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SHORT-NOTICE TERMINATION CLAUSES IN COAL LEASES: EFFECT ON PERCENTAGE DEPLETION

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INTRODUCTION

The effect of clauses providing for termination without cause on short-notice in coal leases¹ on percentage depletion² has been

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¹ One of the difficulties in this area is determining whether the arrangement in question gave the taxpayer any interest in the coal in place. This problem is discussed in the body of this article and centers on whether the purported lease was a traditional bona fide lease or created some other form of legal relationship between the parties. At this point in the article the term "lease" is used loosely to refer to the legal relationship established between owners or sublessors of coal and the parties with whom they have made certain legal arrangements.

For a very recent article addressing this problem, see Bulleit, *A Tax Incentive Approach to the Depletion Allowance Dilemma*, 82 W. VA. L. REV. 1115 (1980). See also Coggin, *Federal Income Tax Treatment of the Acquisition and Disposition of Coal Interests: An Examination of I.R.C. § 631(c)*, 82 W. VA. L. REV. 1139 (1980).

² The depletion deduction is permitted generally by § 611 of the Internal Revenue Code of 1954, as amended. (Section references in this article will be to the Internal Revenue Code of 1954, as amended, unless otherwise noted.) The pertinent provisions of § 611 are the following:

(a) *General Rule*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by Secretary. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals

the subject of considerable litigation since the United States Su-

from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

(b) *Special Rules*—

(1) *Leases*—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

* * * * *

§ 613 provides for percentage depletion with the general rule set forth in subsection (a):

(a) *General Rule*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would if computed without reference to this section.

* * * * *

Under § 613(b)(4) the rate of percentage depletion for coal is 10%.

The general guidelines for determining depletion are found in Treasury Regulation § 1.611-1 (Regulation sections hereinafter cited will be to Treasury Regulations unless otherwise noted.), the pertinent parts of which are quoted here:

§ 1.611-1 Allowance of deduction for depletion.

(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general*. Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

preme Court decided *Parsons v. Smith*³ in 1959. The most recent

(2) See § 1.611-5 for methods of depreciation relating to improvements connected with mineral or timber properties.

(3) See paragraph (d) of this section for definition of terms.

(b) *Economic Interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. 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 derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber, coal, or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or domestic iron ore, if such disposal is considered a sale of timber, coal or domestic iron ore under section 631(b) or (c).

³ 359 U.S. 215 (1959). *Parsons* was not the first case to wrestle with the terminability question.

In *Stilwell v. United States*, 250 F.2d 736 (4th Cir. 1957), involving contract miners, the facts indicated that the oral contracts were not terminable at the will of the coal owner. Based largely on that fact, the contract miner was held to have an economic interest in the coal.

In *Weirton Ice and Coal Supplies Co. v. Commissioner*, 231 F.2d 531 (4th Cir. 1956), though either party could terminate the contract on 90 days' notice, the contract miner was held to have an economic interest. The emphasis on termination was minimal, however, because the power to terminate was never exercised during the taxable years in question. *Id.* at 535.

In *Commissioner v. Mammoth Coal Co.*, 229 F.2d 535 (3rd Cir. 1955), *cert. denied* 352 U.S. 824, the contract with the strip miner could be terminated only for cause. Based on that fact as well as others, the stripper was held to have an economic interest.

In *Usibelli v. Commissioner*, 229 F.2d 539 (9th Cir. 1955), the contract could be terminated at the discretion of the federal government. That fact, coupled with others, was enough for the court to hold that the contractors had no economic interest. It should be noted that all these cases, including *Parsons v. Smith*, 359

decision dealing with this problem is *Swank v. United States*,⁴

U.S. 215 (1959), involved contract miners rather than persons owning bona fide leasehold interests in the coal.

In 1950 the Internal Revenue Service issued G.C.M. 26290, 1950-1 C.B. 42, declared obsolete in Rev. Rul. 70-277, 1970-1 C.B. 280, explaining under what circumstances contractors, as opposed to lessees, would be considered as having an economic interest. The contract miners would not have an economic interest if the contracts were terminable at the will of the owners or on short notice without cause. If a year's notice was required, generally an otherwise "valid" economic interest would not be destroyed. If less than a year's notice was required or the contract could be terminated at will, then the contractor would not have an economic interest.

This attempt by the Service to place contract coal miners on an equal footing with bona fide coal lessees, using terminability as part of the test, appears to be the first time termination was introduced into the economic interest arena. It was done to bring contractors who otherwise would not have had an economic interest within that term (at the same time giving this test no application to holders of leasehold interests). Yet later the Service used terminability as a weapon to deny depletion to bona fide lessees who unquestionably had investments in coal in place. See *Bakertown Coal Co. v. United States*, 485 F.2d 633, 638 (Ct. Cl. 1973). It is quite probable that this attempt to expand the concept of economic interest arose out of a great deal of political pressure in the early 1950's when Congress felt that the coal industry needed a boost. It was in 1951 that both the percentage depletion rate for coal was increased from 5% to 10% and the special capital gains treatment for coal royalties was introduced into the law in what is now § 631(c). Revenue Act of 1951, P.L. 183, §§ 319, 325, at 497 & 501.

H.R. 586, 82nd Cong., 1st Sess. (1951) reporting on the Revenue Act of 1951, bears the following statements regarding percentage depletion for coal and capital gain treatment for coal royalties:

I. Percentage Depletion

Under existing law depletion based on cost is available to all mining industries and in addition percentage depletion is available to oil, gas, sulfur, metal mines, and certain nonmetallic minerals. The allowable rate of percentage depletion is 5 percent in the case of coal, and 15 percent in the case of the other non-metallic minerals except sulfur which is allowed 23 percent.

The testimony received by this committee both in connection with this bill and the bill which became the Revenue Act of 1950 revealed that in a number of cases nonmetallic minerals which are not in the enumerated group under existing law are competitive with those receiving percentage depletion, or have just as good a claim for such treatment as the enumerated minerals. The testimony also indicated that the 5 percent rate allowed coal is of little practical value, and that the coal mining industry is peculiarly in need of more favorable tax treatment because of the inroads which alternative sources of energy, particularly oil and gas, have made on the potential markets of coal.

Section 304 of this bill adds to the list of nonmetallic minerals to

which was decided by the United States Court of Claims on July

which percentage depletion is available at a 15 percent rate, borax, fuller's earth, tripoll, refractory and fire clay, quartzite, perlite, diatomaceous earth, and metallurgical and chemical grade limestones. The amendment also makes it clear that the 15 percent rate applies to thenardite, whether or not obtained from brines, or mixtures of brine.

