The Depletion Deduction with Respect to Oil and Gas Interests Under the Federal Income Tax

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Comments

THE DEPLETION DEDUCTION WITH RESPECT TO OIL AND GAS INTERESTS UNDER THE FEDERAL INCOME TAX*

The Constitution takes no articulate cognizance of depletion as a deduction from gross income in computing the federal income tax. The body of law governing this deduction is made up

of a variety of statutes,\(^1\) administrative\(^2\) and other rulings,\(^3\) and decisions of the federal courts and of the Board of Tax Appeals and the Court of Claims.

I. NATURE AND THEORY OF THE DEDUCTION

The Sixteenth Amendment authorized Congress to “lay and collect taxes on income from whatever source derived.” Although it would seem that the “income” referred to would be the “true net income,”\(^4\) the courts have interpreted this power to levy taxes to extend to “gross income.”\(^5\) Thus it is said that “every deduction from gross income is allowed as a matter of legislative grace and only as there is clear provision therefor can any particular deduction be allowed.”\(^6\)

Depletion is one of the deductions authorized by law, and is intended to allow the tax-free return of the cost element out of

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1. Section 23(m) of the Internal Revenue Code authorizes “such reasonable [depletion] allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner [of Internal Revenue] with the approval of the Secretary [of the Treasury].” See Section 114(b) of the Code for the alternative percentage depletion allowance.

2. U.S. Treas. Reg. 103, §§ 19.23(m)-1 to 19.23(m)-28 (authorized by the Secretary of the Treasury) covers the depletion allowance. Amendments to these regulations are the “Treasury Decisions,” issued also with the approval of the Secretary of the Treasury.

3. Interpretations issued without the approval of the Secretary of the Treasury, e.g., “General Counsel’s Memoranda.”

4. The income referred to in the Sixteenth Amendment should be income in its true sense, not gross proceeds, which may include a return of capital. U.S. Const. Art. I, § 9(4). In Taft v. Bowers, 278 U.S. 470, 49 S.Ct. 199, 73 L.Ed. 460 (1929), the court said: “the settled doctrine is that the 16th Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income.” Hence Congress is no more free to tax “gross proceeds” than it was before the amendment. See Evans v. Gore, 253 U.S. 245, 40 S.Ct. 550, 64 L.Ed. 887 (1920). Depletion and other substantive capital deductions should be excluded from “income” as used in the Constitution solely by dint of the fact that they are essentially a return of capital, which was never intended to be subjected to the income tax. Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521, 9 A.L.R. 1570 (1920). These substantive deductions should be contradistinguished from other deductions which are essentially acts of grace, such as the allowance for charitable contributions. In a treatment of the depletion deduction in Comment (1937) 51 Harv. L. Rev. 1424, it is stated: “it would seem that a tax on the gross income from an oil well without allowing a deduction for incurred depletion would be in part a direct tax on capital and thus have to be apportioned.” For the Treasury’s view that the Sixteenth Amendment is a grant of power to tax gross income, see Taxation of Government Bondholders and Employees (1939) 91 et seq.


the gross proceeds from the operation of mines, oil and gas wells, other natural deposits, and timber. The theory of the allowance is that as the gas and oil produced from the wells is sold, a gradual sale of the taxpayer's capital investment in the property is being made. "The depletion charge permitted as a deduction from the gross income in determining the taxable income . . . represents the reduction in the mineral content of the reserves from which the product is taken." 

Inasmuch as depletion is designed to return to the taxpayer his capital interest or the cost to him, it seems natural that the general rule for determining the allowance would be the cost recovery method. An alternative method—the discovery method—is available in the case of mines (except coal, metal, and sulphur mines), but this will not be considered here because the term "mine" does not include oil and gas wells. The alternative method in the case of oil and gas wells is the percentage method, wherein a flat 27½% of the taxpayer's gross income from his oil or gas property is used as the depletion allowance.

II. WHO MAY TAKE THE DEDUCTION

Every owner of an economic interest in the mineral deposits is allowed the annual depletion deduction. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in the mineral in place and secures income derived from the severance and sale of the mineral, to which he must look for a return of capital. This interest may be acquired by any form of legal relationship, and "the formal attributes of [the] instruments (whether assignment, lease, sublease, et cetera) or the descriptive terminology which may be applied to them in the local [state] law are both irrelevant."

