1963

Sale or Lease of Mineral Interests - Fact or Fiction

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Recommended Citation
Ottis Jan Tyler, Sale or Lease of Mineral Interests - Fact or Fiction, 17 Sw L.J. 567 (1963)
https://scholar.smu.edu/smulr/vol17/iss4/4

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FACTS are stubborn things. They are stubborn because they are facts. Because they are facts, they cannot yield. Ideas may twist, theories may bend, contentions may yield, but a fact—if it is really a fact—remains rigid and changless.¹

In the interest of uniformity and consistency in the law, it would seem that the legal effect of a sale of a fee simple interest in land with a one-eighth mineral interest retained would be the same in every instance. The transaction should not be considered a “lease” in one instance and a “sale” in another. Unfortunately, this desired uniformity has not been obtained.

The determination of whether a particular transaction is to be treated as a conveyance of all of the transferor’s interest in the minerals under his land or merely as a lease for production is not as simple as it may appear.² Distinctions arise not only in the name given a particular transaction, but also in the legal relations created by it. Statements can be found to the effect that the legal result is governed by certain privileges granted or retained by the parties,³ although it is generally accepted that the intention of the parties should be the predicate of the legal result.⁴ The difficulty lies in finding that intention.

Suppose A owned Blackacre in fee. X went to A and initiated negotiations for the purpose of securing a mineral lease covering Blackacre. A refused to give the lease because the consideration offered by X was not adequate. As an alternative, X then suggested that

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¹ Campbell v. Fasken, 267 F.2d 792, 797 (5th Cir. 1959) (J. Brown, dissenting).
² See Comment, Determination of Whether an Instrument Is a Lease or an Absolute Conveyance of Oil and Gas, 25 Texas L. Rev. 117, 119 (1946).
he would purchase the entire fee interest from A for 100,000 dollars. A proposed a counteroffer of 100,000 dollars cash plus a one-eighth retained interest in the minerals to which X agreed. A contract was then executed containing, inter alia, the following clauses:

The seller (A) does hereby grant, bargain, sell and convey all rights of ownership now owned or subsequently acquired by the seller in Blackacre to the buyer (X).

Notwithstanding the above grant of all interests in the surface and minerals in the estate of Blackacre, the seller does expressly reserve and except for his own interest one-eighth of the undivided minerals in and under Blackacre.

Except for the one-eighth undivided mineral interests hereinbefore reserved and excepted, the seller makes to the buyer all warranties of title.

In consideration for the above conveyance, grant and sale, the buyer does hereby deliver to the seller 100,000 dollars in cash.

In addition, assume that at the time of the execution of the above instrument there had been exploration, development, and production of oil and gas within a radius of five miles of Blackacre but not on any property adjacent to Blackacre. Within a year after execution of the instrument, X began exploration activities on Blackacre which ultimately led to the discovery and production of oil and gas.

What are the legal consequences of the above transactions? Will the results be the same under both substantive law and tax law? In accordance with existing precedent, the following conclusions may be drawn:

(1) In an action between the buyer and the seller or their privies, the above transaction would evidence an outright sale of A's entire interest in the surface and minerals save the one-eighth undivided mineral interest he reserved. The 100,000 dollars would be the sales price of the interest purchased by the buyer.  

(2) For tax purposes, the Commissioner would consider the transaction as a sale of the surface, but merely a lease of the minerals. Accordingly, the consideration received would be apportioned between the sale of the surface and the lease of the minerals. The amount apportioned to the surface would be considered as the sales price, and any gain would be accorded capital gain treatment. The

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* Although the facts of the suggested hypothetical transaction do not fit those of any one particular case, they are the accumulation of various ingredient facts from the following cases which are significant in this area. See Campbell v. Fasken, 267 F.2d 792 (5th Cir. 1959); West v. Commissioner, 150 F.2d 721 (5th Cir. 1945), cert. denied, 326 U.S. 795, rehearing denied, 327 U.S. 815, 2d rehearing denied, 328 U.S. 877, 3d rehearing denied, 328 U.S. 881 (1946); Danciger Oil & Ref. Co. v. Powell, 137 Tex. 484, 154 S.W.2d 632 (1941).

* See notes 9-14 infra and accompanying text.
amount apportioned to the minerals would be considered as a bonus taxable as ordinary income subject to depletion.\(^7\)

(3) For tax purposes, the courts would likely consider the entire transaction as a completed sale and not merely a lease of the minerals.\(^8\)

The discussion that follows is an analysis and evaluation of the reasoning and theories that have been advanced in support of the above described conclusions. Although primarily concerned with the taxation problems involved, an inquiry into the substantive law is a requisite for a thorough treatment.

I. The Substantive Law Question

In disputes between the parties or their privies, the sale or lease question usually has arisen in one of two contexts. Either the plaintiff-transferor was seeking to have the estate of the transferee declared terminated because of abandonment\(^9\) or nonuse, or he was attempting to recover damages or declare a forfeiture because of a breach of implied covenants.\(^10\) The transferee has generally answered that there could be no abandonment of an interest by mere nonuse or that there was no breach of the implied covenants.

\(^7\) The authority for this conclusion is G.C.M. 27322, 1952-2 Cum. Bull. 62. See notes 74-81 infra and accompanying text.

\(^8\) This conclusion is based on the absence from the hypothetical facts of a covenant to develop which was held to be controlling in Campbell v. Fasken, 267 F.2d 792 (5th Cir. 1959); West v. Commissioner, 150 F.2d 723 (5th Cir. 1945), cert. denied, 326 U.S. 795 (1946); and Arthur N. Trembley, 7 CCH Tax Ct. Mem. 972 (1948); 17 P-H Tax Ct. Mem. 862 (1948). See notes 47-70 infra and accompanying text.

\(^9\) At common law, incorporeal interests, but not corporeal estates, were subject to extinguishment by abandonment. 3 Powell, Real Property 423 (1952). Thus, it becomes of controlling importance to determine whether the mineral interest is classified as incorporeal or corporeal. E.g., Boatman v. Andre, 44 Wyo. 352, 12 P.2d 370 (1932). However, in those states, such as Texas, which have adopted the "ownership in place" theory, the severed mineral interest (Humphreys-Mexia Co. v. Gammon, 113 Tex. 247, 254 S.W. 296 (1923)) and the interest of an oil and gas lessee (Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290 (1923)) are viewed as corporeal estates. Accordingly, it would seem that the interest received by a transferee under any instrument, whether it be considered a lease or a deed of conveyance, would not be subject to extinguishment by abandonment in the states following the "ownership in place" theory. See, e.g., Barrett v. Kansas & Texas Coal Co., 70 Kan. 649, 79 Pac. 170 (1901). The Texas Supreme Court in Texas Co. v. Davis, 113 Tex. 321, 254 S.W. 304 (1923), held that the interest of a lessee was corporeal and hence not subject to abandonment. However, the court stated that an oil and gas lease is executed for the purpose of mineral exploration, and if the lease is no longer held for that purpose but for reasons of speculation on the part of the lessee, the estate terminates without need of further conveyance. It is uncertain whether this principle will apply to an absolute conveyance, but it would seem to be the better view that it does not apply if the instrument is actually an absolute conveyance. Thus, the importance of the lease-sale dichotomy again becomes paramount. It should be noted that Kentucky classifies severed mineral interests as corporeal but leasehold and royalty interests as incorporeal. See 1 Williams & Meyer, op. cit. supra note 2, at § 209.

cause the estate possessed was indefeasible and not merely determin-
able.

