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Sale or Lease: Capital Gain or Ordinary Income Subject to Depletion in Mineral Transactions

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COMMENTS

SALE OR LEASE: CAPITAL GAIN OR ORDINARY INCOME SUBJECT TO DEPLETION IN MINERAL TRANSACTIONS

An owner of land or a mineral interest may enter either of two basic transactions involving the mineral rights: a sale[1] or a lease. Few problems arise where the landowner or mineral owner intends to dispose of his rights to one not normally in the business of exploration and exploitation, who is purchasing these rights for the purpose of speculation. However, problems do arise in those situations in which the landowner or mineral owner desires to enter into a transaction for the purpose of developing his property by exploration and extraction. To the extent that the tax laws, administrative regulations, and jurisprudence permit, the attorney for the landowner or mineral owner should attempt to structure the transaction to obtain the most favorable tax effect for his client. If a transaction is considered a sale, both cash received upon execution of the contract and any subsequent payments treated as installments will be considered the return of capital and any gain will be capital gain. However, if it is found that a lease is executed, the cash payment is regarded as ordinary income in the form of advance royalty and is subject to the applicable statutory depletion allowance. Similarly, payments made as royalties on actual production will be characterized as ordinary income subject to depletion. If there exists the option to choose between these transactions, the ultimate result will be determined by the knowledge and expertise of the attorney and the relative bargaining position of the client.

The jurisprudence[2] reflects an inconsistency in the treatment of functionally similar transactions which look to the development of mineral property, depending upon whether oil and gas

1. In Louisiana, it is well settled that minerals may not be owned separate from the land of which they form a part, and any sale or reservation of mineral rights will only create a servitude giving the owner thereof the right to go on the land to search for and reduce the minerals to possession. Frost-Johnson Lumber Co. v. Salling's Heirs, 150 La. 756, 91 So. 207 (1922). This concept was applied to "hard" minerals in Lee v. Giauque, 154 La. 491, 97 So. 669 (1923). Nevertheless, a sale for federal income tax purposes corresponds to the creation of a mineral servitude in Louisiana jurisprudence, and for the purposes of this paper, the term "sale" will be used for convenience throughout.

2. *Compare* Palmer v. Bender, 287 U.S. 551 (1933) *and* Burnet v. Harmel, 287 U.S. 103 (1932) *with* Linehan v. Commissioner, 297 F.2d 276 (1st Cir. 1961), Crowell Land & Mineral Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957), *and* Turner v. United States, 226 F. Supp. 970 (D. Me. 1964).

or "hard" minerals[3] are involved. As a general rule in the field of oil and gas taxation, a transaction in which the owner of mineral property transfers the property, but retains an economic interest running for the life of the property, will be regarded as a lease or sublease rather than a sale or assignment. Under the basic tax treatment previously outlined, cash received on execution of the contract is taxed as ordinary income subject to depletion, and payments measured by production are treated similarly. However, hard mineral transactions with a similar economic structure have occasionally been treated as sales, with the result that cash payments received either on execution of the contract or on units produced have been regarded as gain realized on the sale of a capital asset.[4] Two possible explanations exist for this dichotomy. First, it might be suggested that, in some instances at least, reserves of hard minerals can be accurately estimated with the result that the combination of cash received on execution of the contract and payments measured by units of production can be found to represent a fair total sales price. Second, the statutory depletion allowances for most hard minerals are substantially smaller than those for oil and gas. This latter fact may have motivated some courts to permit those persons dealing with hard minerals, particularly sand and gravel, to obtain the benefit of capital gain treatment rather than the less advantageous tax consequences of a lease transaction.[5]

This Comment will examine the jurisprudence concerning the above-mentioned transactions by landowners or mineral owners in regard to oil, gas, and hard mineral taxation. Recent decisions demonstrate that the opportunity to choose between

3. The term "hard" minerals should be understood as referring to sand, gravel, sulphur, uranium, *etc.*, but excluding coal, timber, and domestic iron ore, to which special rules apply. *See* INT. REV. CODE of 1954, § 631.

4. United States v. White, 311 F.2d 399 (10th Cir. 1962); Linehan v. Commissioner, 297 F.2d 276 (1st Cir. 1961); (Crowell Land & Mineral Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Turner v. United States, 226 F. Supp. 970 (D. Me. 1964). *See also* Comment, *Sale or Lease? Disparate Tax Treatment of Mineral Transactions by Courts Based on Nature of Minerals Involved*, 42 TEX. L. REV. 707 (1964).

