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COMMENT

THE TAXATION OF CARVED-OUT PRODUCTION PAYMENTS

A production payment is a flexible device frequently used to carve interests out of a larger royalty or working interest. "Production payment," "oil payment," and "in-oil payment" can be used as synonymous terms to describe the interest created when the owner of the royalty or working interest transfers to another the right to all or a fractional part of the transferor's share of production free and clear of production costs with the duration of the transferred interest measured in terms of barrels of oil, dollars received, or in terms of time. Simultaneously with the increase in the use of production payments has come the attempt by such royalty or working interest owners to carve out production payments and use the carved-out portion for various purposes and still achieve a favorable tax result, namely capital gains treatment on the sale of such payment. Recent litigation on carved-out production payments has centered around oil payments, but the following discussion will also be applicable to sulfur payments, and payments for limestone, natural gas, and any other depletable asset.

The carved-out production payment may be created in either of two ways. First, the grantor could make a complete conveyance of his present mineral interest retaining a reversion. Second, the grantor could convey a designated amount of the income from the royalty or working interest to the grantee. The amount which the grantee is to receive can be determined by limiting it to (1) a specified time, e.g. the royalty payments for the next ten years, (2) a specified dollar amount, e.g. the royalty payments to the extent of $10,000,000, or (3) a specified number of units produced, e.g. the oil royalties paid on the next 200,000 barrels produced. The conveyances described above should be distinguished from a conveyance by the grantor of a fractional interest, i.e. a conveyance that is not limited in one of the three ways set out above, but is instead a fraction of the grantor's entire interest.
If the conveyance of a fractional interest is a sale, the grantor is entitled to capital gains; if it is a gift, he is entitled to be treated as having made an ordinary gift of property. It is only where the grantor conveys an interest of shorter duration than the expected life of the property that the tax consequences are disputed.

SALE OF CARVED-OUT PRODUCTION PAYMENTS

The difficulties have arisen in this field of the law because the cases have approached the problem of carved-out production payments from two wholly different and contradictory directions. One view considers the production payment an ownership interest in the oil in the ground. Acknowledging that a property interest in oil is a capital asset, the courts following this view hold that the sales of in-oil payments are sales of capital assets and thus subject to capital gain treatment. However, the effect of the transaction is anticipation of income as capital gain, whereas if the money were received as the royalties accrued, it would be taxed as ordinary income subject to depletion.¹

The second view is that the oil itself is not sold. Only the right to receive income from the property changes hands, and that shifts only for the specified duration, to revert thereafter to the grantor. Since only the right to income, i.e., the "fruit" of the "tree" of property ownership changes hands, the grantor who has retained the "tree" of ownership interest is not entitled to the benefit of capital gain treatment, for he has not conveyed an interest in a capital asset. The grantor has merely anticipated some income by the assignment of it to the grantee.²

Perhaps this latter view with its analogy of the "tree and fruit" ignores the basic fact that conveyances by the grantor of the "fruit" in the case of carved-out production payments also results in a diminishing in the size of the "tree," and conveyances of enough of the "fruit" will exhaust the "tree" itself. This objection is particularly applicable where the grantor has conveyed a carved-out production payment out of a larger production payment created by

¹ Caldwell v. Campbell, 218 F.2d 567 (5th Cir. 1955), 4 OIL & GAS REP. 305; and see the cases cited in note 13.
someone else. E.g. the grantor with a $3,000,000 carved-out production payment carves out a $2,000,000 payment and conveys it to someone else. The grantor may have disposed of only his “fruit,” but it would appear that his “tree” has shrunk to a third of its former size. In any event, the second view denies capital gain treatment to the grantor in the conveyance of a carved-out production payment, unless the grant could be considered substantial.

If the assignment of ordinary income is given capital gain treatment, no one need pay a tax of over 25%, for anyone could assign his anticipated income, e.g. salary or attorney’s fees, to someone else before receipt. This proposition is verified by the fact that cases allowing capital gain in the sale of carved-out production payments made it apparent that all income from the property could be treated as capital gain. However, to obtain this tax benefit, the income had to be assigned, and in every case the grantor could expect to litigate the tax consequences of the assignment. The following comment was made shortly before a case appeared opposing the taxpayer’s capital gain contention:

Any time a business group is successful in converting their operations into capital gain rates without selling their complete interest, eventually the Bureau will be successful in changing the law.

