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Licensees and Economic Interest in Minerals After *Swank* and Revenue Ruling 83-160*

BY MARTIN J. McMAHON, JR.**

INTRODUCTION

Slightly over three years have elapsed since the decision of the Supreme Court in *United States v. Swank*.¹ In that decision the Court held that a coal operator mining a coal deposit under a written lease terminable without cause on thirty days prior notice held an economic interest in the mineral in place.² Accordingly, the lessee-coal operator was entitled to claim the percentage depletion allowance deduction.³ *Swank*

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¹ 451 U.S. 571 (1981).

² *Id.* at 577-85. The term "economic interest" was first used by the Supreme Court in *Palmer v. Bender*, 287 U.S. 551, 557 (1933). The definition, derived from *Palmer*, along with subsequent judicial gloss, has been incorporated into the Treasury Regulations as follows:

Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits. . . . An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . . to which he must look for a return of his capital. . . . A person who has no capital investment in the mineral deposit 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 . . . 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.

Treas. Reg. § 1.611-1(b)(1), T.D. 7261, 1973-1 C.B. 309, 317.

Because the precision of the definition in the regulation is an illusion, the true story of the definition of the economic interest concept is a tale of ever-continuing litigation. See Sneed, *The Economic Interest—An Expanding Concept*, 35 TEX. L. REV. 307 (1957).

³ 451 U.S. at 584-85. See I.R.C. § 611 (1982) (allowing a deduction for depletion

rebuffed an argument advanced by the Internal Revenue Service that so called "short-notice terminability" was invariably fatal to the taxpayer's claim of an economic interest.⁴

The *Swank* decision generated some notice in tax literature, largely because it rejected a position vigorously asserted by the Internal Revenue Service (IRS or Service) for over twenty years.⁵ But, because the issue was framed by the Court in narrow terms, most commentators looked at *Swank* as merely deciding the precise issue involved—whether an unexercised thirty day termination clause would vitiate an otherwise valid economic interest.⁶ Some commentators, including this author, believed the long range impact of the theoretical underpinnings of the *Swank* decision could not be so confined.⁷ Although there has not yet been sufficient time for expansive judicial reexamination of the definition of an economic interest based upon the ramifications of *Swank*, the impact of *Swank* is beginning to be felt.

Recently, the IRS acknowledged that the holding of *Swank* is not confined only to its particular facts.⁸ In Revenue Ruling 83-160, the IRS held that the terminability of a mineral lease at the will of the lessor "is not an essential criterion that, by itself, will preclude a taxpayer from acquiring an economic interest."⁹ This ruling goes beyond *Swank* in concluding that there is *no minimum period* during which a lessee must have a legal right to extract minerals as a necessary pre-

with respect to "mines, oil and gas wells, other natural deposits, and timber"); I.R.C. § 613 (1982) (providing for percentage depletion allowance deduction).

⁴ For a discussion of the history of the litigation of the terminable lease cases, see Lathrop, *Short-Notice Termination Clauses in Coal Leases: Effect on Percentage Depletion*, 83 W. VA. L. REV. 159 (1980); McMahan, *Defining the "Economic Interest" in Minerals After United States v. Swank*, 70 Ky. L.J. 23, 52-60 (1981-82).

⁵ See, e.g., *Mullins v. Commissioner*, 48 T.C. 571, 582-83 (1967) (court agreed with the Commissioner that a lessee did not have an economic interest in minerals mined under a lease terminable on short notice).

⁶ See, e.g., *Henshaw & Minor, Short-Notice Terminability No Bar to Lessee Mineral Depletion, Says Sup. Ct. in Swank*, 55 J. TAX'N 102 (1981); Note, *Percentage Depletion Allowance Not Dependent on Duration of Lease Interest Tax Law*, 22 NAT. RESOURCES J. 239 (1982); Note, *Supreme Court Decisions in Taxation: 1980 Term*, 35 TAX LAW. 443, 540-50 (1981).

⁷ See McMahan, *supra* note 4, at 67-68.

⁸ See Rev. Rul. 83-160, 1983-2 C.B. 99.

⁹ *Id.* at 100.

requisite to an economic interest. As a result, the rationale of *Swank* is not limited to leases terminable only upon the thirty day notice period presented by the facts of that case. Seemingly flying in the face of Revenue Ruling 83-160, however, is Revenue Ruling 84-88,¹⁰ which cited the fact that a percentage of sales contract miner had acquired the right to mine a coal deposit to exhaustion as a relevant factor in holding that he had an economic interest in the deposit.

While Revenue Ruling 83-160, like the *Swank* decision, is by its express language intended to be narrowly confined in its impact, the reasoning behind the ruling, as is true with *Swank*, cannot logically be so confined. If the ruling is conceptually correct, further changes in the definition of an economic interest should follow. Also, if that ruling is correct, the holding of Revenue Ruling 84-88 is subject to an erroneous qualification. The purpose of this Article is to assess the impact of Revenue Ruling 83-160 on the definition of "an economic interest in minerals" and to examine the proposition that—after *Swank* and Revenue Ruling 83-160—licensees, who previously were generally considered not to have acquired an economic interest, should now be found to have an economic interest in the mineral deposit that they are extracting.¹¹

I. TERMINABLE LEASES BEFORE *Swank*

That a lessee of a mineral deposit has an economic interest in the deposit has been beyond question since the 1925 decision of the Supreme Court in *Lynch v. Alworth-Stephens Co.*¹² Prior to the Supreme Court's decision in *Parsons v. Smith*,¹³ the IRS generally did not assert that a lessee did not have an economic interest in minerals acquired under a lease terminable by the lessor on short notice and without cause. In

¹⁰ 1984-25 I.R.B. 13.

¹¹ This article is a sequel to my article in note 4 *supra*. My earlier article discussed the difficulties which before Revenue Ruling 83-160 were present in any attempt to identify the presence of an economic interest. See McMahan, *supra* note 4, at 23.

¹² 267 U.S. 364 (1925).

¹³ 359 U.S. 215 (1959).

that case the Court held that contract miners receiving a fixed fee for each ton of coal extracted did not have an economic interest in the coal in place.¹⁴ Among the factors cited by the Court as the basis for its holding was that "the contracts were completely terminable without cause on short notice."¹⁵

After the decision in *Parsons*, the IRS began to assert vigorously that short notice terminability vitiated an otherwise valid economic interest acquired by a lessee.¹⁶ Previously, the Service had used this factor to argue that a taxpayer did not have an economic interest only with contract miners, or nominal lessees who were in substance contract miners because they were under a contractual obligation to sell the extracted coal to the lessor.¹⁷ In the case of contract miners, this argument can be traced back to G.C.M. 26290,¹⁸ promulgated in 1950. Prior to *Parsons*, however, the Service had not generally attempted to apply this argument to lessees.

The basic thrust of the Commissioner's argument in the terminable lease cases was that the lessee under a short notice termination lease had only a mere "economic advantage" derived from extraction of coal under the lease.¹⁹ This distinction between an "economic advantage" and an economic interest is based on *Helvering v. Bankline Oil Co.*²⁰ In that decision the Supreme Court held that a taxpayer processing casinghead gas to remove the oil under contracts with the well owner did not have an economic interest.²¹ After examining the taxpayer's relationship to the gas in place, the Court concluded the taxpayer had no "investment" in the gas in place

¹⁴ *Id.* at 225-26.

¹⁵ *Id.* at 225.

¹⁶ See McMahan, *supra* note 4, at 52-53.

¹⁷ See *id.* at 44-53. See, e.g., *Weirton Ice & Coal Supply Co. v. Commissioner*, 231 F.2d 531 (4th Cir. 1956); *Usibelli v. Commissioner*, 229 F.2d 539 (9th Cir. 1955); *Eastern Coal Corp. v. Yoke*, 67 F. Supp. 166 (N.D. W. Va. 1946).

¹⁸ G.C.M. 26290, 1950-1 C.B. 42, 44-46, declared obsolete by Rev. Rul. 70-277, 1970-1 C.B. 280.

¹⁹ See, e.g., *Weaver v. Commissioner*, 72 T.C. 594, 601 (1979); *Winters Coal Co. v. Commissioner*, 57 T.C. 249 (1971), *rev'd*, 496 F.2d 995 (5th Cir. 1974); *Whitmer v. Commissioner*, 28 T.C.M. (CCH) 1480 (1969), *aff'd*, 443 F.2d 170 (3d Cir. 1971); *Mullins v. Commissioner*, 48 T.C. 571, 579 (1967).

²⁰ 303 U.S. 362 (1938).

²¹ *Id.* at 368.

and, accordingly, no economic interest.²²

An actual investment in terms of a capital expenditure has, however, never been a requisite for an economic interest. In *Palmer v. Bender*,²³ the landmark case from which the definition of an economic interest was born, the Court found an "investment" in the absence of actual capital expenditure.²⁴ The taxpayer was held to have an investment arising from "complete legal control of the oil in place."²⁵ An actual financial investment in the mineral in place, such as a purchase of a royalty interest, clearly gives rise to an economic interest.²⁶ The history of the development of the concept of economic interest reveals that an economic interest can also be obtained by making a valuable contribution to the acquisition or development of the deposit.²⁷ Frequently, this "contribution" has entailed the ability to exercise legal control over the mineral in place.²⁸ Absent either such a contribution

²² *Id.* at 367.

²³ 287 U.S. 551 (1933).

²⁴ *See id.* at 558-59.

²⁵ *Id.* at 558. Nevertheless, in many cases courts continue to seek an actual cash "investment" by the taxpayer in the minerals in place or in connection with the minerals. *See, e.g.,* *Winters Coal Co. v. Commissioner*, 496 F.2d at 1000-01 (lessee purchased surface rights); *Weaver v. Commissioner*, 72 T.C. at 605 (lessee incurred development expenses); *Victory Sand & Concrete, Inc. v. Commissioner*, 61 T.C. 407, 416-19 (1974) (investment in riparian land essential to dredging sand and gravel under license). In other cases, however, the courts have found an investment to be insufficient where the taxpayer's investment was in equipment associated with extraction or processing. *See, e.g.,* *Parsons v. Smith*, 359 U.S. at 224-25 (movable equipment); *Helvering v. Bankline Oil Co.*, 303 U.S. at 368 (processing plant); *McCall v. Commissioner*, 312 F.2d 699, 704-06 (4th Cir. 1963) (movable equipment). Some courts have decided that the investment requirement has not been met when the taxpayer's expenditures were recoverable through deductions other than the depletion allowance. *See, e.g.,* 312 F.2d at 705 (deductible development expenses, depreciable improvements).

²⁶ *See, e.g.,* *Thomas v. Perkins*, 301 U.S. 655, 661 (1937) (quoting *Palmer v. Bender*, 287 U.S. 551, 557-58 (1933)).