The bill increases the percentage allowed in the case of coal from 5 to 10 percent, and sets up a new group of minerals to which percentage depletion is available at the rate of 5 percent. This group consists of sand, gravel, stone, pumice, scoria, and slate, brick and the tile clay, shale, oyster shell, clam shell, granite, marble, and asbestos.

Most of these changes would have been made under the House version of the bill which became the Revenue Act of 1950 but they were eliminated from the final legislation largely because of the revenue loss involved. It is apparent, however, that the need for equalization is substantially greater now because of the additional taxes imposed under the legislation of 1950 and under this bill. Therefore, the committee believes that the proposed extension of the percentage depletion system is necessary in spite of the revenue loss involved. The latter is estimated to be about \$67 million in a full year's operation.

The amendments made by this section of the bill apply to taxable years beginning after December 31, 1950.

II. Coal Royalties

Section 307 of this bill provides tax relief for the recipients of coal royalties. Most leases on coal properties are long-term and call for royalty payments expressed in cents per ton. Therefore, the lessor does not receive the automatic adjustment for price changes which occurs when a royalty is expressed as a percentage of the value of the mineral extracted from the property. Many of the existing coal leases are old and the royalty payment called for under them is small.

It is reported also that as a practical matter the lessor of a coal property is not likely to benefit from percentage depletion even under the new 10 percent rate provided in this bill, although it is anticipated that this rate will be of material benefit to the coal operators.

Section 307 extends to the recipients of coal royalties the capital-gains treatment now available to timber under section 117(k)(2) of the Internal Revenue Code. It is intended by this provision that coal royalties receive the same treatment as timber royalties. In the case of timber coming under this section percentage depletion is not allowed, and it also will not be available in the case of these coal royalties.

Section 307 applies to taxable years ending after December 31, 1950, but only with respect to amounts received or accrued after such date.

The revenue loss involved is estimated to be about \$10 million annually.

1951-2 C.B. 378-80.

While the posture which the Internal Revenue Service took in this situation

18, 1979. In *Swank*, the Court of Claims reaffirmed its position that a lessee, holding an otherwise valid legal interest in coal in place, has an "economic interest" for percentage depletion purposes. This economic interest will not be destroyed by a clause allowing short-notice termination without cause.⁵ The Fifth Circuit in *Winters Coal Co. v. Commissioner*⁶ appears to agree with the Court of Claims.⁷

The United States Tax Court, however, has consistently held against taxpayers in cases involving clauses allowing either party to terminate on short-notice without cause.⁸ The Third Circuit has affirmed this position.⁹

In view of this conflict between the Court of Claims and the Fifth Circuit on the one hand and the Tax Court and the Third Circuit on the other, the United States Supreme Court, on May 12, 1980, granted the government's petition for *certiorari* in *Swank*.¹⁰ The only issue before the Court is the effect of a clause providing for short-notice termination without cause by the lessor on an otherwise valid "economic interest" in coal in place.¹¹

may have been for the most humane reasons, it generated a tremendous amount of litigation, even after *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965).

⁴ 602 F.2d 348 (Ct. Cl. 1979), *cert. granted*, 100 S. Ct. 2150 (1980).

⁵ *Id.* at 350.

⁶ 496 F.2d 995 (5th Cir. 1974).

⁷ The *Winters* opinion, however, is weak on the point regarding terminability because only one of three judges found for *Winters* squarely on the terminability aspect of the lease.

⁸ See, e.g., *Weaver v. Commissioner*, 72 T.C. 594 (1979) (In this case, though, on the particular facts, one lease which was terminable at will on 120 days' notice was held to grant the lessee an economic interest because the 120-day period was shown to be long enough to mine the mineral to exhaustion.); *Holbrook v. Commissioner*, 65 T.C. 415 (1975); *Winters Coal Co. v. Commissioner*, 57 T.C. 249 (1971), *rev'd*, 496 F.2d 995 (5th Cir. 1974); *Constantino v. Commissioner*, 29 TCM 189 (1970), *aff'd*, 445 F.2d 405 (3d Cir. 1971); *Whitmer v. Commissioner*, 28 TCM 1480 (1969), *aff'd*, 443 F.2d 170 (3d Cir. 1971); *Mullins v. Commissioner*, 48 T.C. 571 (1967).

⁹ *Constantino v. Commissioner*, 445 F.2d 405 (3d Cir. 1971); *Whitmer v. Commissioner*, 443 F.2d 170 (3d Cir. 1971).

¹⁰ 100 S. Ct. 2150 (1980). Argument was heard by the Court on December 9, 1980, 49 U.S.L.W. 3442 (1980).

¹¹ Pet. for Writ of *Certiorari* at 2.

This article focuses on the issue before the Court. That question assumes that, but for the termination clause, the lessees have a valid economic interest.

Swank involves three taxpayers: Rita and Elwood Swank;¹³ Black Hawk Coal Corporation;¹³ and Bull Run Mining Company.¹⁴ The Court of Claims, in a *per curiam* opinion ruling in favor of the taxpayers, viewed the pertinent facts in each case to be the same for the purpose of disposing of the litigation. The court summarized these facts as follows:

Each taxpayer held a lease (or leases) of coal-bearing property with unstated duration or duration for a term of years—subject to the termination clause or clauses. These leases provided for royalties (plus, in at least one of the cases, a flat annual rent) to be paid by the lessee [footnote omitted]. Each lease contained a clause permitting either party (or the lessor alone) to terminate the lease (and operations thereunder), apparently without cause, within thirty days. In each case the plaintiffs mined coal under these leases during the taxable years and for a substantial time before. The proceeds from the sales of the coal represented the sole source of revenue from which the lessees could recover any rents and royalties paid to the lessor for the right to mine.¹⁵

The court followed its decision in *Bakertown Coal Co. v. United States*,¹⁶ and held that “the mere existence of the unused termination clause is not enough to deprive the taxpayer-lessees of their ‘economic interest’ they would otherwise admittedly have.”¹⁷

In response to the government’s contention that the coal-lessees in *Swank* were no different from coal contract-miners who generally have been held not to have an economic interest in the

Therefore, discussion of what generally constitutes an economic interest is brief. For a recent article discussing *Swank*, and its court of claims predecessors, as well as the authorities in conflict with them, see Pratt and Ferguson, *Depletion Deduction in Coal Leases: Courts Split on the Effect of Lease Terminability*, 51 J. OF TAX. 240 (1979).

¹³ Hereinafter referred to as Swank.

¹³ Hereinafter referred to as Black Hawk.

¹⁴ Hereinafter referred to as Bull Run. The author was on brief for Bull Run in the proceedings on the merits before the United States Supreme Court and he extends his deep appreciation to Woodrow A. Potesta, counsel for Bull Run, for his incisive and helpful comments.

¹⁵ 602 F.2d at 350.

