The Use of Mineral Interests in Short-Term Trusts - A New Tax Problem

Donald L. Wilson
THE USE OF MINERAL INTERESTS IN SHORT-TERM TRUSTS — A NEW TAX PROBLEM

by

Donald L. Wilson*

I. INTRODUCTION

The short-term trust is today a widely used implement among the tools of the income tax planner. It is generally used most effectively where the potential grantor can look forward to at least ten years of substantial earnings, but does not believe that he can afford to part with his property indefinitely. Such a person can transfer property in trust for the life of the beneficiary or ten years, whichever is less, with a reversion of the corpus to him. The income may be accumulated for the beneficiary for the term or distributed currently. These trusts are often used to provide for aged relatives or a fund for the children's education. For example, if a person is in the fifty per cent bracket and has property which produces $3,000 of annual income, he retains only $1,500 after taxes. If this same person were to transfer the property into three separate trusts for his three children, with at least $650 of the income distributable annually to each child, the children would pay no tax because of the $600 exemption and the ten per cent standard deduction. In addition, each trust would have an exemption of $100 each year. Consequently, the $650 distributed to each child, plus the $100 exemption for each trust, or a total of $2,250 escapes tax.

* B.A., L.L.B., University of Oklahoma; Attorney at Law, Ft. Worth, Texas.


2 The short-term trust is principally an income tax saving device and has only incidental estate tax consequences. If the person in question has a substantial estate, he would probably make gifts of the property and retain no reversion in order to effect estate tax savings as well as to avoid future income.

3 Int. Rev. Code of 1954, § 673(a) provides that the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest which may reasonably be expected to take effect within ten years from the date of transfer.


7 Int. Rev. Code of 1954, § 642(b). If the trust under its governing instrument is required to distribute currently all of its income for the taxable year, the exemption is $300.

495
tion. The tax on the remaining $750 would be about $150 as compared to $1,500 in the grantor's hands, or a saving of $1,350. After ten years the corpus could revert to the grantor and the children's college fund would be better off by approximately $13,500.

Where the transfer is to a trust with the income payable for certain charitable purposes, the term of the trust need be only two years. Since the taxpayer is not taxed on any of the income during the term, it has the effect of increasing his thirty per cent charitable deduction by the amount of that income each year. If the corpus reverts to the grantor after the two years, he gets no deduction for the value of the income right transferred. However, at least for the present, if the remainder is distributable to some other person, the grantor could also deduct the value of the charitable gift.

This discussion should serve to illustrate the importance of short-term trusts and the statutory provisions which control their tax effects. It is not the purpose of this Article to delve into the many requirements which must be met to satisfy the statutory provisions. It should suffice to say that they are complex and demanding of the draftsman.

II. Statement of the Problem

The use of the short-term trust as a stable tax-planning technique is the result of a long history. The cases on this point are legion, and the courts have time and time again weighed the facts and drawn the line between what constituted the assignment of income, taxable to the grantor, and what constituted a transfer of property, taxable to the grantee. In an effort to curb this flood of litigation by drawing an arbitrary line, the Treasury issued the Clifford Regulations. When doubt was cast upon their validity, Congress presumably settled the issue by outlining in detail what was necessary for the remainder to certain members of the grantor's family, but it was rejected by the Senate.


See Commissioner v. Clark, 202 F.2d 94, 100 (7th Cir. 1953).
for a grantor to avoid being taxed on income received by the grantee from the property transferred. In view of this, tax practitioners had every reason to believe that this problem had finally been laid to rest. Yet recent actions of the Revenue Service have caused this rest to be uneasy.

This cause for apprehension arose in the form of a private ruling which held that a grantor who transferred his entire interest in certain oil and gas properties to a short-term trust for more than ten years or the life of the beneficiary, whichever is the lesser period, with a reversion to the grantor, would be taxed upon the income produced by the property and received by the beneficiary. The theory upon which the ruling was based is that such an assignment is equivalent to the assignment of a "carved out" production payment and hence an assignment of income taxable to the grantor, unless it can be shown that the term of the trust would extend over the entire depletable life of the property, i.e., that the minerals would be exhausted before the trust terminated.

At first glance one might be inclined to think that this recent pronouncement is a result of the Service's having obtained a key to increased revenue in the form of Commissioner v. P.G. Lake, Inc.; however, a closer scrutiny may demonstrate that the theoretical basis of this ruling is strong enough to persist and harass the tax planner.

Because this is a very important planning area, it would seem advisable to examine this problem to see what logic prompted the ruling, to determine if the ruling is a correct statement of the law, and if so, to ascertain whether such a law is fair and just in the light of a critical analysis. In seeking to accomplish this purpose, the following factors will be analyzed: reasons for the Service's position, cases bearing upon the assignment of income problem generally, the Clifford case and the Grantor Trusts Provisions (sections 671-78 of the Code), the carved-out oil payment, and the definitional problem.

