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The Supreme Court and Taxation of Oil, Gas and Production Payments: The Lake Cases*

*Edward B. Benjamin, Jr.,*** *and Thomas S. Currier*†

I. The Background: Assignments of Carved-Out Oil, Gas and Production Payments Were Regarded Prior to 1946 as Alienations of Capital Assets

The statement has been made and repeated that whenever a method is discovered whereby the conversion of ordinary business income into capital gain is coupled with retention of the business itself, the Internal Revenue Service will ultimately succeed in changing the law.[1] This theory has proved true at least in the history of the tax treatment of assignments of carved-out oil payments. In this instance, some twelve years were required to accomplish the change.

An oil payment is an *in rem* right to receive a specific portion of the oil produced from a specific tract of land, free of production expenses, until a certain quantity of oil, or a certain sum of money from the sale of production has been received.[2] A gas payment is similar to an oil payment, but is payable out of gas production. A production payment is similar to an oil or gas payment and, as the term is generally used in the oil and gas industry, is payable out of production of oil and gas, or either of them. In this paper, the term "production payment" is used to

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1. Hammonds & Ray, *Oil Payments Revisited*, 33 TAXES 349, 352 (1955). For an earlier discussion of the taxation of sales proceeds of carved-out production payments, see Ray & Hammonds, *The Income Tax on Proceeds from the Sale of Oil Payments: The Validity of G.C.M. 24849*, 25 TEX. L. REV. 121 (1946). For other more recent discussions, see McClure, *Effect of Supreme Court Decision in* Commissioner v. P. G. Lake et al. *on Transfers of Production Payments*, 7 OIL & GAS TAX Q., No. 4, 245 (1958); 6 OIL & GAS TAX Q., No. 4, 231 (1957); Note, 25 GEO. WASH. L. REV. 724 (1957); Note, 69 HARV. L. REV. 737 (1956).

2. See Palmer v. Bender, 287 U.S. 551 (1932); Thomas v. Perkins, 301 U.S. 655 (1937). See also BREEDING & BURTON, TAXATION OF OIL AND GAS INCOME 25 (1954).

include oil payments, gas payments, production payments, and similar payments payable out of other minerals. Satisfaction of a production payment is thus contingent upon, and limited by, production, but it is limited also by an inflexible maximum recovery.[3] The owner of a production payment has been uniformly regarded as owning an economic interest in minerals in place, thereby entitling him to the benefit of the deduction for depletion.[4] A production payment is not, however, a "continuing" mineral interest and, therefore, retention of a production payment in a conveyance of a mineral, leasehold or royalty interest, or of a production payment, does not prevent the transfer of the interest from qualifying as the sale of a capital asset from which no ordinary income is realized.[5]

A "reserved" production payment is distinguished from a "carved-out" production payment in that the former, as indicated above, is created by reservation in a conveyance of the mineral ownership, or of a mineral leasehold interest, a royalty interest or a production payment, whereas the latter is created by a mineral, leasehold, or royalty owner, or the owner of a production payment, who reserves his mineral, leasehold or royalty interest, or a portion of his production payment, and conveys a production payment, which is thereby "carved out."[6] For tax purposes, the distinction between reserved and carved-out production payments is of the utmost importance, for reasons that will subsequently become apparent.[7]

Independent of tax considerations, the production payment is an interest that can be and has been put to many uses. In an undeveloped area, for instance, an operator can sometimes diminish his risk or make up a deficiency of risk capital by conveying speculatively large production payments in exchange for materials or services to be used in exploration or for money to

3. Ultimate recovery is frequently geared, however, to provide payments equal to interest on the balance of the production payment remaining unpaid from time to time during pay-out. See the discussions of O'Connor v. Scofield, 143 F. Supp. 240 (W.D. Tex. 1956), aff'd, 241 F.2d 65 (5th Cir. 1957), rev'd, 78 Sup. Ct. 691 (U.S. 1958), discussed page 587 *infra*; and of the *Lake* cases, 353 U.S. 982 (1957), discussed page 591 *infra*.

4. Palmer v. Bender, 287 U.S. 551 (1932); Thomas v. Perkins, 301 U.S. 655 (1937). But see discussion of the Commissioner's argument that a carved-out production payment is not an economic interest in minerals in place, page 594 *infra*.

5. Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936); Witherspoon v. United States, 8 Oil & Gas Rep. 139, 57-2 USTC ‖ 9858 (D.C. Tex. 1957); Atlantic Refining Co., Private Ruling dated May 15, 1956, 565 CCH ¶ 6608.

6. See G.C.M. 24849, 1946-1 CUM. BULL. 66.

7. Compare discussions under Parts IV-A and IV-B *infra*.

be used in property acquisition or in defraying exploration expenses.[8] A production payment might be especially attractive to the assignee in this situation because the assignor will normally be willing to assign a production payment payable out of a fraction of production larger than the royalty interest that the assignor would be willing to assign for the same consideration. In an undeveloped area or even in a proven field, further development can be financed by conveyance of production payments, either as security for loans or in outright sales or in exchange for materials or services or money pledged to development.[9] Production payments are also one of the means by which an operator may be reimbursed for the expenses of "carrying" other investors through a specified stage in the exploration and development of a property in a "carried interest" transaction.[10] When separate operating properties are pooled or unitized, or an operating property is brought into a previously existing unit, the differential in well and equipment values (and, in instances of cycling or recycling operations, plant investment) can be conveniently equalized by the use of production payments.[11] Production payments have successfully been used as a means of compromising a title dispute.[12] But perhaps the most popular uses to which production payments have been put are financing the acquisition of producing properties,[13] and the immediate realization of cash from producing properties, in excess of proceeds of current production, without alienation of any interest fixed in relation to the total reserves of, or eventual recovery from, the producing property.[14] This last use is implemented by the sale

8. Ortiz Oil Co., 37 B.T.A. 656 (1938), aff'd, Ortiz Oil Co. v. Commissioner, 102 F.2d 508 (5th Cir. 1939), cert. denied, 308 U.S. 566 (1939), discussed page 585 *infra*.

9. See discussion of sharing arrangements under Part IV-A-1 *infra*.

10. Herndon Drilling Co., 6 T.C. 628 (1946), acq. and nonacq. on other issues, 1946-2 CUM. BULL. 3. In the *Herndon* type of carried interest transaction, the carried party assigns an undivided fraction of the working interest, plus a production payment carved out of the assignor's retained interest, measured by the expense incurred by the assignee for the benefit of the assignor's retained interest.

11. E. V. Whitwell, 28 T.C. 372, 7 Oil & Gas Rep. 673 (1957), rev'd in Whitwell v. Commissioner, 58-2 U.S.T.C. ¶ 9658 (5th Cir. 1957).

12. John Vaccaro, 2 T.C.M. 820 (1943).

13. See discussion of reserved production payments and *ABC* transactions under Part IV-B *infra*.

14. Among other reasons for which taxpayers have sought this immediate realization of cash are payment of death taxes, O'Connor v. Scofield, 143 F. Supp. 240 (W.D. Tex. 1946), aff'd, 241 F.2d 65 (5th Cir. 1957), rev'd, 78 Sup. Ct. 691 (U.S. 1958) ; *cf.* Commissioner v. Weed, 353 U.S. 982 (1957) (sale of production payment for cash and notes to assure source for payment of future income taxes) ; payment of indebtedness, Commissioner v. P. G. Lake, Inc., 353 U.S. 982 (1957) ;

of a carved-out production payment by the owner of a mineral, leasehold or royalty interest or of a larger production payment.

Prior to 1946, the status of assignments of carved-out production payments as alienations of capital assets — whether the transfer took the form of a sale, exchange or a gratuitous assignment — was, with one exception,[15] recognized by the then Bureau of Internal Revenue (hereinafter referred to by its present title). It may be that the Internal Revenue Service's acceptance of this alienation-of-capital-asset status was at least in part attributable to the relatively longer holding periods that were then required for long-term capital gain treatment of sales proceeds.[16] Whatever the reason, the fact that carved-out production payments were treated as capital assets led taxpayers more and more to use conveyances of carved-out production payments with an eye to the tax advantages thereby made possible. For example, by sale of a carved-out production payment, even of relatively short duration, depletable income from proceeds of production could be transformed into capital gain.[17] Carved-out production payments could be exchanged for continuing royalty or leasehold interests in other mineral properties or even for a fee interest in real property, and the exchange might result in no recognition of gain.[18] At the very worst, such an exchange would result only in a taxable capital transaction.[19] By donation of a carved-out production payment to charity, a taxpayer might not only exclude from his income the proceeds from production, but avail himself of the deduction for charitable donations as well.[20]

These were the tax advantages that led to the issuance in 1946 of G. C. M. 24849,[21] and to the twelve years of all-out assault by the Internal Revenue Service on the existing treatment of assignments of carved-out production payments.

and acquisition of funds for other operations, Commissioner v. Slagter, 238 F.2d 901 (7th Cir. 1956).

15. R.E. Nail, 27 B.T.A. 333 (1932), acq. XII-1 CUM. BULL. 9, acq. withdrawn and non-acq., 1949-1 CUM. BULL. 6, discussed in text accompanying note 58 *infra*.

16. See BREEDING & BURTON, TAXATION OF OIL AND GAS INCOME 67 (1954), citing Section 117(j) of the 1939 Code, which was added to Section 117 of the Revenue Act of 1942, and which reduced the holding period from eighteen to six months.

17. See cases cited under Part II-A *infra*.

18. See cases cited under Part II-B *infra*.

19. *Ibid.*

20. See cases cited under Part II-C *infra*.

21. 1946-1 CUM. BULL. 66.

