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Economic Interest - Some Further Thoughts

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ECONOMIC INTEREST—SOME FURTHER THOUGHTS

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I. INTRODUCTION

The revenue codes since 1913 have provided for depletion in the exploitation of minerals. However, the criteria to be applied in determining whether the depletion deduction is allowable have never been prescribed by Congress. In 1933 the Supreme Court in *Palmer v. Bender*[1] set forth the definition, which with some qualification is applied today, that an economic interest exists in "every case in which the taxpayer has acquired, by investment, any interest in the . . . [mineral] in place, and secures, by any form of legal relationship, income derived from the extraction of the . . . [mineral] to which he must look for a return of his capital."[2] This two-part definition which was adopted and has been perpetuated in the regulations[3] requires a certain prerequisite interest in the taxpayer and it is this first element of the definition with which this paper primarily concerns itself. The second element requires essentially an economic dependence on production only as the means for capital recovery. The risk of the lack of mineral or production must have been assumed by the taxpayer in order to qualify under this second element. For example, if a taxpayer ostensibly has been assigned all right to a certain mineral in place but the quantity of mineral or the amount of production obtainable has been guaranteed by the transferor, taxpayer is not dependent on production for a return of capital. Rather, the risk of production has been retained in effect by transferor since it is he and not taxpayer who will lose if there is insufficient production. Therefore, taxpayer will not be held to have acquired a depletable economic interest.[4]

Nevertheless, it appears presently settled within the limits discussed below[5] that one who owns an interest in the mineral fee

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1. 287 U.S. 551 (1932).
2. *Id.* at 557.
3. Treas. Reg. § 1.611-1(b)(1) (1954).
4. *See* Anderson v. Helvering, 310 U.S. 404 (1940); Christie v. United States, 436 F.2d 1216 (5th Cir. 1971); Donnell, 48 T.C. 552 (1967); Landreth, 50 T.C. 803 (1968); Holbrook, 54 T.C. 1617 (1970). *Contra*, Vest v. CIR, 32 AFTR 2d 73-5209 (5th Cir. 1973) (an unsettling decision holding an economic interest existed despite taxpayer's right to look for a return of his capital to extraction not only from his own land but also from neighboring lands and from other sources completely unrelated to extraction).
5. See text accompanying notes 62-64, *infra*.

estate or the leasehold has the requisite economic interest.[6] In addition one who owned such an interest and assigned it retaining one of the following interests would have an economic interest:

1.) Royalty[7] is a share in gross production of the proceeds from the sales of production reserved by the lessor under a mineral lease free of all development and operating costs. The fact that the royalty or other nonoperating interest is payable on a fixed price per unit of production basis rather than a percentage of net or gross production or proceeds from the sale thereof should not appear to vitiate the economic interest status of the interest in question.[8]

2.) Overriding Royalty[9] is typically a cost free royalty created by the mineral lessee generally, but not necessarily, as the result of an assignment of the lease out of which the overriding royalty is reserved.

3.) Net Profit Interest[10] is an interest that gives the holder no operating rights but entitles him to a specified percentage of the net proceeds from production. Net proceeds are usually defined as a specified percentage of gross income less the interest owner's proportionate share of the operating costs and in some instances of the costs of development. Although the Supreme Court has held in both *Kirby Petroleum Co. v. Commissioner*[11] and *Burton-Sutton Oil Co.*[12] that a net profits interest is an economic interest, the Court did not expressly overrule *Elbe Oil Land Development Co.*[13] or *Helvering v. O'Donnell*[14] wherein the court previously held that a net profit interest was not an economic interest.[15] However, because of the *Kirby* and *Burton-Sutton* cases and a more recent Supreme Court decision[16] the revenue service has accepted the view that a net profits interest can be an economic interest at least where one in the chain of title to the operating (either the fee or the mineral leasehold) remains the same.[17]

6. Greensboro Gas Co. v. Commissioner, 79 F.2d 701 (3rd Cir. 1935).
7. Palmer v. Bender, 287 U.S. 551, 554 (1932).
8. *See* Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932); Tres. Regs. § 1.613-2(c)(5) ex. *But see* text accompanying notes 41-45, *infra*.
9. Hogan v. Commissioner, 141 F.2d 92, 94 (5th Cir. 1944).
10. Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946).
11. 326 U.S. 599 (1946).
12. 328 U.S. 25 (1946).
13. 303 U.S. 372 (1938).
14. 303 U.S. 370 (1938).
15. GCM 22730, 1941-1 CUM. BULL. 214, wherein the revenue service so construed the two cases cited immediately above as holding that a net profits interest is not an economic interest.
16. Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956).
17. REV. RUL. 69-332, 1969-1 CUM. BULL. 87; Treas. Reg. § 1.614-1(a)(2) (1954).

