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Vester T. Hughes Jr.

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TAX CONSEQUENCES TO LESSEE OF
BONUS PAID FOR AN OIL
AND GAS LEASE†

by

Vester T. Hughes, Jr.*

I. INTRODUCTION

This Article deals with the effect of a bonus payment, previously made by a lessee in the purchase of an oil and gas lease, on the computation of his taxable income and the allowance for depletion if there is production under the lease.1 The treatment indicated by the recent regulations* adopted January 20, 1960, is consistent with the Government's long-standing position. These regulations require the lessee to exclude a pro rata share of bonus payments from gross

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* B.A., Rice Institute; LL.B., Harvard University; Attorney at law, Dallas, Texas. The author gratefully acknowledges the invaluable assistance of Mr. J. Paul Jackson of the Texas Bar, and Mr. J. A. O'Connor of the Arkansas Bar in the preparation of this paper.

1 See general treatment of the subject, see Ervin, The Bonuses, Minimum Royalties and Delay Rentals, Southwestern Legal Foundation 5th Annual Inst. on Oil & Gas L. & Tax. 529, 547-50 (1954); Williams, Assignment of Leasehold, Royalty and Oil Payment, Southwestern Legal Foundation 2d Annual Inst. on Oil & Gas L. & Tax. 469, 498-99 (1951).

2 T.D. 6446, filed with the Federal Register January 20, 1960, adopted the following final regulations:

In the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit or standing timber recoverable through the depletion allowance. See paragraph (c) (7) (ii) of Section 1.613-2 in cases in which percentage depletion is used. Regulations Section 1.612-3 (a) (3).

If bonus payments have been paid in respect of the property in any taxable year or any prior taxable years, there shall be excluded in determining the "gross income from the property," an amount equal to that part of such payments which is allocable to the product sold during the taxable year. The following example illustrates this rule:

Example: In 1956, A leases oil bearing lands to B, receiving $200,000 as a bonus and reserving a royalty of $240,000 of all oil produced and sold. It is estimated at the time the lease is entered into that there are 1,000,000 barrels of oil recoverable. In 1956, B produces and sells 1,000 barrels for $240,000. In computing his "gross income from the property" for the year 1956, B will exclude $30,000 ($200,000 x 1/8 of 1,000,000 barrels estimated to be recoverable), the royalty paid to A and $20,000 (100,000 bbls. sold x $200,000 bonus) attributable to the bonus payment shall not be either excluded or deducted from B's gross income computed under section 61. (See paragraph (a) (3) of § 1.612-3). Regulation Section 1.613-2 (c) (5) (ii).
income in computing percentage depletion, but deny any comparable exclusion of a pro rata part of bonus payments in computing his taxable income. In other words, under these regulations, for purposes of section 63 of the Internal Revenue Code defining taxable income, a bonus is a part of the lessee's capital investment so that it does not affect "gross income" on which taxable income is based. However, the regulations require that under section 613 a bonus be treated as advance royalty and hence a pro rata part excluded from "gross income," thus reducing the amount of gross income subject to depletion. It is submitted that in treating bonus payments as advance royalties and hence excludable from "gross income" for purposes of one section of the Internal Revenue Code and in treating the same payments as constituting a part of "gross income" for purposes of another section of the Code, the regulations are erroneous in their interpretation of the law. Furthermore, judicial developments have withdrawn the sanction previously granted comparable regulations and have rendered these regulations invalid. Thus, the present judicial approach to the problems here being considered dictates a change in the regulations, and this interim administrative action should be taken at once. However, there should also be legislation correcting many additional tax problems relating to the characterization of bonus payments made for an oil and gas lease, including problems relating to lessors as well as lessees.

II. BACKGROUND

Before going into the changes and developments of the case law which necessitate a re-examination of the regulations, a brief review of the pertinent tax law relating to a cash bonus paid for an oil and gas lease may prove helpful. Ignoring technical differences in the property laws of the several states in order to establish uniform tax rules, the Supreme Court early held that a cash bonus paid to a lessor was an advance royalty and, hence, was taxed on the bonus as ordinary income and was entitled to the statutory depletion allowance on such receipt. This rule became firmly established, and out of this concept grew the so-called

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5 Anderson v. Helvering, 310 U.S. 404 (1940); Thomas v. Perkins, 301 U.S. 655 (1937); Palmer v. Bender, 287 U.S. 551 (1933); Murphy Oil Co. v. Burnet, 287 U.S. 299 (1932); Burnet v. Harmel, 287 U.S. 103 (1932). However, the Canadian treatment is otherwise. McDonald, Canadian Income Tax §§ 88-89, 88-86 (1933) contains the following statement of Canadian law:

§ 53-3 Tax Treatment of Mineral Leases—General. (a) Oil and Gas Lease
“restoration of depletion” rule. If the lease proved dry or was abandoned without production, the lessor was required to restore to income in the year of abandonment an amount equal to the depletion claimed on the bonus in the earlier year; otherwise, depletion would be allowed with respect to properties that were not physically depleted.\footnote{Douglas v. Commissioner, 322 U.S. 275 (1944); Herring v. Commissioner, 293 U.S. 322 (1934).}

While the rule became well settled that a bonus was an advance royalty to the lessor, it became equally well established that the lessee had made a capital purchase; the bonus paid by him became the cost of his interest in the property and in the oil in place. As his capital investment, the bonus was returnable through cost or statutory depletion, whichever was greater. If the lease were abandoned, the lessee was entitled to an abandonment loss equal to this capital investment. It is this dual concept of the bonus as being, on the one hand, an advance royalty to the lessor, and, on the other, a capital investment to the lessee, which is the source of our problem.