7. For comprehensive list of mineral deposits included, see U.S. Treas. Reg. 103 § 19.23(m)-1-(d), which enumerates, among others, building stone, clay, fuller's earth, gravel, peat, precious stones, salt, sulphur, and soapstone.


9. Percentage depletion since 1932 has been available in the case of coal, metal, and sulphur. However, the percentage allowed as depletion is 5 per centum of the gross income for coal, 15 per centum for metal, and 23 per centum for sulphur mines. See U.S. Treas. Reg. 103, § 19.23(m)-5, and Internal Revenue Code, § 114(b)-4.


13. Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489 (1933). In that case the court held that whether the instrument was called an assign-
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The depletion allowances are not confined to the fee owner, but are available to any who have an interest in the substance to be depleted. Thus, where a wife had an equitable interest which arose out of an implied (purchase money resulting) trust, she had a depletable interest, although legal title was in her husband. The instrument by which the taxpayer acquires need not, moreover, convey the deposits themselves; a right to extract the mineral and reduce it to possession is sufficient. But a mere permit to drill, with the option of obtaining a lease if oil was found, would not vest the holder with a depletable economic interest.

Although only an economic interest in the oil or gas in place is required, this does not include a mere "economic advantage" derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit. An example of a contract of this type is the casing-head gas contract, where one purchases casing-head gas from the producer and processes it. In *Hurley v. United States*, the court said: "One who buys the oil at the mouth of the well owns the oil, but has no interest in the oil 'in place.'" It seems that the economic interest must extend, one might say, down through the mouth of the well into the oil or gas in place. This was the situation in *Signal Gasoline Corporation v. Commissioner*, where the casing-head operator had the right to connect his pipes directly with the oil wells and extract the gas by means of lifts and other devices. The court emphasized the fact that it was the operator who performed the extraction of the gas, and that the intention of the parties was that the operator should have an interest in all gas he might reduce to possession.

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7. 180 U.S. 362, 58 S.Ct. 618, 82 L.Ed. 897 (1938). The distinction between an economic interest and an economic advantage seems to be whether the mineral
A mere owner of shares in a corporation which itself owns oil and gas interests is not entitled to the benefit of the depletion deduction.\footnote{21} The corporation is a separate entity and a non-conductor;\footnote{22} when the earnings are distributed to the stockholders, the character of their origin is lost. As their character as a partial return of capital exists only in the hands of the corporation, the corporation alone can take the deduction. In no case may the same depletion be taken by more than one party, and "the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."\footnote{23}

But where the separate legal entity is a conductor—such as a trust or a partnership—a different situation presents itself. In the case of the partnership, the matter is simply that the partner must include in his gross income his share of the partnership's net profit, whether distributed or not.\footnote{24} Since the income is then taxable to the partner, not the partnership, it is the partner who is given the deduction.

With trusts the matter is somewhat different. The beneficiaries of a trust which holds depletable mineral interests are entitled to make the deduction from income realized to them from such mineral production. But although the trust is a conductor, the beneficiaries are taxed only on the distributed portion of the trust income—the trust itself is taxed on the part undistributed. By applying the fundamental principle that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable,\footnote{25} the trust will be taxed and may take depletion on the undistributed portion, and the beneficiaries will be taxed and may take depletion on the distributed portion of the trust income.\footnote{26}

\footnote{21} Helvering v. O'Donnell, 303 U.S. 370, 58 S.Ct. 619, 82 L.Ed. 903 (1938).
\footnote{24} Internal Revenue Code, § 182.
\footnote{25} See note 23 supra.
\footnote{26} In the absence of controlling provisions in the trust instrument. Internal Revenue Code, § 25(m). Merle-Smith v. Commissioner, 42 F.2d 837 (C.C.A. 2d, 1930), cert. denied 282 U.S. 897, 51 S.Ct. 182, 75 L.Ed. 791 (1931). See also Fleming v. Commissioner, 121 F.2d 7 (C.C.A. 5th, 1941).
Some conflict appears on the question whether a beneficiary who has no remainder interest in the capital of the trust may take depletion on the trust distributions to him. In *Helvering v. Falk*[^27^], Justice McReynolds held for the majority that a beneficiary who had no remainder interest in the corpus of the trust nevertheless had such an economic interest as to entitle him to take the depletion deduction; and that this might be done even though the settlor has not capitalized the wasting asset by providing for a depletion reserve or otherwise, but merely provided for the payment to the beneficiaries of the gross proceeds less expenses. Three dissentient justices—Stone, Brandeis, and Cardozo—insisted that one holding no remainder interest or capital investment, but only a right to gross proceeds from mineral property, could not take depletion; and that the framework erected by the settlor, and not the character of the interest, should govern. The upshot of this view is that the deduction is lost where the settlor does not capitalize his oil or gas interest in setting up a trust, although the converse would be true had he transferred his legal interests to the beneficiaries directly. In *Reynolds v. Cooper*[^28^], the same three justices concurred with the majority in allowing the depletion deduction where in their view the beneficiaries had been vested with a remainder interest in the corpus of the trust[^29^], but distinguished the case from *Helvering v. Falk*[^27^].

