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ACQUISITION OF COAL PROPERTY INTERESTS: SOME FEDERAL TAX PLANNING OBSERVATIONS

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I. INTRODUCTION

As a result of the current world energy situation, an expectation has materialized that, to a large extent, our future energy needs will have to be met by coal. This has caused a renewed interest by many in the acquisition of coal reserves. Furthermore, as a result of significant price increases there has been an increased interest in the acquisition of gold and silver reserves, as well as those of various other minerals. This article will identify the tax considerations which should be taken into account in structuring the acquisition and future operations of solid mineral interests, with an emphasis on coal.

The acquisition of solid mineral interests may take the form of a purchase of a fee interest or a leasehold interest, entering into a lease arrangement, or the acquisition of stock in a corporation which owns reserves. In recent years many of the larger acquisitions, especially with respect to coal, have taken the form of a purchase of stock of an existing mining corporation. Additionally, the acquisition may involve participation in various forms of sharing arrangements, partnerships or joint ventures.

In structuring the acquisition to minimize taxes, there are a number of areas which should be considered from both the transferee's and transferor's perspective: (1) the most appropriate form of the transaction; (2) the structure of initial payments; (3) the

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Ed. Note. This article is adapted from F. BURKE & R. BOWHAY, INCOME TAXATION OF NATURAL RESOURCES ch. 18 (1980). Mr. Haspel was a contributor to that work.

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tax treatment accorded advanced or minimum royalties; the requirement for receipt of capital gains treatment in the case of coal or iron ore royalties; and (5) the allocation of the purchase price in the case of a producing property. Additionally, there are certain post acquisition planning areas which should be considered. These six topics comprise the subject matter of this article.

II. FORM OF TRANSACTION

The form of the transaction may determine the tax treatment to both the transferor and the transferee. The question as to whether the transaction should take the form of a sale as opposed to a lease\(^1\) is especially important with respect to the acquisition of a direct interest in mineral reserves. In the case of proven mineral deposits, the reserves may be quantifiable with a high degree of accuracy. As such, the economic consequences to both parties to a sale and to a lease can be substantially similar. However, as will be seen, the tax consequences may significantly differ. In the case of minerals other than coal and iron ore, the parties may have conflicting tax objectives. It may be in the transferor's best interest to have the transaction take the form of a sale whereas the transferee would derive greater tax benefits from a lease. In the case of coal and iron ore, as a result of the application of section 631(c) of the Code, there may be a mutual interest in having the transaction take the form of a lease. Where conflicting tax objectives are present, they should be taken into account in the negotiating process.

In the case of minerals other than coal and iron ore, the transferor will generally prefer a sale so that he will receive capital gain treatment of the proceeds through the mechanism of section 1231 of the Internal Revenue Code.\(^2\) On the other hand, the

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\(^1\) A sale can be described as a disposition of a taxpayer's entire interest or a disposition of a part of an interest with a similar interest retained. A lease or sublease, on the other hand, can be described as a transfer of an operating right, with a continuing nonoperating interest retained by the lessor. For a detailed discussion on this point, see F. Burke & R. Bowhay, Income Taxation of Natural Resources chs. 3-5 (1980).

\(^2\) I.R.C. § 1231 provides that certain gains and losses from the sale of property used in a trade or business which is held for more than one year are netted. A net gain is treated as a gain from the sale of a capital asset, while a net loss is considered an ordinary loss. If the property is held for investment and not used in
transferee would prefer that the acquisition take the form of a lease, so that the acquisition amount capitalized as leasehold costs, and consequently recoverable only through cost depletion, can be limited. This consideration arises from the rather unique manner in which the exhaustion of mineral property assets is offset against the income derived from their development under the Code. Under the general rule of sections 611 and 613(a), a taxpayer takes as a deduction the greater of cost or percentage depletion, and thus typically there is no deduction derived from the property's cost basis if percentage depletion is applicable. If lease form prevails, however, the transferee will obtain ordinary deductions apart from depletion for any advanced minimum, or production royalties, or delay rentals paid. A lease bonus, however, will have to be capitalized as a lease cost.

Lease treatment is generally as unfavorable for the transferor as it is favorable for the transferee. While the lessee obtains ordinary deductions or gross income deductions for its rental or royalty payments, the transferor is relegated to ordinary rental or royalty income with a depletion deduction. Such ordinary income tax treatment subject to depletion is normally not as beneficial as

a trade or business, it will constitute a capital asset under I.R.C. § 1221.

The general principles of cost depletion authorized by I.R.C. § 612 are best illustrated by the following example. Taxpayer owns a coal reserve of 10,000 tons, in which his adjusted basis is $10,000. In each unit (ton), he thus has a basis of $1. If during the taxable year taxpayer mines and sells 1,000 tons of the coal, his cost depletion deduction will be $1,000. See Treas. Reg. § 1.611-2(a) (1960). Note—This is only a basic example.

Percentage depletion, authorized by I.R.C. § 613, is computed without regard to the physical amounts of the property mined or its adjusted basis. Instead, this form of depletion is basically derived by multiplying a percentage figure, fixed by statute, times the gross income realized from the sale of the extracted mineral during the year. For example, if the hypothetical taxpayer in supra note 3 sold that coal for $30 per ton, the gross income of $30,000 from the sale of coal would yield a percentage depletion deduction of $3,000. (The fractional multiplier for coal is 10%. I.R.C. § 613(b)(4).) See Treas. Reg. § 1.613-1, T.D. 7170, 1972 C.B. 178, 179. Note—This description merely serves as an introduction to the basic principles of percentage depletion and does not consider the significant details that affect this method of computing the depletion deduction.

Treas. Reg. §§ 1.61-8 (1957), 1.612-3(a), 3(b), 3(c), 3(d) (1960).
capital gain treatment. Thus it can be seen that conflicting interests are entertained where mineral rights other than those in coal or iron ore are transferred.

