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I. Introduction

INCOME tax jurisprudence is replete with applications of the rules that substance should prevail over form and that the federal tax principles are to be applied so as to achieve a uniform system of taxation, disregarding the niceties of local law. Yet there is no other area of federal income tax law in which these principles have been disregarded so completely as in the taxation of the "carried interest" arrangements found in the oil and gas industry. As a consequence, a state of almost hopeless confusion exists with respect to this important, recurring transaction involving the development of the nation's resources.

Economically, the carried interest arrangement arises in any situation in which one of two or more owners of a property is willing to invest his money to develop property and to look for recovery of his investment solely from the property developed. In other words, one or more co-owners are willing to expend the funds necessary for development of the interests of all co-owners and to look only to the income from the developed property for recovery of their investment. Generally, the substantive law, which has always encouraged the development or exploitation of mineral property, has protected the developer as against the nonparticipating co-owners. It has permitted the developer to recover his costs, and in some situations an even greater amount, before the nonparticipating co-owners are permitted to share in the income from the property. However, whether the developing party is entitled to recover his investment by agreement with the other co-owners, or by operation of law, is, and should be, immaterial from an income tax standpoint.

From an economic standpoint the co-owner who pays all of the costs of developing a property and looks only to income from the property for recovery of his investment may never effect a full recovery. Consequently, during the recovery period, he should be regarded as the sole owner of the property, since he is entitled to receive *all* production income. The legal methods by which this economic result is accomplished should be immaterial from a federal income tax standpoint, since for reasons dictated by state law, or

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other reasons, the transaction may be cast either in the form of (1) a nonrecourse loan, (2) a production payment, or (3) a reversionary interest.

By way of explanation, each of these financial arrangements results in what is commonly called a "carried interest." The co-owner who agrees to pay the costs of development is known as the "carrier," or "carrying party," and the co-owner for whom costs are advanced is known as the "carried party." To illustrate the three most typical forms of the arrangement, assume that *A* and *B* own equal shares of an undeveloped property which is a reasonable prospect for development, and that *A* wants to develop it but *B* does not have the money. First, *A* may agree to lend the money to *B* but to look only to the income from the property for repayment of the loan. This is an example of a nonrecourse loan. Second, *A* may agree to develop the property if *B* will assign to *A* a production payment that is payable out of *B*'s interest in the property in an amount equal to *B*'s proportionate share of the development costs. This is the production payment form of financing. Third, *B* may assign his entire interest in the property to *A* but reserve a reversionary interest to take effect after *A* has recovered the entire costs of development plus costs of operation. This, obviously, is the reversionary interest method.

In each of the three situations, *A* must look solely to the developed property for the recovery of his costs. Thus, the economic result in every instance is exactly the same. Because of this identity in the economic realities, the tax consequences should also be similar. However, the decisions of the courts have not resulted in a uniform tax treatment of these three forms of the carried interest arrangement.

In 1941, the Revenue Service issued a ruling[1] dealing with the tax consequences of a number of transactions involving the oil and gas industry and, in particular, the principles which it considered applicable to the carried interest arrangements. The substance of the ruling, in this regard, was that the carrying party was to be regarded as the owner of the entire working interest until such time as he had recovered his costs in full. During that period he was taxable on all of the production income and was allowed all deductions, including depreciation on all equipment costs. When the payout occurred, that is, when he had recovered all of his costs, the carrying party was required to transfer an appropriate fraction of his depreciable basis in the equipment to the cost of the leasehold, since from that time forward he owned only a portion of the equipment.

[1] G.C.M. 22730, 1941-1 Cum. Bull. 214.

The transferred cost was then recoverable only out of depletion. The carried party was not, however, allowed a deduction for depreciation of his portion of the equipment, before or after payout, since he had no investment in the equipment, that is, his basis was zero.

The views expressed in this ruling were sustained by the Tax Court in 1947 in the *Manahan*[2] case in which a reversionary working interest was involved, but before that time, the court had decided the *Abercrombie*[3] and the *Herndon*[4] cases on different theories. These three cases were landmark decisions which for many years established a rather confused direction to the tax treatment of carried interest arrangements. An analysis of these cases, as well as those which have been decided in more recent years, may, however, forecast a trend which will enable practitioners to determine with more certainty the tax consequences of carried interest transactions.

