Linebery v. Commissioner, 64 T. C. 108 (1975)

Payments for the use of mineral and water rights, linked to production, are considered ordinary income rather than capital gains.

Summary

In Linebery v. Commissioner, the U. S. Tax Court ruled that payments received by the Lineberys from Shell Oil Co. for water rights and a right-of-way, as well as payments for caliche extraction, were ordinary income rather than capital gains. The court's decision hinged on the economic interest retained by the Lineberys, as the payments were contingent on production and use of the rights. The ruling followed the precedent set by the Fifth Circuit in Vest v. Commissioner, which deemed similar arrangements as leases, not sales. The Lineberys' argument for capital gains treatment was rejected, reinforcing the principle that income from the extraction of minerals and use of water rights, tied to production, is taxable as ordinary income.

Facts

Tom and Evelyn Linebery owned the Frying Pan Ranch, located in Texas and New Mexico. In 1963, they entered into an agreement with Shell Oil Co. to convey water rights and a right-of-way across their land for the transportation of water used in oil recovery operations. The agreement provided for monthly payments based on a percentage of the amounts Shell received from water sales. Separately, in 1959 and 1960, the Lineberys conveyed surface interests in their land to construction companies, allowing the extraction of caliche, with payments based on the volume extracted. In 1969, Tom Linebery donated a building and lot to the College of the Southwest, claiming a charitable deduction based on the property's fair market value.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Lineberys' federal income tax for 1967, 1968, and 1969, treating the payments from Shell and the caliche sales as ordinary income. The Lineberys filed a petition in the U. S. Tax Court, arguing for capital gains treatment. The court's decision followed the precedent set by the Fifth Circuit in Vest v. Commissioner, which had ruled on a similar issue. The Tax Court also determined the fair market value of the donated property.

Issue(s)

1. Whether the monthly receipts from Shell Oil Co. for water rights and a right-of-way are taxable as ordinary income or as capital gain?
2. Whether the amounts received from the extraction of caliche are taxable as ordinary income or as capital gain?
3. What is the fair market value of the lot and building contributed to the College of

the Southwest?

Holding

1. No, because the payments were contingent on the use of the pipelines and the sale of water, making them ordinary income as per the Vest precedent.
2. No, because the payments for caliche were tied to extraction and the Lineberys retained an economic interest in the minerals, classifying them as ordinary income.
3. The fair market value of the donated property was determined to be $9,000.

Court's Reasoning

The court's decision was heavily influenced by the Fifth Circuit's ruling in Vest v. Commissioner, which characterized similar transactions as leases rather than sales. The court noted that the payments from Shell were inextricably linked to the withdrawal of water or the use of the pipelines, indicating a retained interest incompatible with a sale. The court applied the economic interest test from Commissioner v. Southwest Exploration Co. , finding that the Lineberys were required to look to the extraction of water and caliche for a return of their capital. The court also considered the terminable nature of the caliche agreements and the lack of a fixed sales price in the Shell agreement as evidence of ordinary income. The fair market value of the donated property was assessed based on various factors, including replacement cost, physical condition, location, and use restrictions.

Practical Implications

This decision underscores the importance of the economic interest test in distinguishing between ordinary income and capital gains in mineral and water rights transactions. Attorneys advising clients on similar agreements must carefully structure the terms to avoid unintended tax consequences, ensuring that payments are not contingent on production or use. The ruling reaffirms the principle that income derived from the extraction of minerals or the use of water rights, when tied to production, will be treated as ordinary income. This has significant implications for landowners and businesses engaged in such transactions, as it affects their tax planning and reporting. Subsequent cases have followed this precedent, reinforcing the need for clear delineation between sales and leases in mineral rights agreements.

