Percentage Depletion of Advance Royalties and Lease Bonuses Under I.R.C. Section 613A

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Percentage depletion is a statutory deduction allowed to the owner of an economic interest in minerals. Under this method of depletion, the allowance is computed as a specific percentage of the gross income derived from the property. Oil and gas income qualified for this deduction prior to the Tax Reduction Act of 1975. The Act, however, repealed the percentage depletion deduction on oil and gas income with certain limited exemptions. One of these exemptions permits independent producers and royalty owners to claim percentage depletion on limited quantities of annual production. The linchpin in qualifying for the deduction is determining whether a payment is received with respect to "production," even though this term is not defined by the statute. The failure to define "production" has created considerable uncertainty as to whether lease bonuses and advance royalties continue to qualify for percentage depletion under the Tax Reduction Act of 1975. Three courts have addressed the issue, but they have failed to give a uniform definition of production or to agree on the proper treatment of lease bonuses and advance royalties under Internal Revenue Code section 613A.

In Engle v. Commissioner, the Seventh Circuit allowed the taxpayer to claim percentage depletion on advance royalties even though...
there had not yet been production on the leased property. The court found that production required physical extraction but physical extraction need not have preceded the receipt of income. Section 613A(c) was treated as imposing a quantity limitation to be measured by the current year’s income rather than by physical extraction. The Seventh Circuit did not expressly define production, but its conclusion implied that the term included past, current, and future physical extraction.

The Tax Court interpreted section 613A(c) in Glass v. Commissioner. In this case, the court concluded that lease bonuses were not eligible for percentage depletion under section 613A(c) since the bonuses were not received with respect to actual production. The court defined production as actual physical extraction during the current year. This definition does not allow current depletion of income related to future physical extraction.

The third court which attempted to resolve the problem of whether lease bonuses and advance royalties are exempted from the general repeal of percentage depletion on oil and gas income was the Court of Claims, in Farmar v. United States. The court concluded that lease bonuses were not eligible for percentage depletion, but it gave production a broader definition than did the Tax Court. The Court of Claims defined production as income from, or connected with, actual extraction during the year. Lease bonuses were not within the definition because the court did not consider the bonuses to be sufficiently connected with actual extraction. The court, however, stated that its definition of production possibly would allow a taxpayer to claim percentage depletion on advance royalties.

These three cases present two basic issues. The first issue is whether the term “production” permits current depletion of income related to future physical extraction. The second issue is whether advance royalties are more closely related to actual physical production than lease bonuses and, if so, whether this difference justifies different tax treatment.

Factual Background

The Farmar, Glass, and Engle cases involved similar fact situa-
tions. In each case, the taxpayers were independent producers or royalty owners who claimed percentage depletion on the compensation they received for the execution of oil and gas agreements. The Commissioner disallowed the deductions, asserting that section 613A repealed percentage depletion on the types of payments received by the taxpayers.

The payments in both Farmar and Glass were classified as lease bonuses. In Glass, the taxpayers owned the mineral interests in fee simple in Texas. They received bonus payments of $139,940 in 1975. These payments were due even in the absence of actual production. The agreement also provided that future royalties would not be reduced by the bonus payments. Producing wells were completed during the year on all but one of the leased properties.

The agreement in Farmar resembled the agreement in Glass. The taxpayers received the bonuses in 1976 as compensation for the lease of mineral estates they owned in Texas. The bonuses were payable in several yearly installments and were due even in the absence of production. The lessee could not recover any part of the bonus payments by abandoning the lease. During 1976, the taxpayers received both lease bonuses and royalties.

Engle involved a slightly different factual situation. The taxpayer was the lessee of two oil and gas leases. In 1975, he assigned his interest in these leases to other companies interested in their development. The taxpayer received $7,600 and retained an overriding royalty interest as compensation for the execution of the agreement. The court characterized the payment as advance royalties. During the year of payment, there was no production, discovery, or exploratory work done on the properties.