II. Economic Interest

Before considering the carried interest cases, it may be desirable to review briefly the concept of "economic interest" in natural resources. In general, the owner of an "economic interest" in an oil and gas property is the person who is taxed upon the income produced and is allowed deductions for the expenses, including depletion, incurred in producing such income. The regulations define an "economic interest" as that interest which "is possessed in every case in which the taxpayer has acquired by investment any interest in 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."[5] There are two aspects of this definition which are particularly significant in a consideration of the carried interest cases: the first concerns the phrase "interest in mineral in place," and the second involves the phrase "income de-

[2] Manahan Oil Co., 8 T.C. 1159 (1947).

[3] Commissioner v. J. S. Abercrombie Co., 162 F.2d 338 (5th Cir. 1947).

[4] Herndon Drilling Co., 6 T.C. 628 (1946), *acq.* and *nonacq.* on other issues, 1946-2 Cum. Bull. 3, 6. The nonacquiescence of the Commissioner to this decision maintains that legal verbiage alone cannot create two properties, to wit, a working interest and a production payment, out of one property when the conveyance is made simultaneously to a single assignee. If the Commissioner's view were to be sustained, the *Herndon* case would follow the *Manahan* case. It may not be significant that the Fifth Circuit in Sowell v. Commissioner, 302 F.2d 177 (5th Cir. 1962), contrasts the *Herndon* and *Manahan* rules with the *Abercrombie* rule since the "carried party" involved in the *Sowell* case was treated the same as in both *Herndon* and *Manahan*. However, note Judge Wisdom's dissent in Floyd v. Commissioner, 309 F.2d 95 (5th Cir. 1962), in which he would have held that reservation of an overriding royalty and a concurrent production payment created two separate property interests even though arising simultaneously in a single transaction.

[5] Treas. Reg. § 1.611-1(b)(1) (1960).

rived from the extraction of the mineral . . . to which he must look for a return of his capital."

Concerning the first, it seems abundantly clear that the taxpayer need not own legal title to the oil and gas in place.[6] A right to share in the minerals produced constitutes an interest in the minerals in place for federal tax purposes, even though legal title to the minerals is vested by state law in another person.[7] A right to share in the proceeds from disposition of the minerals has also been held[8] to represent an interest in the minerals in place, even if such share is reduced by costs of production.[9]

With respect to the second phrase, it is clearly established that a taxpayer does not possess an economic interest for federal tax purposes if he can look to anything except a share of production for recovery of the investment. In the leading case of *Anderson v. Helvering*,[10] the assignor of some properties received cash plus a right to additional sums payable out of production from the property and out of proceeds from the sale of the property. The Supreme Court held that the assignor's interest was not an economic interest subject to depletion, since he might receive a portion of his recovery from the sale of the property.[11]

A great deal more could be said about these two fundamental principles, but this brief discussion is sufficient to provide an orientation for the evaluation of the various carried interest cases.

III. Carried Interest Cases

A. *Manahan Oil Co.*[12]

Although the *Manahan* case was not the first of what may be called the guideline cases in the carried interest area, it probably deserves first mention because it affirmed the administrative policy of the Internal Revenue Service pronounced in 1941.[13] That position is still followed by the Service and was even incorporated in principle in the present proposed regulations under the 1954 Code.[14]

In this case, the taxpayer, as an assignee, acquired a one-half working interest in various leases for a cash consideration plus an agree-

[6] See Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956).

[7] Thomas v. Perkins, 301 U.S. 655 (1937).

[8] Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946).

[9] See Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946).

[10] 310 U.S. 404 (1940).

[11] *Id.* at 413.

[12] 8 T.C. 1159 (1947).

[13] See G.C.M. 22730, 1941-1 Cum. Bull. 214, discussed in text accompanying note 1 *supra*.

