The Swank Decision: Economic Interest in Coal Not Dependent on Lease Terminability

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THE SWANK DECISION: ECONOMIC INTEREST IN COAL NOT DEPENDENT ON LEASE TERMINABILITY

TAX LAW: The percentage depletion deduction allowed by I.R.C. §611 and §613 may not be denied to lessees of coal in place because their leases are terminable on 30 days notice. *United States v. Swank*, 101 S.Ct. 1931 (1981).

INTRODUCTION

Congress provides a percentage depletion deduction for taxpayers who develop certain natural resources.\(^1\) Section 613 of the Internal Revenue Code of 1954 (hereinafter I.R.C.) provides that the deduction will be a percentage of the gross income derived from the property, excluding from gross income any rents or royalties paid by the taxpayer with respect to the property.\(^2\) The deduction exists as a matter of congressional grace.\(^3\) Originally, the deduction’s purpose was to compensate taxpayers for mineral exhaustion by returning the taxpayer’s capital investment.\(^4\) Presently, the deduction no longer turns on diminishment of capital investment. Instead, the deduction exists as a statement of congressional tax policy encouraging the development of mineral deposits.\(^5\)

In coal operations, the landowner may develop the mine himself, or he may lease or contract that opportunity out to others.\(^6\) The owner is barred from claiming the depletion deduction by Section 631(c) of the I.R.C.\(^7\) The Internal Revenue Service has required lessees or independent contractors claiming the deduction to establish their economic interest in the coal in place.\(^8\) *United States v. Swank*\(^9\) addresses whether a lessee has established a sufficient economic interest in the coal in place when the lessee’s interest is terminable on thirty days notice.

An economic interest in a mineral in place is created when the taxpayer acquires an interest in the mineral in place by investment and depends on the income derived from mineral extraction for return of capital.\(^10\) The

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1. The percentage depletion deduction is codified in I.R.C. §§611, 613 (1982).
2. Section 613 provides sliding percentages for various classes of minerals, including coal.
7. I.R.C. §631(c) (1981). The owner does not qualify even if the lessee or contractor does not qualify for the depletion deduction.
Internal Revenue Service has adopted regulations describing "economic interest":

An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital.\textsuperscript{11}

The Supreme Court has provided guidelines for determining the existence of an economic interest. \textit{Parsons v. Smith}\textsuperscript{12} held that independent contractors strip-mining coal on behalf of landowners were not entitled to the deduction. The contractors received a fixed sum per ton of coal from the landowners. The Court set out the following test to determine the existence of an economic interest: (1) the taxpayers' investments were in movable equipment, not the coal in place; (2) the investments were recoverable through depreciation, not depletion; (3) the contracts were completely terminable without cause on short notice; (4) the landowners did not surrender any capital investment in the coal in place; (5) the coal belonged to the landowners, depriving the taxpayers of the right to dispose or deliver the coal elsewhere; (6) the taxpayers received fixed sums per ton of coal mined and delivered; and (7) the taxpayers looked only to the landowners for all sums due them under their contracts.\textsuperscript{13}

In \textit{Paragon Jewel Coal Co. v. Commissioner of Internal Revenue},\textsuperscript{14} the Court held a lessee, and not its independent contractor, was entitled to the deduction. The Court said the right to mine to exhaustion was merely an economic advantage, not an economic interest.\textsuperscript{15}

This casenote will survey the effect of terminability on the existence of a lessee's economic interest. Conflict between the federal circuits on the effect of terminability has now been resolved by the \textit{Swank} decision.\textsuperscript{16}

\textbf{PRE-SWANK TERMINABILITY INTERPRETATIONS}

Prior to \textit{Swank}, the Internal Revenue Service had maintained that terminability was fatal to creation of an economic interest regardless of whether mineral rights were acquired by lease or contract.\textsuperscript{17} No economic

