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FEDERAL INCOME TAX TREATMENT OF THE ACQUISITION AND DISPOSITION OF COAL INTERESTS: AN EXAMINATION OF I.R.C. § 631(c)

JOHN C. COGGIN, III

I. The "Economic Interest" Concept

There is perhaps no more important concept in the federal income taxation of mineral resources than the "economic interest" concept.¹ In particular, a complete understanding of that concept as developed by the courts and as set forth in the regulations is essential in order to properly understand the tax consequences resulting from the acquisition and disposition of coal properties for two basic reasons. First, it is necessary that the taxpayer have an economic interest in the coal in order to be entitled to claim a depletion deduction, be it cost or percentage depletion.² Second, the taxpayer must retain an economic interest in the coal upon its disposition in order for him to be entitled to capital gains treatment on the proceeds received under the terms of the transaction, an important tax benefit available under section 631(c) of the Internal Revenue Code.

With regard to the depletion allowance, the taxpayer must

¹ The concept has received much attention by both the commentators and the courts. Pratt & Ferguson, Depletion Deduction in Coal Leases: Courts Split on the Effect of Lease Terminability, J. Tax. 240 (October 1979); Casey, Economic Interest—Play It Again, Sam, 24 Tax. Law. 129 (1970); Blackburn, Sale of Lease? Disparate Tax Treatment of Mineral Transactions by Courts Based on Nature of Minerals Involved, 42 Tex. L. Rev. 706 (1964); Sneed, Economic Interest—An Expanding Concept, 35 Tex. L. Rev. 307 (1957).

possess an economic interest in the coal in place which will not terminate until the coal has been exhausted in order to be entitled to the deduction. The regulations under section 611 of the Code in this regard provide:

Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits . . . An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . . to which he must look for a return of his capital.\(^5\)

It would thus appear that the regulations establish two requirements in order for a taxpayer to qualify for the depletion deduction. The first requirement is an interest in the coal in place acquired by an investment, an interest interpreted by the courts to include the right to mine the coal until exhaustion. This requirement has led to the denial of the depletion deduction by several courts in cases in which the party claiming the deduction had the rights to mine the mineral under an agreement which could be terminated without cause and on short notice.\(^4\) The Service's position has been that if the lease agreement can be terminated by either party at will "or on notice that will not allow the operator to extract a substantial portion of the mineral in place," the coal operator will not be in possession of an economic interest.\(^5\)

On the other hand, the Court of Claims has consistently taken the opposite point of view under somewhat identical circumstances.\(^6\) Although there is an ostensible conflict between the position of the Tax Court and the Court of Claims on the issue of the effect upon the depletion allowance of a short term terminability clause, the positions of the courts probably can be reconciled when the facts of each case are considered and when the

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\(^{5}\) *Id.*


\(^{5}\) Swank v. United States, 602 F.2d 348 (Cl. Ct. 1979); Thornberry Constr. Co. v. United States, 576 F.2d 346 (Cl. Ct. 1978); Bakertown Coal Co. v. United States, 485 F.2d 633 (Cl. Ct. 1973).
provisions of section 631(c) that prohibit percentage depletion to a lessor are also taken into account. In any event, the United States Supreme Court which granted certiorari in Swank v. United States on May 12, 1980, will probably soon resolve the conflict.

The second requirement for a taxpayer to be entitled to the depletion allowance is that income be derived from the extraction and sale of the mineral. Hence, a party selling a mineral deposit in place for a fixed amount is not entitled to depletion, since the seller in such case will not be looking to the extraction and subsequent sale of the mineral for income.

In the early days of income tax administration, it was contended that only the fee owner of the mineral in place was entitled to a depletion deduction. However, the United States Supreme Court as early as 1925 held that a lessee of mineral assets was entitled to depletion. In that case the Court, recognizing that a lease was tantamount to a property right entitling the lessee to mine and remove the minerals, determined that such a right would bestow the required economic interest. Section 611 of the Code, as well, now specifically recognizes a depletion deduction for the lessee of mineral rights and requires that the deduction be equitably apportioned between the lessor and lessee.

Because it is the economic substance rather than the form of a transaction which determines the existence of an economic interest, it is immaterial whether the technical legal title to the property under state law is transferred with a right to share in the mineral or proceeds therefrom. Thus, the United States Supreme Court has held that an adjacent landowner, the use of whose land was necessary in order to extract the mineral, acquired an economic interest in the mineral in place by dedicating the use of the property to the extraction of the mineral until such mineral was exhausted.

The definition of “economic interest” as contained in the present regulations originated with Palmer v. Bender, the 1933 hallmark decision of the United States Supreme Court. In the

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9 287 U.S. 551 (1933).
Palmer case the taxpayer, after acquiring oil and gas leases on certain property, in turn leased the property to an oil company for a cash bonus and a production royalty. The taxpayer, as a sublessor, claimed the depletion deduction on the oil proceeds. The Service took the position that the taxpayer as a sublessor was not entitled to claim a depletion on its proceeds from the oil production. The Supreme Court, holding that the sublessor was entitled to the depletion allowance, observed:

[T]he lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so, he has an economic interest in the oil in place, which is depleted by production.

. . . .

In the present case, the two partnerships acquired by the leases to them, complete legal control of the oil, in place. Even though legal ownership of it, in a technical sense, remained in their lessor, they as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute. . . . When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor. . . . Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships, and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests.10

The Supreme Court, in rendering its ruling in the Palmer case, held that in order to be afforded the depletion deduction, a taxpayer must possess "an economic interest" in the minerals. The Court went on to define such an interest as existing in "every case in which the taxpayer has acquired by investment, any interest in the . . . [minerals] . . . in place and secures by any form of legal relationship, income from the extraction of the . . . [miner-

10 Id. at 557-58.
als] . . . to which he must look for a return of his capital."11 The
definition of "economic interest," as originally announced in
Palmer v. Bender and as subsequently adopted by the Service in
the regulations,12 has been consistently followed by the Supreme
Court.13

II. TAX TREATMENT OF MINERAL INTERESTS OTHER THAN COAL

It is essential to understand the tax treatment accorded the
acquisition and disposition of mineral interests other than coal in
order to properly appreciate the unique tax treatment available to
ccoal under section 631(c).

In the typical situation, the owner of the mineral interests
other than coal is entitled to capital gain income only when the
entire fee interest in the minerals is "sold." The principle has
been developed in tax law that, in order for a transaction involv-
ing the extraction and removal of mineral deposits from land to
be deemed a "sale," the owner must alienate himself from all in-
terests in the mineral as a result of the transaction.14 Thus, the
United States Supreme Court has held that proceeds paid pursuant
to an agreement in the nature of a mineral "lease" are not
gains from the sale of capital assets, and hence, are not entitled to
capital gains treatment.15 Although this case did not set forth any
guidelines for determining whether a given agreement would con-
stitute a sale or a lease, later cases have examined the various
factors which influence that determination.16

In the typical situation involving mineral interests, it is
therefore necessary that there be a complete alienation of all eco-
nomic interests in the minerals in order for the transaction to be
deemed a "sale" and therefore to be accorded capital gains treat-
ment. If an economic interest in the deposits is retained by the
taxpayer, the transaction is usually not regarded as a "sale" for
tax purposes. As a significant consequence, the proceeds of the

11 Id. at 557.
15 Id.
16 Freund v. United States, 367 F.2d 776 (7th Cir. 1966); Albritton v. Com-
missioner, 248 F.2d 49 (5th Cir. 1957); Crowell Land & Mineral Corp. v. Commissi-
ioner, 242 F.2d 864 (5th Cir. 1957).
transaction must be reported for tax purposes as ordinary income, subject to the applicable depletion deduction.

