***Day v. Commissioner*, 54 T. C. 1417 (1970)**

Lump-sum payments for the sale of nonrenewable water rights are taxable as capital gains, not ordinary income, when no economic interest is retained in the water.

## Summary

In Day v. Commissioner, the U. S. Tax Court held that lump-sum payments received by landowners for conveying their water rights to Pan American Petroleum Corp. were taxable as capital gains, not ordinary income. The Days sold the rights to all water under their land for 25 years, renewable for another 20, to Pan American, which intended to extract all the water for oil recovery. The court found that the Days did not retain an economic interest in the water, as the payments were not contingent on production, and the water was a nonrenewable resource. This case illustrates the principle that when a property owner sells a nonrenewable resource without retaining an economic interest, the proceeds are treated as capital gains.

## Facts

Don and Catherine Day and Dan and Roberta Day owned farmland in Terry County, Texas, overlying the Ogallala aquifer. In 1965, they each entered into a "Conveyance of Water Rights and Agreement" with Pan American Petroleum Corp. , granting the rights to all water under their land for 25 years, renewable for an additional 20 years, in exchange for $56,000 each. The water in the Ogallala aquifer was a nonrenewable resource, and Pan American intended to extract all the water to waterflood its oil field. The Days reserved the right to use up to 100 barrels of water per day from the land.

## Procedural History

The Days reported the payments as capital gains on their 1965 tax returns. The Commissioner of Internal Revenue determined deficiencies, treating the payments as ordinary income. The Days petitioned the U. S. Tax Court, which consolidated the cases and held for the petitioners, ruling that the payments were taxable as capital gains.

## Issue(s)

1. Whether the lump-sum payments received by the Days for conveying their water rights to Pan American constituted ordinary income or capital gain.

## Holding

1. No, because the Days did not retain an economic interest in the water; the payments were not contingent on production, and the water was a nonrenewable resource.

**Court’s Reasoning**

The court applied principles from oil and gas taxation, finding that the Days did not retain an economic interest in the water in place. The court emphasized that the lump-sum payments were fixed and not dependent on water extraction. The Days’ reserved right to use up to 100 barrels of water daily was deemed de minimis compared to Pan American’s intended use. The court also rejected the argument that the aquifer might be replenished, citing United States v. Ludey and United States v. Shurbet, which established that nonrenewable resources are subject to depletion. The court distinguished this case from others where an economic interest was retained, concluding that the Days’ transaction constituted a sale of a capital asset.

**Practical Implications**

This decision establishes that lump-sum payments for the sale of nonrenewable water rights, without retaining an economic interest, are taxable as capital gains. Attorneys should advise clients that structuring such transactions as sales, rather than leases, can result in more favorable tax treatment. The case also has implications for the management of nonrenewable resources, as it highlights the tax benefits of selling such rights outright. Subsequent cases have followed this precedent, reinforcing the principle that the nature of the interest retained by the grantor is crucial in determining the tax treatment of such transactions.

 