5. In discussing this point, one court noted in dicta that the parties are probably not influenced by the considerably lower statutory depletion rates applicable to hard minerals as compared to oil and gas. United States v. White, 401 F.2d 610 (10th Cir. 1968). However, that case involved uranium. At the time of the decision, the statutory depletion rate for oil and gas was 27½%, and the statutory allowance for uranium was 23%; thus, a difference of only 4½% was involved. The difference between the statutory rate for oil and gas and that for sand and gravel was 22½% when this case was decided. 83 Stat. 630 (1969), *amending* § 613(b), INT. REV. CODE of 1954. *See* notes 44-48 *infra* and accompanying text.

ordinary income and capital gain treatment is fast disappearing where hard minerals are involved.[6] It is difficult to predict whether the opportunity to make such a choice has already been or will in the near future be completely foreclosed. However, it is hoped that analysis of the jurisprudence will afford some basis for determining both the present position of the courts and the future possibility of choosing favorable tax treatments.

Sale v. Lease in Oil and Gas Transactions

The key to determining whether the holder of a mineral property[7] is entitled to a depletion allowance is the concept of the economic interest. An economic interest will be found when (1) a taxpayer has acquired an interest in minerals in place, and (2) he secures, by any form of legal relationship, income derived from the extraction of the minerals.[8] The case which first referred to the economic interest concept was *Palmer v. Bender*.[9] Although the precise issue was whether a transaction was an assignment or a sublease rather than whether the transaction was a sale or a lease, the case is nevertheless relevant to the instant discussion. In *Palmer*, a mineral lessee transferred his working interest[10] to an oil company for a cash bonus, a production payment,[11] and an overriding royalty.[12] At issue was the

6. *See* note 43 *infra* and accompanying text. *Accord*, Rutledge v. United States, 428 F.2d 347 (5th Cir. 1970); Wood v. United States, 377 F.2d 300 (5th Cir.), *cert. denied*, 389 U.S. 977, *decided with* United States v. Peeler, 377 F.2d 531 (5th Cir.), *cert. denied*, 389 U.S. 977 *and* United States v. Green, 377 F.2d 550 (5th Cir.), *cert. denied*, 389 U.S. 978 (1967); United States v. Witte, 306 F.2d 81 (5th Cir. 1962), *cert. denied*, 371 U.S. 949 (1963); Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957).

7. A mineral property is each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. INT. REV. CODE of 1954, § 614(a).

8. Treas. Reg. § 1.611-1(b)(1) (1965).

9. 287 U.S. 551 (1933).

10. A working interest is the mineral interest, plus all of the costs and expenses necessary to bring the minerals to the surface, less all production-measured payments, such as royalties and production payments. 4C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES § 2.04 (1971).

11. A production payment is a right to the minerals in place entitling its owner to a specified percentage of production for either a specific period of time or until a certain sum of money or quantity of materials has been received. *Id.* § 2.07. A production payment may or may not be an economic interest. *See* note 21 *infra*. *See also* notes 22-26 *infra*. *Cf.* Proposed Treas. Reg. § 1.636-3(a)(1), 36 Fed. Reg. 12626 (1971).

12. The overriding royalty is similar in many respects to the royalty interest, except that the overriding royalty is created out of the working interest and is a burden on that interest. C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES § 2.05 (1971).

proper tax treatment of these receipts by the transferor. The Supreme Court held that the taxpayer must have an economic interest in the minerals in place to be entitled to depletion; since the transferor did have such an economic interest, the transaction was a sublease rather than an assignment.[13]

The early cases state that where the owner of a mineral property disposes of such property, but retains an economic interest running for the life of the property, the transaction is a lease or a sublease.[14] However, if the retained economic interest does not have a life coterminous with that of the property, a different result obtains under the early decision of *Commissioner v. Fleming*.[15] In that case, the working interest of a lease was sold for cash, but a production payment was retained. The only distinction between *Fleming* and *Palmer*, therefore, was that in *Fleming* no overriding royalty was retained. However, the court in *Fleming* split the transaction into two parts: the sale of the working interest for cash and the receipt of a production payment. The cash received from the sale of the working interest which was not connected with any production was treated as the sale of any other vendible real property and qualified for capital gain treatment. The production payment was viewed as an economic interest, and, therefore, the income received to pay it was ordinary income subject to depletion.

Thus, the following distinctions can be observed:

(1) When the disposition is made without the retention of any economic interest, the transaction is considered a sale and any realized gain qualifies as capital gain.

13. Palmer v. Bender, 287 U.S. 551, 557 (1933): "The language of the [depletion] statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of oil, to which he must look for a return of his capital. . . . [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."

14. *Id.*; Burnet v. Harmel, 287 U.S. 103 (1932). In the *Burnet* case, the taxpayer received a cash bonus plus a royalty interest running for the life of the property. This was all held to be ordinary income subject to depletion, and the cash bonus was merely viewed as advance royalty. A royalty interest is a right to in-place minerals allowing the owner of the interest a specified percentage of production with none of the expense. C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES § 2.03 (1971). Unlike a production payment, a royalty interest is always an economic interest. *Cf.* note 11 *supra*.