In the case of coal and iron ore, the dilemma is eliminated by section 631(c) of the Code. Basically, this section provides that proceeds (e.g., royalties) received from the disposal of coal or iron ore under a contract by which the owner retains an economic interest will be treated for tax purposes as a gain from the sale of a section 1231 asset, i.e., generally capital gain. Thus in cases where coal or iron ore are involved, it is usually to the parties' mutual advantage to have the acquisition take the form of a lease. The transferor will generally obtain capital gain treatment, the same as he would in a sale transaction, and he has the added benefit of only having to recognize income from advanced or minimum royalties or rentals in the year in which such payments are paid or accrued. This timing benefit may not exist where the initial payment constitutes a lease bonus. The transferor may thus have more flexibility with respect to the timing of the recognition of income if the transaction takes the form of a lease. Where the disposition is treated as a sale, the entire gain may have to be recognized upon entering into the transaction, al-

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9 The Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (codified in scattered sections of 26 U.S.C.) greatly modified the minimum tax for individuals and in doing so eliminated the excluded portion of net capital gains as an item of tax preference for purposes of the “add-on” minimum tax of I.R.C. § 56. However, the excluded portion of net capital gain is still taken into account for purposes of computing the new alternative minimum tax on capital gains. Thus, like the pre-1978 minimum tax, the new alternative minimum tax on capital gains may reduce the benefits of capital gain treatment to an individual. Even so, it should be noted that capital gain treatment is generally more beneficial than ordinary income treatment. The rules relating to the computation of “add on” minimum tax with respect to corporations have not changed, and thus, capital gain still constitutes an item of tax preference for that tax.
10 I.R.C. § 631(c); Treas. Reg. § 1.631-3(a) (1960).
11 See supra note 2.
13 In the case of an accrual basis taxpayer, the entire amount of a lease bonus must be taken into income in the year of the contract even if payments are received in installments over more than one year. Rev. Rul. 68-606, 1968-2 C.B. 42. A cash basis taxpayer may likewise be required to recognize the full amount currently where an installment bonus is evidenced by a freely transferable and readily saleable contract with an ascertainable fair market value. Cowden v. Commissioner, 287 F.2d 20 (5th Cir. 1961); Rev. Rul. 68-606, 1968-2 C.B. 42.
though an installment method election may be available for spreading the purchase payments and the gain over a period of time.\textsuperscript{14}

It should be noted that where a transferee intends to sublease the coal or iron ore reserves as opposed to actually engaging in mining, the form of the transaction and the characterization of the initial payments as advanced royalties may not be meaningful to him. This anomaly results because advanced royalties paid or accrued by a sublessor of coal or iron ore are added to the adjusted depletable basis of coal or iron ore disposed of and are not otherwise deductible by him.\textsuperscript{15} The form of the transaction and the character of payments may still affect the time of recognition of the income to the sublessor, however.

As previously mentioned, various factors may dictate the use of alternative forms of acquisition including the acquisition by purchase or in a tax free reorganization of stock in a company that owns mineral reserves or entering into some form of sharing arrangement, joint venture or partnership with the transferor.

When fixing the purchase price in the case of a stock acquisition, it is necessary to determine the tax basis that the target company has in its assets. If the stock acquisition takes the form of a purchase, an analysis should be performed of the net costs and benefits of liquidating the corporation under section 332 in order to receive a step-up in the tax basis of its assets under section 334(b)(2) of the Code. The costs of liquidating and/or the loss of benefits associated with a lower tax basis should be taken into account in arriving at a purchase price. These factors are discussed in more detail in a later section of this article.\textsuperscript{16}

Acquisition of interests through the form of a sharing arrangement, joint venture, or partnership\textsuperscript{17} may vary to a great degree but, in general, have a common ingredient. They usually involve the contribution of a mineral property by one party and

\textsuperscript{14} I.R.C. § 453.
\textsuperscript{16} See notes 82-89 infra and accompanying text.
\textsuperscript{17} This discussion of sharing arrangements, joint ventures, and partnerships is provided solely to acquaint the reader with some of the basic concepts. An in-depth discussion of this area, because of numerous intricacies and the variety of arrangements, is beyond the scope of this article.
A sharing arrangement can be described as a transaction where the owner of the working interest in a mineral property transfers an interest in the property to another party, who in turn contributes cash, property, or services for the exploration or development of that property. Under the pooling of capital concept, the transfer is not considered a taxable exchange, because each party is deemed to have added to the total reservoir of capital for purposes of developing the property.\textsuperscript{20} The party contributing the cash, property, or services is entitled to a deduction for development, exploration, and depreciation costs incurred to the extent of his working interest share.\textsuperscript{21} The party who contributes the mineral property for development is not entitled to deductions for the development, exploration, and depreciation costs incurred by the other party. By caveat, in the event that the pure pooling concept is not strictly followed (for example, where cash is contributed but its use is not restricted to a specified property in which the interest is acquired, or where in exchange for development of one property an interest in more than one property is acquired) then to the extent of the deviation a taxable event is deemed to have occurred.\textsuperscript{22}

A partnership can similarly be used for acquisition. Typically, one party contributes a mineral property and another cash, services, or other property in exchange for a profit interest with respect to the mineral property. One advantage of this form is that the rules applicable to partnerships generally allow more flexibility in the allocation of income and expense items than do the sharing arrangements rules. Special allocations of income and

\textsuperscript{18} Palmer v. Bender, 287 U.S. 551 (1932); G.C.M. 22730, 1941-1 C.B. 214.
\textsuperscript{19} Id.
\textsuperscript{20} Id.
\textsuperscript{21} Various forms of payout arrangements are commonly used to provide the taxpayer with a deduction for exploration and development costs to the extent incurred.
\textsuperscript{22} Rogan v. Blue Ridge Oil Co., 83 F.2d 420 (9th Cir. 1936), \textit{cert. denied}, 299 U.S. 574; Rev. Rul. 77-176, 1977-1 C.B. 77.
expense items which are provided for in a partnership agreement will generally be recognized for tax purposes when they have substantial economic effect. Consequently, the partnership form in many cases can be used to avoid carried interest problems. It should be noted that, in many cases, a sharing arrangement and/or joint venture may be held to constitute a tax partnership. Accordingly, where partnership treatment is not desired, care must be exercised to make certain that the requirements for election out of partnership treatment under section 761(a) are met.