Such controversies apparently never arise if the instrument in-
volved is clearly labeled as a lease. However, if the instrument is
labeled as a sale or absolute conveyance, a question of legal inter-
pretation often develops. If the transaction is held to be an absolute
conveyance, the transferee receives a fee simple or indefeasible estate.
If, on the other hand, the transaction is held to be a lease, the trans-
feree receives a determinable fee. Generally, the courts have inter-
preted the instruments to be leases or deeds depending upon the
number of detailed conditions placed upon the transferee. However,
the court of appeals of Kentucky has developed an independent
criteria of distinction—the amount of initial consideration. By ex-
amining the cases falling in each classification, the distinguishing
characteristics of a particular transaction may be seen.

A. Absolute Conveyance

In each situation in which the instrument involved was construed
to be an absolute conveyance rather than a lease, the transferor
"granted, bargained, sold and conveyed" all his right and title to the
minerals for a cash consideration, but reserved an interest in all the
minerals. In each case, the provisions of the instrument contained
only the customary provisions found in a deed. In no case was there
any symbolance of the language found in leases. No implied cov-

11 As to these facts, there would seem to be unanimity of agreement. In each of the
cases, the instrument contained language similar to the "grants, bargains, sells, and conveys" as used generally in the deed of conveyance. The amount of the initial consideration re-
ceived and the amount of mineral interest retained by the grantor are given within the
parenthesis. Whittenburg v. Phillips, 186 F.2d 36 (5th Cir. 1951) (consideration not given
— ½); Brooke v. Dellinger, 193 Ga. 66, 17 S.E.2d 178 (1941) ($4500 — no retained
interest); Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 69 P.2d 4 (1937)
(consideration not given — ½); Ramsey v. Yunker, 311 Ky. 820, 226 S.W.2d 14 (1950)
($370 — ½); Kentucky Natural Gas Corp. v. Carter, 303 Ky. 559, 198 S.W.2d 311
(1946) ($800 — ½); Adams v. Elkhorn Coal Corp., 199 Ky. 612, 251 S.W. 654 (1923)
($208 — ½); Wilson v. Reed, 97 Okla. 46, 223 Pac. 835 (1924) ($15,000 — ½); Orr
v. Murray, 95 Okla. 206, 219 Pac. 333 (1923) ($15 — no retained interest); Loomis v.
Gulf Oil Corp., 123 S.W.2d 501 (Tex. Civ. App. 1939) error ref. ($250 — ½); Ralph
v. Magnolia Oil Co., 95 S.W.2d 222 (Tex. Civ. App. 1936) error ref. ($25,000 — ½);

12 Many of the cases involving the lease-sale problem are decided on the basis of the
absence or presence of implied covenants. See Danciger Oil & Ref. Co. v. Powell, 137 Tex.
484, 114 S.W.2d 652 (1941). However, two cases have recognized the principle that im-
plied covenants may exist in an absolute conveyance (Danciger Oil & Ref. Co. v. Powell,
supra; Freeport Sulphur Co. v. American Sulphur Royalty Co., 117 Tex. 419, 6 S.W.2d
1019 (1928)), but only the Freeport case actually found such covenants to exist. Because
of the peculiar facts in Freeport, the Texas Supreme Court found that the payment of the
royalty by the grantee was the principal part of the consideration for the conveyance.
have been lost or abandoned by nonuse. Moreover, the result appears to be the same if a royalty is retained rather than a mineral interest, although one authority has stated that a royalty would make the transaction a lease. This problem was presented to the Tenth Circuit in Davis v. Mann. There the grantor conveyed the surface fee, but reserved all the mineral interest except the one-eighth royalty given to the grantee. The plaintiff argued that the instrument should be interpreted as creating a relationship in the nature of an oil and gas lease.

Therefore, the court held that the intention of the parties warranted the finding of implied covenants in the absolute conveyance. It appears that it was easier for the court to find implied covenants existing in the deed than to hold the instrument a lease. Compare this approach to the solution adopted by the Kentucky courts discussed in notes 30-36 infra and accompanying text.

In each of the following cases, the instrument contained language similar to the "grants, bargains, sells, and conveys" as used generally in the deed of conveyance. The amount of the initial consideration received and the amount of royalty interest retained by the grantor are given within the parenthesis. Davis v. Mann, 234 F.2d 553 (10th Cir. 1956) (consideration not stated — ½); Duncan v. Mason, 239 Ky. 170, 39 S.W.2d 1006 (1931) ($10,000 — 2½¢ per ton); Anderson v. Sun Oil Co., 207 Miss. 332, 42 So. 2d 234 (1949) ($10 — ½); Danciger Oil & Ref. Co. v. Powell, 157 Tex. 484, 114 S.W.2d 632 (1911) ($100,000 — ½); Texas Co. v. State, 154 Tex. 494, 281 S.W.2d 83 (1955) ($28,000 — ½); Carpenter v. Smith, 272 S.W. 128 (Tex. Comm. App. 1925) ($5 — ½); Lindsay v. Texas Iron & Steel Co., 9 S.W.2d 287 (Tex. Civ. App. 1928) (error ref. ($1 — 2½¢ per ton); Cockerell v. Haynes, 235 S.W. 494 (Tex. Civ. App. 1923) ($20 — $2,000 production payment); Cockerell v. Griffith, 235 S.W. 490 (Tex. Civ. App. 1923) ($25 — ½); Feather v. Baird, 85 W. Va. 267, 102 S.E. 294 (1919) ($1730 — 1¢ per ton).

Summers, Oil & Gas § 132 (2d ed. 1954), citing as authority, Texas Co. v. Davis, 113 Tex. 321, 254 S.W. 304 (1923); Thompson v. Ham, 113 Tex. 329, 254 S.W. 316 (1923); Munsey v. Marnet Oil & Gas Co., 113 Tex. 212, 254 S.W. 311 (1923); Robinson v. Jacobs, 113 Tex. 231, 254 S.W. 309 (1923); Humphreys-Mexia Co. v. Gammon, 113 Tex. 247, 214 S.W. 296 (1923); Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 214 S.W. 290 (1923); states: "The Texas Supreme Court later held that the type of instrument in question, regardless of the language of the granting clause, if it reserves a royalty, is an oil and gas lease, although it creates a defeasible fee in the lessee in a portion of the oil and gas in place." It is submitted that this is not what the above cases say. It is true that in these cases, the transferee was contending that the instrument involved was a deed since the words "have granted, bargained, sold and conveyed" were contained in the granting clause. A 1/10th royalty was also retained by the transferor. But, the court in those cases did not base its decision upon the mere retention of the royalty in holding the instruments to be leases. The controlling factor was that the instruments contained many provisions describing the relationship between the parties. There were varying terms of up to 25 years, and the transferee had to start development within a certain period of time. Accordingly, the court held the instruments were leases rather than conveyances. In so reasoning, the court in Davis said:

The grant was not of an absolute fee. The estate conveyed, on condition subsequent, was a determinable fee, inasmuch as the land might always produce minerals in paying quantities, causing the grant to endure forever, and inasmuch as the intent is unquestionable that the land was to be used for no other purpose than to drill for and produce the minerals, and that the grant was to be enjoyed only while the work of mineral exploration and production was carried on. Texas Co. v. Davis, supra at 306.