15. 82 F.2d 324 (5th Cir. 1936).

(2) When the disposition is made with the retention of an economic interest running for the life of the property (*e.g.*, a royalty or overriding royalty interest), the transaction is classified as a lease.[16] Cash received upon execution of the contract is treated as advance royalty,[17] and royalty income of whatever nature is ordinary income subject to depletion.[18]

(3) When the disposition is made with the retention of an economic interest for a period less than the life of the property (*e.g.*, a production payment), the transaction is divided into two parts: the cash received on the sale not tied to production, representing gain from the sale of the working interest, is capital gain; the income to pay off the production payment, being in satisfaction of an economic interest, is ordinary income subject to depletion.[19]

The 1969 Tax Reform Act[20] made no change in the sale-lease classifications outlined above. However, whereas before 1969 all production payments were regarded as economic interests, under Internal Revenue Code section 636[21] a production payment

16. *See, e.g.*, Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946); Palmer v. Bender, 287 U.S. 551 (1933); Burnet v. Harmel, 287 U.S. 103 (1932); Commissioner v. Pickard, 401 F.2d 615 (10th Cir. 1968).

17. *See, e.g.*, Burnet v. Harmel, 287 U.S. 103 (1932); Campbell v. Fasken, 267 F.2d 792 (5th Cir. 1959).

18. *See, e.g.*, Palmer v. Bender, 287 U.S. 551 (1933); Burnet v. Harmel, 287 U.S. 103 (1932); Commissioner v. Pickard, 401 F.2d 615 (10th Cir. 1968).

19. *See, e.g.*, Anderson v. Helvering, 310 U.S. 404 (1940); Thomas v. Perkins, 301 U.S. 655 (1937); United States v. Morgan, 321 F.2d 781 (5th Cir. 1963); Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936).

20. Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 630.

21. 83 Stat. 630 (1969), *adding* § 636, INT. REV. CODE of 1954: "Income tax treatment of mineral production payments."

"(a) CARVED-OUT PRODUCTION PAYMENT.—A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property. In the case of a production payment carved out for exploration or development of a mineral property, the preceding sentence shall apply only if and to the extent gross income from the property (for purposes of section 613) would be realized, in the absence of the application of such sentence, by the person creating the production payment.

"(b) RETAINED PRODUCTION PAYMENT ON SALE OF MINERAL PROPERTY.—A production payment retained on the sale of a mineral property shall be treated, for purposes of this subtitle, as if it were a purchase money mortgage loan and shall not qualify as an economic interest in the mineral property.

"(c) RETAINED PRODUCTION PAYMENT ON LEASE OF MINERAL PROPERTY.—A production payment retained in a mineral property by the lessor in a leasing transaction shall be treated, for purposes of this subtitle, insofar as the lessee (or his successors in interest) is concerned, as if it were a bonus granted by the lessee to the lessor payable in installments. The treatment of the production payment in the hand of the lessor shall be determined without regard to the provisions of this subsection.

qualifies as an economic interest in only two situations: (1) where a carved-out production payment is pledged to the exploration or development of the property and otherwise meets the requirements of sections 636(a) and 613;[22] or (2) where the production payment is retained by the lessor in a leasing transaction.[23] If retained on a sale of a mineral property, a production payment is now treated as a purchase money mortgage loan,[24] not as an economic interest as in *Fleming*. The practical consequence of this is that it is the debtor of the production payment, not the creditor, who must report the income from the production payment and who is allowed depletion. The creditor now gets capital gain treatment not only on the cash received upon execution of the contract, but also on the cash received to pay off the production payment because this no longer qualifies as an economic interest. Simply stated, under Internal Revenue Code subsection 636(b), the purchaser of property burdened with a retained production payment is considered to have purchased the entire property, and the income allocable to the retained production payment must now be included in the purchaser's income with all of the attendant consequences. The avowed purpose for adding this section to the Code was to destroy the opportunity which formerly existed under the *A-B-C* transaction:[25] to purchase a mineral property at a low basis and to exclude the substantial amounts of production necessary to pay off the retained production payment from the purchaser's income stream.[26]

"(d) DEFINITION.—As used in this section, the term 'mineral property' has the meaning assigned to the term 'property' in section 614(a).

"(e) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section."

22. 83 Stat. 630 (1969), *adding* § 636(a), INT. REV. CODE of 1954. *See generally* Proposed Treas. Reg. § 1.636-1(b)(1), 36 Fed. Reg. 12626 (1971).

23. 83 Stat. 630 (1969), *adding* § 636(c), INT. REV. CODE of 1954. *See generally* Proposed Treas. Reg. § 1.636-2(a), 36 Fed. Reg. 12626 (1971).

