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FEDERAL TAXATION OF TRANSFERS OF OIL AND GAS LEASES

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The interest in land which is customarily acquired by an oil operator for the purpose of drilling for oil or gas is an oil and gas lease. In its usual form, the landowner grants to the operator for a primary term of years, normally five, the right to enter the property and drill for oil and gas. The operator's interest is called a working interest because he must conduct and pay for the development and operation of the property. An initial cash payment is made called a bonus or advanced royalty. The lease provides that if a well is not started within twelve months, an annual delay rental of a specified amount shall be paid, often one dollar per acre. Payment of each annual rental keeps the lease in force and carries with it the privilege of deferring drilling for another twelve months. If a producing well is not completed on the lease before the end of the primary term, the lease terminates. But if a producing well is secured, the lease remains in force so long as oil and gas are produced and the landowner begins to receive a royalty. This royalty is usually one-eighth of the gross proceeds from the sale of oil and gas produced from the lease and is paid to the landowner free of all expense except gross production or severance taxes.

The operator may decide not to keep the lease during its full life but may transfer it to another operator, either before or after production is secured. Both producing and nonproducing oil and gas leases are actively traded. This Article is concerned with the federal income tax consequences of transfers of oil and gas leases, by sale and by sublease.

DISPOSAL OF ENTIRE LEASE BY SALE

It is well established that the sale of an operator's entire interest in an oil and gas lease may qualify for capital-gain treatment under the provisions of the Internal Revenue Code. Transfers of oil and gas leases have repeatedly been declared to be sales by the courts. Thus, in *Helvering v. Elbe Oil Land Dev. Co.*,[1] the Court held that the transfer of the oil lease resulted in "an absolute sale of all the properties in question, including all the oil and gas in place." Again in *Anderson v. Helvering*,[2] the payments received as a result of the transfer of the lease were stated to be "payments received upon a sale." The court, in *Commissioner v. Fleming*,[3] said "a lessee's interest is everywhere regarded as vendible real property."

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1. 303 U.S. 372, 375 (1938).
2. 310 U.S. 404, 413 (1940).
3. 82 F.2d 324, 327 (5th Cir. 1936).

The Internal Revenue Service has recognized this principle in I.T. 3693,[4] in which it held that an oil and gas lease is real property used in a trade or business. It is thus subject to capital-gain treatment in accord with section 1231 of the Internal Revenue Code, which provides that if the lease has been held over six months, gain on the lease sale shall be netted with similar gains and losses and the net gain taxed as a capital gain; if held less than six months the gain is ordinary income.

Disposal of Part of a Lease by Sale

If the operator retains no interest in the part sold, a sale of a fractional interest in an oil and gas lease will be subject to the same capital-gain treatment as is given to a sale of the full lease interest. In *Commissioner v. Fleming*[5] it was stated that "the lessee may sell his lease or an interest in it and may thus realize income in the way of a profit on the sale." Sales of fractional working interests in oil and gas leases are of frequent occurrence. Thus, the operator may sell a one-half interest in his oil and gas lease to another operator and keep a one-half interest. Thereafter, the two operators will own the lease as tenants in common and will operate the property jointly under an operating agreement. Since the original owner retained no interest in the one-half interest sold, any profit which he made on the sale, measured by the excess of the sale price over the cost of the one-half interest sold, is subject to capital gain under section 1231.

Disposal of Lease with Oil Payment Retained

The operator may dispose of the lease by transferring the working interest but retaining an oil payment. An oil payment has been defined by the Supreme Court, in a footnote to *Commissioner v. Lake*[6] as "the right to a specified sum of money, payable out of a specified percentage of the oil or the proceeds received from the sale of such oil, if, as and when produced." Such proceeds are paid to the oil payment owner free of all expense except production taxes. An oil payment is recognized as an economic interest in the property, subject to depletion.[7]

It follows that when the operator sells the lease and retains an oil payment he has made a sale of a part of his lease and retained a part, just as he did when he sold one-half and retained the other half. He should therefore be entitled to report the profit on the part sold as capital gain; the courts so hold.[8] In computing the gain, the cost of the part sold is determined

4. I.T. 3693, 1944 Cum. Bull. 272.
5. 82 F.2d 324, 327 (5th Cir. 1936).
6. 356 U.S. 260, 261 n.1 (1958).
7. Thomas v. Perkins, 301 U.S. 655 (1937).
8. *E.g.*, Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936).