II. The Period of Conflict: Carved-Out Production Payment Transactions from 1946 Until April 14, 1958

Prior to 1946, the creation and assignment of a carved-out production payment combined the virtues of the tax treatment afforded the alienation of a capital asset (that is, an interest in minerals in place) with retention of the power in the assignor to determine the duration of the interest alienated. This was accomplished by the assignor's simply specifying the portion of production to be allocated to the production payment. This, in effect, provided a device by which the owner of a productive mineral, leasehold or royalty interest, or production payment, could convert any desired amount of future income for any desired amount of time, otherwise taxable at ordinary rates subject to the deduction for depletion, into a capital asset. No tax was incurred by the conversion of future income into a capital asset; the only tax incurred was upon recognition of capital gain on a simultaneous or subsequent sale or exchange. And any recognition of gain could be postponed by a tax-free exchange, or shifted by gift to an assignee, of the capital asset thus created out of future income.[22] Naturally, many taxpayers sought to reap these tax benefits. Therefore, again naturally, the Internal Revenue Service reconsidered the accepted tax treatment of carved-out production payment transactions. The results were the issuance in 1946 of G. C. M. 24849;[23] the issuance in 1949 of I. T. 3935;[24] and the issuance in 1950 of I. T. 4003.[25]

In G. C. M. 24849, the Service expressed the opinion that:

> "[C]onsideration (not pledged for development) received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands. No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of

22. A conflict existed between the Tax Court and the Fifth Circuit on the question of what types of assets production payments could be exchanged for tax-free. See discussion under Part II-C *infra*.

23. 1946-1 Cum. Bull. 66. In I.T. 3895, 1948-1 Cum. Bull. 39, G.C.M. 24849 was limited to prospective application from the date of its issuance.

24. 1949-1 Cum. Bull. 39.

25. 1950-1 Cum. Bull. 10.

the life of the depletable economic interests from which such rights are carved."[26]

In I. T. 3935, the position taken in G. C. M. 24849 was extended to encompass donative assignments of short-lived production payments, and the opinion was expressed that "such donative assignments are assignments of future income. The income thus assigned is depletable income to the donor as it arises."[27]

I. T. 4003 eliminated the distinction between short-lived and long-lived carved-out production payments as to both assignments for consideration and donative assignments, expressing the opinion that "The assignment of in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of an in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises. Notwithstanding the foregoing, G. C. M. 24849 . . . and I. T. 3935 . . . do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property."[28]

These three utterances represent the Service's administrative attempt to "change the law" governing taxation of carved-out production payment transactions. An attempt was made to effect this change by legislation,[29] but ultimately the change was accomplished by judicial decision in the case of *Commissioner v. P. G. Lake, Inc.* and its companion cases.[30] Prior to the issuance of G. C. M. 24849, and in the twelve years following, litigation between the Service and taxpayers relative to the tax treatment

26. 1946-1 CUM. BULL. 69.
27. 1949-1 CUM. BULL. 40.
28. 1950-1 CUM. BULL. 11.
29. H.R. No. 9559, 84th Cong., 2d Sess. (1956). Legislation was proposed to reverse the Service's position in 1950. S.R. No. 2375, 81st Cong., 2d Sess. 66, 91 (1950).
30. Commissioner v. P. G. Lake, Inc.; Scofield v. O'Connor; Commissioner v. Fleming; Commissioner v. Wrather; and Commissioner v. Weed, consolidated for argument and reported in 356 U.S. 260 (1958).

of carved-out production payment transactions involved generally three types of transactions: sales, exchanges and gratuitous assignments.

A. *Sale of Carved-Out Production Payment*

In 1938 the Board of Tax Appeals had before it, in the case of *Ortiz Oil Company*,[31] the question whether the proceeds of sale of a production payment carved out by the owner of a mineral leasehold interest were depletable income to the assignor or recovery of basis and short-term capital gain not subject to depletion. The property involved was in "wildcat" territory, and production payments for the face amount of $350,000 were sold by the taxpayer for $154,000, which was used by the taxpayer to defray acquisition expense. The Board of Tax Appeals agreed with the Commissioner, contrary to the contention of the taxpayer, that capital gain rather than depletable income resulted. *Ortiz* was affirmed on appeal[32] and followed in 1940 in *Majestic Oil Corporation*,[33] in which the taxpayer again contended unsuccessfully that the proceeds of the sale of a carved-out production payment were depletable income and the Commissioner again succeeded in the contention that a short-term capital gain had been realized.

In 1941, the thought apparently had not yet occurred to the Service that sale of a carved-out production payment might result in anything other than a capital transaction. In that year, G. C. M. 22730[34] was issued, an opinion in which a distinction was made between the sale of a carved-out oil payment the consideration for which is pledged to development of the property (in which case a "sharing arrangement" has occurred and the purchaser's investment represents an addition to the reservoir of capital investment in oil and gas in place, so that there has been no taxable event) and the sale of a carved-out oil payment for consideration not so pledged. If the sale proceeds are pledged to development, according to the opinion, the assignor has not "parted with a capital asset," whereas if the proceeds from the sale of the oil payment are not so pledged, the assignor is "required to allocate thereto a part of his basis and compute gain or loss."[35]

31. 37 B.T.A. 656 (1938), aff'd in Ortiz Oil Co. v. Commissioner, 102 F.2d 508 (5th Cir. 1939), cert. denied, 308 U.S. 566 (1939).
32. *Ibid.*
33. 42 B.T.A. 659 (1940).
34. 1941-1 CUM. BULL. 214.
35. 1941-1 CUM. BULL. 222, 224.

In 1946, the Service reversed its position by issuing G. C.M. 24849, augmented in 1950 by I. T. 4003. Subsequent litigation concerning the taxation of sales proceeds of carved-out oil payments took a course generally adverse to the Service's position. In 1954 the Tax Court, with six judges dissenting, held in *John D. Hawn*[36] that capital gain was realized from the assignment of an oil payment in the face amount of $120,000, carved out of a larger oil payment, as consideration for the building of a residence by the assignee. The estimated pay-out time was two years (actual pay-out time was a few months less) and provision was made for additional payments equal to interest and for adjustment to reflect certain contingent variations in construction cost. The Commissioner failed in the Tax Court in his attempt to tax the value of the partially completed house, in the year of partial construction, as depletable ordinary income to the assignor.

In 1955, the Court of Appeals for the Fifth Circuit decided *Caldwell v. Campbell*,[37] in which the taxpayer had assigned an oil payment to a controlled charitable corporation in consideration for a nominal sum in cash plus yearly installment notes for the balance of the price. The corporation had no other assets and the notes were spaced out over the estimated pay-out period of the oil payment, which was between ten and thirteen years. The court held that a capital asset had been sold and that the assignor received capital gain; and that because the cash payment was less than thirty percent of the purchase price, the assignor had an option to report the gain in installments in accordance with the provisions of Section 44 of the 1939 Code.[38]

Caldwell was followed by five Tax Court decisions during 1955 holding carved-out oil payment sales proceeds to be taxable under the capital gain provisions rather than as depletable ordinary income: *John Wrather*;[39] *R. B. Cowden*;[40] *A. J. Slagter Jr.*;[41] *P. G. Lake, Inc.*;[42] and *W. F. Weed*.[43] Then, in March,

36. 23 T.C. 516 (1954), rev'd in Commissioner v. Hawn, 231 F.2d 340 (5th Cir. 1956).
37. 218 F.2d 567 (5th Cir. 1955), 33 TEX. L. REV. 952.
38. INT. REV. CODE OF 1954, § 453.
39. 14 T.C.M. 345 (1955), aff'd in Commissioner v. Wrather, 241 F.2d 84 (5th Cir. 1957), rev'd, 78 Sup. Ct. (U.S. 1958).
40. 14 T.C.M. 475 (1955) (government appeal dismissed).
41. 24 T.C. 935 (1955), rev'd in Commissioner v. Slagter, 238 F.2d 901 (7th Cir. 1956).
42. 24 T.C. 1016 (1955), aff'd in Commissioner v. P.G. Lake, Inc., 241 F.2d 71 (5th Cir. 1957), rev'd, 78 Sup. Ct. (U.S. 1958).
43. 24 T.C. 1025 (1955), aff'd in Commissioner v. Weed, 241 F.2d 69 (5th Cir. 1957), rev'd, 78 Sup. Ct. 691 (U.S. 1958).

1956, the Service's position with regard to sales of carved-out oil payments received its first direct support in the reversal by the Court of Appeals for the Fifth Circuit of the Tax Court's judgment in *Hawn.*

In *Commissioner v. Hawn,*[44] the Fifth Circuit set forth its subsequently repudiated "substantial v. insubstantial transfer" test, reminiscent of the distinction originally made by the Service in restricting its opinion to "short-lived" oil payments in G. C. M. 24849. The court held that the interest transferred by Hawn was too insubstantial, in comparison with the interest retained, for the transaction to qualify as a sale of a capital asset. The sale proceeds — the value of the residence — were taxable to Hawn when received, as ordinary income subject to depletion.

On the day after the Fifth Circuit rendered its decision in *Hawn,* the District Court for the Western District of Texas decided *O'Connor v. Scofield.*[45] In *O'Connor,* an estate in need of money to pay estate and inheritance taxes carved out and sold oil payments from eight royalty interests, in the total face amount of $10 million plus an amount equal to 4 percent on the unrealized balance thereof, to be calculated periodically until pay-out. The purchase price was $9,990,350, all of which the purchaser was able to borrow at 3½ percent interest from a bank, on no other security than a deed of trust on the oil payments. The bank's engineers estimated that pay-out would diminish recoverable reserves by 17 percent, and the actual pay-out time was three years. The district court held that the consideration paid for the oil payments was taxable to the taxpayer's estate under the capital gain provisions.

In November, 1956, the Tax Court's decision in *Slagter* was reversed by the Court of Appeals for the Seventh Circuit.[46] The Service received support for its position that an assignment of a carved-out production payment is not an alienation of a capital asset; but the Commissioner failed in his contention that the consideration for such an assignment is ordinary income taxable to the assignor when received, subject to the deduction for depletion. The holding of the Seventh Circuit in *Slagter* was that the sale proceeds of the carved-out oil payment were not taxable to the assignor at all, but that the sales proceeds of oil runs ap-

44. 231 F.2d 340 (5th Cir. 1956).