See also Walker, Express Clauses in Oil and Gas Leases Affecting the Usual Implied Obligations of the Lessee, 13 Miss. L.J. 292 (1941), which said: "The mere fact that the mineral rights are thereby divided, with the right to receive a royalty upon production vested in one person, and the right to produce vested in another, is not sufficient of itself to establish a 'lease' relationship between the parties." Id. at 293.
leasehold with the usual provisions for the payment of royalties. However, the court reasoned "that by whatever name the reserved interest of the grantor may be called, it constituted the mineral estate in the land, subject only to an obligation to account for a stipulated part of the oil or gas, if the owner of the mineral interest should develop it. . . ." The court then held that the instrument represented an absolute conveyance and not merely a leasehold arrangement.

In addition, even though a royalty may give rise to implied covenants, this alone should not be sufficient to convert a purported deed into a lease. Thus, the hypothetical transaction presented above would be construed as an absolute sale of the mineral interests because the instrument contained only provisions of conveyance and there were no indications that either party intended anything other than an absolute conveyance.

B. Lease

Generally speaking, nomenclature does not control over substance. Since labels are often confusing, the ultimate determination of the legal effect of an instrument depends upon its content. These principles may well be applied to this class of cases. In each of these cases, an instrument, usually entitled "Oil and Gas Deed," contained language to the effect that the grantor thereby "grants, bargains, sells and conveys" all of his "right, title to, and interest in the minerals excepting and reserving a one-eighth interest." If these provisions stood alone without any modifying language or qualifying phrases, they would probably operate to convey a mineral fee in the land. However, the instruments did not stop there. Each pro-

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10 Ibid. at 556.
11 Ibid. at 560.
12 Ibid.
13 See Walker, op. cit. supra note 14, at 294.
14 In each of the following cases, the instrument was held to be an oil and gas lease because of the various provisions other than the granting clause stated in the instrument or because of the provision wherein the transferor retained either a mineral or royalty interest. Crain v. Pure Oil Co., 25 F.2d 824 (8th Cir. 1928); Tennessee Oil, Gas & Mineral Co. v. Brown, 131 Fed. 696 (6th Cir. 1904), cert. denied, 197 U.S. 621 (1901); Lowish v. Rowland, 86 Ind. App. 197, 118 N.E. 913 (1927); Wilson v. Helin, 164 Kan. 229, 188 P.2d 899 (1948); Duncan v. Greene, 253 S.W.2d 592 (Ky. 1952); Dougherty v. Greene, 218 Miss. 210, 67 So. 2d 297 (1953); Back v. Ohio Fuel Gas Co., 160 Ohio St. 81, 113 N.E.2d 865 (1953); Eggleston v. Sinclair Oil & Gas Co., 132 Okla. 81, 269 Pac. 306 (1928); Kelly v. Harris, 62 Okla. 236, 162 Pac. 219 (1916); McMillin v. Titus, 222 Pa. 500, 72 Atl. 240 (1909); Texas Co. v. Davis, 113 Tex. 321, 254 S.W. 304 (1923); Thomason v. Ham, 113 Tex. 239, 254 S.W. 316 (1923); Munsey v. Marinet Oil & Gas Co., 113 Tex. 212, 254 S.W. 311 (1923); Robinson v. Jacobs, 113 Tex. 231, 254 S.W. 309 (1923); Calk v. Miller, 18 S.W.2d 195 (Tex. Civ. App. 1929); Toothman v. Courtney, 62 W. Va. 167, 58 S.E. 915 (1907).
15 See Davis v. Mann, 234 F.2d 553, 556 (10th Cir. 1956).
vided in some manner that the dominant purpose was to obtain exploitation or development of the property for oil and gas mining purposes. Usually, it was stated how and when the first well was to be started or when exploration was to begin. Other provisions described how and when the grantee was to proceed after discovery of oil or gas. The grantee was sometimes given the right to remove all fixtures, and provision was often made for delay rentals. Forfeiture provisions were often included along with clauses providing for a term of years or a reversion should no minerals be found to exist. Certainly, if the instrument was a deed, many of these provisions were mere superfluities. Moreover, in almost every case falling into this classification, had the instrument been labeled as an oil and gas lease rather than as a deed, the instrument would have been almost

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25 F.2d at 829.
identical to the normal oil and gas lease found in many of the form books. In the Crain case, the court stated:

Whatever these instruments may technically be called, it seems clear, from all the terms thereof and the circumstances surrounding the transactions, that the intention of the parties thereto was merely to grant rights to go upon the lands, prospect for oil and gas and other minerals, and, if found, to develop the same and pay royalties there to the owners of the lands; hence they were nothing more than mining leases. 

In each case in this classification, the instrument granted certain privileges to the transferee along with placing certain burdens and obligations upon him. Even though the parties went to such great detail to identify their relationship, the provisions of the instrument determined whether the transaction was a sale or a lease. If the parties desired an absolute conveyance, the instrument should have contained only the granting clause and the reservation without further recitation of detailed provisions inconsistent with a deed.

C. The Kentucky Cases

Several of the decisions of the court of appeals of Kentucky have involved instruments and situations identical to those involved in the cases discussed in A above and in the hypothetical situation, with one major factual exception—the initial consideration. In each Kentucky case, there was either (a) no initial consideration, (b) small initial consideration, or (c) subsequent failure of initial consideration. In each case, the Kentucky court held the instrument involved to be a lease.

97 The purported "deeds of conveyance" in Crain, Dougherty, Eggleston, Kelly, Texas Co., Thomason, Munsey, and Robinson, see note 22 supra, were compared to the form lease provided in Williams, Maxwell & Meyers, Cases on Oil & Gas 739 (1956), and in each instance the instruments contained almost identical provisions.

98 Many instruments contain express provisions covering the relationship of the parties which, if omitted, would have been implied in the instrument as a matter of law. The parties should not be penalized for expressly defining their relationship. Accordingly, it is not meant here that an instrument purporting to be a deed should be construed as a lease just because the parties were represented by competent counsel who inserted all the rights of each party that normally arise out of a conveyance as a matter of law. It is submitted that when the parties start inserting clauses into the instruments which are inconsistent with the deed but consistent with a lease, the instrument should be construed as a lease. It is to this latter proposition that the cases in this classification apply.