by dividing the total lease cost between the working interest sold and the oil payment retained in proportion to their relative values at the date of sale.[9]

Disposal of Lease with Royalty Retained

Instead of retaining an oil payment when he disposes of the working interest, the operator may retain a royalty. A royalty interest has been defined by the Supreme Court as "a right to receive a specified percentage of all oil and gas produced . . . during the entire term of the lease."[10] Royalties are of two kinds, those paid to the lessor from whom the lease was acquired, and those paid to a lessee who has transferred the lease. The first is called a landowner's royalty; the second an overriding royalty. Both royalties are paid to the holder thereof free of all expense except production tax, and the tax treatment of each is the same.

Since a royalty is one of the principal characteristics of an oil and gas lease, it has repeatedly been held that when an operator transfers his lease to another operator for development and retains an overriding royalty, he has made a sublease and not a sale. The cash payment received in connection with the transfer is treated as a bonus or advance royalty, subject to depletion. The cost of the lease is to be recovered through the depletion allowances, and the transaction is not subject to capital-gain treatment.[11]

Retention of Royalty With No Obligation to Develop

Although the courts are agreed that if an oil and gas lease is transferred for development, with a royalty retained, a sublease has been made, the result may be different if there is no requirement for development. Just as a royalty retention is evidence of a lease, so a lack of a development requirement is evidence of a sale. The courts have held that even though a royalty is retained, the transaction may still be a sale if the parties intended a sale. Great weight will be given to the intent of the parties.[12] Lack of a requirement for development is strong evidence that a sale was intended.

In *Helvering v. Elbe Oil Land Dev. Co.*[13] an oil property was sold for a present cash consideration, several deferred cash payments, and a share in the net profits, with no development required of the purchaser. A net profits interest is equivalent to a royalty.[14] The seller sought to have the

9. Columbia Oil & Gas Co. v. Commissioner, 118 F.2d 459 (5th Cir. 1941).
10. Commissioner v. Lake, 356 U.S. 260, 261 n.1 (1958).
11. Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25 (1946); Choate v. Commissioner, 324 U.S. 1 (1945); Palmer v. Bender, 287 U.S. 551 (1933); Cullen v. Commissioner, 118 F.2d 651 (5th Cir. 1941).
12. *E.g.*, West v. Commissioner, 150 F.2d 723 (5th Cir. 1945).
13. 303 U.S. 372 (1938).
14. Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25 (1946).

transfer classified as a sublease in order to get depletion on the deferred payments, but the Court refused to so classify it, stating:

> We agree with the conclusion of the Board of Tax Appeals that the contract between the respondent and the Honolulu Company provided for an absolute sale of all the properties in question, including all the oil and gas in place, and that respondent did not retain any interest or investment therein. . . . [N]either the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty, or a "bonus" in the nature of an advance royalty . . . .[15]

In *Arthur N. Trembly*[16] the taxpayer sold a sulphur property retaining a royalty but making no requirement for development. The Commissioner attempted to treat the transfer as a lease, but the court held it to be a sale, saying:

> This reservation of a royalty interest, while an attribute of a lease, is not controlling. As already pointed out, the essential prerequisite of a lease is that "its predominating purpose" is to secure the development of land for minerals. The record here shows the absence of such a purpose.[17]

A similar conclusion was reached in the case of *United States v. Paul White*.[18] There a transfer of a mineral property for cash with the retention of a ten per cent royalty, without requirement for development, was held to be a sale and not a lease. Again in *Maude W. Olinger*[19] the taxpayer sold iron ore properties for a cash consideration and an agreement for the payment of twenty-five cents per ton for all ore mined in excess of 800,000 tons. The Commissioner alleged that the transfer was a lease because of the retained royalty, but the court held it to be a sale. And in *Jeanette Ord Sager*[20] the taxpayer conveyed mineral rights for cash with a retained royalty. The Commissioner held the transfer to be a lease, but the court held it to be a sale; the mere retention of a royalty did not make the transfer a sale where, as in this case, no development was required of the transferee.

