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IS REVENUE RULING 83-46 A “DUSTER” FOR SERVICE CONTRIBUTORS SEEKING “TAX FREE” POOL OF CAPITAL TREATMENT?

Juan E. Arrache, Jr.*

I. INTRODUCTION

One of the most critical and important aspects of the oil industry is its ability to generate sufficient working capital to maintain and to increase its exploration activities so that it can continue to service the ever-increasing energy needs of this country. Since the first discoveries of oil in this country, development of capital has been fostered, in part, by service providers contributing their services instead of cash, to the acquisition, exploration, and development of oil and gas properties. In the early days of the industry, in oil and gas producing states such as Oklahoma, Texas, and California, the person with a little cash, the prospector with a little knowledge of geology, and the driller who owned a cable tool rig, would come together to discover and to develop oil and gas producing wells. All of them would share the joy of discovery or alternatively, the disappointment of loss in having produced a “dry hole.”¹

As time went on, more and more specialists contributed their services, as did the cash and equipment investor, to the “pool of capital.” Added to the list of types of contributions were the services of the independent geologist/prospector, independent geologist/drilling advisor, geologist/corporation, petroleum engineer, driller/drilling corporation, tax shelter promoter, attorney, accountant, landman/independent contractor, landman/employee, and the corporation executive. Each contributed his services and each received an economic interest in the property rather than a cash payment.²

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1. A dry well is also known as a “duster.”
Long before such decisions as Diamond, Frazell, and James A. Lewis Engineering, Inc. received publicity, the service providers did not usually recognize income until their property interest began producing hydrocarbons. The Internal Revenue Service (IRS) officially recognized this deferral policy in its General Counsel Memorandum (G.C.M.) 22730 memorandum in 1941 and this policy continued to influence IRS decisions with respect to service contributors for over forty-two years. Then, without fanfare, the IRS issued Revenue Ruling 83-46, and some regard its cryptic message to be a substantial shift in policy by the IRS.

The ruling left the area unsettled because of the manner in which the IRS chose to announce its change of direction, rather than from the legal result of the ruling. This is because Revenue Ruling 83-46 offers a mere legal conclusion with no supporting analysis.

The oil industry has expressed dissatisfaction with the ruling. Most of the criticism emanates from the smaller oil companies and service contributors, such as geologists and land agents.
Major oil companies rarely enter into a “pool of capital” arrangement wherein contributors of services acquire an economic interest in property they own. The practice has essentially been confined to the smaller oil companies or independents. The uncertainty caused by Revenue Ruling 83-46 greatly disadvantages an important segment of the oil industry, particularly service contributors such as the geologist, the promoter, the attorney, and the corporate employee. The geologists are concerned because their services are not addressed in the ruling, yet they have been sanctioned in private letter rulings. They fear that their services may be the next to be excluded by the IRS from the “pool of capital” treatment. Thus, the holding of Revenue Ruling 83-46 will function as a force-

ascertainable value until the mineral is marketed and suggests that no value exists for inclusion into gross income under I.R.C. § 83 (P-H 1984)); 21 Tax Notes No. 1, 13 (Oct. 3, 1983) (a letter from William V. Knight, an independent geologist, from Tulsa, Okla., to Rep. James R. Jones, D-Okla., forwarded to the Treasury Dep’t. Mr. Knight opposed Rev. Rul. 83-46 and stated that the ruling “discriminates against small businesses” by discouraging geologists from accumulating overrides to form the capital needed for small oil companies); 21 Tax Notes No. 5, 379 (Oct. 31, 1983) (Joe H.E. Ward, president of the Society of Independent Professional Earth Scientists, Midland, Tex., opposed Rev. Rul. 83-46 and favored the traditional “pool of capital” concept recently reaffirmed in I.R.S. Letter Ruling 8047005 (July 24, 1980). He asks the IRS to reconsider Rev. Rul. 83-46); 21 Tax Notes No. 8, 655 (Nov. 21, 1983) (in a letter from a C.P.A. that Sen. John Tower forwarded to the Treasury, the C.P.A. contends Rev. Rul. 83-46 is incorrect; that in two of the situations cited therein, there occurred acquisitions of property with services rather than § 83 transfers of property for services. He stated; “Section 83 does not relate to the acquisition of an interest in property); 22 Tax Notes No. 1, 12 (Jan. 2, 1984) (a letter from H.B. Scoggins, Counsel for the Independent Petroleum Association of America, Washington, D.C.: Mr. Scoggins pointed out that IRS agents were already applying Rev. Rul. 83-46 to factual situations outside the scope of the ruling); 22 Tax Notes No. 8, 661 (Feb. 20, 1984) (Mr. Scoggins again wrote to Treasury and provided the IRS with a proposed modification of Rev. Rul. 83-46).

10. A major oil company is a large oil company whose stock is typically publicly held and traded. Typically, the major oil company is a wholly integrated company whose assets include oil and gas producing properties, refineries, and a product marketing and distribution system. Some of the major oil companies are Shell Oil Co., Exxon, and Chevron. On the other hand, independent oil companies tend to be smaller in size, closely-held entities and not integrated in most instances. The Internal Revenue Code § 613A(c) provides a definition of an Independent Producer for purposes of percentage depletion. The definition also applies in the provisions concerning the Windfall Profits Tax.

11. Telephone interview with William V. Knight, C.P.G.S., independent geologist from Tulsa, Okla. (June 11, 1984) (Mr. Knight is an alumnus of West Virginia Univ., Ohio State Univ., and the Univ. of Tulsa and holds B.S. and M.S. degrees in geology and lectures to nationwide audiences on acquisition, exploration, and development of oil and gas properties); and telephone interview with Harold Bertholf, geologist from Sacramento, Cal. (June 11, 1984) (Mr. Bertholf attended Univ. of California at Santa Barbara, Univ. of California at Los Angeles, Univ. of So. California, and Loyola Law School. He holds B.S. and M.S. degrees in geology, and is a consultant to government and industry); and telephone conversation with J.H. Parmenter, geologist, and president of Del Paso Exploration to a contract land agent (June 18, 1982) (Del Paso Exploration is primarily a contract land agent).
ful deterrent to the formation of the "pool of capital." This, in turn, will place an additional burden on the owner of the working interest to both raise the necessary capital and to assume the full burden of risk on speculative property. This deterrent will lead to less exploration and development and will ultimately affect all consumers of energy.

A substantial segment of the petroleum industry is affected; independents or small oil companies account for ninety-eight percent of all the oil companies in the United States.12

This article examines the policy and law prior to Revenue Ruling 83-46.13 It then examines the Revenue Ruling itself to determine whether it marks a change in IRS policy or whether the ruling is an attempt to clarify the policy reflected in its private letter rulings during the 1970's and 1980's. Finally, this article will indicate which service contributors the IRS may allow to continue to receive tax deferred treatment.

The focus of the article will then shift to the tax effects of section 8314 on the service contributor should Revenue Ruling 83-4615 apply to them. Some unique and interesting problems lie ahead in the IRS's attempt to fully analyze the tax effects of section 6116 on the service contributor's acquired economic interest.

The article will then explore alternate methods of structuring a transaction to avoid Revenue Ruling 83-46, including joint ventures or partnerships. The tax effects of a service contribution to the partnership will be considered in light of its practicability and acceptability in the industry, and in terms of the tax effects on the service contributor.

II. LEGISLATIVE INTENT AND HISTORY CONSIDERATIONS

The starting point in the analysis of tax consequences for the contributor of services to an oil and gas property should be the relevant social policy and legislative history of the statute governing taxation of oil and gas properties. The focus on policy and legislative

14. I.R.C. § 83 (P-H 1984). This section was added by Congress in 1969 to require the inclusion into income that property received by a person performing services in exchange for such property in the year received, or the year when transferred, or when substantial restrictions are removed. This section was perceived as needed for restricted property as an addition to § 61, which is the general definition of income.
intent is particularly important because prior to Revenue Ruling 83-46, the IRS decided that the congressional intent underlying section 83 suggested a change in the tax treatment of service providers to the pool of capital. The IRS concluded that G.C.M. 22730 had been "partially superseded by the 1954 Code, case law, and the 1969 Tax Reform Act." The foregoing discussion will demonstrate that this conclusion is not warranted.

It is clear that in order for a government to exist and to execute its proper functions, it must have a source of revenue. In the United States, this source in large measure is the income tax system. The scope and breadth of this taxing policy is expressed in section 61 of the Internal Revenue Code of 1954.

A. Legislative History and Intent of Section 61

Section 61(a) was clearly intended to encompass income from all sources. Therefore, it is quite naturally the starting point for the courts and the IRS to analyze cases and rulings which treat the taxation of the service contributor. The IRS further defined the scope of the section in Treasury Regulation 1.61 which includes gross income realized in the form of property, income as compensation paid in the form of property, and particularly, property transferred to an employee or independent contractor. The courts, likewise, have promulgated and fostered a broad definition of gross income under section 61.

What is significant about the legislative history of section 61 is that its predecessor statutes had been on the books for twenty-eight years. The origin of § 61 can be traced to the Act of October 3, 1913, ch. 16 § II, B, G, 38 Stat. 167, 172 (1913). See also, 1954 U.S. CODE CONG. & AD. NEWS 4155 (which indicates the breadth and scope of § 61 as well as the congressional intent to retain the same meaning in the 1954 Internal Revenue Code stating: "This section corresponds to § 22(a) of the 1939 Code. While the language in existing § 22(a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61(a) is as broad in scope as § 22(a)."").

18. I.R.C. § 61 (P-H 1984) (which states in part: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . . (1) Compensation for services, including fees, commissions, and similar items."). (emphasis added). The origin of § 61 can be traced to the Act of October 3, 1913, ch. 16 § II, B, G, 38 Stat. 167, 172 (1913). See also, 1954 U.S. CODE CONG. & AD. NEWS 4155 (which indicates the breadth and scope of § 61 as well as the congressional intent to retain the same meaning in the 1954 Internal Revenue Code stating: "This section corresponds to § 22(a) of the 1939 Code. While the language in existing § 22(a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61(a) is as broad in scope as § 22(a)."").
23. See, e.g., Eisner v. Macomber, 252 U.S. 189 (1920) (denying, however, Congress the power to tax a true stock dividend); Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955) (including punitive damages in gross income).
years before G.C.M. 22730 was decided. Furthermore, there is no evidence that Congress intended a change in the law each time the income tax statutes were revised. On the contrary, the evidence available shows that Congress did not intend to change section 61. Finally, because Congress re-enacted section 61 in substantially the same form as its predecessor, by principles of statutory construction, Congress is presumed to have acquiesced to the IRS practices such as G.C.M. 22730. This IRS memorandum deferred recognition of income where services are exchanged for oil and gas property interests in the "pool of capital."

Likewise, both the statute and regulations which include property as compensation in the calculation of gross income existed for some time before the passage of section 83 of the Internal Revenue Code of 1954. The IRS's interpretation that Congress intended to preempt section 61 by enacting section 83 in 1954 with respect to the treatment of an economic interest in an oil and gas property received by a service contributor, is not based on any evidence of legislative intent to that effect.

B. Legislative History and Intent of Section 83

The policy considerations and legislative history behind section 83 are important to examine in order to fully analyze the IRS posi-

24. See, e.g., Act of May 28, 1938 ch. 289, § 22, 52 Stat. 457 which states: 
(a) General Definition. — "Gross income" includes gains, profits and income derived from salaries, wages, or compensation for personal service, . . . vacations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. 
Id. (emphasis added).