III. Regulations

In question here are two different series of regulations—one dealing with the computation of the lessee’s taxable income and the other with the computation of the lessee’s statutory depletion allowance. Under the first, dealing with taxable income, the lessee may exclude from his “gross income” the royalty payable to the lessor. Thus, under section 1.612-3(b) of the Regulations,\footnote{Treas. Reg. § 1.612-3(b) (1960).} the lessee

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\textit{Acquisition and Maintenance Costs.} Lease acquisition costs, sometimes known as "bonus payments," are usually treated as non-deductible capital expenditures. Although they may be "made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business," within the meaning of s. 12(1)(a), they create an "enduring benefit" for the trade and so are a capital outlay under s. 12(1)(b).

The corresponding treatment is given the lessor:

\section{53-2 Tax Treatment of Mineral Lessor. (a) Oil and Gas Lease Bonus. A lump-sum payment in consideration for the granting of a petroleum and natural gas lease is not taxable as income to a lessor whose business does not include dealing in mineral properties.}

Thus the bonus is treated as the sale of a capital asset (and hence non-taxable in Canada) so far as the lessor is concerned and as capital investment as far as the lessee is concerned.

\footnote{Douglas v. Commissioner, 322 U.S. 275 (1944); Herring v. Commissioner, 293 U.S. 322 (1934).}
who pays an advance royalty deducts this from gross income, either in the year of payment or in the year the mineral product for which the advance royalties were paid is sold. However, the regulation makes it clear that advance royalties are only those royalties which the lessee is required to pay "on a specified number of units of such mineral" annually whether or not extracted within the year. The cash bonus previously paid by the lessee is not here regarded as an advance royalty, because it is not the payment for a "specified number of units"; but is rather the lessee's capital investment in the property to be recovered through cost depletion. Thus, no part of the bonus is excluded from the lessee's "gross income" in determining his taxable income.

However, the second series of rules, relating to the computation of the lessee's depletion allowance, is different. Section 613 of the 1954 Code allows the lessee a depletion allowance of 27½% of his "gross income from the property" during the taxable year, "excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." (Emphasis added.) In determining "gross income," both royalties and advance royalties are excluded as in the case of taxable "gross income"; but, curiously enough, the regulation requires: "If bonus payments have been paid in respect of the property in any taxable year or any prior taxable years there shall be excluded in determining the 'gross income from the property,' an amount equal to that part of such payments which is allocable to the product sold cutting and shall treat the amount so determined as an allowable deduction for depletion from the gross income of the year in which such payment or payments are made. No deduction for depletion by such payee shall be claimed or allowed in any subsequent year on account of the extraction or cutting in such year of any mineral or timber so paid for in advance and for which deduction has once been made. (But see paragraph (e) of this section.)

* * * * *

(3) The payor, at his option, may treat the advanced royalties so paid or accrued in connection with mineral property as follows:

(i) As deductions from gross income for the year the advanced royalties are paid or accrued, or

(ii) As deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid, is sold . . . .

Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for the first taxable year in which such amounts are paid or accrued. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with subdivision (ii) of this subparagraph. Any election made under this section is binding for the taxable year for which made and for all subsequent years, and the taxpayer must treat all advanced royalties paid or accrued in all subsequent years in the same manner.
TAX CONSEQUENCES TO LESSEE

during the taxable year." Thus, in determining "gross income" for depletion purposes, the taxpayer excludes each year a proportionate part of the bonus, called for convenience, the "bonus exclusion"; whereas, there is no such exclusion in determining "gross income" subject to tax.

Hence, the following anomalies result: "Gross income" is said to mean one thing in the part of the statute fixing the tax, but the same phrase means something else in the part of the statute dealing with the depletion allowance. A bonus is one thing (advance royalty) in the hands of the lessor; but something else (capital investment) to the lessee. Even more anomalous, the bonus is two different things at the same time to the lessee: it is a capital investment for general tax purposes, including computation of cost depletion; but suddenly becomes an advance royalty for purposes of computing his statutory depletion.

IV. CIRCUIT COURTS UPHOLD REGULATIONS

Curiously enough, four different United States Courts of Appeal have sustained in whole or in part this anomalous treatment.8 The reasoning of the courts in these decisions is far from clear. They find support for this result in the Supreme Court's decisions holding bonuses to be advance royalties to the lessor, and in section 114(b)(3) of the 1939 Code9 requiring royalties to be excluded from the lessee's "gross income" in computing his depletion allowance. The decisions are not clear as to why a similar exclusion should not be made from his "gross income" subject to tax. Some support for this result is found in section 23(m) of the 1939 Code10 requiring the depletion deductions to be "equitably apportioned between the lessor and lessee." Also, it was felt that the bonus exclusion was necessary to avoid a "double depletion" allowance. Thus, in Sunray Oil Co. v. Commissioner,11 the court said: "The

8 Treas. Reg. § 1.613-2(c)(1)(ii) (1960). Note that the earlier regulation, Treas. Reg. § 39.23(m)-1(e)(1) (1953), provides, "If royalties in the form of bonus payments have been paid in respect of the property . . . the amount excluded from 'gross income from the property' . . . shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year." (Emphasis added.) The Treasury apparently recognized that the word "royalties" pointed up the inconsistencies in the regulations and thus eliminated it from the new regulations.

