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TAX CONSEQUENCES AND DISTINCTIONS INVOLVED IN THE SALE OR LEASE OF OIL AND GAS INTERESTS

Because of the many interests involved in oil and gas investment and because of the complicated nature of the controlling tax statutes, the choice of form for a conveyance of an interest must be carefully made in order to facilitate the interests of the parties and to avoid unfavorable tax consequences. This choice can be made properly only when the consequences of each possible type of conveyance are understood. The two primary categories of conveyance, sale and lease, are to be discussed in this Note with emphasis on their form, attributes and tax consequences.[1] A comparison will be made and conclusions given as to the logical choice in normal situations.

The concept of depletion underlies most of the discussion of income from producing oil and gas properties and the tax advantages of leasing operations. The basic principle is that the oil and gas in the ground are reservoirs of capital investment.[2] Unlike a normal capital investment, the oil and gas in place will be used up in the production of income from the property. A depletion allowance is deducted by each owner of an economic interest in a producing oil and gas property in order to permit him to recover his investment in the wasting asset tax-free.[3] Two methods of computation are available, cost depletion and percentage (or statutory) depletion. Cost depletion is calculated using the taxpayer's adjusted basis and the relationship of current production to total estimated production.[4] Percentage depletion is based on a statutory percentage allowance.[5] The amount of the deduction from ordinary income in each taxable year for depletion is the greater of the two calculated figures.[6] Percentage depletion is allowable even though no basis remains for computing cost depletion.[7]

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1. Exchanges of interest do not fit in either category because they are basically nontaxable transactions.

2. Palmer v. Bender, 287 U.S. 551, 11 Am. Fed. Tax R. 1106 (1933).

3. *Depletion of Oil and Gas Properties,* 21 Oil & Gas Tax Q 14 (1972).

4. *See* Treas. Reg. under § 1.612. In the case of a lease bonus payment, cost depletion depends upon the relationship of the bonus received to the total of the bonus plus estimated royalties.

5. For oil and gas that percentage is 22%. Int. Rev. Code of 1954 § 613(b)(1)(A). Hereinafter I.R.C. § Gross income, less royalties paid and other allowable exclusions, times 22% is the amount of percentage depletion.

6. Percentage depletion, however, cannot exceed 50% of the taxpayer's taxable income from the property (computed without allowance for depletion). I.R.C. § 613(a).

7. *Louisiana Iron & Supply Co., Inc.,* 44 B.T.A. 1244 (1941), *acq.* 1941-2 Cum. Bull. 8. Basis is reduced, but not below $0, by the amount of allowable depletion in each taxable year.

In contrast to depletion, depreciation is an allowance for the exhaustion, wear and tear of property used in the trade or business or of property held for the production of income.[8] It is a method for the recovery, or spreading out, of the cost of an asset over the useful life of the asset. When the useful life is ended, depreciation should have been allowed sufficient to reduce the book value cost of the asset to its salvage value.

LEASE

The leasing transaction provides a practical approach to development of possible oil and gas producing properties. In the normal situation, the operator or developer will procure a "shooting lease" which entitles him to conduct a seismographic survey of the land and which usually gives him the right to take an oil or gas lease on all or any part of the lands surveyed.[9] This type of lease usually provides for a small payment per acre for the whole tract to be surveyed and an additional payment for any acres selected.[10]

The actual oil and gas lease provides for a bonus payment to the landowner, in the nature of an advance royalty,[11] and an agreed fractional royalty interest payable to the landowner if and when production is achieved. It provides for a primary term of the lease which is a fixed period for exploration and discovery.[12] If development has not been begun or production achieved by the end of the primary term, the lease expires. If, however, production is achieved, the lease provides for a secondary term which will continue indefinitely until exhaustion of all oil and gas in paying quantities.[13] For flexibility, the primary term can usually be extended year to year by the payment of a delay rental by the lessee for the privilege of deferring drilling.[14]

> A transaction will be classified as a lease or sublease in any case where the owner of operating rights assigns all or a portion of such rights to another person either for no immediate consideration or for

8. I.R.C. § 167(a).

9. *Acquisition of Oil & Gas Properties,* 21 Oil & Gas Tax Q 1, 4 (1972).