25. See supra note 18.

26. Where Congress recreates a statute it is presumed to have knowledge of Treasury Regulations, court decisions, and administrative practice which have interpreted and fixed the meaning of the terms used. In line with this reasoning, there is a great body of cases holding that the reenactment of a statute substantially unchanged is persuasive indication of the adoption by Congress of a prior judicial construction thereof. . . . Also, it has been held that, where an administrative construction of a statute has been followed by Congressional reenactment without changes, a rebuttable presumption is created that Congress approved such construction of the statute.

1 J. MERTENS, JR., LAW OF FEDERAL INCOME TAXATION § 3.22, at Ch. 3-p. 43 (Rev. 1981) (emphasis added).


29. See supra note 18.
tion in Revenue Ruling 83-46. Section 83, entitled “Property Transferred in Connection With Performance of Services,” was adopted by Congress upon the recommendations of the President and the Treasury Department as part of a series of reform measures. It provides, in part, that if property is transferred “in connection with performance of services” then the person performing the services must include the fair market value of the property, less any amount paid in gross income in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

By adopting section 83, Congress did not intend to change the law then existing under section 61 with respect to inclusion into gross income the value of vested or unrestricted property received as compensation for services. What Congress did intend to do was to clarify a very convoluted and uncertain area of the law concerning restricted or nonvested property. This confusion arose from several years of inconsistent rulings based on regulations which the IRS promulgated. Additionally, section 83 was proposed by the administration and adopted by Congress to stop a perceived abuse, the failure of employees to include the benefits of nonqualified, restricted or deferred compensation plans in gross income.

It is important to note that the administration’s proposal which led to enactment of section 83, was referred to as “Restricted Stock

30. Since Congressional intent is the determining factor in the interpretation of a statute, the legislative history of a statute is extremely important. In determining Congressional intent, it is important to seek the circumstances and causes prompting the enactments, the public history of the times, and the evil to be remedied. See J. MERTENS, JR., supra note 24, at § 3.26, 62 (Rev. 1981).


32. I.R.C. § 83(a) (P-H 1984).

33. Vested is defined as “Fixed; accrued; settled; absolute . . . . Having the character of giving the rights of absolute ownership; not contingent; not subject to be defeated by a condition precedent.” BLACK'S LAW DICTIONARY 1734 (4th ed. 1951). Restriction is defined as follows: “To restrain within bounds; to limit; to confine.” BLACK'S LAW DICTIONARY 1478 (4th ed. 1951). Vested and nonvested property as well as restricted and unrestricted property for purposes of § 83 are defined at Treas. Reg. §§ 1.83-3 and 1.83-5 (1978).

34. See Reid, Property Transferred in Connection with Performance of Services under Section 83—Effectuation of Tax Reform Act Purpose, 17 WAYNE L. REV. 1267 (1971); see also Sexton and Boyle, How Proposed Section 83 Regs. Create Traps in Restricted Stock and Stock Option Areas, 39 J. TAX'N 184 (1973) (which stated: “Section 83, which was enacted as a part of the Tax Reform Act of 1969, was intended to equate treatment of nonqualified restricted stock plans with similar types of deferred compensation arrangements.”). Id.
Plans" transferred in connection with performance of services. This provides strong evidence that section 83 was originally designed for the present taxation of the value received from restricted compensation plans which are only a very narrow form of property. In proposing section 83, the House Report suggested that current law as of 1969 had no provision for rules to govern restricted stock plans. The House envisioned section 83 would override that situation.

Likewise, the Senate Report adopted essentially the same language as the House Report in articulating the then-current status of the law and the reasons for the change. Finally, the Conference Report conclusion contains the policy theme and intent of the House and Senate Reports and mandates that the special rules of section 83 be applied to restricted property, and particularly to stock.

The above-cited authorities make clear that Congress was at-

35. The Proposal

A. Time of Imposition of Tax. Under the proposal, an employee would be subject to tax at the time he acquires a nonforfeitable interest in the restricted stock (or other property). For this purpose, only substantial forfeitures would be taken into account. Thus, for example, requirements that the stock be returned to the employee if the employee commits a crime against the employer, or if he accepts employment with a firm in competition with the employer, would be disregarded as insubstantial. On the other hand, a requirement that the stock be returned to the employer if the employee fails to complete an additional period of service with the employer would be considered substantial, and the employee would not be considered to acquire a nonforfeitable interest until he completes that period of service.


36. Present law. Present law does not contain any specific rules governing the tax treatment of deferred compensation arrangements known as restricted stock plans . . . .

General reasons for change. The present treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for similar types of deferred compensation arrangements . . . .

. . . To the extent that a restricted plan can be considered a means of giving employer a stake in the business, your committee believes the present tax treatment of these plans is inconsistent with the specific rules provided by Congress in the case of qualified stock options, which were considered by Congress as the appropriate means by which an employee could be given a shareholder's interest in the business.


38. The House bill provides that a person who receives compensation in the form of property, such as stock which is subject to a restriction generally is to be taxed on the value of the property at the time of its receipt unless his interest is subject to a substantial risk of forfeiture. CONF. REP. NO. 782, 91st Cong., 1st Sess., reprinted in 1969 U.S. CODE CONG. & AD. NEWS 2392, 2418 (emphasis added).
tempting to fill a void by adopting rules that align nonqualified, restricted or deferred compensation plans with qualified plans, and thereby to eliminate the disparity of treatment between the two.

As noted, the plain language of this section suggests that its provisions apply only in the case of property subject to a restriction. A cardinal rule of statutory construction is that the plain, obvious, and rational meaning of words should be used in constructing a statute. Here the words plainly mean that the only subject matter governed by section 83 is restricted property.

The legislative history and legislative intent analysis suggests that section 83 plainly does not apply to the factual patterns found in Revenue Ruling 83-46. While not expressed in the Revenue Ruling, it is assumed that in each case, the taxpayer was conveyed a present vested overriding royalty interest. The conveyance was unconditional, not subject to any restrictions, and certainly neither subject to substantial forfeiture, nor restricted in transferability of the interest. Likewise, in the oil and gas industry, service contributors to the “pool of capital” typically receive unrestricted economic interests.

(a) General Rule. If in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed the excess of —

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable . . . .

I.R.C. § 83(a) (P-H 1984) (emphasis added).


41. The Revenue Ruling concerned services performed by (1) an attorney, (2) a corporate promoter of oil and gas syndications, and (3) an executive or a corporation in exchange for an oil and gas property interest. Rev. Rul. 83—46, 1983-1 C.B. 16.

42. An overriding royalty is defined as follows: “As applied to an existing oil and gas lease is a given percentage of gross production payable to some person other than the lessor or persons claiming under him.” BLACK'S LAW DICTIONARY 1287 (4th ed. 1957). An overriding royalty interest is defined by the IRS as

an economic interest of oil and gas in place, vested from the evolving interest that entitles its owner to a specified portion of gross production, free of operating and development costs. The terms of an overriding royalty interest is coextensive with the terms of the working interest from which it was created. Thus the transfer of an overriding royalty is an assignment of a property interest and is not an anticipatory assignment of income.

in oil and gas properties for their investment. Given the plain meaning of the language, as well as the clear legislative history of section 83, it is difficult to determine how the IRS supports its contention that section 83 applies to the factual situations in the Revenue Ruling.

The IRS suggests, in opposition to the legislative intent argument, that Treasury regulations adopted under section 83 provide a broad definition of the concept of property for the purpose of section 83, and do not merely limit the section's application to restricted stock arrangements. This argument, however, misses the mark for both the legislative history and the plain meaning of the language of section 83, and compels the conclusion that the section applies to restricted property not to unrestricted property. As to unrestricted property, section 61 continues to apply as it has since the inception of its predecessor in 1913. Furthermore, Treasury Regulation section 1.83-1(a) simply restates section 83 by using substantially equivalent language. The plain meaning of the language of the regulation further suggests that section 83 does not apply to unrestricted property. Nor do the regulations expressly provide for the specific tax treatment of a conveyance of an economic interest in oil and gas. Other sections of the Internal Revenue Code, however, do specifically address the compensation method. The treatment of both percentage depletion under section 613A of the Internal Revenue Code of 1954 and cost depletion under sections 611 and 612 of the Internal Revenue Code of 1954 are specific. Revenue Ruling 83-46 appears to be another attempt by the IRS to improperly enlarge the scope of

43. *See supra* note 2.

44. Treas. Reg. § 1.83-1(a) (1978) which states:

(a) *Inclusion in gross income—(1) General rule.* Section 83 provides rules for the taxation of property transferred to an employee or independent contractors (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. In general, such property is not taxable under section 83(a) until it has been transferred (as defined in § 1.83-3(a) to such person and become substantially vested (as defined in § 1.83-3(b))) in such person. In that case, the excess of —

(i) The fair market value of such property (determined without regard to any lapse restriction, as defined in § 1.83-3(i) at the time that the property becomes substantially vested, over

(ii) The amount (if any) paid for such property, shall be included as compensation in the gross income of such employee or independent contractor for the taxable year in which the property becomes substantially vested. *Id.* (emphasis added).


a statute.\textsuperscript{47}

It has been suggested that while Congress did not expressly validate the "pool of capital" doctrine, it did implicitly consent to the doctrine later by enacting section 636 of the Internal Revenue Code of 1954\textsuperscript{48} in the very same act in which section 83 was adopted.\textsuperscript{49} And the IRS has indirectly admitted that the enactment of section 636 did not affect the pool of capital doctrine as expounded in G.C.M. 22730.\textsuperscript{50} In 1969, the Administration, through the Treasury Department, perceived as an abuse the carved-out or retained production payment\textsuperscript{51} as well as the infamous ABC transaction.\textsuperscript{52}

Through section 636(a)-(b), Congress converted the production payment which heretofore was recognized and treated as an economic interest in oil and gas property, into either a loan in the case of a carved-out production payment or a purchase money mortgage in the case of a retained production payment. An important exception was carved out of section 636(a) which goes to the "pool of capital" theory. Section 636(a) would continue to recognize and to treat a production payment as an economic interest if the payment is

\textsuperscript{47} The Treasury may not make an arbitrary or unreasonable Regulation nor can it restrict or enlarge the scope of a statute, supply a supposed omission, create an exemption, . . . or nullify prior judicial construction of the statute. Although the Commissioner has authority to issue regulations for the enforcement of the revenue laws, such authority does not extend to the establishment of rules of substantive law creating presumptions which are out of harmony with the statutory provisions involved.

J. MERTENS, JR., supra note 26, at § 3.21, Ch. 3-p. 39.

\textsuperscript{48} See Burke, supra note 8, at 354. I.R.C. § 636 (P-H 1984).


\textsuperscript{50} I.R.S. Letter Ruling 74012800010A (1974) stating:

The provisions of section 636 of the Code and the regulations thereunder do not affect the Internal Revenue Service position set out in G.C.M. 22730 in the determination of whether a production payment carved out of an oil and gas property is pledged for exploration or development of such oil and gas property.

\textsuperscript{51} See Technical Explanations, supra note 35.

\textsuperscript{52} C. ABC Transactions

The retained production payment is utilized in connection with the so-called ABC transaction. In an ABC transaction A, the owner, sells a mineral property to B (who will own and operate the property) for a small down payment, and A reserves a production payment (a part of the working interest) for the major portion of the purchase price. A then sells the production payment to C (who is often a bank, a tax-exempt charity, or pension fund). A realizes capital gain on the sale of his interest to C and B. C receives income subject to depletion (normally cost depletion sufficient to eliminate taxable income) on the production payment. B excludes the production payment from his income. Until recently, B was permitted to deduct, currently, the expenses of producing the minerals applied to the production payment.