45. 143 F. Supp. 240 (W.D. Tex. 1956), aff'd, 241 F.2d 65 (5th Cir. 1947), rev'd, 78 Sup. Ct. 691 (U.S. 1958).

46. Commissioner v. Slagter, 238 F.2d 901 (7th Cir. 1956).

plicable to the oil payment were taxable to the assignor when received by the assignee. Apparently the court regarded the transaction as equivalent to a loan by the assignee to the assignor, secured by assignment of the oil payment. The court's attitude may to some extent have been based on the fact that the normal purchaser of the *Slagter* oil runs was also the purchaser of the oil payment, so that the transaction had almost no visible economic effect other than what the court called "an advancement"[47] by the purchaser to the assignor.

The decisions of the Tax Court, in *Weed, Lake,* and *Wrather,* together with the district court's decision in the *O'Connor* case, were appealed to the Court of Appeals for the Fifth Circuit, where they were decided on the same day with *Fleming v. Commissioner,*[48] an appeal from another Tax Court decision[49] involving exchanges of carved-out oil payments. On February 1, 1957, the judgments in favor of the taxpayers in all four of the sale cases were affirmed.[50]

B. *Exchange of Carved-Out Production Payment for Interest in Real Estate or Other Oil Property*

Prior to the Supreme Court's decision of the *Lake* cases in April, 1958, both the Tax Court and the Court of Appeals for the Fifth Circuit consistently held that no ordinary income arose from the exchange of a carved-out production payment for other property. The Tax Court held that such production payments and other oil properties were not properties "of like kind" in the cases of *Midfield Oil Company,*[51] *Kay Kimbell,*[52] and *John Vaccaro,*[53] so that recognition of capital gain by the transferor of the oil payment resulted.[54] In *Fleming v. Campbell,*[55] however, the Fifth Circuit held that a carved-out oil payment and an overriding royalty were properties of like kind, held for productive use or investment, so that no recognition of gain resulted from the

47. *Id.* at 903.
48. 241 F.2d 78 (5th Cir. 1957).
49. William Fleming, 24 T.C. 818 (1955), 56 COL. L. REV. 445 (1956).
50. Scofield v. O'Connor, 241 F.2d 65 (5th Cir. 1957), rev'd, 78 Sup. Ct. 691 (U.S. 1958); Commissioner v. Weed, 241 F.2d 69 (5th Cir. 1957), rev'd, 78 Sup. Ct. 691 (U.S. 1958); Commissioner v. P. G. Lake, Inc., 241 F.2d 71 (5th Cir. 1957), rev'd, 78 Sup. Ct. 691 (U.S. 1958); Commissioner v. Wrather, 241 F.2d 84 (5th Cir. 1957), rev'd, 78 Sup. Ct. 691 (1958).
51. 39 B.T.A. 1154 (1939).
52. 41 B.T.A. 940 (1940).
53. 2 T.C.M. 820 (1943).
54. Int. Rev. Code of 1939, § 112(b)(1); INT. REV. CODE OF 1954, § 1031.
55. 205 F.2d 549 (5th Cir. 1953), 28 TUL. L. REV. 400 (1954).

exchange of one for another, under the provisions of Section 112(b)(1) of the 1939 Code. Subsequently, in *William Fleming*,[56] the Tax Court held that an oil payment and a fee interest in real estate were not property of like kind, distinguishing *Fleming v. Campbell* on the theory that the overriding royalty in *Campbell* (there held to be of like kind with an oil payment) was dependent upon the determinable leasehold interest from which it was created and, therefore, was, like the oil payment, a *determinable* fee in real estate. The Tax Court's judgment in *William Fleming* was reversed by the Court of Appeals for the Fifth Circuit in *Fleming v. Commissioner*,[57] decided on the same day as *O'Connor, Weed, Lake,* and *Wrather.* The Tax Court's distinction between determinable and non-determinable fee interests in real estate was rejected, and the Fifth Circuit held that upon the exchange of an oil payment for a fee interest in real estate there was no recognition of gain.

For the present purpose, the importance of these exchange cases lies not in whether the exchanges did or did not involve recognition of gain, but rather in the fact that all of the cases held that an exchange of a carved-out production payment for other property was a capital transaction, so that the only tax that could result to the assignor of the production payment (either at the time of the exchange, under the Tax Court view, or upon disposition of the property acquired in exchange for the production payment, under the Fifth Circuit view) was under the capital gain provisions.

C. *Gratuitous Transfer of Carved-Out Production Payment*

In *R. E. Nail*,[58] before the Board of Tax Appeals, the question of the tax effect of a donation of a carved-out production payment was first litigated. The donation was to a charitable organization and the taxpayer had, in the year of assignment, taken a charitable deduction of the value of the production payment at the time of assignment. The precise question in issue was whether the income from production applicable to the production payment was taxable to the donor. The Board held that, since there had been a disposition of the income-producing property, such proceeds were not taxable income to the donor.

56. 24 T.C. 818 (1955), aff'd in Fleming v. Commissioner, 241 F.2d 78 (5th Cir. 1957).
57. *Ibid.*
58. 27 B.T.A. 33 (1932), acq. XII-1 CUM. BULL. 9, acq. withdrawn and nonacq. 1949-1 CUM. BULL. 6.

Subsequent to *Nail,* in 1949, I. T. 3935 was issued, expressing the opinion that the income from sales of oil applicable to a gratuitously assigned, short-lived carved-out oil payment should be taxed to the assignor as such income arose. In 1950, this opinion was broadened by I. T. 4003 to encompass any carved-out oil payment the duration of which was less than that of the interest out of which the oil payment was carved. In the meantime, the Court of Claims in 1949 decided *Rudco Oil & Gas Co. v. United States,*[59] which involved not precisely a donation, but rather a dividend of a family-held corporation. In *Rudco* the corporation had carved out and assigned production payments to its shareholders, in proportion to their respective holdings. The production payments were paid out in less than a year. The Court of Claims held, in accord with I. T. 3935, that the income from the dividend production payments was taxable to the corporation as it arose.

In 1954, however, the Service's position with regard to donative assignments of carved-out oil payments was rejected by the Tax Court in *Lester A. Nordan.*[60] The problem was tested in *Nordan* from a different angle. The Commissioner disallowed a charitable deduction taken by the taxpayer for the year in which the production payment was assigned, in an amount equal to the value of the production payment at the date of assignment. The Commissioner contended that the production payment proceeds were income taxable to the assignor as they arose, and that the taxpayer was entitled to take a charitable deduction for each year in an amount equal to the production payment proceeds taxed to him and received by the donee charitable organization. The Tax Court held that the assignment transferred title to property and thereby entitled the assignor to a charitable deduction for the year of assignment in an amount equal to the value of the oil payment on the date of assignment. A necessary corollary to this holding was, of course, that the oil payment proceeds were not taxable income to the assignor.

III. THE SUPREME COURT DECISIONS IN THE LAKE CASES

The United States Supreme Court granted writs of certiorari[61] to the Court of Appeals for the Fifth Circuit in the cases

59. 82 F. Supp. 746 (Ct. Cls. 1949).
60. 22 T.C. 1132 (1954). *Cf.* Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954) (gift of cattle); White v. Brodrick, 104 F. Supp. 213 (D.C. Kan. 1952) (gift of wheat).
61. 353 U.S. 982 (1957).

of *Lake, O'Connor, Fleming, Wrather* and *Weed,* presumably because of the conflict between the Fifth Circuit decisions in these and other cases and the Seventh Circuit decision in the *Slagter* case. From the Commissioner's point of view, the *Lake* cases were ideally suited for the purpose of Supreme Court review for a variety of reasons. In the four sales cases, the oil payments were all of short duration, and the payment periods could have been estimated with a high degree of accuracy at the time of the assignments.[62] In the fifth case, the oil payments had pay-out periods ranging from three to approximately ten years.[63] In none of the five cases can it be said that the oil payment assignee assumed by the assignment any substantial portion of the risk of his assignor.

The five cases were consolidated for argument and, on April 14, 1958, the judgment of the Court of Appeals in each case was reversed.[64] The Internal Revenue Service had, after 12 years of unremitting effort, succeeded in "changing the law." During those 12 years, batteries of theories had grown up in opposition to, and in support of, the Service's position. Those in opposition are of little prospective concern to taxpayers in the light of the *Lake* decisions; those in support are of prospective importance to the Service and to taxpayers alike only insofar as they are adopted by the *Lake* decision.

A. *Theoretical Bases of Fifth Circuit and Tax Court Position*

The basic position adopted by the Court of Appeals for the Fifth Circuit[65] and by the Tax Court[66] has been that the char-

62. In the *Lake* case, an oil payment was assigned to satisfy an indebtedness of $600,000. The face amount of the oil payment was $600,000 plus an amount equal to 3 percent per annum interest on the balance remaining unpaid from month to month. The oil payment was caryed out of 25 percent of two working interests, and paid out in slightly more than three years.

The facts in the O'Connor case are set forth in the text accompanying note 45 *supra.*

In *Weed,* a sulphur payment was carved out of a pooled royalty interest in consideration for cash and two notes, payable in one and two years. The sulphur payment paid out in 28 months.

In *Wrather,* oil payments carved out of working interests were expected to pay out within four to six years, and in fact paid out in a shorter period.

63. In the *Fleming* case, oil payments were exchanged for a ranch and for business real estate. The oil payments were in face amounts equal to the uncontested value of the real estate to be acquired, plus amounts equal to interest on the unpaid balances. The payout periods of the oil payments ranged from three to approximately ten years.

64. Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958).