III. Structure of Payments

As previously indicated it may be in the best interest of the acquirer, from a tax point of view, to have the acquisition of a direct interest in solid mineral reserves take the form of a lease so that part of the consideration will constitute royalty payments separately deductible apart from depletion. Additionally, in the case of coal or iron ore it may be in both parties' interest to have the transaction take the form of a lease for tax purposes. Assuming, based on the economics involved, that the transaction can take the form of a lease, it is necessary to distinguish the various types of payments which may be made pursuant to a lease agreement, including option payments, rentals, advanced or minimum royalties, and the lease bonus.

Option Payments. A potential buyer or lessor may first acquire an option to purchase or lease the property. The option will allow him time to perform certain exploratory and geological work and to analyze the feasibility of the project as well as the geological representations which may have been made by the owner. As a general rule, option payments are not taxable to the recipient until the option is either exercised or expires.4 This rule is based on the reasoning that the character of the gain ordinarily cannot be determined until such time. However, in a leasing transaction for minerals other than coal or iron ore the payments will constitute ordinary income to the lessor in any event. Accordingly, the courts have held that the lessor in such a case is taxable in the

24 Moody v. Commissioner, 1941 B.T.A.M. (P-H) ¶ 41,575 (option to buy oil properties).
year of receipt.\textsuperscript{25} The payments will be considered to be a lease bonus and the lessor should be able to take depletion in the year of receipt.\textsuperscript{26} In the case of a lease of coal or iron ore where the disposition (if it occurred) would qualify for capital gains treatment under section 631(c) of the Code, the general option rule should be applicable and the lessor should not be subject to tax until the option is either exercised or expires, again because of the uncertain character of the gain.\textsuperscript{27} The lessee in all cases would treat the option payment as a lease bonus if the interest is actually acquired.\textsuperscript{28} If the option is not exercised the lessee should be entitled to an ordinary loss.\textsuperscript{29}

Rentals. Rentals (regular minimum payments), commonly found in mineral leases of indeterminable or unproven property, have limited application in the coal industry. They are used as a means of deterring the lessee from postponing or neglecting the exploration and development of the property. \textit{Delay rentals} are more specifically defined by the regulations as "amount[s] paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production."\textsuperscript{30} Minimum royalty payments not subject to recoupment will be treated as delay rentals if they are payable prior to production and avoidable by terminating the lease.\textsuperscript{31} Rental payments that do not meet the definition of delay rentals because they are unavoidable will most likely be characterized as installment payments of a lease bonus\textsuperscript{32} (discussed more fully below) and increase the lessee's cost basis in the property without direct deduction. Delay rentals, on the other hand, may be currently deducted or capitalized at the taxpayer's option.

\textsuperscript{25} Commissioner v. Pickard, 401 F.2d 615 (10th Cir. 1968); Filgo v. United States, 387 F. Supp. 1300 (N.D. Tex. 1974).
\textsuperscript{26} Pickard v. Commissioner, 28 T.C.M. 766 (1969).
\textsuperscript{27} Rev. Rul. 69-166, 1969-1 C.B. 37.
\textsuperscript{28} Id.
\textsuperscript{29} I.R.C. § 1234; Treas. Reg. § 1.1234-1(a)(3), -1(f), -1(g) ex. 3 (1957).
\textsuperscript{30} Treas. Reg. § 1.612-3(c)(1) (1960).
\textsuperscript{31} Lambert v. Jefferson Lake Sulphur Co., 236 F.2d 542 (5th Cir. 1956).
\textsuperscript{32} Patch v. Commissioner, 1941 B.T.A.M. (P-H) ¶ 41,552. \textit{See also} Kleberg v. Commissioner, 43 B.T.A. 277 (1941), \textit{acq. on this issue} 1941-1 C.B. 6, 1944 C.B. 16, \textit{nonacq. on this issue} 1952-1 C.B. 5; McFaddin v. Commissioner, 2 T.C. 395 (1943), \textit{acq.} 1943 C.B. 16.
The lessor is subject to ordinary income tax treatment and is not entitled to depletion on any type of rental payments. 33

Advance Royalties and Lease Bonus. An advanced or minimum royalty represents a production royalty paid in advance of the actual mining. It usually takes the form of advanced minimum royalties in order to encourage the lessee to begin production as quickly as possible. A lease bonus, on the other hand, is an amount, determined without regard to future production, that is paid by a lessee as inducement for the lessor to enter into a lease. In fact, production royalties are provided for in addition to the lease bonus. A lease bonus may be payable in lump sum upon the signing of the lease or in installments over a period thereafter, and generally cannot be avoided by surrendering the lease. It is considered to be in the nature of an advanced royalty, and the payee is subject to ordinary income with a depletion allowance,44 (except in the case of coal or iron ore where section 631(c) is applicable—capital gains treatment) a treatment similar to that afforded the receipt of an advanced royalty.

With respect to the payor, however, the tax treatment significantly differs. A bonus is recoverable through depletion55 while, despite uncertainties resulting from the recent amendment to the regulations56 and revocation of rulings,57 it appears that an advanced royalty will be separately deductible apart from depletion on an earned basis.58 If the royalty payment constitutes an advanced minimum royalty payable pursuant to a minimum royalty provision, it is currently deductible to the extent it relates to the taxable year.59

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33 Treas. Reg. § 1.612-3(c)(2) (1960).
44 Treas. Reg. §§ 1.61-8 (1957), 1.612-3(a), -3(d) (1960).
45 Treas. Reg. § 1.612-3(a)(3) (1960). But cf. Rev. Rul. 79-73, 1979-1 C.B. 218. There the Service held that allocable part of the bonus that is excluded in determining the gross income from the property is likewise excluded when determining the 50% of taxable income limitation. Note that since the bonus is not deductible in arriving of taxable income, this position appears to conflict with the language of I.R.C. § 613(a).
58 Id.
The distinguishing characteristic between a lease bonus and an advanced or minimum royalty is that an advanced or minimum royalty is recoupable out of future royalties, while a lease bonus is not.\(^\text{40}\) In order for a payment to constitute an advanced or minimum royalty, as opposed to a bonus or leasehold cost, it should be distinguishable on economic factors. Such distinction can be drawn based on a likelihood of the advanced or minimum royalty being recouped as well as the commercial reasonableness of the payment. Various other economic factors may have to be taken into account in drawing this distinction.\(^\text{41}\)

As outlined above, in many cases it will be in the interest of both parties to have the payments take the form of royalty payments instead of a lease bonus. Often with respect to proven reserves the same economic objectives can be accomplished with either type of payment, but the tax consequences to both parties can differ significantly. Because of the past and present tax importance of the advanced or minimum royalty as a vehicle for structuring hard mineral investments, a more detailed discussion of this concept is warranted at this point.

