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Vet. Aff. Op. Gen. Couns. Prec. 81-90

TEXT:

Subject: Review of Opinions Concerning Mineral Lease Proceeds

(This, opinion, previously issued as General Counsel Opinion 3-85, dated June 19, 1985, is reissued as a Precedent Opinion pursuant to 38 C.F.R. §§ 2.6(e)(9) and 14.507. The text of the opinion remains unchanged from the original except for certain format and clerical changes necessitated by the aforementioned regulatory provisions.)

QUESTION PRESENTED:

Whether royalty and other payments associated with a mineral lease represent income of the lessor for pension purposes.

COMMENTS:

The VA District Counsel in Waco, Texas, has issued two opinions, dated March 23, 1978, concerning "section 306 pension", and April 26, 1985, concerning "improved pension", advising that royalty payments from mineral leases represent proceeds from the sale of property and as such are properly excludable from income for pension purposes. This office reached the same conclusion in two unpublished opinions dated July 27, 1984, to the Chief Benefits Director, and June 5, 1963, to the Chairman, Board of Veterans Appeals.

Section 503(a) of U.S. Code title 38 lists several exceptions to the general rule that, in determining annual income for pension purposes, all payments of any kind, from any source, shall be included. Among the items excepted is "profit realized from the disposition of real or personal property other than in the course of a business." 38 U.S.C. § 503(a)(6). An identical provision applicable to section 306 pension was found at 38 U.S.C. § 503(a)(10). This exception is incorporated in regulations implementing the improved pension and section 306 pension programs at 38 C.F.R. § 3.272(e) and 38 C.F.R. § 3.262(k)(5), respectively. Improved and section 306 pension regulations specifically include income from real or personal property owned by the claimant as income for pension purposes. 38 C.F.R. §§ 3.271(d) and 3.262(k)(2). Due to the similarity of the income-computation provisions applicable to improved and section 306 pension, these rules are interpreted and applied in the same manner under both programs. Transmittal Sheet 655, July 27, 1979.

In assessing the nature of mineral leases for purposes of the income- computation provisions, we observe that such leases have been the subject of divergent opinions among the state courts. See J. M. Huber Corp. v Denman 367 F.2d 104, 114 fn 31 (5th

Cir.1966). courts in Texas and other states consider an oil and gas lease a sale of an interest in land. E.g., Cherokee Water Co, v. Forderhause, 641 S.W.2d 522,525 (Tex.1982); Martin v Humble Oil and Refining Co., 199 F. Supp. 648, 652 (S.D.Miss.1960), aff'd, 298 F.2d 163 (5th Cir.1961), cert. denied, 371 U.S. 825 (1962). Under this view, the lease vests the lessee with title to oil and gas in place. Cherokee, 641 S.W.2d at 525. Other state courts have found an oil and gas lease does not operate as a conveyance of property, but merely as a grant of a license or right to search for and reduce to possession such oil and gas as may be found by the lessee. E.g., Hinds v. Phillips Petroleum Co., 591 P.2d 697,698 (Okla.1979); Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 553 P.2d 885, 895 (1976).

It has long been held that the income provisions of the veterans' pension statutes are to be applied uniformly to similarly situated veterans without regard to differences in state law which, if applied, would lead to inequitable results. 41 Op. Att'y Gen. 370 (1985); Op. Sol. 591-48. Thus, rather than viewing state mineral law principles as controlling, we must interpret the statutory income exclusion so as to give effect to Congress' intention and purpose, directing our attention to the economic consequences of the transactions in question. See United Gas Improvement Co. v. Continental Iol Co., 381 U.S. 392, 400-01 (1965); Burnet v. Harmel, 287 U.S. 103, 108, 110-1 (1932); Mobil Oil Corp. v. Federal Power Commission, 463 F.2d 256, 259, 261-62 (D.C.Cir.1971), cert. denied, 406 U.S. 976 (1972).