Another case resulting in the same holding is *Arthur E. Moreton*,[21] in which a transfer was made of a mining property for cash, with a reservation of a royalty on all minerals in excess of one million tons, with no obligation for development. The Commissioner treated this as a lease, but the court held

15. 303 U.S. at 375.
16. 17 P-H Tax Ct. Mem. 862 (1948).
17. *Id.* at 865.
18. 311 F.2d 399 (10th Cir. 1962).
19. 27 T.C. 93 (1956).
20. 32 P-H Tax Ct. Mem. (1963).
21. 21 P-H Tax Ct. Mem. 411 (1952).

it to be a sale. Also in *Commissioner v. Charles H. Remer*,[22] the taxpayer assigned mining properties for cash payments and an agreement to pay ten cents per ton for ore shipped, with no obligation for development. The court rejected the Commissioner's contention that this was a lease and determined that it was a sale.

Despite the decisions of the courts holding that the determination of whether a transfer is a lease or a sale shall be based on the intent of the parties and that lack of a requirement for development is strong evidence of a sale, the Commissioner has issued G.C.M. 27322.[23] This ruling states that regardless of whether or not development is required, the IRS will treat any transfer with a royalty retained as a sublease and not a sale. In view of the Commissioner's position, any operator who transfers a lease and retains a royalty can expect the IRS to treat the transfer as a lease. If he wishes to establish that the transaction is a sale he must do so in the courts. The operator can only have the transaction treated as a sale without litigation by retaining an oil payment instead of a royalty.

Retention of a Very Large Oil Payment

In the transfer of the lease the operator, instead of retaining an overriding royalty, may retain an oil payment so large that a reasonable oil man, at the date of the transaction, would say that it would not pay out, but would run for the full life of the property. In such a case the IRS will hold that the oil payment is equivalent to an overriding royalty and that the transaction is a sublease.

The Commissioner took this position in the case of *Howard Glenn*.[24] There the operator sold an oil property for 900,000 dollars in cash and retained an oil payment of 2,850,000 dollars to take effect after oil of a value of 900,000 dollars had been produced by the property. The Commissioner held that the transaction was a sublease, because the oil payment could run for the life of the property and was equivalent to a royalty. The court determined that the evidence showed that at the date of the transfer the parties believed that the oil payment would pay out and that such a belief was justified by the engineering reports. The transfer was therefore held to be a sale with an oil payment retained and not a sublease with a retained royalty. It should be noted that the court applied the well-established rule that the determination of whether the retained interest is an oil payment or a royalty must be made on the basis of the facts known or reasonably to be anticipated at the date

22. 260 F.2d 337 (8th Cir. 1958).
23. 1952-2 Cum. Bull. 62.
24. 39 T.C. 41 (1962).

of the transfer. Facts which did not become known until a later date cannot be used.[25]

In *United States v. Morgan*[26] the operator transferred an oil lease for cash and retained oil payments aggregating 10,000,000 dollars. The Commissioner contended that the oil payment was equivalent to a royalty because it would not pay out and hence the transfer was a sublease. The operator contended that there was no sublease, because the retention was of an oil payment and not of a royalty. The circuit court remanded for a determination of whether, based on the facts known at the date of transfer, there were reasonable grounds for believing that the oil payment would pay out before abandonment of the oil property. If there were, then there was a retained oil payment; if there were not, then the retention was a royalty and the transaction was a sublease.

The treatment of the transfer as a sale and not as a sublease can be assured, where there is doubt that the retained oil payment will pay out, by inserting a special provision in the oil payment instrument. This should provide that unless the oil payment pays out sooner, it will cease on a date which will occur before the abandonment of the properties, such as when the wells have declined to a specified production per day or when the remaining oil reserves in the property have declined to a stated number of barrels.

EXPENSES OF TRANSFER

When an operator makes an outright sale of all or a part of an oil and gas lease, commissions paid and other sales expenses are to be deducted from the selling price.[27] Likewise, when the property is sold with an oil payment retained all selling expenses are to be deducted from the selling price of the part sold since the oil payment has merely been retained and is not a part of the sale.[28]

A different situation exists when the transfer is classed as a sublease because an overriding royalty has been retained. In such a transaction the IRS would hold that all selling expenses must be capitalized as a cost of the sublease to be recovered through the depletion allowances. This action is based upon two Tax Court decisions.

