[Mississippi College Law Review](https://dc.law.mc.edu/lawreview)

Volume 4 | Issue 1 Article 7

1984

Tax Treatment of an Attorney's Receipt of Overriding Royalty Interests as Compensation for Services

Stephen H. Leech Jr.

Custom Citation
4 Miss. C. L. Rev. 73 (1983-1984)

Tax Treatment of an Attorney's Receipt of Overriding Royalty Interests As Compensation For Services

Introduction

An oil and gas property is a subsurface mineral estate.[1] The process of converting the subsurface estate into minerals requires exploration to determine if the mineral exists under the surface, acquisition of a lease to convert the mineral estate, development to drill for and measure the quantity of minerals, production to extract the minerals from the subsurface and marketing of the minerals produced. This estate may be conveyed separately from the surface or land estate.[2]

The formation of a venture to develop mineral deposits usually requires the services of an attorney to examine titles and draft lease agreements. The attorney's role in the examination of titles and drafting of leases for the venture may be compensated by the creation of an overriding royalty interest in lieu of payment in cash. Compensation in the form of an overriding royalty interest creates the possibility of substantial return for his services if the venture produces oil in paying quantities. This comment focuses on the taxation of an attorney's receipt of an overriding royalty interest in the mineral estate in exchange for his services.

Revenue Ruling 83-46

The Internal Revenue Service recently published a ruling on the taxation of service providers in an oil and gas venture who acquire overriding royalty interests. Revenue Ruling 83-46[3] analyzed three typical fact situations in the use of services in oil and gas development. A corporation, an employee, and an attorney each received an overriding royalty interest for services provided in connection with the acquisition and development of oil and gas leases. The corporation syndicated partnerships that acquired interests in oil and gas properties. The employee was administering the financial arrangements and was overseeing the operations for

1. H. Williams & C. Meyers, Oil and Gas Law § 202 (abr. ed. 1981).
2. *Id.*
3. Rev. Rul. 83-46, 1983-1 C.B. 17.

the acquisition and development of oil and gas properties. In connection with their performance of these services, each party received an overriding royalty interest. An overriding royalty interest was defined as follows:

> [A]n economic interest in oil and gas in place, created from the working interest that entitles its owner to a specified fraction of gross production, free of operating and development costs. The term of an overriding royalty interest is coextensive with the term of the working interest from which it was created. Thus, the transfer of an overriding royalty is an assignment of a property interest and is not an anticipatory assignment of income.[4]

Rev. Rul. 83-46 analyzes the tax consequences of receiving an overriding royalty interest in an oil and gas venture by applying § 83(a) of the Internal Revenue Code.[5] However, after describing § 83(a) and citing Rev. Rul. 67-118, for the definition of an overriding royalty interest, the opinion concludes that a transfer of a property interest has occurred and each of the three persons received a property interest in the form of overriding royalties in connection with the acquisition and development of oil and gas leases. Therefore, the fair market value of each overriding royalty interest must be included in gross income under § 83 in the year of receipt of the interest.

Until Rev. Rul. 83-46, the tax consequences of an attorney's receipt of an overriding royalty interest for services performed in connection with the acquisition and development of oil and gas leases have followed from the principle of income realization. *Eisner v. Macomber*[6] provides the classic definition of income realization. In that case, a stockholder of a corporation received a 50% stock dividend and did not report it as income. The Service maintained that this was a gain *accruing* to the stockholder's investment, and income realization was a function of value in the hands of the taxpayer. The Court rejected this theory and held:

> Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in,* being '*derived,*' that is, *received* or *drawn by* the recipient

4. *Id.* (citing Rev. Rul. 67-118, 1967 C.B. 427).
5. I.R.C. § 83(a) (1976).
6. 252 U.S. 189 (1920).

