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WHO HAS A DEPLETABLE INTEREST IN OIL?

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The depletion deduction has come to represent a fantastic amount of money each year.¹ With such sums at stake it is not surprising that the courts have been crowded with tax cases involving depletion. The litigation has involved problems of who gets the deduction, when it may be taken, how the amount is computed, and what income is subject to depletion. Outside the courts, there is vigorous controversy as to whether the deduction in its present form should be allowed at all.² None of these problems has been solved to everyone's satisfaction. The purpose of this article is to analyze how the law as to who gets the deduction in the oil³ industry has developed. For convenience, the evolution of the legal rules for determining who benefits from depletion can be divided into three phases.

During the first phase, beginning in 1909, Congress consistently authorized the deduction only to have the Supreme Court thwart its intentions. Common law rules of estates in land governed the decisions as to who got the deduction. Congress changed the statute frequently to offset the adverse decisions. Underlying this byplay was the growth in importance to the economic welfare of both the oil industry and income taxation. This growth exerted pressure for a realistic solution of the depletion problem. In 1933 the Supreme Court responded and the development reached its next stage.

The second phase of development is marked by a fascinating decision. A new concept, adequate for implementing the intentions of Congress and adjusting the equities of the depletion deduction, was announced.

During the third phase the new concept is used by the courts, the administrators, and the taxpayers in dealing with depletion problems. There is clarification and distortion, but the new approach becomes firmly fixed in the law during this period.

The final stage should be the elimination of confusion as to who gets the deduction for depletion. This point has not yet been reached. The characteristics and effects of the new concept are not settled with certainty.

Somewhere in the examination of the evolutionary process, there

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1. A survey prepared by the Secretary of Treasury showed that 350 corporations deducted as allowable depletion \$555,000,000 in 1946 and \$839,000,000 in 1947-97. CONG. REC. 12313 (1951).

2. See Baker and Griswold, *Percentage Depletion—A Correspondence*, 64 HARV. L. REV. (1951) for skillful presentation of both sides of the question.

3. For convenience, "oil" will be used herein as synonymous with "oil and gas."

should be the key for successful prediction of the future form of the law. It may become apparent only in retrospect. The possibility that it can be detected justifies delving into historical details.

CONGRESS V. COMMON LAW RULES

The Corporate Tax Act of 1909⁴ provided for a deduction of all loss sustained during the year—including a reasonable allowance for “depreciation of property.”

The Supreme Court decided, in cases involving the act of 1909, that no connotation should be attributed to depreciation other than “in its ordinary and usual sense as understood by business men.”⁵ The court recognized that “the revenues derived from working mines result to some extent in the exhaustion of capital”⁶ and that “there seems to be some hardships in taxing such receipts as income without some deduction arising from the fact that the mining property is being continually reduced by the removal of the minerals.”⁷ Nevertheless, the owner-operator and the owner-lessor of mines were denied any deduction primarily because of the scope of depreciation.⁸ In the case of the lessee-operator, the circuit court felt that the deduction should be allowed.⁹ The cases denying the fee owners the deduction were distinguished. The difference, according to the court, was that “when the land is devoted to mining, it is put to only one of the productive uses of which it is capable.” Since the land is left after the mining is finished the owner suffers no depletion. On the other hand, the interest of the lessee, as far as he exploited the minerals, was exhausted each year. When the mining was finished “he did not have left the principal thing, the land, which he could put to another use.” Therefore, the court reasoned, he was entitled to a deduction for depletion. The Supreme Court did not agree with this view.¹⁰ The circuit court was reversed. The reasoning was that the lessee was “in no legal sense a purchaser of the ore in place.” He paid so much per ton for the privilege of removing the ore. This was the only privilege he had under the lease. With no legal interest in the ore in place he could not claim depletion.

The Treasury Department had thought the fee owner had a depletable interest under the Act of 1909 but that the lessee did not.¹¹ When Congress specifically provided for an allowance for exhaustion in the case of

4. Sec. 38, 36 STAT. 11, 112.

5. *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503 (1916).

6. *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399 (1913).

7. *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503 (1916).

8. In the *Stratton's Independence* case the taxpayer owned and operated the mine; in the *Sargent Land Co.* case, the taxpayer owned the land and leased the mineral rights to others.

9. *United States v. Biwabik Mining Co.*, 242 Fed. 9 (6th Cir. 1917).

10. *United States v. Biwabik Mining Co.*, 247 U.S. 116 (1918).

11. T.O. 1606, 13 *Treas. Dec. Int. Rev.* 39, 44-45 (1910); T.O. 1675, 14 *Treas. Dec. Int. Rev.* 16, 23 (1911).

mines in 1913¹² the Treasury held to this view. The position was confirmed by the circuit court in *Weiss v. Mohawk Mining Co.*¹³ In this case the court held that "the statutory reduction for 'depletion' can not be twice credited, once to the fee owner, and once to the lessee; and that the exemption belongs of right to the fee owner." For the time being, this decision fixed technicalities of title and common law estates in land as the determinants of who had a depletable interest in solid minerals.

In the 1916 Revenue Act¹⁴ Congress provided for a reasonable allowance for the reduction in flow and production in the case of oil and gas wells. The statute limited the deduction to recovery of cost and did not say who should receive the deduction. The Treasury Department followed its policy of permitting the deduction to the fee owner only.¹⁵ The lessee was allowed to amortize the cost of his lease.¹⁶

In 1918 Congress completely changed the complexion of the depletion deduction for oil and gas. The deduction was not a constitutional right but rather an act of legislative grace.¹⁷ The war had proved the importance of new oil reserves to national defense and complaints of operators had made clear the financial hazards of searching for oil.¹⁸ Congress used its prerogative of establishing an arbitrary allowance for depletion as a means of encouraging the development of new oil properties. The Act of 1918¹⁹ provided:

In the case of oil and gas wells discovered by the taxpayer where the fair market value of the property is materially disproportionate to the cost the depletion allowance shall be fair market value of the property at the date of discovery, or within 30 days thereafter. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

Depletion for the purpose of income taxation became more than economic or geological depletion. The deduction represented a recovery of cost plus a reward for successful exploration. The fee owner seldom discovered the oil. Normally he did not assume any part of the financial risk of the search. The lessee either assumed the risk or spread it among investors. Clearly the intention of Congress was not to limit the deduction to fee owners.

