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THE TAX TREATMENT OF BONUSES AND RETURNED INCOME PAID PURSUANT TO MINERAL, OIL AND GAS LEASES

by

Melville Peter McPherson

A Thesis
Submitted to the
Faculty of the Graduate College
in partial fulfillment
of the
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Melville Peter McPherson

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CHAPTER I
GENERAL DISCUSSION OF THE THESIS PROBLEM

Purpose

The personal holding company provisions of the Internal Revenue Code restrict the use of corporations as tax avoidance tools. The purpose of this thesis is to aid the tax specialist in applying those provisions to corporations that receive certain income from mineral, oil and gas leases.

Sources

The Internal Revenue Code and a few court cases provide the only information that deals specifically with the subject of this thesis. Although this is limited material to draw from, the Code, court cases and publications of the Internal Revenue are the primary sources of tax law.

Closely-held Corporations As Tax Avoidance Tools (As Opposed to Illegal Tax Evasion)

The goals of the tax planner are to escape completely or postpone taxation and/or to pay capital gain rather than ordinary income. Closely-held corporations can frequently be used to implement these goals. This is because the corporate tax rate is often lower than the rate paid by the individual shareholders, and the shareholders are not taxed on the corporation's income until

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the corporation pays them dividends. The shareholders may have sufficient other income so that they do not need to receive regular dividends. In that case the shareholders, assuming they have effective control of the corporation can use this earned surplus to make more money, and over a period of years a substantial earned surplus may be built up. The corporation can then liquidate, and the distributions to the shareholders will usually be taxed at only capital gain rates, rather than at the ordinary income rates at which dividends are generally taxed. Even if there is not a liquidation, when a shareholder dies his heirs have a basis in the stock equal to the fair market value of the stock at the time of the shareholder's death. The result is that when the heirs sell the stock, they will pay a tax only on the difference between the fair market value of the stock at the date of the original shareholder's death and the value at the time the heir sells. In brief, an individual income tax might never be paid on a certain portion of the corporation's income.

An extreme example of this was the once common "incorporated pocketbooks." An individual would organize a corporation to hold his investments in stocks and bonds. The dividends and interests from the investments would be taxed at the flat corporate rate and the "incorporated pocketbook" would delay paying dividends to the shareholders for tax avoidance purposes.

Tax Restrictions on Closely-held Corporations

The use of closely-held corporations for tax avoidance is now

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restricted in some important ways. For example, Section 531(a) of the Code imposes a tax on corporations which accumulate beyond the reasonable needs of the business. But it is difficult to establish that an accumulation is beyond reasonable needs, especially if the corporation can show some history of expansion.

To supplement this tax on excessive accumulations, in 1934 the personal holding company (hereafter referred to as PHC) provisions of the Code were enacted.

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CHAPTER II
PERSONAL HOLDING COMPANIES

PHCs Defined

PHCs can be defined in general terms as corporations that are owned by a limited number of shareholders and have a certain percentage of passive investment income, e.g., dividends, interest, royalties, etc. as opposed to income from business interests directly managed by the corporation. A PHC tax is imposed on the undistributed passive income of PHCs and, therefore, corporations do not wish to meet the tests of the PHC provisions.

Stock Ownership Test of the PHC Provisions

The PHC stock ownership test is met if, at any time during the last half of the tax year, more than 50% in value of the corporation's outstanding stock is owned, directly, or indirectly, by five or fewer individuals.[1] This provision will automatically be satisfied if all the corporation's outstanding stock is owned by fewer than ten individuals, because more than 50% of the stock will necessarily be owned by five or fewer.

Income Test of the PHC Provisions

Almost all closely-held corporations meet the stock ownership

[1] Section 542(a)(2) of the Code.

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test, and so the primary PHC consideration usually is the corporation's income. The income test[2] for purposes of determining if a corporation is a PHC is met if 60% of the corporation's gross income[3] is "personal holding company income."

The definition of "personal holding company income" is unusually intricate, even for the Internal Revenue Code. That definition is set forth in section 543. PHC income includes income from "dividends," "interest," "rent," "mineral, oil, and gas royalties" etc.[4] It should be noted that an income item is only PHC income if it fits one of these carefully defined classifications. The process of classification is very important because putting an item in one classification rather than another may mean the difference in the corporation having all of its income subject to the PHC tax as opposed to having none of its income subject to the PHC tax. This will be explained in the next chapter.

PHC Tax

If a company meets the PHC stock ownership test and income test, a PHC tax is imposed on the corporation in addition to the regular corporate tax.[5] The tax is at the rate of 70% of the "undistributed"

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[2]Section 542(a)(1).

[3]As adjusted pursuant to section 543(b).

[4]This statement is subject to the limitations of section 543(a).

