

## CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 120

May 8, 1958

### CONSIDERATION FOR TRANSFER OF OIL AND GAS INTEREST: CAPITAL GAIN OR ORDINARY

#### Syllabus:

Bonus payments received for transfer of an oil and gas interest are ordinary income if the transferor retains an economic interest in the oil and gas in place.

Taxpayer owned, as sub-lessee, mineral leaseholds under which it was obliged to explore and develop the lands for oil and gas. In July, 1948 taxpayer concluded an agreement with X Oil Co. by which X Oil Co. was to pay taxpayer a stipulated amount for a one-half interest in the leasehold. X Oil Co. was to advance the cost of operations and carry out taxpayer's drilling obligations, market the oil, and divide the proceeds on a 50-50 basis after reimbursing itself for the joint expense advanced. Taxpayer retained the right to inspect the books and operations, to disprove certain expenditures including the location of new wells, and had an option to advance its share of the expenses and participate in the production. X Oil Co. paid a lump sum as bonus money in 1948. Advice is requested whether the lump sum payment was ordinary income or capital gain.

In determining the character of such bonus payments, it is necessary to determine whether the parties contracted a sale of the mineral interest or a leasing agreement to exploit the minerals for the joint benefit of the contracting parties. If the contract makes no provision for the retention of an economic interest in the oil and gas in place, the transaction is a sale and the bonus payment is capital gain. If the contract provides for retention of such an interest the transaction is a lease and the bonus is ordinary income. Burnet v Harmel, 287 U.S. 103; Palmer v Bender, 287 U.S. 551; see also GCM 27322, 1952-2 CB 62. The economic interest must be retained in the oil and gas in place; a mere economic advantage arising out of the exploitation is insufficient. Helvering v Bankline Oil Co., 303 U.S. 362. The Supreme Court approaches each transaction subjectively to determine whether the mineral interest is sold or whether an economic interest is retained so that both parties must look to production for a return of their capital. Kirby Petroleum Co. v Comm., 326 U.S. 599; Burton-Sutton Oil Co. v Comm., 328 U.S. 25.

The transfer of a one-half interest to X Oil Co. is not inconsistent with the concept of a retained economic interest. The contract contained, in addition to the transfer, covenants to perform which are essential to the enjoyment of both shares, and X's economic expectancy is not to be enjoyed until performance. It is apparent that the parties did not intend a mere sale, but a contract to exploit the minerals for their joint benefit. Therefore, the bonus payment is an advance royalty payment and as such is ordinary income.