65. See, e.g., the decisions in the *Lake* cases in the Fifth Circuit, notes 50 and 57 *supra.*

66. See, e.g., Lester A. Nordan, 22 T.C. 1132 (1954).

acterization of production payments as real property interests under the applicable state law is controlling for the purpose of determining whether an assignment of a production payment is an alienation of a capital asset. This reliance on state law is of course vulnerable in the light of *Palmer v. Bender*[67] and similar cases. Classification of a production payment as an economic interest in minerals in place entitling the owner to the deduction for depletion has reinforced the conclusion based on state law that production payments are generically capital assets for the purpose of Sections 1221 through 1241.[68]

In the *Hawn* case, the only case before either the Tax Court or the Court of Appeals for the Fifth Circuit in which sales proceeds of a carved-out production payment were held to constitute depletable ordinary income to the assignor, the basis advanced in support of the Fifth Circuit decision was that the interest assigned, relative to the interest retained, was too insubstantial for the transaction to qualify as a sale or exchange of a capital asset.[69] This substantiality theory was subsequently disavowed by the same court in its decisions in the *Lake* cases, in which the *Hawn* decision was attributed to a finding that the transaction there was a mere sham or subterfuge not entitled to treatment as a sale of a capital asset.[70] This "pretended sale" test provided no reliable basis for prediction of the tax results of the sale of a carved-out oil payment; and the "substantial v. insubstantial transfer" test, judicially applied, was very little better.

B. *Theoretical Basis of the Seventh Circuit Position*

The decision of the Court of Appeals for the Seventh Circuit in *Slagter*[71] was necessarily based on an extension of the assignment of income concept set forth in other areas by the Supreme Court in cases such as *Helvering v. Horst*[72] and *Harrison v. Schaffner*.[73] In each of those cases the assignor of a right to

67. 287 U.S. 551 (1932).
68. *But see* discussion in Note, 69 HARV. L. REV. 737, 739, 747 (1956).
69. Commissioner v. Hawn, 231 F.2d 340, 346 (5th Cir. 1956) ("Where the legal effect to be given for tax purposes to what appears in form to be a transfer of an interest in property is raised, we have the clear teaching of the cases . . . that we must determine whether such transfer is for a substantial interest in the total property owned by the transferor. Although it might be better if Congress provided the answer, in the absence of a Congressional determination, it devolves upon the Court to supply it.").
70. Scofield v. O'Connor, 241 F.2d 65, 67 (5th Cir. 1957).
71. Commissioner v. Slagter, 238 F.2d 901 (7th Cir. 1956).
72. 311 U.S. 112 (1940).
73. 312 U.S. 579 (1941).

receive future income was held taxable on that income *as it arose*, on the theory that the assignor derived economic benefit from the income in assigning it. These cases involved donative assignments, so that the economic benefit was realized by the assignor concurrently with receipt of the income by the assignee. In *Slagter*, the economic benefit was, of course, the sale proceeds of the carved-out production payment, received at the time of assignment. The Court in *Slagter*, emphasizing that an "advancement" had been made to the assignor, apparently regarded the transaction as an assignment of future income to secure a present loan, so that economic benefit was realized by the assignor concurrently with the receipt of the assigned income by the assignee. This theory is vulnerable for the reason that the "loan" is without a debtor, so that no economic benefit whatsoever is realized by the assignor as the oil payment is satisfied. The economic benefit, whether resulting in capital gain or ordinary income subject to depletion, is the receipt of the purchase price.[74]

C. *Arguments in Support of the Service's Position*

When the *Lake* cases were before the Court of Appeals for the Fifth Circuit, the Commissioner used four arguments in support of the contention that the proceeds of sale or exchange of a carved-out oil payment are taxable income subject to depletion in the hands of the assignor. These four arguments are representative of the theories relied on by the Service prior to review of the *Lake* cases in the Supreme Court. They are:

(1) Assignments of production payments carved out of operating or working interests do not convey any part of the income-producing property (the operating or working interests) and are, therefore, necessarily anticipatory assignments of income. (This argument is not, of course, applicable to production payments carved out of larger nonoperating interests such as royalty or a larger production payment.)

(2) All the assignments of production payments, whether carved out of operating or nonoperating interests, were too insubstantial under the *Hawn* test to qualify as sales or exchanges of capital investment property.

(3) Even if the assignments of production payments were alienations of capital investment property, the properties as-

74. See further discussion under Part IV-B-1 *infra*.

signed (the production payments) were created at the time such properties were carved out, which was the time of the respective assignments, so that the carved-out production payments had not been held for the six-month holding period necessary to qualify the gains therefrom as long term capital gains.

(4) Even if the assignments of production payments were assignments of property, the property was the oil (sulphur in the *Weed* case) to be produced and applied in payment of the production payments, which was property held primarily for sale to customers in the ordinary course of the trade or business[75] of the assignor.

Before the Supreme Court, the Commissioner's arguments were broadened in scope, and the distinction between oil payments carved out of operating interests and those carved out of nonoperating interests was abandoned. The arguments employed by the Commissioner before the Supreme Court were:

(1) The capital gains provisions of the Code express a legislative intent to give preferential tax treatment to gain derived from the conversion of the increase in value of capital investment property, and the gain realized from an assignment of a carved-out production payment is not derived from a conversion of the increase in value of capital investment property, but from conversion of future income into present income.

(2) Assignments of carved-out production payments are assignments of future income rather than sales or exchanges of property within the meaning of the capital gains provisions because the assignment of a production payment carved out by the owner of a larger depletable economic interest in minerals in place does not convey a depletable economic interest in minerals in place to the assignee. This argument attempts to overrule the doctrine set forth in *Thomas v. Perkins*[76] by distinguishing between reserved and carved-out production payments. The Commissioner's theory is based upon an identification of the sale proceeds of an oil payment with the future sales proceeds of the oil itself as depletable income. Consideration for a carved-out production payment is distinguished from consideration for a royalty or leasehold interest on the theory that the latter interests are capital investment property, while a production payment

75. Specifically excluded from the definition of capital asset.
76. 301 U.S. 655 (1937).

is exclusively an income right severed from capital investment property, for tax purposes, regardless of its status under state law.

(3) Assignments of carved-out production payments are assignments of future income even if the assignment conveys a depletable economic interest in minerals in place, because the economic interest of the assignor is not severed or partially alienated by the assignment. Rather the assignor by the assignment creates and retains an entirely different economic interest, and the cash or property received as consideration for the assignment is depletable income paid in advance for oil to be produced, analogous to lease bonus.[77]

(4) Finally, without reference to the ownership of economic interests in minerals in place or to the lease-bonus analogy, the assignments of carved-out production payments in question were mere assignments of future income, because practical considerations are controlling and, as assignments of capital investment property, these assignments were too insubstantial[78] to qualify for capital gain treatment.

In the *Fleming* case, the Commissioner argued that no tax-free exchange occurred because:

(1) The assignments of the production payments were assignments of future income and not transfers of capital investment property.

77. The treatment of cash bonus paid for acquisition of a lease or sublease in which the assignor retains a continuing interest as income subject to the depletion deduction originated with Burnet v. Harmel, 287 U.S. 103 (1932), and became established by application in Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); and Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946). The theory is that the bonus is an advance royalty payment. See G.C.M. 22730, 1941-1 CUM. BULL. 214.

An interesting case in this area involving a reserved production payment is Frey v. United States, 159 F. Supp. 436 (N.D. Tex. 1957), in which a lessor, in addition to a royalty, reserved an oil payment coupled with an option to sell the oil payment for half of its face value to the lessee at a future date. After unsuccessful exploration had been conducted, the lessor exercised the option. The sales proceeds were held to be delayed lease bonus taxable as depletable income. The holding turned on the option to sell, but if there had been no option, the Commissioner would presumably have argued that there was a carving-out of the oil payment from a single reserved interest, so that the proceeds would have been depletable income to the lessor under the theory of G.C.M. 24849 and I.T. 4003, rather than under the theory of G.C.M. 22730.

78. In addition to the Fifth Circuit holding in the *Hawn* case, (231 F.2d 340, 346 (5th Cir. 1956)), the Commissioner relied on this argument in Helvering v. Clifford, 309 U.S. 331 (1940); Harrison v. Schaffner, 312 U.S. 579 (1941); Helvering v. Stuart, 317 U.S. 154 (1942); Commissioner v. Sunnen, 333 U.S. 591 (1948); and Commissioner v. Culbertson, 337 U.S. 733 (1949).

(2) The production payments were not property held for productive use in trade or business, because the production payments were newly created by the assignments and, therefore, the assignments did not qualify for capital gain treatment.

(3) If the assignments were transfers of oil, they were transfers of property held primarily for sale and thereby expressly excluded from the operation of Section 112(b) (1) of the 1939 Code.

(4) Finally, the carved-out oil payments were not property of a like kind to real estate. The Commissioner distinguished exchange of an oil payment for a leasehold or royalty interest as being an exchange of one mineral interest for another, and distinguished exchange of a royalty or leasehold interest for real estate as an exchange of one simple fee interest in real estate for another. An exchange of an oil payment for real estate, the Commissioner's argument concludes, is neither a like-exchange of mineral interests nor a like-exchange of simple fee interests in real estate.

D. *Position Adopted by the Supreme Court*

The opinion of the Supreme Court in the *Lake* cases, delivered by Justice Douglas, is quite short, and the scope of the Court's holding is therefore difficult to determine. The Court was apparently impressed by the lack of risk assumed by the assignees and the degree of certainty with which the pay-out of each production payment could be ascertained at the time of its assignment, and held "that the consideration received for these oil payment rights (and the sulphur payment) was taxable as ordinary income" on the theory that in each case "consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property."[79] Thus, in the view of the Court, no alienations of capital assets were involved in the assignments of production payments considered in the five *Lake* cases. Emphasis was placed on the practical effect of the assignments as transferring nothing more than what would otherwise have been depletable income of the assignors. No sweeping statement was made to the effect that the same result would follow any assignment of a carved-out production payment, but, on the other hand, no language was used to limit the holding to the precise facts of the five cases being decided.

