to maintain secrecy about the statement had been abandoned. In all such considerations regarding the scope of the privilege and its possible waiver, the intent and needs of the parties should be emphasized.

Thomas J. Bradley

TAXATION—GAIN ON SALE OF EXTRACTED EARTH FILL IS ORDINARY INCOME.

Laudenslager v. Commissioner (3d Cir. 1962)

The taxpayer owned property which he used as a residence and farm and which adjoined a highway construction project. The taxpayer entered into an agreement with the successful bidder for the highway contract wherein the latter agreed to buy a certain minimum quantity of earth fill, at a fixed price per cubic yard, but subject to the provision that if the State Highway Authority reduced the fill requirements to the construction company, the latter could reduce its minimum accordingly. Further, the soil had to meet certain specifications. The contract also provided that after the agreed amount of soil had been removed, the taxpayer, at his option, could call upon the contractor to respread the topsoil which the latter was obliged to set aside before excavating. The necessary fill was removed in compliance with the contract and the taxpayer exercised his option to have the contractor respread the soil. Thereafter, pursuant to an intention that had been expressed before entering into the agreement with the contractor, the taxpayer sold the land for residential purposes. Its use as such was not affected by the soil removal. The taxpayer reported the proceeds from the sale of the fill as a long-term capital gain. The Circuit Court of Appeals for the Third Circuit affirmed the decision of the district director and the Tax Court, *holding* that under the present circumstances, since there was no sale of earth fill in place, the proceeds were to be counted as ordinary income. *Laudenslager v. Commissioner,* 305 F. 2d 686 (3d Cir. 1962).

A transaction involving the extraction of natural deposits from the taxpayer's land may give rise to either capital gain or ordinary income, depending on whether the transaction qualifies as a sale or lease.[1] Preferential tax treatment as a long-term capital gain will be afforded to the taxpayer provided he can prove the transaction is a sale of a capital asset held for more than six months.[2] However, if the transaction involves

1. Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957).

2. INT. REV. CODE OF 1954, §§ 1221, 1222(3). A capital asset is defined in § 1221 as:

> All property held by taxpayer except: (1) property held primarily for sale to customers (2) depreciable property or real property used in trade or

a lease the proceeds will be taxed as ordinary income.[3] At the present time there appear to be two distinct tests applied by the courts in determining whether the transaction qualifies as a sale or a lease. The Third[4] and Ninth[5] Circuits and the Tax Court[6] follow the retained economic interest test, while the First,[7] Second[8] and Fifth[9] Circuits adhere to the intent of the parties test.

The retained economic interest test was supported by the oil and gas producers who sought to prevent a sale of royalty interests and thereby take advantage of the percentage depletion provision[10] rather than the capital gain provisions of the Code. If the application of this test indicates an economic interest was retained by the taxpayer, the transaction will be determined a lease.[11] The United States Supreme Court stated that an economic interest was retained when the taxpayer had: (1) "acquired, by investment, an interest in the oil in place," and (2) secured by legal relationship "income derived from the extraction of the oil, to which he must look for return of his capital."[12] This standard of determining the existence of a retained economic interest was applied to transactions concerning natural deposits in place, such as sand, earth fill or gravel.[13] Generally, the existence of an interest in the deposit in place is rarely the subject of controversy between the taxpayer and the

business (3) a copyright, a literary musical, or artistic composition (4) accounts or notes receivable (5) certain short-term discount obligations issued by government.

A long term capital gain is defined in § 1222(3) as:

> The term long-term capital gain means gain from sale or exchange of a capital asset held for more than 6 months . . . .

3. INT. REV. CODE OF 1954, § 61(a)(6).

4. Laudenslager v. Commissioner, 305 F.2d 686 (3d Cir. 1962).

5. Gowans v. Commissioner, 246 F.2d 448 (9th Cir. 1957) which held that a removal of all sand was a sale even though there was a unit price and provision for monthly payments. Although the court used the retained economic interest concept, it did look beyond the terms of the contract to discover its principal purpose. 246 F.2d 448, 451. *Cf.* Note, 71 HARV. L. REV. 376 (1958).

6. Samuel L. Green, 35 T.C. 1065 (1961). Note that the Tax Court in the present case based its decision solely on the *Green* case.

7. Linehan v. Commissioner, 297 F.2d 276 (1st Cir. 1957), stated that a removal of sand and gravel at fixed prices per cubic yard was a sale. *Cf.* Note, 30 U. CINC. L. REV. 534 (1961) which said the failure to use words of sale and absence of quantities did not make this a very significant decision.

8. Barker v. Commissioner, *supra* note 1, where no minimum quantities, but minimum quarterly payments, were deemed evidence of a sale.

9. Crowell Land & Mining Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957), where contractor had five years to remove all sand and gravel, and, at the end of five years, materials not removed would revert to taxpayer. The Court found a sale. *Cf.* Note 46, GEO. L.J. 359 (1958) where the author sees no reason why these transactions cannot be treated as a sale so long as there is the requisite intent. *But see* Case Note, 71 HARV. L. REV. 376 (1958) which criticized the decision.

10. INT. REV. CODE OF 1954, § 613:

> "Allowance Of Deduction For Depletion. (a) General Rule: In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion . . . ."

Cf. SURREY & WARREN, FEDERAL INCOME TAXATION 782-83 (1960) where the "royalty" area in general is discussed.

11. *E.g.*, Gowans v. Commissioner, *supra* note 5.