An example of the foregoing basic tax principle is contained in the case of Freund v. United States.\(^7\) In the Freund case, capital gains treatment of the proceeds paid to the lessor of mineral rights was denied. There the taxpayer had entered into an agreement with a sand and gravel company giving that lessee five years usage of its land for the purpose of mining and processing sand and gravel. In return for entering into the lease, the taxpayer was to receive twelve cents per ton on the aggregate materials removed from the premises, and a minimum payment equal to twelve thousand dollars per year. The Seventh Circuit Court of Appeals held that the agreement was a lease with a retained economic interest in the taxpayer rather than an absolute sale of the sand and gravel in place, and thus the income was subject to ordinary income tax treatment.

Another example of this basic tax principle is illustrated by the Fifth Circuit case of Albritton v. Commissioner.\(^8\) In the Albritton case, the taxpayer executed an agreement requiring royalty payments measured by a fixed percentage of the retail sale value of the sand and gravel removed from the property. The Fifth Circuit held that, since the taxpayer had retained an economic interest in the property, the proceeds were to be treated as ordinary income, subject to the applicable percentage depletion deduction.

The foregoing brief examination of the basic tax principles involved in the disposition of mineral interests other than coal illustrates the unique tax treatment which has been accorded coal by Congress. Under section 631(c), the disposition of coal, even though an economic interest is retained, is treated for tax purposes as a "sale" of a section 1231 asset. As illustrated in the foregoing cases, this tax treatment is diametrically opposite to that accorded other minerals, whose owners must demonstrate that a bona fide sale of a deposit has occurred and that all economic interests in the deposit have been alienated before such taxpayers can treat the transaction as the sale of a capital asset.

\(^{17}\) 367 F.2d 776 (7th Cir. 1966).
\(^{18}\) 248 F.2d 49 (5th Cir. 1957).
In the typical mineral transaction, a taxpayer's retention of an "economic interest" in the minerals will prevent the transaction from being characterized as a "sale" for tax purposes and, therefore, will preclude capital gains treatment on the proceeds. In the usual case, if the Service deems the arrangement to be merely a lease of the mineral interests (and thus a disposition of the mineral with a retained economic interest), the proceeds to the lessee must be reported as ordinary income subject to the applicable depletion allowance.¹⁹ The significance of the tax concession which Congress has made to owners of coal through section 631(c) should now become apparent. The owner of a coal deposit may retain an economic interest, as in a lease arrangement, and still be entitled to capital gains treatment upon the disposition of the coal.

It should be noted that a taxpayer may elect to sell coal outside the special provisions of section 631(c). The taxpayer may elect to do this by simply selling the coal deposit outright to another party for a fixed sum rather than leasing the coal property and receiving a certain amount per ton of coal extracted by the lessee. However, where a sale of coal does not qualify for capital gains treatment under section 631(c), the tax treatment accorded the transaction depends upon whether the coal properties are classified as capital assets or as property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

If the taxpayer cannot demonstrate an investment intent, and if the coal is property held for sale in the ordinary course of business, then the sale of the coal will result in ordinary income to the taxpayer. The courts have consistently taken this position with respect to those sales of timber which fail to qualify under the analogous provisions of section 631(b).²⁰ In the alternative, if a taxpayer can demonstrate that the coal property which has been disposed of has been held primarily for investment and not for sale, then the taxpayer will be entitled to the tax treatment

¹⁹ Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957). See also Rose v. Commissioner, 56 T.C. 185 (1971).

accorded any other capital asset.\textsuperscript{21} It should be obvious though that the sale of coal outright by a coal company engaged in leasing or subleasing coal property would be inadvisable, since the Service probably would take the position that the coal was not a "capital asset" but rather constituted "inventory" of the coal company, and as a result the coal company would realize ordinary income from the sale. Thus, the utilization of section 631(c) in the case of a coal company disposing of its coal interests may very well be mandatory in order to obtain the most advantageous tax treatment.

III. ACQUISITION AND DISPOSITION OF COAL INTERESTS UNDER SECTION 631(c)

A. History of Section 631(c)

As early as 1943, timber owners obtained a special concession from Congress which allowed them capital gains treatment with respect to the proceeds of certain leasing transactions.\textsuperscript{22} The same tax benefits were extended to the recipients of coal royalties beginning in 1951.\textsuperscript{23} By granting capital gains treatment for certain coal royalties, Congress was in effect granting a tax subsidy to the coal industry.\textsuperscript{24} The capital gains treatment was made available in the case of coal royalties to encourage production at a time when the coal industry was facing strong competition from alternative fuels.\textsuperscript{25} Congress likewise extended this tax subsidy in 1964 to the owners of iron ore in order to encourage leasing (and therefore production) of that mineral.\textsuperscript{26}

When iron ore was added to section 631(c), certain restrictions were also imposed. First, the statute was made applicable

\begin{footnotes}
\item[21] Butler Consol. Coal Co. v. Commissioner, 6 T.C. 183 (1946); Harman v. Commissioner, 4 T.C. 355 (1944).
\item[22] Revenue Act of 1943, ch. 63, § 127, 58 Stat. 21 (1944) (formerly 26 U.S.C. § 117(k)) (current version at I.R.C. § 631(b)). This statute provided that timber owners who disposed of timber under a cutting contract, retaining an economic interest, were entitled to § 117(j) treatment (now I.R.C. § 1231).
\end{footnotes}
only to disposals of iron ore mined in the United States. However, Congress did not impose a geographical restriction with respect to coal.

In addition, Congress greatly restricted the use of section 631(c) as to the disposal of iron ore between related taxpayers. Its benefits are not available with regard to any disposal of iron ore to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under sections 267 or 707(b) of the Code, nor to any disposal of iron ore to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore. It is important to note that Congress did not extend this restriction between related taxpayers to transactions of coal properties. Section IV of this article will examine in greater detail the application of section 631(c) in such instances.

In analyzing the tax treatment to be accorded any transaction involving coal interests, it is crucial to appreciate the interplay between section 611 of the Code, dealing with the depletion allowance, and section 631(c), dealing with the income tax treatment to be accorded a taxpayer's gain or loss upon the disposal of coal with a retained economic interest. Section 611(a) provides for a "reasonable allowance for depletion . . . according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary . . . ." The depletion deduction is designed to permit the taxpayer to recoup its capital investment in the minerals so that, when the mineral is exhausted, the taxpayer's capital is in effect unimpaired.27

In the case of mineral resources such as coal, the allowance for depletion is computed upon either the adjusted depletion basis of the property (known as the cost depletion method)28 or upon a percentage of gross income from the property (known as the percentage depletion method),29 whichever results in the greater allowance for depletion for any taxable year.30 Cost depletion is determined by dividing the tax cost basis of the depletable

28 See I.R.C. § 612.
29 See I.R.C. § 613.
natural resource by the number of units estimated to be contained in the deposit. The quotient is the cost depletion per unit. The depletion deduction for the year is determined by multiplying the number of units extracted and sold during the year by the cost depletion per unit.\textsuperscript{31}

Under percentage depletion, the alternative method, a flat percentage of the gross income realized during the year from the property is allowed as the depletion deduction.\textsuperscript{32} This deduction may not exceed fifty percent of the taxable income from the property, computed without regard to the depletion allowance.\textsuperscript{33} Percentage depletion typically results in a larger deduction than the cost depletion method.

