Killam v. Commissioner, 33 T.C. 350 (1959)

The sale of an oil payment carved out of a larger interest is treated as an assignment of future income, taxable as ordinary income subject to depletion, not as a capital gain.

Summary

O.W. Killam sold an oil and gas lease, reserving two oil payments to be paid from production. He then sold the oil payments for cash. The Commissioner determined that the proceeds from the sale of the oil payments were ordinary income, not capital gains. The Tax Court agreed, holding that the substance of the transaction was a sale of future income, not the sale of a capital asset. The court distinguished this situation from a sale of an entire depletable interest, emphasizing that Killam retained a portion of his interest.

Facts

O.W. Killam owned an oil and gas lease. He sold the lease to a partnership, reserving two oil payments totaling $350,000 plus interest, payable from a percentage of the oil produced. Killam then sold these oil payments to a third party for cash. The Commissioner determined that the proceeds from the sale of the oil payments were ordinary income. Killam argued the transactions resulted in capital gains.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Killam's income tax. Killam petitioned the Tax Court to challenge the Commissioner's decision, arguing for capital gains treatment. The Tax Court ruled in favor of the Commissioner.

Issue(s)

1. Whether the sale of an oil payment resulted in capital gain or ordinary income subject to depletion.

2. Whether a payment for the purchase of assets of an oil lease should be allocated between the oil reserves and the equipment.

Holding

1. No, because the sale of the oil payment was an assignment of future income, taxable as ordinary income.

2. Yes, because Killam and Hurd were correct to allocate the payment between depreciable and non-depreciable assets.

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Court’s Reasoning

The court relied heavily on *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958), which established that the sale of a carved-out oil payment is essentially a transaction of future income. The court emphasized that Killam only transferred a fraction of his interest, retaining the balance. “The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future.” The court considered Killam’s actions as an attempt to convert ordinary income into capital gains. The court rejected the argument that the oil payment was a separate capital asset. It distinguished cases where the entire depletable interest was transferred. Regarding the allocation of the payment for assets, the court deferred to the taxpayer’s allocation, as it was supported by evidence.

Practical Implications

This case is a key precedent in the tax treatment of oil and gas transactions. It clarifies that the sale of a carved-out oil payment is generally treated as an anticipatory assignment of income, not the sale of a capital asset, and thus is taxed as ordinary income. This decision requires attorneys and accountants to carefully structure oil and gas transactions to avoid the recharacterization of income. It also means that the timing and structure of the disposition of oil interests have significant tax consequences. For example, this case would be relevant in analyzing the tax consequences of an oil and gas operator selling a portion of the reserves to raise capital.

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