In 1922 the Treasury Department decided that its policy of denying

12. Sec. II C (b) and Sec. B, 38 STAT. 166.

13. 264 Fed. 502 (6th Cir. 1920), cert. denied, 254 U.S. 638 (1920).

14. Sec. 12 (a), 29 STAT. 756, 769.

15. T.D. 2447, 19 Treas. Dec. 31 (1917).

16. *Ibid.*

17. *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916).

18. H. R. Rep. No. 767, 65th Cong., 2d Sess. (1918) and hearings before committee on Ways and Means, 65th Cong. 2d Sess., p. 455, 516-17, 523-28, 530-531.

19. Sec. 214 (a) (10) and Sec. 234 (a) (9) 40 STAT. 1057, 1067, 1078.

the deduction of the lessee did not apply to oil leases. In LO 1103²⁰ the solicitor for the Treasury Department distinguished oil and gas from solid minerals. He avoided overriding the common law rules by reference to Supreme Court decisions of 1895²¹ and 1900²² which held that the surface owner had no title to oil and gas, but only the right to reduce them to possession. The theory was that oil and gas were migratory and somewhat like wild animals. The exclusive right of the fee owner to seek to acquire them on his own property was held to be a property right. From these decisions the solicitor deduced two things:

- (1) There was no absolute ownership of oil in place.
- (2) Under an oil lease the fee owner conveyed to the lessee the only interest he had in the oil—the right of extracting it. Therefore the solicitor submitted that the deduction could not be limited to fee owners. Indeed, under this reasoning the depletable interest that remained to the lessor is not clear. The regulations were accordingly amended to allow the lessee the full benefit of the depletion deduction.²³ In 1925, the Supreme Court gave the lessee of solid mineral properties the same benefits. In *Lynch v. Alworth-Stephens Co.*²⁴ the court overruled *Weiss v. Mohawk Mining Co.*, holding that the right of the lessee to reduce the ore to ownership was a property right, and as such was a depletable interest under the statute.

Depletion based on discovery value imposed the tremendous administrative burden of estimating the market value of existing and newly discovered oil reserves at the date of discovery or thirty days thereafter.²⁵ In 1926 Congress dropped discovery value and substituted an allowance based on gross income from the property during the taxable year.²⁶ The amount of the deduction was determined by applying an arbitrary percentage (27½%) to the gross income. The allowance so computed was limited to 50% of net income. Congress felt this provided a simple method of computation, met equitable considerations, and also would encourage investment in the oil industry. The method became known as percentage depletion. It must be noted that percentage depletion is not limited to recovery of cost. A deduction for exhaustion of the minerals is permitted as long as there is production. Recovery of cost is incidental; reward for discovery and production of oil describes the spirit of the deduction. Decisions as to who has a depletable interest in oil based on notions of estates in land and recovery of capital would no longer be realistic, if they ever were, as

20. CUM. BULL. 1-2, 128 (1922).

21. *Brown v. Spilman*, 155 U.S. 665 (1895).

22. *Ohio Oil Co. v. Indiana*, 177 U.S. 190 (1900).

23. T.D. 3386, CUM. BULL. 1-2, 134 (1922).

24. 267 U.S. 364 (1925).

25. S. Rep. No. 52, 69th Cong., 1st Sess. 17.

26. Sec. 214 (a) (9) and Sec. 234 (a) (8), 44 STAT. 27 (1926).

long as Congress maintained this attitude. Percentage depletion has been a part of every revenue act since 1926 with no significant change.²⁷

The Treasury and the Supreme Court had stretched the property law so that the lessee could receive the benefit Congress intended him to have. But the financial arrangements for exploiting oil properties seldom stopped with the simple lessor-owner, lessee-operator situation. The lessee, if not willing to assume the entire financial risk, would assign the lease to an operator, reserving an interest in the oil recovered, if any, in the form of a royalty or an oil payment.²⁸ The risk could also be spread by inducing investors to contribute to the expense by giving them an interest in the oil recovered, if any. The lower courts decided who was entitled to depletion in these situations by reference to rules of property law governing lease assignments and subleases.²⁹ The lessee was often denied the right to depletion by the courts on the theory that he had transferred his entire interest in spite of his reserving a share of the income from the oil. The depletion deduction was divided between the fee owner and the transferee. Any income the original lessee received from oil production was considered part of the consideration for his transfer of the lease and was not subject to depletion. In *Herold v. Commissioner*³⁰ the Circuit Court of Appeals so held. But Judge Dawkins dissented vigorously. He said, "[The Statute] did not say depletion shall be allowed to those having a particular relationship to the land, such as owner, lessor or lessee, and, to my mind, clearly intended that it should apply to anyone having a property right or interest in the oil which was to be produced—he was entitled to depletion." Judge Dawkins understood the clear intent of the statute. He sought to implement it by a further stretching of "property interests." However, any elasticity of the established rules as to property interests would always be offset by the rigidity of the thought processes of jurists who applied them. The situation demanded penetrating insight and creative genius. The demand was met by Justice Stone in his decision in *Palmer v. Bender*.³¹

PALMER V. BENDER

Palmer v. Bender has been described as "one of the nearly perfect decisions in the judicial history of federal income tax law."³² In this case Jus-

27. Sec. 613 of the 1954 Code provides for percentage depletion. The rate for oil and gas wells is 27½% of gross income from the properties. The limits are not more than net income from the property and not less than cost depletion.