²⁷ *See, e.g.,* *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 316-17 (1956) (net profits interest received for use of land from which to whipstock drill for offshore oil deposits is an economic interest); *Omer v. United States*, 329 F.2d 393 (6th Cir. 1964) (royalty received in consideration of surface rights was economic interest); *Cline v. Commissioner*, 67 T.C. 889 (1977), *aff'd*, 617 F.2d 192 (6th Cir. 1980) (royalty received in consideration of negotiating mineral lease was economic interest); *Rev. Rul. 77-84*, 1977-1 C.B. 173.

²⁸ The significance of control over the deposit is best illustrated by *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308. In that case the Supreme Court

or an actual capital investment a taxpayer could not have an economic interest, but merely an economic advantage.²⁹

In all of the terminable lease cases decided by the Tax Court, lessees under leases terminable on short notice were found not to have an economic interest.³⁰ Clearly, if a lease could be terminated on nominal notice, the lessee's control over the deposit, when viewed prospectively, is illusory.³¹ Although the Commissioner generally took the position that a lease terminable on less than one year's prior notice was to be considered terminable on short notice,³² the Tax Court focused on whether the notice period was sufficiently long to enable the lessee to extract a significant amount of the mineral in place after notice was given, but prior to the termination date.³³ If so, the notice period was not nominal and did not

held that a littoral land owner held an economic interest in an offshore oil deposit in which the taxpayer neither made an actual financial investment nor held an interest as an owner or lessee. Under California law, offshore oil deposits could be extracted only from wells drilled on land. The taxpayer received a net profits royalty in consideration for granting the holder of the working interest the right to whipstock drill from its land. *Id.* at 310-11. Because of the taxpayer's unique control over extraction of the mineral, the Supreme Court found that the taxpayer had made an "indispensable contribution . . . in return for a share of the net profits," and held that the taxpayer had an economic interest entitling him to claim the depletion allowance. *Id.* at 317. *See also* *Winters Coal Co. v. Commissioner*, 496 F.2d at 1001 (lessee under lease terminable on short notice without cause who had acquired surface rights had an economic interest).

²⁹ The requisite "investment" may be made in an indirect manner, however. For example, a lawyer who receives a royalty interest in a mineral deposit in consideration of providing legal services in connection with the examination of title and preparation of the lease document has an economic interest in the deposit with respect to the royalty. Rev. Rul. 83-46, 1983-1 C.B. 16. As a result of the receipt of the royalty, under I.R.C. § 83(a) (1984), the lawyer recognizes income equal to the fair market value of the royalty interest. *Id.* Cf. G.C.M. 22272, 1941-1 C.B. 214, 221-22.

³⁰ *See, e.g., Weaver v. Commissioner*, 72 T.C. 594; *Winters Coal Co. v. Commissioner*, 57 T.C. 249; *Whitmer v. Commissioner*, 28 T.C.M. (CCH) 1480; *Mullins v. Commissioner*, 48 T.C. 571 (1967). *See also* *Holbrook v. Commissioner*, 65 T.C. 415 (1975) (terminable, nonexclusive license); *Smoot v. Commissioner*, 25 B.T.A. 1038 (1932) (terminable license). *See generally* *McMahon, supra* note 4, at 52-60.

³¹ *See Weaver v. Commissioner*, 72 T.C. at 609.

³² *See* G.C.M. 26290, 1950-1 C.B. 42, 45-46, *declared obsolete* by Rev. Rul. 70-277, 1970-1 C.B. 280.

³³ *See* 72 T.C. at 594. In *Weaver* the Tax Court held that a taxpayer had no economic interest in a sand and gravel deposit leased subject to termination by the lessor at will, without cause, but that he did have an economic interest in another deposit with respect to which his lease was terminable without cause on 120 days

vitate an economic interest.

Although the Tax Court and the IRS arrived at different views of the minimum notice period required to find an economic interest in the lessee, the theory used by each was the same. In Revenue Ruling 74-506 the IRS held that where a six month period was sufficient to enable the taxpayer to remove all of the remaining materials, a mineral lease with a six month term was sufficient to confer an economic interest on the lessee.³⁴ Although the facts of the ruling indicated that all remaining minerals could have been removed during the term, the ruling specifically stated that a term which permitted the lessee to remove a substantial amount of the mineral would be sufficient to find an economic interest.³⁵ This was in accord with the Tax Court view.³⁶

Under the IRS view, abstract legal rights, as opposed to actual conduct of the parties, were talismanic. Thus, in Revenue Ruling 77-341 the Service held that a lessee did not have an economic interest under an oral lease that was unenforceable under the Kentucky Statute of Frauds, notwithstanding the fact that the lessee had mined coal and paid royalties for a period in excess of one year.³⁷ Since the contract was unenforceable, the lessee had not acquired a legal interest in the coal and, accordingly, did not have an economic interest. A similar result was reached in Revenue Ruling 77-481.³⁸ In that ruling the taxpayer had entered into a mineral lease for the removal of rock which was coterminous with the taxpayer's contract to supply rock to a governmental agency. The IRS held that the taxpayer did not have an economic interest because the taxpayer had no enforceable right to extract a substantial portion of the deposit. His right to extract the rock could be terminated at any time by cancellation of the contract to supply rock by the government agency.

Prior to *Swank*, Revenue Rulings concluding that a lessee

prior notice. *Id.*

³⁴ Rev. Rul. 74-506, 1974-2 C.B. 178.

³⁵ *Id.*

³⁶ *Compare Mullins v. Commissioner*, 48 T.C. 571 *with* Rev. Rul. 74-506, 1974-2 C.B. 178.

³⁷ Rev. Rul. 77-341, 1977-2 C.B. 204.

³⁸ 1977-2 C.B. 205.

did have an economic interest relied specifically on the fact that the lease was terminable neither at will nor upon short or nominal notice.³⁹ Other than the six month lease described in Revenue Ruling 74-506 which was of a duration sufficient to exhaust the deposit,⁴⁰ the shortest lease term recognized by the Service as conferring an economic interest on the lessee was one year. Revenue Ruling 74-507 held that a lessee mining operator had an economic interest under a one year lease commencing on January 1 and automatically continued for successive one year terms unless cancelled, with or without cause, at the end of any term by notice due ten days prior to November 1 of the current lease year.⁴¹ Although the period between notice and the earliest possible termination of the lease was only sixty-one days, the shortest possible lease term was one year.

While the Commissioner's view prevailed in the short notice terminable lease cases decided by the Tax Court and the Third Circuit Court of Appeals,⁴² the Court of Claims and the Fifth Circuit Court of Appeals held that lessees under such leases did have an economic interest.⁴³ In *Bakertown Coal Co. v. United States*⁴⁴ and *Swank v. United States*,⁴⁵ the Court of Claims held that short notice termination clauses were irrelevant when the lessor did not exercise his right to terminate the lease and the taxpayer in fact extracted the mineral.⁴⁶ The Court of Claims specifically noted that if the lessee were denied an economic interest, no one would be allowed a depletion deduction with respect to the gross income from the extraction and sale of the coal.⁴⁷ Under the Court of Claims view the legal rights of the lessee were not as important as the fact

³⁹ See Rev. Rul. 72-477, 1972-2 C.B. 310; Rev. Rul. 73-32, 1973-1 C.B. 301.

⁴⁰ Rev. Rul. 74-506, 1974-2 C.B. 178, 179.

⁴¹ Rev. Rul. 74-507, 1974-2 C.B. 179.

⁴² See, e.g., *Weaver v. Commissioner*, 72 T.C. 594; *Whitmer v. Commissioner*, 28 T.C.M. (CCH) 1480 (1969), *aff'd*, 443 F.2d 170 (3d Cir. 1971).

⁴³ See, e.g., *Winters Coal Co. v. Commissioner*, 496 F.2d 995 (5th Cir. 1974); *Swank v. United States*, 602 F.2d 348 (Ct. Cl. 1976) (per curiam), *aff'd*, 451 U.S. 571 (1981); *Bakertown Coal Co. v. United States*, 485 F.2d 633 (Ct. Cl. 1973).

⁴⁴ 485 F.2d 633.

⁴⁵ 602 F.2d 348.

⁴⁶ 602 F.2d at 350; 485 F.2d at 640-41.

⁴⁷ 602 F.2d at 351; 485 F.2d at 642.

that the lessee had actually extracted and sold a substantial amount of minerals.⁴⁸

II. THE *Swank* Decision

In *United States v. Swank*⁴⁹ the Supreme Court affirmed the decision of the Court of Claims and thus rejected the position of the Commissioner.⁵⁰ The lessees in *Swank* mined coal under leases terminable without cause on thirty days prior notice. All of the lessees operated continuously under the leases. The Court held that the thirty days prior notice termination clause, standing alone, did not void an otherwise valid economic interest.⁵¹ *Parsons v. Smith*⁵² and *Paragon Jewel Coal Co. v. Commissioner*⁵³ were distinguished as involving miners who, having neither rights to sell the coal to a third party after extraction nor any interest in the coal prior to its extraction, had no rights to share in the value of the mineral deposit.⁵⁴ The lessees in *Swank*, however, had a legal interest in the mineral both before and after it was extracted and were free to sell the coal at the market price. The Court concluded that the lessee's interest was not a mere economic advantage.⁵⁵

The Court also rejected the government's argument that, as a matter of practical economics, only the lessor held an economic interest. Although several rationales were stated, including the Court's conclusion that "practical economics" did not dictate that the lessor would terminate the lease to seek a higher royalty anytime the price of coal increased, the heart of the Court's decision lay in policy analysis.⁵⁶ The Court recognized that the percentage depletion deduction is not a cost

⁴⁸ See 485 F.2d at 642.

⁴⁹ 451 U.S. 571 (1981).

⁵⁰ *Id.* at 585.

⁵¹ *Id.*

⁵² 359 U.S. 215 (1959).

⁵³ 380 U.S. 624 (1965).

⁵⁴ 451 U.S. at 583. The Court noted: "[I]t seems clear that the contract miners' interest in the Parsons and Paragon Jewel cases would have been insufficient even if their agreements had been for a fixed term." *Id.*

⁵⁵ *Id.*

⁵⁶ See *id.* at 584.

recovery provision, but rather a special incentive to encourage the extraction of natural resources.⁵⁷ Accordingly, the Court found no logical policy reason for entitlement to the depletion allowance to turn on "whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers operating for successive shorter periods."⁵⁸ Furthermore, the Court noted that the policy behind the percentage depletion deduction would be frustrated by a decision denying the depletion deduction to the lessee, because then no one would be entitled to depletion on the gross income from the sale of the coal extracted by the taxpayer.⁵⁹ In this respect the Court again distinguished *Swank* from *Parsons* and *Paragon Jewel Coal Co.*⁶⁰

It was not immediately clear whether the *Swank* decision merely established a safe harbor, where a lessee would have an economic interest under a lease terminable without cause on not less than thirty days notice, provided the lease was not terminated, or whether *Swank* completely eliminated terminability as a factor in determining whether a taxpayer had an economic interest. Although the Court did not expressly state that the latter was the rule, the Court's language certainly indicated that terminability was simply not to be considered at all:

If the authorization of a special tax benefit for mining a seam of coal to exhaustion is sound policy, that policy would seem equally sound whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers operating for successive shorter periods. The Government has suggested no reason why the efficient removal of a great quantity of coal in *less than 30 days* should have different tax consequences than the slower removal of the same quantity over a prolonged period.⁶¹

⁵⁷ *Id.* at 576. See also *Commissioner v. Engle*, ____ U.S. ____, 104 S. Ct. 597, 605 (1984) (The purpose of I.R.C. § 613A (1984) is to "subsidize the combined efforts of small producers and royalty owners in the exploration and production of the nation's oil and gas resources.").

