***Maddrix v. Commissioner, 83 T. C. 613, 1984 U. S. Tax Ct. LEXIS 22, 83 T. C. No. 33 (1984)***

Advance royalties are not deductible in the year paid unless paid pursuant to a minimum royalty provision requiring substantially uniform annual payments.

**Summary**

In Maddrix v. Commissioner, the Tax Court ruled that advance royalties paid by James Maddrix for a coal mining venture were not deductible in the year paid because they did not meet the criteria of a minimum royalty provision. Maddrix had invested in a coal mining program and paid royalties partly in cash and partly through a nonrecourse note. The court found that the obligation to pay royalties was contingent on coal sales and not a uniform annual requirement, thus failing to qualify as a deductible expense under the applicable tax regulations. This decision emphasizes the importance of a clear, enforceable obligation for annual payments in determining the deductibility of advance royalties.

**Facts**

James Maddrix invested in Investors Mining Program 77-2, a coal mining venture, and entered into a sublease agreement with Olentangy Resources, Inc. for coal extraction. The agreement required an "annual minimum royalty" of $300,000 payable each year. Upon commencement, Maddrix contributed $31,230 in cash and executed a nonrecourse promissory note for $103,239 as his share of the royalty. Simultaneously, a mining services contract was made with Big Sandy Creek Mining Co. , Inc. , an affiliate of Olentangy, which agreed to mine coal and pay liquidated damages if it failed to meet minimum delivery obligations. No coal was mined in 1977, the year Maddrix claimed deductions for the royalties.

**Procedural History**

The Commissioner of Internal Revenue issued a notice of deficiency to Maddrix for the 1977 tax year. Maddrix petitioned the U. S. Tax Court, and the Commissioner moved for partial summary judgment regarding the deductibility of the advance royalties. The Tax Court granted the Commissioner's motion, determining that the royalties did not qualify as deductible under the applicable tax regulations.

**Issue(s)**

1. Whether the royalties paid by Maddrix in 1977 constitute "advanced minimum royalties" within the meaning of section 1. 612-3(b)(3) of the Income Tax Regulations.
2. If so, whether Maddrix may deduct the entire claimed prepaid advanced minimum royalties in 1977 or only the portion allocable to that year.

**Holding**

1. No, because the royalties were not paid pursuant to a minimum royalty provision requiring substantially uniform annual payments.
2. No, because the royalties do not qualify as advanced minimum royalties, and no coal was sold in 1977.

**Court's Reasoning**

The court analyzed whether the royalties met the regulatory definition of a "minimum royalty provision," which requires a substantially uniform amount of royalties to be paid at least annually over the lease term. The court found that the nonrecourse note, payable solely from coal sales proceeds, did not establish an enforceable requirement for annual payments, as the payment was contingent on coal sales. The court also noted that the liquidated damages clause in the mining services contract did not guarantee payment of the royalties, due to the close affiliation between Olentangy and Big Sandy Creek and the latter's limited financial resources. The court cited its decision in Wing v. Commissioner, emphasizing that the requirement for payment must be enforceable and not contingent on production.

**Practical Implications**

This decision clarifies that for advance royalties to be deductible in the year paid, they must be pursuant to a minimum royalty provision that mandates uniform annual payments regardless of production. Tax practitioners should ensure that lease agreements contain clear, enforceable obligations for annual payments to secure deductions for clients. The ruling may impact the structuring of mineral leases and the tax planning for investors in such ventures, as it underscores the importance of non-contingent payment terms. Subsequent cases like Walls v. Commissioner have followed this reasoning, reinforcing the court's stance on the deductibility of advance royalties.

 