10. *Id.*

11. Quintana Petroleum Co. v. Commissioner, 143 F.2d 588, 32 Am. Fed. Tax R. 1031 (5th Cir. 1944); Canadian River Gas Co. v. Higgins, 151 F.2d 954, 34 Am. Fed. Tax R. 411 (2d Cir. 1945); Sunray Oil Co. v. Commissioner, 147 F.2d 962, 33 Am. Fed. Tax R. 763 (10th Cir. 1945).

12. Sullivan, *Anatomy of An Oil Lease,* 19 Prac. Law. 49, 50 (Mar. 1973).

13. *Id.*

14. *Acquisition of Oil & Gas Properties, supra* note 9, at 9. The delay rental is ordinary income not subject to depletion for the landowner, and is an ordinary deductible business expense for the lessee.

cash or its equivalent, and retains a continuous, nonoperating interest in production.[15]

A continuous, nonoperating interest in production has been held to mean an economic interest in the property.[16] An economic interest means an interest which the taxpayer has acquired by investment in oil and gas in place and from which he has secured, by *any* form of legal relationship, income derived from the extraction of the minerals, to which he must look solely for a return of his capital.[17] Under this definition, any time operating rights of any dimension are assigned and any kind of economic interest is retained, the transaction will be considered a lease or sublease. In the normal agreement between the landowner and the operator, this result is foreseen and agreed to because of the essential business purposes of the transaction. However, where the developer or operator wishes additional funding or additional developers to share the risk, he would prefer the best possible tax consequences of the conveyance, and taxation of his gain from the disposition at ordinary rates subject to depletion is not nearly as favorable as capital gains tax treatment. Unless the transaction is structured to avoid the essentials of a lease conveyance, the unfavorable consequences may arise. Whenever the owner of operating rights (the working interest) assigns any part of those rights and retains a royalty, an overriding royalty, a net profits interest, or a production payment (under I.R.C. Section 636 (c) only), he will be deemed to have conveyed a leasehold interest.[18]

The owners of economic interests are taxable at ordinary income rates for income received less the allowance for depletion. This group includes holders of royalty interests, overriding royalties, net profits interests,[19] and some production payments.[20] The owner of the operating interest, on the other hand, will deduct these payments from his gross income for depletion purposes.[21]

15. C. Breeding, F. Burke, Jr., & A. Burton, Income Taxation of Natural Resources 302 (1973).

16. Palmer v. Bender, 287 U.S. 551, 11 Am. Fed. Tax R. 1106 (1933). Such economic interest is what entitles the holder to depletion allowance on the proceeds of production. Under I.R.C. § 636(c), a production payment retained on the lease of a mineral property may still properly be called an economic interest.

17. Treas. Reg. § 1.611-1(b)(1), *amended* T.D. 6841, 1965-2 Cum. Bull. 200 and T.D. 7261, 1973 Int. Rev. Bull. No. 16, at 12 paraphrasing the language used in *Palmer v. Bender*, 287 U.S. 551; *Depletion of Oil & Gas Properties, supra* note 3.

18. All of these interests have been held to be economic interests. *See* 287 U.S. 551; U.S. v. Thomas, 329 F.2d 119, 13 Am. Fed. Tax R.2d 949 (9th Cir. 1964) (net profits interest is an economic interest); Rev. Rul. 69-466, 1969-2 Cum. Bull. 140.

19. By its nature, the net profits interest shares in the operating expenses of the property.

20. *See* footnote 18, *supra.*

21. Equitable apportionment of the depletion allowance requires that the owner of the

The lease bonus is paid to the landowner or lessor (or sublessor in a sublease transaction) in anticipation of production, and as a matter of economic substance the lessor is discounting a portion of his economic interest in the oil in place for an immediate cash payment.[22] In this sense the bonus received is not proceeds from disposition of the property, but payment in advance for oil and gas to be extracted in the sense of an advance royalty.[23] As an advance royalty, it is part of gross income from the property and entitled to the allowance for depletion.[24] The bonus is an outright payment by the lessee and as such is not refundable even if no development is undertaken.[25] It is distinctive, however, in that it is the only interest entitled to depletion prior to production.[26] Although the lease bonus is ordinary income subject to depletion for the lessor, the payment must be capitalized as part of the leasehold cost to the lessee.[27] The reasoning behind this is that although the payment diminishes the value of the lessor's economic interest by reducing his royalty share in future production, it correspondingly enhances the value of the lessee's economic interest by giving him a larger share of minerals produced.[28] Although the bonus payment is not refundable to the lessee, the lessor may, in effect, be forced to restore the depletion allowed to taxable income if the lease terminates without production.[29] The entire amount of the bonus becomes taxable income to the lessor in the year the lease is abandoned.[30] This restoration occurs because when the lease bonus is paid initially it is not known whether the payment will be advance royalty or simply rent (ordinary income not subject to depletion).[31] Deductions for depletion were only tentatively charged to basis, subject to the contingency that extraction of mineral units would occur which would be allowable to the deduction.[32] When the contingency fails, the