4.) Production Payment[18] is an interest under which the holder is to receive a specified portion of the production until he has received a specified amount. The holder of this interest is deemed to have an economic interest in only certain circumstances due to the 1939 Tax Reform Act.[19]

5.) Extraction which is trespassory will probably not give rise to an allowable depletion allowance in light of two Fifth Circuit holdings that one does not have an economic interest in oil produced from wells which are illegally bottomed outside the limits of the leasehold and therefore depletion on such production is not allowable.[20]

The discussion above has dealt with the question of whether an interest holder in the chain of title to the operating interest possesses an economic interest. This, based on decisions issuing from the Supreme Court, appears to be settled and the recent Supreme Court decision of *Commissioner v. Southwest Exploration Co.*[21] appears to expressly so acknowledge.

> It is to be noted that in each of the prior cases where the taxpayer had had a sufficient economic interest to entitle him to depletion, he has once had at least a fee or leasehold in the oil-producing properties themselves.[22]

II. ECONOMIC INTEREST EXTERIOR TO CHAIN OF TITLE

Because of four Supreme Court decisions, i.e., *Helvering v. Bankline Oil Co.*,[23] *Commissioner v. Southwest Exploration Co.*,[24] *Parsons v. Smith*,[25] and *Paragon Jewel Coal Co. v. Commissioner*[26] when one is not in the chain of title to the operating interest (whether leasehold or mineral fee) and either transfers money or property or agrees to perform some labor or process whether in the exploration, development, production, or post-production or manufacturing stage, in consideration for either a percentage of production or a fixed price per unit of production, uncertainty exists as to whether such consideration received constitutes an economic interest. The *Bankline Oil* case involved a taxpayer who operated a casinghead gasoline plant which extracted gasoline from wet or natural gas.

18. Thomas v. Perkins, 301 U.S. 655 (1937); United States v. Witte, 306 F.2d 81, 87 (5th Cir. 1962).
19. P. MAXFIELD, THE INCOME TAXATION OF MINING OPERATIONS 180 et seq. (1973).
20. Commissioner v. Donnell, 417 F.2d 106 (5th Cir. 1969); Harrington v. Commissioner, 404 F.2d 237 (5th Cir. 1968).
21. 350 U.S. 308 (1956).
22. *Id.* at 314-15.
23. 303 U.S. 362 (1938).
24. 350 U.S. 308 (1956).
25. 359 U.S. 215 (1959).
26. 380 U.S. 624 (1965).

By contract with the oil producers, taxpayer provided pipelines from the well casingheads to its plant where it extracted the gasoline paying the producers a one-third of the gross proceeds derived from the sale of the gasoline. Taxpayer argued unsuccessfully that it was entitled to depletion on the difference between the fair market value of the wet gas at the wellhead and the price it was required to pay for it. The Court, noting that taxpayer played no part in and had no control over the production process, concluded that taxpayer had no investment in gas in place and therefore no economic interest. Though the taxpayer was looking to extraction for a return of its capital, there was a failure to satisfy the first of the two part definition in *Palmer v. Bender*,[27] i.e., the relationship was insufficient to justify a conclusion of ownership of mineral in place. The impact of the language was that formal ownership of the lease or fee interest was not a necessary prerequisite to a conclusion of ownership in place but rather that sufficient involvement in the production process with some right to production would suffice. As of this decision, however, the Supreme Court had not formulated the chain of title concept referred to above.

In *Southwest Exploration* taxpayer sought to obtain leases on off-shore oil deposits owned by the State of California. California law provided that the leases were conditioned upon and that oil could be extracted only if the wells were drilled on filled land or were slant drilled from upland sites adjacent to the oil deposits. There being no available filled land, taxpayer obtained a right to drill from an upland site in consideration for 24.5 per cent of the net profits from extraction and sale of the oil. It should be noted that the agreement between the upland owners and the taxpayer provided that the former would acquire no interest in the lease or oil deposit. The Supreme Court held that the upland owners and not the taxpayers were entitled to depletion on the amounts paid to the former emphasizing that the contribution of the upland owners was absolutely essential to the extraction or production of oil. In this decision the Supreme Court articulated the chain of title concept referred to above and contracted, in this author's view, the holding of *Bankline* by ruling that one who is not in the chain of title must demonstrate an essential contribution in order to qualify for the depletion allowance.