[14] See Proposed Treas. Reg. § 1.612-4(a)(2), 25 Fed. Reg. 3761 (1960).

ment to drill and complete one well. If additional wells were required, the taxpayer was to drill and complete them also, but the assignor agreed to assign to the taxpayer an additional one-fourth of the working interest until such time as the taxpayer had recovered, from the net proceeds from total production, the entire amount of the development costs, including costs of the first well, and an amount equal to the cash consideration paid for the one-half interest. After recovery of such sum, the taxpayer's interest in one-fourth of the production was to terminate, and the assignor and taxpayer were then each to own one-half of the working interest. The taxpayer was to have sole control of the development and operation of the properties at all times.

The question presented for the court's consideration was whether the taxpayer should be taxable on the income attributable to the assigned one-fourth interest. The taxpayer argued that the income should be taxable to the assignor, since the taxpayer had received those proceeds only as reimbursement of the assignor's costs. The court held, however, that the income was taxable to the taxpayer. The fact that he held the one-fourth interest for only a limited period of time did not disturb the court. "The assignors did not receive the income in question either actually or constructively."[15]

B. *Herndon Drilling Co.*[16]

Slightly more than a year before the decision in the *Manahan* case, the Tax Court decided the *Herndon* case. Here the taxpayer was a drilling contractor who entered into a contract for the drilling of wells on two leases. Under the terms of the contract, the taxpayer received an undivided one-half share of the working interest in each of the leases. Simultaneously, with the conveyance of the working interest, the assignor assigned the remaining one-half interest in the leases in the form of an absolute conveyance, but this conveyance was made pursuant to the terms of a contract which provided that "said assignment [is] to be in the nature of a mortgage to secure contractor against the cost and expense advanced by contractor hereunder for the account of owners."[17] Provisions were made for reassignment of the assignor's remaining one-half interest after the recovery of specified costs by the assignee. The contract provided that the assignors were to have no personal liability for amounts advanced by the assignee to develop the leases. However, the assignors

[15] 8 T.C. at 1162.
[16] 6 T.C. 628 (1946).
[17] *Id.* at 630.

did have the right at any time to pay in cash the unrecovered portion of the advances made by the taxpayer and thereby secure a reassignment of the undivided interests previously conveyed in the form of a mortgage.

In this case, as in the *Manahan* case, the taxpayer argued that the income accruing to the interest assigned for a limited period of time represented only the repayment of a loan. The Commissioner contended that all of the income accruing to the taxpayer's permanent interest, as well as the income accruing to the temporarily assigned interest, was taxable to the taxpayer. In addition, the Commissioner argued that the two interests merely represented a single property for purposes of computing depletion. The court agreed with the Commissioner only in part. Although agreeing that the assignee had to report all of the income during the payout period, the court held that the taxpayer did have two separate depletable interests; one was represented by the permanent working interest, the other by the oil payment interest.

It is interesting to note that in the *Manahan* case, decided only a year after the *Herndon* case, the court made no reference to *Herndon*. Yet, the economic circumstances of the taxpayers in both cases were almost identical, in that the taxpayer in both cases acquired an interest in a lease and, as a part of the consideration given, agreed to drill and equip one or more wells on the property. The costs incurred on behalf of the assignors were to be recovered by the assignees solely from production from the properties. In both cases, the assignors' interests were conveyed to the assignees with provisions for a reconveyance after recovery by the assignees of specified costs. The only difference between the two appears to be that in the *Herndon* case, there was an express contractual provision that the conveyance was to be in the nature of a mortgage to secure the assignee against costs and expenses advanced by him on behalf of the assignor. However, the court in its analysis dismissed the effect of the mortgage language of the contract as not controlling in determining whether a loan was made. The two cases are consistent in that they tax to an assignee, all of the income accruing to both the permanently and temporarily assigned interests. They are inconsistent in that *Herndon* treats the temporarily assigned interest as a production payment; whereas, *Manahan* treats the temporarily assigned interest as a working interest. The consequences of this inconsistency affect principally the computation of percentage depletion, since the separate properties theory of *Herndon* causes separate depletion computations to be made for each property.