99 Similarly, as in the cases cited in notes 11 and 13 supra, the instrument in each of the cases contained language similar to the "grants, bargains, sells and conveys" as used generally in the deed of conveyance. The amount of the initial consideration received and the amount of royalty interest retained by the grantor are given within the parenthesis. Clark v. Wilson, 316 S.W.2d 69 (Ky. 1958) (25 shares of $100 par corporate stock — no retained interest); Bardill v. Sellers, 298 S.W.2d 5 (Ky. 1956) (49 shares of corporate stock — no retained interest); Kentucky Rock Asphalt Co. v. Milliner, 234 Ky. 217, 27 S.W.2d 937 (1930) ($5 — 10%); Eastern Ky. Mineral & Timber Co. v. Swann-Day Lumber Co., 148 Ky. 82, 146 S.W. 438 (1912) ($1 — $6).
The reasoning supporting these holdings was that if the transferor received a small amount of consideration, or none at all, at the time of execution of the instrument, it must have been the intention of the parties that the return from the mineral interest was to be a principal part of the purchase price. The court reasoned that it should not give fee simple property rights to the purchaser without any loss, outlay, or disadvantage on his part. Thus, because of the lack of adequate consideration, the instruments were held to be leases.

It is interesting to note that the consideration received by the transferor in each case was sufficient to support a contract. Moreover, despite the general rule that courts normally will not inquire into the adequacy of the consideration, the Kentucky court considered such adequacy, or inadequacy as the case may be, to be determinative of the classification of the transaction.

A study of Texas cases in this area reveals that two cases have held transfers to be absolute conveyances although only the nominal consideration of five dollars and one dollar, respectively, was given. Furthermore, in Cockerell v. Griffith, the Texas court answered an argument based on the inadequacy of consideration theory as adopted by the Kentucky court by stating:

There is no evidence tending to show that the mineral rights conveyed had any greater market value than $25—or for that matter, any value whatever, or that minerals of any value had at any time been discovered in the locality of said land.

Under these circumstances, how can it be contended that the $25 shown to have been paid was not a valuable consideration for the execution and delivery of the deed? It has been held in several cases in Texas that $1 was a valuable consideration and sufficient to support a conveyance of mineral rights in land where, as in this cause, there was no showing that mineral rights in the land had any particular market value, that is, where such lands were [not] proven mineral lands.

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22 See 1 Williston, Contracts § 102 (1957).
23 See Mandel v. Liebman, 30 N.Y. 88, 100 N.E.2d 149 (1951); see also 1 Williston, op. cit., supra note 32, at § 115.
26 Id. at 494. In the Kentucky cases, the mineral interests were apparently of little value. In the Clark case, five or six dry holes had actually been drilled without bringing in any producers. Similarly, in the Bardhill case, two dry holes had been sunk without any success. In the Milliner case, thirty-nine years had passed without any exploration or development. Yet, the court said: “The cash consideration of $5, being at the rate of only six cents an acre, was merely nominal. The real consideration was the development of the property and the payment of royalties.” 27 S.W.2d at 939. Also, in the Swann-Day case, twenty-eight years passed before any timber was cut.
D. Summary Of Substantive Law

It is difficult to make generalizations in this area of the law, for each instrument must be judged upon its own merits. Nevertheless, by applying the reasoning of the above cases, any future case involving the lease-sale dichotomy can be classified and analyzed as follows:

(1) If the instrument purports to convey the mineral interest with the mere retention of a portion thereof, or of a royalty interest, provided there is substantial initial consideration, the instrument will be construed as an absolute conveyance of the minerals.

(2) Although the instrument contains words of absolute conveyance, it will nevertheless be held to be a lease if there are detailed enumerations as to the duties and privileges of each of the parties.

(3) If there is only nominal consideration, the Kentucky courts, if not others, will hold the instrument to be a lease.

II. Sale or Lease for Tax Purposes

The preceding discussion was directed to the interpretation of a typical "sale of land with a one-eighth mineral interest retained" transaction as a matter of substantive property law. The following discussion will focus on the tax consequences of such a transaction—namely, whether the transferor of the mineral interest is entitled to capital gain treatment on the initial consideration received or whether he will have to report it as ordinary income subject to a depletion allowance. Of course, the answers to these questions depend upon whether the consideration was the proceeds from the sale of an asset qualifying for capital gain treatment or whether it was, in reality, a bonus received for the execution of the mineral lease. The question also arises in an assignment by a lessee of his interest in a lease. Whereas the problem in the first situation is one of a sale or

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39 See, e.g., Commissioner v. Southwest Exploration Co., 330 U.S. 308 (1936); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Helvering v. Elbe Oil Land Dev. Co., 303 U.S. 372 (1938); Helvering v. O'Donnell, 303 U.S. 370 (1938); Commissioner v. Felix Oil Co., 144 F.2d 276 (9th Cir. 1944) (retention of a working interest); see note 93 infra and accompanying text.
Palmer v. Bender, 287 U.S. 551 (1933); Hogan v. Commissioner, 141 F.2d 92 (5th Cir. 1944); McLean v. Commissioner, 120 F.2d 942 (5th Cir.), cert. denied, 314 U.S. 670 (1941); Cullen v. Commissioner, 118 F.2d 651 (5th Cir. 1941) (retention of an overriding royalty); see notes 85-90 infra and accompanying text.
Kline v. Commissioner, 268 F.2d 854 (9th Cir. 1959); Commissioner v. Roeser & Pen- dleton, 118 F.2d 462 (5th Cir. 1941); Commissioner v. Thomas Peckham Oil Co., 115 F.2d 685 (5th Cir. 1940); Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936); Howard Glenn, 39 T.C. 427 (1962) (retention of oil payment); see note 91 infra and accompanying text.
lease, the problem in the latter situation is one of sale or sublease, and the capital gains tests may not necessarily be the same in both situations.  

Only three cases concerning minerals have arisen which presented the sale-lease issue for tax purposes. The first was West v. Commissioner, thought by some to be the alpha and omega of the law in this area. This was followed by Arthur N. Trembley and, in 1959, the Fifth Circuit case of Campbell v. Fasken. Sandwiched between the Trembley and Fasken cases was the issuance of an opinion giving the Internal Revenue Commissioner's position. Because of the importance of these cases and of the ruling, each will be discussed in detail.

A. West v. Commissioner

The first tax case concerning the problem of the sale-lease dichotomy was the West case. The taxpayer transferred certain lands, improvements thereon, and minerals therein by deed to Humble Oil & Refining Co. The consideration received was approximately 2,000,000 dollars, but West retained a three-eighths royalty interest in all the oil and gas produced from the tracts of land involved. Furthermore, Humble was obligated to drill not less than four wells, to drill offset wells, and to drill certain deep-test wells. The entire consideration received was reported as proceeds from the sale of a capital asset. The Commissioner made an allocation of the consideration received to: (1) the surface, (2) the improvements, and (3) the minerals. The amounts received for the surface and improvements were treated as proceeds from a sale or exchange of a capital asset, and accordingly any gain was taxable at capital gain rates. As to the minerals, the Commissioner determined that there had been, in
substance, nothing more than a mining lease. The Tax Court48 sustained the Commissioner’s determination, and the Fifth Circuit affirmed.