Case Law

The carved-out production payment is a flexible device, the business and personal advantages of which are obvious. The problem facing the government is that, if such sales of depletable economic units result in capital gain, any royalty owner or lessee could convert his ordinary income from production into capital gains by making frequent sales of short term interests. There would be no difficulty in making such sales, because the vendor could set an attractive price in the light of his tax savings, and thereby find a ready market.

A case in point showing how the royalty owner can convey a carved-out portion of his interest and thereby anticipate future

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8 3 R.I.A. FEDERAL TAX COORDINATOR § N-3003; 2 MERTENS, LAW OF FEDERAL INCOME TAXATION § 18.13.

4 Hammond and Ray, Oil Payments Revisited, 33 TAXES 349, at 352 (1955).

5 Kuntz, Assignments of Oil Payments, 31 TAXES 863 (1953).
income at capital gain rates is that of *John D. Hawn*,\(^6\) decided by the Tax Court in December, 1954. Hawn was the owner of a carved-out oil payment given to him by his grandmother and originally amounting to $1,000,000. In 1949 he assigned this oil payment to a contractor, who in return agreed to build a house for Hawn. By the terms of the contract, when the contractor had received $120,000 the oil payment reverted to the taxpayer. The oil payment reverted to Hawn in 19 months.

Thus, in that case the owner of a carved-out production payment carved out of it a smaller payment and assigned it to a contractor. Hawn claimed that his gain from the transaction was long term capital gain, for he had held the property interest for more than six months. The Commissioner contended that the gain realized on the assignment was ordinary income, for the effect of the transaction was to anticipate income which if received as royalties would be ordinary income subject to depletion. The carved-out payment was of such short duration (19 months) that the Commissioner's argument seemed to have merit, but the Commissioner admittedly had no cases directly on point with which to justify his contention.\(^7\) The taxpayer, Hawn, did rely on several recent cases showing that the assigned interest was an interest in the oil in place and thus entitled to capital gain treatment.\(^8\) The Tax Court held, with six judges dissenting, that Hawn was entitled to capital gain treatment on the sale, and the Commissioner appealed to the Court of Appeals for the Fifth Circuit.

Before the Fifth Circuit rendered its decision in the *Hawn* case, it decided in January, 1955, the case of *Caldwell v. Campbell*.\(^9\) In the *Caldwell* case taxpayer had organized the D. K. Caldwell Foundation as a tax-exempt organization. During the fiscal year 1948 the taxpayer conveyed royalty interests to the foundation, which interests would revert to and revest in the taxpayer when the foundation had received a certain sum of money. In return


\(^7\) The Commissioner did rely on several regulations which would have subjected the income to tax as ordinary depletable income from the property. G.C.M. 24849, Cum. Bull. 1946-1, 66, which was later clarified by I.T. 4003, Cum. Bull. 1950-1, 10.


\(^9\) 218 F.2d 567 (5th Cir. 1955), 4 Oil & Gas Rep. 305.
the taxpayer received notes of the foundation, which of necessity would have to be paid for out of the income from the property. The oil payment was expected to revert to the taxpayer in nine to thirteen years. The Commissioner contended that the taxpayer's gain was ordinary income, and the district court supported that view. The Court of Appeals for the Fifth Circuit, in an opinion by Chief Judge Hutcheson, reversed the district court and held that the transactions were bona fide sales of property and not assignments of income, and that, therefore, the gain realized was ordinary capital gain.

Judge Rives dissented in the Caldwell case, stating that:

It seems to me that, if by this process the taxpayer could convert his ordinary income from these properties into capital gain, then hereafter there will be no necessity for an owner of oil royalty interests to receive therefrom ordinary income. He need only "convey" the oil payment rights for one year, ten years, thirteen years, or such other period as may be most profitable, and report his receipts as capital gains.

Judge Rives added that the owner of oil royalty interests stands upon the same footing as other taxpayers with the exception of the depletion allowance. He analogized the situation to that of an ordinary lessor under a long term lease, who anticipates income by selling some of his annual rent notes, say ten or thirteen of them. Judge Rives then asked, "Would that be a transfer of the fruits or of the tree on which they grew?"

