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Taxation-Federal Income Tax-Transfers of Mineral Rights in Soil Deposits as Lease or Sale

Philip Sotiroff
University of Michigan Law School

TAXATION—FEDERAL INCOME TAX—TRANSFERS OF MINERAL RIGHTS IN SOIL DEPOSITS AS LEASE OR SALE—Petitioner executed a written agreement with a contractor in 1954 whereby the contractor acquired the right to enter petitioner's land and extract sand and gravel for a fixed amount per

cubic yard. This agreement was terminated in 1955 when the excavations had reached the desired level of street access. Petitioner had entered into a previous oral agreement in 1949 with a different party for the sale of the gravel on the same land down to the same elevation, but that party had not fully exploited the agreement.[1] Petitioner claimed that the agreements were sales of sand and gravel in place down to the level required to make the land marketable. The Commissioner contended that these arrangements were merely leases of the property with the payments constituting rent and therefore taxable as ordinary income. The Tax Court decided in favor of the Commissioner.[2] On appeal, *held*, reversed. The terms of the 1949 and 1954 agreements, considered in light of the intent and purpose of the parties, and the divestiture of any rights of petitioner in the sand and gravel after severance, indicate a transfer of all economic interest in the in-place mineral rights; therefore, the proceeds are to be treated as gain from the sale of a capital asset. *Linehan v. Commissioner*, 297 F.2d 276 (1st Cir. 1961).

To obtain preferential capital gains treatment, there must be a "sale" or exchange of a capital asset.[3] Generally, in determining whether there has been a sale, a court will apply the usual rules of intent, form, and purpose of the agreement to pass absolute title in the property immediately or at a future date in accordance with the terms of the contract.[4] Thus, for example, gains from a conditional sales contract,[5] or a business transfer with a lease-back provision[6] are treated as gains from a sale or exchange of a capital asset. In most instances where full consideration is not presently given, as in the above examples, the vendor retains what might commonly be considered an economic or security interest in the property until the transaction is complete. Nevertheless, for tax purposes a sale has occurred as of the time of execution of the agreement.

However, in situations involving mineral rights, the general criterion used to determine if a particular transaction is to be afforded capital gains treatment is whether the taxpayer has retained *any* "economic interest" in the mineral rights transferred.[7] The courts reason that if any economic interest is retained there has not been a sale, and conversely if there has been a complete divestiture of all economic interest there must have been

1 In addition there was an earlier oral agreement for the "sale" of the sand and gravel in 1943, the nature of which was undisclosed.

2 Charles A. Linehan, 35 T.C. 533 (1960).

3 INT. REV. CODE OF 1954, § 1222.

4 See, *e.g.*, Truman Bowen, 12 T.C. 446, 465-66 (1949).

5 Truman Bowen, *supra* note 4.

6 Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961).

7 See, *e.g.*, Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958); Palmer v. Bender, 287 U.S. 551 (1933); Estate of Weinert v. Commissioner, 294 F.2d 750 (5th Cir. 1961).

a sale; thus the two possibilities are considered mutually exclusive.[8] This concept of "economic interest" is, however, more restrictive than what one might normally consider the term to encompass. The taxpayer is held to have retained an economic interest in every case where he has retained any interest in the minerals still in place and has secured from any form of legal-relationship income derived from the extraction of the minerals to which he must look for a return on his capital.[9] This test originated in cases involving the question of depletion allowances and has been applied by the courts in conjunction with the so-called "substance over form" theory.[10] This has been especially apparent in cases dealing with oil deposits where the arrangements are often extremely complex, with the courts seemingly reluctant to bring in common-law property concepts which may tend to cloud the intricate relationship established by the contracts.[11]

In situations involving soil deposits the taxpayer is generally seeking to establish a sale of the mineral deposits in order to obtain capital gain treatment since the depletion allowance in this area is relatively low. While the federal courts of appeal and district courts verbally adhere to the economic interest and true substance tests carried over from the oil depletion cases, they seem to approach the problem as a general "sale or exchange" question. With an apparent attitude favoring taxpayers,[12] these courts have stressed the factors present in the cases which would normally point to a sale rather than a relinquishment of all "economic interest." Reliance is placed on such indicia as the terms of the agreement set out in words of sale,[13] the intent of the parties to sell,[14] and large initial payments with fixed periodic payments as indicating an outright sale by the taxpayer with no further interest in development of the mineral resources.[15]

Until recently, the Tax Court had viewed some of these court decisions as erroneous.[16] It felt that a retained economic interest was present in some of the decisions since the agreements involved made provision to pay the consideration on a per unit basis as the mineral was extracted, the vendor

8 See Griffith v. United States, 180 F. Supp. 454, 458 (D. Wyo. 1960). See also Samuel L. Green, 35 T.C. 1065 (1961).

9 See, *e.g.*, Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956); Samuel L. Green, *supra* note 8, at 1071. See also Treas. Reg. § 1.611-1(b) (1962).