9 Corresponding to Section 613 of the 1954 Code.

10 Corresponding to Section 611(b)(1) of the 1954 Code.

11 147 F.2d 962 (10th Cir. 1945).
royalties paid to the lessor are excluded from the gross income from production on which the lessee's depletion allowance is based because otherwise a double depletion allowance would result."13 A like explanation is contained in the Fifth Circuit Court's decision in Quintana Petroleum Co. v. Commissioner:14

It follows that if the percentage depletion is allowable upon the cash bonus (advance royalty) received by the lessor, such bonus must be deducted from the gross income from production received by the lessee in computing depletion; otherwise double percentage depletion deductions would result contrary to the statute.15

V. CHANGE OF JUDICIAL APPROACH

With four circuits supporting the regulation it would initially appear that the law in this area is settled. More recent developments, however, demonstrate fundamental error in these cases and in the regulations under consideration.

The most important of these later developments are the "net profit" cases. These cases involve transfers of oil or gas properties under a contract by which the transferee agrees to pay the transferor a certain percentage of his (the transferee's) net profits from the development and operation of the properties. At first, the Supreme Court had held that on such a transfer the transferor had not retained any "economic interest" in the properties; thus, the receipt of "net profits" was unlike the receipt of a royalty and the transferor was not entitled to percentage depletion thereon.16 The result was that the transferor had sold his interest and thus probably was entitled to capital gain. The transferee, correspondingly, did not exclude the "net profit" payments from his gross income for either tax or depletion purposes because they were not royalties. The transferee had to capitalize.

Later, the Supreme Court reconsidered the net profits problem, and in Kirby Petroleum Co. v. Commissioner17 and Burton-Sutton Oil Co. v. Commissioner18 overruled its earlier decisions. It held

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13 Id. at 965. Although a state governmental agency was lessor in fourteen of the sixteen leases involved, apparently counsel did not raise the point that with respect to the fourteen leases, at least, there could never be double depletion inasmuch as the lessor was not a taxpaying entity. Even if the approach of the regulation were otherwise valid, there would seem to be no reason to apply the regulation (excluding a portion of bonus from gross income for computing depletion) to any situation where the lessor is a governmental or other tax exempt organization.
14 143 F.2d 588 (5th Cir. 1944).
15 Id. at 591.
18 328 U.S. 25 (1946).
that a "net profits" interest was an "economic interest" in oil in place and was like a royalty. As royalties, the net profits received by the transferor were taxed at ordinary rates; and he was entitled to the depletion allowance on such receipts. Since they were royalties to the recipient, they were royalties to the payor, who could each year reduce his "gross income" for general tax purposes as well as for depletion purposes by the amount of the net profits paid. This is the rule today and is established Treasury practice.

Of particular concern to our problem is the language in the Burton-Sutton case:

If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other. 10

The above-quoted statement of the Supreme Court requires a review of the tax treatment of cash bonuses. If the cash bonus is a capital investment to the lessee, then there would be a capital sale by the lessor which would entitle him to capital gain treatment. On the other hand, if the bonus is advance royalty to the lessor, it must be regarded as advance royalty to the lessee; thus, an aliquot part of the bonus would be eliminated from the lessee's gross income, both for taxation as well as depletion purposes.

Later decisions have indicated that one effect of the Burton-Sutton rule is to overturn Quintana and the other circuit court cases. 2 Also, now lessees are entitled to deduct the bonus from "gross income" in determining taxable income as well as depletion.

The Fifth Circuit, in Commissioner v. Gracey, 21 noted the change of approach called for by the Burton-Sutton case, and indicated that the Supreme Court had overruled the Quintana case.

The district court in Lambert v. Jefferson Lake Sulphur Co. 22 (involving payments resembling an installment bonus) so interpreted the Gracey case:

The Fifth Circuit seems to have held that advance royalties are not excludable by the lessee in Quintana Petroleum Co. v. Commissioner of Int. Rev. 5 Cir., 143 F.2d 588. In Commissioner of Internal Revenue v. Gracey, 5 Cir., 159 F.2d 324, however, the Fifth Circuit apparently admits that its decision in Quintana is contrary to the

10 Id. at 27. The Court, to support this statement, cited Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 603-05 (1946); Anderson v. Helvering, 310 U.S. 404, 407 (1940).
20 See cases supra note 9.
21 159 F.2d 324, 326 (5th Cir. 1947).
principles approved by the Supreme Court in Burton-Sutton Oil Co. v. Commissioner. . . .

Further, the district court said:

It would appear, however, that these quarterly payments are excludable from income by the taxpayer as advance royalties. Admittedly, these payments were depletable as advance royalties by the lessor. Consequently, they should be excludable as such by the lessee. Int. Rev. Code of 1939, §114(b)(4)(A), 26 U.S.C. §114(b)(4)(A) (1946 ed.). It is true that three cases from the Second, Third and Tenth Circuits are to the contrary. But those cases are inconsistent with principles expounded by the Supreme Court in Burnet, Bankers Coal Co., Murphy Oil Co. and Palmer. In addition, they were written before the opinion of the Supreme Court in Burton-Sutton Oil Co. v. Commissioner. . . . (Emphasis added.)

The court added:

It is true that in the Burton-Sutton case the payments from the operator to the owner were not characterized as bonuses or advance royalties and were, in fact, materially different therefrom in that the payments there were 50 per cent of the net profit from the mineral operation. Nevertheless, though that case may be distinguishable from the one at bar on its facts, the principle there applied is applicable here. If the payments here are advance royalties depletable by the lessor, as admitted by the Government, then they are excludable from income as advance royalties by the lessee.