operating interest deduct these payments in the computation of his depletion allowance so as to prevent a double allowance. Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25, 34 Am. Fed. Tax R. 1017 (1946).

22. Krystal, *Tax Consequences of Lease Transactions,* P-H Oil & Gas-Nat. Res. Taxes ¶ 1007, at 1105 (1970); *see generally* Maxfield, *Bonus, Delay Rental, and Minimum Royalty–Treatment and Distinction for Tax Purposes,* 7 Land & Water L. Rev. 343 (1972).

23. Herring v. Commissioner, 293 U.S. 322, 14 Am. Fed. Tax R. 717 (1934).

24. *Id.* It is ordinary income subject to depletion.

25. Krystal, *supra* note 22, at 1105.

26. *Id.*

27. Treas. Reg. § 1.612-3(a)(3). Treas. Reg. § 1.612-3(a)(2), *amended* T.D. 6841, 1965-2 Cum. Bull. 200.

28. G.C.M. 22730, 1941-1 Cum. Bull. 214, 217.

29. Treas. Reg. § 1.612-3(a)(2), *amended* T.D. 6841, 1965-2 Cum. Bull. 200; *see also* G.C.M. 22730, *supra* note 28.

30. *Id.* at 1.612-3(a)(3).

31. *Depletion of Oil & Gas Properties, supra* note 3, at 18.

32. Douglas v. Commissioner, 322 U.S. 275, 32 Am. Fed. Tax R. 358 (1944).

suspended sums are returned to income.[33] However, any quantity of oil produced from the well may validate the contingency and negate restoration.[34] Not only must the lessee capitalize the bonus payment, he must also allocate a portion each year (amortize) and subtract that portion from gross income for depletion purposes. This is called the Bonus Exhaustion Rule.[35] The reason for the rule is that the lessor has already been allowed depletion on the bonus and to allow the operator a depletion allowance on the same income (or advance royalty) to which that bonus applied would be to allow double depletion.[36]

Prior to the 1969 Tax Reform Act,[37] since all production payments were classified as economic interests, they were a favorite method of financing by operators and investors. The operator could "carve-out" a production payment (receive money for a specified share of future production or a specified dollar amount), receive the proceeds, and, since the income earned to repay the payment was attributable to an economic interest, he could deduct this income from gross income. Accordingly, the operator could repay the oil payment with before-tax dollars.[38] The 1969 Act changed that situation by making such a carved-out production payment the equivalent of a mortgage loan unless it expressly is to be applied to exploration or development of a mineral property.[39] The result of this is that the repayment of the consideration received by the operator becomes a return of capital to the oil payment holder plus an interest factor (taxable as ordinary income not subject to depletion). Since this is no longer an acknowledged economic interest in the property, the repayment amounts are not deductible from gross income for the operator, and the return is made from after-tax dollars.[40] A production payment which is retained by the lessor in a lease transaction is in the nature of a bonus granted by the lessee payable in installments and is treated as such by the lessee.[41] The

33. *Id.*

34. Dolores Crabb, 41 B.T.A. 686 (1940) (Amount of royalty income received was $36.98).

35. Romak, *Types of Oil And Gas Interests and the Taxation Thereof,* 27 N.Y.U. Inst. Fed. Tax 899, 902 (1969).

36. *Id.*

37. 83 Stat. 487 (1969).

38. *See* discussion of this topic in Breeding et al., *supra* note 15, at Ch. 6.

39. I.R.C. § 636(a).

40. The interest payment is deductible expense by the lessee. Alexander & Bell, *Tax Basis in Oil and Gas Interests,* Oil & Gas-Nat. Res. Taxes, ¶ 1001.4 (1970).