**Lease Bonuses and Advance Royalties**

An oil and gas lease typically compensates the mineral owner at the time of execution of the lease and provides the mineral owner with a royalty interest. The initial compensation generally is referred to as a lease bonus or advance royalty. A lease bonus is the compensation paid by the lessee for the right to exploit the land for oil and gas. The payment is due whether or not there is production.

15. Engle, 677 F.2d at 595; Glass, 76 T.C. at 950; Farmar, 689 F.2d at 1018.
16. 76 T.C. at 950.
17. 689 F.2d at 1018.
18. 677 F.2d at 595.
19. 1 L. FISKE, FEDERAL TAXATION OF OIL AND GAS TRANSACTIONS § 2.05 (1982).
and, ordinarily, it is computed on a per-acre basis. An advance royalty contains many of the characteristics of a lease bonus. Like a bonus, an advance royalty is paid for the right to exploit the land for oil and gas.\textsuperscript{21} It provides the mineral owner a royalty computed on the basis of a specific number of units, whether or not extracted within the year.\textsuperscript{22} The advance payments are then applied against royalties due on minerals extracted thereafter.

Prior to the Tax Reduction Act of 1975, lease bonuses and advance royalties were considered to have a similar meaning, and one term was even used to define the other.\textsuperscript{23} Both payments were defined as compensation paid to the lessor for the diminution in value of the leased property,\textsuperscript{24} and therefore both were eligible for depletion. Despite this, the Court of Claims suggested that an advance royalty “may possibly be considered somewhat different, and more closely related to actual production” than a lease bonus, and therefore it still may be eligible for percentage depletion under section 613A.\textsuperscript{25} This fact makes it necessary to attempt to distinguish a lease bonus from an advance royalty, as the characterization of the payment may have tax significance.

The courts historically have distinguished between payments given for the exploitation of minerals and payments given for other consideration. An example of a payment in the latter category is the delay rental. The delay rental grants the lessee the privilege of deferring commencement of drilling operations or production. The payment is considered to be in the nature of liquidated damages or a penalty for the failure to drill upon or exploit the property.\textsuperscript{26} Lease bonuses, however, can not be distinguished from advance royalties on this basis. Both are examples of payments that fall in the former category since they both are considered to be given for the exploitation of minerals.\textsuperscript{27}
Attempts to distinguish advance royalties from lease bonuses are further complicated by the fact that the exact form of the advance royalty may vary. A common variation of the advance royalty is derived from the “minimum royalty” agreement. Under this type of agreement, the lessee guarantees the lessor a minimum annual royalty. The payment is due regardless of actual physical extraction during the year, with the entire payment being considered in the nature of a royalty. The courts have rejected attempts by the Commissioner of Internal Revenue to treat as a delay rental the excess of the amount paid over the amount earned based on actual production.

The major distinctions which exist between lease bonuses and advance royalties are that lease bonus payments are computed on a per-acre basis while advance royalties are computed on units of production and advance royalties, unlike lease bonuses, may be recouped through future production. The latter distinction, however, is less clear when lease bonuses are compared to minimum royalties, because the “minimum” payment, like the lease bonus, may not be traceable to a specific unit physically extracted from the property. Lease bonuses and advance royalties are regarded as the same in all other respects.

Depletion of Lease Bonuses and Advance Royalties Prior to 1975

The depletion allowance has been part of the tax laws since 1913. The Revenue Act of 1913 contained a provision permitting a “reasonable allowance for depletion . . . not to exceed [in the case of mines] 5 per centum of the gross value.” The depletion computation was based on the greater of the cost of the property or its market value on March 1, 1913. Typically, this statutory limitation restricted the depletion allowance to a fixed percentage of gross income. The five-percent limitation, however, was short-lived; it was removed by the Revenue Act of 1916, which provided for a “reasonable allowance, 

Code. “Bonus” means money or other property given for the execution of a mineral lease, except interests in production from or attributable to property on which the lease is given. LA. MIN. CODE: LA. R.S. 31:213(3) (1974).

