2 T.C. 395 (1943)

Payments designated as ‘rental’ under an oil and gas lease may be treated as advance royalties subject to depletion if they guarantee a minimum payment regardless of production, and a trust’s profits from subdivided real estate sales are ordinary income when the trust actively markets the lots through an agent.

Summary

This case addresses several tax issues related to a family trust in Texas. The Tax Court considered whether annual payments under an oil and gas lease were delay rentals or advance royalties, determining they were advance royalties subject to depletion. It also ruled that profits from the sale of subdivided lots were ordinary income because the trust was actively engaged in the business of selling real estate through an agent. Furthermore, the court addressed whether recoveries of bad debts, from which no prior tax benefit was received, should be included in gross income and the characterization of trust income as separate or community property under Texas law, and the deductibility of legal fees. The court ultimately found in favor of the taxpayer on the depletion issue, against the taxpayer on the character of the subdivided land sales, and addressed the legal fee and bad debt recovery issues, and against the taxpayer on the community property issue.

Facts

The McFaddin family created a trust in 1927, conveying substantial land holdings to it. The trust instrument gave the trustees broad powers to manage the estate, including the power to lease land for mineral exploration and subdivide real estate. In 1933, the trust entered into an oil, gas, and mineral lease with Humble Oil & Refining Co., receiving annual payments labeled as “rental.” The trust also subdivided a portion of its land into lots known as Central Gardens and engaged a real estate broker to sell them. The trust had also recovered some debts that it had previously written off, but from which it received no tax benefit from the write-off. The IRS assessed tax deficiencies, challenging the trust’s treatment of these transactions, the characterization of the income as separate or community property, and the deductibility of certain attorney fees.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against the petitioners, who were beneficiaries of the McFaddin Trust. The beneficiaries challenged these deficiencies in the Tax Court. The cases were consolidated for trial.

Issue(s)

1. Whether annual payments under the Humble oil lease, designated as

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