\textsuperscript{Id.} at 107.
assigned for exploration or development.\footnote{53} This interest, a carved-out production payment, was the very type of interest which was conveyed to the well driller (designated as "E") in G.C.M. 22730. The conveyance in that instance was not conditioned and not restricted, and hence, was not the type of payment which would fall within the purview of section 83. This suggests that the IRS position in Revenue Ruling 83-46 which rests on its interpretation of section 83, is unreasonable in light of the section's history and purpose and hence, it must fail.\footnote{54}

From the foregoing analysis of policy considerations and legislative history of sections 61 and 83, one can logically conclude that section 83 does not apply to the conveyance of an economic interest in oil and gas property of an investor of services in cases where the conveyance is vested and not restricted. As a general rule, section 61 requires the inclusion of property transferred as compensation for services, at its fair market value, in the taxable year in which it is received. However, there is a long-standing administrative practice of excluding services invested into the reservoir of capital oil and gas properties, a practice which has survived at least two major revisions of the Internal Revenue Code in 1939 and 1954. One can assume that Congress did not intend to change the "pool of capital" theory. Therefore, if the IRS is going to change its direction, it should not do so on the theory that section 83 compels such a change.

\section*{C. National Policy Considerations}

Does any good policy reason exist for a change in the IRS administrative practice and its resulting longstanding interpretation of section 61 today? National policy considerations suggest there is no such policy reason. As an energy source, oil and gas is crucial to

\footnote{53} However, in this application the principle may be simply stated as follows: if the owner of a working interest assigns a carved production payment to another party who makes a contribution to the exploration for or development of a mineral property, or assigns a production payment for a cash consideration that is pledged to be used in the exploration for development of a mineral property, he does not realize taxable income. In the former case, the assignor is entitled to no deduction for the expenditures incurred by the assignee in the development of the property, and in the latter case, the assignor is required to offset the cash received against appropriate exploration and development costs. Under the Tax Reform Act, a production payment carved out under these circumstances would constitute an economic interest in the property and the holder of such a carved-out production payment would be taxable on the income, and allowed depletion in respect of such income. I.R.C. § 636(a) (P-H 1954); \textit{see also} F. \textsc{Burke} & R. \textsc{Bowhay}, \textit{1984 Income Taxation of Natural Resources} § 6.18, 612 (1984).

every business enterprise and in fact, to every person within the United States. One need only reflect momentarily on the catastrophic effect of the shift in the economic structure of the oil and gas industry in 1973 to understand that oil and gas are the life-blood of the economy. As a result of the 1973 experience, the United States has been attempting to formulate a comprehensive national energy policy in order to become energy self-sufficient within the next several years. Although the efforts of this policy have been somewhat obscure from time to time, this strong national policy ought to encourage domestic production of oil and gas while reducing dependence on foreign sources of crude oil and natural gas. It is abundantly clear, in any event, that income tax measures clearly produce changes in the economy and have a profound effect on businesses and industries.

The United States has always had a strong policy of promoting competition and fostering small business. This is evident from such sweeping protective legislation as the Sherman Antitrust Act, the Clayton Antitrust Act and from several programs such as the grants, direct government loans, insured loans, and guarantee programs of the Small Business Administration for small business, and the Farmer’s Home Administration for farmers.

Congress has also evidenced its intent to promote and to assist smaller oil companies by preserving to some degree the percentage depletion allowance in section 613A. To assist independent produc-
ers or small oil companies and to encourage domestic production, Congress reconfirmed the policy established in section 613 by providing lower rates and exemptions for producers with the Windfall Profits Tax.  

Perhaps the best policy reasons for continuing the pool of capital doctrine, as it applies to persons investing their services, are set forth in G.C.M. 22730. An investor in an oil and gas property, whether an investor of services or of money, ultimately looks to the "mining" of the hydrocarbons for his return on investment. A fractional economic interest, whether a production payment, oil payment, or overriding royalty interest prior to discovery has very little value, if any, in relation to the amount invested. This is particularly true before production is firmly established. In other words, the investor of either services or money assumes a substantial risk of completely losing his return on investment. Similarly, if the project is successful, the rewards are great for the investor. The owner of the working interest, by engaging the cash investor or service provider, substantially reduces his need to personally provide capital to the project. In short, the owner of the working interest shares the burden of risk of loss with the service contributor. The arrangement fulfills the policy objectives of expansion and development of domestic crude oil production and lessening dependence on foreign imports.

Initially, the allowance for oil depletion was 2,000 barrels per day and the percentage was gradually reduced from 22% down to 15%).

61. Pub. L. No. 223, Tit. I, § 101(a)(1) (1980) (I.R.C. § 4986 (P-H 1984)). The Windfall Profits Tax was adopted as a temporary excise or severance tax applying to domestically produced crude oil. It was enacted to absorb what Congress perceived as excess profits occurring from two unusual events, the rise in world prices as a result of the O.P.E.C. oil cartel and the administration's decision to remove domestic crude price controls which had been in effect since shortly after the Arab Embargo in the fall of 1973. The Senate believed that the form of the tax would not adversely affect the incentive of the oil companies to produce oil. See S. REP. No. 394, 96th Cong., 2d Sess., reprinted in U.S. CODE CONG. & AD. NEWS 410, 414-17. "The Finance Committee substitute is intended to tax a fair share of the additional revenues received by oil producers and royalty owners as a result of oil price decontrol in a way that will not adversely affect the incentive of the oil companies to produce oil." Id. at 417. The Conference Committee Report provides for independents exempt from the tax or eligible for reduced tax rates, on part or all of their production. Joint Explanatory Statement of the Committee of Conference, H. REP. No. 304, 96th Cong., 2nd Sess., reprinted in 1980 U.S. CODE CONG. & AD. NEWS 642, 645. See also id. (which discusses the exemption for independent producers owning working interests and royalty holders where the owner of the working interest is an independent producer).

62. 1941-1 C.B. 214.

63. Id. at 221.

64. Telephone conversation with Harold W. Bertholf, geologist, from Sacramento, Cal. (June 11, 1984), and telephone conversation with J.H. Parmenter, geologist and president of Del Paso Exploration from Sacramento, Cal. (June 18, 1984).
It accomplishes these goals because assistance with capital formation and risk-spreading encourages the owner of the working interest to engage in projects involving properties where the evidence of hydrocarbons is uncertain or somewhat speculative, a risk he often would not take without the help of others. Historically, such transactions were attractive to the cash investor or service contributor primarily for business purposes. The investor evaluated the business risks associated with the transaction before investing cash, services, or equipment. However, as will be seen, Revenue Ruling 83-46 creates insurmountable disincentives to the service contributor by requiring him to pay the tax liability before he knows when or if he will realize actual income from oil or royalty payments.

The case of Commissioner v. Engle is relevant to the issue at hand not so much for its holding, but for its use of the risk analysis which is the very same used by the Revenue Service in G.C.M. 22730. The court reviewed the long-standing industry practice wherein lessors negotiate and pay bonuses and royalties to reduce the cost of leases. The court observed that lessors were willing to enter into bonus and advanced royalty arrangements because of the availability of percentage depletion. If the deductions were no longer available, lessors would be inclined to accept bonuses or advances at higher amounts in order to pass on the tax cost to the lessee or alternatively, would require higher annual royalties over time. The court concluded that the IRS interpretation of section 613A would mean less capital would be available for leases and would result in less exploration and development. The court suggested that the depletable bonus and reduced lease costs and allows for a "pooling of the risk" between lessor and lessee. The court stressed repeatedly that

65. Apparently, the IRS takes the position that an overriding royalty always has some value even if the prospect is a rank wild cat (conference with John Braden, C.P.A. with the Independent Petroleum Producer Association of America (June 11, 1984)).

66. Comm'r v. Engle, 84-1 U.S. Tax Cas. (CCH) ¶ 9134 (U.S. Oct. 10, 1984). The court held that legislative history supported the notion that Congress intended to assist independent producers and to encourage domestic production of oil. The case provides an excellent review of industry practices in capital formation and risk-taking, which is the foundation of the pool of capital doctrine, which was first espoused in Palmer v. Bender, 287 U.S. 551 (1933).

67. Comm'r v. Engle, 84-1 U.S. Tax Cas. (CCH) ¶ 9134, at 83, 108. "Lessees who are forced to pay increased royalties will, in turn, have less money with which to produce leases or to extract minerals therefrom."

68. . . . But since lessees can spread their risks over many leased properties, they predictably will be willing to pay nonrefundable lease bonuses in exchange for reduced prices on the overall lease arrangements. By pooling risks in this fashion, lessors and lessees, like insurers and their insureds, optimize the allocation of resources in the production of oil and gas from the property.
Congress adopted section 613A to encourage development of domestic production and to support the small oil companies.\textsuperscript{69}

Like the advanced royalty and the bonus, the "pool of capital" doctrine is also an important method of developing capital for an exploration program and for spreading the risk of loss. Revenue Ruling 83-46 clearly runs contrary to the business objectives of this industry and national policy goals.\textsuperscript{70}

A conclusion that can be drawn from a review of the legislative history is that contracting the "pool of capital" doctrine runs contrary to a well-established national policy of enhancing domestic crude oil production and promoting competition between the independent petroleum producers in the United States. Particularly, it is counterproductive to what Congress was trying to accomplish in preserving percentage depletion for independent producers.

III. The Case Law

In order to put the Service's position in Revenue Ruling 83-46 in perspective, it is necessary to review briefly the cases which have raised the issue of taxability of economic interests in oil and gas properties which are transferred in return for investment of services in the pool of capital. The issue has arisen in a number of cases as a

\textit{Id.} at 4037 (emphasis added).

\textsuperscript{69} Congress wanted to encourage domestic production and to improve the competitive position of "small producers"—the independents and the royalty owners—vis-a-vis the major integrated ones. Section 613A's goal, more simply put, was to subsidize the combined efforts of small producers and royalty owners in the exploration and production of the nation's oil and gas resources. Any reasonable interpretation of the statute, therefore, must harmonize with this goal. \textit{Id.} at 4037. The Court also stated: "The House and Senate debates of the 1975 Congress are replete with references to the nation's domestic oil and gas shortage." \textit{Id.}

Similarly, Senator Dole stated that the 2000 barrel figure "identified the particular importance of independent producers." . . . Senator Dole believed that the exemption from the depletion allowance [would] permit most of these small producers to remain in production, giving us the additional oil and gas that we so greatly need . . . It would also encourage most of the independents who do the vast bulk of exploration in the country to continue their drilling programs.

\textit{Id.} (emphasis added).

\textsuperscript{70} Shapiro, \textit{Restricted Property Received as Compensation for Services}, 22 \textit{The Tax Lawyer}, 529, 538 (1969). Some support for this contention can be gleaned from a recent Supreme Court case entitled Bob Jones Univ. v. United States, wherein the Court held that the Revenue Ruling therein was a valid interpretation and adhered to national policy. Congress had not enacted a statute concerning the issue raised in the ruling. The case implies that if the Revenue Ruling in question had not followed national policy, then it would have been invalid. The Court is suggesting that IRS rulings ought to be coordinated with national policy. \textsuperscript{____ U.S.____, 103 S. Ct. 2017 (1983). The case involved a 1971 Revenue Ruling, Rev. Rul. 27-447, 1971-2 C.B. 230, denying tax exempt status under I.R.C. § 501 (c)(3) (P-H 1984) to schools violating the national policy against social discrimination.}
result of an IRS attempt to meet the demands of section 61 and its predecessor statutes. However, it appears that initially the courts, particularly the tax court and the Fifth Circuit Court of Appeals, recognized that something unique occurs when an economic interest is transferred in return for an investment of services in the acquisition, exploration and development of an oil and gas property. What appears to happen is that each participant invests something of value—whether money, equipment, or services into a hydrocarbon bearing prospect. Each participant then shares both the risk of failure, and the anticipation of profit, while providing a source of capital for the owner of the working interest. Justice O'Connor surely had this principal business motivation in mind in the policy considerations discussed in Engle.71

While the Court's decisions after Palmer did not always articulate the "pool of capital" doctrine as the basis for exempting service providers from the general inclusion rule of section 61, Palmer influenced the cases. Certainly Palmer influenced the IRS because the pool of capital doctrine was adopted as the theory supporting the Service's position in G.C.M. 22730.72 The IRS then expanded the reasoning of the Court in G.C.M. 22730 by interjecting that as the property interests in oil and gas are passed on to those contributing services, equipment, and cash to the property, there is a sharing of

71. See supra note 66. Furthermore in Palmer v. Bender, 287 U.S. 551 (1933), wherein the "pool of capital" doctrine was first articulated, the Court stated:

Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests.

