

Oil & Gas Tax Alert

Recent tax court case highlights tax considerations for landowners receiving bonus payments

A recently issued Tax Court memorandum opinion, *Dudek v. Commissioner*,¹ addressed the tax treatment of a bonus payment received by landowners in connection with the signing of an oil and gas lease agreement. The court concluded that the lease bonus payment received by the taxpayers in this case is taxable as ordinary income and not capital gain, and that the taxpayers were not entitled to a depletion deduction. While the analysis of the court was not novel or surprising, the case does serve as a reminder of the basic tax rules surrounding the receipt of these payments by landowners. In light of the proliferation of domestic oil and gas leasing activity in recent years, this topic is of increasing relevance to many taxpayers that may not historically have received these types of payments.

The taxpayers in *Dudek* owned acreage in Pennsylvania and entered into an oil and gas lease agreement with an independent oil and gas company. Under the lease agreement, the taxpayers received an upfront payment (the lease bonus payment) to induce them to enter into the lease agreement. Additionally, the lease agreement entitled them to a royalty payment equal to 16 percent of the net profits of any oil and gas extracted from the property. The lease bonus payment was not dependent on any extraction or production of oil or gas. The taxpayers reported the lease bonus payment on their federal income tax return as a long-term capital gain, which upon examination the Internal Revenue Service (“Service”) re-characterized the payment as ordinary income. The Service also asserted a 20 percent accuracy related penalty because of the taxpayers’ treatment of this payment. While contesting the government’s character determination, the taxpayers further argued that if the bonus payment is taxable as ordinary income, that they are entitled to a deduction for depletion.

Character of bonus payments — Lease v. Sale

The Tax Court highlighted the long established ruling of the Supreme Court that the receipt of a lease bonus payment by a lessor pursuant to an oil and gas lease is taxable as ordinary income, not as capital gain.² The court then analyzed the facts to ascertain whether the transaction at issue was in fact a lease or was in substance a sale transaction, as argued by the taxpayers.

In concluding that the agreement at issue was a lease and not a sale, the court referenced a number of historical cases focused on the “sale v. lease” determination. Under these cases, the crux of the analysis is whether the owner of the land “retains an economic interest in the deposits.” If so, the transaction is regarded as a lease and the proceeds are taxable as ordinary income.³ To determine whether the taxpayers retained an economic interest, the court sought to determine whether the taxpayer retained a right to share in the oil produced, based on the economic realities of the transaction.⁴

In this situation, the court noted that the agreement entitled the taxpayers to future royalty payments equal to a percentage of the net profits of any oil or gas extracted from the property, and that it is well established that the holder of a royalty interest in natural resources possesses an economic interest in the minerals in place.⁵ Moreover, the court noted that the economic realities of a sale would be evidenced by an exchange of a determinable quantity of oil and gas for a determinable price, which did not exist here.

Depletion

The court quickly discounted the taxpayers’ claim that they should be entitled to a percentage depletion deduction related to the lease bonus income. I.R.C. § 613A(d)(5) specifically provides that a percentage depletion deduction for income from oil and gas wells does not apply to “any lease bonus, advance royalty, or other amount payable without regard to production from property”.⁶ The bonus payment at issue was paid to induce the taxpayers to enter into the lease agreement and it did not relate to any extraction or production of oil and gas.

The court did acknowledge, however, that bonus payments are eligible for cost depletion under Treas. Reg. § 1.612-3(a)(1), such cost depletion amount being dependent upon the taxpayer’s basis for depletion, the amount of the bonus payment, and the future royalties the taxpayer expects to receive. In this case, the court concluded that the taxpayer failed to meet its evidentiary burden to provide any evidence as to the amount of royalties the taxpayers expect to receive. Without this information, it was not possible for the court to compute any amount of cost depletion.

Penalties

Finally, the Tax Court upheld the Service’s assertion of the 20 percent accuracy related penalty. The court noted that the taxpayer failed to establish that it acted with reasonable cause and in good faith. While not elaborating on the basis of its conclusion that the taxpayer lacked reasonable cause in detail, the court’s repeated commentary throughout the opinion that the underlying tax principles were well settled provided a pretty clear view that the court viewed most of the taxpayers’ arguments as meritless.

Other considerations

Establishing a separate basis for minerals

While not specifically addressed by the court, this case does implicitly raise the issue of what is necessary for a taxpayer to establish a separate “basis” for mineral rights when the land and minerals are purchased together in a single transaction. Many purchasers do not allocate cost basis to mineral rights when they are acquired in the same transaction with the underlying land.