[5]Section 541.

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PHC income. The tax can be escaped by a timely distribution of dividends in an amount equal to the PHC income. Of course, distributing dividends would result in taxable income to the shareholders and, therefore, to that extent, the corporation would not be a tax avoidance tool in the manner discussed in Chapter I.

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CHAPTER III
APPLICATION OF THE PHC PROVISION TO BONUSES

The PHC provisions discussed in Chapter II will be applied in this chapter to certain income from mineral, oil and gas leases.

Definition of Bonuses and Returned Income

Owners of mineral, oil and gas properties frequently do not wish to develop their interests themselves because of lack of capital, lack of desire to be directly involved with day to day management, or some other concern. Accordingly, owners often grant leases on their properties to other parties, who agree to explore, extract, or in other ways exploit the asset. Most of the leases provide that the lessor is to receive royalties when and if there is actual production on the leased premises. As an extra stimulus for the owner to lease, many leases also provide for lump sum payments to the lessors at the outset of the leases. These payments, called bonuses, pay for the right of the lessees to enter upon the leased premises and explore for mineral, oil and gas. The lessors are allowed a cost depletion deduction on the bonuses pursuant to section 1.612-3(a)(1) of the Income Tax Regulations. Deductions are taken against the income of the lessors in the year the bonuses are received by the lessors. Of course, some of the leases expire, terminate or are abandoned before any income is derived from the extraction of minerals, oil or gas under the leases. The depletion

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previously deducted on those unproductive leases must be returned to the income of the lessors in the year the leases expire or in some other way come to an end. See section 1.612-3(a)(2) of the Income Tax Regulations.

Application of the PHC
Provisions to Bonuses

Two old court cases indicate that the position of the Internal Revenue service as to bonuses was that they were not PHC income in the year they were received by the lessor. In Porter Property Trustees, Ltd. v. Commissioner[6] it was held that the bonuses did not fall within the PHC income classification of "mineral, oil and gas royalties." (The classification of "mineral, oil,and gas royalties" is defined in a few general words at section 543(b)(4).) The Court said that the bonus in question was not "mineral, oil and gas royalties" because no mineral, oil or gas was ever produced under that particular lease, and, therefore, the bonus was not in any way related to mineral, oil or gas.

It was not necessary for the Court in the Porter Property case to determine if the bonus should come within any of the other PHC classifications, such as "rent." ("Rent" is defined in section 543 (b)(3) as income received by a lessor in return for the "use of, or right to use, property." As noted above, bonuses pay for the right of the lessees to enter upon the leased premises and explore for mineral, oil and gas.)

[6] Porter Property Trustees, Ltd. v. Commissioner, 42 BTA 681 (1941).

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The Internal Revenue Service acquiesced to the Porter Property decision.[7] (The Service publishes its agreement or disagreement with many tax cases.)

In the case of Commissioner v. Clarion Oil Co.[8] bonuses had been paid pursuant to a lease under which no mineral, oil or gas was ever produced. It will be recalled that these were the facts in the Porter case. But unlike Porter, in Clarion Oil the Court ruled that the bonuses were PHC income as "mineral, oil and gas royalties." The Court stated that it would be inconsistent to say that depletion could be taken on bonuses and then deny that they are royalties for PHC purposes. Also, the Court pointed out that the U.S. Supreme Court had treated bonuses as an "advance royalty," not a cash consideration for execution of a lease.[9] The Service nonacquiesced to the Clarion Oil decision, thereby being consistent with its position on Porter.[10]

The Service position appears to have changed since the Porter and Clarion Oil cases. In the cases of Churchill Farms, Inc. and Bayou Verret Land Co.[11] the Service set forth, and the Court upheld, the

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[7]Acq. C. B. 1942-2, 6.

[8]Commissioner v. Clarion Oil Co., 148 F 2d 671, Cert. den., 325 U.S. 881 (1944).

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

[10]Nonacq. C. B. 1943, 28.

[11]Churchill Farms, Inc., v. Commissioner, T.C. Memo. 1969-192 (1969) and Bayou Verret Land Co.,v. Commissioner, 52 T.C. 971 (1969).

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position that the full amount of the bonuses, including the amount of the depletion that was deducted, was PHC income as "mineral, oil and gas royalties" in the year the bonuses were paid. Note that Churchill Farms and Bayou Verret were decided pursuant to the section that defines PHC income, section 543, as it was in effect until 1964.

But section 543 was modified so that in 1964 and thereafter the amounts of depletion deducted from bonuses are not PHC income as "mineral, oil and gas royalties" in the year the bonuses are paid.[12] The modification does not change the PHC income status of bonuses, less the deductions for depletion.