The Fifth Circuit affirmed the district court in the Jefferson Lake case "on the grounds assigned by it as its basis." Thus, in effect, the Fifth Circuit overruled its earlier decision in the Quintana case and held that a bonus payable in installments was an advance royalty in the hands of the lessee as well as lessee, excludable by the lessee from his "gross income" for general tax, as well as for depletion purposes.

The rule announced in Burton-Sutton that if a payment is royalty to the lessor it must be royalty to the lessee, had been foreshadowed

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23 Id. at 200 n. 10.
25 Ibid.
26 236 F.2d 542, O. & G. Rep. 514 (5th Cir. 1956). The Fifth Circuit’s opinion gave rise to various comments: Freling, New Developments in the Tax Consequences of Bonus Payments, P-H Oil & Gas Taxes § 2010 (1957); McClure, Recent Developments and Trends in Oil and Gas Tax Decisions and Legislation, Southwestern Legal Foundation 8th Annual Inst. on Oil & Gas L. & Tax. 449, 488-92 (1957); Miller, Are Bonus Payments Now Deductible? 6 Oil & Gas Tax Q. 155 (1957); Stroud, Major Points of Impact of New Natural Resources Regulations on Oil and Gas, Southwestern Legal Foundation 8th Annual Inst. on Oil & Gas L. & Tax. 393, 446-47 (1957).
27 In what may have been an effort to avoid reversal by the United States Supreme Court, the court stated that the payments were also deductible as delay rentals. This dictum can only add to the confused thinking in this area.
by Judge Learned Hand in his dissent in Canadian River Gas Co. v. Higgin, where he said:

The reason for this, as I gather, is that such a “bonus” is payment in advance for units of gas, in which, although the lessee has the right to withdraw them in the future, the lease gives him no immediate interest. Conversely, the lessor does not part with any interest in the gas until the lessee withdraws it. These decisions thus put a “bonus” on the same footing as current royalties, in spite of the fact that it is not apportioned to future withdrawals, and is not recoverable, if there are no withdrawals; and it is because it is upon that footing that it is income. The important thing to observe is that this consequence is a deduction from the rights which the lease creates.

The plaintiff merely asks that the lease shall be construed in the same way, when the lessee is taxed. It says that if a “bonus” is “advance royalties,” and a payment for units to be later withdrawn, which remain the lessor’s while they are in situ, it must be “advance royalties,” when the opposite party, the lessee, is taxed: that the rights created cannot vary as one looks through different ends of the same document. My brothers find it a sufficient answer to say that the same payment may be at once income to the payee, and a capital expenditure to the payor. That is true: for example, when a customer buys goods from a merchant, he may be making a capital expenditure, yet the merchant will receive income. Nevertheless, the legal effect of the transaction does not shift; the same contract is not construed to create one kind of right when the customer is to be taxed, and another when the merchant is. Yet that is what we must do here, if we are to escape the force of the decisions I have mentioned. . . .

VI. THE REGULATIONS MUST BE REVIEWED

As seen above, under the regulations the bonus is excluded from the lessee’s “gross income” for computing depletion but not for computing tax. Under the approach of Judge Hand and the later Burton-Sutton and Jefferson Lake cases, the bonus should be excluded from “gross income” in computing both taxable income and depletion. In evaluating the merits of the two approaches, it may be helpful to consider a simple hypothetical case. Assume a lessee pays a $100,000 bonus to a lessor for an oil and gas lease. The lessor retains the usual 1/8th royalty so that the lessee has a 7/8ths working interest. Assume that oil is developed by the lessee and that over the life of the property, the total 8/8ths of production is sold for $800,000 of which 1/8th or $100,000 is paid by the pipeline company to the lessor on account of his royalty, and $700,000 is paid to the lessee on account of his 7/8ths interest. In the interest

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28 151 F.2d 914, 917 (2d Cir. 1945).
29 Ibid.
of simplicity, ignore the lessee’s expenses and the effect of the 50% limitation on depletion, and deal only with the 27 1/2% allowable with respect to gross income. The total gross income from actual production from both interests is $800,000, of which the lessor’s royalty is 1/6th or $100,000, and the lessee’s interest is 7/8ths or $700,000. However, under the Murphy and Harmel decisions, the $100,000 bonus paid is treated as an advance royalty, so that the lessor has $200,000 of gross income and the lessee $700,000 of gross income. Thus, the total gross income of both taxpayers is $900,000. However, if we follow the regulations, the total “gross income” from the properties for depletion purposes is only $800,000. The lessor’s depletable income including the bonus is $200,000, but the lessee’s is only $600,000 ($700,000 of the income received from the production and sale of his 7/8ths of the oil minus the $100,000 bonus he has previously paid). With respect to depletion, the beneficiary of the present regulations is the lessor, who is allowed depletion on $200,000 although his income from the actual production and physical depletion of the properties is only $100,000. He is allowed depletion not only on his royalty but also on the bonus, which has no relation to the production or physical exhaustion of the properties. The lessee, on the other hand, is penalized; he is required to pay tax on $700,000, his 7/8ths of actual production, but because of the “bonus exclusion,” he is allowed depletion only on $600,000. This treatment is manifestly unfair and inequitable to lessees, and, as will be more fully developed, is legally unsound.