24. 83 Stat. 630 (1969), *adding* § 636(b), INT. REV. CODE of 1954.

25. Although there were many varieties, the basic *A-B-C* transaction involved the sale of the working interest by *A* to *B*, the developer, for cash plus a retained production payment. Under *Fleming*, the cash received upon execution qualified for capital gain treatment. *A* would later sell the production payment to *C* and would be allowed to take capital gain treatment as on the sale of any other capital asset. *B* would have the benefit of a very low depletable basis. *C* would realize income on the difference between the purchase price and the maturity value of the production payment and, in addition, would be able to exclude a substantial portion of this income as depletion.

26. *See generally* Proposed Treas. Reg. § 1.636-1(a)(2), 36 Fed. Reg. 12624-5 (1971); C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES §§ 3.03, 6.19 (1971); Lane, *The Effect of the Tax Reform Act on the*

Various attempts have been made to manipulate tax treatment by changing the legal structure of oil and gas transactions. However, attempted juggling of the sale-lease distinction has generally failed, and the courts have adhered to the time-honored principle that substance, not form, must govern in matters of federal income taxation. For example, the disposition of a mineral property subject to a retained production payment of such size that it could not possibly pay out within the life of the property in question has been treated as a sublease rather than a sale.[27] One of the most interesting attempts to disguise a lease as a sale occurred in *Campbell v. Fasken.*[28] In that case, the landowners conveyed an undivided forty-five percent interest in all of the minerals under their lands to three oil companies. The agreements provided for the payment of a sum of money to the landowners and an obligation on the part of the oil companies to commence drilling within thirty days. Should any of these wells be completed, the landowners were to pay fifty-five percent of the drilling expenses, not to exceed $25,000. In reporting their federal income tax, the landowners treated the amounts received upon execution of the contracts and upon delivery of the mineral deeds to the oil companies as capital gain. The amounts received on their share of production were treated as ordinary income subject to depletion. The Fifth Circuit, relying on the principle that the substance rather than the form of transactions controls their classification, held that the agreement was a leasing transaction, and thus the cash received on execution of the contract amounted to an advance royalty.[29] One of the more interesting aspects of the decision is that the court appears to have disregarded the parties' contemplation of development, which should be a determinative factor in characterizing the transaction as a lease rather than a sale. This would have no application to those situations in which the transaction involves a firm which intends to conduct exploration and exploitation operations on the land;

Investor in Oil and Gas, 23 MAJOR TAX PLANNING 673, 683 (1971); *Effect of Tax Reform Act of 1969 on Taxation of Oil and Gas and Mining Transactions*, 10 OIL & GAS TAX Q. 79, 87 (L. Fiske ed. 1970).

27. United States v. Morgan, 321 F.2d 781 (5th Cir. 1963).

28. 267 F.2d 792 (5th Cir. 1959).

29. Campbell v. Fasken, 267 F.2d 792 (5th Cir. 1959). The dissenting judge took the occasion to point out that the lessor reserving a royalty interest receives this free of cost and that all the landowners had left after entering this agreement was 55% of the minerals, whereas they owned all the minerals before transaction. He was of the opinion that the landowners had sold 45% of the minerals under their land. *Id.* at 797.

however, in those situations alluded to above where the transaction is made with one who intends to hold the property for speculative purposes, this decision indicates that the intention of the parties insofar as development is concerned is immaterial. Thus, a transaction which the landowner or mineral owner genuinely intends to be a sale may nevertheless be characterized as a lease for tax purposes.

It can therefore be observed that the oil and gas jurisprudence has been consistent in applying the principle that the retention of an economic interest running for the life of the property, whether that interest be an overriding royalty, a lessor's royality, or a net profits interest,[30] will characterize the transaction as a lease or sublease, rather than a sale. Additionally, the concept that substance and not form must govern tax consequences has been honored.

Sale v. Lease in Hard Mineral Transactions

In *Crowell Land & Mineral Corp. v. Commissioner*,[31] the landowner and a firm entered into an agreement termed a "Contract of Sale" for the purpose of extracting the sand and gravel under the landowner's property. The landowner was to receive a cash payment upon execution and at each anniversary of the contract, with the amount of the advance payment being recovered from production before any additional amounts were due the landowner. Taking full recognition of the oil and gas jurisprudence and the fact that the landowner did have an interest in production, the Fifth Circuit nevertheless held the transaction to be a sale because the landowner had no remaining economic interest in the property. The court used language which could be taken to mean that, unlike the oil and gas cases, form rather than substance could control tax consequences.[32] *Albritton v.*

30. A net profits interest, for federal tax purposes, is a share of gross production measured by net profits from operation of the property. Like the overriding royalty in that it is created from the working interest, the net profits interest differs from other production-measured payments in that it represents a fractional share of the profit of the operating company, rather than a fractional share of the minerals themselves as produced. C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES § 2.06 (1971).