79. 78 Sup. Ct. 691, 695 (U.S. 1958).

Of the arguments advanced by the Commissioner, it is impossible to say which were accepted; none were specifically rejected. The Court stated that it was proceeding on the assumption that the assignments conveyed interests in land, which might indicate that depletable economic interests in minerals in place had also been conveyed. The Court's emphasis on the absence of any assumption of risk by the assignee seems to deny the lease-bonus analogy, since a lessee of mineral property always assumes substantial risk. While the Court does not discuss the timing of the depletable income received by the taxpayers, its opinion specifically negates the Seventh Circuit's *Slagter* theory by holding that the consideration received for the assignment of the production payments, rather than the sales proceeds of production itself, was depletable income to the assignors. This differentiation, coupled with the absence of any remand of the cases, makes it clear that the income was received, in each case, in the year of assignment.

As to the *Fleming* case, the Court held that no tax-free exchange occurred, because the oil payments, being mere rights to future income, were not property of like kind with real estate within the meaning of Section 112(b)(1) of the 1939 Code.

IV. Implications of the Lake Decisions

A. *Carved-Out Production Payments*

1. *Sales and Exchanges*

a. *Developed Property*

The *Lake* decisions leave no room for doubt that ordinary income subject to depletion results to the assignor of a production payment carved out of a producing property, if the duration of the production payment is less than that of the property from which it is carved and the proceeds of the assignment are not pledged to development of the property. While the language of Justice Douglas' opinion in *Lake* is confined to the five cases then before the Court (in one of which an oil payment with an estimated ten-year pay-out period had been assigned), it seems unlikely that any different treatment will be given to sale or exchange of a carved-out production payment on the basis of a longer estimated pay-out period, unless the estimated period is sufficiently long so that the term of the production payment is coextensive with that of the interest from which it is carved or,

at the very least, with the productive life of the reservoir to which the production payment applies.[80] The Court's emphasis on the absence of risk to the *Lake* assignees certainly indicates that whenever ultimate satisfaction of a production payment right carved out of an interest of longer duration is assured by the estimated reserves, ordinary depletable income to the assignor will result. Sale of a carved-out production payment results in current depletable income equal to the sale proceeds; exchange of the same production payment results in current depletable income measured by the value of the property received by the assignor.

It seems clear that this rule does not conform to the legislative purposes of the capital gain provisions, and yet it is doubtful whether any judicially created rule would be more satisfactory. Three legislative purposes have been indicated in discussion of the capital gain provisions:[81]

(1) counterbalancing the heavier tax burden incurred by the taxpayer who otherwise "bunches" income in the year of sale of a capital asset that has appreciated in value over several years;

(2) promoting capital investment by potential purchasers of capital assets; and

(3) reducing the tax burden incurred upon sale of property sufficiently to balance, from a tax standpoint, the advantages of alienation with the advantages of retention for production of income, in order to avoid the freezing of appreciated property in the hands of its owners.

The validity of the first enumerated legislative purpose has been questioned;[82] but any of the purposes would be best served by some rule granting capital gain treatment to assignments for consideration of carved-out production payments the duration of which is sufficiently substantial relative to the estimated life of production from the property. Sale of any production payment that does not pay out within the same assignor's same taxable year will cause a bunching of profit which may result from the increase in value of the assignor's capital asset. If the payment

80. See discussion of the problem of co-extensive duration under Part IV-A-3 *infra*.

81. Note, 69 HARV. L. REV. 737 (1956).

82. *Id.* at 740.

period of a production payment is of sufficient length, relative to the estimated life of the property and projected market conditions in the industry, to impose substantial risk upon the assignee, then the assignment of the production payment to him is within the ambit of the legislative purpose of promoting capital investment. And if the pay-out period of a production payment is of sufficient length so that the increased tax burden incurred by the assignor in "bunching" future income would prevent his assigning the carved-out production payment, then assignment of the production payment is within the scope of the legislative purpose to avoid the freezing of property in the owner's hands.

Hence, it seems clear, from the viewpoint of legislative purpose, that some middle ground is preferable to the rule drawn from the *Lake* decisions. But, as previously stated, the "substantiality" doctrine of the *Hawn* case is too unpredictable to provide any safe basis for decision by a taxpayer to sell or not to sell. An arbitrary statutory rule of sufficient substantiality of life would perhaps provide the best solution of the problem.

b. *Undeveloped Property*

Substantial risk is assumed by the assignee of a carved-out oil payment applicable to undeveloped or "wild-cat" mineral property. This type of situation was presented in the *Ortiz* case, previously discussed. The consideration paid for the oil payment is much less than the face amount of the oil payment. There can be no accurate discount or other equivalent of interest payment to the assignee based on an estimated payout, because the eventuality of payout, or of any payment at all, is entirely speculative. The speculative factor may vary from one situation to another, but in any case where an oil payment is carved out of a property on which there is no well estimated to be capable of producing sufficient oil to satisfy the payment, the speculative factor is present, and roughly represented by the differential between the face value of the oil payment and the value of the consideration received for it by the assignor.

The *Lake* opinion, emphasizing the risk factor,[83] leaves room for treatment of the sale or exchange of an oil payment carved out of an undeveloped property as an alienation of a capital

83. 78 Sup. Ct. 691, 694, 695 (U.S. 1958).

asset. Substantial risk is conveyed to the assignee. The maximum limitation on his ultimate recovery is incidental to the substance of the transaction, which is distribution of capital risk. If the Court in *Lake* had adopted the Commissioner's analogy between the proceeds of sale of a carved-out oil payment and the cash bonus received by the lessor of a mineral lease, the risk element would not be decisive. The Court neither adopted nor specifically rejected the lease-bonus analogy, but its opinion relies heavily on the absence of risk to the assignees of the oil payments, and the resulting practical effect of the assignments as mere anticipation of income. It appears, therefore, that the lease-bonus analogy was by implication rejected.

Normally, however, sales proceeds of oil payments carved out of undeveloped property are used for development. By pledging the proceeds to development the transaction can be converted into a sharing arrangement so that no taxable event occurs.[84] It therefore seems unlikely that any test will be made of the effect of the *Lake* decisions on assignment for consideration of an oil payment carved out of undeveloped property.

c. *Sharing Arrangements*

In previous discussion of G. C. M. 22730, brief reference was made to the concept of the sharing arrangement. When an interest in a mineral property is taken in exchange for materials, services or money pledged to development of the same property, it is the position of the Service and of the courts that no taxable event has occurred. The consideration so pledged to development is regarded as an addition to the reservoir of invested capital so that the property of the assignor is not diminished by the assignment and the consideration is not, in effect, received by the assignor.[85]

G. C. M. 24849 and I. T. 4003 specifically excepted from their application consideration received for the assignment of carved-out production payments and pledged to development. Justice Douglas' opinion in the *Lake* case contains nothing to indicate

84. See discussion immediately following.

85. The sharing arrangement concept was recognized outside the area of oil and gas transactions in Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943). It was recognized in oil and gas transactions in Dearing v. Commissioner, 102 F.2d 91 (7th Cir. 1939); Rogan v. Blue Ridge Oil Co., 83 F.2d 420 (9th Cir. 1936), cert. denied, 299 U.S. 574 (1936); and Thompson v. Commissioner, 28 F.2d 247 (3d Cir. 1928). The Service recognized the validity of the concept in oil and gas transactions in G.C.M. 22730, 1941-1 CUM. BULL. 214.

that this exception has been affected by the *Lake* decisions, and in fact contains a footnote quotation of the relevant portion of I. T. 4003.[86] It seems safe to say, therefore, that a nontaxable sharing arrangement will still result from the assignment of a production payment for consideration pledged to development of the property out of which the production payment is carved.

d. *Time of Income*

The Commissioner's arguments before the Supreme Court relied heavily on the assignment-of-future-income cases,[87] and the decision of the Court cited three of them, primarily in support of the statement that the total effect, rather than the form, determined the tax effect of the production payment assignments under consideration. Under the assignment-of-income cases, the assigned income was held taxable to the assignor as such income arose subsequent to the date of assignment. In the *Slagter* case,[88] the Court of Appeals for the Seventh Circuit held similarly that the proceeds of sale of produced oil applicable to a carved-out oil payment were taxable to the assignor of the oil payment, as ordinary income subject to the depletion deductions, as such proceeds were received by the assignee of the oil payment. The Seventh Circuit imposed no tax on the proceeds of sale of the oil payment right itself, apparently regarding those proceeds as a loan to the assignor to be repaid out of production.

The Commissioner overcame the *Slagter* theory by the argument before the Supreme Court that the assignment-of-future-income cases involved donative assignments, and that the delay in taxing the donative assignor of future income is, as stated in *Helvering v. Horst*, "founded on administrative convenience" and "is only one of postponement of the tax to the final event of enjoyment of the income."[89] If future income is assigned for consideration, rather than gratuitously, the realization of the income is financial rather than economic, according to the Commissioner's argument, and the financial consideration received without restriction for the assignment of future income (the carved-out production payment) is itself taxable income in the year of receipt.

86. 78 Sup. Ct. 691, 695 (U.S. 1958).
87. E.g., Helvering v. Horst, 311 U.S. 112 (1940) ; Harrison v. Schaffner, 312 U.S. 579 (1941) ; Helvering v. Clifford, 309 U.S. 331 (1940).
88. Commissioner v. Slagter, 238 F.2d 901 (7th Cir. 1956).
89. 311 U.S. 112, 116 (1940).