41. It is subject to the Bonus Exhaustion Rule; *see* I.R.C. § 636(c) and Treas. Reg. § 1.613-2(c)(5)(ii), *amended* T.D. 6841, 1965-2 Cum. Bull. 200, T.D. 7170, 1972-1 Cum. Bull. 178, and T.D. 7261, 1973 Int. Rev. Bull. No. 16, at 12.

payment remains an economic interest for the lessor, and he is entitled to depletion allowance thereon.[42]

SALE

A conveyance will be treated as a sale under any of the following circumstances:[43]

1. Where the owner of a property interest assigns all of that interest or a fractional part thereof identical, except as to quantity, with the interest retained.

2. Where the owner of a working interest assigns any type of continuous non-operating interest and retains his working interest.

3. Where the owner of any kind of continuing property interest assigns that interest and retains a production payment (non-continuous interest).[44]

A transaction is more likely to be considered a sale where a producing well has already been drilled than where exploration and speculation are involved.

Normal property law applies when a fee simple interest is conveyed to the purchaser. Such interest qualifies under I.R.C. Section 1221 as a capital asset. Accordingly, if the interest is held for more than six months, long term capital gain or loss will arise.[45] If the property were held for six months or less, short term capital gain or loss treatment would accrue.[46] The situation becomes more complicated where any interest other than a fee simple is involved.

A royalty interest in oil and gas in place constitutes real property for Federal Income Tax purposes.[47] However, it can give rise to ordinary gain or loss, capital gain or loss, or Section 1231 gain or loss[48] depending on whether it is held for investment, used in the trade or business, or held primarily for sale to customers in the ordinary course of trade or business. If the interest is held primarily for investment, it is a capital asset and subject to capital gains treatment.[49] If the royalty interest is used in the trade or business, it does not qualify as a capital asset under I.R.C. Section 1221(1). However, if the property is held longer than six months it is accorded

42. Treas. Reg. § 1.636-2(b) (1973).
43. Breeding et al., *supra* note 15, at 302.
44. *See* I.R.C. § 636(b).
45. I.R.C. § 1222(3) & (4).
46. I.R.C. § 1222(1) & (2).
47. Rev. Rul. 55-526, 1955-2 Cum. Bull. 574; This treatment should also apply to net profits interests, overriding royalties, and § 636(c) production payments. *See* Rev. Rul. 68-226, 1968-1 Cum. Bull. 362; P-H Editorial Staff, *Tax Consequences of Sale and Purchase Transactions,* Oil & Gas-Nat. Res. Taxes, ¶ 1006 (1973), at 1084.
48. I.R.C. § 1231.
49. Rev. Rul. 55-526, *supra* note 47.

capital gains treatment for a gain and ordinary loss treatment for a loss.[50] If such property interest is held for six months or less, ordinary income or loss applies.[51] If the interest is held primarily for sale to customers in the ordinary course of trade or business, ordinary loss or gain will accrue because the interest would be deemed to be very akin to inventory.[52] This last distinction is an important one because if the interest is deemed to be held primarily for sale to customers, in the sense of inventory, no amount of holding period will ever make it subject to capital gains treatment. The question will nearly always be one of fact,[53] but the burden is on the taxpayer to rebut the Commissioner's presumption that the property actually is held primarily for sale to customers in the ordinary course of business.[54]

The interest of a lessee (working interest) in oil and gas in place is also an interest in real property for tax purposes.[55] However, it is real property used in the trade or business and expressly does not qualify as a capital asset under I.R.C. Section 1221(1).[56] If the interest is held for more than six months, I.R.C. Section 1231 applies. If the interest is held for six months or less or if it is held primarily for sale to customers in the ordinary course of trade or business, ordinary gain or loss applies.[57]

The basis of property generally is its cost,[58] but could also be its fair market value at acquisition, its basis in the hands of a predecessor in interest, or a substituted basis, depending primarily upon the manner in which the property was acquired.[59] If the property were acquired in a tax-free exchange, it would take the same basis as the property exchanged.[60] After the initial basis is determined, ad-

50. *Id.;* the source of the gain and loss treatment is I.R.C. § 1231.