Accordingly, based on the Clarion Oil case, the recent cases of Bayou Verret and Churchill Farms, and on the modification in section 543, one may conclude that bonuses, less the amount deducted as depletion, are PHC income in the year paid as "mineral, oil and gas royalties."

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[12]See section 543(b)(4) with its reference to section 543 (b)(2)(B).

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CHAPTER IV
APPLICATION OF PHC PROVISIONS TO RETURNED INCOME

The proper treatment of returned income, *i.e.*, the amount of depletion deducted from bonuses and returned to income in a later year, is not so clear as the treatment of the original bonuses.

Bayou Verret Case

The *Bayou Verret* case cited above was the first to deal directly with the treatment of returned income, and a more detailed discussion of that case may be helpful. The taxpayer there entered into oil and gas leases between the years of 1959 and 1963. The taxpayer received bonuses under the leases and claimed percentage depletion on the bonuses. In subsequent years some of the leases terminated without production, and the depletion deductions taken on the bonuses paid under the terminated leases were returned to income. The Service argued that the full amount of the bonuses, without dimunition for the amount taken as depletion deduction, was PHC income in the year the bonuses were paid. Therefore, the Service argued, the amount taken as depletion deduction should retain its character in the year it was returned to income. As noted above, the Court agreed with the Service as to the character of the full amount of the bonuses in the year they were paid. But the Court disagreed as to the treatment of the recovered income and its reasoning was that the objective of the PHC sections is to discourage incorporation of passive income companies by taxing them differently than active

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management companies. The same economic gain would be PHC income in two different years if both that part of the original bonuses deducted as depletion and the returned income were PHC income. This repeat classification would distort the passive versus active management income picture of the corporation, and such a distortion would not aid the objective of the PHC sections. Therefore, the Court held that the returned income was not PHC income. The Service has acquiesced to the decision.[13] The Court's decision was based on section 543 of the Code as it was in effect through 1963.

As noted above, that section has been modified so that PHC income in the year the bonuses are received by the lessor does not include the portion of the original bonuses deducted as depletion in 1964 and thereafter. (See section 543(b)(4) with its reference to section 543(b)(2)(B).) Therefore, returned income, which was deducted as depletion from bonuses received by lessors in 1964 and thereafter, should not have been previously classified PHC income. But the absence of prior classification as PHC income of returned income does not automatically make it PHC income. It merely makes it eligible, under Bayou Verret reasoning, to come within the definition of one of the specific classifications of PHC income.

Classification of Returned Income with the Aid of a Comparison of Bonuses and Returned Income

In making the above stated determination, it is necessary to

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[13] A. 1970-32-6.

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carefully define the two PHC income classifications that might apply to returned income. These two classifications are "mineral, oil and gas royalties" and "rent."

At section 543(b)(4), mineral, oil and gas royalties are defined only by title and as including "production payments and overriding royalties." Revenue Ruling 70-153[14] deals with royalties in the PHC context, and provides a definition. That ruling cited authority to the effect that royalties are a share of the product or profit reserved by the owner for permitting another to use the property.

Rent is defined at section 543(b)(3) as income received by a lessor in turn for the "use of, or right to use, property." Also, Revenue Ruling 70-153[15] cited above holds that payments are "rents" when received under a lease agreement, designed as rent, fixed in amount and payable in advance for the use of, or the right to use, oil and gas property.

It may be helpful in determining the classification of returned income to compare it with bonuses, the latter having a PHC classification on which there is substantial agreement. As described above, bonuses, less the amounts deducted as depletion, are probably PHC income as "mineral, oil and gas royalties."

To begin the comparison, the year in which bonuses, less the amount deducted as depletion, are taken into the lessor's income is different from the year in which the returned income is considered income by the lessor. The bonuses are treated as income in the year in which they are paid to the lessor by the lessee. In such a year the leases

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[14] Revenue Ruling 70-153, C.B. 1970-1, 139.

[15] ibid.

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involved have generally not yet been terminated and, even if no mineral, oil or gas production has taken place on the leased land, it is still possible that such production will take place before the leases terminate. In contrast, it is certain by the year when the returned income is treated as income by the lessor that there will be no production under the lease. It will be recalled that no production is the very reason that it is taken into income.

Note that the difference here is the year in which the item is taken into income, not whether the item is at some time associated with production. This statement is based upon the general understanding of tax practitioners that the Service does not open up tax returns specifically to make a change of an original classification of bonuses as royalties when the pertinent leases are in later years terminated without production. This is the case even though the original classification was based on the possibility of production.

It is concluded that neither type of income in the final analysis need be associated with production and so it appears that the year in which the type of income is taken into the lessor's income is the primary difference.

