value, dealt with contracts in

future payments has had a commercial market has the economic benefit concept been applied.⁶⁴ In addition, as pointed out by the dissent, in determining just what evidences of obligation will be considered as having a fair market value, the courts have usually drawn the line at negotiable instruments. This is due to the fact that, unlike executory promises to pay in the future, "a negotiable promissory note is freely and easily negotiable chiefly because equities and defenses available between the original parties thereto are not available as against a third party purchaser for value, before maturity and without notice."⁶⁵ Although the court in this second *Cowden* case placed great emphasis upon the fact that the taxpayer-lessee refused to enter into a contract calling for an immediate cash payment, this factor can only bear upon the solvency of the promisor and upon the value of the rights received, and is wholly irrelevant to the question of whether there existed a commercial market for such rights.⁶⁶

The main difficulty with the Tax Court opinion stemmed from the court's failure to specify whether the decision was based upon a constructive receipt or an equivalent of cash theory. It seems probable that the Tax Court did not recognize a distinction between the two terms. If the Tax Court's underlying intent was to rely on the constructive receipt concept, then it would have attempted to tax the *face value* of the contract right, but if a decision based on equivalent of cash concepts was intended, then the court probably would have spoken in terms of the fair market value of the contract right. Unfortunately, this potential clue leads to no solution because the Tax Court's language is ambiguous, and the fair market value of the contract right was held to equal its face value.

B. *The Decision Of The Fifth Circuit*⁶⁷

The Fifth Circuit opinion did not distinguish between the concepts of constructive receipt and equivalent of cash. It apparently

which the payment was contingent, e.g., *Commissioner v. Garber*, 50 F.2d 588 (9th Cir. 1931); *Edward J. Hudson*, 11 T.C. 1042 (1948), or with fact situations evidencing a lack of market value, e.g., *Curtis R. Andrews*, 23 T.C. 1026 (1955); *Estate of Clarence W. Ennis*, 23 T.C. 799 (1955), some involved solvent obligors unconditionally bound to make payment, e.g., *Commissioner v. Moore*, 48 F.2d 526 (10th Cir.), cert. denied, 284 U.S. 620 (1931); *Alice G. K. Kleberg*, 43 B.T.A. 277 (1941); *Charles C. Ruprecht*, supra note 62.

⁶⁴ E.g., *Paul Haimovitz*, P-H Tax Ct. Mem. 59 (1956).

⁶⁵ 32 T.C. at 861.

⁶⁶ If the court really wanted to tax these rights under the economic benefit concept, a preferable rationalization would have been to hold that the existence of a commercial market is unnecessary if the promisor provides a "one-buyer market" by remaining willing and able to pay cash after the execution of the deferred payment contract.

⁶⁷ 289 F.2d 20 (5th Cir. 1961).

took the view that the Tax Court's decision was based on a constructive receipt theory since the Circuit Court's opinion pointed out that the Tax Court stressed the willingness and ability of the lessee to make the bonus payments, and that the Tax Court "used the amounts which it determined the taxpayers could have received if they had made a different contract, rather than the fair market value cash equivalent of the obligation for which the taxpayers had bargained in the contracts which they had a lawful right to make."⁶⁸ The Fifth Circuit then clearly stated that the Tax Court could not make an exception to the general proposition—that non-negotiable executory contracts to make future payments in money do not have a fair market value—by utilizing a constructive receipt theory, *i.e.*, that the lessee was willing and able to make the bonus payments.

The most novel aspect of the Fifth Circuit's opinion was its modification of the equivalent of cash doctrine. It first declared that "as a general rule a tax avoidance motive is not to be considered in determining the tax liability resulting from a transaction."⁶⁹ The court then qualified this general statement by pointing out that, although tax avoidance is allowable, "it is also true that if a consideration for which one of the parties bargains is the equivalent of cash it will be subjected to taxation to the extent of its fair market value."⁷⁰ This brought the court to the contention of the taxpayers that there could be no equivalent of cash obligation unless a negotiable instrument was involved. This argument was based on the fact that previous cases dealing with unsecured executory contracts had made it clear that such contracts could be taxed only if they had a fair market value and that they had a fair market value only if they were negotiable. The court's answer to this contention clearly modifies prior concepts as to the prerequisites for finding fair market value. The court declared that whereas on the one hand "a promissory note, negotiable in form, is not necessarily the equivalent of cash," on the other hand, the converse should be applicable. Thus the court concluded that:

if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such

⁶⁸ *Id.* at 25.

