87 T.C. 305 (1986)

A taxpayer must look solely to the extraction of minerals for the return of capital to retain an economic interest in those minerals, which is necessary for capital gains treatment of royalty income under Section 631(c) of the Internal Revenue Code.

Summary

Hazel Deskins disposed of coal under a contract termed “Coal Lease,” receiving a guaranteed minimum annual royalty totaling $4.3 million over ten years, regardless of coal extraction. Deskins claimed capital gains treatment on these royalties under Section 631(c) I.R.C., arguing she retained an economic interest. The Tax Court held that because Deskins was guaranteed $4.3 million irrespective of mining, she did not depend solely on coal extraction for capital return and thus did not retain an economic interest. Consequently, the royalty payments were not eligible for capital gains treatment and were subject to imputed interest rules under Section 483 I.R.C.

Facts

Petitioner Hazel Deskins owned land with recoverable coal reserves.

In 1977, Deskins entered into a “Coal Lease” agreement with Wellmore Coal Corp. for coal disposal.

The contract stipulated a tonnage royalty of $1 per ton of coal mined, but capped total payments at $4.3 million.

Wellmore was obligated to pay an annual minimum royalty of $430,000 for ten years, totaling $4.3 million, irrespective of coal mined.

Tonnage royalties earned could offset annual minimum royalties paid, and excess tonnage royalties could be recouped against prior or future minimum royalties.

The contract stated Wellmore held the economic interest in the coal for tax purposes.

Wellmore paid annual minimum royalties but had not mined any coal by the time of trial.

Deskins reported the royalty income as capital gains; the IRS reclassified a portion as ordinary interest income.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Deskins’s 1980 federal income taxes.

Deskins petitioned the United States Tax Court to contest the deficiency.

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The Tax Court reviewed the case to determine if Deskins retained an economic interest in the coal and if payments were subject to imputed interest.

Issue(s)

1. Whether, under the "Coal Lease" contract, Deskins retained an economic interest in the coal such that payments received qualify for capital gain treatment under Sections 631(c) and 1231(b)(2) of the Internal Revenue Code.
2. If Section 631(c) does not apply, whether the payments Deskins received are subject to the imputed interest rules of Section 483 of the Internal Revenue Code.

Holding

1. No, because Deskins was guaranteed to receive $4.3 million regardless of coal extraction, she did not look solely to coal extraction for the return of her capital and therefore did not retain an economic interest in the coal under the contract.
2. Yes, because Section 631(c) does not apply, the payments are considered deferred payments from a sale of property and are subject to the imputed interest rules of Section 483.

Court's Reasoning

The court reasoned that for royalty income to qualify for capital gains treatment under Section 631(c), the owner must retain an "economic interest" in the mineral.

An economic interest exists when the taxpayer (1) has invested in the mineral in place and (2) derives income from mineral extraction to which they must look for capital return. Citing *Commissioner v. Southwest Exploration Co., 350 U.S. 308, 314 (1956)*.

The critical element is whether the taxpayer must look *solely* to the extraction of the mineral for the return of capital. Citing *O'Connor v. Commissioner, 78 T.C. 1, 10-11 (1982)*.

In this case, Deskins was guaranteed $4.3 million, irrespective of coal mining. The court stated, "Because petitioner will receive $ 4.3 million regardless of whether any coal is ever actually mined, she need not look to extraction of the coal for the return of her capital and, consequently, she has not retained an economic interest in the coal."

The court distinguished this case from typical coal leases where royalties are contingent on extraction, emphasizing that the fixed total payment and open-ended recoupment provision in Deskins's contract eliminated the dependence on extraction for capital return.

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Because Deskins did not retain an economic interest, Section 631(c) did not apply, and the transaction was treated as an installment sale of a capital asset, subject to imputed interest under Section 483.

Practical Implications

Deskins v. Commissioner clarifies the "economic interest" doctrine in the context of coal leases and Section 631(c) of the IRC.

It highlights that guaranteed minimum royalties, especially when capped at a total sum regardless of extraction, can negate the retention of an economic interest.

Legal professionals should carefully analyze mineral lease agreements to determine if payment structures create a guaranteed return independent of extraction, which could disqualify royalty income from capital gains treatment.

This case emphasizes the importance of structuring mineral disposal contracts so that the lessor's income is genuinely contingent on mineral extraction if capital gains treatment under Section 631(c) is desired.

Later cases distinguish *Deskins* by focusing on contracts where, despite minimum royalties, the ultimate payout was still primarily dependent on actual production volume and market prices, thus preserving the economic interest.

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