⁵⁸ 451 U.S. at 585.

⁵⁹ *Id.* at 578-79.

⁶⁰ *Id.* at 580-83.

⁶¹ *Id.* at 585 (emphasis added).

In a footnote to this passage, the Court further stated:

As we have indicated, the depletion deduction is geared to the depletion of the mineral in place, and not to the taxpayer's capital investment. Therefore, we can perceive no reason to impose duration requirements on the availability of the deduction for taxpayers who admittedly otherwise have an "economic interest" in the coal, are dependent on the market to recover their costs, and are actually depleting the mineral in place.⁶²

Despite the dissent's assertion in *Swank* that even after *Swank* a lease for only one day would clearly not confer an economic interest on the lessee,⁶³ that conclusion is not clear in light of the above quoted passages. The language in the footnote indicates the total abandonment of any durational requirement.

Nevertheless, after *Swank* it was possible to argue that a lessee under a lease terminable at will still could not have an economic interest. A lessee under a lease terminable on thirty days notice could be found to have an interest in minerals in the ground since, even following notice of termination, the lessee would have the right to continue extracting minerals for thirty days.⁶⁴ A lessee under a lease terminable at will, however, could be said to have no interest in the minerals in the ground since, following notice, he would have no right to continue extraction for any period of time. This being so, it could be said that his interest in the minerals, in substance, would arise only at the moment of extraction.⁶⁵

⁶² *Id.* at 585 n.25.

⁶³ *Id.* at 594 (White, J., dissenting).

⁶⁴ *Cf. Weaver v. Commissioner*, 72 T.C. 594 (1979) (economic interest present if notice period sufficient to allow extraction of significant amount of minerals in place after notice).

⁶⁵ *Cf. Holbrook v. Commissioner*, 65 T.C. 415 (1975) (a licensee has no interest in the mineral until he extracts it); *Caledonian Coal Co. v. Rocky Cliff Coal Mining Co.*, 120 P. 715 (N.M. 1911). Under property law, however, one of the legal characteristics of a lease is that it is a possessory interest. Thus, if the conveyance is in the form of a lease, from a property law viewpoint the lessee has a present possessory interest in the mineral in the ground, subject to the possibility of termination. *See* 3 *ROCKY MOUNTAIN MINERAL LAW FOUNDATION, AMERICAN LAW OF MINING* 269-70 (1982) [hereinafter cited as *AMERICAN LAW OF MINING*]. Nevertheless, even property law recognizes the doctrine of substance over form on occasion, and a document in the form of

III. DEVELOPMENTS AFTER *Swank*

There have been no judicial decisions applying the principles of the *Swank* decision to significantly further expand the definition of economic interest.⁶⁶ *O'Connor v. Commissioner*,⁶⁷ decided by the Tax Court in 1982, was the first decision involving the determination of an economic interest that cited *Swank*. Although the court in *O'Connor* noted the *Swank* Court's acknowledgment that the percentage depletion deduction "implements the congressional intent to encourage the business of exploring, extracting, and producing natural resources,"⁶⁸ this was not crucial to the decision in *O'Connor*. Despite the court's conclusion that an analysis of the cases involving economic interest revealed that an entrepreneurial type risk was a key element in determining whether a taxpayer had an economic interest,⁶⁹ the court's decision that the lessor of a clay deposit had leased, not sold, the clay in the ground and that the lessee had obtained an economic interest could have easily been reached through more traditional analysis.⁷⁰ The lease in this case ran for a term of seven years,⁷¹ so there was no terminability issue raised and no need to apply *Swank*, let alone build upon it using a policy analysis.

a lease may be recharacterized as a mere license. See *Kelly v. Rainelle Coal Co.*, 64 S.E.2d 606 (W. Va. 1951).

⁶⁶ In *L.W. Hardy Co. v. United States*, 1 Cl. Ct. 465 (1982), the Commissioner asserted that a taxpayer mining turquoise under a license did not have an economic interest in the mineral. The court cited *Swank* with reference to the government's argument, apparently for the proposition that without an economic interest a depletion deduction is not allowed. See *id.* at 465. The court never reached this issue because it determined the taxpayer's books and records were inadequate to allow the computation of any depletion deduction. *Id.* at 465-66.

Swank was cited tangentially in *Ridder v. Commissioner*, 76 T.C. 867 (1981), for the proposition that terminability is only a factor in determining the substance of a lessee's interest. *Id.* at 874. *Ridder* did not involve an economic interest in minerals, but rather a claim by a noncorporate lessor that he was not denied the investment tax credit by I.R.C. § 46(3)(3)(B). *Id.* at 875. See also *Xerox Corp. v. United States*, 656 F.2d 659, 667 n.16 (Ct. Cl. 1981) (similar to *Ridder*).

⁶⁷ 78 T.C. 1 (1982).

⁶⁸ *Id.* at 7 (citing *United States v. Swank*, 451 U.S. 571 (1981)).

⁶⁹ See *id.*

⁷⁰ See *id.* at 10-11 (lessee's obligation was conditioned on (1) lessor's clay meeting specifications; (2) feasibility of mining the clay; and (3) the requirements of lessee's plants).

⁷¹ *Id.* at 4.

The Internal Revenue Service initially took a cautious approach to applying *Swank*. In a 1982 private letter ruling, the Service took the position that *Swank* was based significantly on the premise that the lessee had a legal interest in the coal prior to extraction.⁷² The unexercised termination clause did not vitiate the interest itself. Since the taxpayer involved in the ruling did have an interest in the minerals in place prior to extraction under the terms of his lease, which was merely subject to termination on short notice,⁷³ it was not actually necessary for the Service to confront this issue to determine whether an economic interest was present.

In Revenue Ruling 83-160,⁷⁴ however, the IRS appears to have abandoned the position that, even after *Swank*, a taxpayer has an economic interest only if he has, as a practical matter, an enforceable legal interest in the minerals in the ground prior to extraction. Revenue Ruling 83-160 modified two prior rulings and revoked four other rulings, holding that "terminability of a mining lease at will or upon short or nominal notice is not an essential criterion that, by itself, will preclude a taxpayer from acquiring an economic interest."⁷⁵ In so holding, however, Revenue Ruling 83-160 did not change the result in either of the modified rulings, Revenue Ruling 72-477⁷⁶ and Revenue Ruling 73-32.⁷⁷ Both earlier rulings had held that a lessee under a long term lease, terminable during the stated term only for cause, had an economic interest.⁷⁸ Nevertheless, the Service found it necessary to modify those rulings after *Swank*, because both rulings relied on an analysis of *Parsons*⁷⁹ and *Paragon Jewel Coal Co.*⁸⁰ criteria for determining whether the taxpayer had an economic interest, in-

⁷² See IRS Private Letter Ruling 8216007.

⁷³ *Id.*

⁷⁴ 1983-2 C.B. 99.

⁷⁵ *Id.* Rev. Rul. 72-477, 1972-2 C.B. 310 and Rev. Rul. 73-32, 1973-1 C.B. 301 were modified, while Rev. Rul. 74-506, 1974-2 C.B. 178; Rev. Rul. 74-507, 1974-2 C.B. 179; Rev. Rul. 77-341, 1977-2 C.B. 204 and Rev. Rul. 77-481, 1977-2 C.B. 205 were revoked. See *id.* at 100.

⁷⁶ 1972-2 C.B. 310.

⁷⁷ 1973-1 C.B. 301.

⁷⁸ See *id.*; Rev. Rul. 72-477, 1972-2 C.B. 310.

⁷⁹ 359 U.S. 215 (1959).

⁸⁰ 380 U.S. 624 (1965).

cluding the criterion that the interest must not be terminable at will or upon short or nominal notice.⁸¹ Accordingly, Revenue Ruling 83-160 modifies the two earlier rulings to indicate that short notice terminability was not a factor that, standing alone, would preclude a taxpayer from having an economic interest.⁸²

To comport with the letter of *Swank*, however, Revenue Ruling 83-160 need not have gone as far as it did. The Service could have merely modified Revenue Ruling 72-477 and Revenue Ruling 73-32 to indicate that since the leases were not terminable without cause on *less than thirty days prior notice*, the leases were sufficient to confer an economic interest on the lessees. However, the Service broadly ruled that terminability of a lease *at will* is not a criterion that will vitiate an economic interest.⁸³ Applying this rule directly, the Service revoked Revenue Ruling 77-481. That ruling had held that a taxpayer acquired no economic interest in minerals in place under a lease that was coterminous with a separate contract to supply the extracted material to a third party, where the third party had the right to terminate the purchase contract at any time.⁸⁴

By ruling that terminability of a lease at will does not vitiate the economic interest otherwise conferred under the lease, the IRS correctly interpreted *Swank*. In analyzing the impact of the incentive policy underlying the percentage depletion deduction on the determination of an economic interest, the Court had stated: "The Government has suggested no reason why the efficient removal of a great quantity of coal *in less than 30 days* should have different tax consequences than the slower removal of the same quantity over the prolonged period."⁸⁵ In many instances, issues other than depletion turn on whether the taxpayer has an economic interest in the minerals, and these issues may arise for years in which there has been no extraction, or even for years before extraction com-

⁸¹ See Rev. Rul. 73-32, 1973-1 C.B. 301; Rev. Rul. 72-477, 1972-2 C.B. 310.

⁸² See Rev. Rul. 83-160, 1983-2 C.B. 99.

⁸³ *Id.*

⁸⁴ See Rev. Rul. 77-481, 1977-2 C.B. 205.