The criteria used to resolve this case illustrates a basic distinction in the analysis of a sale-lease situation if taxation is involved rather than property issues. As to substantive property law, the problem was to be answered “by looking to the entire instrument with the view of ascertaining the intention of the parties.”49 However, in resolving the tax questions, the court said:

In the field of taxation we are concerned with realities, not formalities. The descriptive terminology that may be used in deeds, contracts, or other written instruments is ineffective to restrict the scope of the income-tax law. Technical niceties of the local law are not allowed to obscure the basic issue as to whether cash received is taxable under the capital-gains or the depletable-income provisions of the income-tax law.50

Thus, in the substantive law controversies, the court is usually going to look only to the instrument; the parol evidence rule will restrict the use of other evidence.51 However, in the tax cases, the court is going to look at the entire situation and decide the tax consequences upon the economic substance of the situation.

The Fifth Circuit looked at the transaction between West and Humble not only from an objective viewpoint but also upon the ground of the subjective intent of the parties and found that the purpose of the transaction was the production of oil. Moreover, the court noted, “that the transferee was contractually obligated to develop; and that the transferors, though securing to themselves so valuable a covenant, were chargeable with no part of the costs thereof.”52 Thus, the economic substance of the transaction was nothing more than a leasing arrangement. Consequently, that part of the consideration received by the taxpayer which was apportioned to the minerals was, for tax purposes, a lease bonus taxable as ordinary income subject to depletion.

B. Arthur N. Trembley

Three years after the West decision, the Tax Court handed down a memorandum decision involving the question of whether a certain assignment of sulphur minerals was to be treated as a sale or as a

48 3 T.C. 431 (1945).
49 See note 4 supra and accompanying text.
50 150 F.2d at 726.
52 150 F.2d at 727.
lease. The taxpayer purportedly sold all of the minerals in place under his property for cash and retained an expense free royalty on the sulphur mined. The instrument relieved the grantee of the "obligation, either express or implied, to drill for, mine, produce, continue to produce, or attempt to produce sulphur from said land."32 The entire amount received was reported by the taxpayer as proceeds from the sale of a capital asset. The Commissioner determined that the instrument was a lease. therefore, the consideration was a lease bonus taxable at ordinary income rates after appropriate deductions for depletion. However, the Tax Court held for the taxpayer.

The Tax Court distinguished the West case because there the instrument expressly obligated the transferee to develop the property. Here, the instrument expressly relieved the transferee of any obligation to develop. Accordingly, the Tax Court reasoned that the primary purpose of the transaction in the West case—to secure the immediate and complete development of the land for oil—was not present in the Trembley case.44 Consequently, Trembley was entitled to capital gain treatment on the proceeds from a sale rather than ordinary income treatment on the proceeds as a bonus for a lease.

C. Campbell v. Fasken

In 1959, the Fifth Circuit was again faced with the question of whether instruments executed by the taxpayer evidenced a sale of mineral rights or merely mining leases.55 In reversing the district court's judgment over the vigorous dissent of Judge Brown, the court held the instruments to be leases.

The Faskens were the owners of approximately 165,000 acres of Texas land. In 1949 and 1950, they entered into agreements, each similar in nature, with three oil companies. They agreed to convey to the companies an undivided forty-five per cent interest "in and to the oil, gas and other minerals in and under and that maybe produced from"56 their land. The instruments used were the conventional "Mid-continent T form" mineral deeds.57 However, each agreement provided that the oil company should commence the drilling of a well

32 T.C.M. at 975.
34 The court also found the cases of Burnet v. Harmel, 287 U.S. 103 (1932), and Palmer v. Bender, 287 U.S. 511 (1933), to be distinguishable because in the Harmel case there was no question that the instrument was a lease and in the Palmer decision, as in the West case, there was an obligation on the part of the assignee to develop.
55 Campbell v. Fasken, 267 F.2d 792 (5th Cir. 1959).
56 Id. at 793. A mother and son were the litigating taxpayers, but for convenience they will be hereinafter referred to in the plural.
57 See Williams, Maxwell & Meyers, Cases on Oil & Gas 750 (1956), for a copy of this form of deed.
within thirty days from the date of the agreement and upon the completion of a well on the forty-acre tract, to begin within thirty days, the drilling of another well on a different forty-acre tract. The Faskens were also to pay to each of the oil companies fifty-five per cent of the drilling costs of each well up to a maximum of 25,000 dollars per well and up to twenty cents for each barrel produced as their share of the cost of production.

In their income tax returns, the Faskens reported the amounts received upon the delivery of the deeds as capital gain. The amounts received from production were reported as ordinary income. The payments made to the oil companies as their portion of the drilling costs were allocated between the intangible drilling and development costs and depreciable tangible equipment. On their records, the oil companies treated the initial sums paid as cost of mineral interests and the amounts received as a reduction of the drilling costs. Thus, there was a consistency in treatment of the various items by the Faskens and the oil companies.

The Commissioner determined that the amounts received and paid by the Faskens should be "netted" and all offsetting amounts disregarded. Only the net amounts received or the net amounts paid would therefore be considered. Accordingly, the Commissioner determined that the 75,000 dollar excess, paid by the Faskens to one of the oil companies, was to be allocated between depreciable equipment and deductible intangible development expenses. Capital gain

The respective amounts received from the oil companies by the Faskens and the amounts paid to the oil companies by the Faskens were as follows:

<table>
<thead>
<tr>
<th>Taxable year</th>
<th>Forest Oil Corp. received from</th>
<th>Forest Oil Corp. paid to</th>
<th>Stanolind Oil &amp; Gas Co. received from</th>
<th>Stanolind Oil &amp; Gas Co. paid to</th>
<th>Anderson-Prichard received from</th>
<th>Anderson-Prichard paid to</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949</td>
<td>$225,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>1950</td>
<td>25,000</td>
<td>25,000</td>
<td>225,000</td>
<td>200,000</td>
<td>325,000</td>
<td>225,000</td>
</tr>
<tr>
<td>1951</td>
<td></td>
<td></td>
<td>25,000</td>
<td></td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$250,000</td>
<td>$325,000</td>
<td>$525,000</td>
<td>$425,000</td>
<td>$325,000</td>
<td>$325,000</td>
</tr>
</tbody>
</table>

Net

$75,000

Total received $1,100,000.

Total paid $1,075,000.

By observation of the above figures, it becomes apparent that the Commissioner completely ignored the fact that the Faskens received the payments without any obligation whatsoever to pay the money back to the oil companies. The right to reimbursement of $25,000 for each well drilled arose only after the companies had incurred the costs. Consequently, there was no obligation on the Faskens to pay any of the money back at the time it was received. Furthermore, the various payments made between the Faskens and the oil companies were made over a three year period. Therefore, to offset the amounts received against the amounts paid, it was necessary to disregard the annual accounting concept and lump three years transactions into one accounting period, a procedure which is expressly contrary to the statute. See Int. Rev. Code of 1954, § 441.
was allowed on the 100,000 dollar excess received by the Faskens from another of the companies. All other deductions were denied and no other capital gain treatment permitted.