During the period from December, 1954, to March, 1956, numerous cases relied on the triumvirate of decisions formed by the Tax Court's decision in the Hawn case, together with the Caldwell case, and the earlier Nordan case. These cases were nearly all concerned with the treatment of carved-out oil payments, but one

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10 45 AFTR 305 (1953).
11 218 F.2d at 573.
12 Judge Rives cited the following case and authority to answer his own question: Lum v. Commissioner, 147 F.2d 356, and 2 Mertens, LAW OF FEDERAL INCOME TAXATION § 18.12.
14 Lester A. Nordan, 22 T.C. 1132 (1954), 3 OIL & GAS REP. 1961. This case deals with gifts and will be discussed later. See also Wellen, Recent Developments in the Taxation of Oil and Gas Interests, SIXTH ANN. INST. ON OIL & GAS LAW & TAXATION, 479, 485-491 (1955), where these three cases are discussed.
case dealt with a carved-out sulfur payment. Still another case allowed capital gain treatment where the oil payment was conveyed in order to pay off pre-existing debts.

Finally on March 27, 1956, the Fifth Circuit handed down a unanimous decision in the Hawn case. The decision of the Tax Court was reversed and the cause was remanded. The court held that the assignment of the oil payment until $120,000 had been received was insubstantial in amount relative to the total oil payment owned by Hawn at that time ($854,993.25). Moreover, the payment of $120,000 plus interest took about 19 months, which period was insubstantial in time. The transfer, therefore, was merely a transfer of income and not a sale of a capital asset.

The Caldwell case was not overruled by this latest decision. In view of the strong language of Chief Judge Hutcheson in the Caldwell case, the court had to distinguish carefully to reach the opposite result. This distinction was grounded on substantiality in time and amount of the carved-out payments. A 9 to 13 year pay out period out of a property with an estimated life of 25 years was considered substantial in the Caldwell case. A 19 month pay out period out of a property with a life of presumably 10 to eleven years was held to be insubstantial in the Hawn decision. The test of substantiality leaves much to be desired when it comes to cases between these two extremes. Consider for example the case of O'Connor v. Scofield, where the grantor carved out an oil payment which reverted to him in less than two years. A district court held that the $10,000,000 payment which had been carved out was substantial, so that the sale of it did not result in the anticipation of ordinary income. If this decision is appealed, it will be interesting to note whether the Court of Appeals will apply the substantiality test of the Hawn case or the earlier rule of the Caldwell case.

17 Commissioner v. Hawn, 231 F.2d 340 (5th Cir. 1956), 5 OIL & GAS REP. 855.
18 See the discussion note in 5 OIL & GAS REP. at 862.
19 P-H 1956-72, 538 (1956), 5 OIL & GAS REP. 1094.
20 The Scofield case was decided by the United States District Court for the Western District of Texas on March 27, 1956, the same day the Fifth Circuit decided the Hawn case.
Underlying Principles

These cases show a conflict which cannot be adequately understood without a basic understanding of the principles underlying their contrasting results. If an oil payment is necessarily property, i.e. a capital asset, it would not seem to matter how substantial the transfer — it would be entitled to capital gain rates no matter how insubstantial it appears in relation to the grantor’s original interest. There are a number of cases illustrating the principle that an oil payment is an interest in the oil in place. The United States Supreme Court in several cases has held that the holder of an oil payment is to be regarded as the owner of the oil in place. The following quotation from Anderson v. Helvering shows the approach taken by the Supreme Court in arriving at that result:

The holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place. The value of the right, even though dependent upon the extent of oil reserves, is fixed at the moment of creation and does not vary directly with the severance of the minerals from the soil. In this sense it resembles the right to cash payment more closely than the right to royalty payments. Yet it does depend upon the production of oil, ordinarily can be realized upon only over a period of years, and permits of a simple and convenient allocation between lessor and lessee of both the gross income and the allowance for depletion.

Accordingly the court held that ordinarily oil payments should be treated as interests in the oil in place, but where the grantor also gives a lien on the land to guarantee the income to the grantee, the grantee was not entitled to depletion, for he held a right to income rather than an ownership interest in the oil.