In *L. S. Munger*[29] a landowner leased his land for oil and gas and in connection therewith paid a broker 4,000 dollars commission for securing the lease. The court, relying on decisions involving real-estate leases,[30]

25. Buena Vista Land & Dev. Co., 19 B.T.A. 895 (1928) ; J. J. Gray, 2 B.T.A. 672 (1925).
26. 63-2 U.S. Tax. Cas. 9653 (5th Cir. 1963).
27. E. A. Griffin, 19 B.T.A. 1243 (1930).
28. Mortimer Kline v. Commissioner, 268 F.2d 854 (9th Cir. 1959).
29. 14 T.C. 1236 (1950).
30. *E.g.*, Bonwit Teller & Co. v. Commissioner, 53 F.2d 381 (2d Cir. 1931).

held that the commission must be capitalized and recovered through depletion. In *Dorothy Cockburn*[31] an operator subleased an oil property and paid a commission of some 15,000 dollars to a broker for securing the sublease together with other expenses. The court, again relying on the real-estate-lease cases, held that the expenses must be capitalized and recovered through depletion allowances.

A fundamental difference should be noted between the result of capitalizing commissions on a real-estate-lease transaction and an oil-lease transaction. In the case of the real estate lease the capitalized commission is amortized over the life of the lease. But with the oil lease the court requires the recovery to be by depletion. In most cases percentage depletion of twenty-seven and one-half per cent[32] of the amount received is allowable on lease bonuses, and this is the amount allowed whether or not a commission has been paid. Thus, the oil-lease operator gets no additional deduction because of the commission. A real-estate operator gets to deduct his commission over the life of his lease; an oil-lease operator gets no deduction for the commission.

In *Naylor v. Dunlap*[33] a district court disagreed with the Tax Court and allowed commissions paid as a deduction. There the operator transferred leases with the retention of overriding royalties and paid a commission to a broker for securing the subleases, together with other expenses. The court allowed the expenses to be deducted as an ordinary and necessary expense. This case was not appealed by the Government. The case was later considered by the Fifth Circuit in *Cowden v. Commissioner,*[34] with respect to the allowance of stamp taxes as a deduction. It was held that stamp taxes were not deductible but the deductibility of the commissions paid was not passed upon by the court of appeals.

In view of the direct conflict between the decisions of the Tax Court and the decision of the district court, and the fact that the court of appeals has not yet ruled on the question, it cannot be said that it has been settled that commissions on sales of oil and gas leases with retained overriding royalties must be capitalized.

It is submitted that if the commission is not deductible as an expense, then it should not be capitalized but should instead be excluded from the bonus income received. The courts have held that when an oil and gas lease is transferred with a retained royalty, the bonus received is an advance royalty.[35]

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31. 16 T.C. 775 (1951).
32. INT. REV. CODE of 1954, § 613(b).
33. 49-2 U.S. Tax Cas. 9446 (N.D. Tex. 1949).
34. 289 F.2d 20 (5th Cir. 1961).
35. Herring v. Commissioner, 293 U.S. 322 (1934); Hogan v. Commissioner, 141 F.2d 92 (5th Cir. 1944).

It has also been held that when a taxpayer has acquired a right to share in the proceeds derived from oil, he has an economic interest therein.[36] Oil income belonging to a economic interest is to be reported by the owner of that interest and is to be excluded from the income of the owners of the remainder of the lease.[37]

In a typical subleasing transaction the purchaser of the lease agrees to pay a bonus or advance royalty. The operator agrees that the broker shall receive a part of this bonus. The operator thus does not pay a commission in the usual sense, but agrees that the broker shall share in the advance royalty paid for the sublease. The broker thus has an economic interest in this advance royalty and should report his share as income and take depletion on it. The broker's share should then be deducted from the total bonus and only the balance included in the operator's depletable income. This method of treating the commission does substantial justice to both the operator and the Government and is applicable in all cases where the bonus exceeds the commission. In the rare case where the bonus is less, the excess, if not deductible as an expense, as determined by the district court, would be capitalized to be returned as depletion, as held by the Tax Court.

CONCLUSION

In this Article the different tax treatment accorded to sales of oil and gas leases and to subleases of oil and gas leases has been set out. It has been shown that subleases get less favorable treatment. Sales proceeds are subject to capital gain and sales expenses are deductible. Sublease proceeds are taxed as ordinary income subject to depletion, and selling expenses must be capitalized. The operator can control the tax consequences by choosing the form of his transaction. If he wishes it taxed as a sale, he should retain an oil payment instead of a royalty.

36. Palmer v. Bender, 287 U.S. 551 (1933).
37. Thomas v. Perkins, 301 U.S. 655 (1937).