No specific reference is made, in the Supreme Court's opinion, to the problem of the time at which income is received by the assignor of a carved-out production payment for consideration not pledged to development, but since the Court's holding imposed tax not on the proceeds of production, but on the consideration received for the assignments of production payments, it seems clear that the income was taxable in the year of assignment in each of the five cases.

e. *Problem of Double Depletion Deductions*

One of the arguments that has been used in opposition to the Service's position as to sales and exchanges of carved-out production payments is that it necessarily permits two deductions to be taken for the same depletion of reserves — one by the assignor of the oil payment and one by the assignee. In *Thomas v. Perkins,*[90] the Supreme Court held that more than one depletion deduction could not be taken for the production of the same oil. It has been suggested that the assignor alone is entitled to the depletion deduction on the consideration received for assignment of a production payment, and that the assignee recovers this amount by amortization and is entitled to take percentage depletion of the differential between this amount and the face amount of the production payment.[91] The Commissioner's argument that the assignees in the *Lake* cases did not receive economic interests in minerals in place involves the same reasoning, and points out that if such an economic interest were conveyed, the assignee would be entitled to take depletion only on the excess of the production payment proceeds over the consideration paid for them.

The *Lake* opinion does not specifically deal with the "double depletion" problem, but does specifically hold that the assignor of a carved-out production payment is entitled to take the deduction for depletion on the consideration received. The problem is unanswered as to precisely how and when the assignee recovers his capital investment. This might be through either cost depletion or amortization. Whether or not the assignee is entitled to a deduction for depletion on the excess of the oil payment over its

90. 301 U.S. 655 (1937).

91. See Benjamin, *Recent Developments in Field of Taxation Affecting Oil and Gas Transactions,* NINTH ANN. INST. ON OIL AND GAS LAW AND TAXATION, SOUTHWESTERN LEGAL FOUNDATION 549, 550 (1958), 32 TUL. L. REV. 607, 608 (1958).

cost to him is a question at present unanswered, as well as the question of the time at which this excess is received. But it seems clear that the production payment assignee should be entitled to a deduction for percentage depletion on this excess. The assignor's depletion deduction was only on the *discounted* value of minerals to be produced in the future and applied to the production payment. The discount differential represents the remainder of the value of the minerals when produced, as to which deductions for depletion should be available.

2. *Gratuitous Transfers*

Although the *Lake* opinion does not specifically deal with the tax effect of a gratuitous transfer of a carved-out production payment the duration of which is less than that of the interest out of which it is carved, there is no doubt that the Service's position will be maintained and that sales proceeds of production applicable to such production payments will be taxable as depletable ordinary income to the assignor. It must be assumed also that the assignor of a carved-out production payment to a charitable organization will be entitled to a charitable deduction each year during payout in an amount equal to the sales proceeds of production applicable to the assigned production payment, and will not be entitled to a charitable deduction in the year of the assignment for the value of the production payment at the time of assignment.

The legislation proposed in 1956 dealing with the carved-out production payment problem provided a different solution in the area of gratuitous transfers. Under H. R. 9559,[92] a rule similar to that taxing trust income to the grantor[93] would provide that carved-out production payment proceeds should be taxed to the donor of the production payment if the estimated pay-out were less than ten years in the case of a donation not to a charitable organization, or if the estimated pay-out were less than two years in the case of a donation to a charitable organization. Also, under H. R. 9559, a donation of a production payment to charity would give rise to no charitable deduction if the donor's reversionary interest therein was worth more than 5 per cent of the value of the donated property.[94] But the rule of

92. H.R. No. 9559, 84th Cong., 2d Sess. (1956).
93. INT. REV. CODE OF 1954, § 673(a),(b).
94. A new subsection (E) would have been added following § 170(b)(1)(D), which contains a similar provision as to deductions for charitable donations in trust.

the *Rudco* case,[95] taxing income from dividend production payments to the corporate assignor, was specifically reiterated in H. R. 9559.

3. *Problem of Coextensive Duration*

Neither the published rulings of the Internal Revenue Service nor the *Lake* opinion provide any certain test that can be applied to *all* carved-out production payments in order to determine whether the production payment is of sufficient duration to qualify as a capital asset for tax purposes. The conclusion of I. T. 4003, however, excludes from its scope assignments of production payments consisting of the assignor's entire depletable interest in the property or a fraction extending over the entire life of that interest. And, as previously stated, this exclusion was quoted in a footnote in the *Lake* opinion.

a. *"Vertically-Cut" and "Tail-End" Production Payments*

When one production payment is carved out of another and assigned either for consideration or gratuitously, and the production payment assigned is an undivided fraction extending over the entire life of the production payment from which it was carved, the assigned production payment is "vertically cut" and should certainly qualify as a capital asset. The same is true if the assigned portion is the "tail end" of the production payment from which it is carved. In either of these situations, gratuitous assignment of a carved-out production payment should result in depletable income to the assignee rather than to the assignor and recovery of capital and capital gain or loss should result from a sale or an exchange.[96] The *Lake* decisions do not, however, determine the conflict between the Tax Court and the Court of Appeals for the Fifth Circuit as to whether gain is recognized in an exchange of a "vertically-cut" or "tail-end" oil payment for an overriding royalty interest or a simple fee interest in real estate. The Supreme Court's holding as to the *Fleming* case was simply that *a right to future income* is not property of a like kind with real estate, while in the "vertically-cut" and "tail-end" production payment situations under discussion, no mere right to future income is involved.

95. Rudco Oil & Gas Co. v. United States, 82 F. Supp. 746 (Ct. Cls. 1949).

96. I.T. 4003, 1950-1 CUM. BULL. 10; 6 OIL & GAS TAX Q., No. 4, 231, 235, 236 (1957).

b. *Overriding Royalties and Production Payments the Duration of Which Exceeds the Estimated Life of the Reservoir*

The concluding paragraph of I. T. 4003, indicating that capital transaction treatment will continue to be given to assignments of carved-out production payments, whether gratuitous or for consideration, if the oil payment consists of the assignor's entire depletable interest or a fraction thereof extending over the entire life of that interest has been generally regarded as applicable not only to assignments of vertically-cut and tail-end production payments but also to overriding royalties and to production payments which, in substance, amount to overriding royalties because of unrealistic pay-out periods greater than the estimated life of the reserves from which the production payments must be satisfied.[97]

The Commissioner argued in the Fifth Circuit that an assignment of a production payment carved out of an operating interest can never qualify as an assignment of capital investment property, because no interest in the income-producing property or business (the operating interest) is conveyed.[98] This argument caused some concern in the industry, because it apparently rejected the concluding paragraph of I. T. 4003 with regard to production payments carved out of operating interests, such as mineral or leasehold interests, even though the estimated payout of the production payment might exceed the estimated life of the interest out of which the production payment was carved. Even more disturbing, the logical conclusion of this argument was that no capital asset would be conveyed by the assignment of any nonoperating interest, including an overriding royalty, carved out of an operating interest, even though the interest carved out be a continuing interest coterminous with the operating interest from which it is carved.[99]

Fortunately, the Commissioner abandoned this argument before the Supreme Court, and the *Lake* decisions involve no distinction between production payments carved out of operating and nonoperating interests. The status of a carved-out over-

97. The Internal Revenue Service has not, however, specifically ruled on this question. McClure, *Effect of Supreme Court Decision in Commissioner v. P. G. Lake et al. on Transfers of Production Payments*, 7 OIL & GAS TAX Q., No. 4, 245, 260 (1958).

98. See discussion under Part III-C *supra*.

99. Comment was made upon this possibility in 6 OIL & GAS TAX Q., No. 4, 231, 246 (1957).

riding royalty as a capital asset therefore is unaffected by the *Lake* decisions.

The status of carved-out production payments with estimated pay-out periods in excess of the estimated life of the reserves out of which the production payment must be satisfied is also unaffected by the *Lake* decisions. Regardless of *Lake*, however, it is unsafe to assume that assignment of such a carved-out production payment would be regarded as an alienation of a capital asset. New production could always extend the life of a leasehold interest beyond pay-out of any production payment; and a mineral interest or a royalty interest not dependent on a lease could acquire new value even after exhaustion (prior to pay-out of the carved-out production payment) of the reserves that were known at the time of the assignment. This possibility is increased in jurisdictions where there is no term limitation of mineral and royalty interests. The Service might well take the position that no production payment carved out of a continuing interest such as a mineral, leasehold or royalty interest can, at the time of assignment, be said to extend over the life of the interest from which it is carved, even though the then-estimated pay-out period of the production payment exceeds the then-estimated life of known reserves.

In the converse of this situation, the Service would probably take an entirely different position. When a continuing interest is assigned subject to a reserved overriding royalty, under the lease-bonus analogy the cash proceeds of sale are held to constitute ordinary income subject to depletion, on the theory that the cash payment is an advance payment for oil to be produced, and that there has been no alienation of a capital asset. When the only interest retained is a production payment with a pay-out period less than the life of the assigned continuing interest, on the other hand, a capital asset has been alienated and the cash consideration is taxed subject to the capital gain provisions.[100] A reserved production payment the pay-out period of which exceeds the estimated life of known reserves will almost certainly be regarded by the Service as the equivalent of a reserved overriding royalty in this situation, so that no alienation of a capital asset will be recognized and the cash sale proceeds will be taxed to the assignor as ordinary income subject to the deduction for depletion.[101]

100. See note 5 *supra*.
101. This problem in modified form is posed in 2 OIL & GAS TAX Q., No. 2,

c. *Assignment of Non-operating Oil Interest by Owner of Non-operating Oil and Gas Interest.*

When oil and gas are produced from the same property, the period of productivity of gas is normally greater in duration than the period of productivity of oil. Frequently no gas is produced, except for a quantity incidental to oil production, until oil reserves have been exhausted. This is uniformly the case in a field where gas recycling is utilized to maintain reservoir pressure. Thus, the owner of an oil and gas royalty by assigning an oil royalty has assigned an interest that is coextensive with the life of production of oil, but that, on the other hand, is shorter in duration than the interest from which it was carved (the oil and gas royalty) and shorter in duration than the interest retained (the gas payment). It is possible that in this situation the Commissioner might attempt to extend the anticipation of income doctrine, on the theory that the assignor has carved the assigned oil royalty out of a portion of the front end of his larger oil and gas royalty. Such an attempt would be ill-founded, however. The ultimate recovery from the assigned oil royalty could not possibly be estimated with any degree of certainty, as was the case with the *Lake* carved-out production payments. The assignee of the oil royalty would thus assume substantial risks of ownership. It seems clear that an oil royalty thus "carved-out" of an oil and gas royalty is a capital asset distinct from the reserved gas royalty. The assignor has assigned his entire economic interest in oil in place.