31. 242 F.2d 864 (5th Cir. 1957).

32. *Id.* at 866: "Like the minority [in the Tax Court], we do not find the arguments of the commissioner and the majority or the cases, involving oil and gas and other mineral leases, cited by them persuasive of the commissioner's contention that Crowell did not make a sale but only executed

Commissioner,[33] decided later in the same year by the same circuit, held that the landowners had entered into a mineral lease by retaining a royalty interest running for the life of the property. The importance of this case is that it distinguishes rather than overrules *Crowell*,[34] and that it lists the relevant factors in distinguishing a sale from a lease.[35]

More recently the Fifth Circuit, in three cases[36] decided on the same day, indicated that it was moving in the direction of applying the well-settled oil and gas jurisprudence in hard mineral cases. In the only one of the three rendered with a full written opinion, *Wood v. United States*,[37] the court was construing

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a mineral lease with a reserved royalty. Indeed, we think that an analysis of the contract of sale and of what was to be, and was, done under it completely rebuts the commissioner's theory that the arrangement was merely one of lease, under which Crowell retained an economic interest within the meaning of the cases the commissioner cites and relies on. The instrument, unlike a mineral lease where the main purpose is development, undertook as its main purposes to convey the entire interest of Crowell for a price to be determined as fixed in it and to be paid in cash in installments. There was no provision or suggestion in it for the retention and payment of a royalty as in oil and gas leases. A bona fide sale was the intent of the parties and it was expressed in terms free from ambiguity throughout the instrument in the provisions and conditions it set out. Looking to the actual circumstances as well as the language of the contract of sale, there is no occasion or basis for resorting to legal niceties of interpretation to defeat the basic purposes and effect of the transaction."

33. 248 F.2d 49 (5th Cir. 1957).

34. Albritton v. Commissioner, 248 F.2d 49, 51-52 (5th Cir. 1957): "[C]onstruing the instrument [in *Crowell*] as a whole and considering it against the total background of transactions under it, the contract was one of sale. Applying the same tests, we hold that the contracts here are leases of the right to remove sand and gravel, yielding to the landowners nothing but royalty."

35. The five factors given by the court were (1) a contract styled a "Contract of Sale"; (2) parties called "vendor" and "vendee"; (3) vendor received a stipulated price per ton, rather than a percentage of sales, indicating that the landowner's receipts are not dependent on the developer's income; (4) production was neither required nor declared to be the central purpose of the contract; and (5) vendee's obligation to reconvey the property at the end of a specific term. *Id.* at 51, n.7 It cannot be denied that all of the factors listed above were present in *Crowell*, but they also indicate the apparent tendency of the court to lend credulity to form over substance. In addition, the final factor can hardly be considered of determinative import since it would be difficult to conceive of a case where a landowner would be willing to part with the ownership of his land in any mineral transaction for the amount he receives as consideration for entering into the agreement. Further, it would appear that whether the landowner's compensation is based on a price per ton rather than on a percentage of sales is a specious distinction inasmuch as production will eventually get into the income stream of the development company.

36. Wood v. United States, 377 F.2d 300 (5th Cir.), *cert. denied*, 389 U.S. 977 (1967); United States v. Peeler, 377 F.2d 531 (5th Cir.), *cert. denied*, 389 U.S. 977 (1967); United States v. Green, 377 F.2d 550 (5th Cir.), *cert. denied*, 389 U.S. 978 (1967).

37. 377 F.2d 300 (5th Cir.), *cert. denied*, 389 U.S. 977 (1967).

a contract, termed a lease, which provided for advance yearly payments to be recouped from production before any additional amounts were due the lessor. The court recognized that the applicable test for determining whether a contract is a sale or a lease is the economic interest test as developed in the oil and gas cases. Consequently, the court held that the royalty interest retained by the lessor was an economic interest running for the life of the property, and therefore, that the transaction was taxable as a lease. The facts which really put at issue the distinction between the two lines of jurisprudence arose in *Rutledge v. United States*.[38] In this case the parties had forsaken a lease agreement to enter into a transaction which tracked the *Crowell* agreement for the purpose of attaining capital gains.[39] The landowners' compensation under both agreements consisted of monthly advance payments to be recouped from production before additional payments were due the landowners. Again the court avoided overruling the *Crowell* decision, although that decision was squarely in controversy. However, the court did follow the *Wood* decision, holding that the transaction, though termed a sale, was a lease because the landowners had retained an economic interest which was coterminous with the mineral property.[40]

Presently, all of the circuits, except the First[41] and Fifth,[42] accord in holding that a transaction in which a landowner retains an economic interest running for the life of a hard mineral property will be regarded as a lease and that, similar to the oil and gas cases, substance rather than form controls federal tax conse-

38. 428 F.2d 347 (5th Cir. 1970).