Id. The Court went on to state in concise language the policy compelling the decision therein; the same policy consideration repeated in Engle:

The statute made effective the legislative policy favoring the discovery of oil, by valuing his capital investment for purposes of depletion at the date of the discovery rather than at its original costs. The benefit of it accrues to the discovery if he operates the well as owner or lessee, or if he leases it to another.

Id.

72. The Court stressed the general view that all persons having a right to share in the oil produced or the proceeds from its sale irrespective of the legal form of their interest in the property, have an economic interest in the oil and gas in place to which the depletion allowance shall be allocated between lessor and lessee, being held to be found enough to provide, at least, for every case in which the taxpayer has acquired by investment any interest in the oil in place, or has secured, by any form of legal relation, income derived from the extraction of oil to which he must look for a return of his capital.

G.C.M. 22730, 1941-1 C.B. 214, 216 (emphasis added).
the burden of the risk of a dry hole.\textsuperscript{73}

The IRS then makes the leap from a depletion allowance to carving the exception to section 61 in G.C.M. 22730.

If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through depletion allowance rather than by way of expense deduction, \textit{and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished.}\textsuperscript{74}

By so stating, the IRS announced its position that the service provider would not have to count as income the fair market value of the economic interest acquired. He would recognize income from the oil as it was produced and sold. And the income would be subject to depletion.

Adopting this policy was a clear reversal of the Service's position for several years prior to G.C.M. 22730.\textsuperscript{75} The well drillers apparently were the first to present this issue to the courts. \textit{Commissioner v. Edwards Drilling Co.},\textsuperscript{76} \textit{Cook Drilling Co. v. Commissioner},\textsuperscript{77} and \textit{Dearing v. Commissioner.}\textsuperscript{78} In each case, the IRS has

\textsuperscript{73} The point assumes importance in view of the many contracts entered into by owners of lessee interests with well drillers to drill wells, equipment dealers to furnish equipment and investors to furnish money for use in developing the leased property in return for agreements to make stated payments out of a share of the oil. \textit{By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production.} The lessee or assignee, like the lessor or assignor who retained a share of the interest in production having a value equivalent to that of the lessor's prior interest but has passed on to the lessee the investment obligations and risks that attend development for a share in production, has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person.

\textit{Id.} at 221 (emphasis added).

\textsuperscript{74} \textit{Id.} at 221-22 (emphasis added).

\textsuperscript{75} The policy reversal was probably triggered by a series of defeats in court for the IRS, where it asserted the contrary position, that the value of the economic interest was includible in gross income when received, or alternatively when the property began producing. Interestingly, none of the cases are mentioned in G.C.M. 22730.

\textsuperscript{76} \textit{Comm'r v. Edwards Drilling Co.}, 95 F.2d 719, 38 U.S. Tax Cas. (CCH) ¶ 9211 (5th Cir. 1938) (a well driller contracted to drill wells in exchange for oil payments and the court held that the present discounted value of the payments were not includible when the contract was entered into, but when the payments were received).

\textsuperscript{77} \textit{Cook Drilling Co. v. Comm'r}, 38 B.T.A. 291 (1938) (also involved a well driller who received oil payments by contract for drilling wells. The Board of Tax Appeals held that the oil payments already received were to be included in gross income, but the present worth of future payments was not includible as being too speculative and contingent on future events).
argued that the taxpayer must include in gross income the present worth of future oil payments as compensation for services rendered. The courts, however, have held that while actual oil payments received during the taxable year should be included in gross income, the value of future payments should not be included in the year in which the interest is received primarily on grounds that future payments are speculative and uncertain of actually being received in the future.\(^\text{78}\)

The IRS argued varying approaches to support its theory. The first approach was that where the taxpayer kept its books on an accrual basis, the receipt of an interest in future oil payments must be accrued as income when the events occur to fix the amounts due and determine liability to pay.\(^\text{80}\) However, the IRS did not limit its attack to accrual basis taxpayers. Its second approach challenged cash basis taxpayers as well, arguing "the right to receive in the future the agreed oil payments was, when the well turned out a producer, a property having present market value, and, therefore, was a taxable gain in the year the well was completed . . . ."\(^\text{81}\) The holding in

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78. Dearing v. Comm'r, 102 F.2d 91, 39-1 U.S. Tax Cas. (CCH) ¶ 9344 (5th Cir. 1939) (the IRS argued unsuccessfully that the present worth of the value of the payments were includible in the driller's income when the wells were completed).

79. The holdings of these cases are confused somewhat because of the different approaches the courts took to the question of whether each of the drillers in question could take a percentage of the depletion allowance deduction in addition to expensing the drilling costs under I.R.C. § 162 (P-H 1984). The courts took a formalistic approach and suggested that because the oil payment agreement was personal or contractual in nature, they did not rise to the level of an economic interest in the oil in place and, therefore, a depletion deduction was denied. A later case pointed out that administrative practice and case law removed the differences between a royalty and an oil payment so that both are now considered an economic interest in the oil in place allowing depletion, but not allowing the costs to be deducted from production. See Lee v. Comm'r, 126 F.2d 825, 42-1 U.S. Tax Cas. (CCH) ¶ 9375 (5th Cir. 1942), aff'd, 42 B.T.A. 1217. This is also the approach taken in G.C.M. 22730, 1941-1 C.B. 2143, namely the costs are capitalized and returned through depletion. The approach was tacitly sanctioned in Comm'r v. Rowan Drilling Co., 130 F.2d 62, 42-2 U.S. Tax Cas. (CCH) ¶ 9628 (5th Cir. 1942), aff'd, 44 B.T.A. 189 (the court held that a driller who received an economic interest in the property on which he performed the well drilling service has made capital investment and must return his cost through depletion, not through an I.R.C. § 162(c) (P-H 1984) deduction). In Rowan, however, the court rejected the IRS contention that because the taxpayer had taken a § 162 deduction in 1931, he had no basis to deplete in 1932. The court stated that percentage depletion does not require a cost basis as a prerequisite for the deduction.

80. Comm'r v. Edwards Drilling Co., 95 F.2d 719, 38-1 U.S. Tax Cas. (CCH) ¶ 9211, at 9714 (5th Cir. 1938); see also Cook Drilling co. v. Comm'r, 38 B.T.A. 291 (1938) (also an accrued taxpayer case); see also Treas. Reg. § 1.446(c)(ii) (1960): "Accrual method, generally under an accrual method, income is to be included for the taxable year when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."

81. Dearing v. Comm'r, 102 F.2d 91, 91, 39-1 U.S. Tax Cas. (CCH) ¶ 9334, at 9790
each instance was that the present value of future oil payments is not includible in gross income, which draws direct support from Burnett v. Logan. 82

The Logan case adopted the concept of the "open transaction," which provided that where a property interest or contract might be received in the sale or exchange, and the fair market value for income tax purposes is not ascertainable because of indefinite deferred payments, the transaction is not closed but rather stays open until all payments are received. This provides for recovery of basis first then gain thereafter in the tax periods corresponding to the receipt of the payments. In reading its conclusion, the Court stated: "The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit if any, is actually realized, the taxpayer will be required to respond." Since Logan, the IRS has attempted to curtail the application of the "open transaction" principle. 83 It has nearly abolished the income tax deferral technique wherein basis is recouped before gain or loss is recognized, by requiring a pro-rata recovery of basis over the life of the contract or in the alternative, over a pre-determined time period. 84 Despite these changes with respect to basis, the portion of the Logan rule which precludes inclusion into gross income of future indeterminable payments at their present worth, still survives and would be applicable under the facts presented in Revenue Ruling 83-46. 85

Another case supporting the open transaction theory advocated in the drilling cases 86 is North American Oil Consolidated v. Burnett. 87 This case determined that where the proceeds from oil production are contingent and the taxpayer has no control over their receipt, the proceeds are not includible in gross income. While the

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82. 283 U.S. 404 (1931). This case established that where the consideration in the sale of stock was based upon the amount of iron ore mined, the value of the consideration received could not be determined with "fair certainty," gain is not realized until the aggregate payments received exceeded the taxpayer's basis in the stock, after which recovery of basis, the taxpayer was to then report as income the payments as received.


84. This practice has been nearly abolished partly as a result of these recent code changes: I.R.C. § 453(j)(2) (P-H 1984); Temp. Treas. Reg § 15A.453-1(c) (1980).

85. See, e.g., Vestal v. United States, 498 F.2d 487, 74-2 U.S. Tax Cas. (CCH) ¶ 9407 (8th Cir. 1974).

86. See supra notes 76-81.

87. 286 U.S. 417 (1932). In this case, proceeds from the production of some oil properties in the hands of a receiver were not includible in the taxpayer's gross income until they were paid over to the taxpayer under the claim of right doctrine.
case dealt with oil proceeds held by a receiver in litigation, the reasoning seems analogous to a situation where a service provider receives a conveyance of oil or production payments or an overriding royalty interest, particularly where he has no control over the production.

Logan and North American Oil Consolidated are two cases among many where the courts have not required the inclusion into gross income of future payments that are speculative or indefinite.88

The employer-employee contingent compensation cases offer an interesting analogy to the contributor of services in oil and gas property.89 Certainly, the office employee who is the object of a declared but unpaid bonus has a valuable contract right which a willing buyer could purchase at a discounted amount based on the nature of the contingency, and the financial strength and sales history of the declaring company. Why is the value of such a bonus not includible in the gross income of the employee when the bonus is declared? The IRS might distinguish the case of the oil property service contributor from the employee with the declared bonus, by suggesting that in the later case Treasury Regulation § 1.451-1(a)90 controls and that there is no constructive receipt of income in the year the bonus is declared. While the regulation might apply, that does not alter that the economic reality of each case which is arguably the same. The employee has a valuable contract right which he may transfer to a willing buyer for consideration as soon as it is declared. The service contributor may have a valuable property right which he can sell when it is received. Revenue Ruling 83-46,91 however, re-

88. Examples of other cases include those where insurance brokers argued unsuccessfully that renewal commissions were earned by them when the insurance policy was first issued. However, the IRS argued, and the courts hold, that renewal commissions are includible when the premiums are paid, because the commissions are contingent until received. See Edwards v. Keith, 231 F.2d 110 (2d Cir. 1951); see also Woods v. Lewellyn, 252 F.2d 106 (1918); Seattle First Nat'l Bank v. Henrickson, 24 F. Supp. 256, 38-1 U.S. Tax Cas. (CCH) ¶ 9466 (W.D. Wash. 1938).

89. Kahn v. United States, 81-1 U.S. Tax Cas. (CCH) ¶ 9187 (W.D. N.C. 1981). In this case, a bonus declared in one year and payable in the next, was not includible in the gross income of an officer/controlling shareholder where the company policy historically was to declare one year and pay the next. It is interesting that the IRS did not argue the applicability of I.R.C. § 83 (P-H 1984) in that case. See also Rev. Rul. 75-180, 1975-1 C.B. 142. The IRS here ruled that a senior officer/major stockholder of a corporation did not have to include in income in the year declared, a bonus based on a percentage of gross sales normally calculated and paid the following year. Again, the IRS did not allude to I.R.C. § 83 (P-H 1984).