In the case of leased property, depletion deductions must be equitably apportioned between the lessor and the lessee.\textsuperscript{34} Although section 611(b) establishes an equitable apportionment of the depletion allowance between those parties, this provision of the Code must be read in conjunction with section 631(c), which provides that an owner who disposes of coal under any form of contract in which he retains an economic interest in the mineral is not entitled to percentage depletion on the income received upon the disposal.\textsuperscript{35} Rather, the royalties received are subject to capital gains treatment, without the benefit of percentage depletion. The result of the operation of these two sections is that, in the typical leasing situation, the lessee becomes entitled to the entire depletion allowance and deducts it from the gross income gained by the sale of the coal while the lessor is entitled to report its royalty proceeds from the leasing of the coal at capital gains rates.\textsuperscript{36}

B. Statutory Requirements of Section 631(c)

The language of section 631(c) is deceptively simple and

\textsuperscript{32} For coal, the allowance is ten percent. I.R.C. § 613(b)(4).
\textsuperscript{33} I.R.C. § 613(a); Treas. Reg. § 1.613-2(c)(1), T.D. 7170, 1972-1 C.B. 178.
\textsuperscript{34} I.R.C. § 611(b)(1).
\textsuperscript{36} See, e.g., Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624, 632-33 (1965).
straightforward.\textsuperscript{37} It should initially be noted that it is not an elective provision. If the requirements of the section are met, the statute will apply to the transaction irrespective of the wishes of the taxpayer. Analyzing its prerequisites, section 631(c) provides that a "disposal" of coal is deemed to be a sale where (1) the coal has been held for more than one year before such disposal; (2) the disposing taxpayer is the "owner" of the coal; and (3) the disposal is under any form of contract by virtue of which such owner retains an economic interest in the coal. There are thus three basic requirements for the applicability of the statute to a transaction: the holding period requirement of one year; an ownership requirement; and a disposition requirement under which the property must be transferred pursuant to a special type of contract whereby the disposing party retains an economic interest in the coal.

\textsuperscript{37} The section provides:

In the case of the disposal of coal (including lignite), or iron ore mined in the United States, held for more than 1 year before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal or iron ore, the difference between the amount realized from the disposal of such coal or iron ore and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal or iron ore. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal or iron ore, and the word "owner" means any person who owns an economic interest in coal or iron ore in place, including a sublessor. The date of disposal of such coal or iron ore shall be deemed to be the date such coal or iron ore is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535(b)(6) or section 545(b)(5)). This subsection shall not apply to any disposal of iron ore—

(1) to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under Section 267 or 707(b), or

(2) to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore.
coal. If section 631(c) applies, the coal becomes a section 1231 asset and is eligible for section 1231 treatment.38 This is the case regardless of whether the coal is held as a part of the owner's inventory for sale to customers in the ordinary course of its business. The difference between the amount realized from the disposal of the coal and the adjusted depletion basis thereof (plus the deductions disallowed for the taxable year under section 272)39 is accorded capital gains treatment.40

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39 Section 272 provides a special tax treatment for the expenses incurred by a taxpayer in making and administering a contract for the disposal of coal pursuant to § 631(c). The expenditures referred to in § 272 include such items as ad valorem taxes, fire protection, insurance (other than liability insurance), administrative costs, interest on loans, legal and technical expenses, and expenses of measuring and checking quantities of coal disposed of under the contract. Treas. Reg. § 1.272-1(d)(1), T.D. 6841, 1965-2 C.B. 200. It has been held that state income taxes on iron ore royalties are not allowable expenditures under I.R.C. § 272, and thus taxpayers may only deduct them from ordinary income rather than adding those taxes to basis under I.R.C. § 631(c). Higgins Co. v. United States, 39 AFTR 2d 77-702 (D. Minn. 1977), aff'd, 566 F.2d 595 (8th Cir. 1977). The same rule would presumably apply to coal.

Although § 272 itself precludes a deduction for these items, they are added to the adjusted depletion basis of the coal for purposes of computing gain or loss under § 631(c). However, in the event that these expenditures plus the adjusted depletion basis of the coal disposed of in any taxable year exceed the amount realized under the § 631(c) contract during such taxable year, such excess is considered under § 1231 as a loss from the sale of property used in the trade or business. Treas. Reg. § 1.1231-1(c), T.D. 6841, 1965-2 C.B. 200. Any excess not used as a reduction of gain under that section is a deductible loss under § 165(a). I.R.C. § 272. Where no gross royalty income is realized under the contract of disposal in a particular taxable year, the expenditures are treated without regard to § 272. Id.

In addition, the provisions of that section have no application for purposes of computing personal holding company income under § 543. Treas. Reg. § 1.1272-1(e), T.D. 6841, 1965-2 C.B. 200 provides in pertinent part:

For example, the taxpayer may, for the purposes of section 543(a)(3)(C) or the corresponding provisions of prior income tax laws, include in the sum of the deductions which are allowable under Section 162 an amount paid to an attorney as compensation for legal services rendered in connection with the making of a coal royalty contract or iron ore royalty contract (assuming the expenditure otherwise qualifies under section 162 as an ordinary necessary expense incurred in the taxpayer's trade or business), even though such expenditure is disallowed as a deduction under section 272.

40 I.R.C. §§ 631(c), 1231(b)(2).
1. **Holding Period Requirement**

For determining the bounds of the one year holding period, section 631(c) provides that "the date of disposal . . . shall be deemed to be the date such coal or iron ore is mined." Congress saw fit to insert this language into the statute in an effort to clarify the considerable uncertainty that had arisen under the comparable statute dealing with timber leasing. The confusion arose from a Tax Court decision which held, under the particular facts in that case, that disposal of timber occurred when the lease was made, and not when the timber was cut. The insertion of the foregoing language into the statute removed the confusion by providing that the lessor's holding period should run to the time the coal is actually mined. If the coal has been held for more than one year on the date it is mined, it is immaterial that it had not been held for more than one year on the date the contract of disposition was executed by the owner of the coal deposit.

The fact that the disposition date for purposes of section 631(c) is keyed to the date of mining rather than the date on which the rights to it are granted or conveyed is of paramount importance for planning purposes. This is particularly true with respect to a sublessor that intends to dispose of the coal pursuant to a section 631(c) lease. If the coal is mined after one year from the effective date of the lease from the landowners to the sublessor, then the sublessor will be entitled to capital gains upon its disposal of the rights to its sublessee. The sublessor does not have

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43 Treas. Reg. § 1.631-3(b)(1), T.D. 6841, 1965-2 C.B. 200. See also Union Bag-Camp Paper Corp. v. United States, 325 F.2d 730 (Ct. Cl. 1963). There, the court held that the taxpayer was the "owner" of the timber disposed of to third parties under cutting contracts, and that it was entitled to capital gains treatment. The Service had attempted to argue that the entire gain from the cutting contracts should have been taxed as ordinary income because of the failure to comply with the six months holding period requirement. This argument was based on the fact that both the lease and the cutting contract contained the same effective date. It was argued that the timber "disposal" occurred on the same day as its acquisition. The case was distinguished from Springfield Plywood on factual grounds, although the court noted that § 117(k) of the 1939 Code, the predecessor to the current § 631(b) (which contains the same language in this regard as § 631(c)), provided that "the date of disposal of such timber shall be deemed to be the date such timber is cut."
to wait one year before subleasing the property in order to be entitled to capital gains treatment. In fact, the sublessor could enter into a sublease immediately after it acquires the lease from the landowner as long as the coal is mined more than one year after that date. On the other hand, income from coal mined prior to the end of the requisite holding period is subject to tax at ordinary income tax rates, but is also subject to a deduction for depletion.44

The regulations provide that a "successor to the interests of a person" who has disposed of coal or iron ore under a contract by virtue of which he retained an economic interest in the mineral is also entitled to the benefits of section 631(c).46 The Service in Revenue Ruling 59-41648 interpreted the term "successor to the interests of" as used in the regulations to include, among others, (1) a devisee or legatee, (2) a purchaser of the whole or an undivided interest of the original owner or sublessor, (3) a donee, and (4) a shareholder whose interest is acquired upon the liquidation of a corporation. The ruling also sets forth the following general guidelines for determining the applicable holding period with respect to the foregoing entities.