In *Parsons* the taxpayer, a mining contractor, entered into an oral agreement with the owner of coal lands to strip mine the coal for a fixed price per ton of coal produced and delivered to the fee owner. The taxpayer was to furnish all equipment and labor; however, the contract was terminable by the fee owner on

27. 287 U.S. 551, 557 (1933).

ten days' notice. The Court cited the above quoted test originating with *Palmer v. Bender*[28] and concluded that taxpayer had no investment in coal in place and therefore no economic interest for the reason that petitioner's investments were in their equipment, all of which was movable, not in the coal in place. The Court further determined that the investments in equipment were recoverable through depreciation, not depletion, that the contracts were completely terminable without cause on short notice, that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place and that the coal at all times, even after it was mined, belonged entirely to the landowners. Finally, the Court concluded that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners and that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered. This, quoting the terms of the contract in a companion case,[29] was agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work." In conclusion, the petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts.[30]

Paragon Jewel was in most respects similar to *Parsons,* except that no express provision was made for the landowner's terminating at will. The Court again concluded that the mining contractor had no economic interest, holding the *Bankline* and *Parsons* cases to be controlling.[31] *Southwest Exploration* was distinguished on the ground that here not only did the mining contractors not receive a fixed percentage of proceeds rather than a fixed price per ton, but also in this case the mining contractors were not essential parties to the extraction of production process.[32]

Because of *Southwest Exploration, Parsons* and *Paragon Jewel* considerations, much confusion has been generated. If *Bankline* only had been applied to the *Paragon* facts, the result might well have been otherwise. However, *Southwest Exploration* required an application of the essentiality test because the Court did not view the contractor as standing in the chain of title.[33] It might be noted, however, that the mining contractors in *Parsons* and *Paragon Jewel* might well have been considered lessees or sublessees and therefore

28. *Id.*
29. Huss v. Smith, 359 U.S. 215, 218 (1959).
30. Parsons v. Smith, 359 U.S. 215, 225 (1959).
31. Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624 (1965).
32. Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956).
33. *Id.* at 317.

in the chain of title. As will be further discussed below, the economic interest argument would still have failed in *Parsons* because the mining contractor's rights were terminable. Nevertheless, in form it would seem that the mining contractor in those cases could be viewed as having assumed the position of a lessee or sublessee. In *Paragon,* however, neither party argued for lease treatment. In any event, casting the transaction as a lease would have put the mining contractor in the chain of title and thereby probably avoided the need to apply the essentiality test.[34]

Taking separately the considerations relied on in the cases, it might be helpful to examine the significance that the lower courts, the revenue service, and the commentators have given them. The considerations raised in *Parsons* will be examined first, followed by a look at the essentiality requirement raised in *Southwest* and applied again in *Paragon.*

A. INVESTMENT IN THE MINERAL

In *Parsons* and *Paragon* the mining contractors invested in movable equipment and nothing in their putative mineral interests. Does this disqualifying factor mean that cash consideration or other property must be given for the mineral interest itself? Many oil and gas leases have been given for no consideration whatsoever except the promise to develop. Is the tax status of the latter now unsettled because of the lack of initial consideration? In no case subsequent to the above two was the actual investment consideration alone determinative or determinative in conjunction with some of the weaker considerations set forth in the two cases.[35] A Court of Claims decision directly responsive to *Parsons* and *Paragon* has held that an investment in a plant and equipment is an investment in the minerals in place.[36] Additionally, the revenue service appears to have ignored the actual investment factor in a recent ruling.[37] One authority concludes that the investment factor carried to the extreme is contrary to the Congressional intent in granting the depletion allowance.[38] It is unfortunate that this point was ever made in the context of the *Parsons* and *Paragon* facts because of the uncertainty that was injected and because of the literal indifference in the statute allowing percentage or statutory depletion to cost or investment in the mineral property. The emphasis in

34. *See* REV. RUL. 73-32, 1973-1 CUM. BULL. 301.

35. *See* Rissler & McMurray Co., Inc. v. United States, 32 AFTR 2d 73-5194 (10th Cir. 1973); Adkins v. Commissioner, 51 T.C. 957 (1969).

36. Food Machinery & Chemical Corp. v. United States, 348 F.2d 921, 928 (Ct. Cl. 1965); *see also* Mullins v. Commissioner, 48 T.C. 571 (1967).

37. *See* REV. RUL. 73-32, 1973-1 CUM. BULL. 301.