The Internal Revenue Service has never agreed with the two property concepts of the *Herndon* decision. It argued in that case, and still maintains as a matter of administrative policy, that the assignee in the *Herndon* type situation does not have two separate properties but has a temporarily enlarged working interest. If the position of the Revenue Service is ultimately sustained, there will be no difference in the depletion computation under either the *Manahan* or *Herndon* theories.

C. *Commissioner v. J. S. Abercrombie Co.*[18]

This case was decided in point of time between the *Herndon* and *Manahan* decisions. Simplifying the facts somewhat, *A* and *B* were co-owners of producing oil and gas properties. *A* assigned his interest to *B* for a cash consideration but reserved an oil payment and a one-sixteenth carried working interest. *A* had no personal obligation to reimburse the assignee for any portion of the operating costs, but unliquidated expenses incurred by the assignee were to be carried forward and charged against future receipts accruing to the benefit of the reserved carried interest.

The taxpayer, *B*, excluded from his income the income and expenditures attributable to *A*'s one-sixteenth carried interest. The Commissioner determined that *B* should have reported the income and deductions in the year before payout occurred as his income and expense. However, the Fifth Circuit held that *A*'s one-sixteenth working interest was a capital investment in the oil property; therefore, the income was not includable in *B*'s income since it was taxable directly to the owner of the capital investment which had produced it.[19]

The economic consequences of the arrangement in the *Abercrombie* case were identical with those in the *Herndon* and *Manahan* cases, that is, the carrying party received the full proceeds from production until all costs had been recouped, at which time some form of reversionary interest in the carried party took effect. However, it is apparent that the *Abercrombie* court reached a substantially different tax result. The only distinction between the latter case and the other two, and this distinction seems more formal than real, is that in *Abercrombie* the assignor retained or held title to the working interest; whereas, the arrangement was accomplished in the other two cases by a temporary assignment of title. If the federal tax laws are to depend upon the substance of transactions rather than their form,

[18] 162 F.2d 338 (5th Cir. 1947).
[19] *Id.* at 339.

it does not appear that a different result should have been reached in *Abercrombie*.

It should be noted that the carried interest arrangement in the *Abercrombie* case was a so-called "perpetual carried interest." In other words, *A* was to be carried for the entire producing life of the property. If payout occurred and *A* received remittances attributable to his one-sixteenth interest, he was not required to account to *B* for such remittances in the event that expenses later exceeded income. However, if, after payout, the expenses did exceed the income, such expenses were to be recouped from later production before *A* would be entitled to further remittances from the property. Under no circumstances could *A* have been obligated to come forward with his portion of the expenses during the deficit period. This result does differ from that obtained in the *Manahan* and *Herndon* cases, because in those cases after initial payout occurred, the assignors received a reassignment of their working interest in the property and were subsequently required to come forward with their proportionate shares of operating expenses. The Revenue Service takes the position that a perpetual carried interest arrangement is nothing more than a net profits interest, which is treated for tax purposes as an overriding royalty.[20] The principal consequences of such a conclusion are the effect upon the computation of depletion on the income from the working interest, with its larger gross income figure, and from the net profits interest, with its absence of an expense burden, and the determination of the character of income received upon assignment of the working interest subject to a retained net profits interest.

D. *Prater v. Commissioner*[21]

The taxpayer, Prater, and two other individuals each took undivided interests in oil and gas properties. Capital for development was provided by the other venturers who pledged the properties as security. The taxpayer was not to be liable personally for any of the development costs nor for the loans made to provide funds for such costs, but the production from the property attributable to Prater's interest was to be charged with his portion of such costs. On his tax returns Prater deducted his proportionate share of the losses. The Commissioner disallowed the claimed deductions on the ground that all losses were attributable to the carrying party. In *Abercrombie*, the court had merely decided that the income was not taxable to the carrying party and did not determine when expenses

[20] See Breeding & Burton, Taxation of Oil and Gas Income § 6.04 (1961).
[21] 273 F.2d 124 (5th Cir. 1959).

