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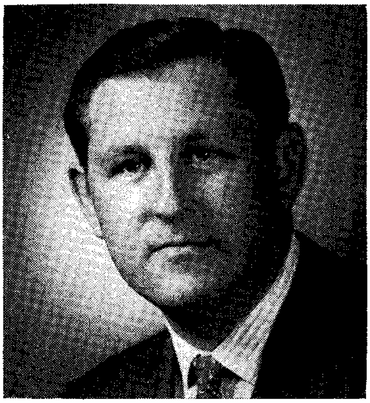

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INTRODUCTION

The oil and gas industry has been characterized by the creation of a variety of contractual arrangements and proprietary interests which in many respects are sui generis and preclude definitive analytical classification as contractual rights or proprietary interests. Inasmuch as tax consequences frequently depend upon such classification, it is not surprising that the in oil payment is the subject of considerable tax litigation. An oil payment is an interest or contract under which the holder thereof is entitled to receive a specified amount out of a specified portion of the oil production or proceeds from the sale of production. A typical oil payment may, for example, provide that the holder thereof shall receive $100,000 out of the proceeds from the sale of one-eighth of the production. Ordinarily there is no obligation to pay the specified amount except out of the designated percentage of production and the specified amount is not a lien against the property generally; the tax consequences of oil payments discussed herein are dependent upon these characteristics.[1]

An oil payment may be created by reservation or it may be created as a result of a direct grant or assignment. If created by grant or assignment, as distinguished from creation by reservation, it is frequently referred to as a "carved-out oil payment." An oil payment may be reserved in connection with a mineral, royalty

[1] Perkins v. Thomas, 301 U.S. 655 (1937). Comparable production payments are created with respect to minerals other than oil and the principles discussed herein are generally applicable irrespective of the mineral involved. Commissioner v. Weed, 241 F.2d 69 (5th Cir. 1957) (sulphur).

or leasehold conveyance and it may be carved out of mineral interests, royalty interests, leasehold interests or a larger oil payment. Oil payments, as indicated in the discussion below, are created in numerous situations and for various reasons, not the least of which are tax reasons.

RESERVED OIL PAYMENTS

A, the owner of an oil and gas lease, assigns the lease to *B* for a substantial consideration reserving a $100,000 oil payment payable out of one-eighth of the proceeds from the sale of production. This is the typical situation resulting in the reservation of an oil payment. *A*, in the context of this transaction, could have reserved an overriding royalty as distinguished from an oil payment, but with entirely different tax consequences. The reservation of an oil payment for tax purposes results in a sale subject to capital gains treatment,[2] whereas the reservation of an overriding royalty tax-wise would result in a leasing transaction and the cash consideration received by *A* would be ordinary income subject to depletion.[3] Inasmuch as it is ordinarily desirable from the taxpayer's standpoint to regard the consideration received as capital gain rather than ordinary income, tax motivations are usually sufficient inducement to the informed taxpayer to reserve an oil payment rather than an overriding royalty in this situation. The disadvantage to *A* in this situation is that if he reserves an oil payment the total proceeds received by him from the sale of production over the lifetime of the property ordinarily will be less than the amount received from a comparable overriding royalty. This disadvantage can be obviated in part by making the oil payment sufficiently large, but if the amount of the oil payment is unreasonable in the light of the estimated reserves of the property, the Internal Revenue Service undoubtedly will contend that the taxpayer has in effect reserved an overriding royalty. Inasmuch as this determination must be made at the time of the transaction it is difficult, if not impossible, to take into consideration such variables as fluctuations in the price of oil and revisions in reserve estimates.

With respect to producing properties, termination of the oil payment prior to depletion of the reserves can be assured by providing that regardless of the amount of the oil payment it shall terminate at any time the value of the estimated remaining reserves is less than, for example, 150% of the unpaid balance of the oil payment. However, with respect to "wildcat" non-producing properties, it is impossible to adopt mechanics which will assure the termination of the oil payment prior to the termination of the economic life of the leasehold. Although the author has found no cases or rulings on this point, it is likely that the Internal Revenue Service will take the position that the reservation of an oil payment on the assignment of non-producing acreage involves a leasing transaction and not a sale.