The sale-of-property exception was added to the pension statutes by Pub.L. No. 88-664, s 1(b), 78 Stat. 1094 (1964). The Chairman of the House Committee on Veterans' Affairs (HCVA), discussing the exception in a letter dated August 18, 1964, to the Chairman of the Senate Committee on Finance, explained that the sale of property, except in the course of business, does not truly constitute income but merely an exchange of an asset from one form to another. See also Transmittal Sheet 331, November 4, 1964. Senator Keating described the exception as permitting a veteran to make necessary sales without fear of jeopardizing family income as a result of the income limitations. 110 Cong. Rec. 20,881 (1964). Clearly, the sale-of-property exclusion
was a liberalizing provision intended to increase claimants' flexibility in disposition of assets by recognizing that conversion of assets to a more liquid form does not change the nature of the assets from corpus to income.

A mineral interest in property represents an asset of the holder, regardless of whether the holder is considered to possess title to minerals present on the property. Under the usual mineral lease agreement, royalties from the lease are based directly on the amount of oil and gas produced. No royalties are payable prior to commencement of production, and no royalties are paid if no minerals are found and removed. Oil and gas reserves and other minerals in place are considered "wasting assets". Anderson v. Helvering, 310 U.S. 404,407 (1940). Since these substances exist in finite amounts, payment of lease royalties is associated with a diminution in the value of the lessor's mineral interest. This diminution in value is recognized in the tax code by means of the depletion allowance, which permits the mineral lessor to recover the value of the

resources exhausted over the term of production. Commissioner v. Southwest Exploration Co., 350 U.S. 308,312 (1956); Anderson, 310 U.S. at 408.

The theory that a mineral lease represents only a license to seek and capture minerals fails to take account of the economic reality that payments under the lease are tied to actual production and that no royalties are paid under the lease if nothing is produced. However, even under the license theory, the lessee of a productive mineral lease, in consideration of royalty payments, ultimately does acquire ownership of minerals in which the lessor previously held an interest. See J.M. Huber, 367 F.2d at 114; Lilly v. Conservation Commissioner of Louisiana, 29 F. Supp. 892, 897 (E.D.La.1939). Thus, the economic consequence of production under a mineral lease is a reduction in the value of the lessor's mineral interest through conversion of this interest into a cash asset or an in-kind royalty payment. This situation is distinguishable from a lease of property by which income is produced through exploitation of a renewable resource, e.g., rental of land for grazing or planting. In the case of a mineral lease, the disposition of a nonrenewable resource and the direct connection between royalty payments and production indicates that production under such a lease must be considered a conversion of the form of assets and thus a sale of property for purposes of the pension statutes.

Regarding equitable treatment of landowners who exploit their holdings by different means, we believe the expendable nature of mineral interests distinguishes mineral lease proceeds from the rental income of other landowners. It is the distinction between renewable and non-renewable resources which is of significance rather than any distinction between surface and subsurface estates. Further, any seeming unfairness in the receipt of mineral royalties by a claimant for need-based pension benefits is ameliorated by the net-worth limitation of the pension law, discussed infra.

Under the tax statutes, proceeds of mineral leases are viewed not as the proceeds of a sale, but as income of the lessor. However, treatment of mineral lease transactions for purposes of the tax statutes is closely tied to the purposes and structure of those statutes and is of limited relevance to interpretation of laws governing provision of veterans' benefits. See, e.g., Harmel, 287 U.S. at 108; Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399,414-18 (1913). Further, the tax treatment of oil royalties is accorded in recognition of the generous depletion allowance available under the tax code. Southwest Exploration, 350 U.S. at 312; Anderson, 310 U.S. at 408. If mineral royalties were treated as income for VA pension purposes, it is unlikely a comparable allowance for the value of depleted assets could be provided under the veterans' benefit statutes. See 67 Op. Sol. 416 (1943) (depreciation could not be deducted from rental income). As with the tax code, the relevance of treatment of mineral lease transactions under the Natural Gas Act is limited by the particular terms and objectives of the statute at issue. See, e.g., Mobil Oil, 463 F.2d at 259-62.