“Rental” means money or other property given to maintain a mineral lease in the absence of drilling or mining operations or production of minerals. “Rental” does not include payments classified by a lease as constructive production. LA. MIN. CODE: LA. R.S. 31:213(4) (1974). However, in determining the federal income tax treatment of these items, the definition of the interest created by state law may be of only limited value, as the time and manner of taxation is determined by the federal statute. Burnet v. Harmel, 287 U.S. 103, 110 (1932).

29. Id.
30. Ch. 16, § II(B), 38 Stat. 114, 172-73 (1913).
not to exceed the actual cost of discovery, or in the case of oil and gas mines discovered prior to March 1, 1913, the fair market value on that date." This statute reflected a policy of limiting the depletion allowance to the actual cost of discovery (except in the case of oil and gas wells discovered prior to March 1, 1913).

The Revenue Act of 1918 changed this policy. Following World War I, Congress became aware of the strategic importance of oil. In an effort to encourage exploration, Congress revised the depletion allowance to give all producers the option of choosing between a depletion deduction based on either cost or market value determined within thirty days of discovery. By electing the market value (or discovery value) method, the taxpayer received a "stepped-up" depletable basis which was completely unrelated to actual cost. This increased basis allowed the oil producer to claim a greater depletion allowance than would have been allowed if the deduction had been based on actual cost. The theory of this legislation was that the tax savings generated by the higher depletion allowance would be reinvested in additional exploration.

The benefits of discovery depletion, however, were limited by Congress both in 1921 and in 1924. In 1921, the depletion allowance was limited to the oil producer's profit from each mineral property owned for the year. The change was designed to prevent oil producers from using the depletion allowance to offset profits from other separate and distinct lines of business. The allowance was further reduced by the Revenue Act of 1924, which limited the depletion allowance to a maximum of 50 percent of the net profits from each property.

While Congress approved of the incentives created by the discovery value method, computation of the depletion deduction proved to be administratively cumbersome and complex. The taxpayer and the Treasury Department frequently disagreed on the value of the discovery. Many of the valuation procedures were left to the discretion of the engineers. To remedy this problem, Congress once again amended the depletion statute. The Revenue Act of 1926 provided

33. 56 Cong. Rec. 10,539-10,542 (1918).
35. Staff of the Joint Comm. on Internal Revenue Taxation, 81st Cong., 2d Sess., Legislative History of Depletion Allowance 2 (Comm. Print 1950).
38. Ch. 234, § 204(c), 43 Stat. 254, 260 (1924).
40. J. Lichtblau, supra note 31, at 38.
for the computation of the depletion allowance as the greater of either a percentage of the gross income from the property or the actual cost per unit produced. The percentage rate of depletion was intended to approximate the deduction which would have been available under the discovery value method. The Senate Finance Committee proposed 25 percent as a rate to substitute for the discovery value deduction, while the Senate amendment proposed 30 percent. A compromise rate of 27 1/2 percent, as recommended by the House Conference Committee, eventually was enacted.

Initially, it was unclear whether lease bonuses were eligible for depletion. The United States Supreme Court answered this question in Murphy Oil Co. v. Burnet and Burnet v. Harmel. Murphy Oil arose under the Revenue Act of 1918. The taxpayer had received a bonus payment of $5,173,595 in a previous year, but it had not reduced its basis in the mineral interest by the amount of depletion allocable to that payment. The Court agreed with the Commissioner that both bonuses and royalties involve a return of capital investment in oil in the ground for which a depletion allowance must be made.

In reaching this conclusion, the Court stated, "A distinction between royalties and bonus, which would allow a depletion deduction of the former but tax the latter in full as income, when received . . . would deny the 'reasonable allowance for depletion' which the statute provides." The question also was addressed in Harmel. The precise issue was whether a lease bonus was ordinary income or the sale of a capital asset. The Court held that the bonus payment was similar to a royalty and, therefore, ordinary income subject to depletion.