4. *Advantageous Uses of Carved-Out Production Payment Assignments Under the Lake Decisions*

Certain tax advantages are made possible by the power to control the timing of receipt of income by the carving out and assignment for consideration of oil payments under the anticipation-of-income theory adopted in the *Lake* cases. Anticipated irregularities of income in future years can be smoothed out by selling or exchanging oil payments, in years of low income, calculated to produce the desired reduction of income during otherwise high income years.

142, 143 (1953). The opinion there expressed was that even if the reserved production payment should contain a provision for reduction of the payment when reserves have been reduced below a certain point, the production payment would probably be regarded as a continuing interest.

In any year in which intangible development expenses exceed 45 per cent of the gross income from a property, so that the 50 per cent of net income limitation[102] on the deduction for percentage depletion prevents a deduction of the optimum 27½ per cent of gross income, net income from the property can be increased by sale or exchange of a carved-out production payment, the value of which should be calculated so that the consideration received will increase the net income from the property to 55 per cent of the gross income. Thus, the maximum deduction for percentage depletion can be made available.

This same result was obtainable in some situations even when assignments of carved-out oil payments were productive of capital gain rather than depletable income. By assignment of a carved-out production payment for consideration pledged to development,[103] intangible development expenses can be reduced, and net income correspondingly increased, during any given year so that none of the optimum 27½ per cent of gross income deductible under percentage depletion will be lost because of the limitation of percentage depletion to 50 per cent of net income from the property.

Any other deduction measured by income will, of course, be affected by an anticipation of income resulting from the sale or exchange of a carved-out oil payment. Thus the ceiling on the deduction for charitable contributions[104] and the threshold for the deduction for medical expenses[105] are both raised by such an assignment.

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102. INT. REV. CODE OF 1954, § 613(a). Under the 1939 Code, anticipation of depletable income by the assignment of a carved-out production payment would have been advantageous to an operator in a year in which he otherwise would have had a net operating loss, since anticipation of sufficient depletable income to avoid the net operating loss would permit the utilization of percentage depletion for all the operator's properties rather than the smaller cost depletion. See Benjamin, *Recent Developments in Field of Taxation Affecting Oil and Gas Transactions*, NINTH ANN. INST. ON OIL AND GAS LAW AND TAXATION, SOUTHWESTERN LEGAL FOUNDATION 549, 550, 551, 32 TUL. L. REV. 607, 608 (1958); Jackson, *Tax Planning Before Drilling: The Operator's Problem*, 1952 TULANE TAX INSTITUTE 175 (1953). *But cf.* 7 OIL & GAS TAX Q., No. 2, 94 (1958) (discussing 1954 Code).

Although an operator ordinarily need not capitalize the expenses of production allocable to royalties or production payments, the Service has indicated that the excess of production cost over the operator's net income from the property must be capitalized. See Welsch, *Acquiring Properties Through Oil Payments and Related Methods*, 32 TAXES 494 (1954). Assuming that the Service's position would be maintained, anticipation of income by the assignment of a production payment could avoid the necessity of capitalizing this excess in any given year.

103. See discussion of sharing arrangements under Part IV-B-A-1-c *supra.*

104. INT. REV. CODE OF 1954, § 170(b).

105. *Id.* § 213.

B. *Reserved Production Payments — ABC Transactions*

As previously indicated the assignment of a depletable mineral or royalty interest with a reservation of a production payment is regarded as the alienation of a capital asset unless the reserved production payment is, in substance, an overriding royalty. The consideration received is not taxable as ordinary income, but (after recovery of basis) as capital gain. The reserved production payment is a depletable economic interest in minerals in place, but is not a continuing interest, so that the lease-bonus analogy is not applicable. As indicated by the concluding paragraph of I. T. 4003 and by the Atlantic Refinery Company private ruling,[106] the Service admits that assignment of a production payment, or of an undivided fraction of a production payment extending over the entire life of the production payment, is an alienation of a capital asset unless the production payment is carved out of a longer-lived property by the assignor. This is true when the assignee of a carved-out production payment subsequently alienates it or an undivided fraction extending over its entire life; and it is true when the owner of a reserved production payment alienates it or an undivided fraction extending over its entire life.

The combination of reservation of a production payment in the sale of a property and sale of the reserved production payment is the basic framework of the *ABC* transaction.[107] *A* sells to *C*, reserving a production payment, and sells the reserved production payment to *B*. *A*'s entire interest in the property is thereby alienated for consideration taxable under the capital gain provisions.[108] The production payment proceeds are taxable to *B*, subject to cost depletion, rather than to *C*. *B*'s profit lies in the "spread" between the discount at which he purchases the production payment and the interest which he pays for a loan to finance the purchase. *C* would otherwise have had to borrow the difference between the cash price he pays and the total consideration to be received by *A*, and the income applicable to the production payment would then have been taxable to *C*, subject to the deduction for depletion; only the remainder after taxes would then have been available to repay the loan. Further,

106. See note 5 *supra*.

107. For discussion of the *ABC* transaction generally, see Welsch, *Acquiring Properties Through Oil Payments and Related Methods*, 32 TAXES 494 (1954).

108. Witherspoon v. United States, 8 Oil & Gas Rep. 139 (D.C. Tex. 1957); Atlantic Refining Co., Private Ruling dated May 15, 1956, 565 CCH ¶ 6608.

C is not liable for satisfaction of the production payment. Countless variations of the basic *ABC* framework, for the accomplishment of special purposes, are possible.[109]

1. *Loan Theory Repudiated*

The theory underlying the Seventh Circuit decision in the *Slagter* case,[110] discussed previously, was that the assignor of a carved-out production payment in substance receives a loan rather than ordinary income, and that the proceeds of the subsequent sales of production applicable to the carved-out production payment are taxable income to the assignor, subject to the deduction for depletion, since those proceeds in substance are the assignor's income, paid by him to the assignee in reduction of the loan.

The "loan" theory would have an extremely undesirable and disruptive impact if applied to reservations of production payments or to *ABC* transactions. If sale of a carved-out production payment resulted in a loan by the assignee to the assignor, extension of the same reasoning might indicate that reservation of a production payment in a sale or exchange of a continuing interest in a property could be regarded as a credit sale (with the equivalent of a loan by the assignor to the assignee), and that an *ABC* transaction could be regarded as a loan of purchase money by *B* to *C*. But the "loan" theory is basically unsupportable, because of the absence of a debtor or of any personal liability in an assignment of a carved-out production payment, in a reservation of a production payment and in an *ABC* transaction. The owner of the production payment in each of these three cases is not a creditor and can look only to his production payment right — an interest in real estate, as the Supreme Court recognized in *Lake* — for return of his investment.

Fortunately, in the *Lake* decisions the Supreme Court repudiated the "loan" theory adopted by the Seventh Circuit in *Slagter*, by the express holding that the consideration received for the assignment of each production payment in question was not a constructive loan to the assignor but depletable income.

109. See Welsch, *Acquiring Properties Through Oil Payments and Related Methods*, 32 TAXES 494 (1954).

110. *Commissioner v. Slagter*, discussed in text accompanying notes 46, 71, and 88 *supra*.

Thus, the *Lake* decisions have reinforced the position of the Service (in the Atlantic Refining Company ruling) and taxpayers alike with regard to reservations of oil payments and *ABC* transactions.

2. *Borderline Situations*

a. *Partially Reserved or Combination Production Payments*

If the assignor of a property receives as part of the consideration for the assignment a production payment payable out of a larger property, including the property assigned, the resulting production payment is neither entirely carved-out nor entirely reserved. Production payments of this character have been termed "combination" production payments.[111] It is generally thought that a combination production payment will be regarded by the Service as no different from a carved-out production payment.[112] Thus, if *X* owns a mineral, leasehold or royalty interest or a production payment covering tract A, and conveys that interest to *Y* in consideration for *Y*'s assignment to *X* of a production payment covering tracts A and B, with or without other consideration, according to the Service position *Y* has carved out the production payment assigned to *X*. Therefore the portion of the consideration received by *Y* that is allocable to the production payment is ordinary income to *Y* subject to the deduction for depletion. *X* has exchanged his interest in tract A for unlike property and, after recovery of basis, realizes capital gain calculated on the value of the production payment at the time he receives it plus any other consideration received. If the Commissioner's depletable-interest argument before the Supreme Court is correct, *X* acquires no depletable economic interest by his acquisition of the production payment, and must recover the portion of his capital investment allocable to the production payment by amortization deductions. However, since *Y* took percentage depletion only on the discounted value of the production payment at the time of assignment, *X* should be entitled to take percentage depletion on the excess of the proceeds of the production payment over the consideration paid for it, which is the allocable portion of the value of *X*'s interest in tract A at the time of assignment to *Y*.

111. See, e.g., Simon, *The Lake Cases*, 9 J. TAXATION 27 (1958).
112. This result was assumed by the Tax Court in Charles Burke, 5 T.C. 1167 (1945) and in John Vaccaro, 2 T.C.M. 820 (1943).