39. The brief filed by the landowners indicated that although the standard form leasing transaction was more beneficial to them, they had entered into the *Crowell* transaction to be able to obtain capital gains treatment, and it was the parties' intention to transfer title to the mineral deposit. Brief for Appellees at 3, 6-7, Rutledge v. United States, 428 F.2d 347 (5th Cir. 1970). To the contrary, the government urged the overruling of *Crowell* in view of the confusion existing in other circuits which had viewed *Wood* as implicitly overruling *Crowell*. Brief for Appellants at 16, *id.* The decisions referred to by the government were Oliver v. United States, 408 F.2d 769 (4th Cir. 1969) *and* Alkire v. Riddell, 397 F.2d 799 (9th Cir. 1968). For a discussion of these latter two cases, *see* note 43 *infra*.

40. Rutledge v. United States, 428 F.2d 347, 350 (5th Cir. 1970). The court specifically held that *Wood*, not *Crowell*, controlled, and that *Crowell* was distinguishable from the instant case because the economic realities involved in *Rutledge* required that legal niceties of interpretation, unnecessary in *Crowell*, be used to pierce the intent of the parties to reach the realities underlying the transaction. *Id.* at 352-53.

41. *See* notes 49 and 50 *infra* and accompanying text.

42. *See* notes 31-40 *supra* and accompanying text.

quences.[43] The *White* cases illustrate how the Tenth Circuit overruled a prior decision dealing with hard minerals when it appeared incorrect, based on contemporary oil and gas jurisprudence. In *White v. United States*[44] an amateur geologist discovered a uranium deposit on the taxpayers' land and purchased a mineral deed from them for $175,000 cash plus ten percent of the gross production. The Tenth Circuit viewed the contract as one of speculation because the vendee was free to explore or refrain therefrom, at his discretion. The transaction was split into two parts as was done by the Fifth Circuit in *Commissioner v. Fleming*,[45] and the court refused to accept the government's position that because the taxpayers had retained an economic interest running for the life of the property they should pay taxes at ordinary rates subject to depletion. Maintaining that the issue of the proper tax treatment of royalty receipts would be settled if and when there was production, the court held that the $175,000 represented the sales price of the mineral deed and was therefore capital gain. Six years later, the court was faced with the proper treatment of the royalty payments because production

43. The decisions of the various circuits on this point are: Royalton Stone Corp. v. Commissioner, 379 F.2d 298 (2d Cir.), *cert. denied*, 389 U.S. 978 (1967) (contract for removal of sand and gravel was in terms of a sale but landowner retained a royalty; held, transaction was a lease); Laudenslager v. Commissioner, 305 F.2d 686 (3d Cir. 1962), *cert. denied*, 371 U.S. 947 (1963) (landowner agreed to furnish landfill for a specified royalty with the advance payments to be recouped from production; held, based on economic interest test this was a lease); Oliver v. United States, 408 F.2d 769 (4th Cir. 1969) (developer given a specific period to remove sand and gravel in return for a royalty to landowner; held, since landowner retained an economic interest running for the life of the contract, the transaction was a lease); Belknap v. United States, 406 F.2d 737 (6th Cir. 1969) (landowners were getting monthly advances on account of limestone to be mined from their land plus a royalty for anything over the minimum: held, per curiam, a lease); Schreiber v. United States, 382 F.2d 553 (7th Cir. 1967) (landowner's agreement for extraction of sand and gravel stipulated a yearly minimum to be paid in advance plus a royalty for production in excess of the minimum; held, landowner's compensation depended upon production, therefore a lease); Rabiner v. Bacon, 373 F.2d 537 (8th Cir. 1967) (landowner entered a transaction termed a lease for the extraction of sand and gravel from his property for a royalty; held, under the economic interest test this was a lease because the landowner's compensation depended solely upon production); Alkire v. Riddell, 397 F.2d 779 (9th Cir. 1968) (taxpayer transferred sand and gravel leases he owned when he sold his business, and received a royalty as consideration; held, the transaction was a lease insofar as it related to the transfer of the lease); United States v. White, 401 F.2d 610 (10th Cir. 1968) (landowners transferred by way of a mineral deed any uranium deposits underlying their land for cash bonus and a royalty; held, this is a lease because landowners were looking to development for compensation).

44. 311 F.2d 399 (10th Cir. 1962).