38. Williams, *The Economic Interest Concept*, P-H NAT. RES. TAXES, ¶1010 (1972).

Paragon and *Parsons* on investment in depreciables as a basis for the disallowance of depletion might be interpreted as stemming from a disagreement with or misunderstanding of the basic allowance of percentage depletion *vel non* which allowance typically involves a recovery of more than the investment made in the property.

B. TERMINABILITY

In *Parsons* the reliance on terminability of the relationship by the transferors appears somewhat settled. If the contractor's interest is terminable on short notice or if the right to mine exists only for a short term even though not terminable for the term, the contractor will probably not achieve economic interest status.[39] The Tax Court has approved a two year term[40] and arguably disapproved a one year term.[41] However, the Fifth Circuit[42] and the Court of Claims[43] have recently held terminability on 30 day notice not to be disqualifying if formal and substantive leasehold rights are otherwise vested in the contractor. Two of the three judges on Fifth Circuit panel also require that the contractor satisfy the "essentiality" test of *Southwest Exploration* (discussed *infra)* at least if the lease is terminable on short notice. The other cases, however, raise the question whether the duration of the interest transferred to the operator must be of sufficient duration to permit a mining to exhaustion. The tax court case involving the two year interest merely stated that taxpayer-contractor could in that time mine a substantial portion of the coal, not all. The case involving the one year term doesn't discuss the question. A recent Tenth Circuit decision[44] concluded that an irrevocable right which was for a short but not an immediately ascertainable period, was too short. It appears that if the period is not terminable by transferor at will or after a short notice period, the period should not be disqualifying primarily because in the sale lease cases the courts and revenue service have concluded that a transfer of any definite quantity of mineral can constitute a sale of mineral and therefore a transfer of an economic interest.[45] If transferor to contractor desires to terminate, then to be safe, make termination contingent on speci-

39. Constantino v. C.I.R., 445 F.2d 405 (3rd Cir. 1971); Rissler & McMurray Co., Inc. v. United States, 32 AFTR 2d 73-5194 (10th Cir. 1973); Mullins v. Commissioner, 48 T.C. 571 (1967); Adkins v. Commissioner, 51 T.C. 957 (1969); Winters Coal Co., 57 T.C. 249 (1971), *rev'd.* 496 F.2d 995 (5th Cir. 1974); Kenneth Witmer, P-H T.C. MEMO 69, 286; REV. RUL. 73-33, 1973-1 CUM. BULL. 307.

40. Mullins v. Commissioner, 48 T.C. 571, 580 (1967).

41. *See* Adkins v. Commissioner, 51 T.C. 957, 968 (1969).

42. Winters Coal Co., Inc. v. United States, 496 F.2d 995, 996 (5th Cir. 1974), *rev'g* 57 T.C. 249.

43. Bakertown Coal Co., Inc. v. United States, 485 F.2d 633, 641 (1973).

44. Rissler & McMurray Co. v. United States, 32 AFTR 2d 73-5194 (10th Cir. 1973).

45. REV. RUL. 69-466, 1969-2 CUM. BULL. 140. *See* P. MAXFIELD, *supra*, note 19, at 155-72.

fied acts of misfeasance by contractor. Thereby contractor retains control of the duration of the interest.

The *Paragon Jewel* case raised the question whether the economic interest status is affected by contractor's being given the right to terminate at will.[46] Clearly, if such were the case, most of the oil and gas leasing transactions would be upset taxwise since a common provision included in such leases today enables the lessee to surrender the lease at will. Countless transactions involving such have not even been questioned on such basis. As a practical matter, the conclusion that the risk of production (and capital recovery thereby) is on the transferee would only be in question for the reason of terminability when transferee's rights are terminable by transferor at will with minimal or no notice. The fact that transferee can conclude his own interest does not in any way preclude him from retaining his interest and looking thereto for a return of his capital if he so wills.

C. OWNERSHIP IN PLACE

This requirement imposed by the *Parsons* and *Paragon Jewel* cases would appear to properly be the conclusion rather than the major premise of the syllogism unless the Court is requiring a formal transfer of property rights which defies a well-settled precept of the Supreme Court eschewing the exaltation of form over substance.[47] No decision or ruling subsequent to the two cases has, to this commentator's knowledge, employed this factor for purposes other than the conclusion to the two part definition of economic interest in *Palmer v. Bender*.[48] There is no indication that the courts or the revenue service will not continue to look through form to substance by examining all the factors and then conclude that a taxpayer either does or does not have an interest in the minerals in place.