> (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property.[7]

The controlling fact in the determination that the stockholder had no income was that the stockholder had received nothing out of the company's assets for his separate use and benefit.[8] This doctrine has been modified by subsequent decisions included in which is the assignment of income doctrine.[9] Under the assignment of income doctrine, the power to dispose of income is indicative of ownership right; therefore, income is realized to the owner.

To understand the holding of Rev. Rul. 83-46, it is necessary to focus upon the nature of the overriding royalty interest conveyed to a service provider prior to production of the minerals and consider whether the Service has correctly characterized it as a property interest. Rev. Rul. 83-46 profoundly changes the tax treatment of overriding royalty interests received in compensation for services in mineral acquisition and development. But the ruling failed to discuss its implications for tax treatment of overriding royalty interests received in compensation for services under the pool of capital doctrine.

The Pool of Capital Doctrine

The fee simple owner of real property owns the right to use and enjoy the surface and the subsurface of the property.[10] "The landowner alone [is] entitled to prospect for, sever and remove from the land anything found on or beneath the surface."[11] Interests in the minerals, which may be granted, take the form of leasehold interests, mineral interests and royalty interests.[12]

A leasehold interest[13] conveys the exclusive right of the owner's interest to enter the land and to prospect for and to remove the minerals from the land. The lease is for a term of years and for as long as economic production of the minerals continues. For signing the lease the landowner usually receives a cash consideration (called a bonus), a royalty interest, and a share of the product of the land or proceeds from its sale.

7. *Id.* at 207.
8. *Id.* at 212.
9. Helvering v. Horst, 311 U.S. 112 (1940).
10. H. Williams & C. Meyers, *supra* note 1, § 202.
11. *Id.*
12. *Id.*
13. *Id.* § 202.1.

A mineral interest[14] conveys the right to enter the land and to prospect for and to remove minerals. It differs from a leasehold in two ways: 1) it may be in fee, in fee simple defeasible, for life, or for a term of years and 2) it conveys the right to drill and the right to execute leases.

A royalty interest,[15] although created in the same manner as a mineral interest, does not convey the right to enter and prospect the land. The royalty interest is an interest in the production, a "share in such minerals as are severed, or the proceeds thereof."[16] The royalty interest may be an incident of a lease, such as the reservation of one-eighth (which gives the landowner one of every eight barrels of oil taken from the ground or the proceeds thereof). The landowner may sever and convey a royalty interest prior to leasing, subject only to the durational limitation of the landowner's interest in the land. An overriding royalty interest may also be severed and conveyed by a lessee, but this grant is limited in duration to the terms of the lease.

Mineral ownership, whether of minerals in place[17] or of the right to remove them from the land,[18] is subject to the law of capture. The owner of mineral rights on a tract of land acquires title to all oil and gas when produced, though part of that oil may have migrated from under the land of adjoining land owners.[19] The producing owner has no liability for draining the other owner's land.[20]

Taxation of interests created by oil and gas leases recognizes that a lease grants the exclusive possession of mineral deposits and the right to remove and reduce the minerals to ownership, thereby creating a substantial property interest.[21] The lease passes to the lessee the privilege of producing oil and gas for a defined period. These operations resemble a manufacturing business using the soil and are not a sale of the land or its mineral content.[22] State law

14. *Id.* § 202.2.
15. *Id.* § 202.3.
16. *Id.*
17. Texas Co. v. Daugherty, 107 Tex. 226, 176 S.W. 717 (1915).
18. H. WILLIAMS & C. MEYERS, *supra* note 1, § 203.1.
19. Eliff v. Texon Drilling Co., 146 Tex. 575, 210 S.W.2d 558 (1948).
20. However, state regulatory authorities have been established in the oil producing states to regulate production among various properties and ownership interests within producing fields. The regulatory schemes provide for pooling and unitization so that actual production of oil and gas may be limited to one parcel, but the proceeds are divided among all landowners. *See* MISS. CODE ANN. § 53-3-7 (1972) and MISS. CODE ANN. § 53-3-103 (Supp. 1983).
21. Lynch v. Alworth-Stephens Co., 267 U.S. 364 (1925).
22. Burnet v. Harmel, 287 U.S. 103, 106-08 (1932).