If *X* owns a production payment payable out of production from tract A and tract A is pooled or unitized with tract B or included in a pre-existing unit consisting of tract B by an order of a state conservation agency, and *X* thereby acquires an equal production payment payable out of the unit consisting of tracts A and B, the results outlined in the preceding paragraph would be difficult to justify. If, on the other hand, *X*'s leasehold or mineral interest or *X*'s royalty interest in tract A is compulsorily pooled or unitized with tract B, or included in a pre-existing unit consisting of tract B, *X* will not normally receive a production payment as consideration for such an interest. If the interest is an operating interest, however, *X* might receive a production payment payable out of the new unit as compensation for his well and equipment costs. In this case, it seems clear that the value of the production payment should, after recovery of basis in the well and equipment, constitute capital gain to *X*, while the owners of operating interests in tract B should receive ordinary income, subject to depletion, in amounts equal to the value of each of their acquired interests in the wells and equipment acquired from *X*. The questions raised by "combination" production payments, and by production payments assigned as a result of pooling and unitization, are numerous, complex and, for the most part, unanswered.[113]

113. The confusion that is current in this area is illustrated by the varying positions adopted by the taxpayer, the Commissioner, the Tax Court, and the Fifth Circuit in E. V. Whitwell, 28 T.C. 372, 7 Oil & Gas Rep. 673 (1957), rev'd in Whitwell v. Commissioner, 58-2 U.S.T.C. ¶ 9658 (5th Cir. 1957). Whitwell received an oil payment upon inclusion of his property into a pre-existing unit. The oil payment was supposedly to compensate him for the value of his wells and equipment. The oil payment was carved out of the revised unit including Whitwell's acreage. Whitwell contended that his oil payment was "boot" received in a like-kind exchange; the Commissioner contended that there had been an exchange, but that the oil payment proceeds received by Whitwell were nevertheless depletable income because received from an economic interest in oil in place; the Tax Court held that there had been no exchange, relying on Belridge Oil Co., 27 T.C. 1044 (1957) (appeal pending in Ninth Circuit); and in the Fifth Circuit Judge Hutcheson stated that the oil payment conveyed to Whitwell was no more than "a convenient arrangement to all concerned for the payment to [taxpayers] of their debt, and the return to them of their capital investment." Actually, under the Fifth Circuit's findings, it was unnecessary to decide whether the assignment to Whitwell had any different effect than a cash payment would have had. Unlike the Tax Court, the Fifth Circuit found that a payment made by Whitwell for his share of the cost of a recycling plant (owned by the owners of operating interests in the revised unit together with the owners of several other units) should be offset against the oil payment Whitwell received, so that Whitwell's net reimbursement was in an amount smaller than his adjusted basis in his capitalized wells. Therefore, it was immaterial whether Whitwell in substance received a true oil payment or its equivalent in cash. In either event Whitwell was recovering a part of his capital.

Although the Fifth Circuit stated in dictum that apparently no exchange took place, the court treated the *Whitwell* transaction as if there had in fact been an

b. *Identity of Interest Between A and C in ABC Transaction.*

It is understood that the Service is presently studying the situation in which the executor or administrator of an estate owning producing mineral properties performs the function of *A* in disposing of the properties by an *ABC* transaction in which the heirs or legatees fill the role of *C*. The objection to this transaction is that the heirs or legatees, who are the beneficial owners of the property, in effect are carving out the production payment assigned by *A*, the executor or administrator, to *B*.[114] The same objection, of course, will exist in situations where *A* is the trustee of a trust, the property forms part of the trust estate, and *C* is the beneficiary of the trust.

A similar objection will exist in situations where an *ABC* transaction is consummated and *A*, a corporation, is the alter ego of *C*, or *C*, a corporation, is the alter ego of *A*. And a similar objection might be made if *A* donated the property to *C*, or in trust for the benefit of *C*, reserving a production payment to be assigned to *B*. However, the identity of interest between a donor and his donee does not seem sufficient to justify a conclusion that, in the latter case, the donee has carved out the production payment.

c. *Reservation of Deferred and Stepped-Up Production Payments*

It is also understood that the Service is presently studying

exchange for tax purposes, with the Whitwells receiving property of a value less than their adjusted basis in their equipment and in their capitalized wells.

Despite the language of the Whitwell decision, caution dictates constant awareness of the existence of two taxable events: acquisition of the carved-out production payment by the assignor of wells and equipment in exchange for unlike property; and receipt of the sales proceeds of the oil applicable to the production payment. It seems clear that upon the exchange, the assignee of the production payment (i.e., the assignor of wells and equipment) should first recover his adjusted basis in the unlike property given in exchange for the production payment, and that if the value of the production payment at the time of assignment exceeds this basis, the assignee should realize capital gain on the excess. The assignee thus should acquire a new basis in the production payment, which in his hands is a capital asset, and should realize (a) ordinary income subject to cost depletion or amortization deductions upon receipt of sales proceeds of oil applicable to the production payment to the extent of his new basis, and (b) ordinary income subject to percentage depletion on any receipt of sales proceeds in excess of his new basis. For an earlier discussion of *Whitwell* and its complex facts and issues, see Benjamin, *Recent Developments in Field of Taxation Affecting Oil and Gas Transactions*, NINTH ANN. INST. ON OIL AND GAS LAW AND TAXATION, SOUTHWESTERN LEGAL FOUNDATION, 549, 580 *et seq.* (1958), 32 TUL. L. REV. 507, 626 (1958).

114. See McClure, *Effect of Supreme Court Decision in Commissioner v. P. G. Lake et al. on Transfers of Production Payments*, 7 OIL & GAS TAX Q., No. 4, 245, 258 (1958).

the situation where, in the assignment of a depletable property, the assignor reserves a deferred production payment or a production payment payable out of a percentage of production to be increased after a certain quantity of production or production proceeds have been applied to the production payment.[115] It is possible that the Service will take the position that, in effect, the assignor has constructively reserved an undeferred or non-stepped-up production payment and has carved out the front end or a fraction of the front end of his reserved production payment and assigned the constructively carved-out portion to the assignee of the property. Under this view, a portion of the consideration received by the assignor would have to be allotted to the elusive carved-out production payment, and the allocable portion would be taxable to the assignor as ordinary income subject to the deduction for depletion.

d. *Reservation of More Than One Production Payment*

It seems probable that if *A* sells a producing property to *C* and reserves two successive production payments, and subsequently sells the immediately effective production payment to *B*, the Service would regard the transaction as analogous to the situation previously discussed in which *A* reserved a deferred production payment. Here the Service position is much more easily comprehended, however. The sale of the immediately effective production payment would probably be regarded as a sale of a production payment carved out of the front end of a single, larger production payment reserved in the assignment to *C*. In *Witherspoon v. United States*,[116] the assignor in an *ABC* transaction retained two concurrently running production payments of different pay-out periods and immediately sold to *B* the production payment with the shorter pay-out period. The Commissioner failed to sustain his contention that *A*, the assignor taxpayer, had carved the shorter reserved production payment out of a portion of the front end of a single larger stepped-down production payment. This result seems justified, since no analogy can here be drawn to the constructive carving-out visualized in the reservation of a deferred production payment. It has been suggested that a transaction of the *Witherspoon* variety might be accomplished with less hazard if *A* sells the property to *B*, reserving the desired production payment (which ought not to be

115. *Id.* at 259.
116. See note 5 *supra*.

a deferred production payment) and *B* then sells to *C*, reserving a second production payment.[117]

V. Conclusion

The *Lake* decisions make it clear that the Internal Revenue Service has prevailed in its position that assignments of production payments carved out of longer-lived interests by the assignor are not alienations of capital assets, at least, as to developed or partially-developed property. Consideration received for such an assignment, if not pledged to development, is ordinary income subject to depletion. It seems clear that sales proceeds of minerals produced and received by a gratuitous assignee of such a production payment are depletable income to the assignor as received by the assignee, and that no charitable deduction can be taken for a donative assignment of such a production payment. Charitable deductions can, however, be taken for the sales proceeds of minerals taxed as income to the assignor but paid to the charitable donee of such a carved-out production payment.

It seems equally clear, on the other hand, that the Supreme Court, in rejecting the constructive loan theory advanced by the Seventh Circuit in *Slagter*, has destroyed the most serious threat to the presently accepted tax treatment of reserved production payment transactions and *ABC* transactions. In this respect, the *Lake* decisions should have a salutory effect on the industry.[118]

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117. Benjamin, *Recent Developments in Field of Taxation Affecting Oil and Gas Transactions*, Ninth Ann. Inst. on Oil and Gas Law and Taxation, Southwestern Legal Foundation 549, 554 (1958), 32 Tul. L. Rev. 507, 610 (1958).

118. It has been suggested that the Commissioner may attempt to draw an implication from *Lake* that would be not only unsound but extremely disadvantageous to the industry: that an assignment of an operating mineral or leasehold interest in which the assignor reserves a carried interest may be regarded as an assignment of an undivided fraction of the operating interest plus a carving out and assignment of an oil or production payment, since the assignee receives the proceeds of production of the carried interest for a period of time shorter than the life of the interest, i.e., until he recovers therefrom the cost of "carrying" the assignor's reserved interest through a stipulated stage of development. This recovery may or may not take the form of a production payment. See note 10 *supra*.

If the carrying party's recovery is not by means of a production payment, no reason appears to support the suggested theory. And even if the carrying party's recovery is via a production payment, the consideration received therefor by the assignor is development of the property, so that a sharing arrangement, rather than a taxable event, has taken place. Thus, in no event should the *Lake* decision affect carried interest transactions. Compare discussion of deferred production payments, Part III-B-2-a *supra*.

Until the right to an amount becomes accruable through fixation of the right to receive, the taxpayer is under no obligation to return it as income. Otherwise, he would be required to pay a tax on income which he might never have a right to receive.

—Johnson v. Commissioner, 233 F.2d 952, 56-2 USTC ¶ 9608—(4th Cir. 1950).

. . . we think it is sufficient to preclude a taxpayer from claiming refund, in relation to an executed settlement agreement, that the statute of limitations has run against the right of the Commissioner to deal with the situation further.

—Cain v. U.S., 255 F.2d 193, 58-1 USTC ¶ 9476—(8th Cir. 1950).