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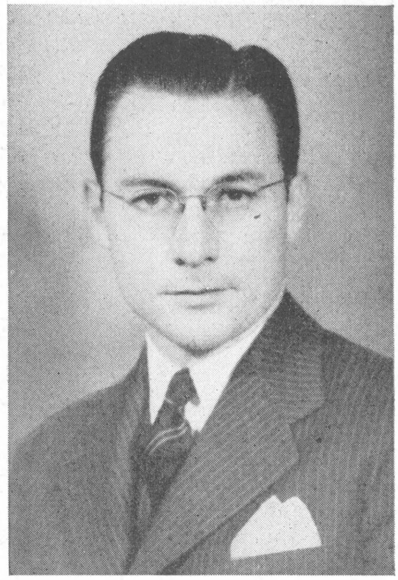
Abner E. Hughes



Abner E. Hughes is a real Southerner, having been born in Florida, gone to high school in Alabama, to college in Washington, D. C., and finally arrived at New Orleans. He has B.C.S. and M.C.S. degrees from Strayer College, and C.P.A. certificates from Louisiana, Texas and Mississippi. He is now a partner in the firm of Barton, Pilie, Sere & Wermuth, one of the outstanding accounting firms of New Orleans.

Taxation Problems of the Oil Investor

ABNER E. HUGHES, M.C.S., C.P.A.

New Orleans, Louisiana

Recent years have witnessed a tremendous increase in the number of persons interested in oil leases and development. New oil fields are constantly being discovered, resulting in a continual extension of the number of persons directly interested in the taxation problems arising from such development. High income levels of the current war years have produced surplus funds so that a great many individuals have turned to oil investment as an outlet for the use of such surplus.

For these reasons, it is believed that tax accountants will be beset with an increasing number of problems arising from these oil investments, and it is for the purpose of presenting a brief discussion of a few of the more prevalent problems that this article has been written.

Types of Oil Interests: Oil interests may be broken down into four general classifications:

(a) Ordinary Royalties
(b) Working Interests
(c) Overriding Royalties
(d) Oil Payments

There are innumerable combinations of these general types, but careful review of each lease or agreemnt will reveal that the basic classification prevails in all cases. The interests may be created through leasing directly from the land owner or by lease from the owner of the mineral rights. Mineral rights may be acquired in fee and as a perpetuity in most states, separate and distinct from the land itself and conversely are often retained by the original land owner upon disposal of the land. The owner of the mineral rights may lease or dispose of the rights just as the original land owner could have done. Important legal distinctions between the two methods of acquisition exist but for this general discussion may be ignored.

While there continues to be considerable difference of opinion as to the precise description of the several basic types of oil interests, it is believed that the following general definitions will serve the purposes of this article:

(a) The "ordinary royalty" interest is that interest retained by the lessor at the time the lease is executed. The customary provision is for the retention of a one-eighth interest in the oil, gas and other minerals produced from the property, free and clear from development and operating costs.

(b) The remaining interest, usually seven-eighths, is the operator's interest and is known as the "working interest." It is from the sale of oil and gas produced from this interest that the operator must recover his cost of drilling, equipping and operating the property, as well as the profit, if any, from the venture.

Frequently two or more persons or groups of persons will join together in the acquiring of a working interest, thereby becoming "joint operators." It is customary in these cases for one person to actually operate the lease and to submit periodically a "statement of joint operations" to his co-operators.

Many times it is necessary that the small operator sell off a number of small working interests from his original seven-eighths in order to provide the necessary working capital. Confining such sales to working interests provides a greater degree of protection to the operator than would overriding royalties, in that the working interest holders share only in the net profits rather than the gross.

(c) In the majority of cases two other general types of interests are carved out of the holdings. The first of these occur when the operator disposes of a portion of his holding in the form of an "overriding royalty." This is similar to an ordinary royalty in that it stands no part of the development and operating costs, but while the ordinary royalty attaches to the land, the overriding royalty extends only to the life of the lease.

(d) The second general type of interest which may be derived from the seven-eighths working interest is an "oil payment." The "oil payment" interest is for a definite amount, either in barrels or money, payable if, as and when produced, and it may or may not be subject to the payment of certain costs and expenses.

The most common types of investment are ordinary royalties, non-operator's working interests, overriding royalties and oil payments. These appear in the holdings of both small investors and larger operating companies. The operator's working interest is confined to individuals and companies in the business of crude oil production. This article does not concern itself with the operator's working interest as the problems of actual operation are so extensive as to require separate and lengthy treatment. We here confine our statements to some of the specific problems of the non-operator.

Income from the Property: It would appear to the uninitiated that the determination of gross or net income, as the case may be, would not present too serious a problem. However, as is true of all phases of the Federal tax upon "income," the almost endless chain of legislation, regulation and court decision has caused the concept of net taxable income to be far removed from that which may be considered correct income from an accounting standpoint.

