April 1960

Income Tax--Fair Market Value of Overriding Royalty Interest--Implied Reserved Economic Interest

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doctor to be well informed about the subject in both treating and testifying. Since an equal amount of knowledge of the injury is necessary in either case, the New Mexico court echoed the other contra cases in saying that they failed to see how any harm could be done by the fact that the examination was not made for the purpose of treatment. The fact that a man's viewpoint as to the magnitude and grievousness of his injury can well shift when that person seeks legal rather than medical relief was ignored or vitiated by this court.

Regardless of the contra holdings, it is believed that the West Virginia supreme court has reached a sound and meritorious decision in the principal case. Granted that the opposite parties in litigation will still use physicians who are either liberal or conservative in answering hypothetical questions based primarily on the plaintiff's alleged condition, still these questions must have a foundation in facts in evidence in order for the jury to make a causal connection between the injury and any answer to these questions, and, therefore, the opportunity for fabricated or exaggerated claims will be greatly lessened.

L. O. H.

INCOME TAX—FAIR MARKET VALUE OF OVERRIDING ROYALTY INTEREST—IMPLIED RESERVED ECONOMIC INTEREST.—Taxpayers sold shares in one corporation for cash and an overriding royalty interest. The cash received in excess of what the shares had cost was declared on their return as capital gain. The amounts received from this overriding royalty had for years after the sale been declared as ordinary income by the taxpayers. They now seek a refund on the basis that the income was not ordinary but was long term capital gain. Held, the fact that they received the overriding royalty interest as part of the sale price of the property is irrelevant. Such an overriding royalty is a property interest, and therefore, the question of whether it must have a fair market value need not be considered. Income received by the owner of a property interest is taxable to him as ordinary income rather than as a capital gain. Warren v. United States, 171 F.Supp. 846 (1959).

Courts may generally treat the acquisition of an overriding royalty by a vendor in a transaction in three distinct ways.

1. They may consider it as part of the entire consideration paid to the vendor, and by reducing it to its fair market value, combine
it with any other payment received to arrive at the whole of the purchase price. This will close the transaction for tax purposes and any amount later received, in excess of such fair market value, will be taxed as ordinary income.

2. They may consider it as part of the purchase price but may decide because of its contingent nature that it has no fair market value. The whole consideration for the purchase could not then be presently ascertained and the transaction would remain open for tax purposes. Since capital gain or loss cannot be computed until the amount realized on the sale is determined, each future payment will be added to purchase price and once the vendor's basis is recouped will be taxed as capital gain.

3. They may consider it as reservation or retention of an economic interest by the vendor. Since he has never actually parted with it, then it was not part of the sale and it continues to earn income for the vendor the same as before the transaction and is taxed in the same manner as ordinary income. The vendor need not actually reserve this interest in the transaction whereby he parted with all of his other interests in the land. The court may imply it from the facts and circumstances of the case.

On first viewing this case there seems to be, in the majority opinion, a new approach in determining what will constitute capital gain derived from a sale of property, where part of the sale price includes an overriding royalty interest. The general rule apparently applicable here is found in INT. REV. CODE of 1954, § 1001 (a), which states that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in section 1011. To determine the amount realized from the sale or other disposition of the property, we must then look to section 1001 (b), which states it shall be the sum of any money received plus the fair market value of the property (other than money) received. Fair market value was used in Treasury Regulations to mean that if a person received for his services something for which there was no market, it could not be considered income. Walls v. Commissioner, 60 F.2d 347 (10th Cir. 1932).

It seems well established that before there is a taxable gain, consideration must be received in cash or it must be readily reducible to cash. Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929); Salt Deposit & Trust Co. v. Miles, 273 F. 824 (D.Md. 1921). The mere expectation of a profit will not give rise to a taxable transaction; for the purposes of taxes, the gain must be realized. Lucas v.
American Code Co., 280 U.S. 445 (1930); Lynch v. Turrisi, 247 U.S. 221 (1918); O'Meara v. Commissioner, 34 F.2d 390 (10th Cir. 1929).

