25 T.C. 223 (1955)

Payments received for the right to extract sand and gravel, where payment is tied to the quantity removed and the grantor retains an economic interest, are considered ordinary income subject to depletion, not capital gains from a sale.

Summary

Crowell Land & Mineral Corporation granted Gifford-Hill and Company the right to remove sand and gravel from its land for five years, receiving payments based on cubic yards extracted, with advance annual payments. Crowell reported these payments as long-term capital gains. The Tax Court determined that these payments constituted ordinary income, not capital gains, because Crowell retained an economic interest in the minerals. The court reasoned that the payments were contingent on extraction and resembled royalty payments, thus aligning with ordinary income treatment and allowing for depletion deductions. The court also denied Crowell's claim for discovery depletion due to lack of factual basis.

Facts

Crowell Land & Mineral Corp. (Petitioner) owned land with sand and gravel deposits.

Petitioner entered into a "Contract of Sale" with Gifford-Hill and Company, Inc. (Gifford-Hill) granting Gifford-Hill the right to remove sand and gravel for five years.

The contract stipulated payments of 15 cents per cubic yard of material removed, with annual advance payments of $1,200.

Gifford-Hill was responsible for severance taxes, while Petitioner paid ad valorem taxes.

After the contract term, any remaining materials and the land were to revert to Petitioner.

Petitioner reported income from the contract as long-term capital gain.

The Commissioner of Internal Revenue (Respondent) determined the income to be ordinary income.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Petitioner's income tax for 1949, classifying income from the sand and gravel contract as ordinary income instead of capital gains.

Petitioner appealed to the United States Tax Court.

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The Tax Court reviewed the contract and relevant tax law to determine the proper classification of the income.

Issue(s)

1. Whether payments received by Petitioner under the "Contract of Sale" for gravel constitute long-term capital gain or ordinary income for federal income tax purposes?

2. If the payments are deemed ordinary income, whether Petitioner is entitled to an allowance for discovery depletion?

Holding

1. No, the payments received by Petitioner constitute ordinary income because the agreement, despite being termed a "sale," retained for the petitioner an economic interest in the minerals in place, making the income akin to royalties.

2. No, Petitioner is not entitled to discovery depletion because there was no factual foundation presented in the record to support such a deduction in this case.

Court's Reasoning

The court reasoned that the crucial factor is whether the taxpayer retained an "economic interest" in the mineral in place. Citing *Anderson v. Helvering*, the court emphasized that depletion is allowed because the taxpayer is being deprived of property as the mineral is removed. The agreement, while termed a sale, only required payments as sand and gravel were "mined and removed." The court noted, "Not only the time of removal, but the act itself is shrouded in the mists of speculation. At the end of the lease period, even if none is removed, the mineral remaining is not the property of the lessee, but of the lessor."

The court distinguished between capital gains and ordinary income treatment, stating that capital gain treatment is intended for lump-sum realizations of accumulated value, whereas the periodic payments here resemble ongoing income from the land. The court stated, "In the case of the kind of agreement with which we are here confronted, it is of little consequence whether it is described as a lease, royalty agreement, bonus, advance royalty, or other arrangement for periodic payment." Referencing *Burnet v. Harmel* and *Palmer v. Bender*, the court highlighted the established precedent of treating proceeds from mineral extraction agreements, where economic interest is retained, as ordinary income subject to depletion.

Regarding discovery depletion, the court found no factual basis in the record to justify such an allowance, citing *Parker Gravel Co.*

Judge Murdock dissented, arguing that the contract was a sale of a capital asset

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because the price was fixed, and Petitioner did not share in Gifford-Hill's profits or income from the removed material. The dissent viewed the payment structure as a practical method to determine the quantity of material sold, not as a retention of economic interest.

Practical Implications

This case clarifies that the nomenclature of an agreement (e.g., "Contract of Sale") is not determinative for tax purposes. The substance of the agreement, specifically whether the grantor retains an economic interest in the minerals, dictates the tax treatment of payments. Agreements where payments are contingent on extraction and the mineral rights revert to the grantor are likely to be treated as generating ordinary income, not capital gains. This ruling is significant for landowners entering into agreements for the extraction of natural resources like sand and gravel, requiring them to report income as ordinary income and consider depletion deductions rather than capital gains tax rates. Later cases and revenue rulings have continued to refine the "economic interest" test, but *Crowell Land & Mineral Corp.* remains a key example of how courts analyze these arrangements for income tax classification.

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