Lesher v. Commissioner, 73 T. C. 340 (1979)

Income from the extraction of gravel is ordinary income subject to depletion when the landowner retains an economic interest in the gravel in place.

Summary

The Leshers sold gravel from their farmland to Maudlin Construction Co. under agreements specifying payment per ton extracted. The key issue was whether this income should be treated as capital gains or ordinary income subject to depletion. The court ruled that the Leshers retained an economic interest in the gravel in place, as their payment was contingent on the quantity of gravel extracted, thus classifying the income as ordinary and subject to depletion. Additionally, the court found that a structure built by the Leshers for hay storage and cattle feeding qualified for investment credit as a single-purpose livestock structure.

Facts

Orville and Carol Lesher purchased farmland in Iowa in 1967, aware of existing gravel deposits. In 1974, they contracted with Maudlin Construction Co. to sell gravel needed for specific road projects and county needs. The agreements specified that Maudlin would pay the Leshers 25 cents per ton of gravel extracted and weighed by county authorities. The Leshers also built a Morton Building in 1974, primarily used for storing hay and feeding cattle during winter months.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Leshers' income taxes for 1974 and 1975, treating the gravel income as ordinary income subject to depletion and disallowing an investment credit for the Morton Building. The Leshers petitioned the U. S. Tax Court, which heard the case in 1978 and issued its decision in 1979.

Issue(s)

1. Whether payments received by the Leshers from Maudlin for gravel extraction constitute ordinary income subject to depletion or long-term capital gains?
2. Whether the Morton Building erected by the Leshers qualifies as a storage facility for bulk storage of fungible commodities or as a single-purpose agricultural structure for investment credit purposes?

Holding

1. Yes, because the Leshers retained an economic interest in the gravel in place, as their payment was contingent upon the quantity of gravel extracted.
2. Yes, because the Morton Building qualifies as a single-purpose livestock structure for investment credit, as it was specifically designed, constructed, and used for

feeding cattle with stored hay.

Court's Reasoning

The court applied the "economic interest" test to determine the character of the income from gravel extraction. It found that the Leshers' income was tied to the extraction process, as payment was based on the quantity of gravel removed and weighed. The court rejected the Leshers' argument that the agreements constituted sales contracts, noting that Maudlin was not obligated to extract all gravel and that the Leshers retained rights to use extracted gravel. The court also considered the Leshers' continued participation in the extraction risks and their reliance on extraction for return of capital. Regarding the Morton Building, the court determined it did not qualify as a storage facility under the "bulk storage of fungible commodities" provision due to its adaptability to other uses and its function beyond mere storage. However, it did qualify as a single-purpose livestock structure because it was specifically designed and used for feeding cattle, with the storage of hay being incidental to this function.

Practical Implications

This decision clarifies that landowners who receive payments based on the quantity of minerals extracted retain an economic interest in those minerals, resulting in ordinary income subject to depletion rather than capital gains. This ruling impacts how similar agreements should be structured and analyzed, emphasizing the importance of the terms of payment in determining the tax treatment of income from mineral extraction. For legal practice, attorneys must carefully draft and review mineral extraction agreements to ensure clients' desired tax treatment. The decision also affects business practices in the mining and construction industries, where such agreements are common. The court's interpretation of the investment credit provisions for agricultural structures provides guidance on how to classify structures used in farming operations, potentially affecting tax planning for farmers and ranchers. Subsequent cases, such as those involving similar mineral extraction agreements, have cited Lesher to support the application of the economic interest test.