90. Treas. Reg. § 1.451(a) (1960). This section requires inclusion in gross income in the year gains, profits, or income are either actually or constructively received.

91. Rev. Rul. 75-180, 1975-1 C.B. 142. This ruling requires income to be included when it is actually or constructively received, unless the taxpayer had a different method of
quires a different tax result, and denies the deferral to the oil property service contributor, while Revenue Ruling 75-180 allows a deferral to an employee.

A. Pool of Capital Doctrine Affirmed by the Case Law

Perhaps the strongest affirmation of the pool of capital theory, as articulated in G.C.M. 22730 is the oil well driller case of Commissioner v. Rowan Drilling Co. While the issue before the court was different than the issue here, the court recognized the service provider's services as an investment in the property.

It is no longer open to doubt that the ownership of oil in place is a capital asset, and that the acquisition price of the asset, whether paid in cash or services, is a capital investment that may not be treated as a business expense for income tax purposes but must be recouped by depletion deductions from gross income.

The court also affirmed that incurrence of costs or a cost basis was not a precondition to the availability of the percentage depletion deduction to be taken by the driller. All that is required is that the taxpayer has an economic property interest in the oil.

Another case which recognized the unique circumstances of making a valuable contribution to the acquisition, exploration, or development of an oil and gas property was Rocky Mountain Develop-
ment Co. v. Commissioner,\textsuperscript{98} which concerned a taxpayer who contributed oil well equipment to the development of an oil and gas property in exchange for an economic interest in it. As in the well driller cases, the court held that the present value of future payments was not presently includible in gross income due to the speculative nature of the payments.\textsuperscript{99}

Another line of cases has developed a corollary rule of law to the principle that a service provider to the pool of capital need not presently include in gross income the present value of future payments from an economic interest. Early on, the IRS attempted to tax both sides of the transaction, not only the service contributor, but also the transferor of the economic interest.\textsuperscript{100} The Service viewed the transferor as selling a part of his interest for services, equipment, or cash. For example, in one case the IRS attempted to tax as income to the transferor, the value of the services provided by a well driller. The court, however, held that because the driller made an investment in the pool of capital, the value of the wells were not includible in the gross income of the taxpayer.\textsuperscript{101} A similar conclusion was made in Transcalifornia Oil Co. v. Commissioner\textsuperscript{102} and Rawco Inc. v. Commissioner.\textsuperscript{103} In these cases, the investors joined with the service contributors and with the operator/owner of the working interest. The operator gave the investor and the service provider production certificates which meant that each contributor could share in production to obtain his return on investment. In each case the IRS attempted to tax the operator on the theory that the transfers amounted to sales of its interest. The court, however, held that the operator was in fact a trustee holding funds to be used exclusively for the development of the properties in question in each case and as such was not includible in the gross income of the operation. The court also held that each contributor was separately entitled to his share of the production gross income for depletion purposes be-

\textsuperscript{98} 38 B.T.A. 1303 (1938). Here, the IRS again asserted that the present value of future payments should be included in the taxpayer's gross income although the economic interest was exchanged for equipment contributed to the development of the property.

\textsuperscript{99} "The consideration received by petitioner for its sales of equipment during 1932 and 1933, being the right to receive such contingent oil payments, was not the equivalent of cash because the promise to make such oil payments had no definite ascertainable fair market value." \textit{Id.} at 1305-06.

\textsuperscript{100} Laster v. Comm'r, 43 B.T.A. 159 (1940), \textit{modified on other grounds,} 128 F.2d 4, 42-1 U.S. Tax Cas. (CCH) ¶ 9425 (5th Cir. 1942).

\textsuperscript{101} "The lessees here received nothing more than completed wells, the cost of which constituted the investment of a third party for a right to share in production." \textit{Id.} at 174.

\textsuperscript{102} 37 B.T.A. 119 (1938).

\textsuperscript{103} 37 B.T.A. 128 (1938).
cause each was a participant in the pool of capital.104

B. Cases Rejecting Pool of Capital Treatment for Certain Service Providers

Another group of service providers connected with oil and gas properties are attorneys and accountants. Several cases involve the issue as to whether the value of an economic property interest in the oil received for services contributed by the attorney should be included in his income in the year the interest is received.105 These cases serve as a limit to the pool of capital theory. Commentators who have reviewed the personal services cases and the pool of capital theory suggest that there are several tests as to whether the service investor falls within the pool of capital. The most important test being that the services must be contributed to the “acquisition, exploration or development” of the oil and gas property.106 If the attorney’s services are in connection with quieting title, they do not fall within the purview of “acquisition, exploration, or development” of the oil


105. Massey v. Comm’r, 143 F.2d 429, 44-2 U.S. Tax Cas. (CCH) ¶ 9384 (5th Cir. 1944). In this case, attorney for a contingent fee of one-half of the interest of his client in an oil and gas property, proceeded to obtain a determination of the validity of a lease in a Louisiana guardianship case where the ward signed the lease before an insanity determination. The court held that the attorney had to include in income, the production proceeds accumulating as well as the present value of the economic interest, when the litigation was successfully concluded. In Walls v. Comm’r, 60 F.2d 347 (10th Cir. 1932), an attorney taxpayer received one-third of the working interest for “professional services,” and did not indicate whether the services were performed in the acquisition of the property in which he acquired the interest. The court held that the attorney had to include in income the value of the interest, but he was allowed a deduction for depletion. In Allen v. Comm’r, 5 T.C. 1232 (1905), an attorney received contingent fees of an economic interest in an oil and gas property and the court held that he had to include in income the accumulation of proceeds during the pendency of the action as well as the present worth of the interest he acquired (distinguishing Dearing v. Comm’r, 102 F.2d 91, 39-1 U.S. Tax Cas. (CCH) ¶ 9344 (5th Cir. 1939)). In Blake v. Comm’r, 20 T.C. 721 (1953), an attorney received a percentage of the working interest in an oil and gas property for his services in quieting title to the property. The court held that the value of the interest should have been included in the tax year when it was acquired, but for the running of the statute of limitations.

106. K. MILLER, MILLER’S OIL AND GAS FEDERAL INCOME TAXATION §§ 2-16, 23-33 (wherein the author sets forth six requirements); see also Shelton, The Taxation of Oil and Gas Interests Received in Payment for Property or Services, The Fifth Annual Institute on Oil and Gas Law and Taxation as it Affects the Oil and Gas Industry, SOUTHWESTERN LEGAL FOUNDATION 440 (1954), wherein the author prescribed three requirements to fall within the ambit of G.C.M. 22730, 1941-1 C.B. 214; see also IRS Letter Ruling 8137006 (July 23, 1980), wherein the IRS expressed its view that services performed under the pool of capital theory covered by G.C.M. 22730, are those prior to discovery of oil or gas. Also, the property in which the interest as confined must be the same property to which the services are contributed.
and gas property. Furthermore, by the time the attorney's interests in the properties vested, the properties were developed, producing and, therefore, their values were ascertainable. No case has yet been decided wherein the attorney furnished legal services for the acquisition, exploration or development of a specific nondeveloped property. However, it would seem that attorney services would directly benefit the pool of capital and should not be excluded from "tax free" treatment.

C. Other Cases Limiting the Pool of Capital Doctrine

In recent years, long after the pool of capital theory had become well-entrenched in administrative practice, the decisions in several cases put limitations on the pool of capital doctrine and could by implication provide support for the position taken in Revenue Ruling 83-46. In each case, the court held that the taxpayer was required to presently include in gross income, the value of the property or interest in property received as compensation for services rendered. Each case, however, is clearly distinguishable from the situation where a taxpayer invests in services in the acquisition, exploration or development of the property for a share of property, and seeks return on his investment from the operation and production of the property.

United States v. Frazell is clearly distinguishable. Here the taxpayer was to receive an interest in hydrocarbon producing properties after certain investors recovered their investments. But before they fully recovered their investments, the investors formed what the court perceived to be a partnership. They then formed a corporation, and transferred either a partnership interest or corporate stock to Frazell instead of an economic interest in the property. The conveyance of stock or a partnership interest clearly transcends

107. Rev. Rul. 54-84, 1954-1 C.B. 284, perhaps provides yet another distinction, for therein, Massey, supra and Wells, supra note 105, were distinguished by the IRS. Therein, B, a lawyer, joined a partnership with a venture capitalist, a lease superintendent, and a drilling superintendent and they contracted to acquire, explore, and develop oil and gas properties. The IRS designated the lawyer as a true bona fide partner and not an employee or agent as in Massey and Wells and, thus, the leases held in A's name were partnership assets and not A's individual assets.

108. K. Miller, supra note 106, at ¶ 2-16, 22-3; United States v. Frazell, 335 F.2d 487, 64-2 U.S. Tax Cas. (CCH) ¶ 9684 (5th Cir. 1964); James A. Lewis Engineering, Inc. v. Comm'r, 339 F.2d 706, 65-1 U.S. Tax Cas. (CCH) ¶ 9122 (5th Cir. 1964); Diamond v. Comm'r, 492 F.2d 286, 74-1 U.S. Tax Cas. (CCH) ¶ 9501 (7th Cir. 1974); Vestal v. United States, 498 F.2d 487, 74-2 U.S. Tax Cas. ¶ 9501 (8th Cir. 1974).

109. 339 F.2d 706, 65-1 U.S. Tax Cas. (CCH) ¶ 9501 (7th Cir. 1974).
the scope of the pool of capital doctrine which requires an investment of services in property.¹¹⁰

In *James A. Lewis Engineering, Inc. v. Commissioner*,¹¹¹ the Fifth Circuit affirmed the Tax Court's holding that the services here were beyond the acquisition, exploration or development stages; rather the services performed were in connection with the installation of a water flood program which is normally introduced after the primary production phase has commenced. Of concern to scholars of the pool of capital theory was the dictum in this case, which suggested that if the issue of the pool of capital doctrine—an exception to the section 61 requirements of inclusion of property as compensation—were squarely before the court, the court would have to take a long hard look to determine whether such an exemption existed at all. The language is ironic in that it was uttered by the very court that was operative in the formulation of the pool of capital doctrine in the *Rowan* decision years earlier.

Finally, the taxpayer in *Vestal*, was to receive an economic interest for the geological services he contributed to the development of hydrocarbon-bearing property after the investors recovered their investment. Before they fully recovered their investment, the investors sold the property and paid the taxpayer cash for his contingent share in the property. The court treated this as compensation income despite the taxpayer's argument that he had recognized compensation income when he received the right in an earlier year.¹¹² The court suggested that the contract was executory, initially speculative, and had no certainty that the taxpayer would ever receive anything in the future and was, therefore, not income in the earlier year but in the later year when he was paid. Perhaps, the result would have been substantially different if the taxpayer had received a vested interest initially before he performed the services, and then looked to his return from production which he helped create, and not to the sale of the property.¹¹³

¹¹⁰. *See* Treas. Reg. § 1.721-1(b)(1) (1960) (which provides “to the extent that any of the partners gives up any part of his right to be repaid his contribution (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.” *Id.; see also* Priddy v. Comm'r, 43 B.T.A. 18 (1940)) (the taxpayer performed services in organizing and incorporating a company for the purpose of acquiring and holding oil property. He had shares of the corporation as compensation and the court required him to include the value of the stock in gross income).

¹¹¹. 339 F.2d 706, 65-1 U.S. Tax Cas. (CCH) ¶ 9684 (5th Cir. 1964).

¹¹². The statute of limitations or inclusion of the property right to income had expired during the year before the right vested.