⁸⁵ 451 U.S. at 585 (emphasis added).

mences.⁸⁶ Therefore, although the Court refers to removal of "great quantities" of the mineral, the amount of mineral actually extracted should not have any bearing on whether the taxpayer has an economic interest. Nor should the legal right to extract a "great quantity" of mineral be determinative. The position of the IRS that the taxpayer's interest must be of some minimum duration was a surrogate measure for a right to extract a significant quantity of mineral. That position, however, was rejected by the Court in *Swank*. Therefore, the impact of the statement of the Court quoted above⁸⁷ is that the taxpayer's interest need not have as much as thirty days' certainty of duration in order to qualify as an economic interest. To attempt to draw a line somewhere between a lease terminable on thirty days notice and one terminable at will would be splitting hairs with an axe. Such a differentiation would make significant results turn on trivial facts and would exalt the legal form of the taxpayer's rights over the economic substance of his rights in the mineral deposit. The well known doctrine of substance over form has long been applied in the determination of whether a taxpayer has an economic interest.⁸⁸

Revenue Ruling 83-160 appears to acknowledge that the existence of an economic interest does not turn on the amount of mineral that can be extracted. Another of the revoked rulings, Revenue Ruling 74-506, had held that an economic interest was conferred under a six month lease when the term of lease was sufficient to enable the lessee to extract the entire remaining deposit.⁸⁹ The rationale behind that ruling was not that the taxpayer could totally exhaust the deposit, but that the interest was of sufficient duration to enable him to remove a "substantial" amount of the mineral available. Although

⁸⁶ For example, only the holder of a working interest, which is necessarily an economic interest, may deduct solid mineral mine development expenses under I.R.C. § 616. See IRS Private Letter Ruling 8338008 (although not specifically stated in I.R.C. § 616, this is implied by Treas. Reg. 1.616-1(b)(4), (c) (1984)) or intangible drilling and development expenses for oil and gas wells under I.R.C. § 263(c). See Treas. Reg. § 1.612-4(a) (1965).

⁸⁷ See text accompanying notes 61-62 *supra*.

⁸⁸ See, e.g., *Palmer v. Bender*, 287 U.S. 551, 557-58 (1933).

⁸⁹ See Rev. Rul. 74-506, 1974-2 C.B. 178.

Revenue Ruling 83-160 does not indicate the rationale behind the revocation of Revenue Ruling 74-506, the logical conclusion is that, after *Swank*, a legal right to extract any quantifiable amount of the mineral, however small, is not a prerequisite to finding an economic interest in the lessee.

In addition, the IRS revoked Revenue Ruling 74-507, which had held that a lessee had an economic interest under a lease that was automatically renewed for successive one year terms each January 1, unless terminated without cause by notice given ten days prior to November 1 preceding the renewal day.⁹⁰ This ruling had essentially established a one year lease term as a safe harbor minimum term to have an economic interest in the minerals in place. Since Revenue Ruling 83-160 held that an economic interest exists even if a lease is terminable at will, it would be logically inconsistent to impose any minimum term requirement on leases.

The absence of any minimum term requirement is also reflected in the revocation of Revenue Ruling 77-341.⁹¹ Superficially, it might appear that Revenue Ruling 77-341 was revoked on the same logic supporting the revocation of Revenue Ruling 77-481, but a closer examination reveals that the revocation of Revenue Ruling 77-341 may be a harbinger of further changes in the concept of economic interest. Revenue Ruling 77-341 had held that a lessee under an oral mineral lease which was unenforceable under the local statute of frauds did not have an economic interest. When viewed as a matter of substance, for purposes of determining if a lessee holds an economic interest, a lease terminable at will and a lease that is unenforceable under state law are not significantly different. Whatever the subtle distinctions of property law that may describe the two lessees' interest in the minerals prior to extraction,⁹² in both cases, as against the lessor, the

⁹⁰ See Rev. Rul. 74-507, 1974-2 C.B. 179.

⁹¹ 1977-2 C.B. 204.

⁹² A mineral lease that is unenforceable under the statute of frauds is treated as a license. When the mineral is severed, title passes to the licensee, but until that time, the license is revocable. 3 AMERICAN LAW OF MINING, *supra* note 65, at 270. A lessee under a tenancy at will, although holding a present possessory interest in the mineral in place, may have his rights terminated instantly by the lessor, absent a statutorily required notice period. 3 G. THOMPSON, REAL PROPERTY § 1022 at 48-50 (1983).

lessee has no enforceable rights in the mineral prior to extraction and acquires a vested right to the mineral only upon extraction.⁹³ Under the logic of *Swank*, lessees in both situations should have an economic interest because they "are dependent on the market to recover their costs, and are actually depleting the mineral in place."⁹⁴

In contrast to the broad reading of *Swank* that apparently underlies Revenue Ruling 83-160 when analyzing the rights of lessees, the IRS appears to be taking the view that the principles of *Swank* are strictly confined to cases involving leases, to the exclusion of other interests that might be tested against the definition of an economic interest. This may be based on the language in *Swank* that distinguished *Parsons v. Smith* and *Paragon Jewel Coal Co.* on the basis that the lessees had a legal interest, however tenuous, in the coal prior to extraction, where the contract miners had none.⁹⁵ In Revenue Ruling 84-160,⁹⁶ the IRS reaffirmed the principle that a contract miner that is entitled to a percentage of sales, rather than a fixed fee, as compensation for extracting the deposit may have an economic interest. In one sense, Revenue Ruling 84-160 has a liberalizing impact. Under the facts in the ruling, the contract miner was entitled to seventy percent of net sales of all coal that he extracted, but was guaranteed a *minimum fee* on the first 1,000 tons of coal extracted and sold. This *minimum fee* would be the lesser of \$22x or the net sales proceeds. In the event the contract miner received payments under the guarantee, the excess over seventy percent of the net sales proceeds could be recouped by the owner of the deposit, who retained the right to process and sell all of the coal.

Although one would think that the critical question would be whether the guarantee vitiated the possibility that the contract miner could have an economic interest,⁹⁷ the IRS

⁹³ For cases discussing the significance of the time at which the taxpayer's rights in the mineral arise, see, e.g., *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, 30 (1946); *Palmer v. Bender*, 287 U.S. at 557; *Burnet v. Harmel*, 287 U.S. 103, 111 (1932); *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925).

⁹⁴ *United States v. Swank*, 451 U.S. at 585 n.25.

⁹⁵ *Id.* at 583.

⁹⁶ 1984-25 I.R.B. 13.

⁹⁷ The expected issue would be whether the minimum payment guarantee would

did not focus on this issue at all. Because Revenue Ruling 84-88 is terse, it is difficult to ascertain the relative significance of the various facts, but one clearly emphasized fact was that the contract miner had obtained an exclusive contractual right to mine the coal deposit to exhaustion. In light of the seeming total elimination of durational requirements for leases in Revenue Ruling 83-160, this emphasis is surprising, particularly because the distinction between leases and percentage of sales contract mining agreements with respect to term is neither noted nor explained in Revenue Ruling 84-88. Yet the message seems clear. As far as contract mining agreements are concerned, the Service continues to emphasize that duration of the interest is significant in determining whether it is an economic interest.⁹⁸

run afoul of the sixth and seventh factors cited in *Parsons v. Smith*, 359 U.S. 215, 225 (1959), for denying an economic interest to contract miners, or the doctrine of *Anderson v. Helvering*, 310 U.S. 404 (1940). In *Parsons*, among the reasons enumerated by the Court for denying the contract miners involved in that case an economic interest were

(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. The agreement of the landowners to pay a fixed sum per ton for mining and delivering the coal "was a personal covenant and did not purport to grant [petitioners] an interest in the [coal in place]."

359 U.S. at 225 (quoting *Helvering v. O'Donnell*, 303 U.S. 370, 372 (1937)). The negation of an economic interest by the possibility of receiving payment pursuant to a "personal covenant" rather than as a result of an interest in the deposit can be traced back to *Anderson v. Helvering*, 310 U.S. at 404. In that case, the Supreme Court held that a taxpayer who was entitled to an oil payment, payable out of either production or the sale of the fee to the land, did not have an economic interest because payment was "not dependent entirely upon the production of oil for the deferred payments." 310 U.S. at 412. Upon examination, the method of compensation in Rev. Rul. 84-88 violates neither of these rules. The contract miner was merely entitled to a variable amount of the proceeds of production. Although his compensation could vary, it could never exceed production. While the contract by which the payment varies might technically be a personal covenant as opposed to a property interest, the very purpose of the economic interest concept is to avoid reliance on principles of property law. Therefore, the *result* in Rev. Rul. 84-88 is clearly correct.

⁹⁸ Not only is the emphasis on a durational requirement for contract miners to have an economic interest, when lessees apparently are subject to no such requirement, puzzling, but the emphasis on the right to mine to exhaustion is even more

Similarly, it appears that the Internal Revenue Service has not critically analyzed the application of the theory of *Swank* and Revenue Ruling 83-160 to licensees. If a lessee under an unenforceable lease is to be treated in the same manner as a lessee under a lease terminable at will, because in substance, if not in form, they both have the same rights to extract the mineral, it would seem to follow that a licensee extracting minerals under a revocable license should be eligible to have an economic interest since his right to extract the mineral is, in substance, if not in form, the same as the right of a lessee under an unenforceable oral lease.⁹⁹ In fact, the substantive rights of a lessee under an unenforceable oral lease are more akin to the rights of a licensee than they are to the rights of a lessee under a valid lease terminable at will. The IRS, however, has long argued that a licensee does not have an economic interest.¹⁰⁰ This position does not seem to have been altered by *Swank*. In *L.W. Hardy Co. v. United States*, decided in 1982,¹⁰¹ the government argued that a licensee mining turquoise was not entitled to claim the percentage depletion allowance deduction. However, the court disposed of the taxpayer's claim on other grounds and never reached this issue.

Even after issuing Revenue Ruling 83-160, the IRS has continued to assert that licensees lack an economic interest in the deposit they are extracting. In its 1984 decision, *Missouri Pacific Corp. v. United States*,¹⁰² the Claims Court gave

puzzling. Prior to *Parsons*, the I.R.S. had ruled in 1950 that a fixed fee contract miner did have a contract that was not terminable by the owner of the deposit upon prior notice of less than one year. G.C.M. 26290, 1950-1 C.B. 42, declared obsolete by Rev. Rul. 70-277, 1970-1 C.B. 280. As a result of the multiplicity of factors cited in *Parsons* for denying the contract miners in that case an economic interest including the fixed fee method of computation, as well as short notice terminability, this rule became obsolete.

⁹⁹ As a proposition of property law, an attempted lease of a mineral deposit, which is unenforceable under the Statute of Frauds because it is oral, should be held to create a revocable license in the purported lessee. See 3 AMERICAN LAW OF MINING, *supra* note 65, at 270. In many instances the license may be subsequently rendered irrevocable if the lessee (licensee) has made improvements, such as development of a mine.

¹⁰⁰ See, e.g., *Holbrook v. Commissioner*, 65 T.C. 415 (1975).

¹⁰¹ 1 Cl. Ct. 465.

¹⁰² 54 A.F.T.R.2d (P-H) 84-5157 (Cl. Ct. 1984).

Swank a narrow interpretation in denying an economic interest to a license. The taxpayer in that case dredged sand and gravel from the Missouri River.¹⁰³ Under state law no specific express grant from the state was necessary to dredge sand and gravel from the river. Anybody was free to extract sand and gravel without regard to riparian land ownership, and without the payment of any royalties to the state. The taxpayer leased a parcel of land having a small amount of river frontage and conducted dredging operations in a several mile stretch of river near the facility it erected on the leased land. Although several other companies had obtained Corps of Engineers permits to dredge sand and gravel in the area in which the taxpayer conducted its operations, none of the other companies actually conducted operations during the years in question.