If, on the other hand, we follow the Jefferson Lake case, apply Burton-Sutton and say that since the bonus is an advance royalty to the lessor it is also an advance royalty to the lessee, then an aliquot part of the bonus would be excluded from the lessee’s gross income for taxation as well as depletion purposes. The result in our hypothetical case would be that the lessor’s gross income over the life of the property is $200,000—$100,000 of bonus plus the $100,000 of royalty receipts. So far as the lessee is concerned, the bonus, being advance royalty, would be eliminated from gross income for both tax and percentage depletion purposes. He would, over the life of the production, eliminate from his $700,000 of gross income the $100,000 of advance royalty paid, and report and pay tax only on $600,000. Correspondingly, he would take percentage depletion on the remaining $600,000 of adjusted gross income. The result of this treatment would be that taxable income of both taxpayers and the total depletable income of both
taxpayers would be the same. The total income for both tax and depletion purposes would be equated to the total income derived from production, *viz.*, $800,000—$200,000 to the lessor and $600,000 to the lessee. This treatment would result in substantial benefits to lessees in that their taxable income from their share of production would be reduced by the amount of the bonus previously paid.

Although lessees would welcome this treatment, it must be admitted that the results may be questionable. The acceptance of the *Jefferson Lake* case would undoubtedly involve a substantial revenue loss. If the bonus is excluded from taxable gross income, the lessee pays a tax on less than his actual income. In our hypothetical case the lessee has actually received $700,000 from the sale of his $\frac{7}{8}$ths of the production, but if his prior bonus is excluded he pays tax on only $600,000. If the true nature of a bonus is capital investment, in effect the lessee gets two kinds of depletion: by excluding his bonus payment from taxable income as a royalty, he obtains a full return of his investment just as if he had taken cost depletion, and then he takes percentage depletion on the remaining gross income. Of course, if the bonus is actually a kind of royalty, there is no duplication.

Thus, whereas the present regulations are inequitable and discriminate against lessees, the *Jefferson Lake* rule may be too favorable to them. The Commissioner is confronted with a dilemma brought about, first, by the *Harmel* and *Murphy Oil* cases and, secondly, by the later *Burton-Sutton* decision. If the choice is between (a) the *Burton-Sutton—Jefferson Lake* rule and (b) the regulations as presently written, then certainly *Burton-Sutton* should prevail and the regulations be held invalid. While the *Burton-Sutton—Jefferson Lake* rule is merely a logical extension of an illogical premise, the regulations are both inequitable and illogical in light of the premises and regardless of the premises.

Thus, both *Jefferson Lake* and the regulations have their objections. To resolve their dilemma, the following solutions are available.

**A. Legislative Action**

One escape from both the questionable result of the *Burton-Sutton* and *Jefferson Lake* decisions and the incongruity of the present regulations is to recognize that the heart of the problem lies in the fundamental errors of the *Harmel* and *Murphy Oil* cases, and
to seek legislative action to change the rule of those cases. Those cases are wrong. The bonus is not an advance royalty.

A royalty represents the lessor's share of the product derived from the production of some natural resource. In Texas and many other states an oil lease operates as a horizontal severance of oil in place, and the sale, by determinable fee, of \( \frac{7}{8} \)ths (or other fraction) of oil in place. The lessor retains or reserves \( \frac{1}{8} \)th of the oil in place, which, when produced, he sells directly to a purchasing pipeline company. He actually retains title and ownership to this \( \frac{1}{8} \)th so that this retained "royalty" represents his share of the oil when produced and sold. In states where the lease is regarded as a *profit à prendre*, the lessee obligates himself to pay the lessor either a share of the future production or a fixed sum for units to be produced, e.g., $1 per ton of ore when and as produced. In either case, the royalty represents a share in future production and is based on and measured by actual production.

A true advance royalty is likewise tied to production and is the advance payment for a specified number of units to be produced at a later date. In either case the royalty or advance royalty is directly related to the production and exhaustion of natural resources. It is a payment made *solely* on account of minerals being produced or to be produced, and measured *solely* by current or anticipated production and exhaustion.

A bonus is not a royalty or advance royalty in either sense. It is a payment made by the lessee for the whole bundle of rights he obtains under the lease. The rights include the lessee's right to \( \frac{7}{8} \)ths (or other fraction) of future production; but even in this sense the bonus is payment for the lessee's full interest in the minerals in place and thus is more in the nature of a purchase price of an entire property interest than an advance payment for a specified number of units to be produced in the future.

But it is even more than this. On the payment of the bonus the lessee acquires many other rights. Among others he obtains the right to go upon the land and explore. He may conduct seismic and other geophysical and geological operations on the property to determine the probabilities of finding oil and to determine whether or not to drill an exploratory well, to abandon the acreage in whole or in part, or to hold the lease for its primary term without drilling. He obtains the right to drill one or more exploratory wells on the property at locations of his own selection, to build roads, and otherwise to use the surface in his exploratory operations. If he finds oil he
may drill such development wells as he may determine, again using the surface for this purpose. He obtains the exclusive right (and duty) to operate the properties without the interference of the lessor. If he discovers gas or certain hard rock minerals he has the right (sometimes quite valuable) to market and sell the lessor's share of the production. Thus, the bonus is not simply the price paid for an interest in the minerals in place, but is also the price paid for the whole bundle of rights set forth in the lease. Consequently, it is not simply a royalty or advance royalty. It is much more.