Murphy Oil and Harmel arose before the Revenue Act of 1926 amended the Code to allow a statutory percentage of gross income as a depletion deduction. The Commissioner originally took the position that percentage depletion was allowable on lease bonuses only

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41. Ch. 27, § 204(c)(2), 44 Stat. 9, 16 (1926). The pertinent provisions of this statute are as follows:

   In the case of oil and gas wells the allowance for depletion shall be 27 1/2 percent of the gross income from the property during the taxable year . . . except that in no case shall the depletion computation be less than it would be if computed without reference to this paragraph.


43. Id.

44. 287 U.S. 299 (1932).

45. 287 U.S. 103 (1932).

46. 287 U.S. at 302.

47. Id. at 302.

48. 287 U.S. at 105.

49. Id. at 111.
if at the time it was received, the future production of oil and gas from the property was practically assured or the property became productive during that taxable year.\textsuperscript{50} However, in the case of cost depletion, the Commissioner required no development or production of any oil or gas. The Supreme Court rejected the Commissioner's position in \textit{Herring v. Commissioner},\textsuperscript{51} in which the Court allowed the percentage depletion deduction in the year of receipt, regardless of the probability of future production or actual production during the taxable year. The Court found "neither statutory authority nor logical justification for withholding [the deduction] in the one [percentage depletion] and granting it in the other [cost depletion]."\textsuperscript{52} The Court reserved judgment as to the income tax liability in the year of termination of the lease, where there had been no production.\textsuperscript{53}

After the Supreme Court rejected the Commissioner's position, he issued a pronouncement that was consistent with \textit{Herring}.\textsuperscript{54} Additionally, the Commissioner stated that when there had been no production under the lease, the taxpayer was required to restore the depletion deduction to income in the year the lease was terminated.\textsuperscript{55} The Commissioner's "recapture rule" was affirmed by the Court in \textit{Douglas v. Commissioner}.\textsuperscript{56}

\textbf{The Tax Reduction Act of 1975}

Percentage depletion of lease bonuses and advance royalties continued, without change, from the date of the \textit{Herring} decision until the enactment of section 613A. Section 613A generally repealed the percentage depletion deduction, but it provides an exemption for a limited amount of an independent producer's or a royalty owner's average daily production.\textsuperscript{57} Because the exemption is available only if there is production, the Commissioner has taken the position that lease bonuses and advance royalties are not within the narrow exemption of section 613A.\textsuperscript{58}

The Commissioner bases his conclusion on his interpretation of

\begin{itemize}
\item \textsuperscript{50} G.C.M. 11,384, XII-1 C.B. 64 (1933), revoked by G.C.M. 14,448, XIV-1 C.B. 98 (1935).
\item \textsuperscript{51} 293 U.S. 322 (1934).
\item \textsuperscript{52} \textit{Id.} at 328.
\item \textsuperscript{53} \textit{Id.}
\item \textsuperscript{54} G.C.M. 14,448, XIV-1 C.B. 98 (1935).
\item \textsuperscript{55} \textit{Id.}
\item \textsuperscript{56} 322 U.S. 275 (1944).
\item \textsuperscript{57} I.R.C. § 613A(c) (1976).
\item \textsuperscript{58} Rev. Rul. 81-44, 1981-1 C.B. 384; see also Engle \textit{v. Commissioner}, 677 F.2d at 595; Farmar \textit{v. United States}, 689 F.2d at 1018; Glass \textit{v. Commissioner}, 76 T.C. at 950.
\end{itemize}
congressional intent. He believes that Congress, by using the term “production,” intended to require a direct link between payments received by the taxpayer and actual physical extraction in order for the payments to qualify for percentage depletion. Additionally, the Commissioner believes that this direct link is necessary in the same year or the year immediately preceding that in which payment is received. Thus, the Commissioner would allow percentage depletion on payments received in the same year as physical extraction and on payments received in a subsequent year when physical extraction occurred in the immediately preceding year. Lease bonuses and advance royalties would not qualify for percentage depletion under this definition because these payments typically precede physical extraction.