The reserved oil payment is an economic interest in oil and gas in place and the owner thereof can take statutory or cost depletion on all income received from the oil payment.[4] Inasmuch as the

[2] Palmer v. Bender, 287 U.S. 551 (1933).
[3] *Ibid.*
[4] Perkins v. Thomas, 301 U.S. 655 (1937).

holder of the oil payment has no operating rights, he is not entitled to take any deduction for intangible drilling costs.[5] The sale of the entire reserved oil payment at some subsequent date permits the seller to subject the proceeds from the sale to capital gains treatment.[6] The holding period for capital gains purposes commences from the date on which the taxpayer acquired the oil and gas interests out of which the oil payment was reserved.[7]

CARVED-OUT OIL PAYMENTS

Carved-out payments may be used as vehicles to finance the drilling of a well either by the sale of such payments for cash with the proceeds pledged for the development of a well or in exchange for services and/or equipment employed in the drilling of a well. In the event the proceeds from the sale are pledged to the development of a well or if given in exchange for services or equipment employed in the drilling of a well, the transaction is not taxable and the taxpayer merely reduces his development costs by the amount of cash, services, or equipment received.[8] The taxpayer's principal problem in connection with oil and gas payments created for development purposes is establishing that he was obligated to use such proceeds in the development of a particular well and that the proceeds were, in fact, used for this purpose. Taxpayers on frequent occasions have been unable to sustain the burden of proof on these issues because of loosely or improperly drawn agreements or because of failure to maintain adequate records.[9]

The taxpayer may carve out an oil payment in order to realize cash to be used for purposes other than the development of a well or may assign a carved-out oil payment as a gift to a family member or to a charity and it is in these situations that the Commissioner of Internal Revenue and the taxpayers are now doing battle. Three conflicting views as to the nature and tax consequences of such transactions have been advanced:

(1) The Internal Revenue Service position is that a carved-out oil payment is an attempt to anticipate income and that the consideration received by the assignor is to be regarded as ordinary income subject to depletion.[10] With respect to the gift situation, under this view the donor must continue to report the income payable to the holder of the oil payment as income subject to the depletion allowance and at the time of the donor's death the oil payment is regarded as part of the donor's estate. In the case of a gift to a charity the donor cannot deduct the oil payment as a charitable contribution in the year of its creation, but at the time of the receipt of income from the oil payment can deduct the amount of such income as a charitable contribution for that particular year.[11]

(2) The position of most taxpayers is that the creation of a carved-out oil payment is either a sale or gift, as the case may be, of a capital asset.[12] In the sale situation any consideration received is subject to capital gains treatment. In the gift situation income re-

[5] Proposed U.S. Treas. Reg. § 1.612.4.
[6] G.C.M. 24849, 1946-1 Cum. Bull. 66.
[7] Alice G. K. Kleberg, 2 T.C. 1024 (1943) (acq.).
[8] G.C.M. 24849, 1946-1 Cum. Bull. 66.
[9] See e.g., Rogan v. Blue Ridge Oil Co., 83 F.2d 420 (9th Cir. 1936).
[10] I.T. 4003, 1950-1 Cum. Bull. 10.
[11] *Ibid.*
[12] See, *e.g.*, Scofield v. O'Connor, 241 F.2d 65 (5th Cir .1957).

ceived is subject to capital gains treatment. In the gift situation income received from the oil payment[13] is taxable to the donee and the oil payment is not part of the donor's estate.[14] In the case of a gift to a charity the taxpayer deducts the value of the oil payment as a charitable contribution in the year in which it is created.[15]

(3) The loan rationale obviously can be applicable only to the sale situation. Under this theory the transaction is regarded as if the consideration advanced to the assignor is a loan to him from the party acquiring the oil payment. The consideration received by the assignor is not taxable at the time the oil payment is created, but the income received by the holder of the oil payment is regarded as ordinary, depletable income to the assignor taxable as received by the holder.[16] The holder of the oil payment regards the income from the oil payment as received as the repayment of a loan and not taxable to him except to the extent that such income is greater than the amount originally paid for the oil payment. The Internal Revenue Service initially distinguished between the carving out of short-lived and long-lived oil payments; regarding the carving out of a long-lived oil payment as a sale or completed gift, as the case may be, and the carving out of a short-lived oil payment as an

