4 T.C. 600 (1945)

A conveyance of a direct interest in mineral rights in land is not a “security” for the purpose of determining personal holding company income under Section 502(b) of the Internal Revenue Code.

Summary

Plow Realty Co. sold mineral deeds conveying undivided interests in mineral content of land and sought to avoid personal holding company status. The Tax Court addressed whether these mineral deeds were “securities,” impacting the company’s tax liability. The court held the mineral deeds were not “securities” under Section 502(b) of the Internal Revenue Code, and the gains from the sale were not personal holding company income. The court also addressed the cost basis for computing gain and a claimed loss deduction. The company was found to have no established cost basis, and the loss deduction was denied.

Facts

Plow Realty Co. was reorganized in Texas in 1938, succeeding Plow Realty Co. of Missouri. The company owned land in Texas with mineral rights. In 1940, Plow Realty executed mineral deeds to Ryan and Lake Shore Corp., conveying undivided interests in the mineral rights for $60,001. The land was subject to an oil and gas lease with Shell Oil Co. The deeds stipulated that grantees receive a share of royalties but not annual rentals or bonus money from future leases. Shell Oil completed a producing well on the land in May 1940.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Plow Realty’s income tax, personal holding company surtax, and asserted a penalty for failure to file a timely personal holding company return. Plow Realty contested these determinations in the Tax Court. The primary dispute centered around whether the gains from the sale of mineral deeds constituted personal holding company income.

Issue(s)

1. Whether the mineral deeds conveying undivided interests in mineral rights constitute “securities” under Section 502(b) of the Internal Revenue Code, thus classifying the gains from their sale as personal holding company income.

2. Whether Plow Realty had an established cost basis for the mineral rights conveyed.

3. Whether Plow Realty sustained a deductible loss due to a shortage in acreage of purchased land.

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Holding

1. No, because the mineral deeds conveyed direct interests in real property (mineral rights) and were not merely certificates of interest or participation in a royalty or lease.

2. No, because Plow Realty failed to provide sufficient evidence to establish a cost basis for the mineral rights or their fair market value as of March 1, 1913.

3. No, because the transaction was not completed, as Plow Realty continued to hold the other acreage acquired.

Court's Reasoning

The court reasoned that the mineral deeds conveyed direct interests in the mineral content of the land, passing title to the grantees before severance. The court distinguished these deeds from mere royalty interests, emphasizing that the grantees' rights extended beyond the existing Shell lease. The court emphasized that while the Commissioner's regulations defined "stock or securities" broadly, the instruments in this case were deeds conveying interests in realty, not the type of instruments commonly understood as securities.

Regarding the cost basis, the court found Plow Realty's allocation of cost to the mineral content unsubstantiated. The court emphasized the lack of evidence for an allocation between land and minerals at the time of purchase or any basis for fair market value as of March 1, 1913.

Regarding the loss deduction, the court concluded that the shortage in acreage did not constitute a deductible loss because the transaction was ongoing, and Plow Realty continued to hold the remaining acreage.

Judge Hill dissented, arguing that the instruments conveyed only a share in royalties and a contract to share in royalties under future leases, which fell within the definition of "securities" under Treasury Regulations. Hill also asserted that state law characterization of the instruments as real property should not disturb the uniform application of federal tax law. He cited *Burnet v. Harmel*, 287 U.S. 103, emphasizing that federal tax law should have uniform application irrespective of state property law definitions.

Practical Implications

This case provides guidance on distinguishing between a direct conveyance of mineral rights and a mere royalty interest for tax purposes. It clarifies that conveying a direct interest in mineral rights, even with certain limitations, does not automatically classify the instrument as a "security" for personal holding company income determination. Attorneys should carefully analyze the specific rights and obligations conveyed in mineral deeds to determine their tax implications,

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particularly regarding personal holding company status. The case also underscores the importance of establishing a reasonable cost basis when selling mineral interests to minimize potential tax liability. Future cases involving similar instruments should be analyzed based on the economic substance of the transaction and the rights actually conveyed, rather than solely on the form of the instrument.

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