As a large part of oil and gas operations take place on public lands leased by private parties, it might be well to note that the doctrine of intergovernmental immunity does not now prevent the levying of a general non-discriminatory tax on the income of oil and gas lessees who operate on state and federal lands[^30^]. The *Coronado* case[^31^], holding that a lessee of state lands was an instrumentality of the state and exempt from the federal income tax; and the *Gillespie* case[^32^], holding that a lessee of federal lands was

[^29^]: In *Cooper v. Reynolds*, 60 F.(2d) 650 (D.C. Wyo. 1932), the district judge held that the determining factor was whether the beneficiaries had an interest in the corpus of the trust. This decision was affirmed in 64 F.(2d) 644 (C.C.A. 10th, 1933), certiorari was granted in 290 U.S. 616, 54 S.Ct. 66, 78 L.Ed. 538 (1933), and the ruling was affirmed by the Supreme Court in 291 U.S. 192, 54 S.Ct. 356, 78 L.Ed. 725 (1934), on the basis of *Helvering v. Falk*, 291 U.S. 183, 54 S.Ct. 353, 78 L.Ed. 719 (1934).
[^30^]: Supra note 27.
an instrumentality of the federal government and exempt from
the state income tax, have both been overruled.\textsuperscript{34}

III. TREATMENT OF ROYALTIES, BONUSES, AND OIL PAYMENTS

When a taxpayer possesses an economic interest in oil or gas
in place, he becomes taxable on the amount of the gross proceeds
realized therefrom by production and operation. Proceeds from
the sale of the entire interest are logically not includible in the
"gross proceeds from production and operation."\textsuperscript{35} Therefore when
an owner of such an economic interest disposes of it in its entirety
by sale, his gain or loss is the difference between the sale price
and the "adjusted basis"\textsuperscript{36} in his hands. The depletion factor does
not enter, and the transaction is governed by the provisions relat-
ing to capital gains.\textsuperscript{37} Thus, when there is an absolute sale and no
economic interest is reserved, the full basis of the interest sold
must be recovered before there exists any taxable gain on the
transaction.\textsuperscript{38}

But suppose that the consideration consists of a speculative
interest in the future production of the property. This would
place the transaction in the "exchange" category, where the ordi-

\textsuperscript{34} Supra note 31.
\textsuperscript{35} Darby-Lynde Co. v. Alexander, 44 F.(2d) 186 (D.C. Okla. 1930),
affirmed 51 F.(2d) 56 (C.C.A. 10th. 1931), cert. denied 284 U.S. 666, 52 S.Ct. 40,
76 L.Ed. 564 (1931).
\textsuperscript{36} Internal Revenue Code, § 113(b).
\textsuperscript{37} Internal Revenue Code, § 117(a),(b). The capital gains rates are so
favorable (66\% per centum of the gain is taxed if the capital asset has been
held between 18-24 months; only 50 per centum of the gain if the holding
period has been longer than 24 months) that the taxpayer will sometimes
attempt to place himself in the category where he may take advantage of
the capital gains percentages instead of the depletion percentages. These
percentages, however, do not apply to corporations. See McLean v. Commiss-
ioner, 120 F.(2d) 942 (C.C.A. 5th, 1941), for an unsuccessful attempt to call
a leasing transaction a sale. Hence the government and the taxpayer often
shift sides in an attempt to get the most for their own advantage out of a
taxable transaction.
\textsuperscript{38} Subject to the capital gains limitations. See Internal Revenue Code,
§ 117(b). See also limitation of surtax on the sale of oil and gas properties—
the part of the surtax attributable to the sale of such properties cannot ex-
ceed 30 per centum of their selling price. Internal Revenue Code, § 105; U.S.
Treas. Reg. 103, § 19.105-1.
\textsuperscript{39} Another type of uncertainty is where there is a cloud on the title to
the oil or gas interest. Even though there is an adverse claimant, the in-
come from the interest is taxable to the possessor and he cannot be denied
the depletion deduction. Champlin v. Commissioner, 78 F.(2) 905 (C.C.A. 10th,
1935).
though there is a market value for such oil or gas right, the uncertainty is too great to afford a basis for the computation of income until actual realization.\textsuperscript{40} When the income is finally realized, the proper deduction is the depletion allowance, not the capital, gains percentages.