From an income determination viewpoint, the first and simplest group of oil interests includes both ordinary and overriding royalties. In the typical case, the operator of the lease or the purchaser of the oil presents monthly royalty statements to the royalty interest owner. The statements have now taken on a generally uniform appearance in that they reflect gross sales for the period; conversion to dollar value; deductions for State severance tax, State sales tax and sometimes handling or other charges, dependent upon the terms of the particular agreement; and finally the net distributable interest. This net distributable amount is then spread to the various individuals and copies of the statement are transmitted to the respective interest owners monthly, together with a check in payment of the net amount due.

As indicated, this is the simplest type of arrangement. Perhaps the only common error made in reporting this income in the Federal income tax return concerns the computation of statutory depletion. Later in this article, we will expand upon the method of computing cost or statutory depletion, but at this point it is sufficient to emphasize that statutory depletion is based upon *gross* income from the property and consequently any deductions from such gross income (severance tax, handling charges, etc.) should be added back in arriving at the true gross income subject to depletion.

The remaining types of interests—non-operator's working interests and oil payments—require considerably more attention from the investor or his tax accountant in order to ascertain that the provisions of the particular contract or agreement are being complied with and that the interest owner is being charged for no expenses or costs other than those specified. Information of this nature is usually obtained from monthly statements submitted by the operator showing in detail, income from the property and the pro rata portion of expenses and costs adhering thereto. Here again, the determination of true gross and net income rather than merely the net proceeds received from each property is of ultra importance for purposes of computing depletion.

It is well, at this juncture, to point out that the holder of the non-operator's working interest, and, in some cases, of an oil payment, will be billed by the operator for certain capital expenditures and certain expenditures which may be capitalized or expensed at the option of the interest holder. Those which must be capitalized include the interest holder's pro rata of equipment on the lease, and care must be taken to see that the taxpayer claims the proper amount of depreciation on such equipment. Optional items include intangible development costs and workover costs. These may be expensed or capitalized, but the option once exercised is binding for all future returns. Ordinarily, it is to the advantage of the taxpayer to expense such optional items, for in the majority of cases statutory depletion will exceed cost depletion even if development costs are capitalized thereby causing the taxpayer to lose any benefit from the capitalized items.

Depletion: In its early stages, the Federal income tax law provided for cost depletion only. This method of recovery of investment provided that cost or March 1, 1913, value might be recovered by the taxpayer over the productive life of the property by dividing such cost or value by the estimated number of recoverable units and multiplying this cost per unit by the number of units produced during a given taxable period. This method continues to be available to all owners of an economic interest in an oil and gas lease, but in many cases will be found to result in a much smaller depletion allowance than is provided through subsequent statutory provisions.

The first attempt by Congress to reward the taxpayer for discovering a hitherto unknown natural resource was to provide for the allowance of "discovery depletion." This allowance was based generally on the fair market value of the newly discovered oil and gas property at or near the date of discovery. This type of allowance insofar as oil and gas properties are concerned has not been allowed with respect to such properties in recent years and has been supplanted with the "percentage depletion" provision.

"Percentage depletion" was originally included in the 1926 Act as a substitute for discovery depletion. In the case of oil and gas properties, the percentage depletion allowance is 27½% of the gross income from the property, but not in excess of 50% of the net income from such property. However, it must be kept in mind that cost depletion is at all times allowable; the taxpayer is entitled to the higher of these two—statutory or cost—regardless of the type claimed in his income tax return as filed. In the case of oil and gas, no election as to the method to be used is necessary as the taxpayer is at all times entitled to the higher of the two.

It is important to the owner of any of the indicated types of oil and gas interests that cost depletion be considered, particularly if the cost of the interest is of a sizeable amount. The computation of cost depletion will require the obtaining from lease agreements, etc., the true cost of the property, and an estimate of the remaining oil in ground from the operator. Production in terms of barrels during the taxable period may usually be obtained from monthly royalty statements, but if these statements are not sufficiently clear, the production figures may also be obtained from the operator.

Statutory depletion in the case of owners of ordinary or overriding royalties may be computed very simply by taking 27½% of the gross income from the property. As previously indicated, this will not be the net amount received by the taxpayer as this net amount will ordinarily have been reduced by such items as State severance and sales taxes, handling charges, pipeline charges, etc. The limitation of 50% of net income will be without effect in the case of royalties, as usually the only deductions from gross income will be the relatively nominal items enumerated in this paragraph, so that 50% of net income will always be greater than 27½% of gross income.