III. REASONS FOR THE SERVICE'S POSITION

The taxpayer was advised, after making his initial request for the ruling, that because the Supreme Court had granted certiorari in the Lake case, no ruling would be issued pending the outcome of that

---

17 For references to the private ruling, see Jewett, Estate and Gift Tax Consequences of Oil and Gas Ventures, Southwestern Legal Foundation 10th Annual Inst. on Oil & Gas L. & Tax. 389, 399 (1959); Johnson, Tax Problems of an Operator of Oil and Gas Properties, 1959 Ill. L. Forum 615, 628.
18 See Johnson, supra note 17, at 628.
case. After the decision was forthcoming, the request was renewed and the ruling under discussion was issued. This sequence of events gives some indication of the Service's position.

If the Service believed the Grantor Trusts Provisions applied to the proposed transfer to the trust of all of the taxpayer's interest in the mineral property, the Service would have issued a favorable ruling or else have shown wherein the terms of this trust violated the provisions and required the taxation of the income to the grantor.\(^2\) Also, the refusal to rule pending the Lake decision and the discussion in the ruling of G.C.M. 24849\(^2\) and I.T. 4003\(^2\) would have been unnecessary since neither applies to the statutory requirements. Therefore, this ruling apparently means that the Service feels the Grantor Trusts Provisions do not apply where the property transferred is any kind of mineral interest with a depletable life that will exceed the term of the trust.

One of the principal reasons for the Service's ruling probably stems from the decision of the Supreme Court in the Lake case. There, the Court held that the consideration received for the transfer of certain carved-out production payments was taxable as ordinary income and not taxable at capital gains rates. The Court was of the opinion that the transfers were anticipatory assignments of income and not the transfer of capital assets. In reaching its decision the Court cited I.T. 4003, which held that the assignment of an in-oil payment right which extends over a period of less than the life of the depletable interest from which it is carved is an anticipatory assignment of income.\(^2\)

The Service stated that since under the facts of the requested ruling it was not shown that the minerals would be exhausted before the trust terminated, it was equivalent to a carved-out production payment even though it was recognized that the taxpayer proposed to transfer all his interest to the trust, retaining only a reversion after the term.

Since Congress has enacted specific statutes governing the tax consequences of transfers of income-producing property in trust, these provisions would presumably control. To avoid this conclusion, it would seem the Service must have some reason for denying the application of these statutes. This reason is probably found in the language of the regulations under section 671, which provides in part as follows:

However, the provisions of Sections 671-678 do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his rights to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in Sections 671-677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust.24

This regulation in turn appears to be derived from a discussion of section 671 in the Committee Reports:

Thus, this subpart has no application in situations involving assignments of future income to the assignor as in Lucas v. Earl (281 U.S. 111), Harrison v. Schaffner (312 U.S. 579) and Helvering v. Horst (311 U.S. 112), whether or not the assignment is to a trust. . . .25

Consequently, under the Service's views, if such a transfer is an assignment of income, it is taxable to the grantor under the Lake decision since the Grantor Trusts Provisions do not apply where an assignment of income is involved.

These, then, are the principal reasons underlying the Service's position: First, such a transfer by a grantor of all his mineral property to a short-term trust with a reversion in the grantor after the term is equivalent to an oil payment and is an anticipatory assignment of income taxable to the grantor; and, second, the Grantor Trusts Provisions, though fully satisfied, will not transfer the tax liability away from the grantor since these provisions do not apply to situations involving an assignment of future income. Each of these reasons will be considered more fully hereafter.

IV. Cases Bearing on the Assignment of Income Generally

Without attempting to cover the multitude of cases on this problem, it is usual to begin with Lucas v. Earl,26 a recognized classic which was cited in the two main sources upon which the Service must have relied, viz., the Committee Reports and the Lake case. In the Lucas case, Earl and his wife entered into a contract whereby they agreed that any property either of them owned or thereafter acquired, including earnings and salaries, would be owned by them as joint tenants. Thereafter, the question arose as to who was taxable on salaries earned by Earl. The Court cited the controlling statute27 defining income and stated its holding as follows:

24 Treas. Reg. § 1.671-1(c) (1956).
26 281 U.S. 111 (1930).
27 The Revenue Act of 1918, § 213(a).
There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.\textsuperscript{28}

This language was the first statement of the "tree and fruit" doctrine. This often quoted principal has not been seriously questioned since that time. However, the avoidance of this problem is not, of itself, necessarily decisive where transfers in trust are involved.\textsuperscript{29}

A case which, by way of contrast, is very important is that of \textit{Blair v. Commissioner}.