The speculative interest which the owner receives in return for the sale is generally in the form of a royalty or oil payment contract. A royalty is a fractional interest in the gross production of the oil or gas, while an oil payment usually represents a fixed sum to be paid to the vendor out of the gross production, or out of a fractional portion of such production. In either case the proceeds received are gross income subject to depletion.\textsuperscript{41}

If the owner receives, in addition to the speculative interest, a cash payment, another set of rules applies. Where the speculative interest is a royalty, the cash payment may be treated as a bonus\textsuperscript{42} or "advance royalty," and depletion may be taken on both the royalty and the bonus.\textsuperscript{43} But where the speculative interest is an oil payment,\textsuperscript{44} the cash payment is not subject to depletion.

\begin{itemize}
\item \textsuperscript{40} Dearing v. Commissioner, 102 F.(2d) 91 (C.C.A. 5th, 1939).
\item \textsuperscript{41} Murphy Oil Co. v. Burnet, 287 U.S. 299, 53 S.Ct. 161, 77 L.Ed. 318 (1932); Commissioner v. Fleming, 82 F.(2d) 324 (C.C.A. 5th, 1936).
\item \textsuperscript{42} Depletion taken on a cash bonus or "advance royalty" must necessarily be percentage depletion. Treated the same as "advance royalties" are fixed bonuses which are payable each year regardless of production. Alice G. K. Kleberg, 43 B.T.A. 277 (1941). See qualification to this right to take depletion on bonuses or "advance royalties" stated in note 43, infra. But "delay rentals" (payments by a lessee or assignee for the privilege of postponing development) are taxed as ordinary income to the lessor or assignor, without any depletion allowance. J. T. Sneed, Jr., 33 B.T.A. 478 (1935).
\item \textsuperscript{43} Pitman v. Commissioner, 64 F.(2d) 740 (C.C.A. 10th, 1933). The existence of a well is not a condition precedent to the right to take depletion on a cash bonus or "advance royalty." Herring v. Commissioner, 293 U.S. 322, 55 S.Ct. 179, 79 L.Ed. 389 (1934). The difference between a cash bonus or "advance royalty" and a royalty is, of course, the latter is dependent on production. But the bonus is for anticipated depletion, and when it is certain that this depletion will never occur (i.e., that there is no oil on the land; or that none was found during the term for development, if a lease), then the taxpayer's income will be adjusted so as to include the part of the bonus deducted for depletion as ordinary income. Sneed v. Commissioner, 119 F.(2d) 767 (C.C.A. 5th, 1941), rehearing denied 121 F.(2d) 725 (C.C.A. 5th, 1941). This restoration of the depletion allowance on the bonus is unnecessary if there has been some production, it seems immaterial how small. Dolores Crabb, 41 B.T.A. 686 (1940), affirmed 119 F.(2d) 772 (C.C.A. 5th, 1941), remanded on other issue 121 F.(2d) 1015 (C.C.A. 5th, 1941).
\item \textsuperscript{44} The costs of oil payments, like royalties, must be recovered by depletion, and their cost may not be recouped out of the gross proceeds from the payments before reporting any gain on the transaction. Lee v. Commissioner, 126 F.(2d) 825 (C.C.A. 5th, 1942), holding that Laird v. Commissioner, 97 F.(2d) 730 (C.C.A. 5th, 1938), may be regarded as overruled. Pugh v. Commissioner, 49 F.(2d) 76 (C.C.A. 5th, 1931), insofar as it conflicts with Palmer v. Bender, 257 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489 (1933), is no longer authority. Commissioner v. Elliott Petroleum Corp., 82 F.(2d) 103 (C.C.A. 9th, 1936).
\end{itemize}
and gain on the cash received is a capital gain. In this case, however, the income received as oil payments is still gross income.