The taxpayer in each of the three cases did not interpret congressional intent so restrictively. These taxpayers assert that the reference to section 613 in section 613A evidences a congressional intent to link production to gross income. Under this interpretation, gross income is converted to units of production and the limitations of section 613A(c)(5) are applied. This definition of production allows the taxpayer to claim percentage depletion on income directly linked to current physical extraction, as well as on income related to future physical extraction. This definition, like the Commissioner’s, is derived primarily from the legislative history.

**Legislative History**

The original purpose of the Tax Reduction Act of 1975 was to stimulate the economy. The Act provided for a reduction in individual income taxes, a tax credit for the purchase of new homes, and certain other provisions designed to accomplish its goal. The Act originally did not contain any provisions for the repeal of percentage depletion. The Act, however, was under consideration in Congress following the oil embargo, during which time several members of Congress were attacking the profits of the major oil companies. The remarks of one senator during the floor debates on the Tax Reduc-

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59. Rev. Rul. 81-44, supra note 58; Engle, 677 F.2d at 597; Farmar, 689 F.2d at 1019; Glass, 76 T.C. at 951.
61. See Engle v. Commissioner, 677 F.2d at 597; Farmar v. United States, 689 F.2d at 1019.
64. Id.
tion Act of 1975 reflected the mood of some members of Congress: "[The repeal of percentage depletion] closes the most flagrant single loophole in the Internal Revenue Code, a loophole that has been the symbol for a generation of the way the tax laws can favor the wealthy and the special interest groups . . . ."65

The major oil companies were the obvious target of the percentage depletion repeal provisions. This view is supported by the fact that the repeal provisions affected only oil and gas income and not other types of mineral income.66 The original floor amendment, however, not only repealed percentage depletion available to the major oil companies but also repealed percentage depletion available to independent producers and royalty owners.67 An attempt in the House to exempt a limited quantity of oil and gas income from the repeal provisions failed.68 In the Senate, the bill was amended to provide an exemption for independent producers and royalty owners.69 This limited exemption was retained in the conference bill and eventually enacted.70

The House and Senate debates of the bill discussed the independent producers exemption. The debates primarily dealt with whether there should be an exemption and, if so, the quantity to be exempted.71 The debates neither addressed the treatment to be given lease bonuses and advance royalties nor defined the term "production." Congress's failure to expressly discuss these problems has created difficulties with the statute. Although statements can be found to support either view, it remains unclear whether Congress intended for exempt production to be measured by gross income or by physical extraction.72

Although the treatment of lease bonuses and advance

65. 121 CONG. REC. 8,865 (1975) (Remark of Sen. Hollings).
66. Section 613A(a) provides: "the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613." (emphasis added).
68. 121 CONG. REC. 4639-41, 4645 (1975).
69. 121 CONG. REC. 7770-73, 7807, 7813 (1975).
72. Senator Long, Chairman of the Senate Finance Committee, stated that the conference version retained a sizeable amount of depletion for the independent producer. 121 CONG. REC. 8,860 (1975). Senator Mathias' statements, however, seem to indicate a requirement of production: "[twenty-two] percent depletion on oil and gas will be available on the first 2,000 barrels of oil in 1975 . . . ." 121 CONG. REC. 8,873 (1975). In the House debate on the conference bill, Representative Ullman said: "The conference bill retains some percentage depletion for the independent[cr] producer but at a reduced rate." 121 CONG. REC. 8,918 (1975) (emphasis added).
royalties was not addressed specifically in the 1975 legislative history, it was discussed in a similar proposal during the 1974 session of Congress. The proposed bill would have imposed a windfall profits tax, phased out percentage depletion, and made certain other tax adjustments. The proposal, which would have exempted a limited quantity of oil and gas production, but not lease bonuses, was explained in the House report:

[The reduced rate] applies only to gross income attributable to oil which is sold or removed from the premises and not to other types of depletable income. For example, a lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be within any of the exemptions.