While there is not a lot of direct authority on this topic as it relates to depletion, there is analogous authority in the context of claiming a worthless deduction for minerals.⁷ This authority supports a view that unless a cost basis was established for the mineral rights at the time of purchase or at the time of receipt, if inherited or received as a gift, the mineral rights may have no separate cost basis. The Internal Revenue Manual references the Service's general view that there is no separate cost basis in the minerals unless:⁸

- a) the seller's cost included a stipulated amount for mineral rights;
- b) the seller's basis was the result of an estate tax valuation in which minerals and surface were valued separately; or
- c) the seller's cost basis can be properly allocated between surface and minerals because of substantive evidence of value attributable to the minerals at the date of acquisition.

While a taxpayer may be able to factually establish a separate basis for the minerals by evidence of the relative values at the time of acquisition,⁹ the taxpayer generally has the burden of proving the basis allocable to the minerals.¹⁰

Estimated future royalties on wildcat acreage

Another potential issue highlighted but not discussed in *Dudek* is some of the historical authority potentially supportive of claiming a 100 percent cost depletion deduction in situations where a zero estimate of future royalties to be received in the future is reasonable.¹¹ In *Collums*, the court concluded that a zero estimate of future royalties was reasonable where the lease was in a wildcat area and where there was no evidence to indicate there would be future production during the lease term. Based on this factual determination, the court applied the cost depletion formula in the treasury regulations and concluded that the taxpayer was entitled to a cost depletion deduction in the year of the receipt of the lease bonus equal to the entire basis in the leases.

The Service, however, has published a contrary view in a subsequently issued technical advice memorandum.¹² In this ruling, the Service argued that a determination that no future production was likely was equivalent to arguing no mineral deposit exists. As such, the Service contended that a deduction for cost depletion cannot be claimed when there is no mineral deposit present.

Carving out royalty interest prior to sale

Compare the facts above to a situation where prior to entering into negotiations with the oil company the taxpayer separates an overriding royalty interest from the working interest and transfers the overriding royalty interest to a separate related

party for a business reason. Later, the taxpayer negotiates a similar deal with the oil company and transfers the entire working interest to the oil company. At the end of the day, the economics are similar and the oil company has obtained the working interest "subject to" the pre-existing overriding royalty interest held by the related party.

Now, under the form of the transaction the taxpayer has a stronger case that it has entered into a sale and not a lease transaction because it sold a working interest and the taxpayer did not retain an economic interest in the oil and gas deposit by retaining a royalty. Instead, the overriding royalty interest is a pre-existing interest owned by a separate taxpayer (e.g., the related party). The taxpayer has disposed of the taxpayer's entire interest in the minerals.

Query whether the Service, however, could challenge the transaction using a step-transaction or a substance over form type argument.¹³

Conclusion

With the recent proliferation of domestic drilling activity in the United States, many taxpayers and their advisors are addressing tax issues specific and unique to the oil and gas industry that were not historically relevant to them. While the Tax Court's recent opinion in *Dudek* does not contain any new or novel tax considerations of significance, it does serve to highlight a number of these unique industry issues as they relate to receipt of lease bonus payments by the owner of a mineral interest. As the above discussion illustrates, while many of these issues are considered well settled, there also remain a number of areas potentially subject to controversy between taxpayers and the government.

Endnotes

- ¹ *Dudek v. Commissioner*, T.C. Memo. 2013-272 (December 2013)
- ² *Burnet v. Harmel*, 287 U.S. 103, 104, 112 (1932)
- ³ See e.g., *Laudenslager v. Commissioner*, 305 F.2d 686, 690 (3d Cir. 1962); *Cox v. United States*, 497 F.2d 348 (4th Cir. 1974).
- ⁴ Citing, *Palmer v. Bender*, 287 U.S. 551 (1933); *Deskins v. Commissioner*, 87 T.C. 305 (1986).
- ⁵ *Kittle v. Commissioner*, 21 T.C. 79 (1953); see also *Palmer*, 287 U.S. at 557.
- ⁶ See also, *Treas. Reg. Sec. 1.613A-3(j)*.
- ⁷ See e.g., *Henley v. United States*, 396 F.2d 956 (19XX).
- ⁸ IRM 4.41.1.2.1.2 (12-03-2013).
- ⁹ *Plow Realty Company of Texas v. Commissioner*, 4 T.C. 600 (1945); *Perkins v. Thomas* 86 F.2d 954 (5th 1936).
- ¹⁰ *Rev. Rul. 69-539, 1969-2 CB 141*.
- ¹¹ *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932); *Collums v. United States*, 480 F. Supp. 864 (DC Wyo. 1979).
- ¹² TAM 8532011 (May 7, 1985).
- ¹³ See e.g., FSA 1999-819.

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