¹⁶ 485 F.2d 633, 638 (Ct. Cl. 1973).

¹⁷ 602 F.2d at 350.

coal in place,¹⁸ the court stated that on the records in each case it was clear that the taxpayers had mined the coal for a substantial period of time before the taxable years in question and that they had good expectations of being able to continue to do so. The court went on to say that there had been either rare, or no, exercise of the termination clauses without cause, which indicated that the coal lessees had real expectations that they could mine the coal pursuant to their leases for a substantial amount of time and extract most of the coal, if not all of it. Therefore, the questionable requirement of being able to mine to exhaustion was met by the taxpayers in economic reality.¹⁹ Furthermore, the court took note of the fact that the records contained no evidence that, were one of these leases to be cancelled upon thirty days' notice, the coal-lessee could not have mined a substantial amount of the coal in that period of time.²⁰

The reason for the existence of the mining-to-exhaustion requirement under percentage depletion, according to the government and as reflected in the court's opinion, was the fact that under cost or discovery depletion it was necessary to make estimates of the coal in the ground as one would do under cost or discovery depletion. Since percentage depletion was introduced as a substitute for cost or discovery depletion, whatever requirements applied to cost or discovery depletion applied as well to percentage depletion.²¹ No comment was made on whether this analysis was accurate, rather, as already discussed, the court looked to the economic reality of the situation to dispose of that argument.²²

The final point considered by the court, centered on the fact that the taxpayers involved were the only persons entitled to the percentage depletion allowance. Reason indicated that to deny it to them would result in denying it to all parties, thus violating

¹⁸ *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965); *Parsons v. Smith*, 359 U.S. 215 (1959). *But see* note 3, *supra*, for contract miner cases before *Parsons* going both ways, as well as the contract miner cases decided after *Parsons* discussed in text. *See also* Note, 66 W. VA. L. REV. 41 (1963), for a summary of some of the contract miner cases.

¹⁹ 602 F.2d at 351.

²⁰ *Id.*

²¹ *Id.* at 350-51.

²² *Id.* at 351.

the intent of Congress. This reasoning was premised on the fact that the lessors had treated the royalty payments under Section 631(c) as being from the sale or exchange of property, and thus, were prohibited by the terms of that section from claiming any percentage depletion.²³

In light of the foregoing introduction, the purposes of this article are to state briefly what in general constitutes an "economic interest" and to examine how the courts and the Treasury have treated leases and other arrangements providing for short notice termination without cause for the purpose of percentage depletion. This examination results in the conclusion that the court of claims in *Swank* was correct in holding that a clause providing for termination on short notice and without cause by either party, or the lessor alone, does not preclude the lessee from having an otherwise valid "economic interest."²⁴

THE GENERAL CONCEPT OF "ECONOMIC INTEREST"

The concept of an "economic interest" as a condition to taking depletion was first enunciated in *Palmer v. Bender*,²⁵ in which the Court set forth the test so often quoted:

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.²⁶

The Court, in discussing *United States v. Biwabik Mining Co.*,²⁷ went further to state:

But this Court held that regardless of the technical ownership of the ore before severance, the taxpayer, by his lease, had ac-

²³ *Id.* Because this issue does not involve the terminability problem, it is beyond the scope of this article.

²⁴ At least two commentators have suggested that terminability clauses of the type under discussion are fatal to their being an economic interest in the lessee. McDowell, *Depletable Interests: Economic Interest vs. Economic Advantage*, 18 NYU TAX INST. 517, 541 (1960); Sneed, *Supreme Court Strip Mining Decisions alter Tests for Depletable Interests*, 11 J. OF TAX 2, 4 (1959); Sneed, *The Economic Interest—An Expanding Concept*, 35 TEXAS L. REV. 307, 352 (1957).

²⁵ 287 U.S. 551 (1933).

²⁶ *Id.* at 557.

²⁷ 247 U.S. 116 (1918).

quired legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights under the lease. Depletion was, therefore, allowed.²⁸

The *Palmer* concept of an "economic interest," which the Court said should be broadly construed, has been incorporated in the Regulations.²⁹ Based on the Regulations and *Palmer*, where the taxpayer claiming depletion must look to the market place for a return of his capital investment, and where he holds rights to the mineral in the ground as a lessee pursuant to a traditional bona fide lease, the taxpayer should be entitled to the depletion deduction.³⁰

EFFECT OF TERMINATION CLAUSE

a. A Non-Controlling Criteria

The United States Supreme Court never has been presented with a case squarely involving a short-notice, without-cause termination clause where the taxpayer was clearly a bona fide lessee as opposed to a mining contractor performing mining services for the owner of the coal. Nor is there anything in the Internal Revenue Code of 1954, as amended, or the Treasury Regulations to lend guidance in this type of fact situation.

Parsons v. Smith,³¹ involving a contract-miner, is the only case in which the Court has dealt with the effect of a short-notice without-cause termination clause in determining whether the taxpayer had an "economic interest." In *Parsons* the Court set forth seven factors which were indicia of an "economic interest:"

To recapitulate, the asserted fiction is opposed to the facts (1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surren-

²⁸ 287 U.S. at 557.

²⁹ See note 2 *supra*. § 1.611-1 (1980).

³⁰ See also, Casey, *The Economic Interest—Play It Again Sam*, 24 TAX LAWYER 129 (1970).

³¹ 359 U.S. 215 (1959).

der to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in *Huss*, agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts.³³

Unlike Swank, Parsons was primarily a road building contractor who wanted to return to roadbuilding should the opportunity present itself; hence, the termination clause. The oral agreement between Parsons and the owner of the coal was that Parsons' firm would furnish equipment at its expense, as well as the facilities and labor to strip mine the coal. In addition, Parsons was to deliver the coal to the owner's cars. In return for these services Parsons was to be paid a stated amount of money per ton by the owner. Parsons was not permitted to keep or sell any of the coal on the open market.³³ Under these terms Parsons was considered a "contract miner." The agreement concerning termination was open-ended, providing that "if Parsons or Rockhill wanted to quit, all that was necessary to terminate the arrangement was the giving of a ten day notice."³⁴

In the companion case of *Huss v. Smith*,³⁵ there was a written contract between the owner and Huss to strip mine certain coal. As in *Parsons*, Huss was to furnish at its own expense all the equipment, facilities and labor, and was to deliver all coal mined to the owner who would pay Huss a stated amount per ton. As in *Parsons*, Huss was not permitted to sell the coal on the open market. There was a termination clause pursuant to which the owner/lessor, at any time with thirty days' written notice, could terminate the arrangement without cause. The money to be paid to

³³ *Id.* at 225.

³⁴ *Id.* at 216-17.

³⁵ *Id.* at 217.