In the case of a devisee or legatee, the date of acquisition is the date of the decedent's death rather than the date of distribution. The exact period during which the asset was held is computed by excluding the date on which the asset was acquired and including the date of disposal.

In the case of a purchaser of a whole interest or of an undivided interest, the holding period would begin the day following the date of acquisition. The day of acquisition is either the day title passes or that day on which there is delivery of possession and the privileges and burdens of ownership are assumed by the purchaser, whichever occurs first.

In the case of a donee, the holding period begins the day after the date the property was acquired by the donor. However, if the property had a value lower than the basis to the donor at the date of gift and it is disposed of by the donee for less than such

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value, the holding period of the donee begins the day after the date of gift.

In the case of a qualified electing shareholder whose interest is acquired through the liquidation of a corporation under section 333 and who has a substituted basis under section 334(c), the holding period begins to run from the date the shareholder acquires the stock of the liquidating corporation, excluding the date of acquisition. If, however, the interest is acquired in a complete liquidation under section 331 of the Code, there is a new holding period which begins on the day after the liquidation. In the case of a corporation whose interest is acquired in connection with a reorganization as defined in section 368(a) and which has a substituted basis under section 362(b), the holding period for the property begins on the day after the date of acquisition of the property by the transferor corporation.

Revenue Ruling 59-416 also provides that the holding period for a sublessor begins on the day after the effective date of his lease with the lessor or the day after he has assumed all of the obligations and duties of a lessee, whichever occurs first. The lessee who becomes a sublessor is not a successor in interest within the meaning of section 631(c) of the Code and section 1.631-3(b)(4)(i) of the treasury regulations.

2. Ownership Requirements

Section 631(c) by its terms applies only in the case of coal royalties received by an "owner." However, the statute defines the term "owner" as "any person who owns an economic interest in coal or iron ore in place, including a sublessor." A successor to the interest of a person who has disposed of coal or iron ore under a contract by virtue of which he retained an economic interest in such coal or iron ore is also deemed to be an "owner" and therefore entitled to the benefits of section 631(c).

The rents and royalties paid with respect to coal disposed of by a sublessor under section 631(c) increase the adjusted depletion basis of the coal and are not otherwise deductible.\textsuperscript{60} In \textit{Joe C. Davis}\textsuperscript{60,1} the Tax Court recently ruled that a sublessor of coal properties may not deduct under section 162 an advanced minimum royalties payment paid to the lessor of coal properties. In \textit{Davis} the Tax Court held that the taxpayer sublessor had to credit those advance minimum royalty payments against royalties the taxpayers received from the sublessees which were treated as long-term capital gains under section 631(c). For example, suppose the owner of coal lands leases the property to a taxpayer who in turn leases the property to a coal mining company. Assume the sublessor-taxpayer pays the owner of the coal fifty cents per ton royalty for coal extracted and the lessee coal mining company pays the taxpayer a royalty of seventy-five cents per ton. The amount realized by the taxpayer-sublessor under section 631(c) is seventy-five cents per ton. This amount will be reduced by the adjusted depletion basis of fifty cents per ton, leaving a gain of twenty-five cents per ton taxable at capital gain rates under section 631(c) but without the benefit of percentage depletion.\textsuperscript{61}

The foregoing example involving three parties—landowner, sublessor, and lessee mining company—is a typical situation in which questions under section 631(c) arise. The dispositions of the coal from the landowner to the sublessor and from the sublessor to the mining company will qualify for section 631(c) treatment provided the other requirements of the statute are met in addition to the ownership requirement. The sale of the coal by the coal mining company-lessee will not qualify for capital gains treatment under section 631(c). In fact, the statute specifically states that its benefits do not apply to income realized by any owner as a "co-adventurer, partner or principal in the mining of such coal or iron ore." Hence, any taxpayer entity that is involved in the mining of the coal, or shares in the risks of such mining as a co-adventurer or partner, may not be entitled to the benefits of section 631(c). Instead the proceeds from the sales of the coal by


\textsuperscript{60,1} 74 T.C. 66 (1980).

the coal mining company-lessee are treated as ordinary income, subject to the applicable depletion deduction. It should here again be noted that the owner is not entitled to the allowance for percentage depletion provided in section 613 with respect to any coal disposed of under section 631(c).52

Given these rules as the framework for tax planning, it is obviously essential in structuring a coal transaction to properly analyze the most favorable tax consequences for the respective parties involved. Each taxpayer must determine which type of tax treatment—i.e. capital gains treatment without the benefit of percentage depletion or ordinary income treatment with the benefit of percentage depletion—is most favorable under the particular circumstances at hand. The answer to this question may vary with the particular taxpayer involved, the entity involved, and other extraneous tax considerations peculiar to that taxpayer. As a general rule, capital gains treatment will be the more beneficial of the two. However, this is not always the case, and the taxpayer should definitely make the requisite calculations in order to make this decision prior to structuring the transaction.53

It should be noted that the section 631(c) coal royalties paid by the lessee are excluded from its gross income from mining for the purposes of computing its percentage depletion allowable under section 613. For instance, in the prior example, if the lessee-coal mining company mines 100,000 tons of coal and sells it for $30.00 per ton, the percentage depletion would be computed as follows. In computing “gross income from the property” for the year, the lessee would subtract $75,000 (100,000 tons X 75¢ royalty per ton) from the $3,000,000 (100,000 tons X $30 per ton). The lessee’s allowable percentage depletion deduction (without reference to the fifty percent limitation based on taxable income from the property) for the year would be $292,500 [($3,000,000 - $75,000) X 10%].54 It should also be noted that advanced royalties which a taxpayer pays under a coal lease and elects to deduct from gross income in the year of payment must likewise be ex-

52 See note 35 supra.
53 For an illustration of the comparative calculations in two different situations, see Haspel & Sumner, Acquisition of Coal Property Interests: Some Federal Tax Planning Observations, in this issue, infra.
cluded from gross income from the property for purposes of computing percentage depletion for the subsequent year in which the mineral is produced and sold.55

3. Disposition Requirement

Section 631(c) applies only to an owner who has disposed of the coal while retaining an economic interest in the mineral after the disposition. A person who merely acquires an economic interest but who has not disposed of coal under a contract retaining an economic interest does not qualify under the statute.56 Thus, an outright sale of the mineral deposit in place would convey all of the owner's economic interest in the property and would prevent section 631(c) from applying.

Advance royalty payments and minimum royalty payments contained in the typical coal lease and received by an owner of coal qualify for capital gains treatment under section 631(c), provided the contract of disposal grants to the lessee the right to apply such royalties to the payment of coal mined at a later time.57 In fact, the Internal Revenue Service has promulgated guidelines governing the issuance of advance rulings on the question of whether bonuses and advance royalties received by a lessee qualify for section 631(c) treatment.58

To illustrate the foregoing rule, suppose a taxpayer leased a certain coal property from a landowner on January 1, 1980. On January 2, 1980, the taxpayer entered into a contract of disposal (a sublease) providing that mining would begin January 3, 1981. Assuming the mining actually begins no earlier, all of the payments received by the taxpayer qualify under section 631(c), including any payments made prior to January 3, 1981. However, if the right to mine coal under the contract expires, terminates, or is abandoned before the coal is mined, the taxpayer will have to treat any payments attributable to the unmined coal as ordinary income, not qualifying as capital gains under section 631(c). This would require the taxpayer to recompute his tax liability on an

amended return.\textsuperscript{59} In addition to advance payments and minimum royalties, bonuses may also be given section 631(c) treatment.\textsuperscript{60}

In Revenue Ruling 77-84,\textsuperscript{61} the Service reviewed three different fact situations for the purpose of determining the applicability of section 631(c) as affected by the disposition requirement. In one situation, an individual received a royalty interest in a coal lease from a mining company for services performed in connection with obtaining the lease for the mining company. In the second situation, an individual received a royalty interest in a coal lease from a coal company for services performed in negotiating and obtaining certain other coal leases for the mining company. In the third situation examined, an individual who had obtained coal leases for a coal company was compensated by payments determined by a rate per ton of coal purchased and processed by the mining company.