If the oil payment (or any other carved-out production payment) is an interest in the minerals in place, it would seem that it could be sold as a capital asset. On the other hand, persuasive cases present the following argument to the contrary with respect to the income from oil leases:

21 See for example, T. W. Lee, 42 B.T.A. 1217, aff’d, 126 F.2d 825 (5th Cir. 1942), which further held that taxpayer as owner of the oil in place must look to depletion for recovery of his costs, and could not recoup the cost of his oil payment out of production before being required to report any of the proceeds as gross income, since the receipts of oil payments are returns of income and not of capital. See also note 22.


23 310 U.S. at 410-411.
That income would have come to plaintiff at least as certainly as expected salary would come to an employed person, or expected dividends or interest would come to the holder of stocks or bonds. The question then is whether it is tolerable, when an income tax is being imposed upon citizens generally, to permit particular persons to rid themselves of their income and their share of income tax by assignment of the expected income in advance of its receipt to avoid the tax.\(^4\)

The *Rudco* case\(^{25}\) answered its own question by reference to the following cases: *Lucas v. Earl*,\(^{26}\) which had held that a person could not achieve that result by assigning his salary before it was paid; *Harrison v. Schaffner*,\(^{27}\) which had held that one entitled to income from a trust could not escape income taxes by assigning part of the future income to his children, for the gift by a life beneficiary of a right to receive a specified amount of income for the period of one year was an anticipatory assignment of future income rather than a transfer of a substantial equitable interest in the trust estate; *Helvering v. Horst*,\(^{28}\) which had held that the owner of an interest-bearing bond could not, by detaching interest-bearing coupons before they became due and giving them to his son, avoid paying an income tax on the interest, when collected, as if it had been paid to him. These cases dealt with assignments by a taxpayer attempting to completely avoid an income tax on the amounts involved, but the same logical principles apply to situations where the taxpayer attempts by advance assignment to convert his income from ordinary to capital gain rates.

It has been demonstrated that it makes a big difference to the grantor whether the transaction is considered a sale of a capital asset or mere anticipation of income. Does it make any difference taxwise to the grantee-purchaser of that income? Apparently not. Take for example the contractor in the *Hawn* case. For a valuable consideration, viz. the contractor’s agreement to build Hawn a house, Hawn transferred an oil payment to the contractor. Thereafter, the contractor was to be the owner of the oil payment until he collected $120,000, when it was to revert to Hawn. In 1949 the contractor collected $12,782.53 from the oil payment. That

\(^{24}\) The quotation is taken from *Rudco Oil & Gas Co. v. U.S.*, 113 Ct. Cl. 206 at 215, 82 F. Supp. 746 at 751 (1949), and see infra note 44.

\(^{25}\) *Supra*, note 24.

\(^{26}\) 281 U.S. 111 (1930).

\(^{27}\) 312 U.S. 579 (1941).

\(^{28}\) 311 U.S. 112 (1940).
amount was gross income to him from oil production, and he was entitled to depletion. It was not income to Hawn under either theory. In the same year the contractor paid Hawn $20,809.79 in the form of construction work completed. This is the amount in controversy. Under the sale of a capital asset theory, it is capital gain; but under the assignment of income theory, it is ordinary income subject to depletion. Thus, we are not concerned with the amount received by the grantee from the oil payment; we are only concerned with the amount paid to the grantor by the grantee in return for the oil payment. Under either approach, the tax consequences upon the grantee-purchaser are identical.

It is obvious from all of the foregoing discussion that there is a virtually irreconcilable conflict between the two lines of cases. The Fifth Circuit Court of Appeals made an effort to reconcile this conflict with its substantiality of interest test, but that test is indefinite and leaves much to be desired. Time cannot be the only test; relative values of the property carved-out and the property retained must also be considered. An oil payment which will pay out in two years, if carved out of a property which will pay out in three years, is a substantial interest in the larger property. Assume that a property will pay out in twenty years, but because of the decline in production and reserve estimates the eighteen years of remaining life have a present value of considerably less than the present value of the initial two years. In such case, a two year carved-out interest, since it represents a major part of the market value, would also be a substantial interest.\(^2\)

**Proposed Legislation**

Because of the conflict in the case law, there is presently before Congress a bill for amending the Internal Revenue Code which would make clear the law governing the taxation of carved-out production payments.\(^3\) It seems reasonably certain that in the near future this bill or some similar proposal will be adopted, for the

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\(^2\) 5 Oil & Gas Rep. 862.