51. I.R.C. § 1231.

52. Rev. Rul. 55-526, *supra* note 47.

53. Ash Robinson, T.C. Memo. 1954-270, 13 T.C.M. 921 (1954); George S. Engle, T.C. Memo. 1954-167, 13 T.C.M. 520 (1954); J. C. Thompson, T.C. Memo. 1948-164, 7 T.C.M. 612 (1948).

54. Greene v. Commissioner, 141 F.2d 645, 32 Am. Fed. Tax R. 459 (5th Cir. 1944). For an excellent analysis of the criteria for holding property to be held primarily for sale, etc., *see* Smith v. Dunn, 224 F.2d 353, 47 Am. Fed. Tax R. 1418 (5th Cir. 1955); *see also* Fahs v. Crawford, 161 F.2d 315, 35 Am. Fed. Tax R. 1228 (5th Cir. 1947); Dunlap v. Oldham Lumber Co., 178 F.2d 781, 38 Am. Fed. Tax R. 1228 (5th Cir. 1950).

55. Rev. Rul. 68-226, *supra* note 47. This working interst would include a sublease if the sublessee has part of the working interest.

56. *Id.*

57. *Id.;* I.R.C. § 1231 governs the ordinary income or loss treatment if held for six months or less.

58. I.R.C. § 1012.

59. Alexander & Bell, *supra* note 40, at ¶ 1001.1; *see also* I.R.C. § § 1012, 1013, 1014, 1015.

60. I.R.C. § 1031(d). It may be possible for the taxpayer to avoid present tax conse-

justments must be made for certain specified circumstances.[61] These adjustments are intended to arrive at the assessment of the value of the property to the taxpayer at the time of transfer. The difference between the consideration received in the sale and the adjusted basis of the interest conveyed measures the gain or loss from the transaction.[62]

Basis problems can arise even for the holder of a fee simple interest in both the surface and the minerals. Since the amount of gain or loss depends upon the difference between the taxpayer's adjusted basis and the proceeds from the sale and since the mineral rights may be conveyed separately from the surface rights,[63] the taxpayer must determine the extent of his adjusted basis in the mineral rights. A purchaser of a fee interest, if he feels there is a potential value in the minerals, should make a careful record of that portion of the consideration paid which is attributable to the mineral, or better still, insert a recitation in his contract of purchase of the separate amounts paid for the surface and for the minerals.[64] Where the taxpayer can show reasons for attributing part of the total basis to the mineral rights or even if he can show that he was interested in possible mineral deposits at the time of original purchase, the courts will generally allow such allocation or they may equitably make the allocation.[65] However, where no conception of the value of the mineral rights is shown or where it is shown that the purchase was made primarily for the surface value, it is very possible that *no* basis will be allocated to the mineral right and that the gain will be measured by the complete amount of the consideration received.[66]

The holding period, for tax purposes, commences with the date of original acquisition by the taxpayer of an interest in the property, no matter how many changes in the apparent nature of such interest may have taken place.[67] In each transaction short of a complete divestment, the taxpayer conveys an interest, but is considered also

quences entirely if the conveyance can be structured as an exchange of property for other property of like kind. Courts have been very liberal in the past as to defining "like kind" and as to holding such transactions as non-taxable exchanges. *See* I.R.C. § 1031(a) & (d); Kate J. Crichton, 42 B.T.A. 490 (1940), *acq.* 1952-1 Cum. Bull. 2, *aff'd* 122 F.2d 181, 27 Am. Fed. Tax R. 824 (5th Cir. 1941); E. C. Laster, 43 B.T.A. 159 (1940); Rev. Rul. 68-331, 1968-1 Cum. Bull. 352.

61. *See* I.R.C. § 1016. Depletion and depreciation both diminish basis in the item.

62. I.R.C. § 1001(a).

63. *Sale v. Lease,* 20 Oil & Gas Tax Q 9 (1971); *see* L. S. Munger, 14 T.C. 1236 (1950), and Dorothy Cockburn, 16 T.C. 775 (1951).