controls the taxation of property interests only when the federal taxing statute expressly makes its operation dependent upon state law.[23] The conveyance of a lease to a lessee is not a taxable event unless a bonus is paid to the lessor and the bonus is treated as ordinary income.[24]

One often litigated issue of oil and gas taxation, depletion allowance,[25] has required the courts to examine income realization in conveyances of interests in minerals. A landmark case, *Palmer v. Bender*,[26] involved a lessee who subsequently conveyed to drilling companies his interest in a lease in exchange for a bonus payment and one-eighth royalty interest. The Court held that the characterization of the conveyance by the lessee to the operating company under Louisiana law was a sublease, but this was not controlling on the question of how the depletion allowance should be apportioned. As lessees, they each had an economic interest.[27] "[T]he oil in the ground was a reservoir of capital investment of the several parties [and all] were entitled to share in the oil produced."[28] Depletion was therefore allocated by the respective interests of the parties. Therefore, the lessee acquired legal control of a valuable economic interest capable of realization as gross income by the exercise of his rights under the lease.

The *Palmer v. Bender* conception of an oil and gas venture as a sharing of income realized at the time of production of the minerals became known as the pool-of-capital doctrine. The IRS adopted the rule in the publication of General Counsel Memorandum 22730[29] in 1941. This landmark ruling contains "the very fundament of the institutional arrangements . . . for exploration, drilling, development and operation of oil and gas properties."[30] Exchanges of cash, property or services for an economic interest in the venture are nontaxable events under the pool-of-capital doctrine. Contributors acquire economic interests when they contribute to the pool-of-capital. But the transferor of the economic interest gives the contributors a right to share production and does

23. *Id.* at 109-10.

24. *Id.*

25. The depletion allowance is "a deduction in computing taxable income . . . for depletion" of mineral deposits "[i]n the case of mines, oil and gas wells, other natural deposits, and timber . . . ." I.R.C. § 611(a) (1984).

26. 287 U.S. 551 (1933).

27. *Id.* at 555.

28. *Id.* at 558.

29. G.C.M. 22730, 1941-1 C.B. 214.

30. Galvin, *GCM 22730 — Twenty-five Years Later*, 18 INST. ON OIL & GAS L. & TAX'N 511 (1967).

not exchange a property interest.[31] The exchange of the right to share production carries a corresponding shift of the exploration and development costs and the value of the transferor's interest is unchanged. Therefore, the test of tax consequences of a contribution of cash, property or services to an oil and gas venture is whether the net effect of the transfer changes the value of the transferor's interest.[32]

An attorney, as a service provider, should receive a right to share production from the override. The company granting the overriding royalty interest shifts the cost of drafting the leases and of examining titles to the attorney. As a transaction where the net effect of the value of the transferor company's interest is zero, this receipt of an overriding royalty interest is a sharing arrangement. Applying the rule of the pool-of-capital doctrine, the attorney does not realize income at the time of receipt of the interest but instead he capitalizes his expenses and recovers them through depletion and depreciation.[33]

To qualify under G.C.M. 22730 the attorney must receive the interest in return for services rendered in connection with the acquisition, exploration or development of the property.[34] The interest must be in the same oil and gas property for which the services are performed. If the property interest is received in satisfaction of any liability other than the engagement for the property, the interest will not qualify.[35]

In Rev. Rul. 77-176,[36] the Service implicitly applied the pool-of-capital doctrine to an assignment to a driller of a working interest in a portion of a lease. The driller also received a working interest in other acreage under the same lease beyond the drill site. The Service concluded that the conveyance of the interest in other acreage beyond the drill site was taxable. "Upon assignment, X received two separate economic interests in the tract or parcel of land, each such interest being a separate Section 614 property . . . ."[37] Because the acreage exclusive of the drill site is a property separate from that to which the development contribu-

31. Barnett and Coffin, *New Financing Techniques in the Oil and Gas Industry*, 34 INST. ON OIL & GAS L. & TAX'N 431, 461 (1983).