The taxpayer, a life income beneficiary of a testamentary trust, made certain donative assignments of a portion of the income from the trust for the remainder of his life to certain donees. The Commissioner argued that the income received by the donees was taxable to the donor, citing \textit{Lucas v. Earl}, among others, as controlling. The Supreme Court stated that these cases were not in point, that the tax here is not upon earnings which are taxed to the one who earns them, that there was no question of evasion or of the taxpayer's retention of control, but that the tax in this case is upon income which, under the general application of the revenue acts, attaches to ownership. The Court carefully pointed out that the taxpayer was the owner of an equitable interest in the corpus which entitled him to enforce the trust, to enjoin a breach of trust, to obtain redress in case of a breach, and to alienate his interest like any other present interest in property.\textsuperscript{30} This decision must be considered in any attempt to decide whether a given transaction is a transfer of a substantial property interest or a mere assignment of income.

In \textit{Helvering v. Horst} the donor taxpayer detached interest coupons from bonds prior to their maturity and gave them to his son, who received the income therefrom. In holding that the income was taxable to the donor, the Court said:

Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions. . . . When, by the gift of the coupons, he has separated his

\begin{itemize}
  \item \textsuperscript{28} \textit{Lucas v. Earl}, 281 U.S. 111, 114-15 (1930).
  \item \textsuperscript{29} The transfer must also be for a substantial duration. See \textit{Harrison v. Schaffner}, 312 U.S. 579 (1941).
  \item \textsuperscript{30} 309 U.S. 5 (1937).
  \item \textsuperscript{31} Id. at 13.
  \item \textsuperscript{32} 311 U.S. 112 (1940).
\end{itemize}
right to interest payments from his investment and procured the pay-
ment of the interest to his donee, he has enjoyed the economic benefits
of the income in the same manner and to the same extent as though
the transfer were of earnings, and in both cases the import of the
statute is that the fruit is not to be attributed to a different tree from
that on which it grew.²³

This case was likewise cited by both the Committee Reports and
the Lake case.

Another case which must be considered in this regard is Harrison
v. Schaffner.²⁴ In this case a life beneficiary assigned a portion
of the income from a trust to her children for one year. The Court had
no difficulty distinguishing this case from Blair and holding the as-
signor taxable on the income received by the assignees.²⁵ In other
words, the transfer of an interest for the life of the grantor will
carry with it the income tax burden, but the transfer of such an
interest for one year will not.

These, then, are the landmark cases which are recognized as con-
trolling. How would they apply to the problem under consideration?
First, the facts of Lucas v. Earl are far removed from our situation.
Salary is always ordinary income taxable to the person who earns it.
Therefore, this case is not actually in point, since in the problem
under discussion the grantor proposed to transfer all of his interest
in the mineral properties to the trust. However, the “tree and fruit”
doctrine does apply and is a valid test. Consequently, if the tax-
payer in question had assigned only the fruit, he would be taxed
on the income as it arises. Our taxpayer not only proposed to assign
the tree to the trust, but because of the peculiar nature of this prop-
erty, the beneficiary would also receive part of the tree. This, then,
goes beyond the requirements of the “tree and fruit” doctrine.²⁶

In the Horst case, there was, again, a situation that is not at all in

²³ Id. at 120.
²⁴ 312 U.S. 579 (1941).
²⁵ Id. at 582.
²⁶ For example, the assignment of stocks and bonds to a trust which satisfies the pro-
visions of §§ 671-78, or in lieu thereof, the “bundle of rights” rule under prior law, would
shift the income therefrom to the trust beneficiary with all of the stocks and bonds
returning in full to the grantor at the end of the term. For discussion see Cleary, supra
note 13, at 744; Craven, supra note 1, at 905; Holland, Kennedy, Surrey, and Warren,
supra note 13, at 363.

To change this example, then, to the transfer of a mineral interest (which if sold at
a gain would, like the stocks and bonds, be subject to the capital gains provisions) should
result in the same treatment; the only difference being that the grantor will not get all
his tree back, since the oil produced is itself part of the tree. To compensate for this
fact, most state laws require that unless the grantor expressly provides otherwise, the de-
pletion allowance on a wasting asset held in trust shall not be distributed to the income
beneficiary, but a portion of the income shall be retained by the trustee as corpus. 3 Scott,
point. Clearly, Mr. Horst transferred only the fruit (interest coupons) and not the tree (the bonds). In the problem being considered, the taxpayer proposed to transfer both the tree and fruit at the same time (this is always the case where a wasting asset is involved), and he would only receive back the part of the asset remaining when the trust terminated. However, it should be noted that had Mr. Horst transferred the bonds with the interest coupons attached in trust for ten years, assuming the Grantor Trusts Provisions were otherwise satisfied, the income from the coupons as they matured would be taxable to the beneficiary under present law.\textsuperscript{37}