Where the owner receives both a royalty and an oil payment plus a cash consideration, the cash is gross income subject to depletion.

The general rule seems to be that an absolute sale is effected only when the consideration is a fixed and certain cash payment; and that any vendor, lessor, or assignor who becomes possessed of a right to a payment dependent on the development of the property holds an "economic interest in the oil and gas in place." This rule has been qualified in two important particulars:

First, no depletable economic interest is deemed to be reserved by an owner who sells and conveys his rights for a share in the "net profits of production." Such a stipulation is construed as a mere personal covenant on the part of the vendee, assignee, or lessee; and even though development and production are essential to the realization of such profits, the seller is not entitled to the depletion deduction.

Second, it is considered that no depletable economic interest is reserved by an owner who sells his rights but retains a proprietary interest as security for oil payments. Thus, in Anderson v. Helvering, where oil properties were sold for a specified money consideration payable partly in cash and the balance with interest out of one-half of the oil and gas produced or out of the proceeds of the sale of these properties by the vendee, it was held that the transaction did not give rise to a depletable right. The set-up in the Anderson case was distinguished from that in the

46. Ibid.
47. Badger Oil Co. v. Commissioner, 118 F. (2d) 791, 793 (C.C.A. 5th, 1941), cert. denied 314 U.S. 635, 62 S.Ct. 67 (1941): "retention of [this] overriding royalty gave character to the cash consideration paid, and made it a bonus depletable as additional advance royalty." This giving of the character of advance royalties or bonus to the cash consideration when a royalty is stipulated takes place whether an oil payment is present or not. Cf. Heep Oil Corp. v. United States, 32 F. Supp. 762 (Ct. Cl. 1940). The oil payment by itself, unlike a royalty, is not a strong enough "economic interest" to impart its own characteristics to a cash payment so as to make it a bonus. See Lee v. Commissioner, 126 F. (2d) 825 (C.C.A. 5th, 1942), declaring that on most points the treatment of royalties and oil payments is the same.
49. 310 U.S. 404, 60 S.Ct. 952, 84 L.Ed. 1277 (1940). This opinion by Mr. Justice Murphy is one of the best on the subject of depletion, and is a pleasant contrast to those of some judges whose opinions show their unfamiliarity with the nature and theory of the deduction.
Thomas case\textsuperscript{50} by reference to the fact that the deferred payments need not be out of the oil or gas produced or profits from the oil or gas produced, but could be derived from the sale of the property,\textsuperscript{51} and the fact that the deferred payments bore interest.\textsuperscript{52} But the retention of a lien on the oil production, and nothing more, would not be sufficient to make a reservation of a mineral interest a retention of security for payment. It is immaterial that the deferred payments are to be in cash rather than in oil. In any case, a personal covenant that such deferred payments shall at all events equal a specified sum is evidence of an absolute sale, and no reservation of an "economic interest in the oil and gas in place" can be implied.\textsuperscript{53}

The situation in a sale, lease, or assignment is for most practical purposes the same. The point to look for is whether the taxpayer has, in effect, disposed of his entire rights, or whether he has retained a right or rights sufficient to constitute an economic interest in the oil or gas in place. Where there is this division of ownership, each holder of a share in the oil or gas in place is directly the owner of the part of the gross proceeds attributable to his share. This is the reason why the holder of a right to share in the "net profits" may not take depletion; the net profits are taxable to and the depletion is allowed to the direct owner. The transferor merely has agreed to accept an interest in the net profits in exchange for his oil or gas interest.

The question next arises as to the treatment of a transaction where a speculative interest is reserved but where the cash payments are not subject to the depletion allowance. The typical example of this situation is where the consideration is a cash payment plus oil payments.

The taxpayer may not then and there recoup the cost of the interest sold out of the cash payment,\textsuperscript{54} but he is allowed full re-

\textsuperscript{50} Thomas v. Perkins, 301 U.S. 655, 57 S.Ct. 911, 81 L.Ed. 1324 (1937), holding that the right to a payment out of oil or out of the proceeds of oil to be produced should be regarded as a reservation of oil in place sufficient to make the agreed payments, where there was no security taken nor any personal covenant to pay at any event.

\textsuperscript{51} Thus bringing the case under the rule that gross proceeds from the property do not include proceeds from the sale of the property. See note 35, supra.

