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## **Waiting for *Gaudreau***

**A mineral production company granting its employees some form of interest in its mineral properties can be a taxing matter. This article examines a recent case—*Gaudreau v. United States*<sup>1</sup>—that did not turn out well for such an employee and suggests that an alternative format may have been more tax efficient.**

### Case Summary

Mr. Gaudreau was employed by an oil and gas corporation as a landman. The corporation and Mr. Gaudreau entered into an Employee Incentive Agreement (the "Agreement"), under which he received "bonuses" equal to a percentage of the net income produced by oil and gas properties purchased by the corporation through his efforts. Mr. Gaudreau first reported the bonus payments as ordinary income and later filed amended tax returns recharacterizing the bonus income, claiming percentage depletion on the production income received and capital gains treatment for the income derived from his share of the corporation's proceeds from the sale of certain leasehold properties. Mr. Gaudreau filed a claim for refund and the matter proceeded to a district court.

The district court correctly held against the taxpayer. However, the court appears to have focused most of its analysis on an ephemeral issue—the fact that the taxpayer did not have a capital investment in the mineral "property." Nevertheless, the holding should not have changed even if the taxpayer had paid a sum of money to the corporation for the Agreement or treated the fair market value of the Agreement as taxable income and thereby establish a capital interest (tax basis) in the Agreement.

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<sup>1</sup> [Gaudreau v. United States, 2014 WL 7384932 \(D. Kan.\)](#).

## Solely from Production

To understand the issue and the court's decision, first consider the principle that a right otherwise classifiable as an economic interest will not be so classified if the right can be satisfied in any way other than solely from a share in production. This principle is best illustrated by the *Anderson* case,<sup>2</sup> in which an assignor conveyed certain properties to the taxpayer for a specified amount of cash and an additional sum payable from production proceeds and sale proceeds, if fee title to any or all of the land were conveyed. The U.S. Supreme Court held that the reserved interest in the potential sales proceeds of the fee land changed the character of the interest retained because the assignor might receive a portion of the deferred payments from sale of land; such payments were not dependent entirely on production of oil and gas.

The Fifth Circuit in *Christie*<sup>3</sup> held that the holder of a production payment that could be satisfied with proceeds from salvaged equipment did not have an economic interest. A contractual right to receive a definite sum of money within a definite time period, with interim payments measured by production, is not an economic interest, because the right to share in the oil and gas proceeds is incidental to the covenant to pay a sum certain.<sup>4</sup> In *Estate of Donnell*,<sup>5</sup> the transferor of a mineral leasehold received cash and retained a production payment. The transferee issued a takeout letter stating that, if requested, transferee would pay the unliquidated balance on the production payment. The takeout letter was treated as an alternative source of repayment therefore, the production payment was determined not to be an economic interest.

In *Lehigh Portland Cement*<sup>6</sup> contingently cross-collateralized production payments on three geographically separated mineral properties disqualified them from being economic interests. In a technical advice memorandum<sup>7</sup> the IRS found that an economic interest existed for a

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<sup>2</sup> *Anderson v. Helvering*, 310 U.S. 404 (1940).

<sup>3</sup> *Christie v. United States*, 436 F.2d 1216 (5th Cir. 1971).

<sup>4</sup> *Deskins v. Commissioner*, 87 T.C. 305 (1986).

<sup>5</sup> *Commissioner v. Estate of Donnell*, 417 F.2d 106 (5th Cir. 1969).

<sup>6</sup> *Lehigh Portland Cement Co. v. United States*, 433 F.Supp. 639 (E.D. Pa. 1977).

<sup>7</sup> T.A.M. 199918002 (Jan. 15, 1999) (The instrument provides for payment of a variable portion (up to 100%) of the "gross income from the property," but did not permit payment that would be derived from income beyond that generated by the project properties; therefore, there was no alternate source of recoupment.).

taxpayer holding an interest in a project that produced gas and condensate from certain mineral properties. The taxpayer transferred an interest in the mineral properties and retained a net profits royalty interest from the liquefied natural gas sales less certain expenditures, further such payments were limited to the "gross income from the property" attributable to the transferred properties. Under the instrument creating the net profits royalty interest, payments could not exceed the gross income attributable to the properties. Thus, the instrument provided for payment of a variable portion of the gross income from the property, but did not permit payment derived from income beyond that generated by the properties. Therefore, the IRS determined that there was no alternate source for recoupment of the taxpayer's investment in the properties and that retained net profits interest qualified as an economic interest.