Under prior case law, the Clifford Regulations, and the 1954 Code, the fact that both the “tree and fruit” were transferred would not place the income tax burden upon the donee unless the transfer of the property was for a substantial length of time. This concept was early espoused in the \textit{Schaffner} case, which was also cited in the \textit{Lake} case and in the Committee Reports under section 671. Although this test is pertinent, clearly our facts are distinguishable since the term of the trust was for ten years or the life of the beneficiary, whichever was less, and this would satisfy the test under the 1954 Code and probably under prior law.\textsuperscript{38}

In \textit{Schaffner} the Court was very careful to point out that a gift for a day, month, or year was taxable to the donor, but that income from the assignment of a life interest in trust was taxable to the donee. Thus, the facts in \textit{Schaffner} are also clearly distinguishable from those in the \textit{Blair} case.\textsuperscript{39} Certainly, if \textit{Schaffner} had been permitted to prevail, there would be serious erosion of the tax base since all one would need do to avoid the receipt of income for a year would be to transfer the right to that income for that year. However, this was not the case under \textit{Blair}. There, the Court believed, and rightly so, that a substantial, long-term interest had been transferred. The distinguishing feature between the two cases was that under \textit{Blair} the term was substantial so that the erosion factor was not present.\textsuperscript{40}

In \textit{Farkas v. Commissioner}\textsuperscript{41} the taxpayer, a beneficiary of a testamentary trust, transferred all his interest therein to a trust which would terminate after ten years or upon the death of his brother, whichever occurred first. The income from the trust was payable to


\textsuperscript{38} \textit{Int. Rev. Code} of 1954, § 673 (a), (c). See also 6 Mertens, op. cit. supra note 13, at § 37.39.

\textsuperscript{39} \textit{Harrison v. Schaffner}, 312 U.S. 579, 582 (1941).

\textsuperscript{40} See Note, 57 Harv. L. Rev. 382 (1944).

\textsuperscript{41} 170 F.2d 201 (5th Cir. 1948).
the brother. The court stated that the fact the thing assigned could revert to the settlor upon the brother’s death, standing alone, would not render the income taxable to the settlor. The court then emphasized that the taxpayer had assigned a substantial, equitable interest in property and was not taxable on the income therefrom, citing Blair as controlling. The court also stated that the settlor had retained no control which would require the application of the Clifford doctrine. The judge in the concurring opinion pointed out that the Clifford Regulations, enacted after the years in question, added conclusive support to the determination, saying:

They do this by fixing for the future the line within which, though assigned, trust income is taxable to the grantor as substantial owner thereof at within ten years “commencing with the date of the transfer”, thus extending protection to assignments, the duration of which is almost, if not quite, identical with that of the assignment in this case.43

Although the majority opinion is unquestionably accurate, the concurring opinion illustrates the belief that if the transfer to a short-term trust satisfied the Clifford Regulations, the forerunner to the 1954 Code provisions, the grantor would not be taxed on the income during the term.

The Committee Reports do not mention the Blair case when citing the circumstances to which the Grantor Trusts Provisions would not apply, nor has the Service had any question as to the applicability of that case where grantors have transferred long-term interests into trust. In Revenue Ruling 55-3844 it was held that if a life income beneficiary of a trust assigned the trust income irrevocably for more than ten years, such income would be taxable to the assignee. This was the case of an assignment of pure income, but the duration of the assignment was sufficient to give the assignee such substantial rights therein that under the Blair decision it was considered adequate to shift the tax burden from the trust beneficiary to the assignee. The Service has also ruled that where two children transferred income-producing property to their mother for her life, reserving the remainder, the children were not taxable upon the income therefrom during the life of their mother.44

It would seem from the above discussion that the Service is on unsound ground in arguing that Congress intended to exclude the transfer by a grantor of all of his mineral interest, in trust, while retaining a reversionary interest, from the provisions of sections 671-

43 Id. at 204.
The cases referred to above demonstrate that the Service would also be on unsound ground in its holding under prior law even if the 1954 Code provisions did not apply.

V. THE CLIFFORD PROBLEM AND THE GRANTOR TRUSTS PROVISIONS

Probably no other case in all of the tax law has received more comment, been less satisfactory, or engendered more litigation than that of Helvering v. Clifford. It has been said that a decision under the Clifford Rules has no more value as binding precedent than a decision in an average negligence suit, that the court was indulging in judicial legislation, and that the court failed to lay down any standards or guides of conduct for the taxpayer.

Under the facts, Mr. Clifford set up a trust, funded with certain securities he owned, for a term of five years, or the death of his wife or himself, whichever first occurred, with the undistributed net income payable to the wife or her estate as her absolute property upon termination. Mr. Clifford, as trustee, had absolute discretion in deciding how much income, if any, would be distributed each year and had broad powers, including the right to vote, sell, invest, and exchange the stock. It was stipulated that the tax effects were not the sole consideration for the trust, that there was no restriction on the wife's use of the income she received, and that the trust was not designed to relieve Mr. Clifford of his obligation of support. The Supreme Court cited section 22(a) of the 1934 Act defining gross income as controlling and made the following statement:

Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus.

