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Freede v. Commissioner: Closing a Loophole Caused by Closing a Loophole

Gregory R. Schaaf
University of Kentucky

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Freede V. Commissioner: Closing a Loophole Caused by Closing a Loophole

INTRODUCTION

Congress established personal income taxes nearly 80 years ago.[1] Since then, taxpayers have sought ways to avoid paying taxes.[2] In response, the Internal Revenue Service (IRS) and Congress have tried continually to plug holes in the Code discovered by innovative taxpayers.[3] The IRS and the taxpayers frequently wage battles in the courtroom.[4] The IRS attempts to convince courts the legislature intended one side while the taxpayers try to prove the opposite. Many times the taxpayers' battle is futile, but in other cases, like *Freede v. Commissioner*,[5] the taxpayers appear to hold the winning hand.

Unfortunately, the holding of *Freede* teaches a painful lesson to all taxpayers. Freede won the battle in the Tax Court,[6] but he lost the war in the court of appeals.[7] Freede thought he had found a loophole that would allow him to defer his income to a future period.[8] However, when a cash basis taxpayer tries to

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[1] "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

[2] *See* Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir. 1941), *cert. denied*, 331 U.S. 859 (1947) (L. Hand, J., dissenting) ("[N]obody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions."); Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *cert. granted*, 293 U.S. 538 (1934), *aff'd*, 293 U.S. 465 (1935) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.").

[3] *See* P. Dooher, Section 448: *New Limitations on the Use of the Cash Method of Accounting*, 28 Tax Mgt. Memorandum 203-08 (August 17, 1987) (available on WL, TM-TMM database); Rustigan, *Important New or Changed Doctrine Emerging from Recent Tax Shelter Cases*, 64 TAXES 814-23 (Dec. 1986).

[4] *See* cases cited *supra* note 2.

[5] 864 F.2d 671 (10th Cir. 1988), *cert. denied*, 110 S.Ct. 52 (1989).

[6] Freede v. Comm'r, 86 T.C. 340 (1986), *rev'd*, 864 F.2d 671 (10th Cir. 1988), *cert. denied*, 110 S.Ct. 52 (1989).

[7] *Freede*, 864 F.2d at 672-73.

[8] *Id.*

create a loophole by using a statute enacted to close a loophole, the IRS reacts. This comment discusses the decision by the Tenth Circuit Court of Appeals[9] reversing a Tax Court decision which appeared to properly interpret the applicable law. The comment does not suggest the Tenth Circuit was wrong. Instead, the paper suggests that other issues outside of a strict statutory interpretation played a significant part in the reversal.

I. *FREEDE V. COMMISSIONER*

The taxpayers in *Freede v. Commissioner*[10] were part owners of several operating leases who contracted with Oklahoma Gas & Electric (OG&E) under a take-or-pay agreement.[11] The minimum provisions of the take-or-pay contracts required OG&E to pay for 80% of the gas produced from the wells.[12] OG&E had the power to recoup any deficiency between the gas taken and the minimum during the remaining years of the contract.[13] OG&E also could compel production equal to 100% of the wells' capacity to recover the deficiency.[14] OG&E paid for, but did not take, the minimum quantity of oil for 1979, the year at issue.[15]

Freede contended the contract deficiency was a carved out production payment[16] and should be treated as a mortgage loan for tax purposes under section 636(a) of the Internal Revenue Code.[17] Freede determined that OG&E had carved out a production payment in the form of a deficiency subject to recoupment in the remaining years of the contract. Stated another way, OG&E had made a loan to Freede which would be repaid in

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[9] *See infra* notes 44-50, 54-62 and accompanying text.

[10] *Freede*, 86 T.C. 340. This case consolidates the cases of taxpayers Freede, docket No. 16339-82, and Folsom, docket No. 20768-82, investors in the leases under review. Taxpayers' wives are also involved because they filed joint returns. [Hereinafter, references to the petitioners will either be to Freede or taxpayer.].

[11] *Freede*, 86 T.C. at 342.

[12] *Id.*

[13] *Id.* at 343.

[14] *Id.*

[15] *Id.*

[16] *See* [1990] 7 Stand. Fed. Tax Rep. (CCH) 3597.001 ("A carved-out production payment is one in which the person who creates the payment (Freede) retains the mineral property while transferring the production payment [to another] (OG&E).").