\(^3\) H.R. 9559, 84th Cong., 2nd Session (1956). This bill is reproduced in full in 5 Oil and Gas Tax Quarterly 165 (April 1956), and in 5 Oil & Gas Rep. 909.
need for legislation is readily apparent. Since there are numerous proposals to modify H. R. 9559, there will be no attempt in this article to quote it extensively in its present form.

Basically the proposed law provides that the consideration received by the transferor from the sale or exchange of a carved-out production payment shall be considered income subject to the allowance for depletion. The anticipation of the income approach would be definitely established by the proposed statute.

The basic rule would not apply where the proceeds received are pledged for the development of the property from which the production payment is carved or where the production payment is transferred in return for services, materials, or supplies used in the development of the property from which such payment is carved. This exception to the basic rule would not apply to the extent that the carved-out production payment is created to discharge a liability previously created and fixed in amount. These exceptions merely continue the tax treatment accorded to such transfers under the present law and administrative ruling.

Even if a proposal similar to H. R. 9559 is not enacted into law, the Hawn decision will provide for ordinary income treatment where the production payment does not meet the substantiality of interest test. Of course, if such legislation is adopted, the substantiality of interest test will no longer be important, and the proceeds from the sale of a carved-out production payment would be ordinary income, unless the proceeds are used for the exploration or development of such property. From the point of view of certainty, it would be far better to have a Congressional enactment

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31 A recent comment in the Harvard Law Review suggested the Congress or the Commissioner might promulgate a rule that a transfer of an oil payment would be taxed at ordinary rates where the price paid is equal to or greater than the face amount of the oil payment discounted for a given length of time at a specified rate. The regulation or statute would set a discount rate low enough and a discount period short enough to assure that a purchase price in excess of this discounted value would only be paid for an oil payment on which there was very little risk that the entire face value would not be recovered over the estimated pay off time. Thus, the taxpayer-grantor would have to sell at a price below this artificially determined figure in order to receive capital gain rates. Distinguishing Ordinary Income from Capital Gain where Rights to Future Income are Sold, 69 HARV.L.REV. 737 (1956).
32 Supra, note 30.
33 H.R. 9559 § 1 proposes to do this by adding a new section 633 to the INT. REV CODE of 1954. The basic rule would be found in § 633(a) (1).
34 Proposed new § 633(a) (2) to the INT. REV. CODE of 1954.
35 Ibid.
36 G.C.M. 22730, CUM. BULL. 1941-1, 214; G.C.M. 24849, CUM. BULL. 1946-1, 66.
governing the question than to leave the matter to the fate of being decided under the present case law and treasury regulations.\textsuperscript{37} The vagueness of the substantiality of interest test and the already demonstrated possibility of changed attitude on the part of the courts militate in favor of passage of a law to regulate the situation.

**Gift and Distribution of Carved-Out Production Payments**

**Case Law and Underlying Principles**

Entirely different issues in the area of taxing carved-out production payments are presented where the grantor makes a gift of the carved-out interest. First, if the gift is charitable there is the problem of the "double deduction." Is the donor entitled to have the amount left out of his gross income and in addition receive a charitable deduction for the gift? Second, is the donor taxable on the income from the carved-out payment as it accrues to the donee under the theory of assignment of income? Under the doctrine of *Lucas v. Earl*, *Helvering v. Horst*, and *Harrison v. Schaffner*,\textsuperscript{38} it would seem that a donor must give away a substantial or ownership interest, i.e. the "tree" rather than the "fruit," in order to avoid being taxed as having received the income.