The district court rendered judgment for the Faskens holding that the instruments constituted a sale of forty-five per cent of the undivided minerals. The government appealed, urging that:

[T]he district court gave effect to form and ignored substance, that form should be ignored and effect given to substance and that in so doing the agreements between the taxpayers and the oil companies must be treated as leases rather than as sales.

Thus, the government changed horses in mid-stream. Before the Fifth Circuit, the government argued that the instruments executed by the taxpayer were leases and that any consideration received should be taxed as a bonus. However, in his original determination, the Commissioner permitted capital gain treatment on the excess amounts received which is clearly inconsistent with saying that the transaction was a lease rather than a sale.

The court, nevertheless, upheld the Government's appeal and reversed the district court. The majority noted that the oil companies had obligated themselves to develop the properties for oil and gas production. Consequently, the facts were similar to those in the West case, and, therefore, West was a controlling precedent for holding that the transactions were leases rather than sales.

Apparently, both the Fifth Circuit and the Tax Court have rigidly established the criteria for determining whether a transaction is a sale or lease for federal tax purposes—if there is an obligation on the part of the transferee to develop the property, the transaction will be

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60 The unreported proceedings were before Judge Atwell, deceased, in the Northern District of Texas. The judge, in rendering a judgment for the taxpayer, stated: 'The Court would be derelict in a proper scrutiny to pronounce these contracts between the plaintiffs and Stanolind and Forest as methods for defeating and merely covering up agreements so as to defeat the power of the Government to get its proper tax from the citizen. These contracts that were made with these drilling companies by the plaintiffs were in good faith and actually expressed not only the intention of the parties but the carrying out of each particular contract which followed, and accompanied a warranty deed for the drillers.' 267 F.2d at 795.

61 267 F.2d at 795.


63 See note 59 supra and accompanying text.

64 See note 58 supra and accompanying text.

65 However, the court, in overruling the Commissioner, permitted the taxpayers to recognize the entire amount of receipts and payments and did not require an offset. It reasoned that there was no authority for disregarding bona fide payments made as the result of arms-length transactions. 267 F.2d at 797.
considered a lease. It is submitted that the court has extended the principles and rationale of the *West* case too far. No quarrel is taken with the *West* case itself, for the instruments involved appear to have been properly interpreted as a lease. Moreover, if any litigation had ever arisen between the parties as to the legal effect of the instruments, it is very probable that, as a matter of substantive property law, the instruments would have been construed as leases rather than as absolute conveyances. However, this was not the case in *Fasken*. The only ingredient in the instruments similar to those in a lease was the covenant to start drilling within a certain period of time. Other than this one provision, the instruments appeared to be just what the parties called them, mineral deeds.

Furthermore, a comparison of the operating positions of *West* and the Faskens is even more striking. In *West*, the taxpayer was to receive an expense free royalty. He had no burdens and could receive only benefits. If Humble never produced a barrel of oil, he would be out no expense; however, if Humble did produce, he would be entitled to his royalty. True, there was none of the reversion or forfeiture provisions that a lease normally contains, but this is not controlling, even as a matter of substantive law.

The Faskens' situation, if the instrument in *West* was actually a deed, then the same questions may be asked that were asked by the court in Crain v. Pure Oil Co., 25 F.2d 824 (8th Cir. 1928). See note 26 supra and accompanying text.

The taxpayer, however, argued "that in view of the language employed in the instruments and the decided cases there does not appear to be the slightest doubt but that the Texas courts would hold the deed was an absolute conveyance of the land and minerals to Humble." 3 T.C. at 452, citing Danciger Oil & Ref. Co. v. Powell, 137 Tex. 484, 154 S.W.2d 632 (1941). However, when a close comparison is made of the instruments involved in the *West* and *Danciger* cases, it seems clear there are marked distinctions between the two. This was in fact so stated by the Tax Court in *West* when it said:

Our examination of the last cited Texas cases convinces us that none of them involved a situation comparable to the present facts. In analyzing those decisions we noted with interest the statement of the Supreme Court of Texas in the *Danciger* case that 'the most essential difference (between a lease and a conveyance of minerals) is the fact that the predominating purpose of a lease is to secure the exploitation and development of the property for the purpose set out in the lease.' 154 S.W.2d at 635. In our opinion the predominating purpose of the present contract was to secure the exploitation and development of the properties for oil, gas, and other minerals, a fact clearly evidenced by the care that petitioners exercised in drafting the duties, obligations, and covenants imposed on and accepted by Humble. 3 T.C. at 433.

(Emphasis added.)  

Moreover, the dissenting judge in *West* recognized that the *Danciger* case was distinguishable because the instrument in *West* contained "considerable agreement for the development of the property. . . ." 3 T.C. at 457.

Compare Crain v. Pure Oil Co., 21 F.2d 824 (8th Cir. 1928); Tennessee Oil, Gas, & Mineral Co. v. Brown, 131 Fed. 696 (6th Cir.), cert. denied, 197 U.S. 621 (1905); and Eggleston v. Sinclair Oil & Gas Co., 132 Okla. 81, 269 Pac. 306 (1928), discussed in notes 20-29 supra and accompanying text, in which the instruments contained neither reversionary nor forfeiture provisions. Moreover, the Tax Court in *West* answered the taxpayer's argu-
on the other hand, was quite different. The only thing they had in their favor was the covenant to start a well within thirty days. The Faskens were obligated to pay their share of the drilling costs up to a maximum of $25,000 dollars, which they did in fact pay. In addition, they had to pay fifty-five per cent of the operating costs up to a maximum of twenty cents a barrel. In other words, the Faskens were sharing in the risks of both development and operation. They were not guaranteed an expense free royalty as was West. They were, in effect, acting as joint participants in the development and operation of mineral interests held in cotenancy. Judge Brown, in his dissent, compared the facts in West with the Fasken situation and said:

This transaction, the Court says, is the equivalent of a lease with a 55 per cent royalty and the payment [of] a bonus, advance royalties, of $1,100,000.

Analysis of these contracts will demonstrate, I think, that apart from the undertaking to pay back dollars in sums substantially the same as received—a fact which the Court regards as in no way bearing upon the genuineness of these contracts as business arrangements—these conveyances were the sale of an undivided interest in minerals and not the mere creation of the limited estate of a lessee. Conceding that in tax matters, it is proper to treat these things for what the parties purport to call them, . . . these conveyances have all the genuine earmarks of an outright sale of minerals and none of the attributes of limitations of a lease. This is reflected both in the nature of the estate conveyed and more important, in the nature of the liabilities and risks imposed. 69

It is submitted that the dissent properly analyzed the transaction in determining the character of the instrument, whereas the majority has rigidly established the West case as authority for a proposition for which it does not necessarily stand. Similarly, the reasoning in the Trembley case, as to the controlling criteria being the absence of a covenant to develop, is unreasonable although the result appears to be a proper one. It remains to be seen whether this fine distinction will continue to be the controlling factor. 70

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69 267 F.2d at 800.
70 It is interesting, at this point, to observe the different results that are obtained in the Fasken case by applying the various contentions as made first, by the taxpayer, second, by the Commissioner, and third, by the Court. Assuming a 50-50 percentage allocation to the expenditures for intangible drilling costs and depreciable equipment, which may or may not be reasonable, the following tax result is achieved in each situation. See note 62 supra for the figures used.