[17] 26 U.S.C. § 636(a) (1982) states in pertinent part:

> A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property.

future years when OG&E recaptured the minimum payment deficiencies accrued in prior years.[18] Based on section 636(a) of the Internal Revenue Code, Freede believed he had deferred the income to a later year.[19]

This treatment would benefit Freede by deferring the tax on the income to a later period.[20] Deferring income is the purpose behind section 636(a).[21] Congress enacted the statute to reduce the inequities allowed by the calculation of depletion for mineral owners.[22] Depletion is calculated based on a percentage of in-

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[18] *See* Treas. Reg. § 1.636-1(a)(1)(ii) (1973) which states:

> The payer of a production payment treated as a loan pursuant to this section shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income and "gross income from the property" (see section 613(a)) for the taxable year so applied. The payee shall include in his gross income (but not "gross income from the property") amounts received with respect to such production payment to the extent that such amounts would be includible in gross income if such production payment were a loan. The payer and payee shall determine their allowable deductions as if such production payment were a loan.

[19] *Freede*, 86 T.C. at 346. Freede is a cash basis taxpayer who would otherwise have to recognize income in the period received under 26 U.S.C. § 451(a) (1982) which provides: "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless* under the method of accounting used in computing taxable income, *such amount is to be properly accounted for as of a different period*." (Emphasis added).

[20] *Freede*, 86 T.C. at 346.

[21] S. REP. No. 552, 1969-3 C.B. 423, 538.

[22] Inequities include taxpayers avoiding limitations based on taxable income and the ability to pay off what is essentially a loan on pre-tax dollars. *See id.* at 539-40. The report gives the following example of the benefits received by oil and gas investors over other taxpayers:

> Assume that *A* sells an operating business to *B*-the business may be an oil well, or it may be an apartment building. However, assume that *A* retains the right to a production payment-a payment equivalent to the current price of a specified number of barrels of oil-or in the case of the apartment building, a mortgage, which is not much different from the production payment. Then suppose that *A* sells the production payment or mortgage to *C*.
>
> However the similarity between the oil well and the apartment building ends here. In the case of the apartment building, all of the rental income after ordinary expenses and depreciation is taxable income to *B* and he must pay off the mortgage out of "after tax" dollars. In the case of the oil well, however, *B* is not considered as receiving the production payment at all -which, in the typical case, may well amount to as much as 90 percent of the income from the well. Thus, in this case *B* is, in effect, paying the production payment out of "before-tax dollars." This privilege of purchasing capital interests out of tax-free income is not a privilege accorded ordinary taxpayers. At the same time (until recently in the *Brooks*

come during the year.[23] Mineral owners were abusing the depletion policy by recognizing income as quickly as possible to generate a higher deduction.[24] Section 636(a) corrects this manipulation by treating income, satisfying the criteria of a production payment, as a mortgage loan. The result: a producer's depletion is more closely matched to the actual production of income.[25] Unfortunately for Freede, the IRS did not like his attempt to use a loophole in a statute which had been enacted to close a loophole.

II. THE COURT OF APPEALS' DECISION

A. The Economic Interest Concept

The *Freede* controversy centered around the creation by OG&E of an economic interest in the unremoved minerals.[26] The

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> case), *B*, in the case of the oil well, claims the right to take the operating expenses for the entire well against his share of the income with the result he is likely to have hardly any taxes to pay while he is acquiring a full interest in the oil well.
>
> At the same time *B* is paying little or no tax in the case of the oil well, *C*, who is receiving the production payment is receiving cost depletion on this payment. Thus, he is amortizing his entire cost over the period he receives his payments.
>
> The *C* who has the mortgage on the apartment house fares no better than his counterpart with the production payment despite the special advantages of the *B* with the oil well. The *C* with the mortgage can spread his cost over the period of the mortgage, but presumably, any excess he receives is interest income and therefore ordinary income.
>
> The crucial difference between the *A-B-C* transaction in oil and the mortgage for the apartment, therefore, lies in the treatment of *B* and the fact that in the *A-B-C* transaction *B* can amortize *C*'s capital interest out of tax-free dollars rather than the "after-tax dollars" he must use in the apartment case.

Id.; *see also* Brountas v. Comm'r, 692 F.2d 152, 155-56 (1st Cir. 1982), *cert. denied*, 462 U.S. 1106 (1983) (discussed *infra* at text accompanying notes 86-97).