In *Standard Oil*<sup>8</sup> the Seventh Circuit held that the owner of a retained production payment on the transfer of a mineral leaseholds was an economic interest, even though the proceeds of a later sale by the transferee of one or more of the leaseholds to a third party could be applied to reduce the outstanding balance of the production payment, because the "additional security" was not "significant." After its success in *Standard Oil*, however, the IRS reversed its position stating that, "the Service does not follow the decision in *Standard Oil*."<sup>9</sup>

### Basket Net Profits Interest

In assorted rulings over the years, the IRS has determined that basket net profits interests (and basket production payments) are treated as economic interests if the basket cannot be added to after its creation.<sup>10</sup> The rationale was that if a mineral interest transferred to a taxpayer is structured in a manner that causes the financial returns from more than one property of the transferor to be economically interrelated, the transferee of the interest has a single depletable property when it is received.

The basket net profits interest principle would not have applied to Mr. Gaudreau's situation, however. Even if the Agreement could be treated as

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<sup>8</sup> *Standard Oil Co. (Indiana) v. Commissioner*, 465 F.2d 246 (7th Cir. 1972).

<sup>9</sup> T.A.M. 8941002 (June 16, 1989).

<sup>10</sup> P.L.R. 9147028 (Aug. 22, 1991); P.L.R. 9127028 (Apr. 4, 1991); P.L.R. 9127024 (Apr. 4, 1991); T.A.M. 8412002 (Oct. 27, 1982); T.A.M. 8125001 (Dec. 24, 1980); G.C.M. 38907 (Oct. 14, 1982); G.C.M. 32478 (Jan. 3, 1963).

a net profits interest, it appears that this was a basket calculation but that mineral interests were added to the basket at different times as Mr. Gaudreau acquired them on behalf of the corporation; therefore, it would not qualify as an economic interest.

### Absence of an Actual Legal Interest

Citing *Freede*<sup>11</sup> the district court in *Gaudreau* noted that the Tenth Circuit had reversed the Tax Court's decision, presumably because there was an absence of a mineral deed form in that case. The Tax Court found that, "[w]hen the rights and obligations of [taxpayer] under the contracts are viewed in their entirety, they rise to the equivalent of an economic interest under the statute, regulations, and case law."<sup>12</sup>

The main distinction between the Tenth Circuit's decision and the Tax Court's decision in *Freede* was that the Tenth Circuit did not mention or discuss the "economic equivalency" rule of section 1.636-3(a)(2) and instead held that the taxpayer's rights did "not constitute an *economic interest* in the minerals in place."<sup>13</sup> The apparent lesson here is to use a mineral deed rather than a contractual right for conveying nonoperating mineral interests.<sup>14</sup>

### Alternative Planning

What other options might be available to an oil and gas corporation that wants to incentivize its employees by granting them the equivalent of a

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

<sup>11</sup> *Freede v. Commissioner*, 864 F.2d 671 (10th Cir. 1988), rev'g 86 T.C. 340 (1986).

<sup>12</sup> 86 T.C. at 349. The court relied on section 1.636-3(a)(2), which provides, in part, that:  
A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest). ... [An] example of an interest which is to be treated as a production payment under this subparagraph is the interest in a partnership engaged in operating oil properties of a partner who provides capital for the partnership if such interest is subject to a right of another person or persons to acquire or terminate it upon terms which merely provide for such partner's recovery of his capital investment and a reasonable return thereon.

<sup>13</sup> *Freede*, 864 F.2d at 677 (Emphasis added.).

<sup>14</sup> *Cf.* section 1.612-4(a) which defines an operating interest owner as including, "one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or *any other form of contract* granting working or operating rights" (Emphasis added.)

nonoperating interest in some of its mineral properties? The corporation should consider using a passthrough entity such as a limited partnership (an "LP"). The corporation could carve out nonoperating mineral interests from its nonproducing operating mineral interests and contribute them to the LP in exchange for the general partnership interest. The corporation's capital account would be credited with the fair market value of the contributed nonoperating mineral interests. The depletable tax basis in the contributed nonoperating mineral interests could be allocated to the corporation under section 613A(c)(7)(D) along with the simulated depletion for capital account purposes. The LP could issue profits-only interests to selected corporation employees with no present capital account interest. The employees could make appropriate section 83(b) elections as the nonoperating interests are contributed to the partnership and have a low value.<sup>15</sup> If the corporation sold a working interest and the LP owned a nonoperating mineral interest which burdened the working interest sold, the LP could also sell its nonoperating interest to the buyer.

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<sup>15</sup> If the oil and gas company was a limited liability company ("LLC") (rather than a corporation) it could elect to have the section 83 safe harbor described in the proposed Revenue Procedure set forth in Notice 2005-43 apply to the LLC profits only units granted to its employees.