The Service ruled in all three instances that none of the royalty payments were subject to capital gains treatment under section 631(c). In the first and second situations, the Service ruled that the royalty payments were not subject to capital gains treatment, but were ordinary income subject to percentage depletion. In the third situation, the amounts received by the individual were not subject to capital gains treatment but were ordinary income not subject to depletion. The distinction between situations one, two and three was that the individual in situations one and two was deemed to have acquired an interest in the minerals in place and was to secure income derived from the extraction of the minerals, whereas in situation three the individual was merely to receive future payments measured by the amount of coal purchased by the mining company from a third party and processed through the mining company's preparation plant, rather than having acquired an interest in the minerals in place and receiving income measured by the amount of coal extracted.

The Tax Court in \textit{Cline v. Commissioner},\textsuperscript{62} reviewed a set of circumstances similar in many ways to the fact situations

\begin{itemize}
\item\textsuperscript{60} Id. § 1.631-3(c)(3).
\item\textsuperscript{61} 1977-1 C.B. 173.
\item\textsuperscript{62} 67 T.C. 889 (1977).
\end{itemize}
presented to the Service in the ruling just discussed. In the Cline case, certain individuals acquired a royalty interest in certain leases as the consideration for the negotiation of those coal leases on behalf of the mine operator. Subsequently, the taxpayers and the mine operator entered into a second contract whereby, in lieu of the royalty interest on the coal mined from those specified leases, the individuals would receive a lesser royalty on all of the coal to be handled by the mine operator. The Tax Court deemed the second agreement to have resulted in a sale or exchange of the royalty interests originally acquired by the taxpayer individuals under the original contract. Significantly, the Tax Court ruled that the individuals did not retain an economic interest (within the meaning of Section 631(c)) under the second contract and therefore did not qualify for section 631(c) treatment. The Tax Court went on to hold that the amounts received by the individuals under the second contract were taxable as gain from the sale of a capital asset which, in that particular case, had not been held for the requisite holding period. Finally, in a related type of arrangement, the Service has ruled that royalty payments received in exchange for an option to purchase coal lands are not subject to capital gains treatment under section 631(c), but are taxable as ordinary income subject to the depletion deduction.63

The foregoing general principles were again recently addressed in a private ruling letter issued by the Department of the Treasury.64 In the private letter ruling, A, a wholly owned subsidiary of D, was formed to own and lease certain coal properties. B was a wholly owned subsidiary of E, which, in turn, was a wholly owned subsidiary of D as well. B was formed to lease the coal properties from A and to sublease these properties to C mining company under certain lease agreements providing for minimum payments.

Based on the foregoing fact situation, the Service ruled that the interest to be retained by A under the A lease with B was an economic interest of an "owner" within the meaning of section 631(c). Since A was not an active participant in the production of coal, royalty income received by A qualified as income from the sale of coal subject to the treatment provided under sections

631(c) and 1231. The interest to be retained by B under the sublease to C was also deemed to be an economic interest of an "owner" within the meaning of section 631(c), and so that entity received the same treatment accorded to A in the lease with B.

The Service also indicated that the minimum payments received or accrued by B with respect to coal leased under a certain sublease with C, and not applied as a credit against payment for coal subsequently mined, constituted ordinary income. In such case, B would be required to recompute its tax liability for the taxable year such payments were received, in accordance with the applicable regulations.65

C. Distinctions Between Surface and Mineral Ownership Under Section 631(c).

In determining the applicability of Section 631(c) to a particular transaction, it is crucial to distinguish between the surface and mineral interests to the coal properties.66 If there has been a severance of the surface and mineral interests, only the royalties paid with respect to the mineral interests are entitled to section 631(c) treatment. Royalty payments made to the surface owners will have to be treated as ordinary income. However, based on the case law, it would appear that this ordinary income should be subject to the benefit of the applicable ten percent percentage depletion deduction.

A situation involving a division of royalty payments between the surface and mineral owners was presented to a United States District Court in Kentucky in 1962. In Omer v. United States,67 the taxpayers owned the surface but had no title to the coal in place. The predecessor in title had conveyed the mineral interest to a coal company, thereby severing ownership of the minerals from ownership of the surface. In 1956, the taxpayers executed a five-year written lease to an individual lessee, providing that "if the Lessee secures the right to mine and remove said coal" from the owners thereof, the lessee was granted the right to use the

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66 See, e.g., Martin v. United States, 409 F.2d 13 (6th Cir. 1969); Omer v. United States, 329 F.2d 393 (6th Cir. 1964).
67 Omer v. United States, 63-1 STAND. FED. TAX REP. (U.S. Tax Cas.) (CCH) ¶ 9113 (W.D. Ky. 1962), aff'd, 329 F.2d 393 (6th Cir. 1964).
surface of the lands and the strata overlying the coal for the purpose of mining and removing the coal by strip mining.

Under the terms of the lease, the taxpayers in *Omer* were to be paid twelve cents for each ton of coal mined and sold from the leased premises. The royalties received by the taxpayers were reported as capital gains, upon the theory that section 631(c) applied to the transaction. Both the district court and the United States Circuit Court of Appeals for the Sixth Circuit held that the taxpayers did not own the coal or any economic interest therein at the time of the execution of the lease to the individual lessee and, under the terms of the lease, made no "disposal of coal" within the meaning of section 631(c). Therefore, the taxpayers were not entitled to capital gains treatment, and the royalty payments were deemed to be ordinary income.

An interesting point in *Omer* is that the taxpayers were able to take a depletion deduction on this ordinary income. The court appeared to be making a distinction between economic interest for purposes of section 631(c) and for purposes of the depletion deduction. In order to be able to take a depletion deduction, it is essential that the taxpayer establish that it has "an economic interest" in the coal in place.68 Apparently, the Service felt that it had to make this concession to the taxpayers. Although the district court did not address this point, the Sixth Circuit made the following statement in a footnote to its decision:

The brief of appellee contains the following explanation of this allowance:
"Because of the apparent hardship to the taxpayers in view of the probable destruction of their land by the strip-mining operation and because Southwest Expl. Co. may possibly justify a conclusion that the taxpayers acquired an economic interest in the coal in place in the transaction with Badgett, the Commissioner conceded in the District Court that the taxpayers are entitled to a depletion allowance. That concession has been taken into account in the judgment."69

It is important to note the distinction that the district court and the Sixth Circuit were making in *Omer* between the economic

68 329 F.2d at 395 (based upon the principles governing depletion as specified in the Internal Revenue Code).
69 Id. at 395 n.2.
interest requirement under section 631(c) and the economic interest requirement under section 611. Although the taxpayers did not have an economic interest in the coal justifying section 631(c) treatment, the courts determined that they did have an economic interest in the coal such as to entitle them to the depletion allowance.

In Martin v. United States,70 the Sixth Circuit was again faced with this issue. In the Martin case, the lessor leased coal properties on which it owned both the surface and mineral interests and, in addition, leased certain areas on which it owned only the surface rights. The taxpayer as lessor claimed capital gains treatment under section 631(c) on all of the royalties received for the leased property, arguing that his circumstances were distinguishable from Omer in that, in the Omer case, the taxpayer did not own any interests in the minerals underlying the surface lands. The district court held that the taxpayer was entitled to capital gains treatment on the royalties received from the surface mining. The Sixth Circuit reversed the lower court's decision on appeal, holding that the payments received under a portion of the contract were merely for the use of the surface of the land and that there was not a disposal of the coal within the meaning of section 631(c) to that extent. That court further observed that although in Omer the taxpayer owned only the surface rights in the land in question, the rationale of that case mandated a similar determination with regard to the applicability of section 631(c).