\textsuperscript{52} Thus attaching to the deferred payments the character of a personal covenant to make certain payments, which covenant does not effect a reservation of a mineral interest. See Helvering v. Elbe Oil Land Development Co., 303 U.S. 372, 58 S.Ct. 621, 82 L.Ed. 904 (1938).

\textsuperscript{53} Anderson v. Helvering, 310 U.S. 404, 60 S.Ct. 952, 84 L.Ed. 1277 (1940).

\textsuperscript{54} Neither may he recoup the cost of the interest purchased out of proceeds of oil payments until they equal the cost, but must depend on depletion
covery of the depreciated cost of tangible well equipment and of the expenses of the sale. The cost basis of the property thus adjusted should be allocated between the interest sold and the interested retained on the basis of the ratio of the respective values of the interests at the time of the transaction. 55

Although it has been frequently stated that the determination of whether the taxpayer owns an economic interest in the oil or gas in place is not dependent on the form of the instrument or the terminology used, it is to be observed that many of the decisions depend on the interpretation of some small phrase. Thus a reservation of one-third of the oil or of the gross proceeds from production may be construed as a royalty; while a reservation of one-third of the net profits from the development, or a stipulation that the payment reserved may be paid out of proceeds of the sale or the proceeds of the production, will be treated as a mere personal covenant so as to effect no reservation of a mineral interest.

The most advantageous position for the taxpayer to take is of course an individual problem, but it readily appears that:

1. If he has a large cost basis, he may profit by having the transaction treated as an absolute sale without reservation, and would entitle him to a tax-free recovery of cost.

2. If he has held the property over eighteen months or over two years, the long-term capital gains holding period percentages may be more favorable than the depletion allowances.

3. If he has a small cost basis or none at all, a reservation of an economic interest, which will entitle him to depletion from all of the gross income from the property, will doubtless be to his advantage.

IV. COMPUTING THE AMOUNT OF THE ALLOWANCE

In computing the amount of the allowance the taxpayer has a choice of two methods: the cost method and the percentage for a return of capital. See Commissioner v. O'Shaughnessy, 124 F. (2d) 33 (C.C.A. 10th, 1941), where plaintiff paid $25,000 for a $100,000 oil payment. 55 In Columbia Oil and Gas Co. v. Commissioner, 118 F. (2d) 459 (C.C.A. 5th, 1941) the company sold certain leases (including equipment) for the cash payment of $550,000 and a $350,000 oil payment. The court determined that 63 per centum of the interest had been sold and 37 per centum retained; and then allowed the following to be recouped out of the cash payment: 63 per centum of the leasehold cost basis, the cost of the tangible equipment, and the expenses of the sale. The difference between the total of these items and the $550,000 cash payment was a taxable capital gain. As to the 37 per centum interest retained, the proceeds from this would be taxable income, less the depletion deduction.
method. He may use that which results in the greater deduction. A principal object in providing the percentage method alternative was to relieve the taxpayer of the rather complicated accounting incident to computing by the cost method; but in actual practice the allowance is computed by both methods, in order to determine the greater deduction.

For cost depletion, the basis used is the same basis which is used for computing gain, or the statutory basis adjusted for depletion. This basis should not include (a) amounts representing the cost or value of the land for purposes other than mineral production, (b) the amount recoverable through deductions other than depletions, such as depreciation, and (c) the residual value of other property at the end of operations. However, this basis should include those amounts of capitalized drilling and development costs which are recoverable through depletion.

There are two types of drilling and development costs: (1) intangible items which will not have any salvage value, and (2) tangible items which will have a salvage value. The taxpayer at his option may charge items of the first class to current expense, or capitalize them and recoup them by means of the depletion and depreciation deductions. "Any election so made is binding for all subsequent years." Those items of the first class which are recoverable through depletion, if capitalized, are expenses in "clearing ground, draining, road-making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells." Those recoverable through depreciation, if capitalized, are expenses of "wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures."

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56. The percentage depletion method was introduced to take the place of discovery depletion, which is now used only in computing depletion on mines, other than metal, coal, or sulphur. See Revenue Act of 1926, § 204(c), (1), (2); Internal Revenue Code, § 114(b)(2); U.S. Treas. Reg. 103, § 19.23(m)-3.

57. "The basis upon which [cost] depletion...is to be allowed...is the basis provided in Sec. 113(a) [Internal Revenue Code], adjusted as provided in Sec. 113(b) [I.R.C.], for the purpose of determining the gain upon the sale or other disposition of the property." U.S. Treas. Reg. 103, § 19.23(m)-2. See §§ 19.115(a)-1 to 19.114-1.