IV. TREATMENT OF ADVANCED OR MINIMUM ROYALTIES

As previously noted, advanced or minimum royalties may constitute a significant portion of the payments made by a lessee. The tax treatment accorded to the payor of such payments will depend on the date and terms of the contract pursuant to which they are payable.

*Advanced or minimum royalties paid or payable pursuant to a binding contract entered into before October 29, 1976.* The owner of an operating interest who paid or accrued advanced royalties before October 29, 1976 could elect to deduct such advanced royalties in the year paid or accrued, regardless of whether the mineral to which the royalties applied was extracted in such year.\(^\text{42}\) This treatment spawned a popular tax shelter

\(^{40}\) Treas. Reg. § 1.612-3(a), (b) (1960).

\(^{41}\) Note that an initial payment should be distinguished from production payments. See Treas. Reg. § 1.636-3(a) (1973).

\(^{42}\) Treas. Reg. § 1.612-3(b)(3) (prior to 1977 amendment). The fact that the payee may receive capital gain treatment pursuant to I.R.C. §§ 631(c) and 1231 on the advanced or minimum royalties plays no part in determining the deductibility.
scheme involving shared participation in the deduction of large front-end advanced royalties. In an effort to curtail the tax shelter activity in this area, the regulations were amended, effective October 29, 1976, and the Revenue Service revoked the rulings that had stood as the authority for the structuring of these transactions.

However, the treatment accorded the payor under the amended regulations will nonetheless follow pre-amendment rules for advanced royalties paid or accrued on or after October 29, 1976, if prior to such date the mineral lease was: (1) binding upon the party who in fact pays or accrues such royalties; or (2) required, pursuant to a written contract which bound the party who in fact pays or accrues such royalties to execute a lease requiring the payment of the advanced royalty. The payor must establish that such written contract was binding upon him prior to October 29, 1976, and that the obligation was substantial and not illusory. In the case of advanced royalties paid or accrued by a partnership, the "party" who must have been obligated prior to October 29, 1976, with respect to the payment, is the partner and not the partnership.

The pre-amendment regulations had provided that if an owner of an "operating interest" in a mineral deposit was required to pay royalties on a specified number of units of such mineral annually, whether or not they were extracted within the year, and could recoup the amounts paid on units not extracted during the year against royalties otherwise payable upon subsequent mineral extraction, then that owner could elect to treat such advanced royalties as deductions from gross income either (1) in the year paid or accrued, or (2) in the year the mineral, in respect of which

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43 Supra note 36.
44 Supra note 37.
45 Supra note 36.
46 Id.
47 Id.
the royalties were paid, was sold. The fact that the payee may receive capital gain treatment pursuant to sections 631(c) and 1231 of the Code on the advanced or minimum royalties plays no part in determining the deductibility of the royalties by the payor. However, if the payor is a sublessor subject to the provisions of section 631(c) of the Code, the amounts paid are treated as part of the cost depletion basis of the units produced and are not otherwise deductible. In a rather broad interpretation of that regulation, the Service held that where sufficient mineral reserves existed to assure recoupment, even a single advanced royalty payment was deductible, despite the requirement of the regulations that such payments be made annually. The Service also recognized the deductibility of advanced royalties in respect of a contract calling for royalties based on a specific percentage of the total proceeds, despite the fact that such advanced royalties were not literally paid on a specified number of units, as required by the same regulations.

This election to deduct advanced royalties represented a significant tax incentive to the industry, whereby an initial payment made on entering into a lease, if structured as an advanced royalty, was currently deductible. Structuring the consideration for the acquisition of reserves in the form of advanced royalties was used in many cases as a financing technique.

Advanced or Minimum Royalties Paid or Payable Pursuant to a Binding Contract Entered Into After October 29, 1976. On October 29, 1976, the Service proposed an amendment to the regulations concerning the deductibility of advanced royalties, effective as of such date, and suspended on a prospective basis the Revenue Rulings which espoused the seemingly broad interpretation of the regulations. The regulations were subsequently

48 Treas. Reg. § 1.612-3(b)(3) (prior to 1977 amendment).
49 Treas. Reg. §§ 1.612-3(b)3, 1.631-3(b)(3)(ii)(a), see also Davis v. Commissioner, 74 T.C. (No. 66) (1980).
50 Rev. Rul. 74-214, 1974-1 C.B. 148 (later revoked by Rev. Rul. 77-489, 1977-2 C.B. 177). In Rev. Rul. 70-20, 1970-1 C.B. 144 (also revoked by Rev. Rul. 77-489), the Service ruled that advanced minimum royalties paid over a limited number of years were deductible as well.
52 Internal Revenue Service News Release, I.R. 1687 (Oct. 29, 1976); Notice of
amended and the Revenue Rulings revoked.\textsuperscript{53} The regulations now provide that the payor of advanced royalties which are subject to recoupment shall treat them as deductions from gross income for the year the mineral, in respect of which the advanced royalties were paid or accrued, is sold.\textsuperscript{54} Where the mineral is sold before production, the mineral product is considered to be sold when the mineral is produced.\textsuperscript{55} However, in the event that advanced royalties which are subject to recoupment are paid or accrued as a result of a minimum royalty provision that requires substantially uniform royalty payments over the life of the lease, or for a period of at least 20 years, the payor at his option may deduct such minimum royalty payments in the year they are paid or accrued.\textsuperscript{56} In the case of a lease which is subject to renewal or extension, the period for which it may be renewed or extended is treated as part of the term of the original lease for purposes of determining whether a minimum royalty provision as defined is present.\textsuperscript{57} The Service has held that the regulations limit the deduction for advanced royalties in a taxable year to the extent they are properly attributed to that year and not to additional future years.\textsuperscript{58}