[13] Lester A. Nordan, 22 T.C. 1132 (1954).
[14] Int. Rev. Code of 1954, § 2031.
[15] Lester A. Nordan, 22 T.C. 1132 (1954).
[16] Commissioner v. Slagter, 238 F.2d 901 (7th Cir. 1956).

assignment of future income.[17] In 1950 the Internal Revenue Service abandoned the distinction between short-lived and long-lived oil payments both with respect to sales and gifts and now takes the position that all carved-out oil payments involve assignments of income rather than assignments of income-producing property and as such result in the anticipation of income with the consequence noted above.[18] This position has been consistently rejected by the Tax Court, but not without dissent.[19]

The carved-out oil payment has had a checkered career in the Fifth Circuit Court of Appeals. In 1953 the Fifth Circuit held that the creation of carved-out oil payments having from nine to thirteen year payouts involved the sale of capital assets and that the consideration received was subject to capital gainst treatment.[20] In 1956 in the *Hawn* case[21] the Fifth Circuit without equivocation established "substantiality" as the criterion for determining whether the creation of an oil payment involved a sale or anticipation of income. Relying primarily on gift in trust cases of the type that gave rise to the *Clifford* rules[22] the court held that if the oil payment was insubstantial in terms of duration or in terms of its relation to the assignor's total interest,[23] its creation and assignment is an assignment of future income. The court went on to hold that an oil payment with an anticipated two-year payout and with an actual nineteen month payout was not of substantial duration. The fair inference of *Hawn* is that the carving out of an oil payment which will not continue for a substantial period of time is not a sale of a capital asset but is rather an anticipation of future income.[24]

Early in 1957 the Fifth Circuit, despite its own protestations to the contrary, in fact, but not in words, repudiated the *Hawn* decision in a series of five cases[25] holding that as to both oil payments carved out of a royalty and oil payments carved out of a working interest the creation of such oil payments with estimated times of payout varying from three to twelve years and actual payout periods of from twenty-eight months to nine years resulted in sales rather than anticipation of income. The only reference to substantiality is a passing reference to the amount of the oil payment[26] the court declaring that the *Hawn* case was not a holding to the effect that there was no sale because "in amount it [the oil payment] was insubtantial" but "that it was not a sale at all, it was a credit arrangement, which, though in form an assignment of the oil interest . . . was in fact and in law nothing but an anticipatory assignment of in-

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[17] G.C.M. 24849, 1946-1 Cum. Bull. 66.

[18] I.T. 4003, 1950-1 Cum. Bull. 10.

[19] See, e.g., John David Hawn, 23 T.C. 516 (1954), *rev'd sub. nom* Commissioner v. Hawn, 231 F.2d 340 (5th Cir. 1956).

[20] Caldwell v. Campbell, 218 F.2d 567 (5th Cir. 1955).

[21] Commissioner v. Hawn, 231 F.2d 340 (5th Cir. 1956).

[22] Int. Rev. Code of 1954, § 674.

[23] "In all of these cases, therefore, it is apparent that the courts have held income is still taxable to various kinds of transferors, notwithstanding the fact that a transfer, complete and in good faith, has been made to another. There is no different rule of law that requires the court to give any degree of finality to a transfer which apparently fits under Section 117, than to one made under the terms of the gift sections of the law." 231 F.2d at 345.

[24] "We are to consider the substantiality of the transfer and that the duration of the estate covered by the transfer is an element of such substantiality." 231 F.2d at 348.

[25] Commissioner v. P. G. Lake, Inc., 241 F.2d 71 (5th Cir. 1957); Scofield v. O'Connor, 241 F.2d 65 (5th Cir. 1957); Commissioner v. Weed, 241 F.2d 69 (5th Cir. 1957); Fleming v. Commissioner, 241 F.2d 78 (5th Cir. 1957); Commissioner v. Wrather, 241 F.2d 84 (5th Cir. 1957). The Supreme Court has granted certiorari in all five cases. 25 U.S.L. Week 3357 (U.S. June 3, 1957).