³⁶ *Id.*

both Parsons and Huss by the respective owners of the coal "was agreed to be in 'full compensation for the full performance of all work and for the furnishing of all material, labor, power, tools, machinery, implements and equipment required for the work'."³⁶

To the *Parsons* Court the termination clause was only one of several factors to consider in determining whether the taxpayers had an economic interest which would entitle them to the depletion deduction. In holding against the taxpayers the Court considered all seven factors, found that the taxpayers failed them all, and concluded that the taxpayers involved were merely contract miners who had to look to the owners for payment for the work done (therefore bearing no risk of the market) and thus had no investment in the coal in place. Hence, they were paid by the coal owners for their services of mining the coal for the owners rather than for their own benefit.³⁷

*Winters Coal Co. v. Commissioner*³⁸ involved leases very similar to the ones in *Swank*. The lease in *Winters* was automatically renewable every year, but each party had the right to give thirty days' notice of intent not to renew. Furthermore, either party had the right to terminate at will upon sixty days' notice (subsequently reduced to thirty days).³⁹ The court found (and the government has conceded the same in *Swank*)⁴⁰ that the lease conveyed to Winters Coal Company the leasehold rights to the coal in place.⁴¹ Therefore, the only question before the court was whether the termination clause by itself would destroy what was clearly otherwise an economic interest.⁴² The court then reviewed the *Parsons* criteria and determined with respect to the short-notice without-cause termination clause: "This being the only contra point to the vesting of an economic interest in the petitioner, to say that ABC had not passed an economic interest to Winters pursuant to the leases gallops beyond all reason and logic."⁴³

³⁶ *Id.* at 218.

³⁷ *Id.* at 224-26.

³⁸ 496 F.2d 995 (5th Cir. 1974).

³⁹ *Id.* at 996.

⁴⁰ 602 F.2d at 349.

⁴¹ 496 F.2d at 999.

⁴² *Id.*

⁴³ *Id.* at 1000.

In *Bakertown Coal Co. v. United States*,⁴⁴ a case involving leases similar to the ones in *Swank*, the court indicated clearly its view that, in dealing with the seven factors set forth in *Parsons*, the terminability factor was only one of several to be considered in determining whether a taxpayer possessed an economic interest so as to entitle it to the depletion allowance. The court said:

Though terminability was one of the seven disqualifying factors mentioned, it cannot be considered either in isolation or in the abstract, as the Government would have it. Rather, it is clear that in the context of the contractor-oriented opinion, coming in the wake of G.C.M. 26290 and the decisions that followed it, the matter of terminability becomes only a colorably relevant factor where the applicant for the allowance lacks the traditional qualifications for depletion, as reflected by the other six conditions referenced by the court.⁴⁵

In *Swank* the Court of Claims followed its reasoning in *Bakertown*, again holding that the *Parsons* criteria are a bundle of several different factors, none of which was necessarily controlling. The terminability factor was not even relevant if all other six factors were met. The government has conceded in *Swank* that all other six factors have been met.⁴⁶

In *Mullins v. Commissioner*⁴⁷ Judge Drennen in his dissent suggested that the terminability factor is not controlling but is an important factor to consider in determining whether a lessee holds an economic interest. He said with respect to the so-called Bolling lease:

I agree that the presence of a clause permitting the lessor to terminate the lease without cause on short notice is an important factor to be considered in determining who has the requisite economic interest in the coal under a lease or contract, but I do not think it is conclusive, as does the majority [footnote omitted]. In my opinion we should look to the overall purpose of the depletion statute, and all the circumstances of the particular transaction, to determine how much weight to give to the termination clause in determining who had the economic

⁴⁴ 485 F.2d 633 (Ct. Cl. 1973).

⁴⁵ *Id.* at 639.

⁴⁶ 602 F.2d at 349.

⁴⁷ 48 T.C. 571 (1967).

interest in the mineral deposit.⁴⁸

Judge Drennen's comments reflect the manner in which the Court of Claims and the Fifth Circuit have approached this problem. This approach is the generally accepted view of the resolution of tax disputes; i.e., the disposition should be based in economic reality and not in technical legal terms.

It is interesting to note that while the Court in *Parsons* did not regard the presence of terminability as controlling, neither did it regard the absence of terminability as controlling in *Paragon Jewel Coal Co. v. Commissioner*.⁴⁹ Yet in both cases the percentage depletion deduction was denied to the contract miners involved. The denial was based, then, not on the presence or absence of a terminability clause, but on the broader and controlling rationale that the contract miners did not have an investment in the coal in place and did not have to look to the market for a return of their investment. They looked only to the owners for a set return in exchange for the service of mining.

b. Bona Fide Lessees v. Contract Miners.

By the terms of the leases⁵⁰ it is clear that in *Swank* the lessees obtained, by investment, interests in the coal in place by way of their bona fide leaseholds and had to look to the open market to recover their investment in the coal in place.⁵¹ In other words,

⁴⁸ *Id.* at 584.

⁴⁹ 380 U.S. 624 (1965).

⁵⁰ See text accompanying note 15, *supra*.

⁵¹ For example, pursuant to the lease in *Bull Run*, Preston County Coal and Coke leased to Bull Run all of a certain tract of unmined coal and granted the lessee the exclusive right to mine that coal. The mining had to be performed in a good, workmanlike manner so as to mine and remove a maximum amount thereof consistent with modern mining methods. The lessee had to mine pursuant to existing rules and regulations of the United States and West Virginia and any which might be enacted after the effective date of the lease. The lessee also had to comply with all existing workman's compensation laws and save the lessor harmless from any liability arising out of the operation of the mine. The lessee was to operate as an independent contractor. The term of the lease was for five years with an option in the lessee to renew for five years if the coal had not been removed by the end of the original term. The lessee was to pay the lessor a royalty of 25 cents per ton for the coal mined and removed. The parties agreed that upon written notice at least thirty days prior to the effective date of the termination, either party could cancel the lease without cause. The lease was assignable with the prior

the lessees bore all the risks of ownership of the minerals in place as the only means by which they could recover their investment. It is leases of this precise nature, under which the lessees were really entrepreneurs,⁵² that led the Court of Claims in *Swank, Thornberry Construction Co. v. United States*,⁵³ and *Bakertown*, as well as the Fifth Circuit in *Winters*, and Judge Drennen in his dissent in *Mullins*, to hold that a short-notice, without-cause termination clause will not destroy an otherwise valid economic interest as long as the leasehold interest clearly represents an investment in the minerals in place.