The Court, in affirming the Board's decision, held that (1) the short duration of the trust, (2) the fact that the wife was the beneficiary, and (3) the retention of control over the corpus by the grantor, led irresistibly to the conclusion that Mr. Clifford continued to be the owner of the property. In reaching this holding the Court emphasized that there was no substantial change in his economic posi-

---

49 309 U.S. 331 (1940).
6 Mertens, op. cit. supra note 13, at § 37.39; Greenberger, supra note 13, at 166; Nance, Taxation of Trust Income to Grantors and Others as Substantial Owners of the Property, 33 Taxes 899 (1955).
tion due to his dominion and control over the property, and although no one fact is normally decisive, where the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, the income must be taxed to Mr. Clifford. The Court further indicated that since Congress did not adopt any rule to determine this problem, it would be a question of fact in each case whether the grantor remains the owner and hence subject to the tax on the income.\(^\text{9}\)

The language used by the Court in *Clifford* has since been said to establish a "bundle of rights" test for these cases. If too many "rights" are retained, the grantor remains the owner for tax purposes; if not, the trust or beneficiary bears the tax.\(^\text{90}\) For five years the battle raged to determine how small this "bundle" must be before the grantor could successfully deflect the tax liability, until a truce was presented in the form of the Clifford Regulations.

Another item of significance must be pointed out which may clarify the Service's position. The Court in the *Clifford* case specifically stated that in view of the result reached there was no need to examine the contention that the trust device fell within the rule of *Lucas v. Earl*, relating to the assignment of future income. This illustrates a principle which is often confused. First, the *Clifford* case was not decided on the ground that the taxpayer assigned the income. The only question decided by the Court was whether Mr. Clifford remained the owner of the securities by virtue of the "bundle of rights" he retained.\(^\text{91}\) Second, the *Clifford* case differs from the *Blair* case in that the question under the latter decision was whether Mr. Blair had anticipatorily assigned his right to receive future income. The Court was not concerned with whether Mr. Blair remained the substantial owner of the interest assigned by reason of his retention of control and the other factors involved in the *Clifford* case. This aspect would appear very important to the Service's view that the Grantor Trusts Provisions do not apply to the assignment of income problem.

Section 671 provides that no items of a trust shall be included in computing the taxable income and credits of the grantor or any other person solely on the grounds of his dominion and control over the trust, except as specified in this subpart.\(^\text{92}\) The Congressional

---

\(^{9}\) Id. at 338.

\(^{90}\) Cleary, supra note 11, at 744.

\(^{91}\) Helvering v. Clifford, 309 U.S. 331, 338 (1940).

\(^{92}\) For an excellent discussion of the technical requirements under the Grantor Trusts Provisions see Yohlin, The Short-Term Trust—A Respectable Tax-Saving Device, 14 Tax L. Rev. 109, 123 (1958).
intent in enacting this provision is, in turn, explained in the Committee Reports as follows:

The effect of this provision is to insure that taxability of Clifford type trusts shall be governed solely by this subpart. However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust.\(^3\)

The Committee Reports further state that the subpart has no application in situations involving assignments of future income as in the *Earl, Schaffner,* and *Horst* cases. This points up the dilemma considered herein very precisely. If the question presented is whether the grantor remains the substantial owner as in *Clifford* because he has retained an equivalent "bundle of rights," the question shall be answered under sections 671-78 without regard to the hodgepodge of prior law on the subject.\(^4\) If the situation involves an assignment of future income as in *Earl, Schaffner,* or *Horst,* sections 671-78 have no application to that problem. This must mean that the fact that interest coupons or salary rights are transferred into a trust for ten years, which satisfies all the statutory requirements, is not, of itself, determinative that this transaction is not an assignment of income taxable to the grantor. In other words, Congress did not intend to establish an arbitrary test which would afford a basis by which it could be argued that the transfer of rights to salary or interest payments in conformity with the Grantor Trusts Provisions would pass the tax liability to the beneficiary.

This analysis points up the ambiguity in the Committee Reports and appears to lend support to the Service's position that the Grantor Trusts Provisions have no application since the Service is not arguing dominion and control but the assignment of income question. However, Congress specifically pointed out the types of income transfers to which these provisions were inapplicable. In reality every transfer to a short-term trust involves a transfer of income since the grantor gets back his corpus on termination.\(^5\) Consequently, if the Service's view is correct, the Service could foreclose the application of the statutes in every instance merely by raising the assignment of income question. The discrepancy in this position can be easily illustrated. For example, if Mr. Clifford, after the effective date of the 1954 Code, were to transfer his securities into a short-term trust which satisfied

the Grantor Trusts Provisions while retaining a reversionary interest, the fact that the Service could again raise the assignment of income question, as they did in the initial case, should not make these provisions any less controlling. In discussing section 671, Congress emphasized that the effect of this provision is to insure that the taxability of Clifford type trusts shall be governed solely by the Grantor Trusts Provisions. This must mean that the Service cannot avoid the controlling effect of these statutory provisions merely by raising the assignment of income question.

