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Income Tax: Oil and Gas Leases as Capital Assets

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This seems to be indicated by the limitation that there must be "some other evidence of an aggression by the deceased," and, (2) that this type of evidence is easily fabricated.[23] In view of these fears, and the resulting limits placed upon the doctrine by the courts, will the *Griffin* case have a marked effect upon future decisions? As has been indicated, the decision clearly represents an extension of the rule beyond the bounds heretofore contemplated by the courts. Its acceptance in the future is at least a matter open to serious question. It is submitted that Judge Clark was on firmer ground in his dissent when he stated:

> "It is indeed a far cry from this simple, logical doctrine entirely based on self-defense to the rule announced by this court in the present case which is without limit."[24]

CECIL WALDEN

INCOME TAX: OIL AND GAS LEASES AS CAPITAL ASSETS

In *Petroleum Exploration* v. *Commissioner of Internal Revenue*,[1] the issue before the court was whether the taxpayer had held a capital asset for six months. On March 2, 1937, the taxpayer had taken an oil and gas lease on certain lands. This lease was renewed February 23, 1938. On August 24, 1938 the taxpayer entered into an agreement with another oil company whereby the latter agreed to drill a test well on the leased premises. Pursuant to this agreement, a successful oil well was completed on September 14, 1938. Within a short time five more wells were also located on the properties. On January 31, 1939, the lease was sold to a third oil company for a considerable sum of money. The operating equipment which was on the property was also included in the sale. Following disputes between the taxpayer and the commissioner, the Tax Court held that what the taxpayer sold on January 31, 1939, was a capital asset held by the taxpayer since the execution of the lease on March 2, 1937. The gain realized on the sale was therefore a long term capital gain.[2] On appeal, the circuit court of appeals[3] reversed the Tax Court's decision by holding that what the taxpayer sold on January 31, 1939, was not the bare lease which

[23] I WIGMORE, EVIDENCE sec. 111 at 552 (3rd ed. 1930).
[24] *Supra* note 1 at 995.

[1] 193 F. 2d 59 (4th Cir. 1951).
[2] 16 T. C. 277 (1951).
[3] *Supra* note 1.

was acquired on March 2, 1937, but was a new property which came into being when the oil was discovered September 14, 1938. This property had not been held the requisite six months,[4] and therefore the result was that the taxpayer had realized a short term capital gain on the sale. Pursuant to this case, no ordinary oil and gas lease can ever be a capital asset prior to discovery of the oil. It is questionable whether the court's position on this narrow point of property law will always be a sufficient answer to the question "why?"

The tax treatment given a long term capital gain by the Federal Internal Revenue Code is a major exception to the general pattern of the ability-to-pay theory of income taxation embodied by that statute.[5] Profit realized from the sale of a long term capital asset escapes the full force of the graduated income tax rates. Only half of the profit realized from the "sale or exchange"[6] of a "capital aset"[7] held for longer than six months is to be attributed to the seller's income upon which tax is to be computed.[8] The preferential treatment thus afforded capital gains was brought about by an inclination on th part of Congress to tax gains realized upon the sale of an investment less harshly than income derived from other sources.[9] It was felt that capital investments were not the product of any particular year's endeavor, and therefore should not be taxed under the full force of a graduated tax rate scheme in any subsequent year.[10] The effect of the decision in the *Petroleum Exploration* case is that an oil and gas lease is not an investment of the character deserving preferential tax treatment. There is something to be said for a contrary opinion.

The theory of the case is that the taxpayer did not dispose of an oil and gas lease, but that the interest which was sold was a property interest in the oil which did not arise until its discovery. There is a

[4] INT. REV. CODE, sec. 117 (a) (4).

[5] For an examination of the theory behind the income tax code, see Bueller, *Ability to Pay*, 1 TAX L. REV. 243, (1946).

[6] INT. REV. CODE, sec. 117 (b).

[7] The code makes no specific definition of a capital asset. The statute attempts to distinguish between "investment", "speculation" and "property used in trade or business", classifying the former as the capital asset. "To differentiate between 'investment' and 'speculation', the statute provides that favorable treatment is to be accorded to profit realized upon the sale of only such assets as were owned by the taxpayer for more than six months preceding sale. To separate 'investment' from 'business', the statute provides that special treatment is not to be given to profit realized upon the sale of various kinds of business assets, particularly 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . .'" Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation* I, 59 YALE L. J. 837, 838 (1950) citing INT. REV. CODE, sec. 117 (a) (1), 117 (b), 117 (c) (2).

[8] INT. REV. CODE, sec. 117 (b), 117 (c).

[9] Rollingwood Corp. v. C.I.R., 190 F. 2d 263 (9th Cir. 1951).