Moreover, both the bonuses, less the amounts deducted as depletion, and the returned income are paid to the taxpayer at the same time for the same purpose, *i.e.*, so that the lessee can enter upon the leased premises to explore for mineral, oil and gas.

In view of the above, it would seem inconsistent to treat bonuses, less amounts deducted as depletion, as "mineral, oil and gas royalties"

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and then to treat returned income as rent or some other type of PHC income.

Possible Results of Classifying Returned Income As "Rent"

The possible end result of treating returned income as "rent" or some other type of PHC income is further reason to classify returned income as "mineral, oil and gas royalties." A review of section 543 (a)(3) is necessary to explain these possible results. The purpose of that section is to exclude companies from the PHC tax if their principal business is the active management of mineral, oil and gas leases as opposed to merely investing in such leases. The tests of section 543(a)(3) attempt to implement this distinction. Those tests are as follows: "Mineral, oil and gas royalties"[16] of a company are not PHC income if (1) the sum of certain deductions allowed under section 162 ("ordinary and necessary" business expenses)[17] equal or exceed 15% of gross income,[18] thereby evidencing active management of the leases; if (2) the "mineral, oil and gas royalties"[19] are 50% of the company's gross income,[20] thereby showing that the company's

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[16]Adjusted pursuant to section 543(b)(2)(B).

[17]See section 543(a)(3)(6).

[18]Adjusted pursuant to section 543(b)(2).

[19]Adjusted pursuant to section 543(b)(2)(B).

[20]Adjusted pursuant to section 543(b)(2).

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principal business is mineral, oil and gas leasing and if (3) no other classification or group of classifications of PHC income are more than 10% of gross income[21] thereby further evidencing that the company if primarily in the business of mineral, oil and gas leasing and indicating that the company is not holding several different kinds of passive investment.

A hypothetical case may clarify the above tests and will illustrate how the classification of returned income as rent rather than "mineral, oil and gas royalties" will affect the PHC results of the tests. Assume that a company in 1969 had "ordinary and necessary" section 162 deductions which equaled or exceeded 15% of gross income.[22] Assume further that 89% of the company's gross income[23] is from production royalties and bonuses, all of which are properly classified as "mineral, oil and gas royalties." Lastly, assume that returned income is the remaining 11% of the company's gross income.[24] It would appear that the company's business in 1969 was the active management of mineral, oil and gas leases because of the amount of the qualifying "ordinary and necessary" deductions and the sources of the company's income. In other words, the company appears to meet the spirit of the tests of 543(a)(3) and probably should not be subject to the PHC tax. This would be the result of the application of the tests of section 543(a)(3) if the 11% returned income was

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[21]Adjusted pursuant to section 543(b).

[22]Adjusted pursuant to section 543(b)(2).

[23]Adjusted pursuant to section 543(b)(2).

[24]ibid.

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classified as "mineral, oil and gas royalties." This is true because all of the company's income would be "mineral, oil and gas royalties." But if the 11% returned income was classified as "rents" or some other type of PHC income, more than 10% of the corporation's gross income[25] would be classified as something other than "mineral, oil and gas royalties" and, therefore, under section 543(a)(3), all of the company's income would be subject to the PHC tax. This would defeat the above discussed goal of the section 543(a)(3) tests, that goal being to exclude corporations from the PHC tax if their principal business is the active management of mineral, oil and gas leases.

Classification of Returned Income and Tax Planning

Also, if returned income is "rent" or some other type of PHC income, PHC status might be very difficult for the tax planner to predict. This is because the existence of return income depends on whether there is production under the leases before the leases expire or terminate. Obviously, production is unpredictable in many if not most situations.

The effect of classification on tax planning is relevant because, unlike the regular corporation income tax with its primary goal of revenue collection, the PHC provisions are largely to prevent certain tax avoidance uses of closely-held corporations. This primary aim of the PHC provisions is made clear by section 547 which allows a

[25]ibid.

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corporation to escape the PHC tax by a timely payment of dividends equal to the corporation's PHC income. In other words, the PHC provisions are not to punish corporations for doing certain things but are for the purpose of preventing certain tax avoidance. It appears that Congress intended that the PHC provisions be guide posts around which the tax specialist may plan. As indicated above, classification of returned income as rent would make planning more difficult.

Returned Income As "Mineral, Oil and Gas Royalties"

It is concluded that classifying returned income as "rent," or some other type of PHC income would be inconsistent with the classification of bonuses, might defeat the goals of section 543(a)(3) and would add uncertainty to the PHC provisions. Therefore, the returned income should be classified as "mineral, oil and gas royalties."

Conclusions

It is believed that bonuses, less the amount deducted as depletion, are PHC income as "mineral, oil and gas royalties," and that returned income should also be PHC income as "mineral, oil and gas royalties."

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