In analyzing the issue of whether the taxpayer was entitled to the depletion allowance, the court went back to the beginning, citing and discussing the early cases that consistently described the purpose of the depletion as an allowance for the recovery of capital.¹⁰⁴ Although the court recognized that despite the language of the early decisions, no capital investment, in the sense of an actual money expenditure to obtain rights, was necessary, the court misperceived the broad implications of *Commissioner v. Southwest Exploration Co.*¹⁰⁵ and *Swank*—both of which reduced the relationship of a capital investment and an economic interest to a tautology by making the former a prerequisite for the latter and deeming

¹⁰³ The taxpayer was required, however, to obtain a permit from the Army Corps of Engineers under the Rivers and Harbors Act of 1899 § 10, 33 U.S.C. § 403 (1982) and the Federal Water Pollution Control Act of 1972 § 404, 33 U.S.C. 1251 (1982). These permits conferred no rights in the sand and gravel deposit upon the taxpayer, but merely permitted the performance of work in navigable waters and the discharge of fill material into navigable waters.

¹⁰⁴ 54 A.F.T.R.2d at 84-5158 to -5160. Those classic cases include *United States v. Ludey*, 274 U.S. 295 (1927); *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938); *Anderson v. Helvering*, 310 U.S. 404 (1940); and *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946). For a discussion of the contribution of the failure of the Supreme Court in these cases to recognize the changing rationale for the depletion deduction through successive statutory amendments see McMahon, *supra* note 4, at 30-44.

¹⁰⁵ 350 U.S. 308 (1956). See note 28 *supra* for a brief synopsis of *Southwest Exploration Co.*

the former to have been made if the latter were found to exist.¹⁰⁶ Based on the fact that the *Swank* opinion quoted the classic formulation of an economic interest from *Palmer v. Bender*, the Claims Court concluded that "even in *Swank* the Court did not treat the percentage depletion as a rootless and arbitrary allowance or subsidy to mineral producers, unrelated to the original purpose of the depletion allowance."¹⁰⁷

Whether or not this correctly describes *Swank* depends on whether one listens to what *Swank* said or examines what it did. If one examines the *facts* of *Swank* against its holding when simply expressed—that the taxpayer held an economic interest—the argument that *Swank* effectively rewrote the *Palmer v. Bender* test for an economic interest is compelling. *Palmer v. Bender* was cited but subsequently ignored in reaching the holding in *Swank*. Under the new test, emphasis is on whether the taxpayer is relying on the extraction and sale of a mineral for a profit. If he is doing so in an entrepreneurial capacity, however tenuous his legal relationship to the deposit, he has met the test of an economic interest.¹⁰⁸ To require anything more is to ignore what *Swank* did, because the result in that case cannot otherwise be reconciled with the rationale of prior cases. That *Swank*, from the property interest perspective, in fact has rendered percentage depletion a rootless subsidy for the extraction of minerals eligible for percentage depletion is illustrated by Revenue Ruling 83-160, which correctly interprets *Swank*, as applied to leases. However, as has been discussed, to treat an unenforceable oral lease differently from a license is to elevate words over economic effect.¹⁰⁹ To do so defeats the very purpose of using an economic interest test, as opposed to a legal interest test, to determine eligibility for the depletion allowance.

Under the case law as it developed prior to *Swank*, some licensees were held to have obtained an economic interest in the mineral deposit, and others were held not to have ac-

¹⁰⁶ See McMahon, *supra* note 4, at 29-30, 68.

¹⁰⁷ 54 A.F.T.R.2d at 84-5160.

¹⁰⁸ See McMahon, *supra* note 4, at 70-71.

¹⁰⁹ See note 99 *supra*.

quired an economic interest.¹¹⁰ The cases cannot be entirely reconciled. In an early Board of Tax Appeals case, *Lewis E. Smoot v. Commissioner*,¹¹¹ a riparian land owner had granted the taxpayer a nine year exclusive right to dredge sand and gravel from a river bed. Under the controlling state law, however, the riparian land owner had merely a revocable license granted by the state, not a title in the sand and gravel.¹¹² Thus, the taxpayer, whose rights could be no greater than the riparian land owner's, in substance, held the rights of a licensee under a revocable license. Making a careful and subtle distinction, the Board held the taxpayer could not deplete the mineral deposit itself because he had no interest in it, but he could deduct an allowance for the depletion of the fair market value of his contractual right to dredge the deposit.¹¹³ The possibility that the taxpayer's rights might be terminated through a revocation of the land owner's license did not preclude the deduction, but merely affected the valuation.¹¹⁴

Two modern cases, on the other hand, have allowed licensees to claim percentage depletion with respect to gravel and sand deposits extracted by taxpayers operating under licenses. In both *Oil City Sand & Gravel Co. v. Commissioner*¹¹⁵ and *Victory Sand & Concrete, Inc. v. Commissioner*,¹¹⁶ the taxpayer dredged sand and gravel from a river bed under licenses and permits from governmental authorities. Neither taxpayer had ownership of the gravel until it was removed. Whether the taxpayer's rights in *Oil City Sand & Gravel Co.* were subject to short notice termination was ambiguous at best. Although the taxpayer was in that case not specifically granted an *exclusive* license, it owned the only riparian land from

¹¹⁰ Compare *Missouri River Sand Co. v. Commissioner*, 83 T.C. —, 1984 TAX CT. REP. (CCH) No. 41,404 at 3432 and *Holbrook v. Commissioner*, 65 T.C. 415 (1975) (no economic interest) with *Victory Sand & Concrete, Inc. v. Commissioner*, 61 T.C. 407 (1974) (economic interest found) and *Oil City Sand & Gravel Co. v. Commissioner*, 32 T.C. 31 (1959).

¹¹¹ 25 B.T.A. 1038 (1932).

¹¹² *Id.* at 1042.

¹¹³ *Id.* at 1045.

¹¹⁴ *Id.* at 1044.

¹¹⁵ 32 T.C. 31.

¹¹⁶ 61 T.C. 407.

which dredging operations could be conducted. Applying the principles of *Commissioner v. Southwest Exploration Co.*,¹¹⁷ the Tax Court found that the taxpayer had an economic interest due to its practical, physical, and economic control over the deposit.¹¹⁸

In *Victory Sand & Concrete, Inc.* the taxpayer had an even stronger case for an economic interest. Although the Tax Court found the taxpayer to have an economic interest on the basis of its similarity to *Oil City Sand & Gravel Co.*, the court also found that in *Victory Sand & Concrete, Inc.* the taxpayer's rights were *not* terminable and were *legally*, as well as physically, exclusive. The court's basis for finding that the license was not terminable is unclear. The contract between the taxpayer and the State of Kansas was entirely silent regarding termination by the State, although it was terminable at the will of the taxpayer, and the court did not look at underlying state law to determine the parties' rights regarding termination. Conversely, although the contract was silent regarding the exclusivity of the taxpayer's rights, the court found that the applicable state law conferred upon the taxpayer an exclusive right to dredge sand and gravel from the river.¹¹⁹

Both *Oil City Sand & Gravel Co.* and *Victory Sand & Concrete, Inc.*, as well as *Southwest Exploration Co.*, on which the decisions in those cases were based, were distinguished by the Claims Court in *Missouri Pacific Corp.*¹²⁰ Unlike the earlier licensees, the taxpayer in the latter case did not *own* the riparian land from which it conducted its dredging operations; it merely leased the land. Specifically noting that "there is no evidence in the record that the value of the leasehold was in excess of the amount that plaintiff agreed to pay as rent,"¹²¹ the Claims Court concluded that the deduction for rent was an adequate allowance for the taxpayer's costs.¹²² Furthermore, even if the taxpayer in *Missouri Pacific*

¹¹⁷ 350 U.S. 308. See note 28 *supra* for a discussion of this case.

¹¹⁸ 32 T.C. at 39.

¹¹⁹ 61 T.C. at 408, 416-17.

¹²⁰ 54 A.F.T.R.2d at 84-5161 to -5164.

¹²¹ *Id.* at 84-5161.

¹²² *Id.* at 84-5162, -5163.

Corp. had owned the riparian land from which it conducted its dredging operations, unlike the earlier cases, the taxpayer's *specific land was not necessary* to conduct dredging. The area of the river in which the taxpayer conducted dredging could be dredged using other riparian parcels as a base of operations. Therefore, the taxpayer made no *essential* contribution and the doctrine of *Southwest Exploration Co.* was not applicable.¹²³ Although the Court of Claims distinguished both *Oil City Sand & Gravel Co.* and *Victory Sand & Concrete, Inc.* on two bases, the taxpayer's rights to the riparian land—rental as opposed to ownership—and the nonexclusivity of control over the gravel deposits, only the latter distinction is significant. Even before the formulation of the concept of economic interest, the Supreme Court had held that a lessee of a mineral deposit was entitled to claim the depletion allowance.¹²⁴ The heart of the *Southwest Exploration Co.* doctrine is control over the extraction of the mineral deposit, and it seems unwarranted to superimpose on it a formalistic test that distinguishes leases from ownership. If a riparian lessee's relationship to the deposit seems too tenuous to support depletion, perhaps the point at which the concept of economic interest was overextended was in *Southwest Exploration Co.* itself.

Shortly after the Claims Court decision in *Missouri Pacific Corp.*, the Tax Court reached the same conclusion on similar facts in *Missouri River Sand Co. v. Commissioner*.¹²⁵ Unlike the Claims Court, the Tax Court saw no need to even mention *Swank*. Citing its earlier decision in *Holbrook v. Commissioner*,¹²⁶ denying an economic interest to the holder of a terminable nonexclusive license, the Court acknowledged that acquisition of an "economic interest does not require that any money actually be invested in the minerals in place."¹²⁷ The Court concluded that "there must exist some 'ownership'

¹²³ *Id.* The court also noted that the taxpayer's investments in improvements to land were recoverable through depreciation rather than depletion. *Id.* See Treas. Reg. § 1.612-1(b)(1)(i) (1984).

¹²⁴ *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925).

¹²⁵ 83 T.C. ____, 1984 TAX CT. REP. (CCH) No. 41,404 at 3432.

¹²⁶ 65 T.C. 415.

