56 T.C. 185 (1971)

Payments received for extracted minerals are taxed as ordinary income subject to depletion allowance, not capital gains, if the grantor retains an economic interest in the minerals, regardless of the formal language of the conveyance.

Summary

Ollie G. Rose, a part-owner of land, entered into a “Sand and Gravel Deed” with grantees, styled as a sale of minerals in place. The agreement included a fixed sum payable in installments and additional payments based on the quantity of sand and gravel extracted beyond a certain threshold. The Tax Court determined that despite the deed’s language, the substance of the agreement was a royalty arrangement where Rose retained an economic interest. Consequently, the payments received were deemed ordinary income subject to a 5% depletion allowance, not capital gains from the sale of property.

Facts

1. Ollie G. Rose co-owned land containing sand and gravel deposits.
2. On July 1, 1963, Rose and other co-owners executed a document titled “Sand and Gravel Deed” with Richard C. Prater and R.W. Dial (grantees).
3. The deed purported to sell all sand and gravel in place for $10,000, payable in annual installments over eight years.
4. Grantees were allowed to extract 2,500 cubic yards of sand and gravel annually without additional payment.
5. Extraction beyond 2,500 cubic yards per year required additional payments based on a set price per cubic yard depending on classification.
6. The deed included clauses for reversion of title to unextracted minerals upon default or after eight years.
7. Rose reported income from the agreement as long-term capital gain.
8. The Commissioner of Internal Revenue determined the income was ordinary income subject to depletion.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Ollie G. Rose for the taxable years 1964, 1965, and 1966. Rose petitioned the Tax Court contesting the Commissioner’s determination that income from the “Sand and Gravel Deed” was ordinary income rather than capital gain.

Issue(s)

Whether payments received by Rose under the “Sand and Gravel Deed” for sand and gravel extraction constitute long-term capital gain from the sale of property, or ordinary income subject to a 5-percent allowance for depletion.

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Holding

No. The payments received by Rose constitute ordinary income subject to a 5-percent depletion allowance because Rose retained an economic interest in the sand and gravel, and the agreement, despite being styled as a sale, was in substance a royalty agreement.

Court's Reasoning

The Tax Court reasoned that the substance of the agreement, not merely its form or the terminology used, dictates its tax consequences. The court emphasized that the key question is whether the landowner sold the minerals "in place" or retained an "economic interest." Referencing prior cases like *Wood v. United States* and *Rutledge v. United States*, the court highlighted that retention of an economic interest means the income is ordinary income.

The court found several factors indicating Rose retained an economic interest:

1. **Contingent Payments:** Beyond the initial $10,000, payments were directly tied to the quantity and quality of sand and gravel extracted. This royalty-like structure is inconsistent with a sale of minerals in place.

2. **Reversion Clauses:** The automatic reversion of title to unextracted minerals after eight years and upon default is characteristic of a lease or royalty agreement, not a sale. The court stated, "An automatic reversion after 8 years is no different than the provision for a term for years commonly found in leases or royalty agreements."

3. **Substance Over Form:** Despite the deed's language of "sale" and "conveyance," the court looked to the "total effect" of the agreement, citing *Commissioner v. P. G. Lake, Inc.*, stating, "The essence of the agreement 'is determined not by subtleties of draftsmanship but by * * * total effect.'" The court concluded that the agreement's total effect was a royalty arrangement.

4. **Minimum Guaranteed Royalty:** The $10,000 fixed payment was considered an advance royalty or a minimum guaranteed royalty, further supporting the interpretation as a royalty agreement rather than a sale.

The court dismissed the taxpayer's reliance on *Crowell Land & Mineral Corp. v. Commissioner*, distinguishing it by noting that in *Crowell*, the Fifth Circuit heavily emphasized the unambiguous language of sale, which was not the case here. The court concluded that the "transparent attempt to metamorphose a royalty agreement into a sale" failed, and the payments were indeed ordinary income.

Practical Implications

Rose v. Commissioner reinforces the principle of substance over form in tax law,

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particularly in mineral rights transactions. It clarifies that merely labeling an agreement as a “sale” does not guarantee capital gains treatment if the economic realities indicate a retained economic interest. For legal professionals and businesses in the natural resources sector, this case underscores the importance of carefully structuring mineral extraction agreements. The presence of royalty-based payments, reversion clauses, and term limitations are strong indicators of a retained economic interest, leading to ordinary income tax treatment. When analyzing similar cases, courts will look beyond the formal language to the underlying economic relationship between the parties to determine the true nature of the transaction and its tax implications. This case is frequently cited in disputes involving the characterization of income from natural resource extraction, emphasizing the enduring relevance of the economic interest test.

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