# OKLAHOMA TAX COMMISSION

STATE OF OKLAHOMA

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OFFICE OF THE GENERAL COUNSEL

July 11, 2007

RE: , Request for Letter Ruling: File No. LR-06-005.

Dear :

By letter dated December 5, 2006, you requested a letter ruling on behalf of ") inquiring as to whether royalty payments made to on mineral interests it owns in Oklahoma are subject to the withholding requirements of 68 O.S. § 2385.26. A Letter Ruling from the Office of General Counsel, Oklahoma Tax Commission, is an "informal written statement of policy or treatment of *specific fact situations* under Oklahoma law." *OAC* 710:1-3-73(e) (emphasis added).

This Letter Ruling addresses the following specific **issue**:

> Whether royalty payments for mineral interests in Oklahoma owned by , a regional federally chartered Farm Credit Bank, are subject to the deduction and withholding requirements of 68 O.S. § 2385.26.

In your request for this letter ruling, you assert the following **facts**:

1. is part of the national Farm Credit System established in 1916 by Congress in the Farm Credit Act (now codified as 11 U.S.C. § 2001 *et seq.*). is a regional federally chartered Farm Credit Bank.

2. is the successor entity to the of ) and the ").

3. In addition to nine other states, provides funds for long-term farm and rural real estate loans made to Oklahoma farmers and ranchers by Agricultural Credit Associations ("ACAs") and Federal Land Credit Associations ("FLCAs"). also provides short- and intermediate-term funds for agricultural purpose loans by ACAs, Production Credit Associations ("PCAs") and other agricultural lenders.

4. is a privately-owned corporation, with a cooperative ownership structure. is owned by its member/borrower ACAs, FLCAs and PCAs. Funding for financing is obtained through sales to investors of system-wide Farm Credit securities. Investors include commercial banks, thrifts, governments, investment funds and private individuals.

5. Over the years, acquired a number of mineral interests within the state of Oklahoma. Although is the actual owner of the subject royalty interest, in most instances record title is in the name of one of predecessor entities since record title was held by those entities before past mergers and consolidations (*e.g.* or ).[1] These royalty interests were acquired by sheriff's deeds or deeds-in-lieu of foreclosure taken in the course of post-default mortgage foreclosure or other loan collection efforts. Today, holds interest in 181,000 gross mineral acres in Oklahoma (55,000 net mineral acres, applying applicable ownership percentages).

6. A number of oil and gas producers in Oklahoma withhold part of royalty payments, presumably pursuant to 68 O.S. § 2385.26.

7. Based on the exemption from taxation by the United States or by any State provided by 12 U.S.C. § 2023 to Farm Credit Banks, does not file Federal income tax returns with the United States or State income tax returns with any of the States it serves as part of the federally created Farm credit system.[2] The ten States served by are: Oklahoma, Arizona, California, Hawaii, Nevada, Utah, Idaho, Kansas, Colorado and New Mexico.

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[1] *See Fibelstad v. Grant County, North Dakota*, 474 N.W.2d 54 (N.D.,1991), subsequent mandamus proceeding 497 N.W.2d 425; (Farm Credit Bank, "by operation of law" was successor in interest to Federal Land Bank, and had standing to intervene in action to quiet title to ranch for which Federal Land Bank issued mortgage even though Farm Credit Bank did not appear in real estate records of ranch, where two federal banks merged and certified copy of charter of Farm Credit Bank was recorded in county register of deeds.) *See also Farm Credit Bank of St. Paul v.* Ziebarth, 485 N.W.2d 788 (N.D., 1992).

[2] Letter from Esq., MOCK, SCHWABE, WALDO, ELDER, REEVES & BRYANT, Oklahoma City, to , Assistant General Counsel, Oklahoma Tax Commission (May 24, 2007) (on file with the Office of General Counsel, OTC).

8. requested this letter ruling for a single purpose. The letter ruling will be used by only to support its notifications to producers/remitters of royalty payments that is exempt from the withholding provisions of 68 O.S. § 2385.26.[3] represents to the Oklahoma Tax Commission that this letter ruling will not be used by U.S. AgBank to seek any refund of amounts withheld in the past.[4]

9. To the knowledge of , there are no other presently pending cases or controversies before the Oklahoma Tax Commission to which is a party. Although is not aware of any such proceeding, there may be cases or controversies pending before the OTC in which one or more of U.S. AgBank's members/borrowers may be a party.

The following **analysis** relies on the facts you present.

During the early 1930s, the predecessor, became the owner of agricultural properties by foreclosure or by deeds tendered in settlement of mortgage debt by borrowers abandoning their farms and ranches.[5] Often, the amount of debt against these properties exceeded the proceeds of sale. *Id.* As a strategy to offset some of these losses, adopted a policy of retaining twenty-five to fifty percent of the mineral rights of acquired properties. *Id.* The United States Supreme Court addressed this policy in *Federal Land Bank of Wichita v. Board of County Commissioners of the County of Kiowa, State of Kansas*, 368 U.S. 146, 152, 82 S.Ct. 282, 287 (1961):

> The banks are...authorized to sell lands acquired after default at the best possible price, absorbing the losses in the reserve accounts and distributing the profits in dividends. It follows that the land banks are not restricted to a sale price merely sufficient to recoup any losses. The retention of a mineral interest might well be a method of increasing the recovery from lands acquired through mortgage defaults. Consequently, we find that the holding of the mineral estate involved here is in furtherance of the bank's governmental function.

*Id.* (Citations omitted.)