Since *Parsons*, all but three of the cases holding that such a termination clause prevents the taxpayer from having an economic interest are distinguishable from *Swank* on their facts. In those cases the taxpayer involved did not have an interest which required him to look to production and then sale of the minerals on the open market, where he assumed all the risks of ownership, to recover his investment. Rather, he was performing services for a set return per unit from the lessor or owner. The difference in those cases is that the taxpayers were essentially performing services for monies to be paid from other than the open market as opposed to the lessees in *Swank* who were entrepreneurs looking to recover their investments in the coal in place on the open market with all its attendant risks.

written consent of the lessor (J.A. 94a-96a). Brief for Respondent, *Bull Run* at 2-3.

⁵² One court, at least, in a case not dealing with terminability on short-notice without cause, characterized the one having an economic interest as an entrepreneur when it said: "It appears to this Court that the thread which ties the several *Parsons* criteria together is the basic question whether the coal operator assumed entrepreneurial-type obligations and risks with respect to the coal itself." *Douglas Coal Co. v. United States*, 429 F. Supp. 322, 338 (N.D. W. Va. 1977). Earlier the court had also taken the position that no single criterion in *Parsons* was controlling: "*Paragon* accordingly suggests that none of the seven criteria in *Parsons* can be considered in isolation (citation omitted). No single criterion is controlling. Instead, all of 'the peculiar conditions in each case' must be examined." 429 F. Supp. at 334.

⁵³ 576 F.2d 346 (Ct. Cl. 1978). This case involved a termination clause which was conditioned on the happening of an event, but the termination power was not automatic even should the lessee not sell to the person intended, for any termination power at that point was at the sole discretion of the lessor. *Id.* at 350.

1. *Contract miner cases.*

The only case which has presented the United States Supreme Court with an opportunity to pass on the question of the effect of short-notice without-cause termination clauses has been *Parsons v. Smith*.⁵⁴ As noted above, in that case the taxpayers met none of the seven criteria set forth and were therefore denied the depletion allowance because they were contract miners and not bona fide lessees. *Paragon Jewel Coal Co. v. Commissioner*⁵⁵ dealt only peripherally with the termination clause problem and based its holding squarely on the fact that the contract miners there did not look to the market place for a return on their investment.⁵⁶

In *United States v. Stallard*⁵⁷ there was a thirty-day notice without-cause termination clause involved which was held to be of some importance in denying the taxpayer-stripmining contractor the depletion allowance. However, the most important factor was that the contract miner was only performing mining services because he did not depend on the market place for a profit or loss. Rather, he provided all the equipment and labor (very much as occurred in *Parsons*), mined the coal pursuant to the agreement, and then delivered it to the owner at a fixed price per ton. That is not the case in *Swank*, where there were bona fide lessees (as opposed to a contract miner), who bore the risk of profit or loss of the open market, operated independently of the lessors,

⁵⁴ 359 U.S. 215.

⁵⁵ 380 U.S. 624.

⁵⁶ After an examination of the entire record, we can only conclude that Paragon at all times retained the right to change its fixed fee at will, and after delivery to the tipple, the contractors could only rely on Paragon's personal covenant to pay the posted price. This is insufficient. As we said in *Palmer v. Bender*, 287 U.S. 551, 557 (1933), the deduction is allowed only to one who "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." Here, Paragon was bound to pay the posted fee regardless of the condition of the market at time of the particular delivery and thus the contract miners did not look to the sale of the coal for a return of their investment, but looked solely to Paragon to abide by its covenant.

380 U.S. at 635.

⁵⁷ 273 F.2d 847 (4th Cir. 1959).

and were not subject to any control by the lessors. In short, the taxpayers in *Swank* were not merely performing contract services for the lessors but were the owners of the coal pursuant to the leases and bore all the risks and responsibilities of owners of such interests.

In *McCall v. Commissioner*⁵⁸ a thirty-day notice without-cause termination clause was held to be the critical factor in denying the depletion allowance to the taxpayer. However, the terms of the agreement between the sublessor and the lessee/taxpayer required the lessee to mine the coal and deliver it to the sublessor at a set price per ton. In addition to the right of either party to terminate without cause after thirty days' notice, the sublessor had the right, if economic conditions prevented him from selling at a reasonable profit the coal mined and delivered by the mining contractor to compel the mining contractor to suspend operations upon twenty-four hours' notice. Also, the sublessor reserved the right to stripmine coal which could not be properly mined by the mining contractor through deep mining. Those factors are not present in *Swank*. The taxpayers in *Swank* were bona fide lessees who had acquired the exclusive rights, without interference or control by the lessors, to mine the coal they owned pursuant to the leases, who bore the risks of the market as would any owner of a leasehold interest, and who were free to sell to anyone at any price.

*United States v. Wade*⁵⁹ involved a contract miner who was paid a fixed amount for quarrying dolomite and delivering it to the lessor. He did not rely on the open market for his profit or loss. While the thirty-day notice without-cause termination clause was deemed to be important, it was not the only factor which caused the court to deny the depletion allowance. Rather, it was one of two major factors, the other being that Wade essentially provided a mining service.

Another thirty-day notice without-cause termination clause case was presented to the court in *Costantino v. Commissioner*.⁶⁰ However, under the arrangement between the mining contractor and the owner, the mining contractor could look only to the own-

⁵⁸ 312 F.2d 699 (4th Cir. 1963).

⁵⁹ 381 F.2d 345 (5th Cir. 1967).

⁶⁰ 445 F.2d 405 (3d Cir. 1971).

er for a set price per ton, thus evidencing the fact that the owner had not parted with any interest in the mineral in place, but rather had contracted for the "lessee" to perform a mining service in extracting the mineral from the ground. This, in addition to the thirty-day notice without-cause termination clause, was important in the court's decision to deny the depletion allowance to the taxpayer. The taxpayers in *Swank*, on the other hand, unquestionably owned the leasehold interest, were not under the control of the lessors, and bore all the risks of the market to recover their investment in the coal in place.

In *Holbrook v. Commissioner*,⁶¹ the Tax Court was faced with another thirty-day notice, without-cause case. Under the "lease" there, title to the coal did not pass until the coal had been reduced to physical possession by the lessee. This factor alone had as much to do with the denial of the depletion allowance, if not more, than the thirty-day notice termination clause. Furthermore, the mining right in *Holbrook* was not exclusive. These facts do not exist in *Swank*, thus, *Holbrook* is easily distinguishable.

2. *Bona fide lessee cases*

The three cases involving bona fide lessees, as opposed to mining contractors, which are directly in conflict with the court of claims opinion in *Swank* may be distinguishable on their facts to some extent. However, for the purpose of this article, it is assumed that they are not distinguishable, at least insofar as the courts involved viewed the facts. The cases are *Weaver v. Commissioner*,⁶² *Mullins v. Commissioner*,⁶³ and *Whitmer v. Commissioner*.⁶⁴

Each of these cases held that the presence of a thirty-day (or other short-term) notice without cause termination clause defeats an economic interest. The rationale of these holdings is that no interest in the minerals in place has been obtained by the transferee because he has no right to mine to exhaustion. Therefore he

⁶¹ 65 T.C. 415 (1975).