\begin{itemize}
  \item Proposed Rulemaking, 41 Fed. Reg. 48,133 (1976) (proposing amendments to Treas. Reg. § 1.612-3(b)(3)).
  \item See notes 33 and 34 supra.
  \item Id.
  \item Id. In Rev. Rul. 80-73, 1980-11 IRB-10 the Service addressed a situation where minimum annual royalty payments were payable by both cash and accrual basis taxpayers, in part with respect to the case basis taxpayer and entirely with respect to an accrual basis taxpayer with unsecured, non-recourse, non-interest bearing notes which had no maturity date and were payable only to the extent of the proceeds received from the sale of the minerals. The service held that the amounts represented by the notes were not advanced royalty payments under U.S. Treas. Reg. Section 1.612-3(b)(3) since they were not payable whether or not the minerals were extracted. Further, the cash payments made by the cash basis taxpayer, which constituted an advanced royalty was held not to be currently deductible since it was not payable pursuant to a minimum annual royalty provision. In Rev. Rul. 79-381, 1979-2 C.B. 244, the Service held that a lease clause requiring advanced royalty payments to be determined using a moving average formula which was computed with reference to production does not constitute a minimum royalty provision since the payments could vary substantially from year to year. Amounts paid pursuant to this clause were thus held not to be currently deductible.
  \item Rev. Rul. 77-489, 1977-2 C.B. 177. The taxpayer entered into a mineral acquisition.
\end{itemize}
The regulations make reference to section 461 of the Code to determine whether a taxpayer may deduct advanced royalties on a paid as opposed to an accrued basis.\textsuperscript{59} They further provide that the rules discussed above do not allow as deductions amounts disallowed under other provisions of the Code,\textsuperscript{60} although at this time the effect of this blanket prohibition is unclear.

As discussed, the amendment to the regulations eliminated a significant tax advantage to the industry as well as effectively eliminating the leverage aspect of the typical mineral tax shelter. A taxpayer may still, however, significantly reduce his taxable income by making advance minimum annual royalty payments, pursuant to a minimum royalty provision as defined in the regulations, on minerals which are to be produced and sold later.\textsuperscript{61} Additionally, certain depletion benefits may result from deducting advanced royalties payable under a minimum royalty provision to the extent deductible in advance of mining. The regulations provide that for purposes of computing percentage depletion, advanced royalties are excluded from gross income from the property in the year in which such royalties are deductible.\textsuperscript{62} Thus, in effect, royalties deductible in advance of mining are never excluded from the percentage depletion base.\textsuperscript{63} It should be noted, however, that the Service in a recent ruling has taken an appar-

lease which provided a nonrefundable minimum royalty of 60x dollars annually over the life of the lease. In the alternative: (1) a cash basis taxpayer paid 600x dollars on the date of the lease, which represented the cumulative minimum royalties due over the life of the lease; and (2) an accrual basis taxpayer executed a promissory note for such amount. The Service held in both cases that the amount deductible in the year of execution of the lease was limited to 60x dollars, i.e., one year's minimum royalty. Contrast the economics of this form of payment with a lump sum advanced royalty, which is now deductible only on an earned basis. In Rev. Rul. 80-70, 1980-11 IRB-5 the Service amplified, Rev. Rul. 77-489, supra and held using the rationale that a minimum royalty payment is similar to rent that it is currently deductible only to the extent it relates to the taxable year. The ruling dealt with a December payment which covered a twelve month period. But see Zaninovich v. Comm. 69 TC 605, rev'd, 616 F.2d 429, 45 A.F.T.R.2d 80-1442 (9th Cir. 1980) which was relied on by the Service as authority in the ruling and which has subsequently been reversed on appeal.

\textsuperscript{60} Id.
\textsuperscript{61} Id.; see supra note 58.
\textsuperscript{62} Treas. Reg. § 1.613-2(c)(5)(iii) (1960).
\textsuperscript{63} Id. This is true because the royalties are never excluded from the gross income from the property when there is no production in the year of deduction.
ently conflicting position that the year of exclusion of advanced royalties is the year of production and sale as opposed to the year of deduction.\textsuperscript{64}

Where advanced monies are necessary, a single payment structured as a recoverable lump-sum advanced royalty may also prove to be more tax beneficial than a lease bonus because it will be separately deductible when the mineral is produced apart from percentage depletion.

\textit{Time and effect of election.} A taxpayer who pays or accrues advanced royalties pursuant to a binding obligation prior to October 29, 1976, or under a minimum royalty provision after such date, must choose between deducting the advanced or minimum royalties when paid (or accrued) or when the mineral product is sold.\textsuperscript{65} The election must be made in his return for the first taxable year, ending after December 31, 1939, in which advanced or minimum royalties are paid or accrued, and the election once made is binding on all subsequent years.\textsuperscript{66} If advanced or minimum royalties are not deducted in the year paid or accrued, the payments are deductible only in the year the mineral is sold.\textsuperscript{67}

V. \textsc{Capital Gains Treatment on Coal Royalties}

First enacted, in part, to encourage the leasing and production of coal when that fuel was facing strong competition from other forms of basic energy,\textsuperscript{68} section 631(c) of the Internal Revenue Code extends the significant tax benefit of capital gain treatment to coal royalties, which otherwise would be taxable to the recipient as ordinary income. While a thorough examination of the various issues that arise under this provision can be found elsewhere,\textsuperscript{69} a brief summary will be sufficient for present

\textsuperscript{64} Rev. Rul. 79-386, 1979-2 C.B. 246 and announcement 79-172, I.R.B 1979-33, 47.
\textsuperscript{66} Id.
\textsuperscript{67} Id.
\textsuperscript{68} H.R. Rep. No. 586, 82d Cong., 1st Sess. 31 (1951). The intent of Congress was to encourage production of coal by benefitting the coal owners, many of whom had entered into long term leases for royalties expressed as a fixed amount per ton of coal extracted rather than as a percentage of the value of the coal when mined. See also H.R. Rep. No. 749, 88th Cong., 1st Sess. 93 (1963).
\textsuperscript{69} See Coggin, \textit{Federal Income Tax Treatment of the Acquisition and Dispo-
purposes.