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[3] *Id.* at p.4.

[4] *Id.*

[5] Letter from Esq., MOCK, SCHWABE, WALDO, ELDER, REEVES & BRYANT, Oklahoma City, to Assistant General Counsel, Oklahoma Tax Commission (April 25, 2007) (on file with the Office of General Counsel, OTC).

In Oklahoma, the relevant provisions for income tax withholding from payments made to a "royalty interest owner"[6] are provided by 68 O.S. §§ 2385.25 through 2385.28. Specifically stated at 68 O.S. § 2385.26:

> A. Each remitter,[7] ***except as otherwise provided in subsection B of this section***, shall deduct and withhold from each payment being made to any royalty interest owner in respect to production of oil and gas in this state, but not including that to which the remitter is entitled, an amount equal to five percent (5%) of the gross amount which would have otherwise been payable to the person entitled to the payment.
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> B. The obligation to deduct and withhold from payments as provided in subsection A of this section does not apply to those payments which are made to:
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> 1. Current or permanent residents of Oklahoma;
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> 2. ***The United States***, this state ***or any*** state or ***federal agency*** or political subdivision;
>
> 3. Any charitable institution; or
>
> 4. Any federally recognized Indian tribe.
>
> The obligation to deduct and withhold from payments as provided in subsection A of this section does not apply if the remitter and the royalty interest owner are the same person.

*Id.* (Emphasis added.)

In *County of Kiowa*, 368 U.S. at 149, 82 S.Ct. at 285, the U. S. Supreme Court noted that the Supreme Court of Kansas correctly conceded "that a federal instrumentality is not subject to the plenary power of the States to tax, that the Congress has the power to determine, within the limits of the Constitution, the extent that its instrumentalities shall enjoy immunity from state taxation, that the

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[6] "Royalty interest owner" means any person who retains a non-working interest in oil or gas production. 68 O.S. § 2385.25(3).

[7] "Remitter" means any person who distributes revenue to royalty interest owners. 68 O.S. § 2386.25(2).

federal land bank is a constitutionally created federal instrumentality, and that Congress ha[d] immunized it from personal property taxes on activities in furtherance of its lending functions." *Id.* (Citations omitted.) With the Agricultural Credit Act of 1987, Congress required that the Federal land bank and the Federal intermediate credit bank of each Farm Credit System be merged into a Farm Credit Bank in that district.[8] "The banks established pursuant to the merger of each District Federal Intermediate Credit Bank and Federal Land Bank (hereinafter referred to in this subchapter as "Farm Credit Banks"), as provided in section 410 of the Agricultural Credit Act of 1987, shall be Federally chartered instrumentalities of the United States." 12 U.S.C. § 2011(a). U.S. AgBank is a Farm Credit Bank established pursuant to the merger of FLBW and FCBW and is a Federally chartered instrumentality of the United States.

"The Farm Credit Banks and the capital, reserves, and surplus thereof, and the income derived therefrom, ***shall be exempt from*** Federal, ***State, municipal, and local taxation***, except taxes on real estate held by a Farm Credit Bank to the same extent, according to its value, as other similar property held by other persons is taxed." 12 U.S.C. § 2023. (Emphasis added.) The United States Supreme Court interpreted a statute similar to 12 U.S.C. § 2023[9] where a political subdivision of the State of Kansas attempted to impose a personal property tax on the interest of a federal land bank in an oil and gas lease and on the royalties therefrom. *Federal Land Bank of Wichita v. Board of County Commissioners of the County of Kiowa, State of Kansas*, 368 U.S. 146, 147-148, 82 S.Ct. 282, 284 (1961). The Court concluded "that the state personal property tax imposed on [the federal land bank's] oil and gas lease and upon the royalties derived therefrom must fall as being unconstitutional by virtue of the Supremacy Clause of the Constitution." *Id.* at 368 U.S. 156, 82 S.Ct. 288-289.

In **conclusion**, as a Farm Credit Bank, is a Federally chartered instrumentality of the United States. (12 U.S.C. § 2011). Pursuant to 68 O.S. § 2385.26(B)(2), the obligation to deduct and withhold from royalty payments as provided in 68 O.S. § 2385.26(A) does not apply to those payments made to .

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[8] Section 410(a) of Pub.L. 100-233, Title IV, Jan. 6, 1988, 101 Stat. 1637: ("Not later than 6 months after the date of the enactment of this section, the Federal land bank and the Federal intermediate credit bank of each district shall merge into a Farm Credit Bank in such district pursuant to a plan of merger agreed on by the Boards of Directors of such banks and approved by the Farm Credit Administration, or if such banks fail to agree, a plan of merger prescribed by the Farm Credit Administration.")

[9] *Federal Land Bank of Wichita v. Board of County Commissioners of the County of Kiowa, State of Kansas*, 368 U.S. 146, 148 n.5, 82 S.Ct. 282, 284 n.5 (1961) ("Every Federal land bank * * * including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from Federal, State, municipal, and local taxation, except taxes upon real estate held, purchased, or taken by said bank * * * under the provisions of (section) * * * 781 of this title.") *citing* 12 U.S.C. § 931.

This "Letter Ruling" generally may be relied upon *only* by the taxpayer to whom it is issued, provided that all facts have been accurately and completely stated, and there has been no change in the facts or the applicable law.

Respectfully,

OKLAHOMA TAX COMMISSION

Assistant General Counsel

APPROVED:

General Counsel

Assistant General Counsel
Opinion Conference Coordinator