¹²⁷ 83 T.C. at ____, 1984 TAX CT. REP. (CCH) No. 41,404 at 3435.

on the mineral deposit 'in place' and a right to share in the income from its production."¹²⁸ In the instant case the court concluded, once again, that a nonexclusive license did not convey "any interest" in the minerals "in place," but rather transferred a "mere economic or pecuniary advantage derived from production."¹²⁹

The taxpayer, who owned riparian land from which it based its operations, argued that the doctrine of *Southwest Exploration Co.*, as applied in *Oil City Sand & Gravel Co.*, and *Victory Sand & Concrete, Inc.* should be applied to find that it had an economic interest in the sand and gravel that it extracted from the river bed. Even though it made a fact finding that the taxpayer had the only riparian sites suitable for constructing a *permanent* base from which to conduct profitable dredging operations in the segments of the river in which the taxpayer operated, the court rejected this argument. Those earlier cases were distinguished as involving instances of *total* physical and economic control of the deposit. In the instant case it was conceivable that a temporary dredging operation could be conducted by another person.¹³⁰ The court further distinguished *Victory Sand & Concrete, Inc.* on the basis of the state law that granted the taxpayer exclusive dredging rights in that case.¹³¹ Accepting the Tax Court's finding that the taxpayer in *Victory Sand & Concrete, Inc.* enjoyed an exclusive *legal* right to extract gravel from the river, it is clear that the taxpayers in both *Missouri Pacific Corp.* and *Missouri River Sand Co.* had far more tenuous rights to the gravel deposits than did *Victory Sand & Concrete, Inc.* The difference between the taxpayers' circumstances in *Oil City Sand & Gravel Co.* on the one hand, and in *Missouri Pacific Corp.* and *Missouri River Sand Co.* on the other, however, is far less significant.

When the fundamental difference between *Missouri Pacific Corp.* and *Missouri River Sand Co.*, on the one hand, and *Oil City Sand & Gravel Co.* and *Victory Sand & Concrete,*

¹²⁸ 83 T.C. ____, 1984 TAX CT. REP. (CCH) No. 41,404 at 3435.

¹²⁹ *Id.* at ____, 1984 TAX CT. REP. (CCH) No. 41,404 at 3435.

¹³⁰ *Id.* at ____, 1984 TAX CT. REP. (CCH) No. 41,404 at 3436-37.

¹³¹ *Id.* at ____, 1984 TAX CT. REP. (CCH) No. 41,404 at 3438 n.9.

Inc., on the other hand, is viewed as the presence or absence of control over the gravel deposits, the issue in those cases closely resembles that in *Holbrook v. Commissioner*,¹³² which the Tax Court did not reexamine in *Missouri River Sand Co.* although there are superficial factual differences. In *Holbrook* the Tax Court held that an economic interest was not conferred on a licensee under a nonexclusive, nontransferable license to extract coal, subject to termination on ten days prior notice.¹³³ Under the terms of the license, title to coal in the ground remained in the licensor, but the licensee acquired title to the coal upon extraction, at which time he paid a fixed royalty to the licensor.¹³⁴ Even though the licensee mined coal continuously for four years, acquired title to the coal upon extraction, and sold it on the open market, the Tax Court concluded he had not acquired an economic interest because the license was nonexclusive, nontransferable, and terminable upon short notice.¹³⁵

As is the case with *Missouri Pacific Corp.* and *Missouri River Sand Co.*, the only factor in *Holbrook* clearly different from *Oil City Sand & Gravel Co.* is the licensee's control over the gravel deposit derived from its ownership of the riparian land in the latter case. If the ownership of the riparian land was the source of its economic interest, then under the logic of *Southwest Exploration Co.* its economic interest should not have extended to all income derived from extraction of the gravel, but only to that portion equal to the royalty that the use of its riparian land could command from a third party.¹³⁶

¹³² 65 T.C. 415 (1975). See also *Rissler & McMurray Co. v. United States*, 480 F.2d 684 (10th Cir. 1973), *aff'g* 342 F. Supp. 432 (D. Wyo. 1972). In *Rissler*, the court denied an economic interest to a taxpayer who extracted sand and gravel from a city owned gravel pit primarily for use in fulfilling the terms of a contract with the city, but partially for sale to others pursuant to an oral agreement with the city. The taxpayer was found to have no interest in the deposit other than for the purposes of fulfilling the construction contract, and it was to that contract that it looked for its profit, not the extraction of gravel. *Id.* at 687-88.

¹³³ 65 T.C. at 419-20.

¹³⁴ *Id.* at 416-17.

¹³⁵ *Id.* at 419-21.

¹³⁶ Cf. *Martin v. United States*, 409 F.2d 13 (6th Cir. 1964) (per curiam) (dividing royalties received for lease of deposit and surface between that portion eligible for I.R.C. § 631(c) and the portion treated as ordinary income subject to depletion); Mc-

On the other hand, if exclusivity of right to extract the mineral is the key, the earlier gravel case is factually distinguishable from *Oil City Sand & Gravel Co.*, as well as from *Holbrook*, *Missouri River Sand Co.*, and *Missouri Pacific Corp.* *Oil City Sand & Gravel Co.* had practical, but not legal, control of the deposit; neither *Holbrook*, *Missouri River Sand Co.*, nor *Missouri Pacific Corp.* held either practical or legal control of the deposit. Before *Swank*, however, logic that examined practical rights to the deposit, absent a legal right, was inconsistent with the Tax Court's analysis in the terminable lease cases, which looked only at abstract legal rights and not at the factual circumstances surrounding the actual conduct of the extraction of the mineral.¹³⁷ After *Swank* analysis based on practical circumstances and factual conduct rather than abstract legal rights is proper. Nevertheless, a careful analysis of *Swank* reveals that such a distinction between *Holbrook*, *Missouri River Sand Co.*, and *Missouri Pacific Corp.*, on the one hand, and *Oil City Sand & Gravel Co.* and *Victory Sand & Concrete, Inc.*, on the other hand, is not tenable.

After *Swank*, and in light of Revenue Ruling 83-160, two of the three factors cited in *Holbrook* as the basis for determining that a licensee does not have an economic interest should clearly be of no relevance. Terminability, even at will, no longer precludes an economic interest.¹³⁸ Nontransferability, even when coupled with terminability, should likewise not preclude an economic interest.¹³⁹ The taxpayer with an unenforceable oral lease in Revenue Ruling 77-341 had a terminable nontransferable interest that was essentially

Mahon, *supra* note 4, at 57 (applying this analysis to *Winters Coal Co. v. Commissioner*, 496 F.2d 995 (5th Cir. 1974)). *But see* IRS Private Letter Ruling 7905006.

¹³⁷ *See, e.g.*, *Mullins v. Commissioner*, 48 T.C. 571, 582-83 (1967).

¹³⁸ *See United States v. Swank*, 451 U.S. 571 (1981); Rev. Rul. 83-160, 1983-2 C.B. 99.

¹³⁹ *But see* G.C.M. 39045, 21 Tax Notes 390 (1983) ("Based on our reading of the *Swank* decision, the terminability factor, while not . . . dispositive . . . is still relevant."); Rev. Rul. 84-88, 1984-2 I.R.B. 13 (nonterminability cited as relevant fact in finding that a percentage of sales contract miner held an economic interest in the deposit).

equivalent to a license, and no economic interest was found.¹⁴⁰ If nontransferability, when coupled with terminability, results in a denial of an economic interest, Revenue Ruling 77-341 should have been modified by Revenue Ruling 83-160 to reach the same result on different logic, not revoked.¹⁴¹ Furthermore, an enforceable written lease may by its terms be nonassignable. It would be difficult to assert, after *Swank* and Revenue Ruling 83-160, that a lessee operating under an enforceable written lease that is not assignable and is subject to termination at will does not have an economic interest merely because the lease is nontransferable.¹⁴² Such an assertion would be inconsistent with the rationale of the Supreme Court in *Swank*, that if the taxpayer extracting the mineral were denied the depletion allowance, no taxpayer would be permitted to claim a deduction for the depletion allowance. To prevent this situation, the Court believed that the taxpayer extracting the mineral should be found to have an economic interest.¹⁴³

Focusing on the concern of the Supreme Court that depletion be allowed on all of the income from extraction of minerals, it is reasonable to conclude that even adding the nonexclusivity feature of the *Holbrook* license to the termina-

¹⁴⁰ Rev. Rul. 77-341, 1977-2 C.B. 204.

¹⁴¹ According to the IRS, revocation of a revenue ruling describes a situation in which the position in the previously published revenue ruling has been determined to be erroneous and the correct position is being stated in the new ruling. See, e.g., 1984-1 I.R.B. 40. Modification of a revenue ruling indicates that the substance of a previously published revenue ruling is being changed. *Id.* Thus, generally speaking, modification is appropriate to change the rationale for reaching a particular result, and revocation is appropriate to change the result. The intent of the IRS with respect to Rev. Rul. 77-341, however, when measured against the above definitions of the effects of revocation and modification, is ambiguous. Rev. Rul. 83-160 clearly revokes Rev. Rul. 77-341, and thus indicates that it is erroneous. Nevertheless, Rev. Rul. 83-160 fails to state any position of the IRS with respect to the factual circumstances described in the earlier ruling. Thus, it appears that, technically speaking, the IRS currently expresses no position for information and guidance of taxpayers on the application of the law to the facts presented in Rev. Rul. 77-341.

¹⁴² See Rev. Rul. 70-499, 1970-2 C.B. 132, in which the IRS ruled that certain lessees, who could assign their interest only with the consent of the lessor, held an economic interest in the deposit. The nonassignability of the lease was apparently not an issue. Rev. Rul. 70-449 is discussed in greater detail in the text accompanying note 145 *infra*.

¹⁴³ See *United States v. Swank*, 451 U.S. at 583 n.21.

ble nature of a licensee's interest should not prevent such a licensee from holding an economic interest. Holbrook's licensor received merely a royalty. If the licensee is denied an economic interest, no one will be entitled to a depletion deduction with reference to the income from the sale of the mineral. The licensor will be permitted to claim depletion, or in the case of coal or iron ore to claim section 631(c) treatment,¹⁴⁴ only with reference to his royalty income. No royalties were payable in *Missouri River Sand Co.* or *Missouri Pacific Corp.* Thus no one would be entitled to any amount of depletion with respect to the sand and gravel extracted by the taxpayers in those cases. Such a result would frustrate the policy underlying the percentage depletion deduction in the same manner that denying the depletion allowance to the taxpayers in *Swank* would have frustrated that purpose. Therefore, the possible distinction between *Holbrook*, *Missouri River Sand Co.*, and *Missouri Pacific Corp.* on the one hand, and *Oil City Sand & Gravel Co.* and *Victory Sand & Concrete, Inc.*, on the other hand, based upon the exclusivity of the licensee's rights, should be irrelevant.

