7 T.C. 120 (1946)

The owner of a carried working interest in an oil and gas lease is taxable on the income from oil production accruing to that interest, even if the operator uses the income to reimburse themselves for expenditures advanced on behalf of the non-operator.

Summary

Abercrombie Co. v. Commissioner addresses the taxation of income from a "carried working interest" in oil and gas leases. The Tax Court held that Atlatl and Coronado, who reserved a one-sixteenth carried working interest, were taxable on the income attributable to that interest, even though the operators, Harrison and Abercrombie Co., used the proceeds to recoup expenditures. The court reasoned that Atlatl and Coronado retained a capital investment in the minerals, making them the proper parties to be taxed on the income their interest generated. This case clarifies that the right to receive a share of production, even if temporarily offset by operating costs, constitutes an economic interest for tax purposes.

Facts

Atlatl Royalty Corporation and Coronado Exploration Company (collectively, "Assignors") assigned oil and gas leases to Harrison Oil Company and Abercrombie Company (collectively, "Operators"). The assignment was subject to the Assignors reserving a one-sixteenth carried working interest in the oil and gas leases. The Operators were responsible for managing and controlling the properties and selling the oil and gas, including the portion accruing to the Assignors' carried interest. The Operators advanced all expenditures related to the properties but were entitled to recoup one-sixteenth of these expenditures from the proceeds of oil and gas sales credited to the Assignors' carried interest.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against Abercrombie Co., arguing that Abercrombie was taxable on the income attributable to the one-sixteenth carried working interest. Abercrombie Co. petitioned the Tax Court for a redetermination of the deficiency. The Tax Court reviewed the agreement and assignment and determined the income was taxable to Atlatl and Coronado, not Abercrombie.

Issue(s)

Whether the income and expenditures attributable to the one-sixteenth "carried working interest" in oil and gas leases belonged to Atlatl and Coronado, the assignors who reserved the interest, or to Abercrombie Co., the assignee and operator.

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Holding

No, the income and expenditures attributable to the carried working interest belonged to Atlatl and Coronado because they retained a capital investment in the minerals and were therefore taxable on the income generated by that interest.

Court's Reasoning

The Tax Court reasoned that Atlatl and Coronado reserved a capital investment in the minerals through the one-sixteenth carried working interest. The court emphasized that the formal assignment was expressly made subject to the reservations in the agreement. Even though the Operators managed the properties and advanced expenditures, the Assignors retained ownership of one-sixteenth of the oil and gas in place. The court cited Reynolds v. McMurray and Helvering v. Armstrong, which held that non-operators with carried interests are taxable on the income accruing to their interests, even if they receive no distributions because the operator is being reimbursed for advanced expenditures. The court distinguished Anderson v. Helvering, stating that the income from oil production is taxable to the owner of the capital investment. The court stated, "Under the contract here, one-sixteenth of the proceeds from oil production — that part attributable to the reserved interest of Atlatl and Coronado — belonged to those companies, as did the expenditures chargeable to the carried interest. The income attributable to their interest is not taxable to petitioner." The court also noted that even if the retained interest amounted to a share in net profits, that would not necessarily mean the assignor disposed of their entire interest, citing Kirby Petroleum Co. v. Commissioner and Burton-Sutton Oil Co. v. Commissioner.

Practical Implications

This case clarifies the tax treatment of carried working interests in oil and gas leases, establishing that the owner of the carried interest is taxable on the income attributable to that interest. This ruling is significant because it emphasizes the importance of economic substance over form in determining tax liability. Attorneys should consider this case when structuring oil and gas lease agreements to ensure proper allocation of tax burdens. The decision influences how similar cases are analyzed, especially those involving complex operating agreements and carried interests. Later cases applying Abercrombie Co. have focused on whether the non-operating party truly retained an economic interest in the minerals in place. The key is that the carried party must retain a right to a share of production, even if that share is initially used to offset operating expenses. This case continues to be relevant in determining who bears the tax burden in oil and gas ventures.

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