Cron & Gracey Co. v. Commissioner, T.C. Memo. 1942-647

In tax-free exchanges, the holding period of property received includes the holding period of the property given up, even if the property given up was not a capital asset, as long as the property received is a capital asset and the basis carries over.

Summary

Cron and Gracey Co. exchanged a depreciable business asset (a drilling rig) for stock in C.I. Drilling Co. and sold the stock shortly thereafter. The Tax Court addressed two issues: (1) whether the holding period of the stock included the holding period of the rig for capital gains tax purposes, and (2) whether payments made to Gulf Oil Corporation constituted deductible business expenses or capital expenditures related to an oil and gas lease. The court held that the stock's holding period did include the rig's holding period, benefiting the taxpayer on capital gains, but that payments to Gulf Oil were capital expenditures, not deductible expenses.

Facts

Petitioner, Cron and Gracey Co., a partnership, acquired a drilling rig which was used in their business and subject to depreciation. In February 1940, the partnership exchanged the rig for stock in C.I. Drilling Co. In March 1940, the partnership sold some of the C.I. Drilling Co. stock. The partnership had also acquired interests in an oil and gas lease from Gulf Oil Corporation, agreeing to pay Gulf one-fourth of the net profits from the lease operations. The partnership claimed deductions for payments made to Gulf Oil.

Procedural History

The Commissioner of Internal Revenue determined that 100% of the gain from the stock sale should be recognized because the stock was held for less than 18 months, not including the rig's holding period. The Commissioner also disallowed deductions for payments to Gulf Oil, classifying them as capital expenditures. The taxpayer petitioned the Tax Court to redetermine these deficiencies.

Issue(s)

1. Whether, for capital gains tax purposes, the holding period of stock acquired in a tax-free exchange includes the holding period of a depreciable business asset (not a capital asset) given in the exchange, under Section 117(h)(1) of the Internal Revenue Code.
2. Whether payments made by the partnership to Gulf Oil Corporation, representing a share of net profits from an oil and gas lease, are deductible business expenses or non-deductible capital expenditures.

Holding

1. Yes. The holding period of the stock includes the holding period of the rig because Section 117(h)(1) of the Internal Revenue Code mandates including the holding period of property exchanged in a tax-free exchange when determining the holding period of the property received, regardless of whether the exchanged property was a capital asset.
2. No. The payments to Gulf Oil Corporation are capital expenditures because they represent part of the purchase price for the oil and gas lease and Gulf Oil did not retain an economic interest in the oil and gas in place after the assignment.

Court's Reasoning

Issue 1 (Holding Period): The court focused on the plain language of Section 117(h)(1) of the Internal Revenue Code, which states: "In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged." The court noted that the statute does not require the property given in exchange to be a capital asset. It only requires that the property received (the stock in this case) be a capital asset, which it was. The court explicitly stated, "It is not stated in that provision that its application is limited to instances where the property given in an exchange is a capital asset. The provision applies where the property received in an exchange is a capital asset. The terms of subsection (h) (1) are clear." The court acknowledged prior rulings cited by the Commissioner but found the statutory language controlling.

Issue 2 (Payments to Gulf Oil): The court relied on established precedent, citing *Anderson v. Helvering* and related cases, which established that income from oil and gas production is taxable to the owner of the capital investment in the oil and gas in place. The court followed *Quintana Petroleum Co.*, a prior Tax Court case with similar facts, which held that such payments to Gulf Oil were capital expenditures. The court reasoned that Gulf Oil, by assigning the lease, sold its entire interest and the retained right to net profits was part of the purchase price, not a retained economic interest. The court quoted from the Fifth Circuit's affirmation of *Quintana Petroleum Co.*: "The obligation of the taxpayer to pay one-fourth of the net proceeds arising from its operation of the lease arose out of a personal covenant. Such obligation vested no interest in the payee in the oil and gas in place, and entitled the payee to no percentage depletion on the amount received. The taxpayer's title to the oil and gas in place was unaffected thereby." The court dismissed the petitioner's arguments regarding the lack of express assumption of obligation in some assignments and the "running with the land" covenant in a later agreement, finding these immaterial to the core issue of economic interest.

Practical Implications

Cron & Gracey clarifies that in tax-free exchanges, taxpayers can tack on the holding period of property given up, even if it's not a capital asset, as long as the property received is a capital asset and the basis carries over. This is beneficial for taxpayers seeking long-term capital gains treatment. For legal practitioners, this case underscores the importance of carefully analyzing the statutory language of Section 117(h)(1) and not imposing limitations not explicitly present in the statute. Regarding oil and gas leases and net profit interests, this case reinforces that assignments with retained net profit interests are generally treated as sales, with payments considered capital expenditures, not deductible expenses, impacting the economic interest analysis in oil and gas taxation. Later cases would continue to refine the economic interest doctrine in oil and gas, but *Cron & Gracey* firmly established the capital expenditure treatment for net profit interests in similar lease assignments.