D. FIXED PRICE PER UUIT OF PRODUCTION

Although the fixed price per unit conclusion of the two decisions has some justification in the abstract since such a formula does not relate directly to value, and thus could be payable by reason of the personal covenant despite a decline in value of the mineral to a point insufficient to meet the "royalty" obligation; nevertheless, the same fact did not vitiate economic interest treatment in a prior Supreme Court case[49] and the conclusion appears inconsistent with the

46. 380 U.S. 624 (1965).
47. *E.g.*, Burnet v. Harmel, 287 U.S. 103 (1932); Palmer v. Bender, 287 U.S. 551 (1933).
48. 287 U.S. 551 (1932).
49. Bankers Pocohantas Coal Co. v. Burnet, 287 U.S. 308 (1932).

regulations.[50] Viewing the question in perspective, there are several other well-settled examples of payments not directly related to production being treated as production for purposes of the depletion allowance. The first is bonus, which can be depletable despite the lack of sufficient production to even equal it.[51] Other examples are minimum royalty and other payments such as *ad valorem* tax payments which are treated in certain circumstances as minimum royalty and depletable.[52]

Nevertheless, in this context, the use of a fixed price per unit formula for royalty may well vitiate economic interest treatment at least where in effect the contractor is the owner of the royalty, i.e., where as in *Paragon Jewel* and *Parsons* the contractor turns over the mined mineral to the transferor subject to the fixed price per unit payable to him, and where the mining contractor formally acquires the leasehold or fee rights in the mineral but must sell it back to transferor at a fixed price per unit.[53]

E. ESSENTIALTY

If the contractor-operator is to be in the chain of title to the mineral fee or leasehold, then this element originally developed in *Southwest Exploration* and reapplied by the Supreme Court in *Paragon Jewel* is probably not relevant[54] unless the Court of Claims analysis discussed below is perpetuated. Thus the question arises when the party who is a stranger to the title to the operating interest receives an interest other than mineral fee or leasehold.

The *Bankline* facts and holding, which involved one not in the chain of title to the operating interest performing some post-extraction process in consideration for what would appear to be a royalty type interest in combination with the *Southwest Exploration* test of essentiality to production, have been adopted by at least the Fifth and Sixth Circuits[55] and the Court of Claims.[56] The Fifth Circuit[57] and the Court of Claims[58] have held in these cases that an agree-

50. Treas. Reg. § 1.613-2(c)(5).
51. Herring v. Commissioner, 293 U.S. 322 (1934). Treas. Reg. § 1.612-3(a)(2). *See* P. MAXFIELD, *supra*, note 19, at 92-104.
52. Louisiana Land & Exploration Co. v. Donnelly, 21 AFTR 2d 1254 (5th Cir. 1968); Handelman v. U.S., 357 F.2d 694 (Ct. Cl. 1966); John McLean, 54 T.C. 569 (1970). *See* P. MAXFIELD, *supra* note 19, at 107-11.
53. See cases cited note 64 and text accompanying note 64, *infra*.
54. *See* REV. RUL. 73-32, 1973-1 CUM. BULL. 301.
55. Scofield v. LaGloria Oil & Gas Co., 268 F.2d 699 (5th Cir. 1959). In Omer v. United States, 329 F.2d 393 (6th Cir. 1964), taxpayer owned the surface but not the underlying coal. He allowed the owner of the coal to use the surface for mining in consideration for a fixed price per ton of coal mined. The Court applied the *Southwest Exploration* essentiality test and concluded that taxpayer had a depletable economic interest.
56. Tidewater Oil Co. v. United States, 339 F.2d 633 (Ct. Cl. 1964); Tidewater Oil Co. v. United States, 677 CCH ¶ Ct. Cl. Comm'r Report (1967); CBN Corp. v. United States, 328 F.2d 316 (Ct. Cl. 1964); 364 F.2d 393 (Ct. Cl. 1966); 388 F.2d 337 (Ct. Cl. 1967).
57. 268 F.2d 699 (5th Cir. 1959).
58. 339 F.2d 633, 638-39 (Ct. Cl. 1964).

ment by a gas processor with a gas producer to process producer's gas in consideration for a percentage of gross sales proceeds of processed gas does not give the processor a depletable economic interest because of the lack of essentiality to the production process. The revenue service in a 1968 ruling dealing with a similar gas processing fact situation relied on *Bankline* without resorting to the essentiality test of *Southwest Exploration* to conclude that the gas processor did not possess an economic interest but was rather merely a gas purchaser.[59] Also the Court of Claims has denied depletion to one operator who transferred his production oil allowable to another operator in consideration for that other operator's paying the transferor a stated price per barrel produced varying with the posted sale price of the oil. Here again the Court of Claims concluded that the transferor's contribution to the transferee in consideration for the production (or proceeds therefrom) received back was only essential to the extraction of part and not all of the oil and therefore the transferor's interest was not a depletable economic interest.[60]