The bill, however, was neither introduced in nor enacted by the Senate. Additionally, the House report was not referred to during the 1975 debates.

Administrative Pronouncements

The Internal Revenue Service has issued proposed regulations and two revenue rulings to explain the provisions of section 613A. While these pronouncements are not binding on the courts, they frequently are relied on in interpreting ambiguous statutes.

The treatment of lease bonuses was addressed in Revenue Ruling 81-44. In this ruling, the Internal Revenue Service stated, “Percentage depletion under section 613A(c) of the Code is allowable only with respect to production.” The Service concluded that the lease bonus involved did not qualify for percentage depletion since the payment was due independent of production. The ruling did not discuss if a lease bonus would be considered as given “with respect to production” where there was actual production under the lease.

Prior to the Tax Reduction Act of 1975, percentage depletion could be claimed only if there eventually was actual production. The taxpayer was allowed to deplete the income in the year received, but

74. Id.
76. Boykin v. Commissioner, 260 F.2d 249, 254 (8th Cir. 1958); 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 3.21 (1981).
77. Farmar, 689 F.2d at 1024 n.12; Gino v. Commissioner, 538 F.2d 833, 835 (9th Cir. 1976).
79. Id. (emphasis in original).
he was required to restore the depletion deduction to income in the
year of termination of the lease if the property later proved to be
unproductive.81 The change asserted by the Internal Revenue Service
in Revenue Ruling 81-44 is that the payment must be dependent on
actual physical extraction to qualify for percentage depletion under
section 613A. An apparent additional requirement is that physical ex-
traction precede or be concurrent with the receipt of income.82

The Internal Revenue Service also issued Revenue Ruling 81-266,83
which dealt with the "bonus exclusion rule." Under the bonus exclu-
sion rule, the lessee is required to exclude from his depletable gross
income an allocable portion of current gross income paid as a bonus
in advance of production to the lessor.84 The purpose of this adjust-
ment is to prevent both the lessee and the lessor from claiming percen-
tage depletion on the same gross income. Revenue Ruling 81-266 held
that Revenue Ruling 81-44 did not alter the bonus exclusion rule.

Revenue Ruling 81-44 and Revenue Ruling 81-266 appear to be
inconsistent. The bonus exclusion rule requires the lessee to reduce
his gross income by bonus payments (the reduction is allocated over
the estimated period of production from the property), yet the lessor
cannot claim percentage depletion on bonus payments since they are
not received with respect to production. These two rulings, in effect,
state that the payment made by the lessee is related to production,
but the same payment, when received by the lessor, is unrelated to
production. The Internal Revenue Service attempts to reconcile these
two positions by claiming that section 613A requires physical extrac-
tion during the same year that payment is received.85 This conclu-
sion, however, is not supported by the language of the statute.

The Internal Revenue Service also has issued proposed regu-
lations explaining the provisions of section 613A. The examples accom-
panying regulation section 1.613A-3, inter alia, illustrate the provi-
sions of the statute. Example 786 illustrates the problem which arises

84. Id. This principle was illustrated by Rev. Rul. 79-73, 1979-1 C.B. 218, amplified
by Rev. Rul. 81-44, 1981-1 C.B. 384, as follows: The lessee pays the lessor a bonus
of $200 in year one. In year two, there is production on the property of 100y units
out of the total estimated recoverable reserves of 1,000y units. The lessee is required
to exclude from depletable gross income of the year $20 (100/1000 x $200). This amount,
however, is not excluded from taxable income.
85. Rev. Rul. 81-266, supra note 83.
when physical extraction occurs in 1975, but the proceeds are not reported in the taxpayer’s income until 1976. In this case, the physical extraction is considered as occurring in 1976.87