Considerably more complication arises in the computation of statutory depletion for oil payments, provided they bear some portion of costs and expenses, and working interests. The regulations require that a detailed statement for each property be filed reporting gross income from the property and deductions therefrom, including the correct pro rata of overhead expenses if such be incurred. The necessity for these statements by properties entails the maintenance during the year of income and expense sheets for the respective properties, although in the case of a small investor this information is usually accumulated at the end of the year from the monthly operating statements.

A standard form, designated as Form "O," is provided by the Government for the submission of this information, and one form should be filed with the income tax return for each property or separate interest.

Gain or Loss on Disposal of Oil Interests: The taxable status of gains or losses arising from sales of royalties, mineral interests and productive or nonproductive working interests necessarily associates itself with I.R.C., Section 117, concerning capital gains and losses. This Section of the law has probably given rise to more litigation and controversy than any other single section. However, in the September Internal Revenue Bulletin (1944-18-11851), the Treasury Department released I.T. 3693 which goes a long way toward clarifying and unifying previous decisions and rulings. In order to intelligently consider the decision reached in I.T. 3693, it is first necessary to outline briefly the principles governing capital gains and losses.

The effect of the provisions of Section 117 is to limit the amount of gain or loss taken into account in computing net income. Generally, in order to make the limitations applicable, both of the following conditions must exist:

(1) The property sold must be a "capital asset."

(2) The method of disposition must be a "sale or exchange."

"Capital assets" consist of all property held by the taxpayer, whether or not connected with his trade or business, except the following types:

(1) Stock in trade or other property of a kind which will properly be included in inventory if on hand at the close of the taxable year.

(2) Property held primarily for sale to customers in the ordinary course of trade or business.

(3) Property, used in trade or business, which is subject to the allowance for depreciation.

(4) Real property used in trade or business.

(5) Certain short-term government obligations issued after March 1, 1941, on a discount basis.

"Sale or exchange" includes not only situations within the ordinary meaning and definition of the phrase but also the following, arising from express provisions of the statute or court decisions:

(1) Receipts of amounts in retirement of certain bonds, etc.

(2) Short sales.

(3) Liquidating dividends.

(4) Worthlessness of securities.

(5) Forced sales.

(6) Worthlessness of nonbusiness debts.

In the case of individuals, capital gains or losses arising from assets held not more than six months are taken into consideration 100%; those arising from assets held more than six months are taken into consideration only to the extent of 50%. After applying the percentages, all gains and losses are combined. In the case of individuals, a net loss is deductible to the extent of $1,000.00 or the net income of the taxpayer, whichever is smaller, subject however to a five-year carryover of the unused portion.

An alternative tax prevails whereby the tax on the actual amount of long-term gains is prevented from exceeding 25%.

Recent changes in the law (now Section 117(j) of the Code) have provided that gains and loses from:

(1) The sale of depreciable business property, held more than six months, and real property used in the trade or business, held more than six months (excluding inventory property and property held primarily for sale to customers); and

(2) the involuntary conversion including condemnation, destruction, etc., of the above or of long-term capital assets,

are treated as long-term capital gains and losses, if the aggregate of such gains exceeds the aggregate of such losses. If the losses exceed the gains, they are treated as ordinary gains and losses.

Prior to the enactment of Section 117(j) above, it had been consistently held that oil leases acquired primarily for development purposes are not held primarily for sale in the ordinary course of business and, therefore, constitute capital assets. (Geo. L. Pace, Memo B.T.A., 12/3/34, petition for review dismissed, 84F (2d) 1010).

Even after the enactment of Section 117(j), treatment of gains or losses arising from sales of such interests was in doubt. Such assets were obviously not depreciable business property and in many States were held not to be real property. Consequently, it was necessary to proceed on the assumption that such assets constituted capital assets, and as such, any gain or loss arising from the *sale or exchange* thereof would have been subject to the limitations outlined above.

It will be noted that we have emphasized the phrase "sale or exchange." This leads to the necessity for expansion on two topics:

(1) The treatment of capital assets disposed of by means other than "sale or exchange."

(2) Types of transactions considered to be a "sale or exchange."

The greatest single consideration in the case of the average investor arises from the abandonment of leaseholdings. In the foregoing we have reached the conclusion that certainly prior to the release of I.T. 3693, all such leaseholdings meet the first of the two requirements which would cause their disposal to be treated as a capital asset transaction—that is, they are capital assets. However, when such leaseholdings are abandoned and written off as worthless, it is important that they not be subjected to the capital loss limitations. It has been possible in the past to treat such abandonments as fully deductible losses for the reason that the abandonment was not considered a "sale or exchange."

This position was substantiated by the decision rendered in Metropolitan Royalty Corp., Memo B.T.A., 5/25/42, wherein it was held that an auction sale of worthless royalty rights would not bar an ordinary loss deduction where worthlessness occurred prior to the auction, the sale being considered merely the mechanics used to effect the abandonment of the property.