[10] 3 MERTENS, LAW OF FEDERAL INCOME TAXATION, sec. 22.02 (1942).

great split of authority over the question when title passes to oil under a lease.[11] Conceding that the court was correct in its view that no property interest in the oil itself can arise prior to its discovery, does it follow that for purposes of income taxation such a lease is nothing? There is, however, abundant authority to the effect that there is a vested property right in the lessee under a lease such as this. It has been held on numerous occasions that the lessee has an estate in the land even though he has no vested title in the oil. As was stated in *Lindlay* v. *Raydure:*[12]

> "That an estate in the surface of the land of some character vests in the lessee immediately upon the execution of the instrument I do not understand to be questioned anywhere."[13]

This opinion is held by practically all authorities. The question whether such an estate coupled with a right to produce is a capital asset would have been worthy of the court's consideration.

In *West* v. *Commissioner of Internal Revenue*[14] an instrument was construed to effect sale of the surface coupled with a lease of the mineral rights beneath the surface. Profits resulting from such a transaction were held to be capital gains. From a practical viewpoint, there is very little difference between the situation of an oil company which is producing oil under an instrument which gives it an estate less than a fee in the surface and a company which owns the fee in the surface. In any event, the oil is what the driller is after, and it

[11] The majority view is that no title passes to the oil. Lindlay v. Raydure, 239 Fed. 928 (1917), 249 Fed. 675 (6th Cir. 1918), cert. den. 247 U.S. 513 (1917); Williams' Adm'r. v. Union Bank & Trust Co., 283 Ky. 644, 143 S.W. 2d 297 (1940). Some jurisdictions classify the interest of the lessee as a *profit a prendre,* Romero v. Brewer, 58 Cal. App. 2d 759, 137 P. 2d 872 (1943). Some jurisdictions hold that title passes to the oil in the ground, Corzelius v. Harrell, 143 Tex. Civ. App. 509, 186 S.W. 2d 961 (1941). It was once contended that since the law of Texas was to the effect that title to the oil passed as a result of an oil and gas lease that a federal court was powerless to hold otherwise in a tax case, Burnet v. Harmel 287 U.S. 103 (1932). This contention fell before the maxim that the exertion of the plenary power of taxation possessed by Congress was not even subject to this negative state control. See also Crooks v. Harrelson, 282 U.S. 55 (1930).

[12] 239 Fed. 928 (1917), 249 Fed. 675 (6th Cir. 1918), cert. den. 247 U.S. 513 (1917).

[13] *Id.* at 934. This is the view held by the majority of jurisdictions, note 11 *supra.* In the *Petroleum Exploration* case, note 1 *supra,* the only description the court made of the position of the taxpayer under the lease was a very general observation that he had an option. There are only a very few jurisdictions holding that the lessee does not have an interest in the property. Louisiana apparently takes the position that such a lessee has only a "personal right," see Gulf Refinery Co. v. Glassell, 186 La. 190, 171 So. 846 (1936). If the court intended to hold that the lessee had only an option in the *Petroleum Exploration* case, it is flaunting the great weight of authority in this country including the federal courts.

[14] 150 F. 2d 723 (5th Cir. 1945); see also Anderson v. C.I.R., 81 F. 2d 457 (10 Cir. 1936).

makes very little difference if he has the fee in the surface or merely a lesser estate which carries with it th right to carry on his drilling operations. It is believed that the *West* case is but a short step removed from a precedent for holding that the interest in the land coupled with the right to produce oil as existed in the *Petroleum Exploration* case was a capital asset. Furthermore, this interest and right was created by the lease itself, and under such a holding, it would be unnecessary that the oil be discovered, as a prerequisite to the existence of the capital asset.

The case of *Anderson* v. *Helvering*[15] brought forth an interesting observation by the Supreme Court as to the nature of the oil drilling business when it said that:

> "The production of oil and gas, like the mining of ore, is treated as an income producing operation . . ., and is said to resemble a manufacturing business."[16]

It seems to be a legitimate inquiry to ask, "Why then, when one sells this manufacturing business hasn't he sold a capital asset?" The gain on sale of any business is normally treated as a capital gain, not as income. Furthermore, the taxpayer also sold his operating equipment in the transaction which included the lease in the *Petroleum Exploration* case. This additional factor is all the more indicative that the observation made by the Supreme Court might very well be a legitimate theory upon which to give the taxpayer an advantage in cases involving the question of capital assets.

It is felt that the court used an unfortunate approach to the problem in the *Petroleum Exploration* case. The court seemed assured that all which needed to be decided in order to determine whether or not an oil and gas lease was a capital asset was the question, "Does such a lease pass title to the oil in place?" The question should have been "What is an oil and gas lease?" and the answer to this question should have been examined to see if the lessee had anything which could have been properly classified as a capital asset from the moment of the execution of the lease. The taxpayer undoubtedly had something when he took the lease, and it is believed that the court should have defined what it was that he had. Did the court "appraise the transaction according to its economic and practical consequences" as it felt it was bound to do?[17]

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[15] 310 U. S. 404 (1940).
[16] *Id.* at 407.
[17] *Supra* note 1 at 62.