In view of the decisions discussed above, one who is not in the chain of title to the operating interest (leasehold or mineral fee) who agrees to perform some post-extraction process in consideration for a non-operating interest such as a royalty or net profits interest probably should not expect allowable depletion on such interest in light of the lack of essentiality to the extraction or production process. In addition *Paragon Jewel* threatens the depletability of such interests even if the activity to be performed is an extraction process, or possibly even a pre-extraction (development) process, because the Court concluded that the mining activity performed there was not essential.[61] This creates some uncertainty in view of the long standing treatment of sharing arrangements.[62] Perhaps *Paragon Jewel* and *Southwest Exploration* can be reconciled with the sharing arrangement doctrine in addition to other ways on the ground that the essentiality test should be applied only to the production or extraction and post-extraction stages and not to the exploration and development stages of mineral operations, i.e., those stages with which the sharing arrangement is involved.[63]

59. REV. RUL. 68-330, 1968-1 CUM. BULL. 291.
60. Tidewater Oil Co. v. United States, 339 F.2d 633, 638-39 (Ct. Cl. 1964).
61. In Food Machinery & Chemical Corp. v. United States, 348 F.2d 921 (1965), the Court of Claims construed *Paragon Jewel* as holding that the contractor's contribution in *Paragon* was not essential since other contractors were availabe.
62. INT. REV. CODE of 1954, § 636(a), however, should prevent such question where the sharing arrangement involves a production payment.
63. For a discussion of sharing arrangements, see P. MAXFIELD, *supra*, note 19, at 263 *et seq.*

III. CONCLUSION

Nevertheless, based on the cases discussed above, the tax treatment of the following situation would appear clearcut:

> A, who has a mineral lease on Blackacre, transfers to B for an unfettered cash consideration, a royalty of 10 cents per ton on the mineral mined by A.

B has two strikes against him or her. First, B's royalty is set at a fixed price per unit rather than a percentage. Secondly and more significantly, B's contribution, being unfettered cash, would seem to be even less of an essential contribution to production than the contribution of the contractor in *Paragon* who was accomplishing the production work. Nevertheless, the regulations provide that B has an economic interest.[64] Yielding to one's impulse at this point would probably be justified, but clearly not constructive.

Perhaps the contractor who is a stranger to the title and who desires a depletable interest might bargain for an undivided share in the operating interest as an alternative course of action. This course of action was approved by the Tax Court in 1948[65] for a gas processor who was assigned an undivided interest in the heavier hydrocarbons in place by the leaseholder. The Tax Court answered the Commissioner's *Bankline* argument of no control over the production process by noting that he was assigned an undivided interest in the specified minerals in place.[66] The Court made no express reference to the chain of title distinction that was developing in the Supreme Court.[67] However, the result was certainly consonant with that distinction, i.e., one who has an interest in the mineral fee or leasehold has a depletable economic interest.[68] However, the revenue service early indicated its disapproval of the holding by nonacquiescing.[69]

If the chain of title concept had been adhered to, however arbitrary it might be, tax planners still could have achieved some certainty by placing the contractor in the chain of title and thereby avoiding the application of the essentiality test of *Southwest Exploration*. However, the two *Food Machinery and Chemical Corp. v. United States*[70] decisions appear to have applied the essentiality

64. Treas. Reg. § 1.631-3(b)(4)(ii) ex. 3.
65. Hudson v. Commissioner, 11 T.C. 1042 (1948).
66. *Id.* at 1049.
67. Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946).
68. *See* Treas. Reg. § 1.611-1(b)(1) (1954).
69. 1949-1 CUM. BULL. 5.
70. 348 F.2d 921 (Ct. Cl. 1965); 366 F.2d 1007 (Ct. Cl. 1966). Simplot Company was in the business of mining and manufacturing phosphate rock. It found substantial reserves of it on an Indian reservation in Idaho; unfortunately, however, it was overlain by phosphate shale which required a very expensive beneficiation process through the use of electric furnaces to extract the phosphorus. The Interior Department was only willing to ap-

test to a contractor who arguably was placed in the chain of title to the leasehold by reason of the contract. The serious problem that is raised by these cases in light of the court's apparent holding that the contractor and not the lessee owned the operating interest is that the essentiality test might be applied even to one in the chain of title. The obvious question unanswered is what approach would be taken by the Court of Claims where the contractor owns not only in substance but also in form the minerals in place, e.g., by a formal sublease. Despite the conclusions to be drawn from these cases, it would seem unlikely that any court would apply the essentiality test in such circumstances.[71]