could be deducted by the carried party. In *Prater*, on the other hand, the court was dealing with the deductibility of expenses by the carried party. It will be observed that the taxpayer here was arguing the application of the *Abercrombie* theory, although the Commissioner, before the Tax Court, argued for the application of the *Manahan* theory. Nevertheless, on appeal the Commissioner abandoned this distinction and sought to disallow deduction of the expenses on the ground that they were not "paid or incurred,"[22] since the requirement to pay would never exist until income from the property exceeded all of the corresponding expenses. The Fifth Circuit rejected this argument and allowed deduction of the expenses or losses because they were charged upon and resulted in a diminution of value of Prater's interest in the property. A strong dissent by Judge Wisdom indicated that he would overrule *Abercrombie*, if necessary, to reach the result that a loan or pledge is not equivalent to payment when there is no personal obligation to repay and when the property has no value. Consequently, under *Prater* the carried party is entitled to a deduction for losses when costs exceed income during the payout period. However, during this same period the carried party is not required to report the income, according to *Herndon* and *Manahan*, unless there is a capital investment as found in *Abercrombie*.

E. *Wood v. Commissioner*[23]

Prior to divorce, Mr. and Mrs. Wood owned, as community property, a forty-five per cent interest in certain oil and gas leases. At the time of the divorce, there were certain community debts. The divorce decree awarded Mrs. Wood a one-half interest in this property "after the payment of community debts."[24] The court found that Texas law recognized that, after divorce, the wife was not personally liable for the payment of community debts. Moreover, in an action to construe the divorce decree, the state court had previously held that Mrs. Wood had only a reversionary interest in the mineral properties. The court of appeals held that since Mrs. Wood had no title to the property and the debts were not her personal debts, she had no income from the property during the years in question. The economic effect of the situation is that a carried interest has actually arisen by operation of law. Although the decision of the majority made no reference to any of the carried interest cases, the decision follows the principles of the *Manahan* case

[22] *Id.* at 126.
[23] 274 F.2d 268 (5th Cir. 1960).
[24] *Id.* at 269.

rather than the *Abercrombie* or *Prater* cases to the effect that the carrying party, and not the carried party, is taxed on the income during the payout period.

F. *Estate Of Weinert v. Commissioner*[25]

Weinert owned an interest in unitized oil and gas properties. He assigned one-half of his interest, plus a production payment of 50,000 dollars payable out of his retained half interest, to Lehman in consideration of Lehman's payment of 100,000 dollars in cash and agreement to advance up to 150,000 dollars of Weinert's share of the costs of development and the costs of a projected processing plant. These advances were to be recovered by Lehman only out of net profit accruing to Weinert's interest, and the assigned production payment was to take effect and to be payable to Lehman only after recovery of the 150,000 dollars in advances. Although Weinert was not relieved of his obligation to third parties under the unitization agreement, he had no personal liability with respect to the advances made by Lehman. Weinert assigned his interest to a trustee with directions to pay the net profits over to Lehman until Lehman had recovered his advances and the production payment, after which the trustee and Lehman were to reassign the interest to Weinert. During the years in question, the net profits had been applied to recovery of the advances, and none had been applied to the production payment.

Even though no notes or other evidence of indebtedness were signed, there was an agreement called a "loan agreement."[26] On the basis of all the circumstances, the Tax Court concluded that the arrangement was nothing other than a loan arrangement and held that the income was taxable to Weinert.[27] The result of such a holding is, of course, logically consistent with the *Abercrombie* case, that is, the income was taxable to the carried party. However, the Tax Court did not rely upon *Abercrombie*. In any event, the holding was in conflict with the prior holdings in *Herndon* and *Manahan*.

In what is probably the most carefully considered and exhaustively reasoned decision on the subject, the Fifth Circuit reversed the decision of the Tax Court and held that Weinert was not taxable on the income during the payout period. The court first pointed out that substance rather than form must control the incidence of tax-

[25] 294 F.2d 750 (5th Cir. 1960).
[26] *Id.* at 753.
[27] Estate of Weinert, 31 T.C. 918 (1959).