32. *Id.*

33. *Contribution of Services for an Economic Interest in Mineral Properties* [1974] FED. TAX OIL & GAS/NATURAL RESOURCES ¶ 1021-1021.1.

34. J. RAY JONES, OIL AND GAS FEDERAL INCOME TAX MANUAL 22 (11th ed. 1982).

35. *Id.*

36. Rev. Rul. 77-176, 1971-1 C.B. 77.

37. *Id.*

tion was made, it was outside the pool of capital.[38] However, in *James A. Lewis Engineering, Inc. v. Commissioner,*[39] the Fifth Circuit suggested in dictum that an attorney or other professional contributing services to the sharing arrangement might not qualify for the narrow class contemplated by the G.C.M.[40]

§ 83 Treatment of the Receipt of a Property Interest for Services

Under § 61 of the Internal Revenue Code and its regulations, gross income means "all income from whatever source derived,"[41] including compensation for services in the form of property. Property received by an attorney as compensation for services is taxable under § 61 unless he qualifies under the pool-of-capital doctrine.[42]

Under § 83(a) and its regulations, the gross income of a provider of services includes property transferred, in connection with such services, to any person other than the person for whom such services were performed.[43] The congressional committee reports state that the purpose of § 83 is to foreclose the avoidance of tax when stock in a corporation is given to an employee with restrictions placed upon it.[44] However, the language used by the committee in its report neither limited the application of § 83 to stock nor to a corporate transaction. The regulations say that the term " 'property' includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future [and] also includes a beneficial interest in assets."[45] The section is applicable whether the services are for past, present or future services and applies to employees and independent contractors.[46] Independent contractors are subject to the provisions of § 83.[47] The courts have applied it to stock,[48] and one court has applied it in

38. *Id.*
39. 339 F.2d 706 (5th Cir. 1964).
40. *Id.* at 709.
41. I.R.C. § 61 (1954); Treas. Reg. § 1.61-2(d)(2) (1978); Commissioner v. Duberstein, 363 U.S. 278 (1960).
42. *See* Walls v. Commissioner, 60 F.2d 347 (10th Cir. 1932); Massey v. Commissioner, 143 F.2d 429 (5th Cir. 1944).
43. I.R.C. § 83 (1976); Treas. Reg. § 1.83-1(a) *et seq.* (1978). *See supra* note 5.
44. H. R. Rep. No. 413, 91st Cong., 1st Sess. 87 (1969).
45. Treas. Reg. § 1.83-3(e) (1978).
46. Treas. Reg. § 1.83-3(f) (1978).
47. Alves v. Commissioner, 79 T.C. 864 (1982); Sakol v. Commissioner, 574 F.2d 694 (2d Cir. 1978); Pledge v. Commissioner, 641 F.2d 287 (5th Cir. 1981).
48. Hensel Phelps Const. Co. v. Commissioner, 74 T.C. 939 (1980), *aff'd,* 703 F.2d

dictum to taxation of the receipt of a partnership interest for services.[49] Section 83 has withstood attack on grounds of unconstitutionality as a violation of the fifth and sixteenth amendments.[50]

The issue of whether § 83 is applicable to property other than stock has not been adequately addressed by the courts. The legislative history of the section does not give a definitive answer. The purpose of the statute was to close a tax avoidance opportunity, which existed for employees to receive restrictive stock and defer the tax until the time the restrictions lapsed.[51] At that time only the value of the stock when it was transferred to the employee was treated as compensation unless the value of the stock had declined and then the lower amount would be treated as the amount of compensation. While the purpose of the statute was narrow in its scope, the language in which the statute is framed is broad. The statute does not speak in terms of stock or its equivalent but rather speaks in terms of "property" and "rights in property." There is no language in the statute which limits its application to transfers of corporate property. Read in light of its purpose, the statute should be limited to corporate transfers and compensation to employees in the form of stock or other property given by the corporation or its principal stockholders.[52]