[23] 26 U.S.C. § 611 (1982) allows a deduction for depletion per the calculation in Treas. Reg. § 1.611-2(a) (1960). The calculation can be stated by the following formula:

$B = [s/(u+s)]$, where

B = the adjusted basis of the property; u = units of oil or gas remaining at the end of the tax year; and s = units of oil or gas sold in the tax year.

H. WILLIAMS & C. MEYERS, 8 OIL & GAS LAW MANUAL OF TERMS 236 (1988).

[24] S. REP. No. 552, *supra* note 21, at 540.

[25] *Id.*

[26] *Freede*, 86 T.C. at 347; *Freede*, 864 F.2d at 673. Both courts recognized Treas. Reg. § 1.636-3(a)(1) (1973), requiring that five criteria be satisfied before the transaction is categorized as a production payment. The Tax Court found all five were satisfied and

Tax Court believed the rights and obligations of the contract between the taxpayer and OG&E created an economic interest in the minerals in place.[27] In *Palmer v. Bender*,[28] the United States Supreme Court set forth a two-pronged definition of the economic interest concept. The two prongs are:

> (1) There must be an interest, acquired by a capital investment, in the minerals in place.
> (2) The return on the investment must be realized solely from the extraction of the minerals.[29]

The Tax Court in *Freede* determined an economic interest existed due to OG&E's liability to pay for 80% of production, the right of recoupment and the ability to control production under the contract.[30]

The court of appeals did not agree with the analysis of the Tax Court.[31] The court of appeals listed five factors that must be satisfied before the first prong of the *Palmer* test is fulfilled.[32] The five factors are: (1) the degree of legal interest in the minerals;[33] (2) whether there is significant control over the mineral deposits;[34] (3) the extent of contribution to the development or operation of the mineral extraction;[35] (4) the risk of loss;[36] and (5) whether the interest is necessarily depleted as the mineral

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the Commissioner only challenged the Tax Court's economic interest conclusion in the appeal. The four factors that are not contested are: (1) OG&E must have a right to a specified share of gas production; (2) the right must have a specified economic life (at the time of its creation) of less than the economic life of the mineral property which it burdens; (3) the right cannot be satisfied by other than the production of gas from the burdened mineral property; and (4) the right must be limited by either a dollar amount, a quantum of mineral, or a period of time. *Id.*

[27] *Freede*, 86 T.C. at 353.

[28] 287 U.S. 551, 557 (1933).

[29] *Freede*, 864 F.2d at 674; *see also* Comm'r v. Southwest Exploration Co., 350 U.S. 308, 314 (1956); Rissler & McMurry Co. v. United States, 480 F.2d 684, 686 (10th Cir. 1973). This standard can also be found in Treas. Reg. § 1.611-1(16) (1973).

[30] *Freede*, 86 T.C. at 350.

[31] *Freede*, 864 F.2d at 674.

[32] *Id.*

[33] *See, e.g.*, Tidewater Oil Co. v. United States, 339 F.2d 633, 637 (Ct. Cl. 1964) (*quoting* Sneed, *The Economic Interest - An Expanding Concept*, 35 TEX. L. REV. 307, 355 (1957)) (legal interest, control, and extent of contribution are weighed in determining the interest in the minerals in place).

[34] *Id.*

[35] *Id.*

[36] *See, e.g.*, Marathon Oil Co. v. Comm'r, 838 F.2d 1114, 1125 (10th Cir. 1987) (in form over substance test, the party who bears the risk is entitled to deduction).

is extracted.[37] The court of appeals established that OG&E had significant control from the contractual rights. However, the control was "in the nature of a buyer's contractual rights, rather than as a producer of the gas."[38] The fourth factor, a risk of loss, was also found to exist based on the rights and obligations established under the contract as discussed by the Tax Court.[39] However, the appellate court felt the remaining three factors had not been satisfied.

B. *Legal Title and Take-or-Pay Provisions*

The court of appeals took special interest in the legal title to the land. The legal title to the land would have specific consequences to the legal interest question and to the extent of the contribution to the mineral extraction. Although *Palmer* had held that legal title was unimportant,[40] the court took note that only one case since *Palmer*, *Commissioner v. Southwest Exploration Co.*,[41] had recognized an economic interest without a fee interest.[42] In *Southwest Exploration Co.*, the property owner of land adjacent to the mineral-bearing property had an economic interest because the only way to extract the mineral was through the property owner's land.[43]

In the instant case, the court of appeals considered the absence of a fee interest significant and critical to the decision. Also, the lack of interest showed that OG&E had not made a contribution to the operation or development of the extraction of the minerals.[44] However, a closer look at the origin of take-or-pay contracts supports a finding that OG&E had an interest in the minerals in place and was an integral factor in the extraction of the minerals.