45. 82 F.2d 324 (5th Cir. 1936). *See* note 15 *supra* and accompanying text.

had, in fact, resulted. In *United States v. White*,[46] the court recognized that no practical reason existed for treating structurally similar transactions differently depending on the type of minerals involved. In reversing its prior decision, the court held that it was improper to have originally split the transaction. The retention of an economic interest running for the life of the property colored the entire transaction as one of lease based on the *Burnet*[47] and *Palmer*[48] decisions.

The leading case in the First Circuit is *Linehan v. Commissioner*,[49] a decision in which the court felt controlled by the *Crowell* case. This case apparently represents the current position of that circuit.[50] As outlined previously,[51] the position of the Fifth Circuit in regard to the classification of hard mineral transactions remains unsettled. *Crowell* is still viable in that it has not yet been specifically overruled. This suggests the availability of choosing tax treatment through careful structuring. However, later decisions like *Wood* and *Rutledge* indicate that if this opportunity exists it is very narrowly confined. It is submitted that if *Crowell* is to be applied in the future, not only will the five tests of *Albritton* have to be met,[52] but it also must clearly appear to the court that the realities of the situation do not command that legal niceties of interpretation be resorted to in order to find the true substance of the transaction.[53]

Conclusion

Obviously, the opportunities for choosing tax consequences in the area of oil and gas taxation are limited by the concepts which were developed early in that jurisprudence. Retention of an economic interest running for the life of the property marks

46. 401 F.2d 610 (10th Cir. 1968).
47. Burnet v. Harmel, 287 U.S. 103 (1932). *See* notes 14 and 16-18 *supra* and accompanying text.
48. Palmer v. Bender, 287 U.S. 551 (1933). *See* notes 9-13, 16, and 18 *supra* and accompanying text.
49. 297 F.2d 276 (1st Cir. 1961).
50. Turner v. United States, 226 F. Supp. 970 (D. Me. 1964), cited *Linehan* as controlling and held a transaction to be a sale where the parties were called lessor and lessee and compensation was based on a fixed price per cubic yard removed.
51. *See* notes 31-40 *supra* and accompanying text.
52. *See* note 35 *supra*.
53. This last hurdle is the result of the decision in *Rutledge*. *See* note 40 *supra*. This would seem to indicate clearly that the parties must originally enter a transaction styled a sale, because if a lease is abandoned to enter a sale for the purpose of attaining capital gain treatment, the court will feel free to examine the intent of the parties.

the transaction as a lease or a sublease, and substance rather than form governs tax consequences. No variation from this theme is apparent, even in light of the confusion in the hard mineral jurisprudence.

The Fifth Circuit's ambivalence in the hard mineral cases[54] is directly attributable to that court's failure to overrule its decision in *Crowell Land & Mineral Corp. v. Commissioner.*[55] *Crowell* does not command allegiance except in the First Circuit,[56] and it now appears that the circuit which gave it life honors it more in its breach than its observance.[57] Because the case is decided incorrectly when judged by contemporary oil and gas jurisprudence, because the case clearly represents the minority viewpoint, and because the case is inconsistent with later cases in the hard mineral jurisprudence, it is submitted that *Crowell* should be dealt a swift death rather than slowly strangled by tenuous distinctions. The fact that the hard mineral developer or owner has a less favorable statutory depletion allowance[58] should not be sufficient reason for different classifications of functionally similar transactions.[59]

Some certainty will obviously be afforded by the enactment of Internal Revenue Code subsections 636(b) and (c),[60] provided these subsections are applied consistently with the economic interest test. Assuming the transaction to be a sale,[61] Internal

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54. *See* notes 31-40 and 51-53 *supra.*

55. 242 F.2d 864 (5th Cir. 1957).

56. *See* text accompanying notes 49 and 50 *supra.*

57. *See, e.g.,* Rutledge v. United States, 428 F.2d 347 (5th Cir. 1970); Wood v. United States, 377 F.2d 300 (5th Cir.), *cert. denied,* 389 U.S. 977 (1967), *decided with* United States v. Peeler, 377 F.2d 531 (5th Cir.), *cert. denied,* 389 U.S. 977 (1967), *and* United States v. Green, 377 F.2d 550 (5th Cir.), *cert. denied,* 389 U.S. 978 (1967); United States v. Witte, 306 F.2d 81 (5th Cir. 1962), *cert. denied,* 371 U.S. 949 (1963); Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957).

58. *See* text accompanying note 5 *supra.*

59. *See* Comment, *Sale or Lease? Disparate Tax Treatment of Mineral Transactions by Courts Based on Nature of Minerals Involved,* 42 TEXAS L. REV. 707 (1964). *See also* notes 44-48 *supra* and accompanying text dealing with the Tenth Circuit's decisions in the *White* cases.

