North Dakota Law Review

Volume 51 | Number 2 Article 9

1974

A Primer on Federal Income Taxation for Coal Land Owners

Gary A. Pearson

How does access to this work benefit you? Let us know!

Follow this and additional works at: https://commons.und.edu/ndlr

Part of the Law Commons

Recommended Citation

Pearson, Gary A. (1974) "A Primer on Federal Income Taxation for Coal Land Owners," *North Dakota Law Review*: Vol. 51: No. 2, Article 9.
Available at: https://commons.und.edu/ndlr/vol51/iss2/9

This Article is brought to you for free and open access by the School of Law at UND Scholarly Commons. It has been accepted for inclusion in North Dakota Law Review by an authorized editor of UND Scholarly Commons. For more information, please contact und.commons@library.und.edu.

A PRIMER ON FEDERAL INCOME TAXATION FOR COAL LAND OWNERS

GARY A. PEARSON*

Congress has seen fit to be particularly kind to the owners of coal-bearing lands. Its largest has included this fortunate group in one of the select few industries which pays taxes on its ordinary business profits at capital gains rates but, when times are bad and losses are incurred, offers ordinary loss treatment.

Since 1951 Congress has allowed this delightfully favorable privilege to the owner of coal-bearing lands on the "disposal" of coal where the owner retains an "economic interest."[1] The concept "economic interest" is exceptionally difficult, and is defined elsewhere in this symposium issue,[2] but it seems certain that in the standard coal lease that has come to the author's attention the owner retains an economic interest. This is evidenced by the fact that his payments from the operating company are almost universally designated as royalties, or less often, as some other form of a share of production. So, the owner who transfers the right to mine coal on his land in return for a set or determinable sum per ton quite clearly has an economic interest and payments received from the operating company will qualify for the joy described below.

Although usually stated that way, it is an oversimplification to say that the owner of coal-bearing lands is on a capital gains basis. Actually his royalties are treated as "section 1231 income" which, simply put, means that if all his section 1231 transactions yield gain, it will be treated as capital gain, while if such transactions result in a loss, it will be treated as an ordinary loss.[3] This obviously allows the owner to have his cake and eat it too, and is historically traceable to special tax benefits granted by Congress as a part of our war effort in World War II.[4] Mechanically, a taxpayer is re-

* Adjunct Professor of Law, University of North Dakota School of Law; Pearson & Christensen, Grand Forks, North Dakota; C.P.A. 1957; J.D. 1958, University of North Dakota.

1. INT. REV. CODE of 1954, § 631(c).
2. Maxfield, *Economic Interest—Some Further Thoughts*, 51 N.D.L. REV. 457 (1974).
3. INT. REV. CODE of 1954, § 1231(a).
4. INT. REV. CODE of 1939, § 117(j).

quired to lump all his section 1231 gains and losses into a so-called "hotchpot." The other section 1231 assets included in this "hotchpot" we are discussing include gain or losses on depreciable personal property used in a trade or business, real property used in a trade or business, livestock held for breeding purposes for 24 months or draft breeding, dairy or sporting purposes for 12 months and unharvested crops when the crop is sold with the land, together with recoveries on casualty losses.[5] As we have seen, the coal land owner will usually obtain capital gains on his royalties but this advantage will be reduced by losses on other section 1231 assets; normally such losses as would otherwise be deductible against ordinary income, but, with section 1231 gain from coal royalties present they will simply reduce capital gain.[6] As a general rule, during inflationary times there are probably few section 1231 losses for the coal land owner in North Dakota; thus, this netting in the hotchpot may not have substantial effect. If it does, it may be possible to time income to achieve maximum benefits. Thus, a farmer with a large casualty loss (his uninsured barn burns to the ground) may be wise to deduct that loss in 1974 and attempt to postpone coal royalties into later years if this can be legitimately accomplished.[7]

The ordinary taxpayer must hold a capital asset for at least six months before he will obtain long-term capital gain treatment.[8] However, in the coal field (no pun intended), the Code grants special benefits to the land owner. Even though our land owner has not owned the interest for six months, he will almost always be entitled to capital gains treatment on his royalties, for the "date of disposal" is the crucial date determining sale, not the date of the coal lease. Accordingly, if a landowner has owned the land for six months at the date the coal is mined he has satisfied this test.[9] It would be unusual for a taxpayer to acquire coal-bearing lands and thereafter enter into a lease that resulted in substantial amount of coal mined all within six months of acquisition.