\textsuperscript{11} 26 C.F.R. § 1.611-1(b) (1980).
\textsuperscript{12} 359 U.S. at 215.
\textsuperscript{13} \textit{Id.} at 225.
\textsuperscript{14} 380 U.S. 624 (1965).
\textsuperscript{15} \textit{Id.} at 633.
\textsuperscript{16} Generally, the Tax Court and Third Circuit held no economic interest exists when the lease is terminable without cause or on short notice. The Court of Claims and Fifth Circuit disagreed. 34 AM. JUR. 2d Federal Taxation ¶ 766 at p. 712 (1981).
\textsuperscript{17} G.C.M. 26290, 1950-1 C.B. 42 ("nominal" notice is usually less than 1 year); Rev. Rul. 77-481, 1977-2 C.B. 205.
interest was created when the agreement was "of insufficient duration to permit extraction of a substantial amount of the mineral deposit." 18

The Tax Court had also maintained that terminability extinguished an economic interest in the lessee or contractor. 19 In addition, the lack of a termination clause in the lease provided no guarantee that the taxpayer possessed an economic interest. 20 Market disposition was also considered. 21 However, a recent Tax Court opinion, Weaver v. Commissioner, 22 signaled greater flexibility in interpreting the effect of terminability. The Tax Court held a lessee entitled to the depletion deduction even though the lease was terminable upon 120 days notice. Under the particular circumstances of the lease, 120 days allowed the lessee enough time to extract substantial amounts of sand and gravel.

The Court of Claims had been more liberal in its interpretation of economic interest. Terminability was not recognized as a conclusive factor, but was weighed in light of the other six factors described in Parsons. 23 The Court of Claims implied that lessees had an economic interest in coal in place until the right of termination was exercised. At that point, the economic interest reverted back to the lessor. 24 The court noted that in light of I.R.C. Section 631(c) the lessee must show entitlement or no party would benefit from the deduction. 25 The Internal Revenue Service expressly rejected the Court of Claims' interpretation of terminability. 26

The Third Circuit required that the lessee or contractor possess an economic interest in the minerals in place which would not terminate until the minerals were exhausted. 27 When the lessee's or contractor's interest in the coal was terminable upon notice or at will, no right to exhaust the coal had been created. Therefore, the lessee or contractor was not entitled to the deduction. 28 Terminability was analyzed relative to the other factors found in Parsons, but terminability was accorded great weight. 29

The Fourth Circuit maintained that terminability at will was conclusive

22. 72 T.C. 594.
24. 485 F.2d at 641.
25. Id. at 642.
28. 443 F.2d at 173.
in determining the existence of an economic interest. Lack of terminability was a bargained-for right. The right to mine without fear of termination created an economic interest in the coal in place.

The Fifth Circuit said a valid lease conveyed an economic interest even if a party could terminate the arrangement on short notice. This circuit distinguished other cases disallowing the deduction because of terminability as involving "contracts merely for the removal of coal and not a lease of the minerals in place." Thus, the Fifth Circuit's allowance of the deduction, in spite of terminability, may have benefited only lessees, not independent contractors. The status given the relationship between landowner and mine operator would be significant.

The Ninth Circuit asked whether the extractor of the mineral depended on market disposition or relied solely on his contract for compensation. Terminability was only a secondary factor to be considered in determining the existence of an economic interest.

The Tenth Circuit construed terminability in Rissler & McMurry Co. v. United States. In that case, a taxpayer who entered into a construction contract with a city elected to use the city's gravel pit for construction materials. The taxpayer was allowed to sell the gravel to other parties pursuant to an oral agreement with the city. The court considered the taxpayer's interest in the gravel to be at most an economic advantage:

The taxpayer did not meet the Parsons and Paragon requirements for the necessary showing of a capital investment in mineral deposits. Rather the facts disclose that the taxpayer had not made any permanent improvements at the gravel pit, and the short-term contract under which the taxpayer operated reflected no intention by the city to surrender its interest in the gravel.

Thus, the tenth circuit construed economic interest in accord with the Parsons test. Terminability was not considered in isolation.