[26] Commissioner v. P. G. Lake, Inc., 241 F.2d 71, 7—(5th Cir. 1957).

come made as security for, and in payment of, Hawn's debt to the contractor[27] . . . . " The court disregarded the entire thrust of the *Hawn* opinion and its detailed consideration of cases for the penultimate paragraph of the *Hawn* opinion where, without citation of authority and at best as an alternative basis, the *Hawn* court had likened the transaction to a loan arrangement.[28] It should be noted that the assignor in the *Hawn* case had no personal obligation to pay the amount of the oil payment and the owner of the oil payment had no lien against the property as such. If Hawn had a "debt" to the contractor it was a debt without any personal obligation and there appears to be no basis for distinguishing this "debt' from that created generally in carving out oil payments. It is true that the purchaser of the oil payment borrowed, at least in part, the moneys used indirectly by him in acquiring the oil payment, and the government contended that in effect he was acting as the assignor's agent in making the loan. However, the court in the *Hawn* case specifically stated with respect to this contention that, "we need not cast it in this mold . . . ."[29]

It is interesting to note that only Judge Borah participated in the decisions in both the *Hawn* case and the 1957 series of Fifth Circuit oil payment cases. Chief Judge Hutcheson, who did not participate in the *Hawn* case wrote all of the opinions in the five recent cases, and Judge Tuttle who did not participate in the five recent decisions wrote the opinion in the *Hawn* case. The conclusion seems almost unavoidable that with respect to carved-out oil payments there is in fact a conflict within the Fifth Circuit.

The Seventh Circuit Court of Appeals has denied capital gains treatment for a carved-out oil payment which paid out within five years, three and one-half months. The Seventh Circuit in the *Slagter* case[30] held that the carving out of the oil payment resulted in the anticipation of income. However, rather than holding the consideration received upon assignment of the oil payment taxable as ordinary income at the time of receipt, the court characterized the moneys advanced for the oil payment as a loan and held the income from the oil payment taxable to the assignor as ordinary depletable income as received by the assignee.

The Fifth Circuit has refused to distinguish between oil payments carved out of royalty interests and oil payments carved out of working interests. The Commissioner argued unsuccessfully with respect to oil payments carved out of the working interest that such interests were mere assignments of future income and not assignments of interests in real property and further that such oil payments actually represented assignments of oil which is property "held primarily for sale in the ordinary course of business." The court, relying primarily on local property concepts, characterized oil payments regardless of their source as interests in real property.[31] The Fifth Circuit also rejected the Commissioner's contention

[27] *Id.* at 67.

[28] See note 21 *supra* at 347.

[29] *Ibid.*

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

[31] Commissioner v. P. G. Lake, Inc., 241 F.2d 71, 76 (5th Cir. 1957), *cert. granted,* 25 U.S.L. Week 3357 (U.S. June 3, 1957) (No. 921).

that the assignor's holding period with respect to a carved-out oil payment does not commence until the oil payment is created.[32]

The Tax Court has held that a gift of a carved-out oil payment resulted in a completed gift rather than anticipation of income.[33] Although this question has not been litigated in the circuit courts, it is clear from the court's reliance on gift cases in the *Hawn* decision that it would have regarded the gift of a short-lived oil payment as involving an assignment of income.[34]

The staff of the Joint Committee on Internal Revenue Taxation and the Treasury Department has recommended legislation which would in effect codify the position of the Internal Revenue Service that a carved-out oil payment involves an anticipation of future income.[35]

