Volume 62 | Issue 3 Article 13

April 1960

Income Tax--Loss Incident to "Sale" Involving Oil and Gas Production Payment--Deduction Allowed

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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* company declared a loss deduction of 82,500 dollars, representing the difference between the adjusted basis of the property conveyed to *B* and the cash payment received therefor. The deduction was disallowed by the Commissioner and his position was upheld by the Tax Court. *Held,* reversed. The company never parted with an eighty-five per cent share of working interest, and the production payment did not constitute part of the consideration. The company, therefore, sustained a deductible loss in the computation of income and excess profits taxes. *Kline v. Commissioner,* 268 F.2d 854 (9th Cir. 1959).

The loss in the principal case was incurred as an incident of a "sale" involving the use of the well recognized A-B-C transaction. See SULLIVAN, OIL AND GAS LAW 535 (1955).

The A-B-C scheme allows *A*, as the operator, to assign tangible assets and the property to *B* for a small cash consideration, while excepting and reserving in himself a production payment, and then permits *A* to assign the reserved payment to *C*. This payment, plus any gain derived from a comparison of the cash received to the basis of the assets and property interests conveyed to *B*, constitutes an alienation of *A*'s entire interest in the property for a consideration taxable under the capital gains provisions. INT. REV. CODE of 1954, §§ 1221, 1231; I.T. 4003, 1950-1 Cum. Bull. 10.

A retained production payment is to be distinguished from a royalty in that the former is an in rem economic interest in oil and gas from a specific tract of land. It is free of production expenses, limited by an inflexible maximum recovery, and it does not extend for the life of the leasehold, but only for a fractional part thereof. A royalty is co-terminous with the life of the working interest, and, in its common form has no maximum recovery. The owner of the latter is accorded ordinary income treatment. *Thomas v. Perkins,* 301 U.S. 655 (1937); *Palmer v. Bender,* 287 U.S. 551 (1932); *Columbia Oil & Gas Co. v. Commissioner,* 118 F.2d 459 (5th Cir. 1941). See generally, BREEDING & BURTON, TAXATION OF OIL AND GAS INCOME (1954).

The problem of the *Kline* case, *supra,* arose not, therefore, from the rather spectacular application of the A-B-C transaction and the resultant 3,600,000 dollars retained payment, but rather from the loss incident to the sale of "adjusted-to-basis" leaseholds and depreciated tangible assets, in that part of the transaction which involved the sale from *A* to *B*. Herein the question arose as to whether such figure (82,500 dollars deduction) represented an actual economic loss to the taxpayer or whether it was merely theoretical, in that the taxpayer retained the production payment.

The Commissioner admitted that in the A-B-C transaction that the sale of the retained production payment was to be accorded capital gains treatment. He argued, however, that the sale of the assets at a consideration lower than their depreciated value should not permit the incidence of a deductible loss, since the transaction was to be viewed as integrated for tax purposes. For his authority he relied upon G.C.M. 23623, 1943-1 Cum. Bull. 313, which provided:

> "In cases in which the cash payment is less than the depreciated cost of the depreciable equipment passing by assignment, the excess of such cost over the cash payment represents part of the depletable cost of the retained economic interest . . . in oil and gas in place. It seems apparent that in such cases the entire cost of the assignor, including the cost of depreciable equipment on the property, represents the cost of the interest retained."

This inflexible rule, disallowing any such loss arising from transactions involving *section 1221* or *section 1231 assets*, and a retained production payment, has been somewhat abrogated by a decision of the Supreme Court. *Choate v. Commissioner*, 324 U.S. 1 (1945) (by implication). The *Choate* case clearly stands for the proposition that the tax result in such a fact situation is determined by the intent of the parties. Specifically, the conclusion in a particular case depends on the Tax Court's findings as to "intent," thereby involving all the varied facts from which inferences may be drawn.

In the *Kline* case, *supra*, the Commissioner and the Tax Court held that there was no evidence in the "sale" itself that the sole consideration for the tangible property was the 250,000 dollars paid. The Tax Court, following G.C.M. 23623, *supra*, held that the parties could have if not restricted, varied with impunity or even eliminated the cash consideration by a collateral variation in the amount of the production payment. That court found nowhere in the instrument of conveyance any language indicating expressly, or by implication, that the sum of 250,000 dollars was the sole consideration. It concluded that, from a view of the instrument in its entirety—with particular emphasis on those covenants permitting *A* (or his assignee, *C*) visitorial privileges, and those fixing the obligation of taxes and interest on *B*—the transaction must be regarded as a "package deal" supported by *sub rosa* consideration far in excess of the actual amount paid.