In summary, the question of the effect of terminability on establishing economic interest had proved confusing. The spectrum of interpretation

31. 315 F.2d at 491.
32. Id.
33. Winters Coal Co. v. Commissioner, 496 F.2d 995 (5th Cir. 1974), rev'g. 57 T.C. 249. But see United States v. Wade, 381 F.2d 345 (5th Cir. 1967).
34. 496 F.2d at 999-1000.
35. Usibelli v. Commissioner, 229 F.2d 539, 544 (9th Cir. 1955).
36. Id.
37. 480 F.2d 684 (10th Cir. 1973). See also Utah Salt Co. v. Wise, 370 F.2d 976 (10th Cir. 1967) which held there is no economic interest in salt in place.
38. 480 F.2d at 687.
had ranged from treating terminability as conclusive to treating it as insignificant. The Supreme Court in *United States v. Swank*\(^\text{39}\) resolved the terminability question.

**UNITED STATES V. SWANK**

In *Swank v. United States*,\(^\text{40}\) three separate lessees\(^\text{41}\) of coal mines brought tax refund suits claiming entitlement to the percentage depletion deduction. The leases provided for a fixed royalty per ton of extracted coal and gave the lessees the right to determine the sale price. Each lease contained a termination provision allowing either party, or the lessor alone, the right to cancel the agreement upon 30 days notice.\(^\text{42}\)

The Court of Claims held that the lessees had an economic interest in the coal in place, which entitled them to the percentage depletion.\(^\text{43}\) "The mere existence of the unused termination clause" did not deprive the lessees of their economic interest in the coal in place.\(^\text{44}\) The court found that the lessees had a "solid expectation" that the leases would not be terminated prematurely.\(^\text{45}\) Also, if the lessees failed to qualify for the depletion deduction, no other party could step forward to claim the allowance. The court said that Congress intended that the percentage depletion be utilized by some party to the coal-mining operation.\(^\text{46}\)

The United States Supreme Court affirmed the Court of Claims in *United States v. Swank*.\(^\text{47}\) The majority opinion began by noting that the original purpose behind the depletion deduction had been expanded. Implementation of a percentage formula clearly reflected an emphasis on mineral development. This emphasis explains why eligibility for the depletion deduction depends on the parties' economic interest in the coal and not on their capital investment.\(^\text{48}\) Also, a finding that lessees possessed an insufficient economic interest in the coal meant no party could benefit from the deduction. The government recognized this potential result but nonetheless argued that the deduction should not be granted to any party where a claimed economic interest was terminable on short notice.\(^\text{49}\)

The government challenged the lessees' eligibility for the allowance on two grounds. First, the government contended that the lessees pos-

\(^{39}\) 101 S.Ct. 1931.
\(^{41}\) Bull Run Mining Co. operated in West Virginia. Black Hawk Coal Co. operated in Kentucky. Swank operated in Pennsylvania.
\(^{42}\) 602 F.2d at 350.
\(^{43}\) Id.
\(^{44}\) Id.
\(^{45}\) Id. at 351.
\(^{46}\) Id.
\(^{48}\) Id. at 1935.
\(^{49}\) Id. at 1936.
sessed a mere economic advantage over the coal, not an economic interest in it, because their leases were terminable on short notice. The government cited Parsons and Paragon Jewel as holding that contract miners lacked sufficient economic interest in the coal in place to entitle them to the depletion deduction. The Court distinguished both cases on the ground that terminability was only one factor among many that the Court had considered in holding the contractors ineligible for the deduction. The Court found that in Swank the lessees possessed a legal interest in the coal both before and after it was mined, as well as the freedom to dispose of it in the market place.

