***24 T.C. 818 (1955)***

Oil payment interests, which are limited rights to oil production until a specified sum is reached, are not considered 'like-kind' property to fee simple real estate for the purposes of tax-free exchanges under Section 112(b)(1) of the Internal Revenue Code of 1939.

**Summary**

In this case, taxpayers exchanged oil payment interests for ranch land and urban real estate, claiming a tax-free exchange under Section 112(b)(1). The Tax Court disagreed, holding that oil payment interests and fee simple real estate are not 'like-kind' properties. The court reasoned that the nature of the rights conveyed in an oil payment—a temporary, monetary interest—differs fundamentally from the perpetual and comprehensive rights in fee simple real estate. Consequently, the gain from the exchange was recognized as capital gain, not ordinary income.

**Facts**

Petitioners, including Wm. Fleming and Mary D. Walsh, engaged in two separate transactions:

1. **Ranch Land Exchange (1948):** Fleming Oil Company, Wm. Fleming, and Wm. Fleming, Trustee, transferred limited overriding royalties and oil payment interests to Marie Hildreth Cline in exchange for fee simple title to ranch land. The oil payments were carved out of existing oil and gas leases and were limited to a specific dollar amount plus interest.
2. **Urban Real Estate Exchange (1949):** F. Howard Walsh exchanged similar limited overriding royalties or oil payment interests for fee simple title to urban real estate in Fort Worth, Texas.

In both cases, the oil payments would terminate once the grantee received a predetermined sum of money plus interest, at which point the interest would revert to the grantors.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax, arguing that the exchanges did not qualify as 'like-kind' exchanges under Section 112(b)(1) and thus the gains were taxable. The petitioners contested this determination in the Tax Court.

**Issue(s)**

1. Whether the exchange of limited overriding royalties or oil payment interests for fee simple title to ranch land constituted an exchange of property 'of a like kind' under Section 112(b)(1) of the Internal Revenue Code of 1939.

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2. Whether the exchange of limited overriding royalties or oil payment interests for fee simple title to urban real estate constituted an exchange of property 'of a like kind' under Section 112(b)(1) of the Internal Revenue Code of 1939.
3. Whether the taxable gain from these exchanges, if recognized, should be treated as capital gain or ordinary income.
4. Whether interest accrued on retained proceeds from endowment policies is taxable income in the years accrued, even if not yet paid out.

**Holding**

1. **No,** because oil payment interests and fee simple title to ranch land are not 'like-kind' properties due to fundamental differences in the nature of the rights conveyed.
2. **No,** because oil payment interests and fee simple title to urban real estate are not 'like-kind' properties for the same reasons as in issue 1.
3. The taxable gain is treated as **capital gain** because the oil payments are considered capital assets.
4. **Yes,** the accrued interest is taxable income because the taxpayer, on a cash basis, cannot avoid taxation by deferring receipt of income that is credited to their account and available in the future.

**Court's Reasoning**

The court reasoned that 'like kind' refers to the nature or character of the property, not its grade or quality. Drawing from Treasury Regulations and established case law, the court emphasized that the rights created in the properties must be of the same general character. The court stated, "*In comparing properties to determine their likeness within the meaning of section 112 (b) (1), we must consider not alone the nature *824 and character of the physical properties, but also the nature and character of the title conveyed or the rights of the parties therein.*"

The court distinguished oil payment interests from fee simple interests, noting that oil payments are limited in duration and amount, resembling a "mortgagee" interest rather than full ownership. "*Notwithstanding the comprehensive terms of conveyance contained in the assignment of the mineral interest, the ceiling limitation therein, whereby the maximum amount the grantee could *145 ever receive therefrom was a fixed sum of money with interest, stamps the extent of grantee's rights therein more in the nature of a mortgagee than that of owner.*" In contrast, fee simple title represents a perpetual and comprehensive ownership of real estate.

Regarding capital gain treatment, the court followed precedents like *John David Hawn* and *Lester A. Nordan*, holding that oil payments are capital assets, and gains from their exchange qualify for capital gains treatment. The court rejected the Commissioner's argument that the transaction was merely an assignment of future income.

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On the issue of interest income, the court found that under both settlement agreements, the interest was taxable. For the agreement where interest was accrued, the court held that a cash basis taxpayer cannot defer income by voluntarily arranging for its future receipt. For the agreement with current interest payments, the court stated that interest is explicitly included in gross income under Section 22(a).

**Practical Implications**

*Fleming v. Commissioner* clarifies that for a Section 1031 like-kind exchange (formerly Section 112(b)(1)), the properties exchanged must have fundamentally similar natures of ownership rights. This case is crucial for understanding that not all real property interests are 'like-kind'. Specifically, it establishes that limited oil payment interests, due to their temporary and monetary nature, are not 'like-kind' to fee simple real estate. This ruling has significant implications for tax planning in the oil and gas industry and real estate transactions, highlighting the importance of analyzing the underlying nature of property rights in tax-free exchanges. Later cases have consistently applied this principle to distinguish between qualifying and non-qualifying like-kind exchanges based on the nature of the property rights involved.

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