The Ninth Circuit, in reversing the Tax Court, found that three interests were involved in the "sale" to *B*. Two interests were sold: (1) fifteen per cent of the working interests in the leases; (2) tangible assets (equipment). One interest was retained, which was a production payment in eighty-five per cent of the working interests in the leases. To add support to this division, it is to be noted that the taxpayer had testified that the consideration was agreed upon with *B*, an unrelated party, and that both interests were set at fair market value as a result of open negotiations prior to the execution of the conveyance. With the above in mind, the Court in sustaining the deduction, said in relation to the production payment:

> "The company never parted with this interest and it, accordingly, has no bearing upon the problem of the amount of gain or loss derived by the company from the sale of what it actually did sell to [*B*]. . . ."

In the principal case the court further held that the visitorial privileges and other covenants relating to taxes and interest were incident only to the production payment and, as such, did not relate to the sale of the tangible assets and the remaining fraction of leasehold interest.

Taxwise, the Ninth Circuit has, therefore, dichotomized the A-B-C transaction. This remarkable decision has done more than merely enhance the vitality of the "intent" theory; it has conclusively rejected the Commissioner's position which was promulgated in G.C.M. 23623, *supra*.

On the assumption that the case will be carried to appeal, one might well question whether the production payment involved was preserved true to form, that is, as a retention of a valid working interest. It is submitted that, by a construction of the language of the conveyance as regards the "tax-free" and "interest-accruing" covenants, a conclusion is suggested of a base retention of an expense-free income right, rather than of a working interest. Such a conclusion, if merited, would call for a different treatment of the facts at hand.

Should the *Kline* decision be accepted, *in toto*, it would probably effect an unintended extension of an existing tax advantage (asset treatment of a production right). Should this decision, however, be directly nullified, it appears that strict application of G.C.M. 23623, *supra,* would exact hardship upon the small operator experiencing bona fide loss in this type of transaction, and that it would be detrimental to the policy adopted by Congress toward encouragement of the development and expansion of this vital industry.

The application of the "intent" theory, which gained tacit approval in the *Choate* case, *supra,* would seem to be the soundest approach in the determination of whether given deductions, occasioned by "sales" involving production payments, are to be permitted as valid economic losses, or to be disallowed as merely theoretical "losses."

C. H. H. II

LABOR LAW—INJUNCTIONS OF STRIKES AFFECTING NATIONAL HEALTH AND SAFETY.—The United States sought and obtained in the District Court for the Western District of Pennsylvania an injunction under the National Emergency provisions of the Labor Management Relations Act (Taft-Hartley Act), §§ 206-210, 208, 29 U.S.C. 176-180, 178 (1947), against the continuation of an industry-wide strike in the basic steel industry. *United States v. United Steelworkers,* 178 F. Supp. 247 (W.D. Pa. 1959). The Court of Appeals affirmed. *United Steelworkers v. United States,* 271 F.2d 676 (3d Cir. 1959). On certiorari, the United States Supreme Court affirmed. *Held,* by eight justices in a per curiam decision which was amplified by a separate opinion filed later by Frankfurter and Harlan, JJ., that the judgement below was amply supported by the district court's finding that the strike's continuation imperiled the national safety and that the statute as applied was not violative of the constitutional limitation prohibiting courts from exercising powers of a legislative or executive nature. Douglas, J., dissented, stating: (1) that the case should be remanded to the district court for particularized findings as to how the steel strike imperiled the national health; and (2) that since equity traditionally exercises jurisdiction, it should not be held that the only way to remove the danger to national safety is to issue a blanket injunction in the absence of a showing that a partial reopening would not be sufficient. *United Steelworkers v. United States,* 80 Sup. Ct. 1 (Nov. 7, 1959), 80 Sup. Ct. 177 (Dec. 7, 1959).

The National Emergency provisions of the Labor Management Relations Act (hereinafter designated L.M.R.A.), §§ 206-210,