28. Royalties and oil payments are discussed *infra* under specific interests in oil. The royalty interest may be briefly described as a right to a fractional part of the oil produced for the duration of the operation of the property. The oil payment is the right to a specific amount of the oil produced or to a specific amount of income from the oil produced.

29. *Pugh v. Commissioner*, 49 F. 2d 76 (5th Cir. 1931); *Waller v. Commissioner*, 40 F. 2d 892 (5th Cir. 1930); *Beene v. Commissioner*, 40 F. 2d 893 (5th Cir. 1930); *Arthur J. Coyle*, 17 B.T.A. 368 (1929); *Lena Brown*, 24 B.T.A. 30 (1931).

30. 42 F. 2d 942 (5th Cir. 1930).

31. 287 U.S. 551 (1933).

32. *Baker, The Nature of Depletable Income*, 7 TAX L. REV. 267 (1952).

tice Stone created a concept that provided the means for realistic solutions of depletion problems. This concept is of "an economic interest in the oil in place." The confusion as to who has a depletable interest in oil that has persisted since *Palmer v. Bender*, remains largely because the courts have been reluctant to rely on the "economic interest" as Justice Stone described it. In order to establish what Justice Stone meant by an "economic interest" it will be necessary to quote the decision extensively.

The facts of the case were: The taxpayer was a member of two partnerships, each of which acquired oil leases on unproved lands, engaged in drilling operations which resulted in the discovery of oil. They conveyed the leases to another for cash, an oil payment, and an additional excess royalty of 1-8 of the oil produced and saved. The taxpayer sought to deduct a reasonable allowance for depletion. The Treasury Department contended that neither the cash, the oil payment nor the royalty was subject to depletion since the taxpayer had transferred his entire interest and had no reversionary interest. The circuit court supported the Commissioner's views.³³ The Supreme Court reversed. Justice Stone said:

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.

. . . the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.

Even though legal ownership of it (oil in place), 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. . . . When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor.

As for the term "capital investment," Justice Stone explained, "The statute makes effective the legislative policy, favoring the discoverer of oil by valuing his capital investment for the purpose of depletion at the date of the discovery rather than at its original cost." In this sense, he described the oil in the ground as "a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees were entitled to share in the oil produced." The Justice, in support of his reasoning, observed that "the loss or destruction of the

33. 57 F. 2d 32 (5th Cir. 1932).

oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships."

From these pronouncements three characteristics of the "economic interest" appear:

- (1) It represents capital investment.
- (2) It entitles the owner to a share of the oil produced.
- (3) It carries with it a portion of the risk involved in exploitation of the oil in place.

The first characteristic is not easily understood. Capital investment has come to mean ordinarily the cost basis of the asset. Justice Stone clearly explains that, when associated with the depletion deduction, capital investment means more than cost basis. It means cost basis plus the reward for production of oil that Congress bestowed by statute on the successful exploiters. "Economic interest" incorporates both these values. Capital investment in its ordinary usage does not. It would be helpful if "capital investment" were discarded as descriptive of the increment in oil that may be recovered tax free under the income tax statute. When the term is encountered in a discussion of depletion (and it is used in most decisions) there is the annoying question: Is "capital investment" used in the sense of cost basis as in the case of depreciation, or is it used in the sense Justice Stone described it in *Palmer v. Bender*? A primary value of the creation of the new concept is lost so long as the use of the inexact term "capital investment" persists. "Economic interest" includes capital investment but also the more important depletable element authorized in the statute—that is, the recovery over and above cost the statutory deduction for depletion permits. Justice Stone thus provided convenient and precise terminology for discussing the depletable interest in oil. However, one essential element of the economic interest appears in this first characteristic: Capital investment, meaning a cost basis, is an essential factor for the creation of an economic interest. Survival of the economic interest does not depend on the continued existence of the cost basis, nor is the value of the cost basis important.³⁴ But without an initial capital investment the economic interest can not come into being.³⁵ For other essential elements of the concept we must look to the other two characteristics.

The second characteristic links the economic interest to production. This seems inescapable. Economic and geological depletion are both associated with exhaustion of natural resources by exploitation. The earliest cases involving depletion for purpose of income taxation held that while

34. *Rowan Drilling Co. v. Commissioner*, 130 F. 2d 62 (5th Cir. 1942); *O'Shaughnessy, Inc. v. Commissioner*, 124 F. 2d 33 (10th Cir. 1941); *Louisiana Iron & Supply Co. v. Commissioner*, 44 B.T.A. 1244 (1941).

35. *Bankline Oil Co. v. U.S.*, 303 U.S. 404 (1938).

proceeds of extractive industries were a result of engaging in business, there should be an allowance for exhaustion of the resources.³⁶ The resource is exhausted by production. Therefore if one is to have a depletable interest one must have the right to share in production. As for the reward element, Congress expressly provides it as an encouragement of production.

That the economic interest must include a portion of the risk is not so clearly expressed in the decision as could be desired. It may be reasonably deduced, however, from Justice Stone's reliance on the fact that loss of the oil would result in loss to the partnerships. Congress sought to benefit those who assumed the risks of searching for and producing oil. To allow the deduction to others is to ignore this intention.

The theory of the economic interest as a basis for determining who has a depletable interest in oil has been accepted by the courts and the Internal Revenue Service.³⁷ Some refinements of its characteristics by the later decisions must be noted. Determination of whether there has been an initial capital investment in the oil in place is made under federal income tax law and not under state law.³⁸ The right to share in the proceeds of the oil produced is the same as the right to share in the oil produced.³⁹ In *Kirby Petroleum Co. v. Commissioner*⁴⁰ the Supreme Court said, "Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." While it can hardly be said that this clarified the concept of an "economic interest," it does point up the necessity of assuming risk if one is to have an economic interest. It can not exist unless income from the interest is "dependent solely upon the extraction and the sale of oil." If the initial capital investment can be recovered independent of production an economic interest does not exist⁴¹ In *Helvering v. Bankline Oil Co.*,⁴² the Supreme Court distinguished an economic interest and an economic advantage. The facts were: The Bankline Oil Company (the taxpayer) had a contract requiring the producer to deliver "wet gas" at the casing head of the oil well. The "wet gas" was transported by pipe lines constructed by the taxpayer to the taxpayer's processing plant. Gasoline was extracted from the "wet gas" and the taxpayer paid the producer a specified share of the gasoline or a specified share of the proceeds from sale of the gasoline. The taxpayer claimed depletion

36. *Stratton's Independence v. Howbert*, 231 U.S. 399 (1913); *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503 (1916); *United States v. Biwabik Mining Co.*, 247 U.S. 116 (1918).