⁶⁹ 289 F.2d at 23: "[T]he taxpayers had the right to decline to enter into a mineral lease of their lands except upon the condition that the lessee obligate itself for a bonus payable in part in installments in future years, and the doing so would not, of itself, subject the deferred payments to taxation during the year that the lease was made."

⁷⁰ 289 F.2d at 23.

promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.⁷¹

Accordingly, the Fifth Circuit remanded the case to the Tax Court and directed it to disregard the ability and willingness of the lessee to pay and to determine the pure fact question whether the agreements in question constituted the equivalent of cash. The effect of this decision is that an unfunded contract to pay future benefits can now have a fair market value (and thus constitute the equivalent of cash) even though the contract itself is not negotiable.

In view of this holding, lessors in a similar position should arrange for executory agreements to pay installment bonuses which lack the various elements indicating the equivalent of cash because negotiability is no longer the test of taxability. Instead, the determinative factors will be based on substance rather than form. Therefore, where, as in the instant case, the contract is considered to have a fair market value by the parties, as well as by the business world, a decision giving a fair market value to the contract may well be justifiable. The apparent result is that the *Bedell*⁷² doctrine can co-exist with the economic benefit concept. Accordingly, although the *Bedell* doctrine seemed to be a fundamental of income tax law, it evidently must give way to the economic benefit concept when the facts warrant.⁷³

Although the decision is undoubtedly based on the economic benefit aspect of the equivalent of cash doctrine, a strong argument can be made that this doctrine is inapplicable to a case such as this. Not only is there a complete and unexplained break with prior judicial precedent, but there is also a direct conflict with a 1960 Revenue Ruling,⁷⁴ promulgated by the Revenue Service, which limits the economic benefit concept to funded contracts.⁷⁵

A more serious ramification of the decision is that if, as in the principal case, the court continues to speak the language of cash equivalent where there is no established market, then all contract rights should be held includible in income to the same extent as under the accrual method. Accordingly, further judicial inroads based on the reasoning in this case could eventually result in equating cash receipts with accrued receipts. This would have the effect

⁷¹ *Id.* at 24.

⁷² *Bedell v. Commissioner*, 30 F.2d 622 (2d Cir. 1929). See note 61 supra.

⁷³ See 9 Oil & Gas Tax Q. 122, 127 (1960).

⁷⁴ Rev. Rul. 60-31, 1960 Int. Rev. Bull. No. 5.

⁷⁵ "A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intentment of the cash receipts and disbursements method." *Ibid.*

of penalizing those who use the cash method for its simplicity since their gross income would probably exceed and could never be less than under the accrual method, and there would be lacking the corresponding advantage of being able to deduct accrued expenses.⁷⁶ In addition, there would be an undue hardship imposed upon taxpayers because they would be subjected to a tax before they received the income upon which the tax is based.⁷⁷

IV. CONCLUSION

There are three approaches which may be taken by the courts in resolving the problem of the tax treatment to be given a sale of rights (represented by unsecured, non-negotiable promises to pay) to installment bonus payments. First, the entire installment bonus technique can be destroyed by taking the position that in the tax year during which the installment bonus arrangement is entered into, the taxpayer-lessor will be taxed in an amount based on all of the payments to be made. Second, each installment can be taxed only in the year of receipt (assuming the necessary prerequisite is met),⁷⁸ but if there is a sale of the right to the installment bonus payments, it can be held that the taxpayer is simply anticipating income and he can be taxed in that year at ordinary income tax rates based on the proceeds received from the sale. Third, the approach that is taken in the second can be used except that the sale of the right to the installment bonus payments can be taxed as the sale of a capital asset and the proceeds taxed at capital gains rates.

It is submitted that the first and third approaches are unsatisfactory. The first must be rationalized on the basis of either the constructive receipt doctrine or the economic benefit aspect of the equivalent of cash doctrine and, as has been previously explained, neither of these is logically applicable. The third, as has also been shown, rests on the erroneous assumption that for federal income tax purposes a leasing transaction in Texas constitutes a sale of an interest in realty, and therefore, this approach is also without merit.