In the case of a disposal of coal which meets the requirements of the statute, the difference between the amount realized (i.e., the taxable year's total of royalty payments) less the adjusted depletion basis (i.e., the pro rata cost to the taxpayer of the mineral extracted, or "cost depletion"), and less the allocable deduction of expenses separately disallowed under section 272 of the Code, is considered gain or loss of a "section 1231 asset" (i.e., one used in a trade or business, the gain upon a transaction of which, if there is a net section 1231 gain, receives capital gains treatment but for which a net loss offsets ordinary income). This treatment applies not only to royalties received by the mineral owner in the capacity of lessor, but also to a sublessor and to their successors in interest.

Significantly, an arm's length lease of coal to a related party does not cause the lessor to forfeit the favorable treatment of the royalties, and the lessee in such an arrangement, who is entitled to a depletion deduction, retains a relatively favorable tax posture as well. This framework may allow a mineral owner/developer to realize substantial tax savings through the use of multi-company structure, a point which is developed below.

VI. ALLOCATION OF PURCHASE CONSIDERATION—ACQUISITION OF PRODUCING PROPERTY

In situations when an operating mine which has depreciable assets in place is purchased or leased, numerous problems may arise as to the allocation of payments between the depreciable and depletable assets. The parties in such case will have conflicting objectives.

In the event of a sale, amounts allocated to depreciable assets may result in depreciation recapture to the seller. The purchaser, on the other hand, would prefer as high an allocation to deprecables as can be justified, since he subsequently will be entitled to depreciation on the amount so allocated. Some method of equita-

sition of Coal Interests: An Examination of I.R.C. § 631(c), in this issue, supra.

70 Id. (examination of transactions between related taxpayers).

71 Id. See also Pomerance, Coal-Leasing Arrangements Offer Substantial Tax-Shelter Benefits, 44 J. Tax. 350 (1976).

72 See notes 77-81 infra and accompanying text.
ble apportionment between leasehold cost or bonus, and the buildings and equipment, based on the fair market value of the assets, is required.  

This allocation of consideration to the various depreciable and depletable assets is similarly required in the acquisition of a lease. For example, assume that the value of a property which includes no buildings is $150,000, consisting of $30,000 worth of equipment and $120,000 of leasehold value. If the entire interest were sold for $150,000, it is clear that the purchaser should treat $30,000 as equipment cost and $120,000 as leasehold cost.

If the property is subleased rather than sold, the assignor retains a continuing, nonoperating interest in production, and the interest acquired by the assignee is worth less to the extent of the value of the interest retained. The same principle of equitable allocation is applicable. Such allocation must be based upon the respective values of the separate rights acquired by the grantee. Thus, if the owner of the property described above subleased the property to B for $100,000 in cash, retaining an overriding royalty, B would treat $30,000 of his expenditures as equipment cost and $70,000 as leasehold cost. As in the case of a sale, B in this transaction has acquired the entire interest in the equipment, which is stated to have a value of $30,000. Since the total value must equal the sum of the values of the combined parts, it follows that the value of the leasehold burdened with the overriding royalty is the difference between the aggregate consideration and the value of the equipment.

Where a leasehold to producing property includes depreciable assets that are not sold in the transaction, the Service has contended for many years that any cash consideration given for the acquisition must be applied first to the recovery of depreciable basis, and any excess of cash received must be treated as a lease bonus.  

The Service presently allows a lessor to deduct depreciation on his mining equipment on a unit-of-production basis.

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when he grants a lease on developed property and retains a royalty based on production. The entire royalty income is nevertheless included in the lessor's base and excluded from the lessee's base for the purpose of computing percentage depletion.

VII. POST ACQUISITION PLANNING CONSIDERATIONS

Having discussed the factors to be considered for determining the most advantageous mode of acquisition from both the transferor and transferee's vantage point, consideration will now be given to various post acquisition planning areas. The planning areas considered herein are (1) the creation of a multi-company structure; (2) determining whether it would be advantageous, in the case of a purchase of stock of a corporation owning reserves, to liquidate the company so as to receive a step-up in the tax basis of the assets; and (3) other planning considerations to maximize future depletion.

A. Multi-Company Structures

In determining how to best structure the acquisition of coal reserves from a tax point of view, consideration should be given to setting up a multi-company structure so that part of the future income from the mine is subject to capital gains treatment under section 631(c) of the Code. In situations where a fee interest or a leasehold interest is acquired, the acquisition generally can be structured so as to qualify a part of the future production income for such treatment by having a company, other than the one which will actually mine the coal, acquire the reserves and then lease or sublease the property, for a retained arm's length royalty, to a related mining company (i.e., the company which will actually engage in the mining business either directly or through contract mining arrangements).

Assuming the land company is a viable entity capable of withstanding I.R.S. scrutiny, it should be subject to capital

76 Id.
77 Because of the nature of the multi-company structure, it may be subject to close examination by the Service. Accordingly, care should be used in setting the royalty rates so as to eliminate any question regarding the arm's length nature of
gains treatment on the excess of the royalties received each year over the sum of cost depletion and expenses disallowed under section 272 of the Code. In turn, the mining company should be entitled to the percentage depletion deduction, computed on its gross production income after exclusion of royalties paid, including those paid to the land company. The group should thus be able to receive both the benefits of cost and percentage depletion (reduced because of the effect of the royalty payments) and of capital gains treatment provided by the Code.

For example, if a coal property is acquired for $300,000 and revenue over the life of the mine will be $7,000,000, and an arm's length royalty on a sublease is $1,000,000 with net income before depletion from the property of $3,000,000, then the effective federal income tax rate (based on this fact situation, and disregarding the effect, if any, of the "add on" minimum tax) would be 35% if operated by a single company and 28% if the multi-company structure was used, as illustrated by Example A.

Although in most situations the use of a multi-company structure will prove beneficial, if one of a number of factors is present a net detriment could result. If the property is subject to the net income limitation on percentage depletion, then for every dollar of royalty paid by the mining company to the land company, the mining company will lose fifty cents of percentage depletion, as opposed to ten cents in the case where the mining company qualifies for percentage depletion on a gross basis. If this is the case, it is necessary to determine whether the cost depletion benefits and capital gains treatment afforded the land the rate. See Valley Camp Coal Co. v. Commissioner, 405 F.2d 1208 (6th Cir. 1969), for an instance in which the court disregarded an acquisition and subsequent lease to a related company, based on lack of economic effect and business purpose.