37. U. S. Treas. Reg. 118, § 39.23 (m)—1(b) (1953), as amended, T.D. 6096 (1954).

38. *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946).

39. *Williams v. Commissioner*, 82 F. 2d 328 (5th Cir. 1936).

40. 326 U.S. 599, 604 (1946).

41. *Anderson v. Helvering*, 310 U.S. 404 (1940).

42. 303 U.S. 362 (1938).

on income derived from sale of the gasoline based on the difference in what he paid for the "wet gas" and its value at the well head. The Supreme Court denied the deduction saying:

. . . the phrase economic interest is not to be taken as embracing a mere economic advantage derived from production, through a contractual relationship with the owner by one who has no capital investment in the mineral deposit . . . Undoubtedly, respondents through the contracts obtained an economic advantage from production of the gas but that is not sufficient.⁴³

Observe how the tests of an economic or depletable interest outlined in *Palmer v. Bender* direct the decision:

- (1) Taxpayer had no initial investment—construction of the pipeline provided a conveyance for the "wet gas", but no investment in the oil in place.
- (2) The taxpayer was a processor, not a producer—he had the right to share after production. He could not compel production.
- (3) Having no investment in the oil in place he assumed no risks.

There is an important factor not implicit in the theory that must not be overlooked—that is, the economic consequence of a decision to the Internal Revenue Service. While the existence or absence of an economic interest may establish the position of the taxpayer in relation to other taxpayers, it may not be decisive when the impact on the tax structure is considered. The revenue should be protected from shams that result in tax avoidance. The Internal Revenue Service should not be burdened with unworkable rules impossible of administration by rigid adherence to any theory.⁴⁴ These considerations can form the basis for sound decisions inconsistent with the theory of an economic interest. If the courts make clear that such is the basis for the decision, no violence is done to the concept of the economic interest. It remains a useful device for the use of responsible taxpayers in determining their rights to the depletion deduction.

In general, the Treasury Department accepts the theory of the economic interest in determining who has a depletable interest in minerals. The Department states:

An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures by any form of legal relationship, income from the severance and sale of the mineral or timber, to which he must look for a return of his capital.⁴⁵

This seems to embody the same requirements as those Justice Stone

43. *Ibid* at 368.

44. *Anderson v. Helvering*, 310 U.S. 404 (1940).

45. U. S. Treas. Reg. 118, § 39.23 (m)—1(b) (1953), as amended, T.D. 6096 (1954).

thought necessary in *Palmer v. Bender*. However, the use the Commissioner and the courts have made of the concept can best be evaluated by examining specific interests in oil in place.

INTERESTS IN THE OIL IN PLACE

Under the usual arrangement for exploitation of oil, the fee owner gives the lessee the right to reduce the oil to possession in return for a cash payment, called a bonus. The lessee agrees that a certain amount of the oil produced belongs to the fee owner—either a specified fraction (usually 1/8), called a royalty; or a specified amount, called an oil payment; or an interest in the net proceeds of the oil produced, called a net profits interest. The interest of the lessee operator is called the working interest and bears all the expense of exploitation. The lessee may transfer this working interest, reserving a fraction of the oil produced (called an overriding royalty), or an oil payment, or a net profits interest. He may retain the working interest, but give others an interest in production in return for investment of capital. The investors receive participating interest, but give others an interest in production in return for investment of capital. The investors receive participating interests. Thus, the basic interests that arise from the lease arrangements are:

- (1) Royalties
- (2) Oil Payments
- (3) Net Profits Interest
- (4) Working Interest
- (5) Participating Interest

The initial cash payment will not be discussed as a separate topic since it involves, primarily, the problem of what income is depletable. If the lessor receives a cash payment only, he has sold his entire interest.⁴⁶ Therefore, before depletion becomes pertinent, the recipient of the cash must have retained an economic interest in the oil. The existing policy as to depletion of the bonus will be discussed briefly in connection with specific interests.

Royalties

In general, a royalty, whether payable to the lessor or the lessee, is an economic interest.⁴⁷ The usual arrangements from which royalty payments arise find the recipient with an initial capital investment, a right to share in production, but no right to receive income except from pro-

46. *Badger Oil Co. v. Commissioner*, 118 F. 2d 791 (5th Cir. 1941).

47. *Palmer v. Bender*, 287 U.S. 551 (1933); *West v. Commissioner*, 150 F. 2d 723 (5th Cir. 1945); *Hogan v. Commissioner*, 141 F. 2d 92 (5th Cir. 1944); *Cullen v. Commissioner*, 118 F. 2d 651 (5th Cir. 1941).

duction. However, this is not true of a transaction calling for minimum royalties.

The arrangement for minimum royalties usually takes one of four forms:

- (1) The lessor reserves a fractional interest in oil, but the lessee must guarantee payment of an annual minimum amount regardless of production. Any excess payment by the lessee may be offset against future production.
- (2) Same as (1) above except the minimum payments can be avoided by forfeiture of the lease.
- (3) The minimum amount must be paid annually but excess payments can not be recouped.
- (4) Same arrangement as (3) above except the minimum payments can be avoided by forfeiture of the lease.