Example 4 illustrates the problems encountered with advance royalties. In the example, the taxpayer receives annual payments of $100 recoupable out of future production. The income based on actual production is $60 in 1975 and $140 in 1976. The example concludes that only $60, the amount of actual production, is eligible for percentage depletion in 1975 and only $100 is eligible for percentage depletion in 1976. The $100 is the amount of advance royalty income received in 1976 relating to production occurring in that year. The example permanently denies percentage depletion on the $40 of advance royalty income received in 1975 relating to physical extraction occurring in 1976.88

Example 4 and example 7 can be factually distinguished. In example 7 physical extraction precedes the reporting of income, while in example 4 the reverse occurs. However, it is difficult to logically distinguish the examples. Provided there is physical extraction during the term of the lease, the tax treatment of each payment should be the same whether extraction precedes or follows payment.

Analysis of Court Decisions

The Tax Court, the Court of Claims, and the Seventh Circuit all have wrestled with the problem of interpreting section 613A. In Engle, the taxpayer argued that congressional intent supported his position that advance royalties were exempt from the general repeal of percentage depletion. The taxpayer relied upon the conference report, which stated, “[T]he Senate amendment retains percentage depletion at 22 percent on a permanent basis . . . .”89 The taxpayer argued that by using the word “retains,” Congress did not intend to change the existing allowance of depletion for independent producers and royalty owners. Congress, according to the taxpayer’s argument, only intended to place a limitation on the amount of production that qualifies for the exemption; Congress did not otherwise intend to change the percentage depletion deduction.90

87. Id.
89. Id.
91. 677 F.2d at 597.
The Commissioner similarly based his position on congressional intent. The Commissioner referred to statements made during the floor debates indicating that Congress was concerned with further exploration and development and that the allowance of percentage depletion on payments received prior to physical extraction would be inconsistent with this policy. The Commissioner also relied on the House proposal made in the previous congressional session. This proposal would have repealed percentage depletion with certain limited exemptions. One of the exemptions would have allowed a limited quantity of production received by an independent producer to qualify for percentage depletion. Lease bonuses were not included within the limited exemption. The Commissioner argued that Congress had the same intent when it enacted the limited independent producer and royalty owner exemption as part of the Tax Reduction Act of 1975. The Commissioner also considered percentage depletion of advance royalties repealed because of the similar treatment historically given advance royalties and lease bonuses.

In analyzing the legislative history, the Seventh Circuit did not rely on the 1974 proposal. The court stated that it could not, "as a matter of common sense," conclude that congressional intent had remained unchanged between 1974 and 1975. This position was reinforced by the fact that the 1974 proposal was never introduced in the Senate, yet it was the Senate's version of the bill that provided an exemption for independent producers and royalty owners. Beyond specifically rejecting the 1974 report, the court stated that both the Commissioner and the taxpayer had presented "reasonable interpretations" of the congressional intent. However, in concluding that section 613A places a limitation on production and does not require physical extraction as a prerequisite to the percentage depletion deduction, the court found "little guidance" in the legislative history.

The Seventh Circuit also analyzed the statutory language of section 613A. The court interpreted the term "production" as meaning more than "actual physical extraction during the taxable year." The
court felt that such a narrow definition of production would create problems when the receipt of income and physical extraction occurred in separate years. The court referred to Judge Fay's dissent in the Tax Court to illustrate this problem. The dissent had dealt with problems arising both when physical extraction preceded income and when income preceded physical extraction. Under a narrow definition of production, the gross income in either case would not qualify for percentage depletion since physical extraction and the receipt of income would not occur in the same year. The definition adopted by the proposed regulations, however, would allow percentage depletion when physical extraction preceded income, but deny the depletion allowance when income preceded physical extraction. Production under this definition, would include past and current physical extraction, but not future physical extraction. In dissent, Judge Fay rejected such a definition, stating that it was not based on either the statutory language or logic, but on a "capricious" interpretation of the statute.