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[37] *See, e.g.* Kirby Petroleum v. Comm'r, 326 U.S. 599, 603 (1946) (because capital investment is decreased as mineral is removed, taxpayer is entitled to depletion deduction).

[38] *Freede*, 864 F.2d at 675.

[39] *Id.* at 676.

[40] *Palmer*, 287 U.S. at 557; *see also* Kirby Petroleum Co., 326 U.S. at 603 ("The technical title to the [mineral] in place is not important.").

[41] 350 U.S. 308 (1956).

[42] *Freede*, 864 F.2d at 674-75. *But see Tidewater Oil Co.*, 339 F.2d at 638 ("[*Southwest*] can best be explained on the grounds that the granting of discovery depletion in that case served the purposes for which the allowance was created.").

[43] *Southwest Exploration Co.*, 350 U.S. at 315-16.

[44] *Freede*, 864 F.2d at 674-75.

One issue not discussed by the court of appeals was the importance of the take-or-pay clause[45] to the transaction. Producers began using take-or-pay provisions to shift the risk of decreases in demand from producers to purchasers. Previously, gas contracts locked producers into contracts to supply single purchasers. When demand decreased, the purchasers would discontinue buying gas.[46] The producers were left with no source of revenues since they could not sell the oil to other purchasers without violating their contracts.[47] The take-or-pay provision required the purchasers to acquire a legal interest in the mineral and provide the necessary resources that would allow producers to survive a downturn in demand.[48] Compare this to the situation in *Southwest*, where the taxpayer had "an interest acquired by a capital investment, in the minerals in place."[49]

The transaction in *Southwest* created an economic interest because the property owner was essential to the extraction of the minerals.[50] Similarly, the purchasers' commitment of capital through the take-or-pay agreement was essential to continued production by the producer. Without the capital outlay, the smaller producers would surely have gone under and purchasers would lose their continuous supply of oil. The Court in *Southwest* said, "[t]he tax law deals in economic realities, not legal abstractions, and upon closer analysis, it becomes clear that [the lack of a legal interest does] not preclude an economic interest."[51] The economic realities that created take-or-pay provisions show that an economic interest did exist in the transaction between Freede and OG&E.

In addition, the interest was created by an investment. Webster's Third New International Dictionary describes an investment as "an expenditure of money for income or profit or to purchase

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[45] A good general discussion of take-or-pay provisions can be found in H. WILLIAMS, 4 OIL & GAS LAW § 724.5 (1989). *See also* Watson, *Take or Pay Provisions in Producer Gas Sales Contracts*, ROCKY MTN. MIN. L. INST. ON OIL & GAS AGREEMENTS Paper No. 11 (1983).

[46] Medina, McKenzie & Daniel, *Take or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 ARK. L. REV. 185, 190-91 (1987).

[47] *Id.*

[48] *Id.*

[49] *Southwest Exploration Co.*, 350 U.S. at 316-17.

[50] *Id.*

[51] *Id.* at 315.

something of intrinsic value; capital outlay."[52] The transaction clearly fits this definition because OG&E supplied cash up front for a return in subsequent periods. By investing in the production of gas through the take-or-pay agreement, OG&E ensured a continuous supply of gas for twenty years. The economic reality is that OG&E clearly had an interest through investment in the minerals in place.[53]

C. *Depletion of Economic Interest Through Mineral Extraction*

The first prong's fifth factor of the *Palmer* test, *i.e.*, whether the interest is necessarily depleted as the mineral is extracted, also merits consideration.[54] The court stated, "[o]nly if OG&E takes more than the minimum quantity in a given year and elects to use the excess to reduce its right of recoupment will its recoupment right be diminished by production."[55] But, consider what occurs after the tenth year if OG&E's deficiency for the past ten years has been equal to or greater than 25% of the minimum. Since OG&E can only compel 25% additional production per year, up to 100% production from the well,[56] after the eleventh year OG&E will have lost the ability to recoup part of its investment.[57] Thus, the fifth prong could be satisfied, suggesting this contract does give OG&E more than a mere economic advantage.