Are these minimum payments derived from an economic interest? They are not. The lessor has an initial capital investment—he is entitled to share in production—but, as regards the minimum payment he has not assumed the risk incident to exploitation of the oil. He receives this payment whether or not oil is discovered and whether or not there is production after discovery. The payment is a personal obligation of the lessee. Provisions for recoupment of excess payment from future production only emphasize the assumption of risk by the lessee. If there is no future production, the lessee suffers the loss. The lessor suffers no loss if the lease is forfeited—he, rather, regains the interest he transferred. The minimum payment can not qualify as an economic interest as defined in *Palmer v.*

Bender.

Neither the Treasury Department nor the courts⁴⁸ agree with the above views. The position of the Treasury Department appears to be:⁴⁹ (1) If the payment of the minimum royalty cannot be avoided by forfeiture of the lease the income is depletable. If the excess payments can be recouped, they represent advanced royalties; if the excess payments can not be recouped, they represent additional consideration for the lease (installment bonus). (2) If the payment of the minimum royalty can be avoided by forfeiture of the lease, then, whether recoupable or not, the income is depletable after production; before production, if payments can not be recouped they are not depletable. It is not clear from the Treasury's pronouncements whether or not payments which are received before production and can be recouped after production are depletable.

The attitude of the courts has been consistent with the Treasury's position. In spite of the advent of the theory of the economic interest,

48. *Wilson v. Commissioner*, 76 F. 2d 766 (5th Cir. 1935); *Hutchinson Coal Co. v. Burnet*, 64 F. 2d 475 (4th Cir. 1933); *McFadden v. Commissioner*, 2 T.C. 395 (1943); *Kleberg v. Commissioner*, 43 B.T.A. 277 (1941).

49. GCM 26526, 1950-2 CUM. BULL. 40; U. S. Treas. Reg. 118, 39.23 (m)—10 (1953).

the courts have reasoned from the earlier cases that royalties represented taxable income from business and not proceeds of the conversion of capital assets. In *Work v. Mosier*,⁵⁰ decided in 1923, Chief Justice Taft classified the bonus paid an Indian tribe for oil interests as follows:

It was really part of the royalty or lump sum or down payment. We do not see how it can be classified as anything else. It was income from the use of the mineral resources of the land.

This classification was adopted by the courts in depletion cases. Both the bonus and the excess payments under a minimum royalty arrangement were considered advances against future production. The creation of the economic interest in oil as a criterion for depletion did not remove this unrealistic approach. As a result much of the effectiveness of the concept has been lost.

Consider some of the complications that result because these views rather than the economic interest theory prevail. If there is no production, depletion taken on the advance payments must be restored to income in the year the lease is abandoned.⁵¹ Of course, the fair method would be to reopen the return of the year the depletion was taken, but the statute of limitations often prevents this. Therefore, the depletion deducted over the years is pyramided into income in one year. In some cases this results in disaster to the taxpayer who must take the deduction in the year of payment or forego it forever.⁵² (At least, the recipient of minimum royalties assumes some risk. However, it is the only risk he does assume and is artificially created. It is not at all the risk Congress had in mind to reward.) Apparently any small measure of production will relieve the obligation to restore the depletion to income.⁵³ Again the economic actualities are ignored. The lessor may not claim depletion after production begins for oil paid for in advance⁵⁴—and he must reduce his depletion base by the amount of the depletion allowed in advance.⁵⁵ The allowance, having lost touch with production, becomes unnecessarily complex. The bonus, in the case of the lessee, is the purchase price of an economic interest, but the lessor does not receive it in payment for an economic interest.⁵⁶ How this can be is not easy to grasp. In the case of excess payments of minimum royalties the lessee, at his election, can expense them in the year of payment.⁵⁷ Thus an expense to the lessee be-

50. 261 U.S. 352 (1923).

51. *Douglas v. Commissioner*, 322 U.S. 275 (1944).

52. *Ibid.*

53. *Crabb v. Commissioner*, 41 B.T.A. 686 (1940).

54. U. S. Treas. Reg. 118, 39.23 (m)—10 (1953).

55. *Ibid.*

56. GCM 22730, 1941-1 CUM. BULL. 214.

57. See note 54 *supra*.

comes depletable income in the hands of the lessor. How this can be is even more difficult to grasp.

The courts have called depletion of advance payments 'synthetic depletion' and 'anticipatory depletion'.⁵⁸ This is to say that the allowance of such a deduction can not be justified by consideration of depletion in any sense. All justification for such allowances, if any ever really existed, disappeared with acceptance of the theory of the economic interest. However, in spite of the confusion and complexities that are inevitable in the present policies, these policies are so firmly supported by precedent and Treasury pronouncements, they may be expected to plague the depletion problem throughout the foreseeable future.

Oil Payments

An oil payment is an economic interest⁵⁹ whether payable out of a specified percentage of the oil or the proceeds received from the sale of the oil.⁶⁰ The right to the oil payment may be acquired by reserving it when assigning a lease, by purchase or by drilling oil wells.⁶¹ Postponement of the right to receive the oil payment until production has reached a specified level does not prevent its classification as an economic interest.⁶² The income received from the right to an oil payment is depletable even though the cost basis of the oil payment has been written off or recovered by other methods.⁶³ In other words, if the test of an economic interest is met, the oil payment is depletable regardless of how acquired, when paid or how paid.

Two decisions by the Supreme Court involving oil payments are significant in the evolution of the economic interest theory. The first, *Thomas v. Perkins*,⁶⁴ involves depletion only indirectly. In this case the other half of the type transaction that produced *Palmer v. Bender* is considered. The question was this: Where an oil lease is assigned and the assignor reserves an oil payment (an economic interest), is the income from that interest chargeable to the assignee? The court said, ". . . the owner of an interest in the deposit is entitled to deduct for depletion of the part producing his income but may not deduct for depletion of a share belonging to another." Therefore, the income from the assignor's share was not chargeable to the assignee. As well as clearing up the position of the assignee, the court also made clear that state laws as to title to the oil could not effect

58. *Driscoll v. Commissioner*, 147 F. 2d 493 (5th Cir. 1945).