64. P-H Editorial Staff, *supra* note 47, at 1087.

65. Perkins v. Thomas, 86 F.2d 954, 18 Am. Fed. Tax R. 699 (5th Cir. 1936).

66. Plow Realty Co. of Texas v. Commissioner, 4 T.C. 600 (1945).

67. R. B. Cowden, T.C. Memo 1950-304, 9 T.C.M. 1148 (1950); P-H Editorial Staff, *supra* note 47, at 1084.

to have "retained" an interest rather than having acquired a new interest because of the change in form.[68]

Special problems arise when the consideration for a sale is not received in one lump sum or in installments within the taxable year of the transfer. This problem arises most often in conjunction with production payments which are retained on the sale of an interest. Under the Tax Reform Act of 1969,[69] a retained production payment on the sale of a mineral property is treated as if it were a purchase money mortgage.[70] This means that even though the payment may be spread out over a period of years, it still is generally recognized as a gain in the taxable year of the transfer to the total amount of consideration received and to be received under the oil payment.[71] However, if the taxpayer reports his income and expenses on the cash basis method,[72] it may be possible for such gain to be reported in installments as received provided the form and substance of the transaction conform to the requirements of I.R.C. Section 453.[73] This option is not open to accrual method taxpayers.[74]

DISTINCTIONS AND COMPARISONS

Three areas of importance will be discussed here: incidental expenses, treatment of equipment on conveyance, and capitalization.

The first comparison is in the area of expenses incident to the conveyance. If the transaction is a sale of property, commissions paid and other transfer expenses are deducted from the selling price as a part of the cost of the property sold.[75] In contrast, the Internal Revenue Service will require the lessor in a leasing or subleasing transaction to capitalize expenses incident to such lease or sub-

68. *Id.*

69. 83 Stat. 487 (1969).

70. I.R.C. § 636(b).

71. Treas. Reg. § 1.636-1(c)(4) (1973).

72. *See* I.R.C. § 446(c)(1) and Treas. Reg. § 1.446-1(c)(i), *amended* T.D. 6584, 1962-1 Cum. Bull. 67, T.D. 6818, 1965-1 Cum. Bull. 713, T.D. 6834, 1965-2 Cum. Bull. 958, and T.D. 7073, 1970-2 Cum. Bull. 98.

73. Among other things, that section requires that payments in the taxable year of the transaction not exceed 30% of the selling price and that the installment plan be a regular procedure of the taxpayer. In addition, if the transaction is accompanied by the issuance of a certificate of indebtedness, that certificate cannot be readily marketable or payable upon demand. *See* Rev. Rul. 68-606, 1968-2 Cum. Bull. 42.

74. I.R.C. § 446(c)(2) and Treas. Reg. § 1.446-1(c)(ii), *amended* T.D. 6584, 1962-1 Cum. Bull. 67, T.D. 6818, 1965-1 Cum. Bull. 713, T.D. 6834, 1965-2 Cum. Bull. 958, and T.D. 7073, 1970-2 Cum. Bull. 98. *See also* Rev. Rul. 68-606, *supra* note 73.

75. Sale v. Lease, *supra* note 63. Note, however, that if the transaction qualifies for installment reporting, the deductions must be prorated over the same period as the installment payments. E. A. Griffin, 19 B.T.A. 1243 (1930).

lease.[76] The Tax Court relied on real estate lease precedent in reaching this holding.[77] Real estate lease costs when capitalized are amortized over the life of the lease. On the other hand oil and gas leases are subject to percentage depletion regardless of remaining capitalization.

The second comparison covers the area of conveyance of producing properties and the tax treatment accorded the transfer of equipment involved in the sale or lease. The investment in the minerals and the investment in equipment are separate and exclusive of each other in terms of basis.[78] Two separate systems of adjustment are involved. The mineral property is depletable and the equipment is depreciable. I.R.C. Section 1245 provides that any proceeds received from the disposal of equipment[79] in excess of the depreciated value[80] are, to the extent of the original purchase price, taxable as ordinary income.[81] The question is whether Section 1245 applies to sale transactions or lease transactions, and if it does what problem arises in valuation and procedures as between transferor and transferee.