This is clearly so at least when the licensor of the legally nonexclusive licensee in fact grants no other licenses. It is difficult to give weight to the argument that in distinguishing *Parsons v. Smith* and *Paragon Jewel Coal Co.*, the *Swank* Court intended to inject into the test for an economic interest an element that requires *legal* rights to any amount of the mineral in the ground, as opposed to a *de facto* right to extract the mineral. After distinguishing the contract miner case from *Swank* on the basis of *legal* rights in the deposit, the Court went on to conclude in *Swank* that the course of conduct of the parties rather than abstract legal rights evidenced the relationship of the lessees to the deposit. Therefore, if such a licensee extracts minerals, acquires title to the ex-

¹⁴⁴ Under I.R.C. § 631(c), the lessee of a coal or iron ore deposit treats royalties received under the lease as amounts realized from the sale of a § 1231 asset subject to capital gains treatment if the royalties are received more than one year after the lessor acquired his interest in the deposit. The lessor's cost basis of the allocable portion of the coal to which the royalties relate will be allowed as a deduction in computing gross income, but no depletion allowance deduction is permitted. See generally Coggin, *Disposition of Coal Interests: Section 631(c)*, 29 TAX LAW. 95 (1975).

tracted mineral by virtue of extraction and the payment of a royalty, and is free to sell the mineral so produced on the open market, the licensee should have an economic interest and, accordingly, should be entitled to the depletion allowance deduction.

Even if the licensor has granted other licenses, such as was the case in *Missouri Pacific Corp.*, it does not necessarily follow that a licensee who exploits the deposit should not have an economic interest. Nonexclusivity of the taxpayer's right to exploit the deposit has not always been rigidly applied to deny a taxpayer an economic interest in a deposit that he was extracting for sale on his own behalf. In Revenue Ruling 70-499,¹⁴⁶ "several" lessees jointly and severally leased oyster deposits from a state agency. Under the lease the rights of the group of lessees were exclusive as against any other person, unless a majority of the lessees voted to allow others to dredge for oyster shells within the leased deposit; but, within the group of lessees, no lessee had any exclusive rights. The rights of all lessees were identical; each could dredge oyster shells from any portion of the leased premises; the only restriction on the location of an individual lessee's selection of a site for dredging operations was a minimum separation requirement. Title to oyster shells passed to the lessees only upon extraction.

In holding that each of the lessees held an economic interest in the oyster shell deposits, the Service described the rights of the lessees as "exclusive." Such a characterization is chimerical. Among themselves, no lessee had any right to a minimum quantity of oyster shells or to exploit a specific portion of the deposit. To preserve his rights to obtain title to any of the oyster shells, each lessee was compelled to commence operations, and operations could be temporarily suspended only at the risk of reducing the proportion of the deposit to which the particular operator could ultimately acquire title. Such rights can hardly be called exclusive as a matter of substance. At best, because a majority of the lessees could bar the granting of rights to any additional lessees, these rights

¹⁴⁶ 1970-2 C.B. 132.

might be described as limiting the lessor's ability to unilaterally dilute the interest of the group of lessees. The same cannot be as easily said with respect to licensees. Whether a licensee has an economic interest, however, should not turn on this gossamer factual distinction.

Both a licensee and any one lessee under a lease of the type described in Revenue Ruling 70-499 are unable to ascertain the number of units of mineral they have an unconditional vested right to extract. If there is any rational basis for tying the existence of an economic interest to exclusivity of rights, it is to enable the taxpayer to determine the number of units of mineral yet to be extracted, and thus form the basis for computing cost depletion.¹⁴⁶ The logic of *Swank*, however, is grounded in the allowance of percentage depletion. No such computation is necessary in order to allow percentage depletion, and therefore, the inability to compute cost depletion, because the number of units of mineral that the taxpayer may extract cannot be computed, should not preclude the taxpayer from claiming percentage depletion. Therefore, he should be found to have an economic interest. This is bootstrap logic at its finest, but then so was *Swank*.

The conclusion that licensees should have an economic interest is reinforced by comparing a licensee to a percentage of sales contract miner. In *Ruston v. Commissioner*,¹⁴⁷ the Tax Court held that a contract miner, who was to receive a specified percentage of the net profits realized by the lessee holding an operating interest, had an economic interest.¹⁴⁸ Although the contract miner in *Ruston* had the exclusive right to extract the coal and his right was not terminable on short notice, the miner never actually acquired title to any of the coal. Title both before and after extraction was lodged in the lessee with whom the miner had contracted. Nevertheless, the contract miner and the lessee were each entitled to claim per-

¹⁴⁶ Under Treas. Reg. § 1.611-2(a), cost depletion is determined by dividing the adjusted basis for the mineral property at the end of the year by the sum of the units sold during the year and the number of units remaining (including units extracted but not sold) at the end of the year, and multiplying the result by the number of units sold during the year.

¹⁴⁷ 19 T.C. 284 (1952). See also *Brown v. Commissioner*, 22 T.C. 58 (1954).

¹⁴⁸ 19 T.C. at 297.

centage depletion on their respective shares of the sales proceeds of the extracted coal. Although *Ruston* predated *Parsons v. Smith*,¹⁴⁹ as reflected by Revenue Ruling 84-88, *Ruston* is undoubtedly still good law.¹⁵⁰

If a percentage of sales contract miner who never obtains title to the mineral has an economic interest, it would be totally anomalous to hold that a licensee who extracts, obtains title to, and sells the mineral does not have an economic interest. It is untenable to distinguish the two based on exclusivity of the nature of their respective rights to extract the coal. In *Swank* the Court concluded that the depletion allowance, which hinges on an economic interest, should be available "whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers operating for successive shorter periods."¹⁵¹ If that is so, there is also little reason to make the entitlement to the deduction turn on whether the extraction is conducted by several taxpayers simultaneously or successively, as long as each taxpayer is entitled to a share of the market price of the coal that he extracts. Such is clearly the case with a licensee.

This conclusion finds further support in the entrepreneurial risk theory of entitlement to an economic interest and, accordingly, to the depletion allowance deduction, first accepted in *Douglas Coal Co. v. Commissioner*.¹⁵² That case involved a lessee who had entered into an agreement to sell all of the mine output to the lessor under a long term contract.¹⁵³ In resolving whether the taxpayer was a true lessee or a contract miner, the court examined the application of the factors considered in *Parsons v. Smith* to determine whether the taxpayer had assumed entrepreneurial risks with

¹⁴⁹ 359 U.S. at 215. See text accompanying notes 13-15 *supra* for a discussion of the *Parsons* case.

¹⁵⁰ See text accompanying notes 97-98 *supra* for a discussion of Rev. Rul. 84-88, 1984-25 I.R.B. 13. See also IRS Private Letter Ruling 8216007; McMahon, *The Coal Depletion Allowance Deduction*, 85 W. VA. L. REV. 581, 594-99 (1982). But see *Utah Alloy Ores v. Commissioner*, 33 T.C. 917 (1960).

¹⁵¹ 451 U.S. at 585.

¹⁵² 429 F. Supp. 322 (N.D. W. Va. 1977).

¹⁵³ *Id.* at 325.

respect to the coal.¹⁵⁴ Although in earlier cases involving fact patterns similar to *Douglas Coal Co.* the Tax Court had never applied an entrepreneurial risk analysis,¹⁵⁵ after *Swank* the Tax Court appears to have accepted the validity of the entrepreneurial risk theory of entitlement to an economic interest. In *O'Connor v. Commissioner*¹⁵⁶ the Tax Court applied a risk analysis to determine whether the taxpayer had retained an economic interest as a lessor, and thus had received ordinary income subject to depletion, or had sold a clay deposit in place and would thus be entitled to capital gains treatment of receipts in excess of the basis allocable to the deposit. In the course of holding the taxpayer had retained an economic interest the court stated “[e]conomic interest, percentage depletion, and risk . . . are inextricably related.”¹⁵⁷ The taxpayer was found to bear the requisite risk because the lease did not obligate the lessee to remove any certain quantity of clay. The O’Connors “continued to share in the risks of production and thus were required to look solely to production to recover their capital.”¹⁵⁸

Although the *O'Connor* opinion utilizes a risk analysis it is not clear how far the Tax Court will carry this type of analysis. Unfortunately, in *O'Connor* the Tax Court continued to cloud the resolution of the economic interest issues by referring to the need for the taxpayer to look to the extraction and sale of the mineral “to recover [the taxpayer’s] capital.”¹⁵⁹ In its statement that risk was inextricably tied to economic interest the court said: “Risk exists when one must look solely to extraction of a mineral resource in order to recover an investment. . . .”¹⁶⁰ Even though it has acknowledged in *Missouri River Sand Co.* that an actual money investment in the deposit is not a prerequisite for an economic interest, it is

¹⁵⁴ *Id.* at 334-38.

¹⁵⁵ *See, e.g.,* *Adkins v. Commissioner*, 51 T.C. 957 (1969); *Bolling v. Commissioner*, 37 T.C. 754 (1962). *See also* *Thornberry Constr. Co. v. United States*, 576 F.2d 346 (Ct. Cl. 1978).

¹⁵⁶ 78 T.C. 1 (1982).

¹⁵⁷ *Id.* at 11.

¹⁵⁸ *Id.* at 17.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 11.

doubtful that the Tax Court would readily apply an entrepreneurial risk analysis to find that a licensee has an economic interest. A licensee not only has no "investment" in the mineral in place, and thus no capital to recover, but neither does he have "ownership" or "control" which were said in *Missouri River Sand Co.* to be the basis for finding an economic interest. It appears that at least one of these three bases for claiming an economic interest is necessary in the Tax Court.

However valid these prerequisites may have been before *Swank*, they are not valid after *Swank*. As the Tax Court itself has acknowledged, continued reference to the need for an investment is clearly erroneous.¹⁶¹

Nevertheless, even if *O'Connor* is shorn of the language seemingly requiring an investment, since an investment is clearly not necessary, the Tax Court might conclude that risk analysis is, nevertheless, appropriate only where there is an actual investment, since otherwise the taxpayer has not placed anything at risk. This too would be incorrect, as is illustrated by *Douglas Coal Co.* and by *Swank*, both of which involved lessees.¹⁶² Neither case involved an actual investment by the lessee in the mineral deposit, which in the case of a lessee would be the payment of a lease bonus,¹⁶³ yet both cases ap-

¹⁶¹ *Missouri River Sand Co. v. Commissioner*, 83 T.C. —, 1984 TAX CT. REP. (CCH) No. 41,404 at 3432. See also *United States v. Swank*, 451 U.S. at 585 n.25.

¹⁶² 451 U.S. at 573; 429 F. Supp. at 324-25.

¹⁶³ A lessee must capitalize lease bonus payments rather than deduct them or exclude them from income. Treas. Reg. § 1.612-3(a)(3). See also Treas. Reg. § 1.613-2(c)(5)(ii).

Mine development expenses are currently deductible by the holder of an operating interest under I.R.C. § 616 and, therefore, the lessee has no "tax investment" in the mineral deposit, although he does have an economic investment that can be recovered only through production.

