T.C. Memo. 1976-111

Payments received for water rights and caliche extraction, where the payment is contingent on production, are considered ordinary income, not capital gain; charitable contribution deductions are limited to the fair market value of the donated property.

Summary

Tom and Evelyn Linebery disputed deficiencies in their federal income tax related to income from water rights and caliche sales, and the valuation of a charitable contribution. The Tax Court addressed whether payments from Shell Oil for water rights and a right-of-way, and from construction companies for caliche extraction, should be taxed as ordinary income or capital gain. The court, bound by Fifth Circuit precedent in *Vest v. Commissioner*, held that the water rights and right-of-way payments were ordinary income because they were tied to production. Similarly, caliche sale proceeds were deemed ordinary income as the Lineberys retained an economic interest. Finally, the court determined the fair market value of donated property for charitable deduction purposes was less than claimed by the Lineberys.

Facts

The Lineberys owned the Frying Pan Ranch in Texas and New Mexico. In 1963, they granted Shell Oil Company water rights and a right-of-way for a pipeline across their land in exchange for monthly payments based on water production. The water was to be used for secondary oil recovery. Separately, in 1959 and 1960, the Lineberys granted construction companies the right to excavate and remove caliche from their land, receiving payment per cubic yard removed. In 1969, Tom Linebery donated land and a building to the College of the Southwest, claiming a charitable deduction based on an appraised value higher than his adjusted basis.

Procedural History

The IRS determined deficiencies in the Lineberys' income tax for 1967, 1968, and 1969, arguing that income from water rights and caliche sales was ordinary income, not capital gain, and that the charitable contribution was overvalued. The Lineberys petitioned the Tax Court to dispute these deficiencies.

Issue(s)

1. Whether amounts received from Shell Oil Co. for water rights and a right-of-way are taxable as ordinary income or capital gain.
2. Whether amounts received from caliche extraction are taxable as ordinary income or capital gain.
3. Whether the Lineberys properly valued land and a building contributed to an exempt educational organization for charitable deduction purposes.

Holding

1. No, because the payments were inextricably linked to Shell's withdrawal of water and use of pipelines, representing a retained economic interest and resembling a lease rather than a sale.
2. No, because the Lineberys retained an economic interest in the caliche in place, as payments were contingent upon extraction, making the income ordinary income.
3. No, the court determined the fair market value of the donated property was $9,000, less than the claimed deduction of $14,164, and allowed a charitable deduction up to this fair market value, which was still more than the IRS initially allowed (adjusted basis).

Court's Reasoning

Water Rights and Right-of-Way: The court followed the Fifth Circuit's decision in *Vest v. Commissioner*, which involved a nearly identical transaction. The court in *Vest* held that such agreements were more akin to mineral leases than sales because the payments were contingent on water production and pipeline usage, indicating a retained economic interest. The Tax Court noted, "The Vests' right to receive payments was linked inextricably to Shell's withdrawal of water or use of the pipelines. Without the occurrence of one or both of those eventualities, Shell incurred no liability whatever. This symbiotic relationship — between payments and production — is the kind of retained interest which makes the Vest-Shell agreement incompatible with a sale and more in the nature of a lease.". The court found the Lineberys' situation indistinguishable from *Vest* and thus bound by precedent.

Caliche Sales: Applying the economic interest test from *Commissioner v. Southwest Exploration Co.*, the court determined that the Lineberys retained an economic interest in the caliche. The payments were contingent upon extraction; if no caliche was removed, no payment was made. The court reasoned, "Quite clearly, the amount of the payment was dependent upon extraction, and only through extraction would petitioners recover their capital investment." This contingent payment structure classified the income as ordinary income, not capital gain from the sale of minerals in place.

Charitable Contribution Valuation: The court considered various factors to determine the fair market value of the donated land and building, including replacement cost, construction type, condition, location, accessibility, rental potential, and use restrictions. Finding no comparable sales, the court weighed the evidence and concluded a fair market value of $9,000, which was less than the petitioners' claimed $14,164 but more than their adjusted basis of $7,029.76.

Practical Implications

Linebery v. Commissioner, following *Vest*, clarifies that income from water rights or mineral extraction agreements, where payments are contingent on production or removal, is likely to be treated as ordinary income for federal tax purposes, especially in the Fifth Circuit. Taxpayers cannot treat such income as capital gains if they retain an economic interest tied to production. This case emphasizes the importance of structuring resource conveyance agreements carefully to achieve desired tax outcomes. For charitable contributions of property, taxpayers must realistically assess and substantiate fair market value; appraisals should be well-supported and consider all relevant factors influencing value. This case serves as a reminder that contingent payments linked to resource extraction generally indicate a lease or royalty arrangement for tax purposes, not a sale.