ation. Then, relying upon *Palmer v. Bender,*[28] and the *Kirby,*[29] *Burton-Sutton,*[30] and *Southwest Exploration Co.*[31] cases, the court pointed out that economic interest, rather than legal title, determines the substance of oil and gas transactions. Despite references to a loan agreement and to Lehman's "loans and advances," the court held that the transaction did not constitute a loan, first, because the parties had not treated it as a loan, and second, because it did not have the attributes of a conventional loan or mortgage transaction. The court's reasoning up to this point suggested the possibility that the court might overrule *Abercrombie* and *Prater,* but rather than doing that, the court distinguished the two decisions on the ground that in each of them the taxpayers had retained title to the interest out of which the carried expenses were paid. In the instant case, Weinert did not retain title, although he did not assign it to Lehman, because title could have been recovered from the trustee only after payout and only then with Lehman's concurrence. The court analogized the transaction to the *Manahan,* or *Herndon,* type arrangement which, it stated, had the same tax consequences.

> In either type of arrangement, as in the Weinert-Lehman transaction, the vital point is that the development burden is redistributed and the production income is reallocated: the particular production income in question is diverted from one owner of the operating interest to another in exchange for contributions dedicated and used to developing the property. Since the carried interest and the production payment are required for development, the effect of either transaction is to establish such a direct relation of the risk capital to the minerals as to qualify the carried interest or carved out production share as an economic interest to the oil and gas in place.[32]

The court concluded:

> During the term of the carry (or the production payment) Lehman received the full economic value incident to the mineral interest in the leases; Lehman, not Weinert, was taxable therefore on all of the production attributable to the interest in the leasehold. The effect of our holding is to gear income to receipts and deductions to expenditures.[33]

Thus, the swing was made back to the principles of *Manahan* and *Herndon.*

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[28] 287 U.S. 551 (1933).

[29] Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946).

[30] Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946).

[31] Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956).

[32] 294 F.2d at 761.

[33] *Id.* at 762-63.

G. *Sowell v. Commissioner*[34]

The *Sowell* case is not strictly a carried interest case, but the economic result is the same. Here, the taxpayer placed full legal title to the working interest in a producing property in a nominee. Banks, relying upon the recorded title, loaned money to the nominee on his personal account, accepting as collateral a mortgage on the entire property. Under state law the taxpayer was estopped to deny the validity of the mortgage.[35] The Commissioner sought to exclude from taxpayer's return the income from the property and, thus, the corresponding depletion deduction, and in addition to deny the taxpayer a deduction for the bad debt uncollectible from the fraudulent nominee. The Tax Court upheld the determination of the Commissioner. The Fifth Circuit reversed, allowing the loss deduction and also holding that since the nominee's action could not be denied by his principals, the taxpayers had, in effect, placed a mortgage on the property and that such a transaction did not divest them of an economic interest in the production. Income was, therefore, realized by the taxpayer each month as the assigned oil runs paid off the indebtedness. Hence, the corresponding depletion deduction was allowed. Debt was thus distinguished from a conveyance. However, the taxpayer was a carried party, and according to the *Weinert*, *Wood*, *Herndon*, and *Manahan* cases, he should not have had taxable income. Yet, the case is consistent with *Abercrombie* and *Prater*.

IV. Proposed Regulations and Carried Interests

The regulations have never dealt specifically with the treatment of carried interest arrangements. On the other hand, the regulations dealing with the deductibility of intangible drilling costs—both those promulgated under the 1939 Code and those proposed under the 1954 Code—do have an important bearing upon the tax consequences of the carried interest transactions.

The regulations under the 1939 Code[36] provided that a taxpayer who properly elected to expense intangible drilling costs and who drilled one or more oil wells in exchange for an interest in a lease could deduct only that portion of the intangible drilling costs attributable to his interest. In other words, if the taxpayer drilled

[34] 302 F.2d 177 (5th Cir. 1962). J. Wisdom starts his opinion by saying: "This is a man-bites-dog case. Here, taxpayers—not disinterestedly, of course—contend that they received income. The Commissioner denies that they did."

[35] See National Bond & Mortgage Corp. v. Davis, 60 S.W.2d 429 (Tex. Comm. App. 1933); Home Owners' Loan Corp. v. Netterville, 110 S.W.2d 628 (Tex. Civ. App. 1937), *rev'd on other grounds*, 134 Tex. 30, 132 S.W.2d 93 (1939).