The court of appeals in Martin failed to discuss the question of whether the ordinary income received by the lessor for leasing the surface rights should have been subject to the depletion deduction. The court simply referred to the result in Omer where an allowance was given to the taxpayer for depletion. Hence, the case law under Omer and Martin made clear that section 631(c) applies only to the disposition of coal interests and does not apply to the disposition of "surface rights."

The Service in its rulings has followed the principle enunciated by the Sixth Circuit in the Martin and Omer cases. In Revenue Ruling 79-144,71 the taxpayer, as lessor, had entered into two

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70 409 F.2d 13 (6th Cir. 1969).
71 1979-1 C.B. 219.
coal leases with a coal mining company. The first lease was a coal lease of ten acres by which the coal mining company acquired the right to mine coal subject to the payment of a royalty of a certain fixed amount per ton for coal mined. The second lease was a lease of the surface by which the coal mining company acquired the right to enter upon, use, and destroy the surface of one hundred acres of real property owned by the taxpayer for the purpose of prospecting for coal. As consideration for the latter lease, the coal mining company agreed to pay the taxpayer royalties for any coal mined by the company from under the one hundred acres. The original ten acre tract was under a portion of the hundred acre tract covered by the surface lease. The question presented the Service was whether royalty payments received under the surface lease were subject to section 631(c) treatment.

The Service ruled that the taxpayer, as a result of having entered into the surface lease, received or would receive a royalty interest in the coal that underlay the area covered by the surface lease when the mining company acquired the right to extract the coal. This royalty income was held to be ordinary income received in return for the right to use the surface overlying such coal. Under the terms of the lease there was no "disposal of coal" within the meaning of section 631(c). Hence, the royalty payments received by the taxpayer from the lease of the surface lands were not proceeds from the disposal of coal under section 631(c).

The Service has also addressed this issue in a recent private letter ruling. In that instance the taxpayer was the owner of certain surface land and the underlying coal rights. The taxpayer granted to a mining company the right to extract coal from the property in addition to the rights of ingress and egress over the surface lands while performing such extraction. The contract agreement called for payment by the mining company of a certain amount per ton of coal mined from the property. The agreement contained the standard reclamation clauses and escalation provisions. The question presented to the Service was whether the owner-lessee of the combined surface and coal lands could treat the entire proceeds received from the lessee-mining company as a disposal of coal subject to section 631(c) treatment or had to ap-

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portion a part of the proceeds and treat them as “rental” receipts for use of the surface lands by the coal company-lessee.

Significantly, the Service ruled that the taxpayer could treat the payments made by the mining company as a disposal of coal subject to the provisions of sections 631(c) and 1231 of the Code. The Service further ruled that no portion had to be allocated to rental receipts for use of the surface lands by the mining company. In comparing these cases it should be noted that there was only one lease involved in this private letter ruling, whereas two lease agreements were involved in Revenue Ruling 79-144 (discussed above).

IV. SECTION 631(c) TRANSACTIONS BETWEEN RELATED TAXPAYERS

There is perhaps no more controversial area under section 631(c) than the question of its applicability to transactions between related taxpayers. This area is of critical concern, since many taxpayers seek to obtain the benefits of both capital gain treatment and the depletion allowance. This goal of obtaining the benefits of both statutory provisions can be accomplished by utilizing different taxpayer entities for various functions. For example, one corporation or entity may engage in leasing the coal properties while another corporation may actually be engaged in the mining of the coal. The question arises whether a lease between one taxpayer (as lessor), seeking to obtain the capital gains benefit of section 631(c), and a related taxpayer (as lessee-miner), attempting to obtain the benefits of the depletion allowance, is permissible.

The provisions of section 631(c) do not apply to income realized by “any owner as a co-adventurer, partner, or principal in the mining of [the] coal.” By this provision, Congress intended to differentiate a lessor entitled to receive royalties from a person participating in the operation of the mine. However, the legislative history of the statute indicates that the Senate Finance Committee rejected an attempt to indicate that the statute’s provisions would be inapplicable if the “owner of the coal was per-

73 L.R.C. § 631(c).
sonally obligated to share a cost of the mining operations.  

Thus, the statutory prohibition in section 631(c) raises the broader question of the applicability of section 631(c) to transactions between related taxpayers.

In the context of related taxpayers, it is significant to note that the statute distinguishes dispositions of iron ore from dispositions of coal. In this regard, the statute specifically states that it shall not apply to any disposal of iron ore—(1) to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b), or (2) to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore.

The Service has expressly ruled that section 631(c) is inapplicable to a transaction between related taxpayers where iron ore is involved. In Revenue Ruling 71-140, the Service was presented with the question of whether royalty payments received by a cost company stockholder qualified for section 631(c) treatment. The cost company was a corporation with three equal stockholder participants. It was organized to mine certain natural iron ore deposits. The three stockholder participants were unrelated parties which owned the company in equal shares pursuant to a contract which provided, inter alia, that the stockholder participants advance all funds, both capital and operative, necessary for the company to operate and share the iron ore produced in the same proportion. One of the stockholder participants in the captive mining company owned in fee certain natural deposits of iron ore. The taxpayer also held leasehold rights to certain iron ore deposits. The taxpayer in turn leased the fee and subleased the leasehold properties to the captive mining company in return for a

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76 Id.


Section 267 deals with the disallowance of deductions between related taxpayers, while § 707(b) deals with the disallowance of deductions between a partnership and a controlling partner or two partnerships in which the same persons own directly or indirectly more than 50% of the capital interests.


78 Id.
royalty amount per ton of iron ore mined. The Service ruled that the proceeds under that lease did not qualify for section 631(c) treatment as a result of the special language in the statute precluding its applicability to a situation involving related taxpayers.

Although Congress saw fit to make section 631(c) inapplicable to transactions between related taxpayers with respect to iron ore, it is significant to note that Congress did not at that time include coal in this prohibition. Coal is conspicuously absent from the exclusionary language in the statute. Thus, there is in fact an implied approval for the disposal of coal to a person owned or controlled directly or indirectly by the same interests which own or control the entity disposing of the coal. The only prohibition would be that the party receiving the royalty proceeds must not be deemed a "co-adventurer, partner or principal in the mining of such coal," which would fall within the statutory restriction.

In Brown v. Commissioner, the Tax Court was presented with a situation in which two partners in a partnership owning a number of coal leases contracted with a coal mining corporation to mine the coal for the partnership. Each of the partners owned fifty percent of the stock in the mining corporation. The specific question before the court was whether the mining corporation obtained an economic interest in the coal in place (as a result of the mining contract) entitling it to a deduction for depletion. The court held that the corporation was entitled to the depletion deduction on its income. It is interesting to note that no question was even raised with respect to the relationship of the parties. The case unfortunately did not address the impact of this relationship upon the application of section 631(c).

However, it was not long before the question was directly addressed. In 1962, the applicability of section 631(c) to the disposal of coal between related taxpayers was considered by the Tax Court. In Keller Mines, Inc. v. Commissioner, a partnership held leases on various coal properties for which it paid a royalty of thirty cents per ton to the landowners. These leases were in turn assigned to a corporation for a royalty payment of fifty cents per ton. The two partners in the subleasing partnership owned and controlled the corporation. The difference between the

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80 21 T.C.M. (CCH) 142 (1962).
amounts the partnership received and the amounts it paid to the landowners was treated by the taxpayers as capital gain income under section 631(c). The partners reflected their proportionate share thereof in their individual joint income tax returns for the taxable years in question.

The Service took the position that the partners were not entitled to use section 631(c) and accordingly denied capital gains treatment on the twenty cent overriding royalty. The Service further contended that the partners' distributive shares should be treated as dividends. This would have resulted in the fifty cents per ton royalties paid to the partnership being treated as ordinary income without the benefit of any depletion deduction.