Although mine exploration expenditures are also currently deductible under I.R.C. § 617(a), due to the recapture provisions of I.R.C. § 617(b), a lessee who has incurred exploration expenditures would have a "tax investment" that may be recovered only through depletion deductions allowed with respect to extraction. It is doubtful, however, that either a lessee with rights as tenuous as a lease at will or a mere licensee would incur any significant exploration expenses. Furthermore, if a lessee or licensee were to be found not to have an economic interest, an expenditure that otherwise would be capitalized into the depletable basis of the mineral deposit under I.R.C. § 612, would probably be deductible under I.R.C. § 162. See *Bolling v. Commissioner*, 37 T.C. 754 (1962) (cost of acquisition of surface rights by contract

plied a risk analysis.¹⁶⁴ While *Douglas Coal Co.* might be distinguished on the grounds that the lease was not terminable on short notice,¹⁶⁵ *Swank* cannot be so distinguished. The risk to taxpayers in *Swank* was not incurred with respect to the mineral in place, but with respect to recovering the costs of extracting the mineral.¹⁶⁶ Nevertheless, the Supreme Court still concluded that the activity in which the taxpayers in *Swank* were engaged was the type of activity for which Congress intended the depletion allowance to provide an incentive, since the taxpayers were actually depleting the mineral in the ground.¹⁶⁷ In this light, the lessees in *Swank* are no different than many licensees. Therefore, the requirement of an actual investment to show risk, which might be used to limit the extension of the entrepreneurial risk analysis, should not be imposed. Similarly, the *Swank* decision on its face obviates the necessity of "ownership" as a prerequisite for an economic interest, leaving only "control" of the three bases that the Tax Court has required. As has already been discussed, a careful

miner was deductible under I.R.C. § 162; court declined to apply *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956) (discussed in note 28 *supra*) to find an economic interest). *Accord Winters Coal Co. v. Commissioner*, 57 T.C. 249 (1971), *rev'd*, 496 F.2d 995 (5th Cir. 1974) (*Southwest Exploration Co.* applied to facts similar to *Bolling*).

¹⁶⁴See 451 U.S. at 585; 429 F. Supp. at 335-38.

¹⁶⁵See 429 F. Supp. at 337.

¹⁶⁶451 U.S. at 585 n.25. In contract miner cases and pre-*Swank* lessee cases involving leases subject to termination on short notice, courts consistently rejected any notion that the payment of development expenses or expenditures for depreciable plant and equipment to be used in the extraction process was an investment in the mineral deposit itself. See, e.g., *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 628 (contract drift miners bore expenses of constructing tipples, power line, railroad siding and spurs, and road, as well as purchases of processing equipment); *Elm Dev. Co. v. Commissioner*, 315 F.2d 488 (4th Cir. 1963) (contract drift miner constructed roads and benches, the costs of which were currently deductible); *United States v. Stallard*, 273 F.2d 847 (4th Cir. 1959) (contract strip miner expended between \$20,000 and \$25,000 to construct roads); *Denise Coal Co. v. Commissioner*, 271 F.2d 930, 939 (3d Cir. 1959) (contract miner agreed to construct all roads and buildings necessary for the mining, removal and transportation of the coal to railroad cars); *Commissioner v. Hamill Coal Corp.*, 239 F.2d 347 (4th Cir. 1956) (contract strip miner constructed tipples and roads); *Adkins v. Commissioner*, 51 T.C. 957, 962 (1969) (drift miner bore all development and mining costs including opening the mines, building supporting structures, such as fan houses, powder houses, transformers, coal tipples, shoring and roads).

¹⁶⁷*Id.* at 576, 584-85.

reading of *Swank* reveals that the decision cannot be reconciled with a "control" theory of entitlement to an economic interest, but only with an entrepreneurial risk theory.¹⁶⁸

There is a final aspect of terminable leases and operating rights, such as licenses, to which neither *Swank* nor Revenue Ruling 83-160 directly speaks, but which is noted in G.C.M. 30945.¹⁶⁹ *Swank* dealt with *unexercised* rights to terminate a lease.¹⁷⁰ Revenue Ruling 83-160 states that "terminability . . . is not an essential criterion that, by itself, will preclude a taxpayer from acquiring an economic interest."¹⁷¹ G.C.M. 39045 states that it is not clear from *Swank* whether terminability has been removed entirely as a factor, concludes that terminability, while not controlling, is still a factor, and declares that Revenue Ruling 83-160 "may go one step too far in its conclusion."¹⁷² This suggests that Revenue Ruling 83-160 has removed terminability entirely as a factor. The question will eventually arise as to whether terminability will nullify an otherwise valid economic interest if the lease or license is in fact terminated. Once again, the policy underpinnings of *Swank* dictate that the lessee or licensee under a terminated lease or license should, nevertheless, be considered to have held an economic interest for the period prior to the termination. Although it is true that among the reasons for the Court's rejection of the Government's argument in *Swank* was that it would be unfair to deny the depletion deduction to a taxpayer "who did in fact conduct a prolonged and continuous operation," simply because there was a risk of termination,¹⁷³ the Court also grounded its conclusion on the absence of any rational basis for linking the right to a depletion deduction to the period of time that the taxpayer *operated* a mine.¹⁷⁴ A thoughtful reading of *Swank* reveals that the implementation of the policy that the Supreme Court believes lies behind the percentage depletion allowance requires that a taxpayer be al-

¹⁶⁸ See text accompanying notes 92-94, 108-109 *supra*.

¹⁶⁹ 21 Tax Notes at 390.

¹⁷⁰ 451 U.S. at 573.

¹⁷¹ Rev. Rul. 83-160, 1983-43 I.R.B. 6.

¹⁷² 21 Tax Notes at 391.

¹⁷³ 451 U.S. at 584.

¹⁷⁴ *Id.* at 585.

lowed depletion whenever he has extracted the mineral and shared in the sales proceeds. To take into account the fact that the lease or license was terminated would improperly return to the concept rejected in *Swank* that the taxpayer must have some continuing future interest in the minerals while they are in the ground and not merely the right to extract them. Therefore, when the issue arises, the IRS and the courts should acknowledge that actual termination of the lease, as well as the possibility of termination, does not preclude an economic interest in the lessee for the period of time that he exercised rights under the lease. Similar treatment should be accorded to licensees.

CONCLUSION

The concept of economic interest has developed slowly. The *Swank* decision arose from an issue that was fueled by the decision in *Parsons v. Smith* over twenty years earlier. During the intervening period, there was great debate regarding whether short notice terminability automatically precluded an economic interest. Conservative conventional wisdom taught that short notice terminability was a fatal flaw. After many years *Swank* told us that this was not so. As is always true of significant pronouncements by the Supreme Court, the *Swank* decision will have its fallout. Revenue Ruling 83-160 is merely the beginning.

The next logical step is the acknowledgement that licensees generally should be treated the same as lessees. The refusal of the Claims Court in *Missouri Pacific Corp.* and the Tax Court in *Missouri River Sand Co.* to do so is inconsistent with the logic of the decision in *Swank*. It is true that both of those cases presented a fact pattern in which, before *Swank*, it would have been inconceivable to allow the taxpayer the depletion allowance. *Swank*, however, must be viewed either as reshaping the theory on which the concept of economic interest turns or as an erroneous decision that overextended the concept of economic interest. Before *Swank*, there was a clear test. Myriad legal interests in a mineral deposit could be denied an economic interest due to the absence of economic control over the exploitation of a significant quantity of the de-

posit. After *Swank* it is difficult logically to distinguish those interests from the lessees in *Swank*, who in fact held no economic control over the deposit.

Unless the result in *Swank* is to be reversed, the logic of the policy orientation of *Swank* dictates that other reconsiderations of the scope of the concept of economic interest are appropriate. First, the suggestion of Revenue Ruling 84-88—that for a percentage of sales contract miner to have an economic interest he must have an exclusive right to extract the deposit for a substantial length of time—should be reconsidered. It is difficult to distinguish a percentage sales contract miner, particularly if he has exclusive operating rights, from a lessee under a terminable lease. If the lessee processes the mineral himself, his gross income from mining may be greater than that of the percentage of sales contract miner. But if the lessee sells raw mineral, aside from the influence of the tax system, the respective gross incomes of the lessees and percentage of sales contract miner should be approximately the same. For the reasons previously discussed in the context of licensees, it should also make no difference whether a percentage of sales contract miner has exclusive or nonexclusive rights. If his income is dependent upon extraction and sale of the mineral, if he has incurred entrepreneurial risks with respect to the extraction of the deposit, and if he has a legal right to extract minerals, he should have an economic interest.

I have suggested previously that the logic of *Swank* may also justify a reversal of the rule of *Parsons* and *Paragon Jewel Coal Co.*¹⁷⁵ Perhaps that will some day come to pass, but there is yet no sign of it. Neither Revenue Ruling 83-160 nor Revenue Ruling 84-88 is itself a harbinger of that change, and the case for allowing an economic interest to fixed fee contract miners is somewhat different from that of licensees and percentage of sales contract miners. Nevertheless, there is need for an expansive reexamination of the linchpins on which an economic interest turns. If a lessee under an unenforceable lease may have an economic interest, as far as operating interests are concerned, conducting the extraction with

¹⁷⁵ McMahon, *supra* note 4, at 67-80.

the legal right to participate in the proceeds of sale, however measured should also guarantee the existence of an economic interest, without regard to examination of the underlying property law rights upon which the taxpayer relied as the basis for his right to extract the mineral.¹⁷⁶

Extending *Swank* to its logical conclusions, as has been done here raises the question of whether *Swank* itself was correctly decided. It is logically difficult to allow the lessees in *Swank* an economic interest and to deny it to licensees such as were involved in the *Holbrook* and *Missouri Pacific Corp.* and *Missouri Sand & Gravel Co.* decisions. But it is not so easy to say that Congress intended that the incentive of the percentage depletion allowance deduction be extended to licensees. Percentage depletion originated as an administratively convenient substitute for discovery value depletion.¹⁷⁷ Under the theory of discovery value depletion it was imperative that the taxpayer have the legal right to extract a substantial portion of the mineral in the ground. In rejecting the argument of the IRS in *Swank*, the Supreme Court failed to examine adequately and critically the historical development of the percentage depletion allowance deduction. Instead it viewed percentage depletion as if it had sprung forth, full grown in one burst of legislation, and, finding that the policy was to encourage the exploration, development and extraction of minerals, allowed the deduction to taxpayers based solely on extraction. Despite the assertion of the Claims Court in *Missouri Pacific Corp.*, following the logical implications of *Swank*, the percentage depletion allowance is largely rootless. In substance it requires only that the taxpayer derive income dependent upon the extraction of the deposit. It may be that, if Congress were considering the enactment of percentage depletion anew, such a broad application would be intended, but that is not so clear when one examines the historical development of the depletion allowance.

¹⁷⁶ This would not change the result in cases such as *Commissioner v. Estate of Donnell*, 417 F.2d 106 (5th Cir. 1969), which held that the operator of a well, who illegally slant drilled to an oil deposit under land of another person, does not have an economic interest. *See id.* at 109, 112.

¹⁷⁷ *McMahon*, *supra* note 4, at 30-36.