[36] Treas. Reg. 118, § 39.23(m)-16(a)(1), 18 Fed. Reg. 5840 (1953).

a well for a seventy-five per cent interest in a lease, he could deduct only seventy-five per cent of the intangible drilling cost. It was under these, or comparable prior regulations, that the Revenue Service policy regarding the treatment of carried interest transactions was developed. It was recognized that in the typical carried interest arrangement, the taxpayer did not own all of the interest in the property throughout its productive life, and it was necessary to consider whether this regulation would cause some restriction on the deductibility of intangible drilling costs incurred by the carrying party. Thus, it was necessary to determine whether a taxpayer who drilled one or more wells in exchange for the entire interest in a property until payout and thereafter retained only a seventy-five per cent interest should be entitled to a deduction for the entire intangible drilling cost. The Service concluded from the regulations that all of the intangibles should be allowed to the carrying party on the ground that at the time of the agreement, there was no certainty that payout would occur, and therefore, the carrying party might be the owner of the property for its entire productive life.

Instances occurred in which taxpayers tried to circumvent the general provision of the regulations by creating carried interest arrangements under which the cost to be recovered represented only a limited portion of the total cost of drilling and completing a well. To the extent that payout was measured by only a limited portion of the cost of the well, the underlying theory justifying full allowance of the deductions on carried interest arrangements became less sound. As a consequence, the administrative policy permitted deduction of the entire intangible drilling cost by the carrying party only if all of such costs were to be recovered before the carried party received an interest in production.

The deductibility of intangible drilling costs was not covered by statute until 1954. In the 1954 Code, Congress specifically directed the Commissioner to adopt regulations comparable to those in effect under the 1939 Code.[37]

Despite the apparent simplicity and directness of this statutory provision, the Revenue Service has had a great deal of difficulty in promulgating regulations. This is evidenced by the fact that the first proposed regulations released in 1956[38] were withdrawn, and new regulations proposed in 1960.[39] Final regulations still have not been promulgated.

[37] Int. Rev. Code of 1954, § 263(c).

[38] Proposed Treas. Reg. § 1.612-4, 21 Fed. Reg. 8446 (1956).

[39] See Proposed Treas. Reg. § 1.612-4, 25 Fed. Reg. 3761 (1960).

One of the factors which appears to be causing the difficulty is the effort on the part of the Revenue Service to incorporate in these regulations an application of the *Manahan* theory as developed in connection with the administrative practice described above. The present proposed regulations provide that a person holding all, or a fraction, of the operating rights in an oil and gas property for the "complete payout period," may, at his option, deduct intangible drilling costs paid or incurred by him to the extent that such costs are attributable to his interest in the property. The complete payout period is defined as "the period ending when the gross income attributable to all of the operating mineral interests in the well (or wells) equals all expenditures for drilling and development (tangible and intangible) of such well (or wells) plus the costs of operating such well (or wells) to produce such an amount."[40] Since it is not necessary, under the proposed regulations, to have legal title to the property in order to hold all of the operating rights, the proposed rule would have exactly the same effect as the *Manahan* case. Some question has been raised as to the validity of the proposed rule, in view of the fact that the previous regulations did not contain a similar provision. However, the Revenue Service justifies the change on the ground that it is consistent with prior administrative practice.

The proposed regulations also provide that if a person holds all or a fraction of the operating rights for less than the complete payout period, he may deduct only those costs which are attributable to his share of such interest immediately after complete payout. Thus, if *A* assigned a lease to *B* with a provision that a fifty per cent interest in that lease should revert to *A* after *B* had recovered fifty per cent of the cost of drilling and equipping a well, *B* would be entitled to deduct only fifty per cent of the intangible drilling costs.[41]

Although several criticisms may be leveled at the proposed regulations, it is not within the scope of this Article to consider such matters. It is sufficient for present purposes to indicate that the Revenue Service still favors the *Manahan* approach to the carried interest problem.