However, in the case of *Lester A. Nordan*\textsuperscript{39} the taxpayer donated to a church an oil payment with reversion to the taxpayer after the church had received $115,000, and the Tax Court held that Nordan was entitled to a charitable deduction for the fair market value of the gift at the time it was made. The Tax Court made no attempt to determine whether the carved-out payment was a substantial part of the value of the $1/8th royalty out of which it was to be paid. The court concluded:

The petitioners retained only a reversionary interest in the property. Cases where the right to receive income in the future was transferrd or where title to the income producing property was retained are not in point.\textsuperscript{40}

The court also held that, since no income had accrued at the date

\textsuperscript{37} The Commissioner's attempt in *Caldwell v. Campbell* to rely on G.C.M. 24849 and I.T. 4003 was met by the statement in the majority opinion that these were "opinions having no more binding or legal force than the opinions of any lawyer." *Cf. U.S. v. Bennett*, 186 F.2d 407 at 410 (5th Cir. 1951).

\textsuperscript{38} *Supra*, notes 26-28.

\textsuperscript{39} 22 T.C. 1132 (1954), 3 OIL & GAS REP. 1961, noted in 9 Sw.L.J. 127.

\textsuperscript{40} 22 T.C. at 1134.
of gift and all the disputed income was earned after that date, the Commissioner had erred in attributing income from the production payment to the taxpayer after the date of the conveyance to the church.

By virtue of this decision the holder of an oil and gas interest may give oil payments to charitable institutions and thereby receive increased total income after taxes. The savings arise out of a "double deduction" to which such taxpayers are entitled, i. e. (1) the income from the oil payment is not included in gross income, and (2) the gift gives rise to a charitable deduction. For example, a married taxpayer with a $300,000 oil income per year may give a $50,000 oil payment (worth $45,000) and have $18,073 more after taxes than if he had not been so charitable. For taxpayers in lower brackets, the same principle would give the donor $600 more after taxes if he gave a $5,000 oil payment (worth face value) out of a $70,000 annual income. Thus, taxpayers now have a new incentive to stimulate their generosity. Not only is it more blessed to give than to receive, but also the taxpayer will realize more hard cash for himself after taxes as a result of the donation.

This result, made possible by the "double deduction," is not limited to gifts of carved-out production payments. Any time a taxpayer can give away something of value without being taxed as having realized that value himself, the effect will be the same. The problem of the "double deduction" and whether it should be corrected by eliminating one deduction or the other are outside the scope of this article. What is important in the field of carved-out production payments is that the taxpayer was allowed by the Nordan decision to make a gift of an oil payment with the same tax consequences as if the gift had been an oil royalty, i. e. a conveyance limited only by the length of the lease. The Commissioner in I. T. 4003 eliminated any distinction between short-lived and long-lived oil payments, and provided that all carved-out production payments were assignments of future income. The

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41 See the discussion note in 3 OIL & GAS REP. 1963, from which these examples were taken. The computation of the tax is shown, and the problem of the double deduction briefly discussed.
42 For example, Cambell v. Prothro, 209 F.2d 331 (5th Cir. 1954), allowed a "double deduction" in the gift to a charity of several hundred calves.
Commissioner's contention was supported by judicial approval in the *Rudco* case, but his ruling seems to have been ignored in the *Nordan* case, for as quoted above the court held that cases dealing with the assignment of future income were not in point.

**Proposed Legislation**

H. R. 9559 and other proposed legislation on the subject would govern the taxation of gifts (as well as sales) of carved-out production payments. The general rule under H. R. 9559 would be that the donor of such a gift would be treated as having received income subject to the allowance for depletion as the income accrued to the donee. The donee would be treated as having received a gift of such proceeds.

The above general rule would effectively abrogate the rule of the *Nordan* case, for the donor would be taxable on the income received. But that general rule would not always apply where the donation was to charity. In cases of gifts to charities, the donor would not be taxable on the income if the payment would be expected to pay out over a period of at least two years. Thus, in the case of gifts to charity we have a proposed statutory "substantiality of interest" test, and if the period over which the property income is to be paid to the charity is long enough the income would not be taxable to the donor. Where the pay out period is too short, it would be the "fruit," rather than part of the "tree," which has been donated.

Other provisions of H. R. 9559 deal with varied problems relating to carved-out production payments. Sections 1221 and 1231 of the Internal Revenue Code would be amended to provide that in no event should a sale or exchange of a carved-out production payment be considered the sale of exchange of either a capital asset or property used in trade or business. Sub-paragraph E would be added to section 170(b)(1) to provide that there shall

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44 *Rudco Oil & Gas Co. v. U.S.*, 113 Ct.Cl. 206, 82 F.Supp. 746 (1949), where it was held that oil payments granted by the taxpayer corporation to its stockholders in proportion to their stock ownership constituted an assignment of future income, and were therefore taxable income to the corporation.