¹¹³. For a further discussion, *see infra* Logan, note 162 and accompanying text.
In view of the cases, Revenue Ruling 83-46 should not summarily require the taxpayers in each of the three situations presented to include in gross income the present value of an economic interest received for their services. Rather, proper application of the principles of the cases would dictate a detailed analysis of each situation in light of the existing case law and administrative practices. For example, there have been circumstances where the services of a promoter, attorney, or employee of a corporation contributed to a hydrocarbon-bearing property have been of equal necessity and value as the services of the driller, welder, or geologist in the success of the acquisition, exploration and development of an oil and gas property.\textsuperscript{114} The cases present some clearly identifiable principles, which if followed, should provide the tax deferral envisioned in G.C.M. 22730.

IV. Administrative Practice

A. G.C.M. 22730

For several years following G.C.M. 22730, very little written direction emanated from the Revenue Service regarding the pool of capital doctrine as it relates to service contributions. Then Revenue Ruling 77-176\textsuperscript{115} and several private letter rulings followed, some favorable to the taxpayer, and some not. Finally, in 1983, the IRS issued Revenue Ruling 83-46 which officially altered its position. Perhaps this change of position was forecast in an IRS handbook pertaining to audits of oil and gas property owners and operators.\textsuperscript{116} The handbook directs agents who are examining oil and gas partnerships and drilling ventures to carefully scrutinize the underlying agreements for interests conveyed in exchange for services. It then points out that a legal problem will be encountered because G.C.M. 22730, while not revoked, is unclear. The handbook states: “It has not been revoked although it seems to have been partially superseded by the 1954 Code, case law and the 1969 Tax Reform Act.”\textsuperscript{117} The handbook then recommends requesting technical advice if the income adjustment is substantial. The handbook refers to the Diamond,
James A. Lewis Engineering, Inc. and Frazell cases. Finally, however, the handbook does confirm the result in Revenue Ruling 77-176.

B. Other Rulings

Revenue Ruling 77-176 considers two overlapping concepts: (1) the pool of capital concept involving service contributors; and (2) the concept of the carried interest. As to the pool of capital concept, the ruling resolves that when a well driller receives an economic interest in the very well site where he contributes his services, he need not take into income presently, the value of the interest received. However, if he also receives for the same service interest from another property, such as the property surrounding but excluding the well site, the interest from the other property is treated as compensation for services. To the extent of its value, the surrounding property is presently includible in income. In support of its position, the IRS refers to G.C.M. 22730. As to the carried interest concept, because the entire working interest of the drill site was conveyed to the driller until payout subject to a retained overriding royalty interest, the IRS said that the arrangement was a good carried interest and that the driller could deduct one hundred percent of his intangible drilling expenses. With respect to the transferor, to the extent the transfer of the drill site fell within the concept of the pool of capital doctrine and was a good carried interest, no sale of the interest resulted. However, since the transfer of the property exclusive of the drill site was neither a carried interest, nor was it covered by the pool of capital doctrine, that transfer was treated as a sale by the IRS.

During the 1970's and 1980's the Revenue Service issued a series of private letter rulings which defined those types of service contributors likely to be members of the pool of capital club. First, the IRS, on two occasions, ruled that independent geologists who provide services in prospecting, locating and preparing prospects for exploration are entitled to "tax free"122 receipt of an economic interest in

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118. Id.; see supra notes 109-114 and accompanying text.
119. 1977-1 C.B. 78.
120. Id. at 78-79.
121. The services contributed in this case benefitted only the drill site and not the property outside the drill site.
122. The IRS in its private rulings uses the concept "tax free." However, the term "tax free" in this context is a misnomer because the taxpayers have to report as income production proceeds when received. Perhaps, "tax deferred" is a better description.
the property for which they provide the beneficial service.\textsuperscript{123}

In 1980, a second IRS ruling held that overriding royalty interests and twenty percent reversionary operating interests reserved by a corporate oil and gas investment program promoter in consideration for contributed services of finding and acquiring the properties in which it received its economic interest, was not presently includible in gross income.\textsuperscript{124} However, because of the opposite conclusion regarding the first factual situation prescribed in Revenue Ruling 83-46, the same result would not be afforded if the ruling request were submitted today.

In a third ruling favorable to the taxpayer, the IRS held that where a group of independent oil companies organized to find and develop hydrocarbon-bearing properties in the North Sea, and one of them was selected to and did contribute services as a locator and developer of properties and as an operator, the economic interest received by that oil company was "tax free" as a contribution of its services to the pool of capital.\textsuperscript{125}

On the other hand, there have been some rulings that have been unfavorable to the taxpayer particularly in the area of employee incentive programs. For example, in one private ruling the chief executive officer (C.E.O.) of a private corporation was instrumental in initiating an incentive program to increase competition among employees. The concept was that the employees would share in overriding royalty interests of properties they developed. Later the board resolved that the C.E.O. should also receive overrides as incentives. The IRS reasoned that the present value of the interest an employee received had to be included in his gross income because services must be contributed to the very property from which the economic interest derives in order to come within the scope of the pool of capital theory of G.C.M. 22730.\textsuperscript{126} The IRS held that the C.E.O. did not provide services to specific properties in that his duties included supervising other employees and participating in policy decisions which are generally not of a type which should receive "tax free" treatment. In two other private rulings, the Revenue Service reached the

\begin{quote}
\textsuperscript{123} See, e.g., I.R.S. Letter Ruling 6801029370A (Jan. 2, 1968) In this letter ruling, the geologist served in two capacities, as president of the company which held title and operated the properties, and as an independent geologist who found the target properties and who in his capacity as geologist, received an economic interest in the nature of an individual reversionary working interest.

\textsuperscript{124} I.R.S. Letter Ruling 8047005 (July 24, 1980).

\textsuperscript{125} I.R.S. Letter Ruling 8137006 (July 23, 1981).

\textsuperscript{126} I.R.S. Letter Ruling 8014024 (Dec. 28, 1979).
\end{quote}
same result.\textsuperscript{127}

These three private rulings are consistent with the IRS position taken in the factual situation number three of Revenue Ruling 83-46. This position, however, is somewhat inconsistent with the position taken by the IRS in its 1968 Private Letter Ruling involving the independent geologist.\textsuperscript{128} There the geologist was an officer of the corporation that operated the property, yet he received overriding royalties on properties which he found for investors and for the corporation. Nevertheless, the position may be justified in that case because the geologist acted in a dual capacity, as an officer on the one hand, and as a consultant on the other.

While private letter rulings cannot be relied on by taxpayers other than those who are subjects of the rulings, they offer insights into IRS policy and position on issues. The letter rulings cited above offer some important considerations which reaffirm and augment the rationale of G.C.M. 22730, and they should be taken into account when structuring a transaction for an oil or gas property service contributor.

First, it should be abundantly clear from the rulings previously cited that the services must be contributed to the specific property from which the economic interest is transferred in return.\textsuperscript{129} The concept was said to be equivalent to G.C.M. 22730's requirement that contributed services must be used on the specific property from which the economic interest is to be transferred to the cash investor.\textsuperscript{130}

The "specific property" rule was the basis of denying the "tax free" treatment to overriding royalty interests received by the chief executive officer, exploration manager, and land manager who are each employees of close corporations.\textsuperscript{131} The question that arises is can a corporate employee ever contribute services to the pool of capi-

\textsuperscript{127} In one case, the taxpayer was a land manager of a corporation and in the other, the taxpayer was an exploration manager. The IRS held that neither contributed services exclusively to the properties from which they received their overriding royalties; rather their services were generally performed on all properties owned or operated by the company including properties in which they could not participate. Therefore, each had to include in gross income the value of the interest when received. I.R.S. Letter Ruling 8152001 (Dec. 28, 1979) (involving the land manager); I.R.S. Letter Ruling 8146006 (undated) (involving the exploration manager).

\textsuperscript{128} I.R.S. Letter Ruling 6801029370A (Jan. 2, 1968); see supra note 123 and accompanying text.


\textsuperscript{130} \textit{Id.}

\textsuperscript{131} \textit{Id.}
tal and receive "tax free" treatment under G.C.M. 22730? As a result of these private letter rulings, and particularly Revenue Ruling 83-46, the IRS is apparently signaling that it will oppose "tax free" treatment in almost every employee incentive plan. This is so because the description of the duties of the employees in those rulings fit the job descriptions of most of their counterparts in other corporations. However, I.R.S. Letter Ruling 680102937A suggests a solution. There the taxpayer acted in a dual capacity—-independent geologist and a officer of a corporation. Perhaps, for some corporations desiring the contribution of its employee's services to the pool of capital on a specific property, such corporations might describe the duties to be contributed by the employees to the specific property as being outside the scope of their regular employment for which they receive normal compensation. In short, such employees would serve in dual capacities. To insure that a dual capacity relationship exists between the parties, an agreement should be drafted to clearly delineate the services to be contributed to the specific properties from which the employee will receive the overriding royalty interest. However, the suggestion may prove cumbersome for most employer/employee arrangements.

As a corollary to the above rule, Revenue Ruling 77-176 suggests that a specific tax treatment should result when services are contributed to a specific property, but economic interests are conveyed to the contributor from the specific property as well as from other property. That ruling held the interest conveyed from the property other than the specific property was compensation income to the service contributor. The transferor of the economic interest, on the other hand, is treated as having made a sale of that interest.

Next, the IRS is not concerned with the formality of the economic interest transferred, in that it can be in any form as long as it

133. See Hall, Contribution of Services to the Pool of Capital: Defining the Boundaries, 30 OIL & GAS TAX Q. 442, 452 (1982) (as an alternative, it is suggested that employers may wish to devise overriding royalty plans utilizing the type of restrictions that are used in conjunction with restricted stock employee incentive plans); see also Glancy, Compensating Key Employees in the Oil and Gas Business, 33 INST. OIL & GAS L. & TAX'N 369, 375-78 (1982) (examples of employee compensation planning devices utilizing "substantial risk of forfeiture" techniques to gain tax deferral under § 83 (P-H 1984) are provided).
134. This would involve a substantial administrative burden on the employer in the form of documenting specific activity expenses and costs to specific properties when the employee may be responsible for many hundreds of properties.
is an economic interest. Thus, I.R.S. Letter Ruling 680102937A\textsuperscript{136} held that the interest could even be a reversionary working interest and need not necessarily be evidenced by a formal conveyancing deed so long as the initial agreement specifying the rights and duties of the parties clearly describes the interest set aside for the service contributor. This reaffirms the concept that was originally set out in G.C.M. 22730.\textsuperscript{137}

The next concept articulated in the rulings is that the only investment into the pool of capital required is that of services. Personal services need not be accompanied with a cash investment or equipment. Thus, the pure services of a geologist qualify for the pool of capital investment affording "tax free" treatment.\textsuperscript{138} Revenue Ruling 83-46 apparently attempts to draw this line on qualifying and non-qualifying services contributed to the pool of capital.\textsuperscript{139} However, the question arises that if pure services of a geologist can qualify, what then is the justification or rationale which supports the decision in Revenue Ruling 83-46 that the services of the promoter, attorney, or chief executive officer are less important to the successful exploration of the pool of capital than the services of the geologist? There is no logical distinction between the types of services and their importance to the pool of capital. Again, it is often the skill and services of the attorney or promoter that make it possible for the geologist to make his contribution to the pool of capital.