12. Palmer v. Bender, 287 U.S. 551, 557, 53 S. Ct. 225, 226 (1933).

13. Gowans v. Commissioner, *supra* note 5.

Commissioner.[14] The critical question has been whether there existed a legal relationship to which the taxpayer must look for a return of his capital.[15] Among the factors which have been considered by various courts as significant in determining whether the required legal relationship was present was whether the taxpayer must look solely to the extraction of the natural deposit for the return of his capital;[16] whether there was provided a unit price and a clause allowing for monthly payments;[17] whether the contracting parties used such terms as "lessor," "lessee" and "royalties" to describe the transaction;[18] whether the payments were based on the retail sales value of the extracted deposit;[19] whether the transferor reserved a royalty of a percentage of the minerals to be produced[20] or of a stated amount per unit mined and sold;[21] and whether the transferor had a right to share in the net profits of production.[22]

Although the intent of the parties test, on the other hand, is relatively new in this area of taxation,[23] there have been hints of it in several older cases. For instance, in *Barker v. Commissioner,*[24] the court indicated that one should "look beyond the mere phraseology of the agreement and determine its substance," that is, try to determine whether "the parties intended present passing of title."[25] Also, in *Crowell Land & Mining Corp. v. Commissioner,*[26] the court indicated that there should be an analysis of the contract of sale to see if it showed as its main purpose an intention to convey the entire interest in the deposits. More recently in *Linehan v. Commissioner,*[27] the First Circuit stated that the "true substance" of the transaction should be examined and not merely the contractual words. In attempting to fix the parties' intention, the courts have looked at such factors as the condition and value of the land after the excavation

14. *Ibid.* But note that the court conceded that the commissioner might dispute this "if the taxpayer is claiming that the proceeds are regular income, subject to a depletion allowance." 246 F.2d 448, 451 (n.4).

15. Robert M. Dann, 30 T.C. 499 (1958), where an agreement which contained provisions indicating all usable soil would be taken was termed a sale with no economic interest retained. The evidence showed that the tracts were useless after the excavation.

16. Commissioner v. Southwest Exploration Co., 350 U.S. 308, 76 S. Ct. 395 (1956).

17. *Ibid.*

18. Albritton v. Commissioner, 248 F.2d 49 (5th Cir. 1957).

19. *Ibid.*

20. Burnet v. Harmel, 287 U.S. 103, 53 S. Ct. 74 (1932).

21. Bankers Pocahontas Coal Co. v. Burner, 287 U.S. 308, 53 S. Ct. 150 (1932).

22. Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 66 S. Ct. 861 (1946).

23. Linehan v. Commissioner, *supra* note 7.

24. *Supra* note 1.

25. *Id.* at 197.

26. *Supra* note 9. Note especially where the court stated that there was an intention "to convey the entire interest of Crowell for a price to be determined as fixed in it and to be paid in cash in installments. There was no provision or suggestion in it for the retention and payment of a royalty as in oil and gas leases. A bona fide sale was the intent of the parties and it was expressed in terms free from ambiguity throughout the intrument in the provisions and conditions it set out. Looking to the actual circumstances as well as the language of the contract of sale, there is no occasion or basis for resorting to legal niceties of interpretation to defeat the basic purpose and effect of the transaction." 242 F.2d at 866.

27. *Supra* note 7 at 279.

was completed,[28] the obligations of the parties under the contract,[29] the manner of computing the purchase price,[30] the method of payment,[31] the terms used in the agreement,[32] the time limitations of the agreement,[33] and the purpose of the contract.[34] If an application of the test indicates the parties intended a sale, the transaction will be determined a sale.[35]

The present court applied the retained economic interest test. It reasoned, first, that the contractor had not really bound himself to remove a minimum amount of fill, since the ostensible minimum set forth in the taxpayer-contractor agreement could be reduced if the Highway Authority decreased the amount of fill required to be furnished by the contractor. Secondly, the court noted that the contractor did not have to take any fill which did not meet the Highway Authority's specifications. For these two reasons the court concluded the taxpayer had retained an economic interest.[36] Apparently the rationale of the court was that the taxpayer, since he failed to convey an absolute interest, must have retained an interest himself. It is submitted that the above factors, although properly considered by the court, are not sufficient to indicate that an economic interest had been retained. First, it seems that the most important question to be considered in applying the retained economic interest test was not asked by the court in the instant decision: must the taxpayer look solely to the extraction of the natural deposit for the return of his capital. The evidence in the present case showed that the taxpayer's property had become quite valuable with the coming of the highway and that he had intended to sell it for residential purposes even before the excavation agreement was consummated. In fact, he paid to have the top soil respread in order to sell the land for residential purposes. The taxpayer did not have to look to the proceeds of the sale of the fill for a return of his capital. Were it not for this fact, the court's decision would have been greatly strengthened. Secondly, the amounts the taxpayer was to receive were in no way dependent upon the contractor's sales price or profits from the latter's contract with the State Highway Authority.

As stated above, although the retained economic interest test had been originally developed to cover transactions involving the removal of oil and gas, the concept has been carried over, by the courts, to transactions involving natural deposits in place, such as sand, earth fill and gravel. Because the quality of these natural deposits is generally diffi-

28. Gowans v. Commissioner, *supra* note 5; Linehan v. Commissioner, *supra* note 7.
29. Barker v. Commissioner, *supra* note 1.
30. *Ibid.*
31. Crowell Land & Mining Corp. v. Commissioner, *supra* note 9; Linehan v. Commissioner, *supra* note 7.
32. Linehan v. Commissioner, *supra* note 7.
33. Crowell Land & Mining Corp. v. Commissioner, *supra* note 9.
34. Gowans v. Commissioner, *supra* note 5.
35. *E.g.* Barker v. Commissioner, *supra* note 1.
36. *But see* Robert M. Dann, *supra* note 15.