⁶² 72 T.C. 594 (1979).

⁶³ 48 T.C. 571 (1967).

⁶⁴ 443 F.2d 179 (3d Cir. 1971). The *Bakertown* court criticizes *Whitmer* because the Third Circuit's authorities were *Wade* and *Stallard*, two contract miner cases.

has no investment in the minerals in place and has not met the first requirement of *Palmer v. Bender*.⁶⁵ *Palmer*, however, involved discovery depletion⁶⁶ which has not been permitted since 1954.⁶⁷ Both cost depletion and discovery depletion require an estimate of the amount of coal in place either at the time of purchase or at the time of discovery, and then the deduction is calculated on a per unit basis.⁶⁸ Where such a depletion method is used, it may make some sense to impose a requirement that the person claiming the deduction be able to mine the deposit to exhaustion because the amount of the depletion deduction per unit is based implicitly on that assumption. However, that is not the case with respect to percentage depletion which has no relation to the estimate of units of coal in the ground.⁶⁹ Though technically, cost depletion should be calculated to determine whether it exceeds percentage depletion,⁷⁰ as a practical matter this is not done by most taxpayers because normally, with respect to coal, percentage depletion will exceed cost depletion. However, in determining amounts to be treated as capital gain under section 631(c), cost depletion must be calculated.⁷¹

Percentage depletion operates solely as a percentage of gross income generated through production and sale, and unlike cost depletion, is available to the taxpayer far beyond the time when the initial investment in the mineral has been recovered.⁷² Hence,

⁶⁵ 287 U.S. 551 (1933).

⁶⁶ *Id.* at 554.

⁶⁷ Regulation § 1.611-1(a)(1), first published in T.D. 6446, 1960-1 C.B. 208, 210.

⁶⁸ Regulation § 1.611-2.

⁶⁹ § 613(a). The appropriate rate is taken against the gross income (with some adjustments and limitations) generated by the sale during the tax year the coal is sold. See Rev. Rul. 76-533, 1976-2 C.B. 189 and Rev. Rul. 68-565, 1968-2 C.B. 263.

⁷⁰ § 613(a).

⁷¹ For a very recent article on the operation of section 631(c) regarding retained coal royalties, see Henshaw, *An Analysis of the Tax Planning Opportunities Unique to the Mining of Coal*, 53 J. of Tax. 357 (1980).

⁷² *Commissioner v. S.W. Exploration Co.*, 350 U.S. 308, 312 (1956); *Commissioner v. Elliott Petroleum Corp.*, 82 F.2d 193 (9th Cir. 1936). See Whiteside and Gillig, *Coal and Conservation-Tax Policy*, 64 Ky. L.J. 573, 584 (1975-76). For an excellent article on natural resource development incentives generally, including coal, see Burke, *Incentives to Develop Natural Resource Exploitation; Oil and Gas; Hard Minerals; Timber*, 33 NYU TAX INST. 1541 (1975). See also Austin, *Percentage Depletion: Its Background and History*, 21 UNIV. KAN. CITY L. REV.

there is no reason why, with respect to allowing percentage depletion, the person claiming the depletion deduction should be required to have the right to mine the deposit to exhaustion. In fact, so long as the person claiming the depletion deduction meets the general test of *Palmer v. Bender*, which is that the taxpayer has acquired legal control of a valuable economic interest from which he can realize gross income by exercising his mining rights, the depletion deduction should be available.⁷³ Thus, in the three cases which are contrary to *Swank*, the requirement of obtaining the right to mine to exhaustion with respect to percentage depletion is misplaced through a loose application of the *Palmer v.*

22 (1952-53).

Percentage depletion was first enacted in 1926, Rev. Act of 1926, ch. 27, 44 Stat. 9, § 204(c)(2), but it was not until 1932 that the coal industry was permitted to use that method of depletion at the rate of 5%. In 1951 the rate was increased to 10%. See note 3, *supra*.

⁷³ See *Thornberry Const. Co. v. United States*, 576 F.2d 346, 353:

What distinguishes this case from *Parsons v. Smith*, *supra*, and *Paragon Jewel Coal Co. v. Commissioner of Internal Revenue*, *supra* (and from other cases cited by defendant) is that, as a matter of form, of substance, and of economic reality, the lease and assignment conferred upon plaintiff the rights to mine coal and to sell that coal, at whatever price it could obtain therefor, to an independent, unrelated, third party (albeit a valued customer of AMAX itself).

Put another way, plaintiff was not simply extracting coal for AMAX under a contract with AMAX from which it derived a pecuniary advantage, but was mining coal for sale to a third party, at an independently determined price, and was required to look to the extraction of that coal and the sale thereof for a return on its investment and profit.

and *Bakertown Coal Co. v. United States*, 485 F.2d 633, 636:

Thus, defendant does not dispute either that these agreements were bona fide mineral leases or that, while in force, they gave plaintiffs essentially the same autonomous authority over extraction and sale of the underlying mineral as did the leases in *Palmer*, *supra*, and *Alworth-Stephens*, *supra*, where such authority was held to constitute an ample basis for a depletable interest.

* * * * *

The erroneous transposition is as between lessees; persons who have acquired the right to remove and retain mineral underlying the leased premises, and mining contractors who, although functionally involved in the production of salable mineral (and therefore financially interested in the life of the deposit as a source of continuing need for their services), have no effective authority over production and acquire no ownership of the extracted mineral.

Bender rule.⁷⁴

Furthermore, a lease containing a clause allowing for termination for cause, does not destroy an otherwise valid economic interest.⁷⁵ Yet, if a lease is terminated for cause, the lessee, as in the case of a termination without cause, will not be able to mine the deposit to exhaustion. Thus, there is inconsistent treatment of these two situations, unless the key difference is the fact that the transferor has retained control over the transferee by reason of having a power of termination on short-notice and without cause.

Interpretations by the Internal Revenue Service of the effect of termination clauses indicate that short-term notice without-cause termination clauses will destroy an otherwise valid economic interest, whether they are exercisable by the transferor of the mineral right or an unrelated third party. In G.C.M. 26290,⁷⁶ dealing with coal contract miners (as opposed to lessees), a without-cause termination clause requiring a year's notice for termination was held to be of such a nature that it would not destroy the economic interest of a contract miner, if indeed he could have such. The same termination clause, with notice of less than a year, was held to defeat any possibility of an economic interest because the transferor was not conveying an interest which would permit the transferee to mine to exhaustion. As a result, the transferee had no investment in the mineral in place; therefore, the first requirement of the *Palmer* rule had not been met.