The Service has taken the position in Rev. Rul. 83-46 that an attorney retained by a corporation in connection with the corporation's acquisition of oil and gas properties is subject to § 83. The Service reasoned that the attorney received a property interest in connection with the rendering of services to the corporation and that as an independent contractor the attorney's receipt of an overriding royalty interest is a taxable event under § 83. This interpretation comports with the view that § 83 is applicable to corporate transfers but fails to comment upon whether a sharing arrangement exists.

---

485 (10th Cir. 1983). In Armantrout v. Commissioner, 570 F.2d 210 (7th Cir. 1978), payments to employees' children for educational purposes were includable as compensation earned by the employees, and the court noted that both § 61 and § 83 could be applied to reach this result. The Internal Revenue Service has applied § 83 to the leasing of business suits by a corporation to its executive employees. Rev. Rul. 80-322, 1980-2 C.B. 36.

49. Sakol v. Commissioner, 574 F.2d 694 (2d Cir. 1978).

50. Pasquale v. Cassetta, 48 TAX CT. MEM. DEC. (P-H) D 79,384 (1979); Cohn v. Commissioner, 73 T.C. 443 (1979).

51. Pledger v. Commissioner, 71 T.C. 618 (1979), *aff'd*, 641 F.2d 287 (5th Cir. 1981).

52. *See* Tilford v. Commissioner, 705 F.2d 828 (10th Cir. 1983).

THE INHERENT CONFLICT

Section 83 is an income realization statute, enacted to recognize income in restricted stock compensation plans[53] and perhaps in other property[54] received in connection with services. By the holding of Rev. Rul. 83-46, an attorney's receipt of an overriding royalty interest constitutes the receipt of a property interest in connection with services. When acquired in connection with services rendered in the formation of a sharing arrangement, the transaction arguably comes within the ambit of the pool-of-capital doctrine.[55] The pool-of-capital doctrine is a nonrecognition-of-income doctrine[56] applied to transactions in the natural resource area. Nonrecognition-of-income avoids taxation of transactions which would otherwise result in taxable income.[57] *Burton-Sutton Oil Co. v. Commissioner*[58] allowed nonrecognition treatment in an overriding royalty measured by net profits acquired by a drilling service provider. This nonrecognition treatment was consistent with *Palmer v. Bender* nonrecognition treatment.[59] In the case of *Manahan Oil Co.*[60] the rationale was that a service provider's receipt of an overriding royalty interest should receive nonrecognition treatment.

Nonrecognition under the pool-of-capital doctrine should apply to the attorney's receipt of an overriding royalty interest as defined in Rev. Rul. 83-46. A sharing arrangement exists in the creation of the oil and gas venture. When the overriding royalty interest is received for services performed in the acquisition of leases from which the override is conveyed, the attorney is contributing services to the pool of capital. The attorney has acquired an economic interest in exchange for his services.

If nonrecognition of income is allowed, the attorney or other

53. Tilford v. Commissioner, 75 T.C. 134, 144 (1980), *rev'd on other grounds*, 705 F.2d 828 (10th Cir. 1983).

54. Armantrout v. Commissioner, 570 F.2d 210 (7th Cir. 1978).

55. Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946). *But see* United States v. Frazell, 335 F.2d 487 (5th Cir. 1964).

56. Galvin, *supra* note 30, at 537.

57. *See* I.R.C. §§ 351, 721 (1984).

58. 328 U.S. 25 (1946).