The questionable validity of the Service's position on this problem can best be illustrated by looking at the provisions of section 673 (b). There, Congress provided that a grantor would not be considered the owner of any portion of a trust in which he has a reversionary interest to the extent the income of any such portion is irrevocably payable for a period of two years to certain enumerated types of charitable beneficiaries. The reason Congress pointed this out so clearly was to avoid the Schaffner problem. In the absence of a statute, such a transfer would have been of too short a term, the interest transferred too insubstantial, to shift the income tax burden to the donee. However, Congress felt the charitable motives important enough to write in this specific exception, permitting, in effect, the assignment of income in this fashion. This illustrates that Congress did provide an arbitrary test on the assignment of income question in these provisions and tends to refute the Service's interpretation of the Committee Reports to the contrary.

An additional illustration of the questionableness of the Service's position can be seen by the fact that the statute also permits the term to depend on the life of the donee. This is permissible regardless of the life expectancy of the donee. For example, if the donee's

57 See Sneed, The Economic Interest—An Expanding Concept, 35 Texas L. Rev. 307, 316 (1957); Yohlin, supra note 32, at 116.
59 To be consistent with its holding on the requested ruling, the Service, it would seem, must also rule that the transfer of any mineral interest to a two year trust for a qualified charity, with reversion in the grantor, would not relieve the grantor from the tax liability on the income received by the charity. Such a position would appear incongruous since any other property so transferred would, in the absence of § 673 (b), probably be considered a mere attempt to assign income, and the grantor would not avoid the tax. See for discussion authorities cited in note 58 supra.
60 Int. Rev. Code of 1954, § 673 (c).
life expectancy is only one year, the trust could still satisfy the statutory requirements and the income would be taxed to the donee. Consequently, under this example, the grantor's mineral interest must have a life of less than one year under the Service's view, which would again negative the application of the statute and the intent of Congress in enacting it. This intent is clearly evident from the following language in the Committee Reports concerning section 673:

Subsection (c) contains a further exception . . . to the effect that the grantor shall not be treated as the owner of a trust by reason of a reversionary interest where such interest is to take effect only on the death of the person or persons to whom the income is payable. This rule is applicable even though, due to the short life expectancy of the beneficiary, the reversionary interest may reasonably be expected to take effect within 10 years.\(^6\)

If the interest transferred will be exhausted before the trust terminates, the grantor has no reversion and has given away all his interest in the property, which would relieve him from the income tax liability without regard to this statutory provision. This statutory exception was unnecessary if the Grantor Trusts Provisions only applied to a gift of the total interest. For this reason, it is difficult to see the validity of the Service's position that there must be no reversion of the mineral interest transferred since the statement of congressional intent in enacting these sections contains no such exception, but to the contrary, specifically permits reversions without limitation as to the kind of property held by the trust.

VI. THE CARVED-OUT OIL PAYMENT

Since the Service stated that under the facts of the requested ruling the transfer by the taxpayer of all his mineral interest in trust with a reversion to him after the term was essentially equivalent to a carved-out oil payment, some review of the carved-out oil payment question would be advisable. This question was early raised in G.C.M. 24849\(^6\) where the Service stated that assignments of in-oil payment rights by owners which were carved out of economic interests held by them were essentially, with respect to the assignor, mere assignments of expected income from such property. The Service reasoned that this was similar to the receipt of a cash bonus by a lessor, the assignment of the right to future dividends by a stockholder, or the assignment of income rights by the earner. This

---

was the result even though it was stated that the assignee of the carved-out oil payment had a depletable economic interest in the oil and gas in place, which was potentially a capital asset. The Service pointed out that such carved-out oil payments ordinarily pay out within one or two years, and no opinion was expressed as to in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved. Three years later the Service ruled that donative assignments of short-lived in-oil payment rights carved out of any type of depletable economic interest in oil and gas in place were assignments of future income, taxable to the donor as ordinary income, and subject to depletion as the income arises. The following year saw the culmination of this reasoning in I.T. 4003, wherein the Bureau stated that the assignment of any in-oil payment right (not pledged for development) which extends over a period less than the life of the depletable property interest from which it is carved is essentially the assignment of expected income from such property interest.