59. *Palmer v. Bender*, 287 U.S. 551 (1933).

60. *Williams v. Commissioner*, 82 F. 2d 328 (5th Cir. 1936).

61. *Lee v. Commissioner*, 126 F. 2d 825 (5th Cir. 1942).

62. *Jones v. Commissioner*, 82 F. 2d 329 (5th Cir. 1936); *Williams v. Commissioner*, 82 F. 2d 328 (5th Cir. 1936).

63. *Rowan Drilling Co. v. Commissioner*, 130 F. 2d 62 (5th Cir. 1942); *O'Shaughnessy, Inc. v. Commissioner*, 124 F. 2d 33 (10th Cir. 1941).

64. 301 U.S. 655 (1937).

the tax implications of an economic interest. An interesting feature of *Thomas v. Perkins* is that Justice Stone dissented. He did not feel that the presence or absence of an economic interest was relevant as far as the assignee was concerned. He considered that income from the oil that was given to the holder of the economic interest represented a part of the purchase price of the assignor's interest. A strange conclusion for a Justice whose genius produced the concept of an economic interest in the oil!

The other decision, *Anderson v. Helvering*,⁶⁵ presented the same question with an added significant fact—the oil payment could be satisfied from the oil produced or from the sale of the fee of any or all of the land conveyed. The court distinguished *Thomas v. Perkins* because an interest in the fee as well as an interest in oil production was received. The taxpayer was not dependent entirely on production of oil for satisfaction of the deferred payments. The court said:

In the interest of a workable rule, *Thomas v. Perkins* must not be extended beyond the situation in which, as a matter of substance, without regard to formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas.

The *Anderson* case brings out clearly that the existence of an economic interest depends upon an unqualified assumption of risk. The court's concern for a workable rule should also be noted. This factor could well influence a future consideration of "carved out oil payments" by the Supreme Court.

The tax situation created when the holder of an economic interest "carves out" and sells a smaller interest is the basis for much current litigation. The smaller interest may either entitle the purchaser to oil (or income) for the duration of the seller's economic interest or it may be for a specified amount which will be satisfied before the termination of the seller's economic interest. In the first instance the interest may be said to have been carved out vertically and, in the latter case, to have been carved out horizontally. These carved out interests meet the test of the economic interest: the purchaser makes an initial capital investment; he has a right to share in production; he must look solely to production of oil for a recovery of his investment. Consistent application of the theory of the economic interest would entitle the purchaser to depletion. But if the seller has conveyed an economic interest he is entitled to capital gains treatment on the proceeds.⁶⁶ This result opens the door to tax avoidance by traffic in carved out oil payments, particularly those carved out horizontally, beyond all reasonable needs for financing the exploitation of

65. 310 U.S. 404 (1940).

66. *Caldwell v. Campbell*, 218 F. 2d 567 (5th Cir. 1955).

oil. The Commissioner tried to block this practice by announcing that oil payments carved out horizontally—transferred for cash not pledged for development of the property—were assignments of income by the holder of the original interests.⁶⁷ However, according to the Commissioner, both the transferor and the transferee were entitled to depletion on the income each realized from the interest, the implication being that the transferee received an economic interest. This strained reasoning by the Commissioner was not accepted by the courts. The seller was permitted capital gains treatment as to the proceeds of the sale in several cases.⁶⁸ However, in the most recent case,⁶⁹ The Court of Appeals denied the seller capital gains treatment because of the “short lived” nature of the carved out payment. This distinction adds to the uncertainty of the proper tax treatment of the transactions.

It is submitted that the position of the Commissioner as to interests carved out horizontally is reasonable and could have been supported without distortion of the economic interest theory. The “carving out” oil interest meets the technical requirements of an economic interest. But the economic realities of the transaction bring into play factors of overriding importance:

- (1) The intention of Congress in granting the depletion deduction.
- (2) The undesirability of opening avenues for tax avoidance by following a theory to the ultimate of consistency.
- (3) The requirement of workable rules in tax administration.

Consider the impact of these considerations on the interests in controversy:

(1) Congress intended the depletion deduction as an encouragement to those who search for oil and as a reward for production of oil. The purchaser of the carved out interest does not contribute to the search for oil since the seller has unrestricted use of the payment. Such a purchaser has it in his power to arrange a suitable reward for the risk he assumes since he can adjust his discount rate. If he is not permitted depletion, he can also offset this additional risk by the same method. There is no necessity for encouraging him. Congress did not intend to encourage or reward him.

(2) The alienability of “economic interests” is desirable from a financial and commercial point of view. In general, alienability is not incompatible with tax collection, and the Commissioner has shown no tendency to restrict it. However, there is no foundation for an assumption that the freedom of alienability accorded legal property interests attaches automatically to “economic interests.” The concept was created for reflecting the

67. GCM 23849, 1946-1 CUM. BULL. 66 as clarified by I.T. 4003, 1950-1 CUM. BULL. 10.

68. *Caldwell v. Campbell*, 218 F. 2d 567 (5th Cir. 1955).

69. *Hawn*, CA-5, 3/27/56.

realities of interests in oil in place for the solution of depletion problems. This purpose would be defeated if notions of alienability, transferred from another area, were allowed to open avenues for tax avoidance. The effective result of allowing capital gains treatment to the seller of oil payments carved out horizontally would be that the majority of income from oil properties would be treated as a conversion of capital. The earliest decisions established that such income is derived from the business of extracting the mineral.⁷⁰ It is difficult to see how a reasonable restriction on the alienability of the economic interest, designed to implement the purpose for which it was created, could be successfully opposed.

(5) That the present situation imposes unworkable rules on the Commissioner is apparent. The decision as to whether a particular payment is "short lived" or "long lived" would have to be made on the facts of each particular case. Agreements would be hard to come by. Litigation would likely be the only solution in most instances.