(1) The taxpayer has capital gains to the extent of $1,100,000 taxable at the maximum
D. The Position Of The Commissioner

In 1952, the chief counsel of the Internal Revenue Service issued a memorandum explaining the position that the Commissioner would take in cases involving the sale-lease dichotomy. It stated that the theory of the West and Trembley cases and the decision in the Trembley case were in conflict with the Supreme Court's decisions in Burnet v. Harmel, Bankers Pocahontas Coal Co. v. Burnet, Murphy Oil Co v. Burnet, Herring v. Commissioner, and Palmer v. Bender.

The Service's position, based on these Supreme Court cases, is that when the grantor extends the right to exploit the land for minerals and he is to receive a portion of the production, the transaction is to be considered, for tax purposes, a lease rather than a sale. The mere fact that the grantor cannot compel development is not controlling, but the fact that he retains an interest in the minerals is controlling. As was stated in the memorandum:

The Supreme Court has repeatedly taken the position that where, in consideration of a lump-sum payment and stipulated royalties payable out of production, a grantor extends to a grantee a right to enter upon land for purposes of exploitation of the minerals therein, the lump-sum payment constitutes an advance royalty, taxable as ordinary income, and not proceeds from a sale of a capital asset. Accordingly, it is believed that irrespective of the presence or absence of a 'dominating purpose' of the parties to secure development and operation of the property, the controlling decisions of the Supreme Court require a lump-sum payment received by a grantor of mineral

rate of 25% for a total tax liability of $273,000. The total deduction for intangible development and drilling expenses would be $538,500 which would be offset against ordinary income. A similar amount, $538,500, would be capitalized as the depreciable basis of the equipment and amortized over the life of the property or the life of the equipment, whichever was shorter.

(2) The taxpayer has capital gain of $100,000 taxable at 25% for a total tax of $25,000 and allocates $37,500 to intangible drilling expenses and $37,500 to the equipment basis.

(3) The taxpayer has ordinary income of $1,100,000, $538,500 in intangible drilling expense deductions and $538,500 of depreciable basis in well equipment.

In conclusion, the taxpayers would have effected maximum tax savings had their contentions been sustained. As it was finally resolved, the taxpayers suffered more tax liability than they would have had they accepted the Commissioner's redetermination. For as Judge Brown said: "The Government achieves this result with no appeal—from the Commissioner's action and long after the statute of limitations has run save again for equity's intervention by setoff." 267 F.2d at 800.

72 287 U.S. 103 (1932).
73 287 U.S. 308 (1933).
74 287 U.S. 299 (1933).
75 293 U.S. 322 (1935).
76 287 U.S. 511 (1933).
78 Id. at 63.
Note that the term "royalty" is always used and not the term "mineral interest." Also, the memorandum states that the transaction is a lease and not a sale if the grantor retains as "his share of the whole reservoir of minerals, a right, upon production, to that portion of the mineral which, freed of the burdens of development and operating costs. . . ." Does the Commissioner take the position that if the grantor retains a "royalty," the transaction is a lease, but if the grantor retains a "mineral interest," the transaction may be a sale? If the question is to be answered "yes" in light of G.C.M. 27322, then the Fasken case is a feather in the Commissioner's hat because, as previously explained, the taxpayers retained a mineral interest and not a royalty. The court did not even question the fact that the result might be different if a mineral interest rather than a royalty had been retained. If the distinction does exist, the West case could not have been controlling. However, in light of the Government's argument in the Fasken case, it would appear that the Commissioner will not limit the theory of G.C.M. 27322 merely to royalty situations, but will also apply the theory to situations in which the taxpayer has retained a mineral interest.

E. Assignment Of A Lease—Sale Or Sublease?

Before entering into a discussion of the lease-sublease cases, it is appropriate to discuss briefly the first Supreme Court case involving the tax problems of oil and gas transactions. In Burnet v. Harmel, the fee owner executed a standard oil and gas lease with the normal one-eighth royalty retained and received a cash consideration. The Commissioner sought to tax the cash received as ordinary income. The taxpayer, on the other hand, claimed that there had been a sale and conveyance of the minerals by the lease, and, therefore, he was entitled to capital gain on the cash received. The Court determined that the cash received was more in the nature of a bonus or advanced royalties. It could see no difference between this lease, which conveyed a determinable fee, and one which conveyed only the right to extract the mineral (proceeds of which would clearly be ordinary income). Moreover, the Court reasoned that this oil and gas lease was not so much different from a regular common-law lease under which a

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79 Id. at 64.
80 Ibid.
81 See note 56 supra and accompanying text.
82 287 U.S. 103 (1932).
similar bonus would have been taxed as ordinary income. The federal taxing power, it stated, was to have uniform application and not to turn on subtleties of local law.

In its discussion of the capital gain statute, the Court made this statement:

[T]he statute speaks of a 'sale' and these leases would not generally be described as a 'sale' of the mineral content of the soil, using the term either in its technical sense or as it is commonly understood. Nor would the payments made by lessee to lessor generally be denominated the purchase price of the oil and gas. By virtue of the lease, the lessee acquires the privilege of exploiting the land for the production of oil and gas for a prescribed period; he may explore, drill and produce oil and gas, if found. Such operations with respect to a mine have been said to resemble a manufacturing business carried on by the use of the soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content.

Thus, the Court expressly recognized that it was dealing with a "lease" transaction and not a "sale." Therefore, the Harmel case is "clearly distinguishable" and is not determinative of the sale-lease problem because the transactions involved were "admittedly" leases, rather than sales.

Shortly after Harmel came Palmer v. Bender. The taxpayers were the owners of producing oil and gas leases which they assigned for cash, payable out of one-half of the production, and a one-eighth royalty. The Commissioner denied the taxpayers depletion deductions on the cash received claiming there had been a sale. The district court and the Fifth Circuit agreed, but the Supreme Court reversed holding that whether the instruments were sales or subleases was immaterial. Depletion could be taken on all funds received which were in fact a return of the investment of the oil in place because nothing in the statute limited depletion to money received from leases. The Court did not state that its decision turned upon the fact that the taxpayers had retained the one-eighth royalty interest. It did say: "When the two lessees transferred their operating rights to the two oil com-

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83 Id. at 107.
85 287 U.S. 551 (1933).
86 This is commonly referred to as a production payment or oil payment. Each represents a right to a specified sum of money payable out of specified percentage of the oil or the proceeds received from the sale of such oil, if, as, and when produced. Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Anderson v. Helvering, 310 U.S. 404 (1940).
87 49 F.2d 316 (W.D. La. 1931).
88 57 F.2d 32 (5th Cir. 1932).
panies, whether they became technical sublessors or not, they re-
tained, by their stipulations for royalties, an economic interest in the
oil, in place, identical with that of a lessor.9 (Emphasis added.)
Thus, the only reasonable interpretation that can be made of the
case is that if royalties are retained, the transaction will be taxed as
if it were a lease.90

The Fifth Circuit in Commissioner v. Fleming,91 apparently fol-
lowing the Palmer case, held that if the lessee assigned leases for
a cash consideration and a production payment instead of a retained
royalty, the transaction was a sale and not merely a sublease. The
taxpayer was entitled to capital gain on the initial cash consideration
received but not depletion. The proceeds received from the oil pay-
ment were a return of a capital investment retained by the taxpayer,
and, therefore, a depletion deduction was allowed. The court, in
making this distinction, stated: "In Palmer v. Bender, however, the
transferor reserved an additional royalty, and so was in reality a
sublessor, and the cash paid him could more readily be treated as a
bonus or advance royalty."92 Thus, the dividing line was clearly
drawn. A retention of a royalty enduring for the entire life of the
property makes the transfer a sublease, but a limited retention of
less than the expected productive life of the property is to be treated
as a sale.