10 Palmer v. Bender, 287 U.S. 551 (1933); Burnet v. Harmel, 287 U.S. 103 (1932).

11 See Estate of Weinert v. Commissioner, 294 F.2d 750 (5th Cir. 1961).

12 See Commissioner v. Remer, 260 F.2d 337 (8th Cir. 1958); Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Gowans v. Commissioner, 246 F.2d 448 (9th Cir. 1957); Crowell Land & Mineral Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Griffith v. United States, 180 F. Supp. 454 (D. Wyo. 1960); Bel v. United States, 160 F. Supp. 360 (W. D. La. 1958) (for taxpayer). *But see* Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957) (against taxpayer where the agreement was clearly in terms of a lease.

13 Commissioner v. Remer, *supra* note 12; Bel v. United States, *supra* note 12.

14 Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957).

15 Crowell Land & Mineral Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957).

16 See, *e.g.*, Robert M. Dann, 30 T.C. 499, 507 (1958).

retaining a reversion in the soil in place. Also, the taxpayer in such cases had no right to obligate the "purchaser" of the in-place deposits to move his deposits off the taxpayer's land under threat of an action for breach of contract.[17] However, with the mounting pressure of decisions handed down by the district courts favorable to the transferor[18] of the in-place mineral deposits and the reversals of Tax Court determinations in the courts of appeal,[19] the Tax Court has recently altered its stand by accepting the decisions of those tribunals as reconcilable.[20] The test formulated to control all of the cases is now whether the contract itself resulted in a conveyance of the deposits "in place" so that the owner no longer retained any interest in such deposits.[21]

However, basic differences between the Tax Court approach and that of the courts of appeals and the district courts still exist. The Tax Court looks to the economic interest, if any, retained by the taxpayer at the time of the agreement. Thus, if after the contract is executed the taxpayer no longer depends on the extraction of minerals for his consideration (except as a convenient method of determining the extent of his consideration where the quantity of matter to be extracted is not definitely known), and where he may force the purchaser to remove all the in-place minerals purchased within a stated or reasonable time or be subject to a breach of contract action, then he is held to have retained no economic interest in the in-place minerals deposits.[22] And since the two are mutually exclusive, it necessarily follows that if he has retained no economic interest then there must have been a sale of those deposits. The other federal courts usually take the opposite approach, relying mainly on form and intent to find a sale.[23] If a sale is found they reason that there necessarily could not have been a retained economic interest; and thus, the courts do not attempt to sift thoroughly the elements of the case to ascertain if any such interest does in fact exist.[24]

The principal case purports to adopt the former approach by first deter-

17 *E.g.*, Robert M. Dann, *supra* note 16.

18 *E.g.*, Griffith v. United States, 180 F. Supp. 454 (D. Wyo. 1960); Bel v. United States, 160 F. Supp. 360 (W.D. La. 1958).

19 Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957), *reversing* 24 T.C. 1160 (1955); Crowell Land & Mineral Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957), *reversing* 25 T.C. 223 (1955).

20 See Samuel L. Green, 35 T.C. 1065 (1961).

21 Samuel L. Green, *supra* note 20, at 1071.

22 See Robert M. Dann, 30 T.C. 499 (1958). See also Samuel L. Green, 35 T.C. 1065 (1961); Charles A. Linehan, 35 T.C. 533 (1960).

23 See Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Bel v. United States, 160 F. Supp. 360 (W.D. La. 1958).

24 In Baker v. Commissioner, *supra* note 23, at 198, the court indicates that at least the sand and gravel cases are to receive individual treatment stating, "Nor should our conclusion in this case [sand and gravel] be understood as an indication that we have any views concerning analogous or similar transactions in the field of oil, gas and mineral extraction."

mining whether there is any economic interest. However, the court arguably misconstrued the real thrust of the test. This is evidenced by the importance attached to the fact that once the gravel was severed from the land, the taxpayer no longer had any interest in it. That observation, while true, is not determinative of the problem. What is essential is the nature of the taxpayer's rights, if any, to the *in-place* mineral deposits, or any portion thereof, the moment after the purported sale. The facts indicate that only the right to enter the premises and extract the gravel was sold, that there was no obligation upon the purchaser to remove all or any of the gravel "sold," and that the bulk of the consideration was dependent solely on the optional excavation and exploitation of the deposit. To this may be added the facts that the same general in-place sand and gravel deposit had been "sold" twice previously, that during one "sale" the price was raised from 10 to 18 cents per cubic yard, that a reversion was retained in the in-place gravel sold which was not extracted, and that a per unit basis of payment was not necessary to any of these agreements since the quantity of the in-place gravel was ascertainable.[25] Thus, the principal case apparently establishes a haven for those taxpayers who fail to put the transfer of their minerals in terms of an absolute sale, but who disclaim any interest in the mineral after severance. This deviation from the in-place oil deposit cases seems unwarranted, and review by the Supreme Court is necessary to clarify the situation.[26] In addition the question remains whether retained economic interest should be determinative of the issue or whether, for purpose of the capital gain provision, an economic interest may properly be retained after a sale.

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25 See Charles A. Linehan, 35 T.C. 533 (1960).

26 See Schoenbaum, *Substance and Form in Assignments of In-Oil Rights and Other Mineral Interests*, N.Y.U. 17TH INST. ON FED. TAX 443 (1959).