It is further submitted that the second approach is the only one legally sufficient to cope with the problem. The installment bonus arrangement itself should be approved because the constructive receipt and economic benefit theories cannot be resorted to for the

⁷⁶ "Constructive payments" are almost never allowed as deductions under the cash method. E.g., *Vander Poel, Francis & Co. v. Commissioner*, 8 T.C. 407 (1947) (cash method corporation not allowed to deduct salaries authorized but not actually paid, even though employees were required to report them as constructively received).

⁷⁷ See *Commissioner v. Garber*, 50 F.2d 588 (9th Cir. 1931).

⁷⁸ I.e., the installment bonus contract must not have a cash equivalent.

reasons previously given.⁷⁹ Therefore, assuming that the installment bonus arrangement can be used with favorable tax results, the next step is to ascertain whether capital gains treatment will be permitted when there is a sale of the right to the deferred installment payments. Of the two techniques used to obtain capital gains treatment, one, *viz.*, that a lease brings about a sale of an interest in realty for federal income tax purposes, has been shown to rest on an erroneous premise. The other technique is probably likewise doomed to fail. It is developed as follows.⁸⁰ When a landowner-lessor executes an oil and gas lease with a royalty reserved, he is considered not to have parted with his capital investment in the oil and gas in place since he has merely given another a share right in the production as consideration for the assumption of burdens associated with the development and operation of the lands by another. It thus follows that the royalty is but a retained portion of the fee acquired at an earlier date which possesses the same holding period. It is undisputed that an undivided portion of the landowner's royalty may be sold and that the proceeds therefrom will qualify for capital gains treatment. Since for tax purposes bonus payments are considered to be mere advance royalties, it is reasonable to conclude that if the landowner assigns his right to the deferred bonus payments for a cash consideration, this assignment can be viewed as a sale of a portion of his royalty thereby entitling him to capital gains treatment on the cash consideration received.

However, recent judicial developments have dampened hopes for the success of this technique. The well-known position of the Bureau is that an assignment of a fraction of a royalty interest is treated as a sale because the interest conveyed is co-extensive with the life of the interest from which it is severed. But the interest conveyed by the landowner-lessor would not be co-extensive with the interest from which it was severed because the installment payments would not run to the exhaustion of production as would the retained royalty interest. Accordingly, this would be the basis for treating the assignment as analogous to the sale of a carved out oil payment⁸¹ which, under the doctrine of the *P. G. Lake* case,⁸² would cause the entire proceeds from the sale to be taxed to the landowner-lessor in

⁷⁹ For support for this position, see Fiske, *Federal Taxation of Oil and Gas Transactions* § 2.06 (1960).

⁸⁰ See 2 *Oil & Gas Tax Q.* 219 (1953).

⁸¹ See Fiske, *Current Practices in Planning Oil and Gas Transactions*, 8 *Tulane Tax Institute* 367, 379 (1959).

⁸² *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), held that where any oil payment carved out of a larger economic interest is assigned, the assignor has anticipated income and the consideration received is taxable as ordinary income subject to depletion.

that year at ordinary income tax rates since it would merely amount to an anticipation of income.

It is quite probable that future litigation will follow this line of reasoning. Not only is this the most logical and legally supportable course to pursue, but there is also a major policy factor⁸³ involved—a failure to apply the analogy of the *Lake* case (and the consequent approval of capital gain treatment to proceeds received from the sale of the right to future installment bonus payments) would lead to a quick extinction of lump sum bonus payments since all bonuses would be cast in the form of installments the rights to which would be sold for capital gains.

Therefore, since this second and only other method for obtaining capital gains treatment upon the sale of a right to bonus installment payments also appears destined for failure, the taxpayer-lessee will probably have to be content with the use of only the first step of this tax minimization technique, *viz.*, he can arrange for installment bonus payments represented by an unsecured promise to pay, spread out the receipt of the bonus, and prevent a concentration of income in one year if the executory contract can be shown not to have a fair market value. On the other hand, if he makes a sale of his right to the deferred payments, the proceeds will be taxed in that year at ordinary income tax rates (rather than capital gains rates) as constituting an anticipation of income. For, once the principle of *P. G. Lake* is focused on this type of transaction, surely the era of capital gains treatment must terminate abruptly.

⁸³ See Oil and Gas Forum, N.Y.U. 12th Inst. on Fed. Tax. 433, 447 (1954).