At this point, a comparison should be made of the Fleming and
Fasken cases. Although there was more than twenty years difference
in the two decisions, each was decided by the Fifth Circuit. In
Fleming, the controlling distinction between the sale and sublease
was whether an unlimited interest was retained; the Fasken case, on
the other hand, held that a sale is distinguished from a lease by the
existence of a covenant to develop. The question that follows is,
why the different criteria when basically the question, i.e., sale v.
lease or sublease, is the same? The only reasonable explanation is that
in the case of the sale-lease, the West case has been extended to its
broadest possible interpretation. The distinction between the sale
and sublease appears to have developed out of the Palmer case. Since
the Palmer case is the only word from the Supreme Court on this sub-
ject, the Fasken and Trembley cases should be overruled. The Com-

89 287 U.S. at 558.
90 The Tax Court in Trembly distinguished the Palmer case because the leases assigned
required the assignee to develop. The absence of such covenant was then determinative that
the instrument in the Trembley case was not a lease. However, a close reading of the case
gives no indication that the Palmer court relied upon the covenant to develop. Moreover, the
fact that the covenant existed is not even mentioned in the opinion.
91 82 F.2d 324 (5th Cir. 1936).
92 Id. at 327.
missioner's position would then be sustained. Irrespective of whether the Palmer theory is sustained, it is at least consistent in its application.

One other situation which inferentially sheds some light on the sale-sublease problem is in those cases in which depletion is sought on a net profits interest. In Helvering v. Elbe Oil Land Dev. Co., the taxpayer transferred his interest in certain oil and gas leases and was to receive compensation to the extent of 400,000 dollars per year, payable out of one-third of the net profits. The Court held that the transaction was a sale and that the proceeds were not entitled to the depletion allowance. However, classifying the transaction as a sale rather than a lease because of the absence of a retained economic interest is putting the cart before the horse; mere retention by the transferor of a net profits interest rather than a royalty should not be automatically determinative.

Whether the Elbe case is still good law is a matter of conjecture. Since that decision, the Supreme Court has faced similar situations on three different occasions. Each time the Court held that the net profits interest holder had a depletable interest. Although the cases did not discuss the question, in each it was stated that the assignment was either a lease or a sublease and therefore an economic interest was retained. Accordingly, the continuing interest for the unlimited life was the controlling factor.

III. Conclusion

All that has been said before can best be summarized in a final analysis of the hypothetical transaction posed at the beginning of this Comment. It seems that the courts would hold the hypothetical instrument, as a matter of property law, to be a deed of conveyance and not merely a mineral lease.

It is also probable that the Commissioner would say that, as to the minerals, there was nothing more than a mineral lease although a sale would be recognized as to the surface. The term probable is used because a hypothetical mineral interest was retained rather than a royalty. Since the ruling refers to expense free royalties, a distinction may have been intended. If so, the Commissioner would agree that there had been a sale of the minerals. But this is difficult to compre-

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93 303 U.S. 372 (1938); see also Helvering v. O'Donnell, 301 U.S. 370 (1938).
95 See note 11 supra and accompanying text.
hend in light of the Fasken case, wherein the court found the instrument to be a lease even though a mineral interest was retained.

The Tax Court and the Fifth Circuit, based on existing precedent, would say that it was a sale because of the absence of the covenant to develop. This determination is made despite having similar facts with the West case, other than the covenant to develop. In the hypothetical situation, no doubt the predominate purpose of X acquiring the properties was the development for oil and gas production. This is identical with the situation in West over which the court made so much ado. Yet, in each situation, the developer could not obtain the right to develop the property in the normal manner, viz., by a lease. Therefore, the right to develop had to be obtained by purchase.

The distinction between a conveyance of the minerals by either a deed or a lease is small; nevertheless, it is significant. No doubt the parties have the right to choose the mode of execution in carrying out the transaction. The parties should not be able to achieve different tax results by merely changing labels. However, significance should be given to their mode when the absolute conveyance is chosen. The instrument should be examined and if it contains the ingredients of a lease, it should be construed as a lease as was done in the West case. Moreover, when the transferor retains a royalty interest rather than a mineral interest and also receives a covenant to develop, the instrument should be held to be a lease since its basic elements are so similar to those in a lease. However, this in no way approaches the situation that existed in Fasken. Except for the covenant to develop, every provision in the instrument was contrary to the normal lease arrangement. Unfortunately, the court hung its hat on the one and only clause that made the arrangement appear to be a lease.

If the question presented is one of sale or sublease, the courts have looked only to see if the transferor retained an interest lasting for the life of the property. No inquiry was made as to whether a covenant to develop exists or not, and it seems this is correct because in every lease the covenant to explore and develop the property will usually be implied if not expressed. Accordingly, under such a test,

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96 See Summers, Oil & Gas § 112, at 217 (2d ed. 1954):
If it is found that some of the principal relations, such as the duty to pay royalties, the duty to drill wells and develop and operate the premises, which make up the legal interest of the lessee of a lease for oil and gas purposes, have been expressly created, it is safe to assume that the intention was to create a leasehold interest, and not a separate estate in fee.

every assignment of a lease would be a sublease. But this does not necessarily mean that the mere retention of the unlimited lifetime interest should be the controlling factor.

How can the whole problem be completely avoided? Following the Fleming case, a production payment could be retained instead of either the mineral interest or the royalty. The production payment could be set at an amount estimated to be the equivalent to the lifetime payout of the mineral or royalty interest desired to be retained. In such a case, the Commissioner would probably take the position that the production payment is likely to extend for the life of the property, and it is in effect a royalty and, consequently, a lease arrangement. However, it has been suggested by one noted authority that this could be avoided by putting a clause into the instrument providing that the production payment would terminate if production dropped to a certain level. This would then prevent the production payment from extending for the life of the property. Although no case has been found sustaining such a theory, the rationale is the most logical one suggested to circumvent the problems in this area.

97 See I.T. 3935, 1949-1 Cum. Bull. 39; I.T. 4003, 1950-1 Cum. Bull. 10. See also Howard Glenn, 39 T.C. 427 (1962). There, the Commissioner contended that since the production payment was so large, it was likely not to pay out over the life of the property; accordingly, it was the equivalent to an overriding royalty making the transaction a lease. The Tax Court found against the Commissioner on the fact question of whether the payment would extend for the life of the property.