These are several caveats if the contractor is to achieve economic interest status by being placed in the chain of title based on the Supreme Court decisions discussed above and the lower court decisions interpreting them. Additionally, the revenue service has

prove the mineral lease if Simplot or an associate constructed the necessary equipment to process the phosphate shale. Taxpayer finally agreed to process the phosphate shale. Taxpayer finally agreed with Simplot to incur the ten to twenty million dollar investment and Simplot agreed to supply taxpayer with all its needs receiving from taxpayer one dollar per ton. Simplot guaranteed taxpayer the twenty-five year supply needed to recover its investment. The agreement also permitted taxpayer to take over operation of the mine if Simplot failed to supply taxpayer's needs. The agreement was to remain in effect as long as the mining leases were in effect and taxpayer had the right to correct any default by Simplot in order to keep the leases running.

The question in the first *Food Machinery* case was whether taxpayer should be allowed a depletion deduction. The Court of Claims in this author's opinion muddied the waters by deciding the question on two basic grounds. The apparent first and confusing basis is that of essentiality to the lease. The Court noted that taxpayer presented a stronger case for depletion here than in *Southwest Exploration* since not only was taxpayer's contribution a *sine qua non* to the lease but also taxpayer had in effect ultimate control over the extraction. The second basis appears to be that taxpayer in effect acquired the operating interest, i.e., the leasehold, or the ownership of the phosphate shale in place by reason of the agreement.

The second *Food Machinery* case involved the question of who depletes on the one dollar per ton which taxpayer paid to Simplot after Simplot extracted the phosphate shale and delivered it to the taxpayer for processing. The Court held that even though Simplot was the ostensible lessee under the lease from the Indians, taxpayer and not Simplot should take the depletion since, first, becacse of the agreement taxpayer, in effect, owned the minerals in place, and second, that Simplot's position was no different from that of the contract miner's position in the *Paragon Jewel* case. This conclusion is even more anomalous if one recalls that Simplot was held to have been in the chain of title.

The Tenth Circuit in 1967 in Utah Salt Co. v. Wise, 270 F.2d 976 (10th Cir. 1967), decided a case adversely to the contractor on the depletion question which case involved facts similar to those in the *Food Machinery* cases except that, first, the contractor's contribution was not essential to the ostensible mineral fee owner's mining operation. Secondly, the ostensible mineral fee owner only guaranteed a five year supply of mineral to the contractor and there was no provision for the contractor's taking over the mining operation if the former failed to adequately supply the contractor's needs. Factually the case arguably is distinguishable from the *Food Machinery* cases on both grounds of the decisions in the latter cases because of the lack of essentiality and because of the lack of sufficient control over the mining operation to, in effect, constitute the contractor as the owner of the minerals in place. None the less the Court simply noted that the taxpayer did not have an interest in place and was surely a purchaser of the mined mineral because the owner did the mining and not the contractor without looking at the factors examined in the *Food Machinery* cases which permitted the Court there to determine that in effect the contractor and not the ostensible owner was the owner of the minerals in place. One eminent author has suggested that *Utah Salt* and the *Food Machinery* cases are inconsistent. Williams, "The Economic Interest Concept," *P-H Oil and Gas Taxes*, § 1010 (1967). *See also* Winters Coal Co., Inc. v. United States, 496 F.2d 995 (5th Cir. 1974), wherein, the essentiality test was applied to a lease interest.

71. REV. RUL. 73-32, 1973-1 CUM. BULL. 301, indicates that the revenue service is not questioning such transactions.

recently provided a model in a ruling for providing the contractor with an economic interest by placing him in the chain of title.[72] The ruling talks in terms of the "two essential criteria of an economic interest for coal mining contractors," and seemingly ignores the balances of the list of factors set forth in *Parsons* and *Paragon.* First, if the contractor is intended to receive a formal and substantive operating interest, e.g., through lease or sublease, there should be either a sufficiently long term or primary term in the lease or the right to mine to exhaustion. The ruling prescribes that the interest of the contractor must not be terminable at will or upon short or nominal notice.[73]

Second, the contractor should be given the right to sell the mineral to anyone at its fair market value with provision for a royalty interest being retained by the lessor of the interest if continued participation is desired by the latter. If lessor insists on taking the whole supply of the mined mineral, the formula for payment to the contractor ought to be the fair market of the mineral less whatever royalty or other continuing interest is retained by the lessor. If lessor and contractor agree that the latter is to sell to the former at a fixed price per unit, the revenue service will probably successfully contend that the transaction is a contract to mine giving contractor merely an economic advantage and not a depletable economic interest,[74] i.e., a mere fee arrangement for the mining services.