D. *The Second Prong—Return on Investment*

The court of appeals spent considerable time on the first prong of *Palmer*, discussing whether there was an interest, acquired by a capital investment, in the minerals in place. The

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[52] WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1190 (1986). An intrinsic value is defined as something desired for its own sake without regard to anything else. *Id.* at 1186. Although legal definitions do not always comply with common meanings, courts generally begin a review of terms with their common meanings.

[53] *See supra* notes 17-18 and accompanying text.

[54] *See supra* notes 28-37 and text at Section II.

[55] *Freede*, 864 F.2d at 676.

[56] *Freede*, 86 T.C. at 341 (If required, "the seller was obligated to maintain deliverability of 125 percent of the minimum contract quantity.").

[57] This assumes equal production over the twenty year period. If a twenty-five percent deficiency occurs in year eleven, after ten years of deficiencies at twenty-five percent or more, the wells can only produce and return twenty-five percent over nine years. Thus, OG&E will have lost two years at twenty-five percent from the recoupment interest.

discussion was ultimately unnecessary, however, because the court found the interest failed the second prong.[58] The court did not find that OG&E's return on investment had come solely from the extraction of the minerals. The court, following *Helvering v. Bankline Co.*,[59] determined OG&E's contract merely established an economic advantage.[60] This conclusion closely coincides with the fifth factor under the first prong, *i.e.*, whether OG&E's recoupment interest was reduced as gas was extracted.[61]

The *Bankline* Court distinguished a contractual advantage from a capital investment. The Court in *Bankline* stated, "[t]he phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital interest in the mineral deposit."[62] In *Bankline*, a processor contracted with well owners to extract and sell gasoline from the wellheads. The producer would then pay the owners a share of the sales proceeds. The Court held that the producer had only acquired an economic advantage and not an economic interest.[63] The producer had no interest in the minerals in place.[64]

The court of appeals in *Freede* found that OG&E's relationship was analogous to a customer paying for gas.[65] The court reiterated the position discussed during its review of the first prong, that there was no legal interest created and that OG&E played no part in the extraction of the minerals.[66] However, the same discussion regarding the nature of take-or-pay provisions shows this situation differed from *Bankline*.[67] OG&E had more than an economic advantage. The production payment existed only to the extent of the deficiency and the deficiency is the property in which OG&E has established a legal interest. After investing in a continuing supply of gas, OG&E could recover this interest only by taking gas in subsequent years. OG&E had legal interest in the minerals that were left for future years under

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[58] *Freede*, 864 F.2d at 676-77.
[59] 303 U.S. 362 (1938).
[60] *Id.*
[61] *See supra* note 37 and text at Section II C.
[62] *Bankline*, 303 U.S. at 367; *see also* Thomas v. Perkins, 301 U.S. 655, 661 (1937).
[63] *Bankline*, 303 U.S. at 367.
[64] *Id.*
[65] *Freede*, 864 F.2d at 676.
[66] *Id.* at 676-77; *see supra* note 32 and accompanying text.
[67] *See supra* notes 44-50 and accompanying text.

the take-or-pay agreement. Without this agreement, Freede could not continue production of the gas and OG&E would be without a steady supply.

III. CLOSING LOOPHOLES

A. *The Purpose Behind Section 636*

An appellate court will reverse a finding of law when the court believes a mistake in application of the law has been made.[68] The court of appeals in *Freede* believed the Tax Court misapplied the economic interest concept. The discussion thus far should raise a question as to why the court found a lack of an economic interest. Freede merely followed the stated purpose and direction of the law, so why was his deduction disallowed? The dissenting opinion in the tax court is one important factor not mentioned by the court of appeals.[69] The dissent recognized the purpose behind section 636 and declared, "I do not believe, however, that by taking this step to close one loophole Congress intended to open another."[70]

Section 636 was enacted in large part in response to the decision in *Comm'r v. P.G. Lake, Inc.*[71] *P.G. Lake, Inc.* involved a taxpayer who received current payment on an assignment of part of a larger mineral interest.[72] The Court allowed the taxpayer to recognize the payment as income in the current period.[73] The result of this case enabled producers to control their flow of income by selling enough carved out mineral rights to offset depletion expense and other deductions.[74] Although enacted more than ten years later, section 636 closed this loophole by requiring treatment of the production payments as mortgage loans.[75]

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[68] J. QUATTROCHI, FEDERAL TAX RESEARCH 105 (1982).