The Tax Court in Keller Mines held that the difference between the two royalties was a capital gain to the partners and not a dividend from the corporation, since a fair and reasonable royalty payment between unrelated parties would have been fifty cents per ton of coal. It is especially interesting to note that this decision came just two years before the special provisions relating to iron ore were added to the statute. Therefore, the subsequent enactment by Congress of the special rules for iron ore, but not for coal, reinforces the position taken by the Tax Court in Keller Mines.81

The Tax Court was again presented with this question in Merritt v. Commissioner.82 There the taxpayer acquired leases on coal properties and then subleased the coal properties to Paragon Mining Company for overriding royalties. The sublessor-taxpayer was the principal stockholder in Paragon. Paragon claimed the deductions for the amounts paid to the taxpayer, its principal stockholder, as coal royalties. The taxpayer reported the amounts received from the corporation in excess of the royalties he paid others as overriding royalties taxable as capital gains under section 631(c).

81 Commentators had also taken the position that it was permissible under § 631(c) for related taxpayers to enter into coal lease transactions and obtain the capital gain benefits. See, e.g., Bohannon, Tax Treatment of Gains and Losses in Timber and Coal Transactions, 27 Geo. WASH. L. REV. 37, 47 (1958).
The Service in *Merritt* disallowed the royalty paid by Paragon to the taxpayer as a business expense deduction for the corporation and denied the taxpayer the benefit of capital gains treatment on the overriding royalty. Essentially, it was the Service's position that the amounts in controversy paid to the taxpayer by the corporation constituted dividends, taxable as ordinary income, and were thus non-deductible items for the corporation as well. The Service, while not attacking the existence of the corporation as a separate taxable entity, did claim that the payments of overriding royalties by the corporation to the taxpayer were unreasonable in amount.

The Tax Court in *Merritt* determined that twenty-five cents of the thirty cents per ton overriding royalty paid by the corporation to the taxpayer as controlling stockholder was reasonable in amount and deductible as a business expense. In addition, the Tax Court in the *Merritt* case determined that the difference between the twenty-five cents, which constituted a reasonable royalty payment from the corporation to the taxpayer, and the royalties the taxpayer paid to the landowners was taxable to the taxpayer as capital gains under section 631(c). The court went on to hold that five cents of the thirty cents per ton royalty paid by the corporation to the controlling stockholder was a dividend distribution, taxable as ordinary income and not deductible by the corporation as a business expense. The court indicated that a stockholder may deal with his control corporation and that transactions entered into between them may be accorded recognition for tax purposes. However, such transactions will warrant close scrutiny by the Service to determine whether they are mere artificialities contrived as a disguise for the distribution of corporate earnings. This decision by the Tax Court was subsequently affirmed by the United States Supreme Court in the famous *Paragon Jewel* decision.83

In *Valley Camp Coal Co. v. Commissioner*,84 the Tax Court and the Sixth Circuit Court of Appeals denied section 631(c) treatment to a lease transaction between Valley Camp Coal Company and one of its subsidiaries. There, Valley Camp entered into an agreement with one of its several subsidiaries, Bethany, which

83 Id.
84 26 T.C.M. (CCH) 1147 (1967), aff'd, 405 F.2d 1208 (6th Cir. 1969).
was a holding company formed to hold titles to inactive, reserve coal lands. In 1959, Valley Camp completed negotiations with an unrelated corporation from which it had been leasing certain coal mining properties. It had entered into negotiation to purchase a fee interest in the coal properties and arranged for the title to be transferred to Bethany. The selling corporation agreed to sell the property for approximately $750,000. Valley Camp transferred this amount to Bethany, since Bethany at the time did not have any capital to use in making such purchase. After Bethany took title to the property, Valley Camp entered into a coal lease agreement with Bethany in which Valley Camp paid lease royalties to Bethany in an amount of $50,000 and deducted that amount from its income.

Based on these facts, the Tax Court ruled that Bethany was merely a conduit through which Valley Camp paid the seller the purchase price. As such, Valley Camp was not entitled to a deduction for alleged coal royalty payments to Bethany under the lease but rather was relegated to an increase in its depletion deduction. Thus, the court determined that the transaction was entirely artificial and entered into merely for tax purposes. As a result, the court ruled that section 631(c) did not apply to the transaction. The artificiality of the transaction and the gravity of the depletion of the Federal Treasury coffers apparently was too much for the Tax Court to bear. Once again the court stressed the importance of reasonableness and business purpose previously emphasized in the Keller Mines and Merritt decisions.

In Lucas Estate v. Commissioner,85 the Tax Court held that all of the royalty payments between related parties constituted an indirect dividend and did not qualify for capital gain treatment under section 631(c). The court based its decision on the fact that the taxpayers could not present any evidence with respect to the reasonableness of the royalties paid. Because such evidence was lacking, the court held that all of the payments constituted dividends subject to ordinary income treatment.

The Service in a revenue ruling has followed the Tax Court's view that mere stock ownership in the lessee will not render the lessor-owner (sublessor) a "co-adventurer, partner, or principal"

85 71 T.C. 838 (1979).
in the mining operation. In Revenue Ruling 73-33, advice was requested as to whether coal royalties received by the lessor were subject to section 631(c) treatment. There, a power company leased its coal lands, which had been held for the requisite holding period, to a joint venture formed for the purpose of mining the coal. One of the members of the joint venture was a wholly owned subsidiary of the power company. The other member of the joint venture was an unrelated mining company. The joint venture paid a fair and reasonable royalty to the power company for the coal mined. Simultaneously with the execution of the coal lease, the joint venture entered into a coal supply agreement, whereby the power company agreed to buy coal from the joint venture to meet all of the requirements of one of its power plants. Despite the relationship between the lessor and lessee, the Service ruled that the royalty income of the power company from the coal lease was entitled to capital gains treatment under section 631. In so ruling, the Service made the following comments:

The terms co-adventurer, partner, or principal imply a sharing of the risks and control of a mining venture so that income to such taxpayer is derived from the direct operation of a mine rather than passive income as a lessor or sublessor retaining an economic interest. The power company has no direct control of the mining operation and does not share in the risk of mining. The income of the power company is that of a lessor and, as such, is passive income arising from the retention of its economic interest upon leasing its coal lands.

In Revenue Ruling 74-10, advice was requested on whether section 631(c) applied to transactions between members of an affiliated group filing consolidated returns and, if so, whether the transactions were deferred inter-company transactions in computing the consolidated taxable income. Corporation X was the owner of the coal properties and corporation Y was engaged in the

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68 In addition see Rev. Rul. 72-477, 1972-2 C.B. 310 for a similar fact situation. There, a utility company (lessor) was held entitled to capital gains treatment under § 631(c) on royalties received from an unrelated coal mining company (lessee).
69 1973-1 C.B. at 307-08.
70 1974-1 C.B. 251.
mining of coal. In 1972, these corporations entered into an arms-length coal lease agreement whereby X disposed of coal in place to Y, which agreement was structured to come within the provisions of section 631(c). The Service ruled that there was nothing in the regulations which precluded the application of section 631(c) to amounts received by a member of an affiliated group from another member of the group. The Service went on to rule that the transaction was an "inter-company transaction" within the meaning of section 1.1502-13(a)(1) of the treasury regulations rather than a "deferred inter-company transaction" within the meaning of section 1.1502-13(a)(2) of the regulations. This meant that the gain realized by X corporation upon the disposal of the coal in place to Y could not be eliminated in computing the consolidated taxable income of the affiliated group for 1972. Although entitled to capital gain treatment on the royalties received from Y, X, the owner-lessee, was not entitled to the percentage depletion deduction. Y corporation was entitled to percentage depletion as determined under section 613.