We were, therefore, based on the foregoing, able to take the position that the loss from the abandonment of a leasehold might be treated as an ordinary fully deductible loss provided nothing had been done to cause the abanonment to take on the aspects of a sale or exchange. Now, however, under the provisions of I.T. 3693, insofar as an oil operator is concerned, we may ignore the distinction between "sale or exchange" or disposal by other means. This I.T. specifically provides that irrespective of the characterization of oil and gas leases under the laws of the various States, for Federal income tax purposes it is held that the interest of a lessee in oil and gas constitutes an interest in "real property."

I.T. 3693 further held in the case being considered that the particular leasehold interests involved constituted "real property used in the trade or business of the taxpayer" within the meaning of Section 117(a)(1) of the Code and that they were, therefore, excluded from the term "capital assets." If such interests were held for more than six months, except with respect to a dealer therein, they would qualify as "property used in the trade or business," as defined by Section 117(j) of the Code and would, therefore, be subject to the treatment provided by that Section.

The effect of this Income Tax Unit Ruling is to clarify and in some cases invalidate certain previous rulings and court decisions insofar as persons or companies in the business of oil and gas production are concerned. There apparently remains some doubt, however, as to the status of a casual royalty owner. For instance, close perusal of the decision elicits the information that it applies to the "interest of a *lessee*." (Italics supplied.) This immediately presents the question as to whether it will apply to the one-eighth ordinary royalty usually retained by the land owner who can hardly be construed to be a lessee from himself.

Again some doubt may be advanced as to whether or not the casual investor, whether he be the land owner or one who has subsequently acquired an overriding or working interest, will be considered to be in a "trade or business." Presumably, this point must be established before the provisions of I.T. 3693 may be relied upon. In the event such persons are not construed to be in the oil business, it would appear that their status would revert to the conclusions reached above and prior to the release of I.T. 3693.

In addition to the restriction that net gains from sales of oil interests may be subjected to a maximum tax of 25% through application of the capital gain and loss provisions of the law, there is still another specific limitation provided by Section 105 of the Internal Revenue Code. This Section provides that the surtax upon the sale of any oil or gas property may not exceed 30% of the selling price of such property where the principal value of the property is due to discovery or exploration work done by the taxpayer. This limitation will be without value to the average investor as it has been held that the lessor cannot claim the benefit of the limitation where the discovery which determines the value of the property was made by the lessee. (I.T. 1568, C.B. II-1, p. 115; Anna Taylor, 3 B.T.A. 1201).

In summary, these conclusions may be reached:

(1) For the lease operator and all other interest owners who may be considered to be in the oil and gas business, with the exception of dealers in leases and the possible exception of the land owner, leaseholds are for Federal tax purposes excluded from the term "capital assets." Gains or losses arising from sales, exchanges, abandonments, etc., of those interests held for less than six months will be fully taxable or fully deductible, as the case may be. For those interests which are held more than six months, gains would be reportable only to the extent of 50% with a maximum tax of 25% on the entire gain, and losses would be fully deductible. For developers a maximum surtax of 30% of the sales price will attach, the smallest tax resulting from the three alternative computations being due.

(2) Holdings of casual investors and possibly the retained royalty of the land owner apparently will be treated as capital assets, and gains or losses arising from the sale or exchange thereof would be subject to the capital gain and loss provisions of the law. Abandonments would be fully deductible as an ordinary loss.

(3) Transactions of dealers in leases would obviously result in ordinary income or loss.

Women's Place in the Post-War World

By DAPHNE ROBERT

Editor's Note: This article is a condensation of a talk given to the Atlanta Chapter of ASWA by Miss Daphne Robert, past President of the National Association of Women Lawyers.

American women have met the challenge of war. Will they meet the challenge of peace?

Women *do* go to war! We are not thinking of the WAC or the WAVES, or even the nurses who go to the fighting zones, or the other women's groups of the warring nations, many of whom are doing valiant service and are ready to do more. Yes, the women also go to war—mothers, wives, sisters and sweethearts. And the battles they fight require no less of courage than is demanded of the men on the battle lines.

American women are rapidly becoming the most important new factor in our war effort. Women who have never worked before find that their natural gift for using their hands is standing them in good stead. A woman down on her knees cutting a sheet of steel with a burner's torch uses the same keen eyes required to stitch on a hem on a sewing machine. Ironing out the seams of a life belt uses the same abilities as ironing the family laundry. The woman who used to drive the kids to school is running tractors carrying materials in the biggest plants.

But—where do we go from here? Do we, as in the last World War, step aside when our men come home and resume economically and industrially where we left off? No, because nothing is permanent but change.

To be sure, the first World War did mark a distinct promotion in our social, economic and industrial status. Also, due in no small measure to a capitalistic system which has enabled women to inherit vast fortunes, much