The next concept which reaffirms and augments the meaning of G.C.M. 22730 is that services contributed up to the point of drilling prior to discovery of oil and gas qualify for the pool of capital treatment.\textsuperscript{140} The IRS selection of this limitation in the private letter rulings presumably are intended to give further meaning to the words, "for use in developing the leased property in return for agreements to make stated payments out of a share of the oil," found in G.C.M. 22730.\textsuperscript{141} This amplification was probably necessary because James A. Lewis Engineering, Inc.,\textsuperscript{142} which denied pool of capital treat-

\begin{footnotesize}
\begin{enumerate}
\item G.C.M. 22730, 1941-1 C.B. 214, 222.
\item I.R.S. Letter Ruling 8129006 (March 30, 1981); I.R.S. Letter Ruling 8137006 (July 23, 1980).
\item Apparently, the services of: 1) an attorney, 2) a corporate promoter of oil and gas syndications, and 3) a corporate executive, do not qualify as services for IRS purposes.
\item I.R.S. Letter Ruling 8137006 (July 23, 1981); see also I.R.S. Letter Ruling 8047005 (July 24, 1980) (emphasis added).
\item 1941-1 C.B. 214, 221.
\item James A. Lewis Engineering, Inc. v. Comm'r, 339 F.2d 706, 65-1 U.S. Tax Cas. (CCH) ¶ 9122 (5th Cir. 1964).
\end{enumerate}
\end{footnotesize}
ment to services contributed to a production phase improvement on oil and gas property. Thus, services contributed beyond the development phase, will receive questionable treatment under the pool of capital concept.

Another concept reiterated in the letter rulings is that services contributed should be "performed prior to the value of the property becoming known." While G.C.M. 22730 does not cite as authority for its opinion any of the well driller cases unsuccessfully litigated by the Revenue Service in the 1930's, it appears that the phrase "performed prior to the value of the property becoming known" in the letter rulings manifests the IRS's continued awareness of those cases. The principle that when the value of a property interest is too speculative to ascertain fair market value it is not includible in gross income, is one that has carried into recent times. This requirement serves as the factor which distinguishes the nontaxability of the economic interest of the contribution of services to the pool of capital, from the taxability of the partnership interest received by the taxpayers in *Diamond*, *Frazell* and *Vestal*.

Two final observations regarding the letter rulings are noteworthy. The first is that the IRS initially manifested concern about the application of section 83 to the service contribution issue in 1981. Prior to 1981 no written material emanating from the IRS referred to section 83 in the context of the taxability of an economic interest received by a service contributor to the pool of capital. A period of twelve years elapsed from the date of its enactment until the first mention of section 83 in that context in I.R.S. Letter Ruling 8129006 and in the new oil and gas audit handbook. During

144. Dearing v. Comm'r, 102 F.2d 91, 39-1 U.S. Tax Cas. (CCH) ¶ 9344 (5th Cir. 1939); Comm'r v. Edwards Drilling Co., 95 F.2d 719, 38-1 U.S. Tax Cas. (CCH) ¶ 9211 (5th Cir. 1938); Cook Drilling Co. v. Comm'r, 38 B.T.A. 291 (1938); see also Burnett v. Logan, 283 U.S. 404 (1931).
145. See, e.g., Vestal v. United States, 498 F.2d 487, 74-2 U.S. Tax Cas. (CCH) ¶ 9407 (8th Cir. 1974).
146. Diamond v. Comm'r, 492 F.2d 286, 74-1 U.S. Tax Cas. (CCH) ¶ 9306 (7th Cir. 1974) (the value of a partnership interest was imputed from the sale of the property shortly after receipt of the partnership interest).
147. United States v. Frazell, 335 F. 2d 487, 64-2 U.S. Tax Cas. (CCH) ¶ 9684 (5th Cir. 1964) (contingencies removed from the contract and stock were transferred when value of the property was known). See also supra notes 109-110 and accompanying text.
148. Vestal v. United States, 498 F.2d 487, 74-2 U.S. Tax Cas. (CCH) ¶ 9407 (8th Cir. 1974) (contingencies in the taxpayer's contract were removed after value of the property was known and taxpayer received cash for his interest).
this twelve-year period, the IRS appeared to follow the administrative practice it had followed since 1941 starting with G.C.M. 22730.

Second, the IRS continues to acknowledge in the letter rulings that if the contributed services fall within the pool of capital theory as described under G.C.M. 22730, then neither sections 61 nor 83 apply to that property transfer.¹⁰¹

C. Revenue Ruling 83-46 is not the Solution

A review of the administrative activity of the Revenue Service over the past decade, suggests that Revenue Ruling 83-46¹⁰² is the IRS's attempt to limit the types of services that qualify for pool of capital treatment. In this regard the IRS recently stated: Because there has been little guidance from the courts on the scope of the doctrine, restrictive interpretations are justified.¹⁰³

In Revenue Ruling 83-46 the Revenue Service excluded from pool of capital treatment: (1) the corporate promoter of oil and gas development programs; (2) the attorney who provides legal services in the acquisition of properties; and (3) the corporate employee who arranges financing for the corporation's acquisition of oil and gas properties and oversees their operation.

The difficulty in arbitrarily drawing the line in this manner, is in the formulation of a sensible and workable approach to the inclusion and exclusion of services from the pool of capital treatment. For example, why is the driller more valuable to the success of a project than the attorney, where but for the attorney's services the project may have never been started nor the pool of capital formed? Does inclusion or exclusion depend on the classification of skill, that is, whether the skills of a driller are involved or those of an attorney?

¹⁵³. Manganaris, Background Information Note, supra note 2 (emphasis added). The IRS added:

In support of this approach, it is noted that in James A. Lewis Engineering, Inc. v. Comm'r, 339 F.2d 706 (5th Cir. 1964), the court in holding that the taxpayer's services in connection with "production" activities were outside the scope of G.C.M. 22730, in dictum stated at 709, that "unless a careful analysis of the reasons underlying the issuing of G.C.M. 22730 compelled it, the court would have great difficulty accepting a construction of the code that would fly in the face of the tax laws to the effect that compensation for services must be returned as part of gross income."

Id.
Or, is it the type of service being contributed by the driller or the attorney? For example, well drillers have been known to contribute a variety of different services to the pool of capital. In one instance he may provide very superficial and ministerial services such as providing the drilling rig and the crew in exchange for an oil payment. On the other hand, the well driller may provide a "turnkey" package including not only the rig and the crew, but also the supervision of the drilling and all of the supplies and equipment. This was the case in Revenue Ruling 77-176, in which the driller committed to drill, complete, and equip the well. The question is whether the IRS had both situations in mind when it issued its opinion in G.C.M. 22730. In the first instance, the driller's cash or equipment investment in the project would be minimal. Is "tax free" receipt of the economic interest by the driller in the first instance any more justified than in the case of the attorney who negotiates with land owners to obtain the minimum cost, structures the minimum tax cost for the project, and in drafting documents, minimizes legal risks and costs to the extent of rendering the project legally and economically feasible? Mindful of the national policy considerations of fostering competition among oil companies and increasing domestic exploration, development, and production of oil and gas, one must question whether the services of the corporate promoter in locating worthy hydrocarbon-bearing prospects and then obtaining the capital necessary by finding interested investors, is any less important to the national policy than the well drillers who merely provide the rig and drill the hole.

As a result of the criticism from taxpayers across the nation, the IRS announced that it will review and clarify its decision in Revenue Ruling 83-46. In response, the Independent Petroleum Association of America submitted to the IRS its suggestion for a modification of Revenue Ruling 83-46. The Association has imposed a

154. The services provided in this situation would be comparable to the "day-rate" drilling contract for cash compensation, wherein the drilling company provides the drilling rig and the crew and is compensated in cash at an hourly or daily rate. He assumes none of the risks of the operation and provides none of the materials. Normally, the owner of the working interest supervises the drilling operation and contracts with, and obtains all of the supplies and equipment for the drilling operation. Telephone interview with Harold W. Berholf, geologist from Sacramento, Cal. (June 11, 1984).


156. See supra note 9.


158. Letter from H.B. Scoggins, Jr., Gen. Counsel, Indep. Petroleum Ass'n. of America
test which determines whether the type of service in question is "essential for the acquisition, exploration or development of the property." Accompanying the test are examples of services that are essential and those that are nonessential and therefore do not qualify for "tax free" treatment. The approach suggested by the Association more equitably distinguishes and acknowledges services which are essential to the acquisition, exploration and development of oil and gas properties, in that it recognizes those services which implement the national policy.

Most likely, the IRS has limited the types of services eligible for pool of capital treatment to prevent the abuse that would develop if every service provider attempted to qualify for pool of capital treatment no matter how remotely connected his services were to the acquisition, exploration or development of an oil and gas property.

The oil and gas industry has existed for at least a century. Existing for almost as long is the practice of conveying an economic interest in exchange for the contribution of services. The fact that this practice has continued for so long supports the notion that valid business motives are involved. History suggests, therefore, that this practice existed for valid business purposes and not just for tax-motivated reasons. Where the type of service can be demonstrated as being accepted in exchange for an economic interest, as matter of historical oil industry practice, it should be afforded deferred income status. A "valid business purpose" test would be an appropriate vehicle to determine which services should receive pool of capital treatment.

D. Validation

Revenue Ruling 83-46 is inadequate as it does not resolve the speculative valuation issue raised in the early cases which were a

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159. For example, a promoter merely finds investors and reviews geological data with them. Forecasts do not qualify. However, if the promoter conducts an independent evaluation of the prospects and based on his independent evaluation, and he seeks out and obtains investors, his services qualify. In the case of an attorney, if he merely examines claims to title and drafts documents within the parameters defined by the oil companies, then his services do not qualify. On the other hand, if he negotiates with landowners and performs services of examining claims to title and drafts documents based on the negotiation, his services will qualify. The Association also provides examples of qualifying and nonqualifying services of the corporate employee, geologist, employee, well driller, independent geologist, and independent petroleum landman.

160. See supra notes 76-80, 82.
prelude to G.M.C. 22730. The inclusion into gross income of the present value of an economic interest continues to present the same valuation problem today as it did forty years ago. How do you value an oil and gas property that has not yet been developed? The predominant valuation method used in the industry is sometimes referred to as the analytical engineering method of appraisal. In order to use this valuation technique, several assumptions have to be made on an undeveloped property that may or may not be correct. For example, the geologist or engineer must calculate the estimated reserves that can be recovered with reasonable certainty under the given economic and technological conditions. If there has been little or no prior production from the subject property, such an estimate amounts to nothing more than an educated guess. Additionally, the valuation method requires estimating a decline curve which is necessary in determining the economic life of the property as well as the recoverable reserves. Without prior production history from the property, the decline curve assumption is again a guess. Most assuredly, the IRS's crystal ball would afford no better insight into these matters than that of the industry. The valuation of oil and gas properties constantly changes as more and more information is obtained and as economic conditions and technology change.

Assuming a value is determined on the subject undeveloped property, there are substantial risks which remain before the service contributor will collect proceeds from oil production. For example, all the hazards of drilling exist as well as the possibility of a dry hole. Even if the well is drilled and completed, the well may not be profitable if the cost of production increases to the point that the well cannot produce in "paying quantities." Most assuredly, these uncertainties played a large role in the Service's opinion in G.C.M. 22730. That approach, in all likelihood, reduced its administrative burden in valuing such interests.

These uncertainties were discussed and considered in Vestal v. United States. In that case, the taxpayer as consulting engineer and geologist found investors for an oil and gas property, and for his

161. Telephone conversation with Harold Bentholf, geologist from Sacramento, Calif. (June 11, 1974).
162. The decline curve is one element of the analytical engineering method of appraisal used by the oil industry to value oil and gas properties. It measures the rate at which a producing oil well declines in production. 3 Campbell, Mineral Property Economics 68 (1978).
163. See supra note 159.
164. 498 F.2d 487, 74-2 U.S. Tax Cas. (CCH) ¶ 9407 (8th Cir. 1974); see also supra note 146 and accompanying text.
efforts he received agreements from each investor that each would deliver a one-eighth interest in the partnership after the investors returned their investments from the proceeds of sale of the oil and gas. Before the interest was conveyed, the partners sold the property and the taxpayer was paid in cash for his interest. The taxpayer took the position that because he received the interest in 1962 when the agreements were entered into, the recent sale in 1964 was a sale of a capital asset. The statute of limitations had run on tax year 1962. The taxpayer presented evidence that his interest had a value of $29,375 in 1962 (although he did not report the value as compensation in 1962) which was even found to be true by the trial court. The IRS on the other hand, took the approach that the rights acquired in the agreements were contingent and speculative and as a matter of law did not constitute income.

