*5 T.C. 1167 (1945)*

When a seller of oil interests reserves a security interest beyond the oil payments themselves, the proceeds from oil production paid to the seller are included in the purchaser's gross income.

**Summary**

Charles and Sylvia Burke, partners in an oil and gas business, purchased interests in oil leases from Signal Hill Oil Corporation. As part of the deal, the Burkes agreed to make oil payments to Signal Hill. The Tax Court addressed two key issues: whether the oil payment proceeds were taxable to the Burkes or Signal Hill, and whether the Burkes could report gain from the sale of an oil lease on the installment basis. The court held that the oil payment proceeds were taxable to the Burkes because Signal Hill retained additional security beyond the oil payments. Further, the amount paid to a third party, Myles, for a separate interest was includible in Myles' income, not the Burkes'.

**Facts**

The Burkes formed a partnership to buy, sell, and develop oil and gas properties. The partnership acquired interests in two oil and gas leases (Nathan Lee and Fred Lee) from Signal Hill. The Burkes paid $5,000 cash and agreed to a written contract called "Oil Payment." Under this contract, the Burkes assigned a portion of the oil produced from the leases to Signal Hill until Signal Hill received $50,000. The contract gave Signal Hill a lien on the leases to secure the payment. Harry Myles, the partnership's general manager, was promised an interest in the leases. Later, when the leases were sold to Texas Co., Myles received $17,187.50 directly from Texas Co. for his interest.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in the Burkes' income tax for 1939 and 1940. The Burkes petitioned the Tax Court, challenging the Commissioner's determination regarding the taxability of the oil payment proceeds and the reporting of gain from the sale of the oil lease.

**Issue(s)**

1. Whether the Burkes, as assignees of fractional interests in oil properties, are taxable on proceeds from the sale of oil extracted from those properties and distributed to Signal Hill under the oil payment contract.
2. Whether the Burkes can report gain from the sale of the Nathan Lee lease on the installment basis, considering the payment made to Myles for his interest.

**Holding**

 

1. Yes, because Signal Hill retained additional security beyond the oil payments, making the Burkes taxable on the oil payment proceeds.
2. No, because the payment to Myles is not includible in the Burkes' income.

## Court's Reasoning

The court relied on *Anderson v. Helvering*, stating that when a seller of oil interests reserves security beyond the oil payments, it indicates an outright sale, and the proceeds are includible in the purchaser's gross income. The court found that Signal Hill had two forms of additional security: 1) The oil payment covered a greater interest in the lease than Signal Hill had originally sold to the Burkes. 2) Signal Hill retained a lien on a larger interest in the leases than what they sold. The court reasoned that requiring allocation of depletion between Signal Hill and the Burkes would create unnecessary difficulties, similar to those discussed in *Anderson*. Regarding Myles, the court found that Myles had an oral agreement to receive an interest in the leases for services rendered, making him the equitable owner of that interest. The court noted that Illinois law recognizes oral contracts for the transfer of real estate for services. Therefore, the amount Myles received from Texas Co. was taxable to Myles, not the Burkes.

## Practical Implications

*Burke v. Commissioner* reinforces the principle established in *Anderson v. Helvering*, providing a specific example of how retaining a security interest beyond the oil payment affects tax liability in oil and gas transactions. This case clarifies that the scope of the interest covered by the oil payment and any liens associated with it are crucial in determining whether the seller has retained an economic interest or made an outright sale. Attorneys should carefully analyze the terms of oil and gas agreements to determine whether additional security has been retained, as this will impact the tax treatment of the parties involved. Furthermore, this case illustrates that oral agreements for property transfer in exchange for services can be recognized, impacting who is taxed on the income from the property sale. Later cases distinguish Burke where there is no additional security beyond the oil payment itself.