59. Galvin, *supra* note 30, at 537.

60. 8 T.C. 1159 (1947). In *Manahan*, the service provider was a driller who acquired a carried interest. A carried interest is one where the carrying party provides capital for the venture and the carried party provides the services. When production occurs, the proceeds go first to repay this investment and then are divided by agreement between the carried party and the carrying party. The carried party receives a percentage of net production; the overriding royalty interest receives a percentage of gross production. H. WILLIAMS & C. MEYERS, *supra* note 1, §§ 424, 424.1.

service provider has avoided tax on the property interest. The attorney will defeat the purpose of § 83 because the attorney's services have been compensated by a property interest. Value attaches to the interest under § 83 notwithstanding the nonexistence of an income producing capacity in the property. Under § 83, the property interest is taxed; under *Palmer v. Bender*, and the pool-of-capital doctrine the property interest is not taxed unless an income producing capability is realized or is transferred.

Section 83 measures tax liability by the value of the property as compared with economic income.[61] To the extent that the nonrecognition principles of the pool-of-capital doctrine are derived from *Eisner v. Macomber*, its measure of tax liability is the actual gain derived from the transaction. For his contribution of services, the attorney would capitalize the value of his property under § 83 but would capitalize only the cost of his services if he qualifies for nonrecognition treatment under the pool-of-capital doctrine.

Section 83 requires a transfer of a property interest to any person. The pool-of-capital doctrine contemplates a property interest that is "acquired" by a person who "contributes" services to the pool of capital. The Regulations[62] say that a § 83 transfer occurs when a person *acquires* a beneficial ownership interest in the property. The regulations seem to expand the "transfer" concept to a breadth capable of encompassing the acquisition concept of the pool-of-capital doctrine.

"Services" within the meaning of § 83 includes the recognition of the performance of or the refraining from performance of services past, present and future.[63] The services contemplated by the pool-of-capital doctrine are those necessary to develop the minerals. The recognition principles of § 83 and the pool-of-capital doctrine clearly conflict in applicability to the attorney's services.

Within § 83 there exists a nonrecognition possibility. If the property is subject to a substantial risk of forfeiture[64] and is not transferable,[65] tax liability on the value of the property is deferred until the property no longer is so restricted or the property becomes transferable. The substantial risk of forfeiture exists where rights in the property are conditioned directly or indirectly upon

61. Gresham v. Commissioner, 79 T.C. 322, 333 (1982) (Footherson, J., concurring).
62. Treas. Reg. § 1.83-3(a)(1) (1978).
63. Treas. Reg. § 1.83-3(f) (1978).
64. Treas. Reg. § 1.83-3(c) (1978).
65. Treas. Reg. § 1.83-3(d) (1978).

future performances of substantial services by any person or the occurrence of a condition related to the purpose of the transfer. The future exercise of the right to drill may be a future performance of service or condition related to the transfer. The property must also be transferable without the substantial risk of forfeiture. The overriding royalty interest may receive nonrecognition treatment, but the measurement of tax liability is deferred until the substantial risk of forfeiture does not exist. If a producing well is brought in, tax liability will arise with the potential of a high valuation. An option exists to be taxed on the property at the time of receipt.[66] If the lease terminates or is abandoned without production, a tax loss will result for the property upon which the option was exercised.[67]

Judge Fay examined the essence of the inherent conflict between § 83 and the concept of income realization in his dissent in *Pledger v. Commissioner.*[68] The general rule for taxation of compensation in the form of property is that tax should be assessed on the fair market value of the property less any amount paid by the taxpayer. When § 83 values property at an amount greater than the difference between its real value and the amount paid, it violates the principles of *Eisner v. Macomber.* He used the example of an attorney who agrees to draft a will for a painter in exchange for a painting worth $200. If the painting has a hole and is worth only $100 his tax should be $100. His point was that § 83 may tax the unrestricted value of the painting, $200, and, force the taxpayer to sell the painting and create a deductible loss to recognize the economic value of the transaction. Section 83 may tax increments of value which accrue from the property but are not received by the recipient.