The Treasury is now sponsoring legislation in order to establish its position.⁷¹ It is unfortunate that the Treasury found legislation necessary. The position of the Department was correct and fully supported by any careful consideration of all the factors. A large segment of the oil industry appears in accord with the Treasury's views.⁷² The Supreme Court would probably rule against the taxpayer if the question of capital gain on the sale of a carved out interest was presented.⁷³ There is always a risk that the legislation, in its final form, may have more far-reaching results than either the Commissioner or the taxpayers anticipated.

If, on the transfer of a lease, the transferor receives a cash payment and reserves an oil payment but no royalty, the cash proceeds represent the consideration for the sale of an asset.⁷⁴ This is the treatment advocated herein for all transactions involving a lease assigned in consideration of cash with an economic interest reserved by the transferor, including the royalty. It is difficult to reconcile the conflicting position of the courts since both a royalty and an oil payment qualify as an economic interest. In each case, the lessor transfers all other interests. To say that without the cash payment the lessor would have reserved a larger royalty payment will not distinguish the transactions. Without the cash payment, a larger oil payment would have been reserved. To nominate the bonus as advance royalty, but not an advance as to the oil payment is to distort the economic

70. *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503 (1916); *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399 (1913).

71. H.R. 9559, now before the House Ways and Means Committee, if passed would make the assignment of income rule applicable to all carved out oil and gas payments after Feb. 27, 1956.

72. See Baker and Griswold, *Percentage Depletion—A Correspondence*, 64 HARV. L. REV. 361 (1951).

73. See discussion of *Southwestern Exploration Co.* case, *infra*, p. 261.

74. *Fleming v. Commissioner*, 82 F. 2d 324 (5th Cir. 1936).

consequences of the transactions. If both are economic interests, the cash payment should be related to both or neither. The realistic view seems to this writer to be that the bonus represents the proceeds from the sale of an asset.

Net Profits Interest

Under the net profits arrangements the beneficiary is entitled to receive a stated percentage of the net profits from the operation of oil properties. This interest has traveled a rocky road to recognition as an economic interest. Four Supreme Court decisions left some doubt as to complete acceptance, and the latest decision did not remove all confusion.

The first decision, *O'Donnell v. Helvering*,⁷⁵ refused to allow depletion to the owner of a net profits interest. The taxpayer owned one third of the stock of San Gabriel Petroleum Company. He sold the stock to Petroleum Midway Company under an agreement that Midway company would pay the taxpayer one third of the net profits from the oil and gas properties operations. The court held that the ownership of the oil properties was in the corporation and that the agreement as to the net profits was a personal covenant and did not give the taxpayer an interest in the properties themselves. In a later case, the Court indicated that the decision in the *O'Donnell* case was based on the fact that the taxpayer was a stranger to the lease.⁷⁶ This represents a departure from the economic interest theory. The clear statement in *Palmer v. Bender* is that conveyancing formalities are not material to the determination of an economic interest.

In *Elbe Oil Land Development Co. v. Helvering*,⁷⁷ the taxpayer sold his interest in certain leases and reserved a net profits interest. The Court refused to allow the taxpayer the depletion deduction saying, "We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction as an absolute sale or was other than a personal covenant of the Honolulu company. We conclude that as respondent disposed of the properties, retaining no investment therein, it was not entitled to make the deduction claimed for depletion." The taxpayer was a party to the lease. The decision seems to hold categorically that a net profits interest is not an economic interest.

However, in *Kirby Petroleum Co. v. Commissioner*,⁷⁸ the Court decided that the lessor who reserved a net profits interest did have an economic interest. The court said:

The lessor's economic interest in the oil is no less when their right is to share a net profit. As in *Thomas v. Perkins*, . . . their only

75. 303 U.S. 370 (1938).

76. *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946).

77. 303 U.S. 372 (1938).

78. 326 U.S. 599 (1946).

source of payment is from the net profit the oil produces. . . . Economic interest does not mean title to the oil in place but the possibility of profit from that "economic interest."

But in the decision the court also said:

A share of the net profits disassociated from an economic interest does not entitle the taxpayer to depletion. The facts of each transaction must be appraised to determine whether transferor has made an absolute sale or has retained an economic interest, a capital investment.

If this means only that the tests of *Palmer v. Bender* must be met before any interest is an economic interest, then the status of the net profits interest does not suffer.

In *Burton-Sutton Oil Co. v. Commissioner*,⁷⁹ the other face of the problem was presented. The question was whether the lessee should capitalize net profits payments made to his assignor. The Court held he should not. The reasoning was that the assignor by retaining rights to payment from the oil retained an economic interest. Thus the assignor was entitled to depletion. Therefore, if the assignee were forced to capitalize the payments he could not recover them through depletion since the allowance as to such receipts belongs to the assignor. Justice Frankfurter dissented. He complained that the distinction drawn between this case and the *Elbe Oil Land Development Co.*⁸⁰ case could hardly be held in mind longer than it takes to state them. It is submitted that the confusion lies not in the theory of the economic interest, but in the failure of the Court to employ it in the *Elbe Oil Land Development Co.* case.

The latest decision of the Supreme Court involving depletion, decided February 27, 1956, gives comfort to the holders of net profit interest and to the advocates of the economic interest theory. The facts of the case, *Southwestern Exploration Co. v. Commissioner*,⁸¹ are unusual and interesting. The California State Lands Act requires that all drilling and other operations in connection with extracting oil from submerged state lands be from upland drill sites or filled land. A drilling company, in order to be given a lease of mineral rights to a particular area by the state, obtained from the upland owners adjacent to the coastal area the necessary easements over their lands. In return it agreed to pay such owners a percentage of the net profits from extraction of oil, for the use of their land. It was held that the contribution by the upland owners for the use of their land for drilling sites in return for a share of the net profits from production was an investment in the oil in place sufficient to establish an economic interest. Accordingly, the upland owners, rather than the pro-

78. 326 U.S. 599 (1946).