59. See note 62, infra.

60. "All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." U. S. Treas. Reg. 103, § 19.23(m)-16-(a)-1.

61. U.S. Treas. Reg. 103, § 19.23(m)-16-(d). As to whether the taxpayer may be permitted to show that he did not intend a binding election, see Lucas v. Sterling Oil and Gas Co., 62 F. (2d) 951 (C.C.A. 6th, 1933).


The option does not exist in adjusting expense items of the second class.64

As aptly stated in Hardesty v. Commissioner:65

"The drilling and development costs dealt with by this article are those incurred by a taxpayer in connection with the development of his own property or lease. The option granted by the regulations does not extend to costs incurred under turnkey contracts,66 or costs which are part of the costs of a completed well which has by agreement been drilled quid pro quo as the purchase price of the property or for an interest in it. The regulation was not intended to and does not apply to costs incurred in connection with drilling of wells as the purchase price of or as consideration for an interest in the lands of others."67

After the basis applicable to the mineral deposit has been adjusted, "the [cost] depletion for that year shall be computed by dividing that amount by the number of units68 of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units sold within the taxable year."69 The number of units remaining includes the number of units sold within the taxable year.70 The number of units sold does not include "units with respect to which depletion deductions were allowed or allowable prior to the taxable year."71

The taxpayer may, in lieu of the cost depletion method, de-

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64. Besides tangible expense items not having a salvage value, "the options do not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells." U.S. Treas. Reg. 103, § 19.23(m)-16-(c)-1.
65. 127 F.(2d) 843, 844 (C.C.A. 5th, 1942).
66. Contracts wherein the driller agrees to furnish all material and work required to complete a well, and to turn over the completed well in condition ready to "turn the key." Grinson Oil Corporation v. Commissioner, 96 F.(2d) 125 (C.C.A. 10th, 1938).
67. Cf. State Consolidated Oil Co. v. Commissioner, 66 F.(2d) 648 (C.C.A. 9th, 1933). But "footage contracts," and contracts where the driller is hired on a "cost plus" basis, are within the option. U.S. Treas. Reg. 103, § 19.23(m)-16-(a)-1. See Commissioner v. Ambrose, 127 F.(2d) 47 (C.C.A. 5th, 1942). The controlling point seems to be whether the driller is an independent contractor, or an agent of the lease owner or landowner.
68. The customary unit is the one to be used, as "barrels of oil," or "thousands of cubic feet of natural gas." U.S. Treas. Reg. 103, § 19.23(m)-2.
70. Ibid.
71. Ibid. Where a taxpayer reports on the cash basis, this includes "units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year."
duct from his gross income from the oil or gas property, an amount equal to 27½ per centum thereof, if this method results in a larger depletion allowance. Gross income from the property means gross income from the property to the taxpayer, and the word “property” refers to the separate tracts or leases of the taxpayer. The deduction computed through the percentage method may not exceed 50 per centum of the net income (computed without allowance for depletion) of the taxpayer from the property. “Net income from the property” and “operating profit” are synonymous, but for the purpose of applying the 50 per centum limitation development, expenses should not be deducted from gross income in determining net income.

The principal advantages of the percentage method are:

1. the simplicity of its computation;
2. that even after 100 per cent of the capital has been recouped by use of the percentage method, the taxpayer may continue the deduction of 27½ per cent of his gross income;
3. that the taxpayer may deduct intangible drilling and development costs as expense, and still take the same amount of percentage depletion;
4. that the percentage deduction may be taken on some proceeds even before oil or gas production has begun, for example, bonuses and advance royalties.