60. 83 Stat. 630 (1969), *adding* § 636(b), (c), INT. REV. CODE of 1954, quoted fully at note 21 *supra.*

61. In C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES § 3.03 (1971), the authors give three situations in which a transaction will be considered a sale: (1) when the owner of a property assigns all or part of that property retaining, if only a partial assignment, an interest identical to that assigned except for size; (2) when the owner of a working interest retains that interest but assigns any type of continuing, non-operating interest; and (3) when the owner of a continuing property interest assigns that interest but retains a non-continuing interest in production.

Revenue Code section 636(b) provides that a production payment retained by the landowner-vendor is a purchase money mortgage loan and does not qualify as an economic interest. The tax consequences of this change have been discussed previously.[62] Assuming the existence of a leasing transaction,[63] the lessor who has retained a production payment is considered as having retained an economic interest in the property. Subsection 636(c) makes no change where a production payment is retained in a leasing transaction. The lessor may treat both the cash received upon execution of the contract and the cash received from any production-based payments as ordinary income subject to depletion. The lessee is able to exclude from his income the amounts necessary to compensate the lessor for production-based payments, but he must capitalize any bonus and recover it through depletion.[64] In the future, therefore, it appears that the determination of whether a transaction will be taxed as a subsection 636(b) sale or as a subsection 636(c) lease will be made in accordance with the type of economic interest which is involved. It is submitted that if the courts use the provisions of Internal Revenue Code section 636 together with the economic interest test as it developed in the oil and gas jurisprudence, there will result both certainty and uniformity in differentiating a sale from a lease in all mineral transactions.[65]

Although this approach adequately resolves the former problem of different tax treatments for structurally identical transactions, a rigid, mechanistic approach may be damaging from another viewpoint. It would not be hard to imagine a situation

62. *See* text accompanying note 24 *supra*.

63. A transaction will be considered as a lease or a sublease in any case where the owner of the operating rights, *i.e.*, the landowner or working interest owner, assigns all or a portion of these rights while retaining a continuing, non-operating interest in production. C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES § 3.02 (1971).

64. C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES § 6.20 (1971); Lane, *The Effect of the Tax Reform Act on the Investor in Oil and Gas*, 23 MAJOR TAX PLANNING 673, 688 (1971); *Effect of Tax Reform Act of 1969 on Taxation of Oil and Gas and Mining Transactions*, 19 OIL & GAS TAX Q. 79, 88 (L. Fiske ed. 1970); *accord*, Proposed Treas. Reg. § 1.636-2(a) and (b), 36 Fed. Reg. 12626 (1971).

65. Thus, if the court finds that an economic interest has been retained which is coterminous with the property, notwithstanding that another economic interest has been retained which is not coterminous, the transaction should be classified as a leasing transaction and governed by Internal Revenue Code subsection 636(c). However, if the court finds the only economic interest retained is one that lasts for a period of time less than the life of the property, the transaction should be classified a sale and governed by Internal Revenue Code subsection 636(b).

in which, as a matter of complete speculation, a landowner disposes of his mineral interest to a person who has no intention of developing the property and retains an economic interest running for the life of the property in addition to the cash received upon execution of the contract. In such a situation, both parties really intend a sale, and both realize that there is no present prospect of development. It would seem unfair and totally unrealistic under these circumstances to cause the entire proceeds to be taxed as ordinary income subject to depletion merely because the transferor retains an economic interest running for the life of the property; the transaction should be taxed as what it clearly is, a sale. Therefore, it is respectfully suggested that when the federal courts are, in the future, presented with the problem of whether a particular transaction is a sale or a lease, the realities of the situation should govern the outcome rather than the unbending economic interest test. This is nothing more than an application of the maxim that substance rather than form should control federal tax consequences.

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UNINSURED MOTORIST COVERAGE IN LOUISIANA

By Act 187 of 1962, the Louisiana Insurance Code was amended to require that all automobile liability insurance policies delivered or issued for delivery in Louisiana contain an uninsured motorist provision.[1] Under such provision, the insured, when injured by an uninsured motorist, can recover from his own insurer damages for bodily injury, sickness, disease, or death to the same extent that he would be legally entitled to recover from the uninsured motorist. However, certain policies are not required to have uninsured motorist coverage. As provided in the statute, the insured may validly reject such coverage.[2] Further, the statute does not apply to policies issued

1. LA. R.S. 22:1406D (Supp. 1962). Although there should be little difference in wording from policy to policy, there is such a possibility, especially if out of state cases or treatises are examined. Because the uninsured motorist provision is a contract, the wording generally governs and a difference in wording may have great impact. Therefore, care should be exercised in studying the wording of each policy.

2. *Id.* D(1) reads in part: "[P]rovided, however, that the coverage required under this section shall not be applicable where any insured named in the policy shall reject the coverage." Soileau v. Hartford Accident & Indem. Co., 182 So.2d 76 (La. App. 3d Cir. 1966). As this is the only case in