In spite of numerous efforts by the Service to convince the judiciary of the validity of its position that the assignment of a carved-out oil payment is not the transfer of a capital asset, but ordinary income, they were unable to achieve much success until the decision by the Supreme Court in the Lake case. Already, we have the benefit of many excellent writings on this case and the observations of those among the Bar who have labored over its meaning.
The principal question involved in Lake was whether the consideration for the assignments, which admittedly was taxable to the assignors, was to be taxed at capital gains or ordinary income rates. For this reason, it was unfortunate that the court, in citing I.T. 4003, also included the portion dealing with the donative assignment of oil payments. Since the donative assignment problem concerns the question of who pays the tax, and not whether there has been a conversion of a capital asset, it was totally unrelated to the question for decision and was mere dicta. However, this dicta becomes more palatable when it is realized that three of the principal cases relied upon by the court in the Lake case were carefully distinguished by the courts deciding them from the facts existing under the Blair decision, which did involve a donative transfer. In fact, the Court in Helvering v. Horst (which was relied upon heavily by the Court in Lake), in distinguishing its facts from the Blair case, had this to say:

> Since the gift was deemed to be a gift of the property, the income from it was held to be the income of the owner of the property, who was the donee, not the donor—a refinement which was unnecessary if respondent's contention here is right, but one clearly inapplicable to gifts of interest or wages. Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away.\(^7\)

This would indicate that the Lake case should not affect the efficacy of the Blair decision or any other donative transfer where income-producing property is transferred and the term of the transfer is substantial.

Lake did not involve a donative transfer in trust, the 1954 Code provisions, or the assignment by a taxpayer of all his mineral interest as distinguished from a carved-out oil payment. For these reasons, it is not determinative where the taxpayer assigns all his mineral interest to a short-term trust, retaining a reversionary interest as permitted by statute.

VII. THE DEFINITIONAL PROBLEM

The crux of the problem considered herein is the determination that the proposed transfer in the requested ruling was equivalent to an oil payment. For this reason, it would appear necessary to examine the question of what constitutes an oil payment.

\(^7\) 311 U.S. 112, 118-119 (1940).
The Supreme Court has defined an oil payment as "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced. . . ." An oil payment has also been defined as a right to oil and gas in place which entitles its owner to a specified fraction of production for a limited period of time, or until a specified sum of money or a specified number of units of oil or gas have been received.

In-oil payment rights were defined in G.C.M. 24849 as follows:

Such rights entitle the assignee to oil or gas produced, or the proceeds derived from an agreed share of production, if, as, and when produced, until a fixed or determinable amount of oil or gas, or an ascertainable sum of money, has been received.

Nevertheless, in the requested ruling, the Service, in effect, held that the assignment by a taxpayer of his entire mineral interest, in trust, for a term which was less than the life of the depletable property transferred was a carved-out oil payment.

Normally an oil payment is created when a mineral owner transfers a right to receive a specified sum of money or a specified quantity of oil or gas payable out of a specified percentage of production. Most of the litigated cases have involved this type of oil payment. This type of transfer is clearly within the Supreme Court's definition and has never been hard to classify. Likewise, it has been held that an oil payment results where the owner transfers half of his mineral interest to another until the transferee has received a specified sum of money. This type of transfer would also be classified as an oil payment under the above definitions.

Apparently no one has seriously questioned the definitions which have been utilized to determine if an oil payment exists. This is because in the decided cases the transfers would have been classified as oil payments under any one of the above definitions. The prin

---


69 Breeding and Burton, Taxation of Oil and Gas Income § 6.01 (1954); Appleman, Exchanges of Properties of Like Kind in the Oil Business, N.Y.U. 11th Annual Inst. on Fed. Tax. 273, 279 (1953); Krystal, Tax Consequences of Lease Transactions, P-H Oil & Gas Taxes 1101, 1107; Patterson, Carved-Out Oil Payments, P-H Oil & Gas Taxes § 1011; Rowen, Introduction to Oil and Gas Interests, 34 Taxes 19, 21 (1956).


71 Cases cited note 61 supra.

72 Rudco Oil & Gas Co. v. United States, 82 F. Supp. 746 (Ct. Cl. 1949); Estate of M. M. Cook, 27 B.T.A. 33 (1932).
Principal use of the term "oil payment" was to describe an interest, the duration of which was not coextensive with the producing life of the property from which it was payable, so as to distinguish it from a royalty interest. The question involved in the cases usually was whether the owner who assigned an oil payment out of a larger mineral interest retained by him would be taxed at capital gains or ordinary income rates. 73

The Service appears to have broadened the definition of what constitutes an oil payment considerably. The cases and statutes permit an owner to make a donative transfer in trust of his income-producing property for a substantial term and thereby transfer the tax liability on the income produced during the term to the transferee. 74 The validity of this concept is elementary in the tax law and applies to the transfer of all income-producing property. 75 The Service, nevertheless, has said that if the property transferred is a mineral property, this is equivalent to the carving out of an oil payment if the life of the property transferred will exceed the term, and is an assignment of income taxable to the assignor. In other words, under the Service's view, the assignor of a mineral interest would have to give all his interest away in order to avoid the income tax on the income received by the transferee. This would place the owner of a mineral property in a unique position, indeed, under prevailing legal theory.

