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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (NATURAL RESOURCES)

FROM: ASSOCIATE CHIEF COUNSEL, PASSTHROUGHS AND SPECIAL INDUSTRIES
CC:PSI

SUBJECT: Salary Bonus as Depletable Income

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LEGEND

Taxpayer A =

Taxpayer B =

ISSUES

Whether an interest in profits from oil and gas well production qualifies as a depletable economic interest and may be received tax free.

CONCLUSIONS

Under the facts of this case, taxpayers are not entitled to claim depletion on their bonus which is taxable upon vesting.

FACTS

Taxpayers A and B were pipe salesmen for their employer which sold pipe and related supplies for oil and gas well drilling and production. At the suggestion of the taxpayers, their employer began entering into drilling contracts in exchange for a percentage of the well production. As a consequence, the parties modified the employment agreements to grant taxpayers a percentage of income from their employer’s share of production. Specifically, taxpayers were to receive ten percent of their employer’s net profits (as defined in the contracts) from oil and gas production from well projects taxpayers recommended which were accepted by their employer.

After the agreements ended, the employer paid the taxpayers a portion of their share of the profits. The employer then refused to pay any further sums. The taxpayers filed suit to recover their share of drilling program proceeds. Taxpayers prevailed in litigation and received an award representing their full share of past accrued profits. An agreed judgment further awarded them "10 percent of all revenue from [three specific drilling programs]."

Taxpayers did not report as income the receipt of a 10 percent joint venture interest at the time their contract right to each well vested. They reported only salary and income from their share of profits as received (including the litigation awards). They did not characterize the income as depletable gross income from production, but rather, reported the income as ordinary income.

Two years after receipt of their litigation awards, after the period of limitations on assessment had expired for the years in which their profits interests had vested, taxpayers filed amended returns re-characterizing their litigation proceeds as income from “working interests” and claiming depletion deductions for these receipts. They also claimed depletion for subsequent years, including the years currently in suit. Their Alternative Minimum Tax schedule did not report depletion as a preference item.

LAW AND ANALYSIS

In order to have a depletable "economic interest" in minerals in place, a person must acquire "by investment," an interest in the oil in place, and secure, by any form of legal relationship, income derived from the extraction of oil, to which he must look for a return of capital. Treas. Reg. § 1.611-1(b); Palmer v. Bender, 287 U.S. 551, 557 (1933)[1]. The rationale for finding that a taxpayer has an economic interest in minerals in place in this circumstance is that the oil in the ground represents "a reservoir of capital investment" that can be recovered only through production. Id. at 558. (Emphasis supplied) It is not material whether the payments are in oil, or in cash which is the proceeds of the oil. Id. Helvering v. Twin Bell Syndicate, 293 U.S. 312, 321 (1934).

An exchange of personal services for an economic interest is taxable. See, Frazell v. Commissioner, 335 F.2d 487 (5th Cir. 1964); and Zuhone v. United States, 883 F.2d 1317 (7th Cir. 1989). In Frazell, the Fifth Circuit held that receipt of a "joint venture"[2] interest in wells for personal services was taxable. The court relied on the fundamental concept that "compensation for services" is taxable as ordinary income under I.R.C. § 61(a)(1). The court also relied on Treas. Reg. § 1.721-1(b)(1) which makes a partnership interest received in exchange for personal services a taxable exchange. See also I.R.C. § 83 (property received for services is taxable); Rev. Rul. 83-46, 1983-1 CB 78 (overriding royalty interest in exchange for personal services is taxable). The Seventh Circuit in Zuhone, relying in part on Frazell and section 83, also held that an overriding royalty exchanged for personal services is taxable.

Based on the facts of this case, taxpayers could arguably show that their employment contract should be bifurcated into two parts: a part paying salary for pipe sales and a second part amounting to a joint venture agreement. Under the joint venture agreement, taxpayers received ten percent of the proceeds from wells drilled by their employer solely in exchange for their services in recommending

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[1]In Palmer v. Bender, the taxpayer explored and developed the subject property, transferred it to a producer, and retained a production payment.

[2]The parties attempted to contribute their interests to a newly formed corporation tax free pursuant to section 351. However, the court analyzed the underlying "joint venture" agreement under which the interests arose to determine taxability prior to application of section 351.

drilling projects. Taxpayers arguably received an economic interest in the properties subject to depletion since they must look exclusively to production to recover the value of their services for drilling recommendations. However, taxpayers would be taxable for the fair market value of their interests in the drilling projects at the time their interests in these projects vested. See, Frazell v. Commissioner, 335 F.2d at 489; Zuhone v. United States, supra; Rev. Rul. 83-46.

In fact, taxpayers did not report the receipt of their interests as taxable exchanges. It is now too late for the Service to issue notices for deficiency for the years in which taxpayers' interests vested. Thus, allowing depletion deductions now would amount to a double benefit.

Consequently, taxpayers are now barred from recharacterizing their income under the "duty of consistency" doctrine. Under this doctrine, a taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction. When such a fact or transaction is projected in its tax consequences into another year there is a duty of consistency on the taxpayer with regard to it, whether or not there be present all the technical elements of an estoppel. Estate of Letts v. Commissioner, 109 T.C. 290, 296-97 (1997); Orange Sec. Corp. v. Commissioner, 131 F.2d 662, 663 (5th Cir. 1942); see also, Herrington v. Commissioner, 854 F.2d 755, 757 (5th Cir.1988); Johnson v. Commissioner, 162 F.2d 844, 846 (5th Cir. 1947); LeFever v. United States, 100 F.3d 776, 786-88 (10th Cir. 1996); Lewis v. Commissioner, 18 F.3d 20, 26 (1st Cir. 1994); Kielmar v. Commissioner, 884 F.2d 959, 965 (7th Cir. 1989); Shook v. United States, 713 F.2d 662, 666-67 (11th Cir. 1983); Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974).

The duty of consistency has the following elements: (1) A representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. Estate of Letts, 109 T.C. at 297; Herrington, 854 F.2d at 758 (citation omitted); see also, Eagan v. United States, 80 F.3d 13, 17 (1st Cir. 1996). If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary.

Taxpayers have met these three elements since: (1) they represented on their tax returns for the years in which their profits interest vested that they received no taxable income upon receipt of these interests, and they represented the profits as non-depletable ordinary income; (2) the Service relied on these representations in assessing only the reported tax and not auditing taxpayers for the years in which their profits interests vested; and (3) after the period for assessing these years expired taxpayers recharacterized their profits as depletable income from economic interests. This recharacterization harms the government since the government was time barred from taxing the receipt of the economic interests when taxpayers first informed the government (through amended returns) of their changed characterization.

Policy reasons also support application of the duty of consistency doctrine in these circumstances. Taxpayers have no basis in their own personal services. Absent the reporting of a taxable exchange, taxpayers should be treated as having only a carryover basis of zero and, similarly, a "capital investment" of zero. Without a capital investment, taxpayers have no economic interest subject to depletion. Treas. Reg. § 1.611-1(b).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted][3] [redacted]

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[3] [redacted]

Please call if you have any further questions.

ASSOCIATE CHIEF COUNSEL,
PASSTHROUGHS AND SPECIAL
INDUSTRIES

By: ________________________________
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