The essence of Judge Fay's analysis was that § 83 must be subject to the income realization principles of *Eisner v. Macomber.* If § 83 is so tested it becomes subject to the *Palmer v. Bender* principles of income recognition in oil and gas transactions. To reach the opposite conclusion requires reasoning that § 83 has modified *Eisner v. Macomber,* a modification to allow taxation of accrued capital. The legislative history of § 83 does not allow such an expansive change in the principle of income

66. Treas. Reg. § 1.83-2 (1978).
67. *Id.*
68. Pledger v. Commissioner, 641 F.2d 287, 294-97 (5th Cir. 1981) (Fay, J., dissenting).

realization.

IS AN OVERRIDING ROYALTY INTEREST A PROPERTY INTEREST?

Section 83 requires a transfer of a property interest. An overriding royalty interest is a form of non-operating interest severed from the working interest by grant or reservation.[69]

> An overriding royalty is, first and foremost, a royalty interest. In other words, it is an interest in oil and gas produced at the surface, free of the expenses of production. It is, as is the lessor's royalty, an interest in land and hence is governed by statutes and common law rules relating to such interests, e.g., venue of an action. Its classification as realty or personalty in any particular jurisdiction corresponds to that jurisdiction's classification of an ordinary royalty. Although an interest in land, it is clearly nonpossessory, and hence the owner is not entitled to possessory remedies, e.g., trespass . . . . The life of an overriding royalty is limited by the duration of the lease or other interest from which it was carved or reserved by grant or reservation.[70]

Termination of the leasehold or other interest out of which the overriding royalty interest was carved or reserved will extinguish the overriding royalty but a transfer of working interest will not destroy it.[71] The owner of the operating interest does not have a duty to the owner of the overriding royalty interest to keep the lease alive and is not liable for damages for failure to do so, in the absence of an express covenant.[72] There is no fiduciary relationship between the owner of the operating interest and the owner of the overriding royalty interest.[73]

The overriding royalty interest should be distinguished from an oil payment, which is a share of the oil produced from the premises which does not share in the surface production costs and which terminates upon the payment of a given volume of production.[74] A reserved oil payment is one retained by the grantor when an interest in oil and gas is transferred. A carved out oil payment, on the other hand, is an oil payment created by conveyance and is to be paid out of an interest retained by the creator-grantor.[75] The

69. H. WILLIAMS & C. MEYERS, *supra* note 1, § 417.
70. *Id.* §§ 418.1, 418.2.
71. *Id.*
72. *Id.* § 420.1.
73. *Id.* § 420.2.
74. *Id.* § 422.
75. *Id.*

duty to pay an oil payment is not a personal obligation but arises only from actual production. "The oil payment terminates when a given volume of production has been paid over or when a specified sum from the sale of such oil has been realized."[76]

An overriding royalty interest may be compared with a net profits interest and a carried interest. None of these interests is responsible for operating costs and all may be used as compensation for services rendered. A net profits interest is distinguishable from an overriding royalty interest in that the net profits interest is payable only from net production after costs while the overriding royalty is paid from gross production. In a carrying interest, the carrying party is usually repaid for costs first and then production is divided between the carrying party and the carried party.[77]

Revenue Ruling 67-118,[78] which the Service cites as authority for the tax treatment of an overriding royalty interest, dealt with the gift by an owner of producing oil and gas leases of an overriding royalty interest to a trust. The overriding royalty interest was for a term of five years. Under the provisions of the trust, the trustees could deal with the royalties as if they were absolute owners. Upon termination of the trust, the overriding royalties (which have an economic life exceeding the term of the trust) or the proceeds of the sale of the royalties would revert to the grantor. In order to avoid taxation on the reversionary interest the income had to be irrevocably payable for a period of at least two years to the beneficiary. An assignment of the right to future income to the trust would have been taxable to the grantor. The Service defined an overriding royalty interest as one created from the working interest entitling the owner to a specific fraction of gross production and which is coextensive with the term of the working interest. In this ruling the assignment of the overriding royalty interest was held to be an assignment of a property interest and not an anticipatory assignment of income such as an in-oil payment right carved out of a larger interest.