The District Counsel's two opinions on this subject also conclude that bonus payments and delay rentals received in connection with a mineral lease must be considered income of the lessor for pension purposes. Bonus payments represent the initial

consideration paid a lessor as inducement to enter a mineral lease. Hasty v. McKnight, 460 S.W.2d 949,952 (Tex.Civ.App.1970). Such payments are retained by the lessor regardless of whether minerals are ultimately produced. Harmel, 287 U.S. at 112. Delay rentals are sums paid by a lessee for the privilege of delaying development of mineral resources, Davis v. Hardman, 146 W.Va. 82, 133 S.E.2d 77, 81 (1963); Millett v. Phillips Petroleum Co., 209 Miss. 687, 48 So.2d 344, 348 (1950), and, in contrast to royalties, are not associated with production of minerals. Davis, 133 S.E.2d at 81. As neither bonuses nor delay rentals are related to production, such payments do not represent a conversion of assets and do not fall within the sale-of-property exclusion of the pension laws. They must therefore be considered income of the claimant.

Although we have concluded that mineral lease royalty payments should be excluded from income under section 503, we emphasize that such payments are relevant to calculation of the corpus of a claimant's estate for purposes of the net worth limitation in the pension statutes. Sections 522(a) and 543 of U.S. Code title 38 provide that pension shall be denied or discontinued when the corpus of the claimant's estate is such that under all the circumstances it is reasonable that some part of the corpus be consumed for the claimant's maintenance. See also 38 C.F.R. § 3.274. Similar provisions were included in the corresponding sections of the section 306 pension statutes. See also 38 C.F.R. § 3.252(b).

In establishing the sale-of-property exception, Congress contemplated that sale receipts would be considered part of the claimant's net estate and could have the effect of barring eligibility if the estate so comprised fell within the terms of the net worth limitation. Letter of Chairman of HCVA, supra; Statement of Senator Keating, supra; Statement of Francis W. Stover, Director, National Legislative Service, Veterans of Foreign Wars, before the Senate Committee on Finance, August 19, 1964. Congress further recognized that a sale of property could affect the liquidity of the claimant's estate, rendering additional sums available for the claimant's support. Letter of the Chairman, HCVA, supra.

When the Veterans Administration issued regulations to implement the sale-of- property exception, it also recognized that sale proceeds could convert a claimant's estate to liquid assets which could reasonably be expected to be used for the claimant's support. Transmittal Sheet 331, p. vi, November 4, 1964. The Agency concluded that when a sale of property is reported, a new determination of new worth is required. Id. Provisions governing evaluation of net worth in both improved and section 306 pension regulations require consideration of whether property can be readily converted into cash at no substantial sacrifice. 38 C.F.R. §§ 3.275(d) and 3.263(d). The liquidity of assets derived from a mineral lease would be of significance in determining whether a portion of a claimant's estate could reasonably be considered available for the claimant's support.

Based on the foregoing, the District Counsel's opinions dated March 23, 1978, and April 26, 1985, are correct in concluding that mineral lease royalties must be considered profits from the sale of property for pension purposes, unless generated in the course of operating a business. These opinions are also accurate in stating that bonus payments

and delay rentals under such leases are to be considered income of the claimant. Thus, these opinions need not be modified or withdrawn. As the conclusion that royalties constitute profits from the sale of property is based on our interpretation of the requirements of 38 U.S.C. § 503, we are without authority to modify the treatment of such payments by regulatory amendment.

HELD:

Mineral lease royalties must be considered proceeds of the sale of property and are properly excludable from income for pension purposes. However, such payments are relevant to evaluation of the corpus of a claimant's estate for purposes of the net worth limitation in the pension statutes. Also, bonus payments and delay rentals received in connection with a mineral lease must be considered income of the lessor for pension purposes.

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