Second, the government argued terminability made the lessees' interest too tenuous to sustain eligibility for the allowance. The government contended that the lessor may be forced to terminate the lease agreement and seek a more advantageous royalty agreement if the market price of coal increases. The Court rejected this argument. Other factors, such as the quantity of coal extracted and a satisfactory business relationship, were as important as royalty rates. The fact that no actual termination had occurred under any of the leases, even though coal had increased in value, defeated the government's argument. In addition, the Court construed congressional intent as not limiting the deduction to only those mining operations strong enough to bargain away terminability in their lease agreements. Last, the Court could find no rational basis for tying the allowance to the period of time the lessee operates a mine. The depletion deduction should not depend on "whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers for successive shorter periods."

Thus, the Court cleared away the considerable confusion coloring the terminability issue. The Court held that the right of termination does not destroy the lessees' economic interest in the coal.

Justice White, joined by Justice Stewart, dissented. The dissent criticized the majority for overstepping the proper role of the judiciary. Justice White noted that I.R.S. regulations must be afforded substantial weight by a reviewing court if the Commissioner's interpretation of the statute is reasonable. Prior court cases, including Paragon Jewel, had expressly accepted and applied the regulations describing economic interest. Since

50. Id. at 1937.
51. Id. at 1938.
52. Id.
53. Id.
54. Id. at 1939.
55. Id.
56. Id.
57. Id. at 1941.
economic interest is not "self-defining," the "Service's interpretation of its own regulation is entitled to deference." The dissent cited National Muffler Dealers Assoc. v. United States, for the proposition that even when a regulation is subject to differing interpretations, the court should defer to the Service if the Commissioner's interpretation is consistent, long-standing and reasonable. The dissent argued that the Internal Revenue Service had consistently concluded that duration of the lease interest was important in determining deduction eligibility. This Internal Revenue Service conclusion was reasonable and warranted deference from the Court.

In addition, the dissent claimed the majority either overemphasized or misconstrued the factors described in Parsons and Paragon Jewel. Justice White said the right to mine to exhaustion was a mere economic advantage. The fact that the lessees did mine to exhaustion was irrelevant. Further, the costs of mining did not alone create an economic interest because such costs are deductible or depreciable under other code provisions. Last, Justice White claimed that terminability was at least as important as market disposition because:

... reliance on the market for economic return on [the lessee's] investment is therefore illusory since it is dependent on the lessor's willingness to permit continued extraction of the coal.

ANALYSIS

The Swank decision has ramifications for both tax planners and litigators. For tax planners, Swank clarifies a narrow tax issue. Tax planners now know that terminability is not considered crucial to determining the existence of an economic interest. The obvious implication of this decision is that minimizing terminability as a dispositive factor necessarily increases the importance to be afforded the other Parsons factors. However, the Swank decision is construed by its dissent as placing great weight on control of market disposition. If control of market disposition is conclusive in determining deduction entitlement, that factor will be crucial in future negotiations of lease agreements. Tax planners should carefully consider the tax consequences of market disposition when negotiating and drafting lease agreements.

The decision also has ramifications for tax litigation. Swank implies

58. Id.  
59. Id.  
61. 101 S. Ct. at 1942.  
62. Id. at 1943.  
63. Id.  
64. Id. at 1944.
that congressional policy is circumvented when no taxpayer establishes entitlement to the depletion deduction. Arguably, any Internal Revenue Service interpretation of a statutory allowance which does not benefit at least one taxpayer violates congressional policy. The case may be useful in situations where taxpayers fail to establish entitlement to tax benefits because of Internal Revenue Service guidelines. The Internal Revenue Service may encounter increased litigation of other statutory interpretations if a potential consequence is that no party may benefit from a statutory allowance.

On a broader scale, Swank signals strong judicial activism in the tax area. The Court will not always abide by Internal Revenue Service interpretations of I.R.C. regulations, even if lower federal courts ratify those interpretations. Thus, even reasonable agency interpretations may be subject to judicial analysis. A consequence of this increased activism may be increased litigation of Internal Revenue Service interpretations.

CONCLUSION

Swank provides a necessary resolution to the confusing question of lease terminability. However, while the importance of terminability has been resolved, the importance of other Parsons factors, like control of market disposition, remains unclear. Swank may also have implications for judicial review of agency guidelines.

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