In computing the amount of his section 1231 gain, the owner is entitled to reduce gross royalties by his basis.[10] This amounts to the same thing as allowing the owner cost depletion, even though the statute specifically forbids the owner cost or percentage depletion.[11] But in recognizing the familiar principal that a government cannot tax "gross proceeds," only "income,"[12] basis must be taken into consideration, and, by a proper allocation of the cost of coal

5. INT. REV. CODE of 1954, § 1231(b).
6. 4 P-H 1974 FED. TAXES ¶ 32,231.
7. *Id.*
8. INT. REV. CODE of 1954, § 1223.
9. *Id.* § 631(c); Treas. Reg. § 1.631-3(b)(1) (1957).
10. INT. REV. CODE of 1954, § 631(c); Treas. Reg. § 1.631-3(b)(2) (1957).
11. INT. REV. CODE of 1954, § 631(c).
12. Eisner v. Macomber, 252 U.S. 189 (1920).

as a part of total land cost a landowner is entitled to a deduction from gross royalties.

Such obscure statements require simple examples; assume a land owner can establish that he purchased a quarter section of land for $20,000 and the land contains 100,000 tons of coal. Assume too that he enters into a mining contract for a royalty of 10 cents a ton and that we can establish that of the $20,000 purchase price, $5,000 was for the coal; hence, we can allocate 5 cents per ton as the cost of the coal in place. In 1974 he is paid royalties on the disposal of 10,000 tons of coal; the computation of his section 1231 income would be:[13]

Royalties at 10 cents a ton, 10,000 tons	$1,000
Less basis in coal at 5 cents a ton, 10,000 tons	500
Section 1231 gain	$ 500

There is a further limitation upon section 1231 treatment for coal landowners. A number of expenses that would normally be deductible against ordinary income must instead be deducted from section 1231 gain so as to avoid the disastrous (from the Commissioner's viewpoint) result of allowing an ordinary deduction when the income from the property produces capital gain. These are so-called "section 272 expenditures" which are statutorily defined as:

> [E]xpenditures attributable to the making and administrating of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract. . . .[14]

The above language is, as usual, somewhat inept but the Revenue Service has suggested that the expenses that are under consideration are state and local taxes, the cost of fire protection, insurance costs (except liability insurance), bookkeeping and technical expenses, legal fees and expenses of measuring and checking quantities of coal disposed under the contract.[15] Should these section 272 expenses exceed royalty income, they are deductible as they would otherwise be.[16] Interest on loans employed to carry the contract may not be a disallowed expense, depending upon the use to which borrowed money is put. This confusing language, which springs from the Revenue Service, not your author, may well mean that a purchase money

13. 3 P-H 1974 FED. TAXES ¶ 22,431.
14. INT. REV. CODE of 1954, § 272.
15. Treas. Reg. § 1.272-1(d)(1) (1965).
16. Treas. Reg. § 1.272-1(c) (1965).

mortgage to acquire coal bearing land will result, in part, in a section 272 deduction, in the proportion that value of the surface bears to the value of the coal deposits.

Lest we mislead, it should be pointed out that an expenditure disallowed under section 272 is not lost; it is allowed, but only as a reduction of the section 1231 gain. Losses caused by a combination of the disallowed expenses and depletion base for units mined during the year are a section 1231 loss or a loss under section 165(a) (allowing the deduction of losses generally).[17]

Employing the example above, assume the same facts but, in addition, the coal-land owner paid real estate taxes attributable to coal of $200, insurance of $100 and paid legal fees in connection with his coal lease of $50; the computation of the total section 1231 gain would be as follows:[18]

Royalties at 10 cents a ton, 10,000 tons			$1,000
Basis, 5 cents a ton, 10,000 tons		$500	
Section 272 expenses:			
Taxes	$200		
Insurance	100		
Legal fees	50	350	850
section 1231 gain:			$ 150

Again assume the same facts except that royalties were only 7 cents per ton. The computation then would be:[19]

Royalties at 7 cents a ton, 10,000 tons		$ 700
Basis, 5 cents a ton, 10,000 tons	$500	
Section 272 expenses, as above	350	$ 850
Loss:		($ 150)

If the taxpayer has other Section 1231 gains, the loss would be applied against them; if not consumed by such gain, the loss would be a deduction, in full, against ordinary income.[20]

It is not just the fee owner of the property who qualifies as an owner. A sub-lessor may qualify and we may have two or more parties realizing capital gains on production from the same tract. The regulations give essentially the following example:[21] Smith is the owner of Blackacre. Smith leases all the coal on his land to Brown reserving a royalty of 50 cents a ton. Brown in turn subleases the coal deposit to White for a royalty of 60 cents per ton and White mines the coal, paying the 60 cents a ton to Brown.