[69] *Freede*, 86 T.C. at 353-56 (Nims, J., dissenting; Jacobs, Parr & Williams, JJ., agreeing with the dissent).

[70] *Id.* at 354.

[71] *Freede*, 86 T.C. at 353, *citing Lake*, 356 U.S. 260 (1958).

[72] 356 U.S. 260 (1958).

[73] *Id.* at 266-267.

[74] *See supra* notes 19-24 and accompanying text.

[75] 26 U.S.C. 636 (1982); *see also* S. REP. No. 552, *supra* note 21 at 540.

B. *Judicial Review of Tax Avoidance Schemes*

Courts have had to review many avoidance schemes created by innovative taxpayers.[76] In the 1970's, oil and gas shelters rose in popularity because of perceived loopholes like those that existed after *P.G. Lake, Inc.*. A court, faced with a decision on whether or not a loophole exists in the Code, has two choices.[77]

First, courts may judically fix the loophole. The court did this in a recent tax shelter case, *Yosha v. Commissioner.*[78] In *Yosha*, the taxpayer entered into a transaction only for the tax consequences that would result.[79] No market risk existed in the taxpayer's investment. Instead of allowing the deduction, the court held the transaction lacked economic substance. Therefore, the transaction could be ignored by the court and the IRS.[80]

The second option for courts is to allow the taxpayer the benefit of the loophole. When this occurs, courts state that they "must take the law as [they] find it."[81] *First Federal Savings and Loan Association of Temple v. United States*,[82] another recent case, provides an example. In the *First Federal* case, the Western District Court of Texas stated, "There is no question that at first blush an R-49[83] transaction smacks of a sham."[84] But the court continued:

> However, on closer analysis of this particular type of exchange . . . . within the structure of the Code, it becomes clear that there is no valid legal reason for disallowing the loss . . . . This Court will not judicially legislate . . . where Congress has specifically addressed the issue and declined to do so . . . . If the drafters of Memorandum R-49 were looking for a loophole

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[76] In 1986, approximately 40,000 tax shelter cases were docketed in the United States Tax Court. E. Rustigan, *Important New or Changed Doctrine Emerging from Tax Shelter Cases*, 64 TAXES 814 (December 1986). In addition, the IRS estimated that 615,000 cases were in the pre-prosecution stage. *Id.*

[77] *But see Freede*, 864 F.2d 671, and discussion *infra* at Section III D, regarding a third choice.

[78] 861 F.2d 494 (7th Cir. 1988).

[79] *Id.* at 500.

[80] *Id.*

[81] First Federal Sav. and Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 249 (W.D. Tex. 1988).

[82] *Id.*

[83] R-49 is a regulation of the Federal Home Loan Bank Board, a regulating body for savings and loans. *Id.* at 233. The regulation allowed recognition of a loss on exchange of like-kind assets, which was contested by the Commissioner. *Id.*

[84] *Id.* at 249.

in the tax laws, then the only response can be that they have found one.[85]

C. *Brountas v. Commissioner*

In an example of judicial review of section 636(a), the section at issue in *Freede*, the First Circuit Court of Appeals dealt with the congressional intent behind section 636. In *Brountas v. Commissioner*[86], the court held that Congress did not intend to create avoidance schemes under section 636.[87] *Brountas* concerned an oil and gas tax shelter which had been set up to obtain tax benefits for investors through the use of nonrecourse financing.[88] Investors in the tax shelter would contribute a lump sum note payable out of production if the wells were productive.[89] If the wells did not produce oil, the drilling company could only look to the property, not the investor, for repayment of the note.[90]

The taxpayer in *Brountas* argued that nonrecourse notes became production payments since the notes would be repaid from future productions.[91] Therefore, the note should be treated like a mortgage loan and increase the taxpayer's partnership basis.[92] The effect was to circumvent the contingent nature of the loan and allow a deduction greater than the initial capital outlay.[93] But the First Circuit Court of Appeals did not agree.[94]

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[85] *Id.*

[86] 692 F.2d 152 (1st Cir. 1982) *cert. denied*, 462 U.S. 1106 (1983). *But see* Gibson Products Co. v. United States, 637 F.2d 1041 (5th Cir. 1981) (under nearly identical facts, the court did not reach the question of statutory intent).

[87] *Brountas*, 692 F.2d at 158-61.