80 I.R.C. § 613 (and regulations thereunder).
81 See Rev. Rul. 74-10, 1974-1 C.B. 251. There the Service ruled that royalties paid pursuant to an arm's length coal lease (qualifying under I.R.C. § 631(c)) between members of an affiliated group filing consolidated tax returns do not constitute a deferred intercompany transaction within the meaning of Treas. Reg. § 1.1502-13(a)(2)(i) or (iii) (1966).
82 The percentage depletion deduction may not exceed 50% of the mining company's taxable income, before depletion, from the property. Treas. Reg. § 1.613-2(c)(1), T.D. 7170, 1972-1 C.B. 178.
company will exceed the tax detriment to the mining company from the loss of percentage depletion.

For example, assuming a coal property will have gross revenue of $7,000,000 and that an arm’s length royalty on a sublease would be $1,000,000 over the life of the mine, with net income (before depletion) of $1,280,000 and total landowner royalties of $600,000, the effective tax rate (based on this fact situation and disregarding the effect, if any, of the “add on” minimum tax) using a one company structure would be 23%, while the rate would be 27% if a multi-company structure were utilized, as illustrated by Example B.

If a consolidated income tax return is filed, the tax posture of other members of the group could adversely affect the benefits otherwise obtainable under a multi-company structure. For example, if the other members of the group generate either net operating losses or section 1231 losses, which eliminate the benefits of the section 1231 gains generated as a result of section 631(c) income, and if the cost depletion to which the land company is entitled does not exceed the percentage depletion lost to the mining company, then a net detriment will result from this structure. Additionally, if the land company incurs expenditures such as interest expense, which is subject to offset against section 631(c) income under section 272 of the Code, the benefits from the preferential capital gains rates will be reduced.

The analysis of a multi-company structure in conjunction with an acquisition effected through a stock purchase presents a complex series of considerations interfacing with the question of whether there would be any net benefit associated with liquidating the corporation under section 332 so as to receive a step-up in the tax basis of its assets under section 334(b)(2) of the Code. These subjects are explored in the next section.
### Example A

<table>
<thead>
<tr>
<th>Mining Company:</th>
<th>One Company Structure</th>
<th>Multi-Company Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Sales</strong></td>
<td>$7,000,000</td>
<td>$7,000,000</td>
</tr>
<tr>
<td><strong>Less: Royalty paid to land company</strong></td>
<td></td>
<td>(1,000,000)</td>
</tr>
<tr>
<td><strong>Gross income from mining</strong></td>
<td>7,000,000</td>
<td>6,000,000</td>
</tr>
<tr>
<td><strong>Less: Operating expenses</strong></td>
<td>(4,000,000)</td>
<td>(4,000,000)</td>
</tr>
<tr>
<td><strong>Net income from mining</strong></td>
<td>3,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Less: Percentage depletion (10% of gross income, limited to 50% of net income)</strong></td>
<td>(700,000)</td>
<td>(600,000)</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>$2,300,000</td>
<td>$1,400,000</td>
</tr>
<tr>
<td><strong>Tax (at 46%)</strong></td>
<td>$1,058,000</td>
<td>$644,000</td>
</tr>
</tbody>
</table>

| Land Company:                                       |                       |                         |
| **Royalty received from mining company**           | $1,000,000            |                         |
| **Less: Cost depletion**                            |                       | (300,000)               |
| **Section 631(c) gain**                             | $700,000              |                         |
| **Tax (at 28%)**                                    | $196,000              |                         |
| **Total tax**                                       | $1,058,000            | $840,000                |
| **Net tax benefit**                                 | $218,000              |                         |
| **Effective tax rate on net income from mining ($3,000,000)** | 35%                   | 28%                     |
EXAMPLE B

<table>
<thead>
<tr>
<th>Mining Company:</th>
<th>One Company Structure</th>
<th>Multi-Company Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Sales</td>
<td>$7,000,000</td>
<td>$7,000,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royalty paid to land company</td>
<td>-</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>royalty paid to fee owner</td>
<td>(600,000)</td>
<td>(600,000)</td>
</tr>
<tr>
<td>Gross income from mining</td>
<td>$6,400,000</td>
<td>5,400,000</td>
</tr>
<tr>
<td>Less: Operating expenses</td>
<td>(5,120,000)</td>
<td>(5,120,000)</td>
</tr>
<tr>
<td>Net income from mining</td>
<td>1,280,000</td>
<td>280,000</td>
</tr>
<tr>
<td>Percentage depletion (10% of gross income, limited to 50% of net income)</td>
<td>(640,000)</td>
<td>(140,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 640,000</td>
<td>$ 140,000</td>
</tr>
<tr>
<td>Tax (at 46%)</td>
<td>$ 294,000</td>
<td>$ 64,400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Land Company:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty received from mining company</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Less: Cost depletion</td>
<td>-</td>
<td>0-</td>
</tr>
<tr>
<td>Section 631(c) and Section 1231 gain</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Tax (at 28%)</td>
<td>$ 280,000</td>
<td></td>
</tr>
<tr>
<td>Total tax</td>
<td>$ 294,000</td>
<td>$ 344,400</td>
</tr>
<tr>
<td>Net detriment</td>
<td>$ 50,000</td>
<td></td>
</tr>
<tr>
<td>Effective tax rate on net income from mining ($1,280,000)</td>
<td>23%</td>
<td>27%</td>
</tr>
</tbody>
</table>

B. Liquidation of a Mining Corporation

As previously discussed, many of the acquisitions of solid mineral interests in recent years have taken the form of an acquisition of stock of a corporation which owns reserves. One of the more important areas to be addressed when the acquisition has taken the form of a "purchase" is whether there would be a net benefit in liquidating the corporation in order to receive a step-up in the tax basis of its assets. This inquiry arises when the acquired corporation's tax basis in its assets is less than the acquiring corporation's adjusted basis in the stock purchased. In general, section 334(b)(2) of the Code provides that, where certain
specific requirements are met, the basis of the assets received by a corporation on liquidation of a subsidiary under section 332 will be equal to the adjusted basis of the stock (subject to certain adjustments) with respect to which the distribution was made. In order for section 334(b)(2) to apply, at least eighty percent of the stock of the distributing corporation must have been acquired by "purchase" (as defined) within a twelve month period, and the distribution must be made pursuant to a plan of liquidation adopted within two years of the date of acquisition of control of the distributing corporation.82