72. Internal Revenue Code, § 114(b)(3).
73. U.S. Treas. Reg. 103, § 19.23(m)-4. Thus the taxpayer is not bound to one method whether he begins using one method or the other.
74. Crews v. Commissioner, 89 F.(2d) 412 (C.C.A. 10th, 1937). Gross income from the property is based on the value of gas or oil at the mouth of the well. Greensboro Gas Co. v. Commissioner, 79 F.(2d) 701 (C.C.A. 3rd, 1935). But gross income to the taxpayer does not include rents and royalties paid on the property by the taxpayer, nor bonuses paid in certain cases. See § 19.23(m)-1-(f)-4.
77. Ambassador Petroleum Corp. v. Commissioner, 81 F.(2d) 474 (C.C.A. 9th, 1938). But a taxpayer who elects to deduct development expenses in computing taxable income cannot refuse to deduct such expenses in computing “net income from the property” in applying the 50 per centum limitation. Helvering v. Wilshire Oil Co., 308 U.S. 90, 60 S.Ct. 18, 84 L.Ed. 101 (1939), and also F.H.E. Oil Co. v. Helvering, 308 U.S. 104, 60 S.Ct. 26, 84 L.Ed. 109 (1939).
79. The following is a sample computation prepared by the writer, which may be of illustrative value: Suppose a taxpayer acquires certain oil property for $20,000, and reliable estimates show that 50,000 barrels of oil are expected to be extracted. Assume that the property will have no salvage value after the mineral is removed. At the end of the first year there is no change in
V. CLOSING REMARKS

There has been considerable agitation especially on the part of the Treasury Department, to erase percentage depletion from the statute books. In the writer's opinion, the percentage method could be eliminated entirely or reduced materially, because it is only an alternative to the general rule—cost depletion; but the laws could not be altered constitutionally so as to allow a taxpayer materially less than cost depletion.80

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the estimate of the oil in place, hence the per unit cost basis would be determined by dividing $20,000 by 50,000—a per barrel cost basis of 40 cents. During the first year’s operations, 20,000 barrels of oil are produced and sold for $20,000. The cost depletion deduction would then be 40 cents multiplied by 20,000, or $8,000. The percentage deduction would be 27 1/2 per centum of the gross proceeds ($20,000), or $5,500. Cost depletion being greater, the taxpayer will deduct $8,000 for the taxable year and have a taxable income from the property of $12,000.

At the end of the first year the cost basis of the property has been reduced to $12,000. During the second year of operation, 30,000 barrels of oil are produced and sold for $30,000, but estimates show that 20,000 barrels of oil still remain to be extracted. This indicates that at the start of the second year there were 50,000 barrels of oil in place. The cost depletion is then computed by dividing the adjusted cost basis ($12,000) by the mineral in place (50,000 barrels at the beginning of the second year), or 24 cents per unit. Cost depletion for the second year is then 24 cents multiplied by the 30,000 barrels sold, or $7,200. Percentage depletion is computed by taking 27 1/2 per centum of the gross proceeds ($30,000), or $8,250. Percentage depletion being greater, the taxpayer will deduct $8,250 from his gross proceeds and have a taxable income from the property during the second year of $21,750. The cost basis of the property will be reduced from $12,000 to $3,750 at the end of the second year.

During the third year 40,000 barrels of oil are produced and sold for $40,000, and the well is exhausted. This means that at the start of the third year there were 40,000 barrels of oil in place. Cost depletion would be equal to the remaining basis, or $3,750. (Computed by dividing the adjusted basis ($3,750) by 40,000, or 8.8 cents cost depletion per barrel. For the year, then, it would be 8.8 cents multiplied by 40,000, or $3,750.) Percentage depletion would be determined by taking 27 1/2 per centum of the gross proceeds ($40,000), or $11,000. Percentage depletion being greater, the taxpayer will deduct $11,000 from $40,000 and have a taxable income of $29,000. It is immaterial that $7,250 more than the cost basis has been recovered. ($8,000 plus $8,250 plus $11,000, or $27,250.)

80. See discussion, note 4 supra. Under this theory, the present statutory allowance for depletion is constitutional, because it permits the taxpayer to recoup his cost basis at least. "In no case shall the deduction computed [by the percentage method] be less than it would be if computed upon the cost or other basis." U.S. Treas. Reg. 103, § 19.23(m)-4. It would seem otherwise if the statute provided that the percentage method must be used when it resulted in a lesser deduction than the cost method. In the early days of the modern income tax Chief Justice White dismissed the argument that an allowance less than cost recovery permits a partial tax on capital, with the reasoning that the tax is an "excise levied on the results of the business of carrying on mining operations," and not a tax on the substance of the mine. Stanton v. Baltic Mining Co., 240 U.S. 103, 114, 36 S.Ct. 278, 281, 60 L.Ed. 546, 554 (1916). Since 1916 the court's knowledge of income tax accounting has been greatly enriched by experience, and despite the glib assertions in recent opinions that the deduction is a matter of grace, it is by no means certain that the theory of the Baltic case would stand up if put to the test today.