It appears that I.R.C. Section 1245 will apply to sales of equipment whether as part of a sale of an entire interest or individually by item. Lease and well equipment are depreciable assets and fall within the purview of the rule. In other words, if equipment is included in the interest to be conveyed, any gain arising from that transaction for the vendor might lose its capital gains treatment to the extent of the gain attributable to the equipment. The question then to be determined is how much of the proceeds received is directly applicable to the sale and purchase of the equipment apart from the oil and gas interest. In such a situation the seller is concerned with assigning as much of the gain as possible to the oil interest (for capital gains treatment) and as little as possible to the equipment (a great part of which will be ordinary income under I.R.C. Section 1245). On the other hand, the purchaser is desirous of assigning as great an amount as possible of the purchase price to the equipment and as little as possible to the interest.[82] The Internal Revenue Service may require that the proceeds of sale be allocated between the

76. *Expenses Incurred In Granting An Oil And Gas Lease,* 19 Oil & Gas Tax Q 321 (1971).

77. L. S. Munger, 14 T.C. 1236 (1950); D. Cockburn, 16 T.C. 775 (1951).

78. Alexander & Bell, *supra* note 40, at ¶ 1001.2.

79. Equipment used in the extraction of oil and gas qualify under I.R.C. § 1245(3)(B)(1).

80. The original purchase price less adjustments for depreciation, etc.

81. Amounts received in excess of the original purchase price are accorded capital gains treatment.

82. Cost attributable to equipment will be depreciable basis. Cost allocated to the inter-

working interest and the equipment on the basis of relative values,[83] but an agreement between the parties as to allocation of basis between equipment and leasehold may be acceptable to the I.R.S.[84] Since substantial equipment cost is usually involved in an oil and gas transaction, this is a major area for pre-transaction consideration.

The present status of Section 1245 with regard to lease transactions is uncertain. The controlling revenue rulings have been declared obsolete and no new rulings have been promulgated to replace them. A look at the prior treatment and releated material may give some idea of the treatment which will be accorded such transactions in the future.

At first the I.R.S. contended that all proceeds of a lease transaction were bonus payments, and the sum of the bases in the leasehold and equipment became the lessor's basis in the retained interest.[85] The Supreme Court changed the treatment.[86] The newer method treated the transaction as a sub-lease of the working interest and a sale of the equipment.[87] Under this method the lessor was allowed to recover the undepreciated cost of the equipment.[88] The cash consideration received was offset to the extent of the remaining undepreciated value of the equipment, and the excess of cash became depletable basis in the working interest.[89] The cases allowed a loss to the lessor if consideration received was not enough to offset the depreciated value.[90] These authorities prevailed prior to the enactment of I.R.C. Section 1245.[91] If such a policy had continued, it would seem that the treatment of equipment transferred in a lease transaction would be exactly the same as that discussed earlier under sale transactions. However, no authority was found to support either view. The only kind of present treatment is found in a revenue ruling[92] which states that a lessor may deduct depreciation on equipment leased with a mineral interest. Such treatment would be a

est will also be capitalized, but since percentage depletion is available with a producing property, this provides no advantage to purchaser.

83. *Application of Depreciation Recapture Rules to Transactions Involving Lease and Well Equipment,* 14 Oil & Gas Tax Q 82, 93 (1965).

84. Beck & Gannet, *Recapture of Depreciation,* P-H Tax Ideas, ¶ 15.003 (1973), at 15,104; *see also* Treas. Reg. § 1.1245-1(a)(5), *amended* T.D. 7084, 1971-1 Cum. Bull. 230 and T.D. 7141, 1971-2 Cum. Bull. 304.

85. Application of Depreciation Recapture Rules to Transactions Involving Lease and Well Equipment, *supra* note 83, at 95.

86. Choate v. Commissioner, 324 U.S. 1, 33 Am. Fed. Tax R. 297 (1945); Rev. Rul. 55-35, 1955-1 Cum. Bull. 286, obs. Rev. Rul. 70-594, 1970-2 Cum. Bull. 301.

87. Alexander & Bell, *supra* note 40, at ¶ 1001.4.

88. 324 U.S. 1, 33 Am. Fed. Tax R. 297.

89. *Id.;* Rev. Rul. 55-35, *supra* note 86.

90. *Id.*

91. In the Revenue Act of 1962.

92. Rev. Rul. 68-361, 1968-2 Cum. Bull. 264.

radical change because it implies that the lessor or sublessor retains an ownership interest in the equipment conveyed with the working interest. Lease transactions would escape the application of Section 1245 entirely and postpone it until final disposition of the equipment.

