***Crooks v. Commissioner, 92 T. C. 816 (1989)***

The conveyance of a mineral interest in exchange for other property, while retaining a royalty interest, is treated as a lease rather than a sale for federal income tax purposes.

**Summary**

In Crooks v. Commissioner, the Tax Court ruled that the conveyance of mineral rights in exchange for four farms and farm equipment, while retaining a royalty interest, constituted a lease for tax purposes. The Crooks argued that the transaction was a like-kind exchange under IRC section 1031, but the court disagreed, holding that no sale or exchange occurred because the Crooks retained an economic interest in the minerals. Consequently, the value of the farms and equipment received was deemed a lease bonus, taxable as ordinary income. This case highlights the importance of the economic interest doctrine in distinguishing between leases and sales in mineral transactions.

**Facts**

In 1981, oil was discovered on the Crooks' 160-acre farm in Brown County, Illinois. In 1982, the Crooks entered into an agreement with Henry Energy Corp. , conveying all their mineral rights in the farm in exchange for four farms in Adams County, Illinois, new farm equipment, and a one-fourth royalty interest in any oil or gas produced from the conveyed minerals. The agreement was formalized through a mineral deed and a quitclaim deed transferring the farms and equipment to the Crooks.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in the Crooks' federal income taxes for 1982 and 1983, asserting that the transaction constituted a lease, and the value of the farms and equipment received was a taxable lease bonus. The Crooks petitioned the U. S. Tax Court, arguing that the transaction was a like-kind exchange under IRC section 1031, and thus, should be non-taxable. The Tax Court ultimately ruled in favor of the Commissioner, holding that the transaction was a lease and the value of the farms and equipment was taxable as ordinary income.

**Issue(s)**

1. Whether the Crooks retained an economic interest in the minerals underlying the Brown County farm.
2. Whether the conveyance of the minerals in consideration for four parcels of real property constituted a like-kind exchange under IRC section 1031.

**Holding**

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1. Yes, because the Crooks retained a one-fourth royalty interest in the minerals, which constituted an economic interest under the economic interest doctrine.
2. No, because the transaction was characterized as a lease rather than a sale or exchange, and thus, did not qualify for nonrecognition under IRC section 1031.

**Court's Reasoning**

The court applied the economic interest doctrine, established in cases like *Palmer v. Bender* and *Burnet v. Harmel*, which states that a taxpayer retains an economic interest in minerals if they have a right to share in the produced minerals. The Crooks retained a one-fourth royalty interest, indicating they had an economic interest and must look solely to the extraction of the minerals for a return of their capital. The court rejected the Crooks' argument that the farms and equipment provided an alternative source for capital recovery, as the agreement did not suggest these assets were to be used in lieu of royalty payments. The court also clarified that state law does not control the federal tax treatment of such transactions. For the second issue, the court followed *Pembroke v. Helvering*, holding that granting a lease in exchange for property does not constitute a sale or exchange under IRC section 1031, as no gain or loss is realized from a lease. The court distinguished *Crichton v. Commissioner*, noting that it involved the exchange of a royalty interest, not the creation of a lease while retaining a royalty interest.

**Practical Implications**

This decision clarifies that when a mineral interest is conveyed while retaining a royalty interest, the transaction is treated as a lease for federal income tax purposes. Practitioners should advise clients that such transactions will result in the value of any received property being taxed as ordinary income rather than qualifying for nonrecognition under IRC section 1031. This ruling impacts how mineral transactions are structured, particularly in oil and gas-rich areas, and may influence business decisions regarding the conveyance of mineral rights. Subsequent cases have followed this precedent, reinforcing the economic interest doctrine's role in determining the tax treatment of mineral conveyances.

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