The Service has recently issued a private letter ruling recognizing the applicability of section 631(c) to a related party transaction.91 In that instance, the Service was presented with a fact situation in which A, a wholly owned subsidiary of D, was formed to own and lease certain coal properties. B was a wholly owned subsidiary of E, which in turn was also a wholly owned subsidiary of D. B leased the coal properties from A and in turn subleased the properties to an unrelated mining company. In reviewing the fact situation, the Service ruled that the interest retained by A under the coal lease with B was an economic interest of an owner within the meaning of section 631(c). Since A was not an active participant in the production of coal, royalty income received by A qualified as income from the sale of coal subject to the treatment provided under section 631(c). The Service came to this result despite the fact that A and B were clearly related parties.

Thus, the statutory limitations on transactions between related taxpayers apply only in the case of iron ore and not to dispositions of coal. As far as the disposition of coal is concerned, the relationship between the lessor and lessee is relevant only in determining whether the owner is so intimately related as to be a

"co-adventurer, partner or principal in the mining" of the coal. These terms require a sharing of the risks and control of the mining venture such that the income to the owner is derived from direct operation of the mine rather than as passive income received by a lessor or sublessor retaining an economic interest. The mere ownership of all of the stock in both the lessor (or sublessor) and lessee mining company will not of itself render the lessor a co-adventurer, partner, or principal in the mining operation, even though, in the case of iron ore, such a relationship would prevent the application of section 631(c). In the case of coal, if the royalties which the sublessor receives are reasonable and the provisions of the statute are otherwise met, then the transaction should be subject to section 631(c) treatment. However, this arrangement should be avoided if possible, since there is always the potential for a determination that the royalties are unreasonable. It is important to note in this regard that transactions between related taxpayers always invite the close scrutiny of the Service. Any amounts in excess of a reasonable royalty payment will probably be considered as dividend income, if paid by a corporation, and subject to ordinary income rates without the benefit of the depletion allowance, as noted in the Merritt case discussed above. Furthermore, it seems highly probable that any losses that the sublessor might attempt to deduct, based on royalty payments from its related lessee, would be subject to attack. The Service might attempt to utilize section 267 or 707(b) to disallow such losses.

V. Statutory Provisions Related to Section 631(c)

It is important to be aware of the relationship between section 631(c) and various other Internal Revenue Code sections such as those governing Subchapter S corporations, personal holding companies, and the accumulated earnings tax. The Code provides that a Subchapter S election will be terminated if, for any taxable year of the corporation for which the election is in effect, such corporation has "gross receipts more than twenty per-

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93 See note 82 supra and accompanying text.
94 I.R.C. §§ 1371-1379.
95 I.R.C. §§ 541-547.
96 I.R.C. §§ 531-537.
The term “passive investment income” is defined in the Code to include royalties received by a Subchapter S corporation.

This raises the question of whether a Subchapter S corporation should ever be used to make a disposal of coal. Significantly, the regulations recognize that amounts received on the disposal of coal pursuant to section 631(c) are not “royalties,” so corporations which have substantial income from such sources will not be barred from use of the election as they would be if the coal receipts were held to constitute royalties and amounted to more than twenty percent of gross receipts. Hence, a Subchapter S corporation could utilize the benefits of section 631(c) without risking the termination of the corporation’s election, but it is very important to be cautious in this area. A subchapter S corporation which disposes of coal without meeting the requirements of section 631(c) will not only lose the benefits of capital gains treatment but will also risk the termination of the corporation’s election if those royalties and other items of passive income, if any, constitute more than twenty percent of the corporation’s gross receipts. In addition, it should be remembered that a Subchapter S corporation will not qualify for section 631(c) treatment if it is a co-adventurer, partner or principal in the mining of the coal, and that the disposal of the coal prior to the one year holding period

97 I.R.C. § 1372(e)(5)(A).
98 I.R.C. § 1372(e)(5)(C). This section provides that “the term passive investment income means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of sales therefrom).”
99 For a detailed examination of the tax consequences to a corporation and its shareholders incurred by alternative disposal methods, see Southworth & Nix, Federal Income Tax Aspects of the Disposition of Coal Interests by a Corporation, in this issue, infra.
100 Treas. Reg. § 1.1372-4(b)(5)(v), T.D. 6960, 1968-2 C.B. 342, provides in pertinent part:

The term “royalties” as used in section 1372(e)(5) means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The term “royalties” does not include amounts received upon disposal of timber, coal or domestic iron ore with a retained economic interest with respect to which the special rules of section 631(b) and (c) apply.
will not be entitled to section 631(c) treatment. If the royalties received during this period amounted to more than twenty percent of the corporation's gross receipts for that year, this fact alone would result in the termination of the corporation's Subchapter S status, with extremely adverse tax results.

Generally, there will be no problem in utilizing a Subchapter S corporation's disposal of coal pursuant to section 631(c). However, Subchapter S status probably should be avoided if the coal property is already held by a non-electing corporation. In that case, code section 1378 will impose some penalty in the event the corporation elects Subchapter S status. Prior to 1966 there was a complete pass through to the shareholders of any capital gains included in the taxable income of a Subchapter S corporation. Section 1378, added to the Internal Revenue Code in 1966,\textsuperscript{101} imposes a capital gains tax on a Subchapter S corporation if for any taxable year: (1) the corporation's capital gains exceed $25,000; (2) such capital gain income constitutes more than fifty percent of the corporation's taxable income; (3) the taxable income of such corporation for such year exceeds $25,000;\textsuperscript{102} and (4) the Subchapter S election has not been in effect for the three preceding taxable years or since the formation of the corporation, if not in existence for the preceding three years.\textsuperscript{103} Thus, a Subchapter S corporation which owns coal property and has had an election in effect for the three immediately preceding taxable years (or since its inception) may dispose of the coal pursuant to section 631(c) without fear of terminating its Subchapter S election or incurring double taxation under section 1378.

Section 631(c) by its own terms has no application for purposes of the accumulated earnings tax or the personal holding company tax. Thus, for purposes of computing both the accumulated earnings tax and the personal holding company tax, section 631(c) royalty payments constitute ordinary income, although this ordinary income treatment raises the interesting question of whether the lessor is entitled to deduct percentage depletion from that ordinary income in computing these taxes.

The Service appears to have effectively closed the door to

\textsuperscript{102} I.R.C. § 1378(a).
\textsuperscript{103} I.R.C. § 1378(c).
this approach by ruling that a corporation computing its taxable income by taking into consideration the provisions of section 631(c) is not entitled to a deduction for percentage depletion in determining its undistributed personal holding company income. In Revenue Ruling 60-283, the Service examined a situation in which a personal holding company owned coal bearing lands. Its sole business activity was the leasing of these coal lands. The taxable income reported for purposes of the corporate income tax was computed under the provisions of section 631(c). The position of the Service was that the company was not entitled to a deduction for percentage depletion in determining its undistributed personal holding company income. The Service noted that a deduction for percentage depletion is not one of the statutory adjustments listed in section 545(b) for the purpose of determining the undistributed personal holding company income and correlative tax imposed upon such companies. Presumably, the principles announced in that ruling would be equally applicable to the accumulated earnings tax.

VI. CONCLUSIONS

It should be evident from the foregoing examination of section 631(c) that this provision of the Internal Revenue Code is critical in properly structuring any transaction relating to coal property interests. The statute permits a taxpayer to obtain the favorable capital gains tax treatment in circumstances that would otherwise yield ordinary income under standard tax principles. In addition, it is possible to gain the benefits of the provision in a situation involving related parties if a legitimate business purpose is demonstrated and royalty payments are reasonable. This provision of the tax law, which was an important tax concession in 1951, has become increasingly important today to all parties acquiring and disposing of coal properties.