17. *Id.*
18. 3 P-H 1974 FED. TAXES ¶ 22,431.
19. *Id.*
20. Treas. Reg. § 1.272-1(c) (1965).
21. Treas. Reg. § 1.631-3(b)(3)(ii)(b) (1957).

Brown in turn pays 50 cents a ton to Smith. The parties' income will be characterized as follows:

1. Smith realizes section 1231 gain in the amount of 50 cents per ton.

2. Brown realizes section 1231 gain in the amount of 10 cents per ton (60 cents - 50 cents).

3. White, having paid a royalty of 60 cents per ton will subtract that royalty from his gross income and will be entitled to percentage depletion on the difference. For example: If White's gross income were $1 per ton, his percentage depletion base would be 40 cents per ton ($1 - 60 cents) and he would apply the percentage depletion rate (10%) against that sum yielding him a 40 cents per ton deduction from income. Of course like in all percentage depletion matters, his percentage depletion may not exceed 50% of his taxable income of the property.[22]

In addition to the favorable treatment accruing to the land owner, other benefits are available as well, both as a matter of law and from sound planning. For example; the land owner who receives a coal royalty may find that income-averaging cuts his effective rate even though the royalties are capital gain.[23] Again, because of the means by which capital gains are taxed, careful planning may effectively cut the tax rate. Basically, only 50 per cent of capital gain is taken into income, as section 1202 provides for a 50 per cent long-term capital-gain deduction.[24] Since an individual taxpayer may find that his tax rate can ascend to a high of 70 per cent, the net effect of receiving capital gain income at that bracket is to cut the effective tax rate to 35 per cent. However individuals may elect the alternative tax, which allows up to $50,000[25] of long term capital gain to be taxed at 25 per cent.[26] Whenever a taxpayer's effective tax rate on a marginal segment of income exceeds 50 per cent (i.e. for a married taxpayer with taxable income greater than $44,000),[27] it will be advantageous to employ the alternative tax. Since only $50,000 of such gain qualifies each year a provision in a coal lease or an understanding between the owner and operator that accomplishes a limitation in the amount of royalties paid each year may be advantageous.

Another reason suggests itself for postponing capital gains into the future inasmuch as the long term capital gain deduction of sec-

22. INT. REV. CODE of 1954, § 613(a).
23. *Id.* § 1302(a).
24. *Id.* § 1202.
25. *Id.* § 1201(d)(3).
26. *Id.* § 1201(b).
27. *Id.* § 1(a)(2).

tion 1202 is an item of tax-preference income.[28] Tax-preference income is taxed at 10 per cent in addition to the regular tax and all items of tax preference income (i.e., the aforesaid long-term capital-gains deduction, accelerated depreciation over straight-line depreciation, the excess of percentage depletion over cost depletion, and certain other items) are aggregated and if the total tax preference income exceeds $30,000 plus the taxes otherwise paid, the excess will be subject to the 10 per cent rates.[29] The postponing of coal royalties into the future may have the effect of avoiding this additional tax.

Although it is understood that the local office of the Internal Revenue Service in Fargo had originally ruled to the contrary, it would appear clear from the Regulations[30] that bonus income received at the time of the signing of a coal lease does qualify as section 1231 income. The same result obtains for advance royalty payments or minimum royalty payments where the lease grants the operator the right to apply the royalties to the payment of coal mined at some later time. However, when the right to mine coal has expired, terminated or is abandoned, unearned advance royalties are to be treated as ordinary income.[31] This position will surely cause some administrative burden particularly where a bonus or advance royalty is paid in 1974 and the decision to terminate or abandon the lease does not occur until the lease expires, which is often as late as 25 years later. The regulation would require the taxpayer to file an amended return to report those amounts as ordinary income. Suffice to say that there are very few 25-year-old returns currently being amended nor do we expect the practice will be more prevalent in 1999.

---

28. *Id.* § 57(9)(A).
29. *Id.* § 56(a).
30. Treas. Reg. § 1.631-3(c) (1957)
31. *Id.* § 1.631-3(c)(2).