In Rev. Rul. 67-118 the Service correctly described an oil payment as an assignment of income.[79] This is true even though the oil payment may be sold[80] and treated by the parties and state law as a property interest. The overriding royalty interest differs

76. *Id.*
77. *Id.* § 424.
78. Rev. Rul. 67-118, 1967-1 C.B. 163.
79. Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958). *Cf.* I.R.C. § 636.
80. *Id.*

in its duration; that is, the overriding royalty interest exists for the life of the lease while the oil payment is limited by the value or amount of production necessary to satisfy the terms of the conveyance. An overriding royalty interest in a producing well receives a specified fraction of gross production or the proceeds thereof free of production costs.

While the overriding royalty interest in a producing well is correctly held to be a property interest in Rev. Rul. 67-118, it does not follow that an overriding royalty interest is "property" in an undeveloped lease. After production the overriding royalty owner has enforceable rights in the property because there is production. Until production, there are no rights against the working interest or in the minerals. The lessee has acquired the right to explore and drill. But the royalty owner has only the right to a pro rata share of any successful exercise of the lessee's right. Value of the overriding royalty may exist in its potential for marketability. But to say that the interest is property for tax purposes because it may be sold begs the question. Obviously the royalty interest may become property if conveyed. The question is what is the economic usefulness of the interest to one who acquires the interest in an exchange. The interest is a nonpossessory, unenforceable possibility of sharing income with a working interest owner who is under no duty to exercise his right to drill. Thus the overriding royalty owner has contributed his services for a right to a share of the "opportunity of converting a right to develop the possibility of oil,"[81] which becomes property for tax purposes only when development of this opportunity into producing wells has created present economic usefulness.[82] The property interest in a producing well in Rev. Rul. 67-118 does not exist in the pre-production overriding royalty interest of Rev. Rul. 83-46 because the economic interest is not entitled to a specific fraction of gross production until production begins. The Rev. Rul. 83-46 overriding royalty interest fails the Service's definition of a taxable property interest in an overriding royalty interest.

If the overriding royalty interest of Rev. Rul. 83-46 is a property interest, it follows that the transfer of a working interest of the lease in a carried interest arrangement is a property interest under § 83. This would effectively overrule *Burton-Sutton Oil Co. v. Commissioner*. Even the conveyance of a lease may be subject

81. Estate of Wernert v. Commissioner, 294 F.2d 750, 762 (5th Cir. 1961).
82. *Id.*

to § 83 treatment because a lease has been held to be a property interest for tax purposes. In a lease transaction the lessor, usually the landowner but often a lessee, will convey to a lessee who will be providing the service of drilling the well. If the fair market value of the lease is greater than the amount paid, the difference may be taxable under § 83 if the property is acquired in connection with the performance of services.

Conclusion

An attorney receiving an overriding royalty interest in compensation for examining the title and drafting leases should be afforded nonrecognition treatment if there is compliance with the pool-of-capital doctrine. The pool-of-capital doctrine has served a useful purpose in the development of vitally needed natural resources. Today, enormous sums are expended to drill for and produce oil and gas. Considering the high cost of capital required to make these ventures possible, the pool of capital continues to serve the purpose of reducing capital costs by bringing in service providers. These service providers enter at their own risk. In this sense the pool of capital is not a legal fiction but a practical economic reality, much like a corporation or partnership.

The Internal Revenue Service has misapplied the concept of property interest in Rev. Rul. 83-46. Failure to examine the impact of the pool-of-capital doctrine on the attorney-service provider brings confusion to formation of sharing arrangements. The holding suggests an unconstitutional violation of the principles of income realization in *Palmer v. Bender*. The Service should reexamine its holding by application of the pool-of-capital doctrine. A less principled alternative would be to reformulate the doctrine in light of § 83 value principles.

Stephen H. Leech, Jr.