A contingent promise has no fair market value and if it is received as part of the sale price of other property, the transaction will remain an open one for the purposes of taxation. If it has ascertainable value, the transaction will be considered closed. Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948); Perry v. Commissioner, 152 F.2d 183 (8th Cir. 1945).

It is an accepted proposition that a court may not consider a transaction a closed one where the promise of payment is contingent and where the value of the contract remains open until payments are completed. Such a promise is in no proper sense equivalent to cash and the taxpayer—promisee, might never recoup his capital investment from payments conditionally promised. Burnet v. Logan, 283 U.S. 404 (1931). In a situation where the property interest has no ascertainable fair market value when received, the only practicable and accurate method of measuring its value is by application of the money to such valuation as it is received. Westover v. Smith, 173 F.2d 90 (9th Cir. 1949). When a fair market value cannot be determined, then the tax statute cannot be satisfied and no tax can be imposed in the immediate transfer. Propper v. Commissioner, 89 F.2d 617 (2d Cir. 1937).

Where there is a contingent promise, until the seller’s capital investment is returned, it cannot be determined if gain or loss will result from the sale; therefore, if it becomes certain that future payments will result in gain, there is no apparent reason for taxing them as ordinary income. Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948).

On the basis of the above stated cases, if the court interpreted the instant transaction as a sale whereby the seller had conveyed all of the property interests involved and had received a contingent promise in the form of an overriding royalty as part payment, then the court would appear to be departing from the norm by its decision in refusing to consider the fair market value. On the other hand, a different opinion of the decision might be reached if the court did not treat the transaction as a sale.

The principal case does not mention an actual reservation of interest in the conveyance between the taxpayer and the buyer of the stock. However, it is not necessary that this reservation be ex-
pressed because, "Whether an agreement of purchase and sale has conveyed all of the property interests involved so as to make the purchaser fully taxable on all of the resultant earnings or whether the contract has reserved an interest in the seller on which the seller is taxable is a question of the intent of the parties in making the agreement. This intent may be inferred from the wording of the agreement and from the surrounding circumstances." Vermont Transit Co. v. Commissioner, 218 F.2d 468 (2d Cir. 1955).

Where the vendor retains a mineral royalty from land sold, it will constitute an economic interest in the land and requires treatment of his income from it as royalties taxable as ordinary income and not as purchase money payments taxable as capital gain. Hamme v. Commissioner, 209 F.2d 29 (4th Cir. 1953).

If a conveyance provides that the vendor is selling his property in consideration of a cash payment and future royalty payments, then it is not a sale but a leasing arrangement and the payments received thereunder are taxable as ordinary income and not as capital gain. Hamme v. Commissioner, supra; McLean v. Commissioner, 120 F.2d 942 (5th Cir. 1941).

There seems to be no doubt that the decision of the court was just and correct. The only problem that presents itself to this writer is why the court spent so much of its time trying to justify its refusal to consider fair market value of the overriding royalty interest when, to begin with, the transaction was not a sale. If the court did not intend to imply the reservation of economic interests to this case and meant to treat it as a sale, then its decision, though good, is seemingly not based on well established authority but appears to be a minority ruling.

M. J. F.

Income Tax—Loss Incident to "Sale" Involving Oil and Gas Production Payment—Deduction Allowed.—A, taxpayer and sole transferee of X oil company, assigned to B developed leaseholds and tangible assets with an adjusted basis of 332,500 dollars, for a consideration of 250,000 dollars, and specifically reserved a production payment in eighty-five per cent of the working interest in the property. This exception was to terminate when A had received a sum of 3,600,000 dollars plus taxes and interest, the payment to be contingent upon production. A subsequently assigned the production payment to C for 3,600,000 dollars. X com-