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Taxation--Conveyance of In-Oil Payment Rights--Capital Gain or Ordinary Income

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TAXATION—CONVEYANCE OF IN-OIL PAYMENT RIGHTS—CAPITAL GAIN OR ORDINARY INCOME—Taxpayer conveyed to the D. K. Caldwell Foundation, a tax-exempt organization created and controlled by him, payment rights in certain long-life oil fields in return for cash and notes to be paid from the proceeds of the sales of oil. The conveyances provided for reversion of the royalty interests when the foundation had received specified sums. The taxpayer reported as ordinary income the gains resulting from the transactions but later sued for a refund of the overpayment. He claimed that the conveyances were sales of capital assets held more than six months under the provisions of Section 117 j of the INT. REV. CODE of 1939 (substantially the same as Section 1281 of the INT. REV. CODE of 1954). The Commissioner argued that the transactions were merely assignments of future income of the taxpayer. Held, the transactions did not constitute anticipatory assignments of future income, but were sales from which the taxpayer realized capital gain. Caldwell v. Campbell.

In the instant case, the court was asked to determine whether the gain resulting from the conveyance of the in-oil payment rights for cash was taxable as ordinary income or as capital gain. Assignments of income only have not been effective to transfer taxable income from the assignor to the assignee, but if the source of the income or the entire property interest is considered to have been assigned, the assignee and not the assignor is thereafter taxable on the income from the property transferred. It also follows that if the entire property interest has been transferred by sale, the assignor may realize capital gain rather than ordinary income on such sale if the property sold was a capital asset. The problem is to draw the line, and this discussion is limited to the resolution of this problem with regard to in-oil payment rights.

In an early case in which the problem arose, the Board of Tax Appeals ruled that the transfer of a fractional interest in oil property to a trust, subject to reversion after the trust had realized a stipulated amount, was to be considered an assignment of corpus and not of future income. In a subsequent case, a sale of a leasehold interest was held to result in capital gain only where a payment right was reserved to the seller (no distinction was made as to whether the right

1 218 F. 2d 567 (5th Cir., Jan. 12, 1955).
4 Bells Estate v. Commissioner, 137 F. 2d 454 (8th Cir. 1943).
5 R. E. Nail et al Executors (Cook), 27 B.T.A. 33 (1932).
6 Commissioner v. Fleming, 82 F. 2d 324 (5th Cir. 1936).
was short-lived or long-lived). Still later, the same court\(^7\) held that the owner of an interest in oil property might carve in-oil payment rights from that interest and treat the proceeds upon the sale as capital gain.

Subsequent decisions turned on whether the court found that the conveyor of oil or gas in place retained an economic interest in the property conveyed.\(^8\) In one of these decisions,\(^9\) the court looked to the intention of the parties and found that despite the use of terms of sale in the agreement, the conveyor had really reserved a royalty interest in the property conveyed.

The Internal Revenue Service has ruled that after April 1, 1946 consideration received for the assignment of an in-oil property right for any period less than the life of the property interest from which it is carved is ordinary income unless such consideration is pledged for use in further development.\(^10\)

Subsequently, the court held\(^11\) that where the conveyance expressly stipulated that the assignee was not obligated to continue to produce, the conveyance of a mineral property with the retention by the seller of a royalty interest constituted a sale, and the cash payments received thereunder were not advance royalties. As a result of the holding in that case, the General Counsel of the Internal Revenue Service ruled that an assignment by which the assignor retains an overriding royalty interest constitutes receipt of advance royalties and not proceeds from the sale of a capital asset.\(^12\) In issuing this ruling, he relied on two Supreme Court holdings:\(^13\) that income from royalties on oil or gas leases is taxable as ordinary income; and that, in connection with a transfer of an oil well lease, retention of a royalty from oil to be produced constitutes withholding of an economic interest in the oil in place.

In the case under discussion, the Commissioner contended that since the royalties out of which the in-oil payments arose would have been income to the grantor when received, the transfers must be

\(^7\) Ortiz Oil Co. v. Commissioner, 102 F. 2d 508 (5th Cir. 1939).
\(^8\) Columbia Oil & Gas Co. v. Commissioner, 118 F. 2d 459 (5th Cir. 1941); Badger Oil Co. v. Commissioner, 118 F. 2d 791 (5th Cir. 1941); West v. Commissioner, 3 T.C. 421, aff'd 150 F. 2d 723 (5th Cir. 1945).
\(^9\) West v. Commissioner, supra note 8.
\(^12\) G.C.M. 27322, Com. Bull. 1952-2.
treated as anticipatory assignments of income. Although he cited no cases in point, he relied on the holdings of several cases, which held that where the taxpayer assigns the right to receive income, the income is still taxable to the assignor. The court, however, distinguished the instant case from the cases relied on by the Commissioner in that here there was an assignment of the property which produces the income, not just of the income from that property.

The Commissioner also relied on a case wherein it was held that where the taxpayer corporation conveyed its entire interest in certain leases to its stockholders subject to a reversion when the oil payments received by the stockholders had reached a specific amount, the income was ordinary income to the corporation. The court distinguished the cited case from this case in that the former was over a short period of time only and was an abortive attempt to reduce taxes.

The Tax Court has previously rejected a contention that the transfer or assignment of an in-oil payment right was an assignment of future income. Also, in another Tax Court case, the taxpayer carved a right out of the property interest and assigned it only for a period long enough to pay a contractor for the residence the latter was constructing for the taxpayer. The court there held that this was income from the sale of in-oil payment rights and was taxable as capital gain rather than ordinary income.

The holding in the instant case appears to be a return to the theory of the holdings in the earlier cases. It is to be noted, however, that under the holding in this case, the property interest itself and not the right alone, must be assigned.

It is submitted that the ruling in the instant case is sound since it recognizes as a property interest not only the entire in-oil payment right but also parts of that right carved out of the larger interest. It is also submitted that the holding in this case may be used in future cases of transfers of property wherein a reversionary interest is reserved.

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17 John David & Bette Hawn, 23 T.C. 64 (1954).
18 R. E. Nail, supra note 5; Commissioner v. Fleming, supra note 6; Ortiz Oil Co. v. Commissioner, supra note 7.