V. Conclusion

The tax consequences of any arrangement involving the sharing of the risks of exploration, development, and operation of a mineral property must be resolved by economic substance. It is well established that the owner of an economic interest in a mineral property

[40] Proposed Treas. Reg. § 1.612-4(a)(2), 25 Fed. Reg. 3761 (1960).
[41] Proposed Treas. Reg. § 1.612-4(a)(3), 25 Fed. Reg. 3761 (1960).

is taxed on the income from that property and entitled to the accompanying depletion allowances.[42] An economic interest in the property contemplates an investment in the minerals in place which, through any legal relationship, entitles its owner to a right to return of his investment exclusively through the extraction of such mineral.

Inasmuch as the carried interest is defined as "an arrangement between two or more co-owners of a working interest, whereby one agrees to advance all or some part of the development costs on behalf of the others and to recover such advances from future production, if any, accruing to the other owners' share of the working interest,"[43] it follows that an economic interest exists in the property because both parties have "made an investment in the minerals in place" and look solely to "the extraction of minerals" for the return of that investment.[44] The carrying party—the owner who advances the funds — is the one upon whom the burden of development falls and to whom the production normally flows. The carried party—the one for whom the funds are advanced—is looking to the extraction of minerals for the return of any capital he has previously invested. In a sense, both have an economic interest in the property. The carrying party has a present interest, and the carried party has an interest from which he hopes to realize income in the future.

Emerging from the web spun by the cases on the subject are the boundaries by which we may test the presence of an economic interest. Whenever the legal language used is that of conveyance, and the assignee cannot look to any other collateral for recoupment of his investment, the result is the transfer of an economic interest together with the inherent right to income and depletion.[45] On the other hand, when the assignee may look to a personal obligation or to other collateral from which to recover his investment, the result is a debt, and the economic interest has not shifted.[46]

Many fact situations lie between these two extremes. Perhaps the most irksome situation involves the use of "subject-to" indebtedness. Abstractly, it may be said that one who invests in a mortgage on oil property behind which there is no personal liability to repay or other collateral must necessarily look solely to the production from the property to recoup his investment. This very result implies that

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[42] See Palmer v. Bender, 287 U.S. 551 (1933).

[43] Breeding & Burton, *op. cit. supra* note 20, at § 2.08.

[44] See Treas. Reg. § 1.611-1(b)(1) (1960); text accompanying note 5 *supra*.

[45] See Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958), holding that even with an abundance of certainty as to payout, the owner of the minerals parted with production and did not make a loan when the form of the transaction was conveyance of an interest in the property.

[46] Anderson v. Helvering, 310 U.S. 404 (1940).

an economic interest has been created. Yet, the cases indicate a closer look is required.[47] The test applied is one of substance. Does the investor in the "subject-to" mortgage have a reasonable expectancy of recovery of his investment as a normal lender, or has he made the investment with the primary intent to participate in the profits arising from the development of a speculative property acquired simultaneously? If profit through risk enters into the transaction, an economic interest has shifted.

The carried interest is frequently created through a conveyance of a property interest with a reversion of a portion of that interest to the "carried party" so that the form of the transaction shifts legal ownership. In some instances, a "carried interest" is framed in the language of a mortgage with no personal liability assumed or additional collateral posted by the "carried party," thus causing the "carrying party" to look solely to a participation in the profits for the recoupment of his investment. In this latter situation, there is an assumption of risk by the "carrying party" far above that undertaken by a normal lender of money. It may be stated, then, that when the arrangement is a carried interest, the economic interest, together with the inherent right to income and depletion, has shifted to the "carrying party."

[47] Crane v. Commissioner, 331 U.S. 1 (1947), is the landmark decision cited or distinguished by many courts in "carried interest" arrangements framed in the language of a mortgage. This case held that income and depreciation attributable to inherited improved real estate against which "subject-to" indebtedness existed was properly a part of the basis computation in determining gain upon sale of the property. The holder of the "subject-to" indebtedness in this case was a financial institution routinely engaged in the business of lending money. Contrasted with this situation are the myriad of cases of loans by corporations to stockholders and by individuals to relatives in which the form of the transaction is ignored by the courts as they seek to determine the intent of the parties and the likelihood of repayment in view of all the circumstances surrounding the transactions.