It is unquestionable that the acquisition of the partnership interest was “restricted” in that it was contingent on the partners returning their investment before the obligation to convey to the taxpayer arose. That point alone was sufficient to support the holding of the court. Nevertheless, the court gave considerable attention to the speculative valuation of the interest arrangement presented by the government. Ironically, the IRS’s argument was exactly the same as used by the taxpayer in the cases that preceded G.C.M. 22730.¹⁶⁶ The court said it recognized that the taxpayer’s right had some value, but that did not mean that the taxpayer received income under the tax laws.¹⁶⁶ The Vestal case seems to reaffirm the cases that preceded G.C.M. 22730 to the extent they relied on Burnett v. Logan.¹⁶⁷ Thus, it would seem that a service contributor can still argue that the economic interest he received had an indeterminable or speculative value and thus ought not be taxed under the Burnett v. Logan¹⁶⁸ rationale.

V. ALTERNATIVES TO THE POOL OF CAPITAL DOCTRINE

In order to provide a complete perspective on the tax treatment of the service contributor, it is important to reflect on the alternatives that are available. For those who are excluded from the pool of capital tax treatment, it has been suggested that the owner of the work-

¹⁶⁵. See supra notes 76-78, 82.
¹⁶⁶. Vestal v. United States, 498 F.2d 487, 491, 74-1 U.S. Tax Cas. (CCH) ¶ 9407 (8th Cir. 1974).
¹⁶⁷. 283 U.S. 404 (1931); see also supra notes 83-85.
¹⁶⁸. 283 U.S. 404.
ing interest convey to the service contributor a contingent interest, subject to a "substantial risk of the forfeiture" or subject to a restriction on the transferability of the interest. The restriction, for example, might be the performance of substantial future services. The purpose for such a restricted conveyance is to evoke the deferral provisions of section 83. While this may be an acceptable approach for the employer/employee relationship, it is not necessarily acceptable where the restricted interest is conveyed to the independent contractor, such as the attorney. The Treasury Regulations under section 83 list several examples where the restrictions are not "substantial." It would seem that the attorney would be required to perform continuing "substantial" services in order for the restriction to qualify for section 83 income recognition deferral treatment. The practical problems associated with such qualifications include defining and quantifying the continuing services so that they are "substantial." Because there are no definitions, the term "substantial" is illusive. Another problem with placing a restriction on transfer is perhaps archaic and academic, but nevertheless, worthy of mention in that the issue has been the subject of much litigation recently in another context. That is, restrictions on alienation of real property interests are said to violate the rule against restraints on alienation. Because an economic interest is an interest in real property, it is possible that the types of restrictions contemplated under section 83 are arguably unenforceable. The issue is academic in the sense that it is unlikely that the taxpayer, his heirs, or assigns would seek to invalidate the restriction, because such an event would accelerate the recognition of the compensation income due under section 83. And it is mere speculation that the IRS would even raise the issue.

Another suggested alternative to the pool of capital theory is the early formation of a partnership including the attorney, promoter, or employer therein before the completion of the surveys and acquisition of the target oil and gas property. At this stage, the value of the interest transferred to the service provider is clearly indeterminable

169. Glancey, Compensating Key Employees in the Oil and Gas Business, 33 SW. INST. ON OIL AND GAS L. & TAX'N 369, 375 (1983).
171. See Fidelity Federal Savings and Loan Ass'n v. Cuesta, 458 U.S. 141 (1982) (upholding a federally charted savings and loan association's ability to foreclose upon the violation of a due-on-sale clause in a promissory note and deed of trust secured by a residential property on the basis that federal law preempts state law); but see Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) (due-on-sale clause an unreasonable restraint upon alienation).
and evokes the rule of *Burnett v. Logan*\textsuperscript{178} and subsequent pool of capital cases.\textsuperscript{174} This proposal has been suggested for syndication of real estate developments, such as commercial and residential properties, as a way for them to get a tax free "piece of the action."\textsuperscript{178}

There is some case support for the early partnership approach.\textsuperscript{176} And the IRS has also distinguished between a lawyer participating in a partnership as a partner with an interest in partnership assets and one acting as an agent receiving compensation income.\textsuperscript{177}

Nevertheless, the partnership should be formed and interest therein transferred before any activity occurs. The service contributor should be limited to a profits interest only\textsuperscript{178} lest he run afoul of the Treasury Regulations. The service contributor should plan to see his return or services invested from the profits of the partnership and should not sell his interest too soon after acquiring it to avoid the invocation of the *Diamond* rule.\textsuperscript{179}

\textsuperscript{173} 283 U.S. 404 (1931).

\textsuperscript{174} See supra notes 76-78.


\textsuperscript{176} Oil Properties Acquired for Services, 21 OIL & GAS TAX Q. 85, 86 (1972) (which cites Weiner v. Campbell, 44 A.F.T.R. (P-H) 125, 54-1 U.S. Tax Cas. (CCH) ¶ 9133 (N.D.C. Tex. 1953) (the court found that the promoter/partner had formed a partnership and as a partner, had to report only his proportionate share of the profits); and Farris v. Comm'r, 222 F.2d 320, 55-1 U.S. Tax Cas. ¶ 9411 (10th Cir. 1955) (the court held that where at the formation of the partnership, one partner contributes capital and the other partners contribute services in a drilling company, and where upon liquidation and distribution of the net assets are prorated according to the percentage of participation of each partner, the service partners are not required to recognize ordinary income). The court stated:

The basic concept of a general partnership is that all parties make a contribution thereto and as a result share in the assets, the profits and the losses, according to their contribution. In the absence of a contrary provision in the agreement where one partner contributes money or physical assets and others contribute personal services, skills and knowledge, they share in the capital assets according to the value placed on each contributor.

222 F.2d at 320.

\textsuperscript{177} Walls v. Comm'r, 60 F.2d 347, 1932 U.S. Tax Cas. (CCH) ¶ 9400 (10th Cir. 1932); Rev. Rul. 54-84 1954-1 C.B. 284.

\textsuperscript{178} Treas. Reg. § 1.721-1(b) (1960). This regulation provides:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished form a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.

*Id.*

\textsuperscript{179} Diamond v. Comm'r, 492 F.2d 286, 74-1 U.S. Tax Cas. (CCH) ¶ 9306 (7th Cir. 1974); see supra notes 109-114 and accompanying text.
Finally, in abundance of caution, one might structure the partnership interest of the service contributor to contain restrictions which provide for "substantial risks of forfeiture" and against transfer in accordance with the guidelines of section 83 and the Treasury Regulations.

Some practical difficulties surface in the context of the partnership alternative. The pool of capital concept had traditionally been the preferred as the most flexible method of structuring a transaction with capital, equipment and service investors. The partnership alternative being more complex and less flexible, may not be accepted in the industry.180 Perhaps, the most important aspect of the pool of capital doctrine is that it preserves the very flexible and uncomplicated approach to financing and risk-spreading activities in the acquisition, exploration and development of oil and gas properties. The alternatives prove to be cumbersome substitutes for this accepted method. Revenue Ruling 83-46 does a major disservice to the national policy and, ultimately, to every citizen who must bear the additional energy costs caused by the Ruling's greater disincentive to service contributors to join the pool of capital.

VI. Conclusion

This analysis focused on the effect of Revenue Ruling 83-46 on service contributors to the pool of capital. It is fair to conclude that the IRS's lack of analysis in the ruling has created an air of uneasiness in the oil and gas community. The question that is being asked is how far will the IRS go in its case-by-case approach to defining the limits of the pool of capital doctrine. While Revenue Ruling 83-46 is limited to the corporate promoter, the attorney, and the corporate employee, the fear is that the IRS will attempt to draw the line at the type of service expressly mentioned in G.C.M. 22730, namely, at the services of the well driller, and excluding all others such as the geologist and petroleum engineer from tax deferred treatment.

By issuing the ruling, the IRS is losing its perspective by not considering the dominant policy considerations, as well as the legislative history and construction principles that affect the governing statutes, sections 61 and 83. The United States has a strong vested interest in a policy that promotes competition among oil producers and

180. Telephone interview with William V. Knight, C.P.G.S., independent geologist from Tulsa, Okla., (June 11, 1984) (he expressed the opinion that a receipt of a partnership interest was not an acceptable substitute for the receipt of an economic interest in the property).
that encourages exploration and development of reserves. Revenue Ruling 83-46 flies in the face of the national objectives so well described in the Engle case by Justice O'Connor. Furthermore, nothing in the legislative history of section 83 suggests that it was designed to replace the operation of section 61 on unrestricted property transferred in exchange for services. Section 83 should operate only on restricted property. Because the original intent and scope of section 61 survived unchanged through various statutory revisions, including the adoption of the Internal Revenue Code of 1954, a presumption arises that Congress approved of IRS administrative practices. These practices, as they relate to the pool of capital doctrine, have been in place since 1941. Therefore, IRS's attempt to base its conclusions on section 83 in Revenue Ruling 83-46 is erroneous to the extent that the overriding royalty interest conveyed therein were found to be presently vested interests.

Case law suggests that the arguments originally motivating the IRS to adopt the pool of capital doctrine to support the "tax free" treatment for the service contributor are as viable today as they were in 1941. This conclusion is suggested by the Vestal case's reaffirmation of the Burnett v. Logan speculative or indeterminable value rule. More importantly, the Supreme Court in Engle reaffirmed the spreading of risk analysis which was the very same analysis detailed in G.C.M. 22730. Namely, this analysis holds that the owner of the working interest spreads the risk of loss by including the service contributor in the pool of capital. This policy would then encourage exploration and development.

The case law also, however, suggests limits to the pool of capital doctrine and, therefore, can be viewed as supportive of the IRS attempt to limit the scope of the pool of capital doctrine. For example, it is clear the pool of capital doctrine does not apply where the services are contributed after the acquisition, exploration, or development phase of an oil and gas property. It also does not apply where a nonvested economic interest is converted to cash or to corporate stock prior to vesting, or where the economic interest has a clear and ascertainable value and is disposed of shortly after the acquisition of the interest.

Yet, the history of the administrative practice does not justify the IRS's sudden policy pronouncement in Revenue Ruling 83-46. The history of private rulings shows that except in the case of corporate employees, the IRS has been supportive of the inclusion of essential services into the pool of capital.

Revenue Ruling 83-46 unfairly discriminates in its determina-
tion of which services are or are not critical to the development of the pool of capital. For example, the pure "day rate" services of a well driller cannot be fairly distinguished from those of the attorney or promoter who, because of their skills, make the development of oil and gas properties legally and financially possible. The ruling also has the potential of creating an administrative burden in the valuation of an economic interest that has a speculative or an indeterminable value. The administrative burden will become a burden on the courts as taxpayers challenge values advocated by the IRS.

It has been suggested that taxpayers, particularly, corporate employees can make section 83 work for them by urging employers to adopt restricted or nonvested compensation plans offering, for example, overriding royalty interest subject to risks of substantial forfeiture or covenants restricting transfer.

Another approach for avoiding current recognition of income in the receipt of an economic interest in exchange for a contribution of personal services, is one suggested by commentators for promoters of real estate syndications. They suggest that the partnership be organized early and that the profit interest be transferred even before the partnership interests are offered and the partnership property is acquired. The service contributor to the pool of capital would receive the economic interest before performing services and before the property is even acquired if possible. In all cases, the service contributor should receive the economic interest before hydrocarbons are discovered and produced.

The IRS should carefully study the request for reconsideration of Revenue Ruling 83-46.