

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 227

October 27, 1959

ROYALTIES – ORDINARY INCOME – DEPLETIONS: TREATMENT OF AN OVERRIDING ROYALTY

Syllabus:

An overriding royalty is a lease bonus herein to the lessor and is a depletable advance royalty.

X owned a royal interest in an oil lease with Y Oil Company. The lease was later modified to increase the acreage covered by the lease and to increase X's royalty interest in the acreage covered by the original lease.

Ordinarily no tax consequences arise out of the granting of an oil and gas lease. But when something of value is given to the lessor in addition to his retained interest in production, the "boot" is taxable as an advance royalty.

The transaction was a lease with a bonus provision. X granted the Y Company additional acreage as consideration for a landowner's royalty on that acreage, and an overriding royalty on the original acreage. The present value of the bonus is ordinary income to X and is subject to a depletion allowance. This is not a nontaxable exchange, since the lessor has not disposed of a capital asset, but has divided the oil and gas in place and retained a royalty interest.