The third major area for comparison concerns capitalization. Since percentage depletion for an economic interest is available regardless of whether the owner of the interest has any basis remaining for cost depletion, the conveyance which produces the smallest amount for capitalization by the lessee or purchaser is the better conveyance from that party's viewpoint. The main disadvantage of a sale of a mineral interest is that the purchaser (operator) must capitalize the entire amount paid for the interest received. In a lease transaction only the bonus paid to the landowner must be capitalized by the lessee (any royalty interest retained by the landowner is merely subtracted from gross income as produced in a form similar to expense). This provides a great advantage for the lease transaction. Where a producing property is conveyed, the capital gains treatment accorded the owner of the working interest (who is usually in a superior bargaining position) may outweigh the capitalization problems for the transferee. Smaller amounts are usually involved in such transactions; hence, not so much is at stake for the transferee.

CONCLUSION

In the conveyance of mineral interests from landowners to developers or oil companies, business purposes tend to predominate and tax consequences become secondary. It would seem that a sale transaction would always be beneficial to the landowner because of the favorable capital gains treatment available. However, here the landowner is dealing with an unknown quantity. He has no way to assess the ultimate value of the oil and gas deposit, and, therefore, any final transaction could leave him short in terms of profit if the deposit is very large. Therefore, the payment of a lump sum (bonus) coupled with a share in the profits of the property (royalty) provides the best source of security for him. On the other hand, the developer is speculating as to profitable quantities of oil and gas being present. The purchase of a great deal of land for a substantial consideration paid is not feasible where much of that investment will be for non-producing properties. Even if the property became productive, the purchase price of such property must be capitalized in full. The leasing transaction provides a much more practical approach to development of possible oil and gas producing properties since the

parties share the risk and the amount of initial capitalization is reduced; yet both parties can profit from the arrangement. The flexibility involved also makes the oil and gas lease the better instrument for business purposes.

> The oil and gas lease . . . has been the product of economic necessity as a device for harmonizing the more or less conflicting desires of the owners of possibly mineralized lands . . . and the entrepreneurs engaged in the discovery, production and sale of oil and gas. The discovery and successful exploitation of oil and gas deposits demands a fund of capital and a background of technical experience which most landowners do not possess. On the other hand, the acquisition of fee simple ownership generally by oil and gas entrepreneurs would involve an excessively burdensome investment of capital.[93]

The situation with regard to sale transactions versus sublease transactions is different because the transaction is not as completely controlled by business purposes, at least where producing properties are concerned. Where the risk is minimized, the parties have more reason to assess the tax consequences of their actions. In the sublease of a producing property, it is almost always advantageous for the transferor if the conveyance is classified as a sale. Capital gains treatment could produce a fifty per cent reduction in taxable income whereas percentage depletion provides only a twenty-two per cent reduction from ordinary taxable income. By this time the transferor has a much better idea of the extent of the mineral deposit and is not nearly so likely to cheat himself in a sale transaction. Treatment of incidental expenses is more favorable in a sale transaction. The transferor's biggest disadvantage lies in the effect of I.R.C. Section 1245 which could deprive him of capital gains treatment. If the conveyance is going to produce a loss, the sale transaction might not be nearly so attractive, since the possibility of capital loss rather than ordinary loss is present.[94] If the interest to be conveyed is an I.R.C. Section 1231 interest, this disadvantage becomes minimal. In a sublease transaction, however, it would seem that the transferor would benefit by retaining a right in the depreciation deduction in the equipment.

From the standpoint of the transferee, it is usually more favorable if the conveyance is structured as a sublease for tax purposes. The transferee then must capitalize only the bonus payment. If, as the Revenue Service maintains, the equipment remains the property of

93. Kent, *When Is A Transaction a Sale or a Lease?*, P-H Oil & Gas-Nat. Res. Taxes ¶ 1002 (1968), at 1012.

94. *See* I.R.C. § 1211.

the transferor, the transferee loses a valuable deduction for depreciation and his investment is entirely in depletable property. The transferor is usually in a more favorable bargaining position, but the smaller amount of interest involved may not provide a substantial disadvantage to the transferee in terms of extra capitalization. If the installment method of reporting is available, the transferee may benefit as well by the sale as by the lease through deferral of payments. If the transaction could be structured to include a production payment retained by the sublessor, both parties could benefit from a sublease (especially where the sublessor wishes to defer income and the installment method of reporting is not available). This measure would be a worthy compromise for the conflicting interests.

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