In determining whether a net benefit will result from such a liquidation and adjustment of the tax basis of the distributing corporation's assets, the immediate tax costs of the liquidation must be measured against future tax benefits. The tax costs associated with the liquidation of a mining company are for the most part similar to those incurred by a manufacturing corporation, although there are certain exceptions such as the recapture of exploration costs previously deducted under section 617 of the Code.83 In addition, the future tax benefits will generally differ significantly from those of a manufacturing company as a result of the interplay between the step-up in tax basis and the future percentage depletion deductions. For example, if a substantial part of the increase in tax basis is allocated to reserves, and thus recoverable only through cost depletion, the tax benefit may be lost since a taxpayer must instead deduct percentage depletion (which is computed without regard to a cost basis) if it is a larger amount.84 Similarly, when the tax basis in depreciable assets is increased as a result of a liquidation, the tax benefit available through greater depreciation deductions will be reduced if the percentage depletion deductions from the property are limited by the fifty percent of taxable income limitation.

Specifically, the tax costs resulting from the liquidation of a
mining corporation under section 332, where basis is determined under section 334(b)(2), would generally include: investment tax credit recapture; tax on depreciation recapture; tax on exploration recapture; tax on recapture of previously deducted items on hand, such as supplies; and a potential step-down in the tax basis of accounts receivable, inventory, and depreciable assets resulting from an allocation of stock basis determined by the relative fair market value of assets. The potential benefits of such a liquidation generally would include: the step-up in tax basis of reserves, taking into account the use of the multi-company structure in the case of coal (if viable) and the interrelationship with percentage depletion; potential minimum tax benefit; the step-up in tax basis of depreciable assets; and the opportunity to change accounting elections, e.g., depreciation, inventory, etc.

In situations where the acquired company does not have a large investment in depreciable assets, either because the reserves are underdeveloped or because they use contractors to mine, it is possible to avoid a significant part of the costs of liquidation (if any). For example, it may be possible to factor accounts receivable and turn them into cash or its equivalent before liquidation, or reduce inventory, etc. In such case, absent certain nontax factors such as restrictions against lease assignment without a precedent renegotiation of the prime lease with the landowner, a net benefit (at a minimum cost depletion or minimum tax) would result from a liquidation of the company. For coal properties, the multi-company structure discussed above can be implemented by arranging for the land company to lease the reserves to an existing or newly formed mining company after liquidation.

Where the acquired company is an operating mining company with a significant investment in depreciable assets, a much more detailed analysis of the net benefits of liquidation is necessary. Although it may be possible to structure the liquidation to reduce some of the tax costs, the more significant components will likely be unavoidable, i.e., depreciation, exploration, and investment tax credit recapture. In any event, once the costs of liquida-

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84 I.R.C. § 1245(g); Treas. Reg. § 1.1245-4(c)(3) (1965); I.R.C. § 1250; Treas. Reg. § 1.1250-3(c)(2) (1971).
85 I.R.C. § 617(d)(3).
tion are determined, an analysis must be performed, on a discounted cash flow basis, of the projected net benefit of a step-up in the tax basis of depreciable assets and reserves taking into account the effect that increased depreciation deductions will have on the fifty percent net income limitation for percentage depletion.

As another consideration, the use of the multi-company structure for coal property operation requires that the reserves be held by one entity and the mining assets (e.g., equipment) by another, because a lessor or sublessor, in order to qualify for capital gains treatment under section 631(c) cannot be a "co-adventurer, partner or principal in the mining" of the coal. Achieving a separation of operating assets from coal reserves upon liquidation of an operating mining company may present certain difficulties, since a transfer of either the reserves or operating assets to a subsidiary may raise questions as to whether the transaction constitutes a reorganization (which would result in a carryover basis of assets) as opposed to a liquidation. There is, however, authority for the proposition that reorganization treatment will not result in such a situation.89

C. Other Planning Considerations

In structuring the acquisition of reserves from a tax point of view, consideration should be given to capitalizing the acquiring entity with only the minimum amount of debt, if practical. The reason that the acquisition should be financed instead with equity is that if the interest expense is incurred by a mining company, it will be allocable to taxable income from mining and thus may reduce otherwise allowable percentage depletion. Additionally, in the case of coal if the multi-company structure is utilized interest expense incurred by the land company would be allocable under section 272 of the Code to offset the royalties received. Accordingly, the tax benefit for the interest expense would be at capital gains tax rates as opposed to ordinary income tax rates.

As a final consideration, it should be noted that the use of a captive equipment leasing company can also provide certain de-

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89 For a detailed discussion, see Mopsick, Yoc Heating Corp. and Two Step Asset Acquisition, 1 J. Corp. Tax 235 (1974), and Bruce, Liquidations and Reorganizations; "Madison Square Garden" and "Kass," 30 Tax. L. Rev. 303 (1975).
pletion benefits. Under this plan, the leasing company would acquire the equipment and then lease it at an arm’s length rental to the mining company, with the leasing company electing an accelerated depreciation method. This could result in maximum current depreciation deductions for the group while minimizing the impact which the depreciation deductions might otherwise have on the mining company’s percentage depletion deduction by reason of the fifty percent net income limitation. The use of such an entity would likely be subject to close IRS scrutiny. Accordingly, the entity should be properly capitalized, the rental agreement should be arm’s length, and a business purpose for the use of the entity should be documented.

VIII. Conclusion

As can be seen from the foregoing observations, the acquisition of coal properties involves a number of far-reaching and complex tax considerations. Because these acquisitions often require large capital expenditures and are expected to generate significant amounts of profits from ongoing operations, the federal income tax consequences are often a pivotal factor in the overall success or failure of the acquisition and subsequent development of the property. For this reason, careful tax planning should be an integral part of the formulation of any acquisition plan.