45 Proposed new § 633(b)(1) to the INT. REV. CODE of 1954.

46 As described in § 170(b)(1)(A) of the INT. REV. CODE of 1954.

47 Proposed new § 633(b)(2).

48 H.R. 9559 §§ 6 & 7 would so amend the INT. REV. CODE of 1954.
COMMENT

be no charitable deduction allowed for the gift of a carved-out production payment, where the value of the retained reversion exceeds 5% of the value of the carved-out payment.⁴⁹ This last provision is consistent with the treatment under existing law accorded to transfers in trust.⁵⁰ This provision would set up another statutory "substantiality of interest" test to support the theory for which the Commissioner had contended in the Nordan case.

Still other sections of the proposed H. R. 9559 deal with corporations which distribute carved-out production payments.⁵¹ Section 311 of the Code would be amended by adding subsection (d) to provide that distributions of carved-out production payments as dividends would be treated as if the corporation had sold such payment and distributed the proceeds.⁵² Finally, section 351 (a) would be amended to make clear that exchanges of carved-out production payments will not be given the tax-free exchange treatment generally accorded transfers to controlled corporations.⁵³

**Conclusion**

The effects of H. R. 9559 have been considered because it seems quite probable that this bill or similar legislation will be enacted into law in the reasonably near future, possibly before this article is published.⁵⁴ It would be impossible to describe thoroughly the taxation of carved-out production payments without mentioning how it is proposed that Congress tax them in the future. H. R. 9559, in addition to being a proposed statute, also indicates the Treasury's position on the taxation of these interests. In view of the *Hawn* decision, it is submitted that the Treasury's position will be accorded greater weight in the Fifth Circuit in the future.

This article has considered the carved-out production payment and the extent to which it has been used in the past to avoid taxes, and some consideration has been given to proposals governing the

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⁴⁹ H.R. 9559 § 2.
⁵⁰ Section 170(b) (1) (D) of the INT. REV. CODE of 1954 deals with transfers in trust.
⁵¹ See for example the *Rudco* case in note 44.
⁵² H.R. 9559 § 3.
⁵³ H.R. 9559 § 4.
⁵⁴ H.R. 9559 § 8 deals with the aggregation of properties, which problem is beyond the scope of this article. H.R. 9559 § 9 provides that the effective date of the proposed amendments to the Internal Revenue Code would be February 27, 1956. No inference is to be drawn from the enactment of the bill with respect to transactions on February 27, 1956, or prior thereto.
taxation of them in the future. The question remains, can carved-out production payments be used, now and in the future, to obtain tax savings. The answer is a definite “yes,” for even though the recent Hawn decision and H. R. 9559 may close the objectionable loopholes, other possibilities for tax maneuvering through the use of such payments are now and in the foreseeable future will be permitted by the Treasury. For example:

1. A producer might offset an expected loss in a given taxable year by selling an oil payment and anticipating future income, too.

2. He might also level out his earnings between low and high income years.

3. If a particular year’s development and operating costs were so great as to eliminate the percentage-depletion allowance by reason of the 50% of net income limitation, the taxpayer might consider making the percentage-depletion allowance available by contracting for another to perform development operations in exchange for an oil payment.

4. He might pledge the oil payment for development of the property, with resulting disposition of income to the pledgee.

5. Where the oil payment constituted the entire depletable interest of the assignor, as was true in the case of a retained as distinguished from a carved-out, oil payment, that retained interest could be disposed of as a capital asset.

6. Where the oil payment constituted a fraction of the assignor’s depletable interest in the property, but such fractional interest extended over the entire life of the property, the Treasury had no quarrel with its assignment.\textsuperscript{55}

The last of the six is not a true carved-out production payment. It is a fractional interest or overriding royalty, but it would seem wise to remember that by conveying one’s entire interest or a fractional part thereof, instead of a carved-out production payment, all of the problems with which this article has been concerned can be avoided.

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\textsuperscript{55} Kuntz, \textit{Oil Payments Revisited}, 31 \textit{Taxes} 863 (1953).