The fallacy of this position can be illustrated by one of the Service's own examples. The Service has likened the carved-out oil payment to the assignment of the right to future dividends on stock without transferring the stock itself and hence an assignment of income. 76 Since the owner of the stock could transfer the stock for a substantial term which would also transfer the tax liability on the dividends accruing during the term to the transferee, 77 the mineral owner should be able to transfer his income-producing mineral property with like results if the analogy chosen by the Service is a true one. This would seem to indicate either that perhaps the definition of an oil payment should be restricted to that pronounced by the Supreme Court or that there cannot be a carving-out of an oil payment where all the income-producing mineral in-

75 See note 1 supra.
interest owned by the grantor is transferred in trust for a substantial term.\textsuperscript{78}

Apparently the Service is bothered here because the beneficiary receives the same income whether the grantor transfers an oil payment, in fact, or the entire mineral property for the term, and the grantor may well have the same mineral interest after the term regardless of which approach is taken. What the Service possibly fails to realize is that this is true where any income-producing property is transferred to a short-term trust. All the beneficiary normally receives is the income and the corpus reverts to the grantor. The law permits the grantor to escape the tax on the income during the term if he transfers his income-producing property; if he only assigns the right to dividends or interest, he is taxed on the income.

The results may be equivalent in either event, but the statutes and case law make a distinction which the Service has seen fit to ignore in this instance.

Under the facts upon which the ruling was requested, as stated above,\textsuperscript{79} the grantor conveyed all his mineral interest to the trust which satisfied the Grantor Trusts Provisions. The beneficiary had a right to all the income from the trust which was indefinite in amount and not a specified sum or the income from a specified percentage of production. There was no monetary limit or any limit other than the term of the trust, which was of substantial duration and satisfied the statutory requirements. The interest conveyed could not be classified as an oil payment under the Supreme Court's definition as pronounced in the \textit{Anderson} case and as reaffirmed in the \textit{Lake} decision.

If a transfer of all of a grantor's mineral interest into a trust which satisfies the Grantor Trusts Provisions is not a carved-out production payment, the assignment of income question never arises and the Grantor Trusts Provisions clearly control. If it is a carved-out production payment, then it must be decided if it is an assign-

\textsuperscript{78} To further illustrate, if the grantor were to transfer the right to receive a specific amount of money payable out of production from mineral property to a trust, this might be said to be analogous to the transfer of interest coupons without transferring the bonds. See Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 267 (1958). However, if the grantor transfers the entire mineral interest for a substantial term (at least ten years), this is analogous to the transfer of stock, which would also transfer the tax liability on the income to the transferee receiving the income. Whether the grantor transfers stock or all his mineral interest, the beneficiary of the trust has an equitable interest in the corpus which entitles him to enforce the trust, to enjoin a breach of trust, to obtain redress in case of a breach, and to alienate his interest like any other present interest in property. Blair v. Commissioner, 300 U.S. 5, 13 (1937). It would, therefore, appear unrealistic to say that the transfer of the entire mineral interest in trust would be any more equivalent to a production payment than the transfer of stock under similar facts.

\textsuperscript{79} See pp. 496-97; see also authorities cited in note 17 supra.
ment of income taxable to the grantor, a transfer of a property
interest within the Grantor Trusts Provisions with the income taxable
to the donee, or a transfer of a substantial property interest
under prior trust cases and taxable to the donee. For these reasons,
a judicial determination of the definitional problem as applied to
the facts of the proposed ruling would be helpful.

VIII. Conclusion

It would appear from the foregoing that the position taken in
the informal ruling either discriminates unfairly against the use of
mineral interests in short-term trusts, or the ambiguity in the
Treasury Regulations under section 671 is being utilized in such a
manner that, if the same position is consistently applied to other
types of property when placed in such trusts, the record of litiga-
tion which was the aftermath of the Clifford decision may well be
exceeded.

The foreclosure of tax avoidance through the assignment of in-
come is important to the country's fiscal structure and warrants
added vigilance on the part of the Service, the Tax Bar, and the
taxpayers to see that the system is not abused by numerous schemes
in that direction. Clearly, if the revenues are to be protected and
if our tax system is to work in an effective, fair, and equitable
manner, the assignment of income problem should be settled. Of
equal importance to the economic well-being of our people is a
healthy, stable climate wherein business and personal planning is
encouraged. With these factors in mind, it is hoped that the Service
will reconsider the position taken in the informal ruling to see if
it is really necessary to subject the short-term trust area to another
round of litigation, regulation, and legislation.