If it is decided that the contractor cannot obtain an economic interest because of other business requirements of the agreement, the owner of the operating interest should take care to cast the agreement so as to obtain a depletion deduction on the full value of the particular mineral at the surface with then a concomitant section 162 deduction to the mineral prior to the owner's losing title thereto. Because of the 1938 Supreme Court decision of *Helvering v. Mountain Producer's Corporation,*[75] only the amount actually received by owner is depletable. Thus the owner should avoid paying the contractor in kind for his services whether the latter purchases all or part of the mineral or not. Rather the transaction

72. *Id.*

73. *Id.* See text accompanying notes 33-37, *supra.*

74. Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624 (1965); Parsons v. Smith, 359 U.S. 215 (1959); Ramey v. Commissioner, 398 F.2d 478 (1968); Mullins v. Commissioner, 48 T.C. 571 (1967); Adkins v. Commissioner, 51 T.C. 957 (1969); Winter's Coal Co., Inc. v. Commissioner, 57 T.C. 249 (1971), *rev'd* 496 F.2d 995 (5th Cir. 1974); Constantino v. Commissioner, 445 F.2d 405 (3d Cir. 1971); REV. RUL. 73-32, 1973-1 CUM. BULL. 307.

75. 303 U.S. 376 (1938). The result is conceptually acceptable if the other participant in the sharing of the minerals has an economic interest. However, if such other participant does not have an economic interest, the result is anomalous in that depletion is lost. If title to minerals in place does not pass for tax purposes and if the contractor ends up with title, then title must have passed after production or extraction. Clearly these services by the contractor were not gratuitous. So it would seem that their value added in the production of the mineral should have been included in the taxpayer-mineral property owner's

should be cast so that the services are paid for in cash (whether, in fact, out of sales proceeds or not) and that the mineral sale agreement, if any, with the contractor is a separate transaction.

So from a planning point of view, there are several alternatives which might avoid the difficulties presented in the cases discussed above if the contractor is not in the chain of title and the parties prefer his possessing an economic interest. First, he can be given the formal and substantive operating interest in the mineral in question by deed, lease, or sublease or an undivided share therein by deed, though the latter suggestion is troublesome in light of the revenue service's nonacquiescence in the *Hudson* case.[76] If the transferor retains a formal and substantive royalty or net profits interest, preferably measured by a percentage of gross or net proceeds rather than a fixed price per unit to avoid the problems discussed above, there should be no problem because the transferor is in the chain of title. Secondly, especially if the relationship is a continuing one, the parties might consider a partnership with a negotiated division of the various tax and non-tax attributes. Thirdly, the parties may consider a joint owner sharing arrangement if the contractor is to perform either exploration or development type and not exclusively extraction or post-extraction work.[77]

gross income from property. *See* James P. Evans, 11 T.C. 726 (1948), wherein depletable gross income from property was reduced on the alternative grounds of *Mountain Producers Corporation* and that the activity performed was manufacturing rather than mining. The *Evans* case is the basis for disallowing depletion on minerals produced and used by producer in production process. *See also*, Roundup Coal Mining Co., 20 T.C. 388 (1953), for an application of the same principle. However, the result in the latter situation is not obtained where the mineral produced is used by an integrated producer in a manufacturing process. *See* Woodward Iron Co. v. Patterson, 73 F. Supp. 251 (N.D. Ala. 1959) (coal produced and used in manufacturing pig iron). Additionally, the result has not applied in the *ad valorem* tax situation wherein lessee pays lessor's taxes. *See* Burt v. United States, 170 F. Supp. 953 (Ct. Cl. 1959); Higgins v. Commissioner, 33 T.C. 161 (1959). Also, the result is not obtained in the "innocent trespassor" situation, Estate of Thomas E. Arnett v. Commissioner, 31 T.C. 320 (1958) (wherein the latter was allowed an offset from the damages of his production expense and yet the owner took depletion on the gross production before the offset).

76. 1949-1 CUM. BULL. 5. *See* REV. RUL. 72-32, 1973-1 CUM. BULL. 301.

77. G.C.M. 22730, 1941-1 CUM. BULL. 214. *See*, P. MAXFIELD, *supra*, note 19, at 263 *et seq.* for a discussion of sharing arrangements.