79. 328 U.S. 25 (1946).

80. See note 77 *supra*.

81. 350 U.S. 308 (1956).

ducer, were entitled to depletion on the income received by such owners. In arriving at the decision the Court discussed *Palmer v. Bender* as well as the decisions discussed earlier. The Court found that in *Palmer v. Bender* two factors constituted the requirement for an "economic interest." The taxpayer must have (1) "acquired by investment, any interest in the oil in place," and (2) secured, by legal relationship, "income derived from extraction of the oil, to which he must look for a return of his capital." It was noted that on each of the prior cases where the taxpayer had been allowed the deduction for depletion, he had once had at least a fee or leasehold in the oil producing properties themselves. "But," the Court said, "the tax law deals in economic realities, not legal abstractions Recognizing that the law of depletion requires an economic rather than a legal interest in the oil in place, we may proceed to the question of whether the upland owners had such an economic interest here." The Court found that they did because the contribution of the easement was a sufficient investment to establish an economic interest, their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. It was not decided that a stranger to the lease could possess an economic interest. The Court felt that the upland owners were not disassociated from the lease and decided only "that where, in the circumstances of this case, a party essential to the drilling for an extraction of the oil had made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party had an economic interest which entitles him to depletion on the income thus received."

This statement should be noted by purchasers of "carved out" oil payments. The Court has carefully left the way clear for a holding that such purchasers do not make a contribution essential to the exploitation of the oil and therefore do not possess an economic interest. While it is believed that the Commissioner's position as to these transactions should be upheld, it would be undesirable to do so on such a basis. It is difficult to see how such a decision could avoid casting doubt on the alienability of economic interests in general. Neither the Treasury nor the taxpayers would benefit by the resulting confusion. The decision could be and should be based, on considerations of the intention of Congress, tax avoidance, and the requirement of workable rules for the Commissioner. The fundamental facts of income taxation should override the existence of an economic interest in this situation, but without distortion of the interest as described in *Palmer v. Bender* and without restricting its alienability unnecessarily. If it is found that application of the theory to the ultimate of consistency permits abuses, the revenue can be protected without penalizing those whose primary interest is the discovery and production of oil.

This latest decision confirms the net profits interest as an economic

interest, apparently puts the economic interest beyond distortion by legal abstractions, but still leaves doubt as to the welcome of the "strangers."

Working Interests and Participating Interests

Working interests and participating interests will be considered together since participating interests may be said to be "carved out" of the working interest.

The owner of the working interest has the obligation to develop and operate the oil properties. Ordinarily, his capital investment is represented by the "bonus" he pays the landowner and such part of the cost of development as must be capitalized. He is entitled to a share of production (usually 7/8 of oil produced and saved) and can recover his investment solely from the production of oil. Working interests meet the test of an economic interest and the owner is entitled to depletion.⁸²

Participating interests arise from the inability or unwillingness of the owner of the working interest to assume the entire financial hazard of developing the property. In order to spread the risk, he may contract with geologists, engineers, drillers and equipment suppliers to furnish the skill and material necessary for exploitation of the oil in return for a right to share in production, carved out of the working interest. Or the lessee, under a similar arrangement, may induce investors to supply funds which he pledges to use for development of the properties. These participating interests are economic interests and are distinguishable from the "carved out" interests previously discussed. The present interests are carved out of the working interest for the sole purpose of developing the oil property.⁸³ The owner of the working interest does not recover any of his capital investment by the transactions, nor does he realize income, if the proceeds are used to develop the property.⁸⁴ His right to share in oil production is reduced, but the reservoir of capital investment necessary to recover the oil is increased. The economic interests represented by the participating interests are created by this addition to the capital investment and not by the sale of an economic interest by the owner of the working interest. Since the owner of the working interest does not receive taxable income and the participating interests are acquired by services or investment directly related to production of the oil, the transaction seems not to warrant the criticisms and restrictions that may attach to "carved out interests" that have neither this tax consequence nor an association with the exploitation of the oil. Participating interests, whether acquired by services or investment, represent consideration for contributions to the discovery and development of oil property. The depletion deduction in its

82. *Greensboro Gas Co. v. Commissioner*, 79 F. 2d 701 (3rd Cir. 1935).

83. *Blue Ridge Oil Co., Ltd. v. Rogan*, 83 F. 2d 420 (9th Cir. 1936).

84. GCM 22730, 1941-1 CUM. BULL. 214.

present form is designed to encourage such contributions. The validity of participating interests as depletable interests seems safe from attack.

CONCLUSION

The following conclusions seem justified by an examination of the development to date of the economic interest theory:

(1) The economic interest theory provides a realistic means of sifting depletable interests out of the complex factual situations that often arise from the financial arrangements of oil exploiters. Economic consequences to the transactors govern the decision rather than the form of legal relationship or technicalities of title and estates in land.

(2) While the bonus and minimum royalties do not meet the test of income derived from an "economic interest," the policy of allowing depletion as to such payments is so well established by the Commissioner and the courts that no change is likely in the near future.

(3) The controversy as to the proper treatment of the "carved out oil payment" may be settled by legislation. If it is not, and the question is presented to the Supreme Court, the Commissioner's position will be upheld. The decision will be based on the fact that the purchaser is a stranger to the lease and has not made an indispensable contribution to the drilling for and extraction of the oil and therefore has no "economic interest" in the oil. Since the seller does not transfer an "economic interest" the transaction will be held, in effect, an assignment of income.

(4) The theory of the economic interest, as described in *Palmer v. Brendre*, affords a simple and fair method for determining who has a depletable interest in oil. It is subject to abuse by taxpayers who insist that it should be applied without regard for the economic consequences to the Treasury Department. The wisdom of this practice is to be doubted. The risk that corrective legislation may unfavorably alter the long-run tax position of all who exploit oil should be weighed against short-run tax advantage.