Moreover, as previously stated, the bonus has no direct relation to production itself. Recent figures show that at least nine out of ten exploratory wells are dry. The overwhelming majority of leases are dropped or abandoned without any production; thus, in the overwhelming majority of cases, the bonus has no relation to actual production or the physical exhaustion of the natural resource since there is none. Even in the relatively small percentage of cases where there is production, the bonus has no direct relation to that production and is not based upon or geared to or measured by that production. It is a payment made irrespective of actual production. It is a payment which is in addition to and over and above the lessor's share of the production. It is a payment which is different from, apart from, and over and above the lessor's retained or agreed royalty. Thus, considering its basic characteristics, the bonus is not a royalty or advance royalty, and the lessor should not have been accorded the "depletion deduction" on the bonus since it is not correlated to the physical exhaustion or "depletion" of the mineral reserve.

As seen above, allowance of depletion on the bonus produced the strange "restoration of depletion" rule. Since a "depletion" deduction is an allowance made for the physical exhaustion or "depletion" of the natural resource, the Supreme Court in the Douglas case recognized that it was "error" to allow depletion on a bonus where the lease was later abandoned without production and there was no actual depletion. It was held that, to correct this error made in the earlier year, the lessor must restore an equal amount to income in the year of abandonment. Thus, we have the curious result that an "erroneous" deduction in the year of the bonus receipt creates income in the later year of abandonment even though in such later year the lessor has nothing "coming in." Indeed, since the dry hole has proved his royalty worthless, he not only
has no income, but has a real economic loss. This subsequent history points up the fallacy of allowing depletion on the bonus in the first instance where the bonus, unlike the royalty, is unrelated to the productive process. This is a case of one bad rule giving rise to another.

The Court in Douglas was wrong. A bonus is not an advance royalty entitled to depletion. It is sui generis, but it is more like a capital investment than a royalty. It is payment not only for the lessee's entire interest in future production but also for a bundle of other rights.

However, until either the Supreme Court or Congress corrects the error we are bound by the rule that the bonus is to be treated as an advance royalty, at least in the hands of the lessor. Since the Supreme Court is not likely to shift its ground, and certainly the lower courts will not, legislative action will be required to change the rule.

B. Administrative Action

At the administrative level, only two courses are open:

(1) Recognize, for right or wrong, the binding effect of Harmel and Murphy Oil that the bonus is an advance royalty and, applying Burton-Sutton and Jefferson Lake, treat it as one in computing the lessee's taxable income and depletion.

(2) Recognize the binding effect of Harmel and Murphy Oil only insofar as lessors are concerned, but refuse to extend the error of those cases to lessees, and insist that, as to lessees, the bonus is not a royalty but a capital investment.

The first course, entailing a revenue loss, may be undesirable; and the alternative presents real difficulties which arise from the necessity of having to accept a fundamental error as our major premise. Not the least of these difficulties is the obvious inconsistency of treatment between the two contracting parties. But perhaps the administrative policy may be that the results of the first course are too great a price to pay for consistency.

If the second course is followed, the Burton-Sutton case would be at least superficially distinguished on its facts. That case dealt not with a cash bonus paid on execution of the lease but with recurring "net profits" payments currently made which, being directly connected with and measured by actual production, were more like a royalty than is a bonus. Hence, it might be contended that Burton-Sutton is distinguishable on its facts.
The Jefferson Lake case represents the views of a single circuit. Considering the unique character of the installment payments in that case and the dictum that they might be regarded as delay rentals, the decision would be regarded as not necessarily controlling.

It may well be that other courts, taking their cue from Burton-Sutton, Jefferson Lake, and Judge Hand’s dissent in Canadian River, will eventually hold the bonus to be an advance royalty insofar as lessees are concerned. Until this occurs, however, the administrative policy under this second course would be to accept Harmel and Murphy only out of necessity and then only insofar as lessors are concerned; but, until such time as the courts compel an adoption of Jefferson Lake, to hold firmly to the view that from the lessee’s standpoint the bonus is, in law and fact, not a royalty but the lessee’s capital investment.

If this second course is followed, the inconsistency might be justified on the somewhat dubious ground that the tax treatment accorded one party to a contract does not necessarily control the tax treatment to be given the other. Advance rental payments, for example, are income to the lessor but must be capitalized by the lessee and amortized over the period to which they relate. If Harmel and Murphy Oil must be rationalized, it might be said that although the bonus is sui generis, in some respects it resembles an advance rent or royalty and in others payment for an interest in property. Holding that the lease was not a sale and deciding that capital gain treatment should be denied, the Court decided that to the recipient the bonus was “closer to” and “more nearly resembled” an advance royalty than consideration received from a sale. As the Supreme Court stated in Anderson v. Helvering, “Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences.” (Emphasis added.) In other words bonuses are not, in reality, advance royalties, but only “are regarded” as such, and, though different, are given “the same” tax treatment to the lessor. But since they are different, having also the characteristics of consideration paid for a property interest, it is permissible to treat them as capital investments from the lessee’s point of view.

In any event, once the gap is bridged and the bonus is held to be a capital investment to the lessee, it must be so regarded in computing both the lessee’s depletion and his taxable income. As a

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31 310 U.S. 404, 409 (1940).
capital investment, no part of it would be excludable as a royalty in computing the lessee's taxable gross income. It would be a capital investment in computing the lessee's cost depletion. Similarly, it would be regarded as a capital investment in computing percentage depletion so that no part of it could be considered to be "royalties paid or incurred by the taxpayer in respect of the property" excludable in determining the lessee's gross income from the property for depletion purposes under section 613 of the 1954 Code. Accordingly, the "bonus exclusion" provisions of section 1.613-2(c)(5)(ii) of the Regulations must be eliminated as violative of the statute.