THE *ABC* TRANSACTION

Oil payments are frequently used to finance the acquisition of producing properties. The tax advantages are better understood by comparing the mechanics employed with orthodox loan financing. *A* is the seller of a productive property, *B* is the purchaser and *C* finances the transaction. In the orthodox loan transaction *B* pays part of the purchase price with his own funds, and borrows the balance from *C* giving *C* an interest bearing note secured by a lien on the property. In the *ABC* transaction *A* sells the entire working interest for a specified amount in cash representing the amount *B* would ordinarily pay with his own capital, and *A* reserves an oil payment in the amount plus interest that ordinarily would have been financed. The oil payment is then sold to *C* for the amount that otherwise would have been financed, usually as a result of a prearranged plan. The tax consequences of the orthodox loan transactions are as follows: (1) *A* realizes capital gains treatment on the purchase price. (2) *C* realizes taxable income on repayment of loan and interest only to extent of the interest. (3) *B* must report as income all the proceeds from production including that portion used in the repayment of the loan. *B*, in computing his taxable income, deducts statutory or cost depletion, whichever is the greater. The tax consequences of the *ABC* transaction are as follows: (1) *A* realizes capital gains treatment both with respect to the consideration received for the working interest and the consideration received for the oil payment. It is extremely important that the oil payment be reserved rather than carved-out by *B* after the conveyance in order to avoid the anticipated income theory discussed above.[36] (2) *C* recovers the amount paid for the oil payment through cost depletion and is taxed only on the amount actually received over the amount advanced, such excessive amount being comparable to interest payments. (3) *B*, the purchaser, realizes the principal tax advantage from this transaction in that the amount payable to *C* under the oil payment is excluded from *B*'s income whereas in the orthodox loan transaction such amounts would be included in *B*'s income

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[32] *Id.* at 74.
[33] Lester A. Nordan, 22 T.C. 1132 (1954). *Accord* R. E. Nail, 27 B.T.A. 33 (1932).
[34] See note 21 *supra* at 345.
[35] Report, Joint Committee on Internal Revenue, Taxation, and Treasury Department, 85th Cong., 1st Sess. (Nov. 7, 1956).
[36] *B* should acquire a sufficient working interest so that operating costs will not exceed revenue during the payment period; otherwise excess costs will probably have to be capitalized as acquisition costs and recovered through depletion rather than deducted as a loss.

even though applied on the loan. Although the amount of the loan in the orthodox loan transaction would be recovered through cost depletion, it would have to be amortized over the entire productive life of the property, whereas use of the oil payment method in effect permits amortization of the "loan" over the payout period of the oil payment. In addition, after the oil payment has terminated *B* can take statutory depletion which will offset in part at least the cost depletion he could have taken if an orthodox loan had been used, and as a result, ordinarily the total taxable income to *B* over the entire productive life of the property is less in the *ABC* situation.

The characterization of an oil payment as a "loan" in the *Slagter* and *Hawn* cases suggests the possibility that a court may apply the loan analysis to the *ABC* transaction and destroy the advantages generally assumed. If, as the Fifth Circuit has indicated in distinguishing *Hawn*, there can be a "debt" without an obligation to pay and an attempt is to be made to analytically determine whether the transaction is in substance a "loan," the loan analysis would logically apply to the usual *ABC* transaction. The implication of the Fifth Circuit's subsequent construction of *Hawn* that the transaction may involve a loan because *C* borrows the money[37] is also disturbing in this context, for if *C* is not a bank, in many instances he has borrowed the money from a bank. While *Slagter* and *Hawn* involved carved-out oil payments and the *ABC* transaction usually involves a reserved oil payment, this does not appear an appropriate distinction if the question for determination is whether the transaction is in substance a "loan."

EXCHANGES FOR PROPERTY OF LIKE KIND

Exchanges of property held for productive use in trade or business or for investment for property of like kind are non-taxable.[38] The Fifth Circuit has held that the exchange of a fee interest in the minerals for an oil payment is a tax-free exchange of real property interests of a like kind,[39] and has recently held that the exchange of an oil payment for developed urban property is an exchange of property of a like kind.[40] In reaching this conclusion the court held that both the oil payment and the developed urban property are interests in real property and the fact that the oil payment is for a limited duration whereas the urban property is an interest in a fee does not preclude the exchange from being an exchange of properties of a like kind.[41]

CONCLUSION

In view of the conflict between the Fifth and Seventh Circuits and within the Fifth Circuit as to the nature of carved-out oil payments and tax consequences arising from their creation, tax planning will be facilitated by an early resolution of this conflict by the Supreme Court. In the event the conflict is resolved prospectively by legislation, the adaptation of the "Clifford Rules" particularly with respect to making "duration" a controlling consideration, appears to be more equitable than legislation designed to require the applicationof the Commissioner's anticipation of income theory.

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[37] See note 29 *supra* and related text.
[38] Int. Rev. Code of 1954, § 1031.
[39] Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953).
[40] Fleming v. Campbell, 241 F.2d 78 (5th Cir. 1957).
[41] *Ibid. Accord* Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941).