Strangely enough, though, in Rev. Rul. 77-481⁷⁷ the Internal

⁷⁴ This proposition should hold true for cost depletion as well on the theory that mining to exhaustion is totally irrelevant to the depletion deduction. See Wiener, *Economic Interest, the Rise and Fall of a Slogan*, 37 *TAXES* 777, 794 (1959).

⁷⁵ See *Whitmer v. Commissioner*, *supra*, at 173, and the cases cited therein. See also Rev. Rul. 74-507, 1974-2 C.B. 179.

⁷⁶ 1950-1 C.B. 42, declared obsolete in Rev. Rul. 70-277, 1970-1 C.B. 280. See note 3, *supra*. See also Rev. Rul. 74-507, 1974- C.B. 179 where a year's notice still seems to be accepted by the Service as not invalidating an otherwise valid economic interest.

⁷⁷ 1977-2 C.B. 205. The Service in Rev. Rul. 77-481 stated it would not follow *Bakertown*; that terminability was equally fatal to contract miners as well as lessees. In Rev. Rul. 77-481 a government agency contracted with a taxpayer/construction company for delivery of a certain amount of rock. The taxpayer in turn entered into a lease with a landowner for the exclusive right to remove as much

Revenue Service took the position that if the lease could be terminated by someone other than the grantor, there still was no economic interest because of the possibility that the deposit would not be mined to exhaustion by the lessee. The Internal Revenue Service by taking this latter position, has invalidated the only distinction to be drawn between termination for cause and termination without cause. If the termination is for cause, the rationale for not having such a right destroy an otherwise valid economic interest is that there is no retention by the transferor of some power over the transferee. But if the termination can be effected at the will of the transferor, then the transferor has retained so much control over the transferee that the transferee for all practical purposes has acquired no substantial interest in the coal in place.

The court in *Swank* pointed out that there is nothing in the record to indicate that the coal could not have been mined to exhaustion within the thirty-day period.⁷⁸ *Swank* is not a *Parsons* situation where the contract was oral with a ten-day notice of termination, primarily, because the "lessee" (*Parsons*), a contract

rock as he wanted for a per ton royalty, but the lease would terminate upon termination of the governmental contract. Furthermore, the governmental agency reserved the right to cancel the contract at any time. Holding that the taxpayer had no economic interest in the rock in place the ruling explained:

In the present case, although the taxpayer's right to quarry and remove the rock is not terminable by either the landowner or the taxpayer-lessee, it could cease at any time as a result of the governmental agency's termination of the governmental contract. Because the taxpayer's rights can be frustrated by the governmental action, the taxpayer has no significant legal or financial interest in the minerals *in place*. It makes no difference whether a taxpayer's mineral rights are terminable by a landowner or whether termination can occur as a result of the actions of a third party. Because, at any time, the taxpayer is not legally entitled to any determinable portion of the mineral in place, the taxpayer obtained only an economic advantage from the agreement.

Accordingly, in the present case, the taxpayer, upon entering into the mineral lease with the landowner for the quarrying of rock required to fulfill the contract with the governmental agency, did not acquire an economic interest in mineral in place within the meaning of section 1.611-1(b) of the regulations because the duration of the mineral lease was so related to taxpayer's construction contract with the governmental agency that the lease was terminable at the will of the governmental agency.

⁷⁸ 602 F.2d at 351.

miner, wanted to be able to terminate the contract as soon as a road building project could be obtained.⁷⁹

Furthermore, in *Weaver, Mullins, and Whitmer*, just as in *Swank*, the right to terminate without cause on short notice was merely a condition subsequent; and until that right was exercised, the lessees had every right, opportunity, and risk in carrying on their operations that a lessee would have under a lease without such a termination clause.⁸⁰ In fact, *Black Hawk* and *Bull Run* mined their coal to exhaustion without any exercise of the termination clauses which are the focal point of this article.⁸¹

By placing emphasis on the fact that certain lease arrangements are subject to short-notice terminations, the Tax Court, at least, has put itself in a position of having to determine how long is short. What difference should it make whether a taxpayer who has a leasehold interest in the minerals in place and who has to look to the market to recover his investment holds that lease subject to a short-notice without-cause termination clause? As long as he owns that leasehold, he has all the right, title and interest to mine the coal and sell it to whomever he pleases. Under *Palmer*, that constitutes an economic interest although it may not last more than one day.⁸²

⁷⁹ 359 U.S. at 217.

⁸⁰ *Bakertown Coal Co. v. United States*, 485 F.2d 633, 641 (Ct. Cl. 1973); *Mullins v. Commissioner*, dissent, 48 T.C. 571, 585 (1967).

⁸¹ With respect to *Black Hawk* see the stipulation of facts at page 71a of the Joint Appendix. With respect to *Bull Run* see Respondent's Brief at page 2.

⁸² While it is highly unlikely that any such leasehold interest would ever be negotiated which was to last only a day, logically, at least with respect to percentage depletion, the interest transferred by the lessor to the lessee which entitles the lessee to mine exclusively and look to the market for his return of capital should be a valid economic interest for whatever time the lease is effective. Judge Drennen so noted succinctly in his dissent in *Mullins v. Commissioner*, 48 T.C. 571, 584-85 (1967):

If the only question here was whether the lessor or the lessees were entitled to the depletion deduction, I would have no hesitancy in saying that the lessees were entitled to it. This is because I think the lessor surrendered all or part of his economic interest in the coal under the Bolling tract to the lessee while the lease was in effect; and we are concerned with depletion on coal that was mined while the lease was effective.

But there is no question that the case law and the Commissioner's regulations have engrafted on the requirements of the law that to be

ECONOMIC REALITY

The termination clauses in *Swank* were never exercised over the period during which the taxpayers mined the coal under the leases.⁸³ Quite clearly, then, the lessees in fact had interests in the coal in place which permitted them to mine the coal to exhaustion. Until the termination clauses were exercised, the lessees had the requisite economic interest to permit their taking the depletion allowance,⁸⁴ for "the mere existence of the unused termina-

entitled to a deduction for depletion the taxpayer must have an economic interest in the mineral deposits. I agree with the majority that the petitioners had an economic interest in the coal underlying the Blair and Clintwood leases, for the reasons stated in the opinion. I cannot agree that they had any less economic interest in the coal underlying the Bolling lease; the only difference was that their interest under the Bolling lease was subject to divestment if the lessor exercised his right to terminate. Until such time as the lessor exercised that right, in my opinion petitioners had such an economic interest in the coal deposit that would support the depletion deduction. If the lessor exercised his right to terminate, the entire economic interest would then revert to the lessor. But we are not here concerned with coal mined after that time.