As has been pointed out, it is difficult enough, in light of the Burton-Sutton decision, to justify giving the bonus one treatment to the lessor and a different one to the lessee. A fortiori, there could be no possible justification in holding it to be two different things at the same time to the same taxpayer, viz., that it is a capital investment in computing the lessee's "gross income" subject to tax, but is a royalty in computing his "gross income" subject to percentage depletion; that it is his capital investment in computing the lessee's cost depletion, but is a royalty in computing his statutory depletion. In fact, in order to avoid the effect of the Jefferson Lake case, the whole foundation of the Commissioner's position at this point must be to insist, despite Harmel and Murphy Oil, that it is not a royalty. If it is not a royalty to be deducted from the lessee's taxable "gross income," it is not a royalty to be excluded from depletable "gross income" under section 613; and if it is not a royalty, the "bonus exclusion" provision must fall.

Quintana Petroleum Co. v. Commissioner, and the other circuit court cases above mentioned, to the extent that they sanction the "bonus exclusion" while at the same time holding the bonus not to be a royalty to the lessee, are clearly wrong. The Quintana and Sunray cases sought to justify the "bonus exclusion" on the ground that this was necessary to avoid a "double depletion" allowance. There is no merit in this. The elimination of the "bonus exclusion" provision and the allowance to the lessee of depletion on his full share of current production does not result in "double depletion."

This may be demonstrated by adverting once more to the hypothetical case referred to earlier in this discussion. Under our present assumption we have these results: The lessor would have $200,000 of taxable gross income, $100,000 from his royalty and $100,000 from

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32 143 F.2d 588 (5th Cir. 1944).
33 See note 2 supra.
the bonus which would be regarded as an advance royalty. Similarly, "his gross income from the property" for depletion purposes would be $200,000. The lessee's taxable gross income would be $700,000, representing the proceeds from the sale of his 7/8ths of the oil. There would be no "bonus exclusion" for either tax or depletion purposes; therefore, his gross income subject to depletion would also be $700,000. Under this treatment the aggregate taxable gross income of both parties is $900,000 and the aggregate "gross income from the properties" for depletion is likewise $900,000. Consequently, taxable gross income and depletable gross income are the same. While the total income, taxable and depletable, is $100,000 more than the $800,000 of total income from actual production, this excess represents the lessor's bonus, on which he is allowed depletion. Of the actual production of $800,000, each pays tax and receives depletion on his share of such actual production.43

As the hypothetical case shows, the elimination of the "bonus exclusion" does not result in "double depletion." The lessee is allowed depletion on $700,000 which is his share of the production and which is taxed to him. The lessor is allowed depletion on $200,000 which is his 7/8th of the production plus his $100,000 of bonus. This is also his taxable income. The total taxable income of both taxpayers is $900,000 and the total income on which depletion is allowed is the same. There is no "double depletion," whatever that term means. There is no "double depletion" in the sense that depletion is allowed twice on the same receipt, nor is there "double depletion" in the sense that depletion is allowed on income in excess of that which is subject to tax. If, by "double depletion deduction," the Court was referring to the depletion allowed the lessor on his bonus, this was a permissible "doubling-up," brought about and made mandatory by the Supreme Court, and even here there is no "double depletion" except to the degree that there is also a doubling-up of taxable income.

What the courts must have meant (and this is apparently the theory underlying the present regulations) is that "depletion" deductions should be limited to physical depletion of the natural resource. It is therefore necessary to limit the over-all depletion

43 Another approach to the characterization of bonus would be to treat it as consideration for the purchase of an override (or a production payment) which would be given cost depletion as a separate mineral interest. Still another would be to reduce the lessee's gross taxable income by a pro rata part of the bonus, treating such amount as a guaranteed royalty premium, i.e., the amount to be received by the lessee for his fractional interest would exceed the market price of the oil by a premium which equals the aliquot share of bonus. Under both of these approaches, a pro rata part of the bonus would be excluded from the lessee's gross income for both tax and depletion purposes.
allowance of all taxpayers to the over-all income from production; that since the lessor is allowed depletion on his receipt of the bonus, the lessee must suffer a “bonus exclusion” in order to equate the depletion deductions to physical depletion. For several reasons, this theory is obviously unsound.

In the first place, there is no provision in the statutes dealing with percentage depletion that even remotely suggests that the aggregate statutory allowance is limited to aggregate physical production; or that the over-all depletion shall be pooled and reallocated to all interested taxpayers to the end that the over-all depletion deductions be equated to physical production. Nor is there the slightest suggestion that because one taxpayer has received too much depletion, another must suffer a corresponding reduction in his allowance. To the contrary, section 613 gives to each taxpayer having an economic interest in oil or gas a deduction for the year equal to 27\(\frac{1}{2}\)% of his “gross income from the property” for that year, limited to 50% of his net income. Each taxpayer’s gross income and net income is computed separately, and no one taxpayer’s gross or net income is made dependent on another’s. Moreover, the allowance is permitted annually so that a taxpayer’s “gross income from the property” for a particular year is not governed by the deductions allowed him in other years, much less by the deductions allowable to other taxpayers in earlier years. Where the lessee receives payment for his share of the actual production in a particular year, this is his gross income for that year on which he must pay tax. It is also his “gross income from the property” for that particular year and on this Congress has said his deduction for that year shall be 27\(\frac{1}{2}\)%.