[88] Nonrecourse notes have been the subject of controversy since Crane v. Comm'r, 331 U.S. 1 (1947). The result of *Crane* was that nonrecourse liabilities were includible in the taxpayer's basis for property. *See also* B. Bittker & M. McMahon, *Federal Income Taxation of Individuals*, ¶ 26.16 at 26-40 (1988) ("*Crane* laid the cornerstone for the tax shelter frenzy of the 1960's, 1970's and early 1980's.").

[89] *Brountas*, 692 F.2d at 154.

[90] *Id.*

[91] *Id.* at 158.

[92] *Id.* at 156.

[93] Increasing the partnership basis was critical to Brountas' loss deduction. The tax shelter requires a cash contribution, here, $4,000, and assumption of a nonrecourse liability, in this case $6,000. 26 U.S.C. § 263(c) (1982) and Treas. Reg. § 1.612.-4(a) (1965) allow intangible drilling costs (IDC's) to be deducted during the year incurred. IDC's in the transaction were $7,500. But, since losses are only deductible to the extent of basis under 26 U.S.C. § 704(d) (1982), Brountas had to prove the nonrecourse debt

The court focused on the purpose of section 636(a). The congressional purpose of section 636(a) seeks to limit the acceleration of income so there is "no avoidance of the limitation on the percentage depletion deduction."[95] The First Circuit concluded that the nonrecourse notes were not production payments since the effect would reach the opposite result of the statute's intent.[96] "[T]he language is best taken as a general instruction to view the whole transaction in a way that carries out the section's purpose."[97]

D. *Freede Follow-up*

Both the Tax Court dissent and the appellate opinion in *Freede* used what may be termed as a third judicial approach to loopholes—ignore them. Neither court really "ignored" the issue of the intent of section 636. Instead, the courts focused their discussions on the economic interest issue.[98] Since neither the Tax Court dissent nor the Court of Appeals believed that Freede created a production payment, the tax avoidance question did not have to be reached. The result would have been unchanged; only the logic would be different. Using the *Brountas* analysis, the courts could have avoided the confusion of the economic interest concept. Because the intent of section 636 is to prevent avoidance of taxation, this provision was not applicable to Freede's situation.

CONCLUSION

Determination of the existence of an economic interest is complex and difficult.[99] Many courts have disagreed since the

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should be added to his cash basis. That is the question addressed by the court. *Id.* at 155-56.

[94] *Id.* at 158-61; *see also* Zappo v. Comm'r, 81 T.C. 77, 88 ("A note or obligation will not be treated as a true debt for tax purposes when it is highly unlikely, or impossible to estimate, whether and when the debt will be repaid.").

[95] S. REP. No. 552, *supra* note 21 at 540.

[96] *Brountas*, 692 F.2d at 155-56; *see* Comment, *Nonrecourse Financing: Does It Still Generate Tax Advantages After Gibson Products Co. v. United States and Brountas v. Comm'r?*, 4 N. ILL. L. REV. 153, 173 (Winter 1983) (*Brountas* used three analytical approaches to control or eliminate the use of nonrecourse financing for oil and gas partnership).

[97] *Brountas*, 692 F.2d at 160.

[98] *Freede*, 864 F.2d at 676-77; *Freede* 86 T.C. at 354-56.

[99] E. Fenton & P. Davis, *The Economic Interest Concept: A Historical & Policy Perspective*, 3 J. MIN. L. & POL'Y 75, 76 (1987-88). In addition to reviewing the history of cases that shaped the economic interest concept, the authors also suggest a quantitative method for analyzing a potential economic interest. *Id.* at 105-11.

Palmer decision over 55 years ago.[100] On the surface, the reversal by the *Freede* appellate court[101] may simply be explained as a correction of misapplied law. But, when a lower court appears to follow the precise wording of a statute and the related regulations, more than a disagreement of interpretation is suspected. Courts will not look favorably at an attempt to use a statute that closes a loophole as another loophole, because the intent of Congress to prevent tax avoidance is apparent. Freede and other taxpayers with similar opportunities must look further than the words in the statute. Congress' intent is the key to finding a loophole. If the court of appeals had argued congressional purpose, the discussion would be different, but the end result, denial for Freede, would remain the same.

Gregory R. Schaaf

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[100] *Palmer*, 287 U.S. 551.
[101] *Freede*, 864 F.2d 671.