This suggested shifting of the economic interest in a mineral deposit is not unusual. Under the pertinent regulation it occurs any time a taxpayer acquires by investment any interest in the mineral in place and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which he must look for a return of his capital. Indeed the conclusion of the majority must recognize the possibility of such a shift in economic interest under the Clintwood lease, because after the original 2-year term thereof the lessor has the absolute right to terminate the lease on short notice without cause and, according to the theory of the majority, the economic interest in the coal in the Clintwood lease, which had theretofore rested in the lessee, would revert to the lessor.

Where, because of the uncertain terms of a mineral lease or contract, it is difficult to determine whether the lessee or contractor is simply mining the coal for the lessor for a fee or fixed price, or whether the lessor has actually surrendered his economic interest in the coal to the lessee, the presence of a short termination clause, considered along with the other terms of the agreement, would usually be entitled to considerable weight. But I do not believe it should be a conclusive factor in determining that the petitioners here, who obviously had an economic interest in the coal deposit and had to look to the extraction and sale of that coal for their profit, were not entitled to the depletion deduction solely because of the termination clause in the Bolling lease.

⁸³ 602 F.2d at 350.

⁸⁴ See note 82, *supra*.

tion clause is not enough to deprive the taxpayer/lessees of their 'economic interest' they would otherwise have."⁸⁵ This statement is based on the economic reality that, until the termination clause is exercised, the lessee has every right to mine the coal and sell it on the open market, taking the risk of profit or loss upon itself. The lessee under these circumstances is in no different position (and thus should not be penalized) from a lessee operating under a lease without such a termination clause.⁸⁶

In *Swank* the court dealt with economic substance and not technical form. The court looked to the records and found:

that each of the taxpayers had regularly mined coal from the leases in question for a very substantial period prior to the taxable years [footnote omitted] and that, in all reality, they had a very good expectation of being able to continue to do so. . . . [W]e accept the showing that the lessors rarely (if ever) terminated without cause, not as demonstrating that the lessors lacked the legal power to terminate without cause [footnote omitted], but solely as showing that in practice and in reality the plaintiff coal-lessees had, at all relevant times, a solid expectation that they could continue under their leases to mine the coal for a substantial period and to extract a substantial amount of the coal [footnote omitted]. This means—unless

⁸⁵ *Id.*

⁸⁶ As is suggested in the *Mullins* dissent, until the termination power is exercised the lessee has an enforceable leasehold interest.

Suppose two coal operators each had the same leasehold interest, for instance, as *Swank* (see note 51 *supra* for the details in the Bull Run lease) except that one lease said nothing about termination on short notice without cause. They each mine coal pursuant to the leases for 15 years and sell it on the open market. During this 15 year period the termination power is never exercised. In economic reality those two coal operators are in identical positions and have identical leasehold interests so long as the termination power is not exercised. To say that one is entitled to depletion and the other is not creates gross inequity between two similarly situated taxpayers, particularly where, as happened in *Black Hawk* and *Bull Run*, the coal deposits were in fact mined to exhaustion without exercise of the termination clause. If and when the termination power is exercised, then the question of depletion disappears with respect to the lessee whose leasehold interest no longer exists.

The same comparison could be made for shorter periods, but the time reference used is close to the facts of *Swank*. As pointed out in note 82 *supra*, the analysis should apply to a leasehold interest of one day. This analysis should apply also to a situation where the lessee has the right to terminate on short notice without cause, which was the case in *Swank*.

we are to depart from defendant's own norm for testing 'economic interest' by substance and reality, rather than by mere nomenclature or the theoretical form of the legal arrangement—that taxpayers are entitled to depletion. They satisfy the proffered criterion of knowing in advance that they will be able to mine for a substantial period and to extract a substantial portion of the coal. Certainly this was true at the beginning of each of the taxable years.⁸⁷

In *Bakertown* the court also indicated that economic reality must be taken into consideration:

The property interest represented by that authority [that is, the authority over extraction and sale of minerals given pursuant to leases] is not varied or diminished simply because the authority is subject to the possibility of extinction in the future by a termination of the leases on short notice. The legal effect of a termination on these leases is no less prospective because the advanced notice requirement is only 30 days, than it would be if the specified period were one year.⁸⁸

Further, there was no danger that if the lessors could obtain better royalties they would terminate the leases. Even though it is a fact that the market had increased substantially, no such action was ever taken because business judgment dictated that the lessors remain bound under the then existing leases.⁸⁹

Based on the reality that 1) the lessees mined the deposits to exhaustion (or for a substantial period of time) without exercise of the termination clause by the lessors, 2) apparently the lessors and lessees never had any intention of exercising these clauses,

⁸⁷ 602 F.2d at 351. The court disposes of the terminability issue entirely on the ground of economic reality, not refuting the "mining-to-exhaustion" argument of the government on any theoretical basis.

⁸⁸ 485 F.2d at 636.

⁸⁹ 602 F.2d at 351, n.9:

We were told at oral argument by counsel for one of the plaintiffs that lessors have not terminated, even though the value of coal has increased markedly in the recent past and the royalties fixed in the leases now seem "outdated," because, for a new lessee, the costs of continuing with an existing mine are usually so great, comparatively, that it is difficult for a lessor to obtain new lessees at terms more favorable to the lessors than the existing leases. We do not accept this as evidence, but the record contains nothing to contradict this explanation for what seems to be the fact that leases of this type have not been regularly cancelled by lessors in recent years.

and 3) even though the price for coal had risen dramatically, the lessors never terminated the leases, the termination clauses had no true independent economic significance.

CONCLUSION

The United States Supreme Court has an opportunity now to put back in order the concept of "economic interest" and the effect of clauses providing for termination without cause on short notice on that concept. The confusion has grown out of the use of termination clauses as an aid to contract miners who had no traditional investment in coal in place, to serve as a basis for claiming the depletion deduction. *Parsons* and *Paragon* stand for the proposition that contract miners have no "economic interest" regardless of the presence or absence of a termination clause. Termination clauses have now been turned around by the Internal Revenue Service as a weapon to deny bona fide lessees, who unquestionably have an investment in the coal in place, a depletion deduction to which they are clearly entitled. The Court should follow the precedent set by the Court of Claims and the Fifth Circuit and (1) base its holding on the original requirements of an economic interest as set forth in *Palmer*, (2) show that termination without cause or for cause is a neutral factor in finding whether an "economic interest" exists with respect to a bona fide leasehold interest, and (3) articulate the critical distinction between contract miners who perform services only for a fixed price with no investment in the coal in place and bona fide lessees who have an investment in the coal in place and who, in order to recover their investment, must look to the open market and bear all its attendant risks.