Since depletion is taken only on his share of actual production, his depletion deductions, at least, coincide with physical depletion. Unless the bonus is an advance royalty, there can be no possible legal justification in the “bonus exclusion” provision of the present regulation. If the bonus is not a royalty, the “bonus exclusion” provision is in direct violation of the statute. The mere fact that the lessor was allowed depletion on the bonus is wholly irrelevant. The deductions previously allowed one taxpayer cannot, legally or equitably, control, determine, or affect the deductions allowable to another in later years. The lessee cannot be penalized by the “bonus exclusion” simply because, for right or wrong, the lessor was allowed depletion on the bonus in the earlier year.

Not only is there nothing in the statutory scheme which limits the statutory depletion allowance to physical depletion, but to the
contrary, the Supreme Court held that the lessor’s bonus is a part of his “gross income from the property” and allowed him depletion on the bonus even though it did not represent a share of actual production. Under the concept that a “depletion” deduction should be allowed only in connection with the physical depletion, it may be said that the Court erred in granting the lessor depletion in the first instance. However, the Court did allow it, and the statutory phrase “gross income from the property” is not now confined to income from “production” but includes certain receipts which are not shares of production, with the result that depletion is allowed where there is no physical depletion. Proceeds from the sale of a production payment constitute another such receipt. In allowing depletion on the bonus, the inevitable and necessary result is that the total “gross income from the property” of all taxpayers interested in a lease will exceed the total income from production. While this may violate the purist’s concept of what a depletion allowance should be, it is the present law under the Supreme Court’s decisions. The result, from a revenue point of view, is not bad, since the lessor or oil payment seller is denied capital gain and taxed at ordinary rates. The 27½% deduction given him is in lieu of the more favorable capital gain.

But whether the Court was right or wrong in allowing the lessor depletion on his bonus, it is entirely clear that this is no justification for penalizing the lessee through a “bonus exclusion.” The allowance to the lessor of depletion on a receipt unconnected with production cannot be the basis for denying the lessee his statutory right to depletion on his share of actual production. If it should be deemed necessary, as a matter of taxing policy, to limit the depletion allowance to physical depletion, the remedy lies in legislative changes to eliminate the depletion to the lessor on his bonus, and not in penalizing the lessee by the so-called “bonus exclusion.” The “bonus exclusion,” insofar as it is based on some assumed need of equating the depletion deductions to physical depletion or of avoiding a “double depletion,” is clearly wrong.

That depletion was allowed the lessor is irrelevant. The sole question is whether the bonus is an advance royalty paid by the lessee. If it is an advance royalty to the lessee, he may, under Jefferson Lake, exclude an aliquot part from both taxable income and also from “gross income from the property” under section 613. But, if, notwithstanding Harmel and Murphy Oil, it is not an advance

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royalty to the lessee, no part of it can be excluded from taxable income under section 613, and the “bonus exclusion” provision of section 1.613-2(c)(5)(ii) of the Regulations must be eliminated.

If further support for this is required, it may be found in Helvering v. Wilsbire Oil Co. There it was held that the intangible expenses deducted in determining taxable income also became a deduction in computing the 50% limitation on the statutory depletion allowance. The Court sustained a regulation which held that “net income from the property” for statutory depletion purposes carried the same meaning and included the same deductions as taxable “net income.” Indeed, it is inconceivable that Congress could intend that the phrase “net income” and the phrase “gross income” on which net income is based, should have one meaning when used in levying the tax but another when dealing with depletion. So it is here. We may not, in defining “gross income” for depletion purposes, exclude an aliquot part of the bonus as a royalty and yet, in defining “gross income” for taxation purposes make no such exclusion. Under our present hypothesis, the bonus is not a royalty and there should be no exclusion in either case.

In summary, the regulations as presently written are wrong. To correct the situation at the administrative level, the Commissioner has these alternatives:

(1) to hold, following Burton-Sutton and Jefferson Lake, that the bonus is an advance royalty to the lessee excludable from gross income for both tax and depletion purposes, or

(2) to insist that the bonus is the lessee’s capital investment, in which event there is no adjustment to gross income for either purpose.

The first is the more logical treatment and finds most support in the cases; the second is perhaps the more equitable and certainly more in the interest of the revenue, but requires the amendment of the regulations to eliminate the “bonus exclusion” rule.

VII. Conclusion

In view of the development of the case law, it seems likely that many lessees will attempt to exclude an aliquot part of bonus from “gross income” in computing taxable income as well as from “gross income” for the purpose of computing depletion. The recent regulations seem to be a clear indication that the Government will resist all such attempts; however, lessees who decide to litigate the question

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36 308 U.S. 90 (1939).
should find other circuits agreeable to the Burton-Sutton—Jefferson Lake approach, the logical extension of an illogical premise which the Supreme Court announced over a quarter of a century ago. If the Treasury does review the matter in the light of possible—perhaps probable—developments, and changes its position to eliminate the "bonus exclusion" rule from the regulations (thus allowing bonus payments to be treated by lessees as capital expenditures for all purposes including the computation of gross income for percentage depletion), lessees may not be inclined to litigate the matter further. But undoubtedly the most desirable course would be corrective legislation affording to the bonus a tax treatment from the standpoint of both lessees and lessors which more nearly recognizes its true character, i.e., a capital payment and not an advance royalty. Such remedial legislation would not only correct the incongruous "bonus exclusion" rule but would also eliminate other tax problems such as "restoration of depletion," growing out of the characterization of bonus payments made in connection with the purchase of an oil and gas lease.