The Seventh Circuit never precisely defined production. The court, however, did refer to Judge Fay's dissent in the Tax Court. Judge Fay's dissent defined production as "extraction (past, current or future) properly attributable to a taxpayer's taxable year as measured by the income received in that year." He gave four reasons in support of this definition. First, placing extraction in a year with reference to income interprets the statute without reading a myriad of calculations and carryovers into it. An interpretation which would base production on actual physical extraction would require the taxpayer to maintain detailed production records and to prepare various carryover schedules reconciling physical extraction records with the reporting of gross income. Second, an interpretation which would restrict production to current or past extraction, while excluding future production, would overrule prior case law without a clear statutory mandate. Third, the reference to section 613(a) in section 613A(c) made it clear that Congress intended that production be tied to income. Finally, he believed this interpretation was consistent with the legislative history.

Judge Fay believed that the position taken by the Commissioner was a reversion to the pre-Herring position explained in General
Counsel Memorandum (G.C.M.) 11,384. This conclusion is not completely accurate. While the application of the pre-Herring rule to the facts in *Engle* would obtain the same result, the Commissioner's reasoning is different. Currently, the Commissioner is not basing his denial of percentage depletion on the probability of future extraction (as he did under G.C.M. 11,384), but on the lack of a direct link between the payment received and the quantity physically extracted. Production in the year of receipt, while changing the result under G.C.M. 11,384, has no effect under the Commissioner's interpretation of section 613A.

The Seventh Circuit ultimately held that section 613A was ambiguous and found nothing in the statute which elucidated whether the term "production" was intended to be a prerequisite to or merely a limitation on the depletion allowance. Since an interpretation of production which would require extraction as a prerequisite to the deduction would be a drastic change without any clear legislative expression, the court rejected this reading.

After the Seventh Circuit issued its decision in *Engle*, the Court of Claims addressed the same issue in *Farmar*. The Court of Claims agreed with the Seventh Circuit that the legislative history provided "minor help." However, unlike the Seventh Circuit, the Court of Claims relied on House Report 1502, the House Ways and Means Committee report from the 1974 congressional session. The court considered the language of this report to be "similar" to the language enacted in section 613A and, therefore, of some value. The court explained its reliance on the report as follows: "We do not lean heavily on the earlier report [House Report 1502], but we do not disregard it entirely (as the Seventh Circuit did)."

The Court of Claims also agreed with the Seventh Circuit that the statutory language was ambiguous. In interpreting section 613A, the court relied on the specific wording of the statute. The court said that repeated use of the term "production" by Congress indicated an intent to allow depletion only with respect to income derived from or connected with actual extraction during the taxable year. The *Farmar* taxpayers had argued that lease bonuses were sufficiently

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108. XII-1 C.B. 64 (1933), revoked by G.C.M. 14,448, XIV-1 C.B. 98 (1935).
110. 677 F.2d at 602.
111. 689 F.2d at 1024.
112. *Id.* at 1023.
113. *Id.* at 1020.
114. *Id.* at 1021.
tied to production because of their economic relationship to royalties. They claimed that an increase in the royalty rate resulted in a decrease in the lease bonus payment. The court, however, viewed lease bonuses differently: "[T]he lease bonus is not tied to actual production, but only to the parties' expectation of production... The lease bonus, while it may affect the predetermined royalty rate, is not adjusted with or sufficiently connected to actual production levels."

The court's statutory analysis did not interpret the reference to section 613 as creating a requirement that production be measured with respect to income. Instead, this reference was interpreted as creating a two-tier test. The first tier of the test involved applying the 50 percent of gross income limitation of section 613 to the depletion computation. The second, more difficult tier required the taxpayers to demonstrate that this income related to actual production not exceeding the barrel limitations. This same argument was presented to the Seventh Circuit in Engle, but that court found "nothing in the statutory language [which] specifically [supported] the... conclusion that Congress intended to incorporate only the methods of calculating 'gross income from the property' and 'taxable income from the property' while abandoning gross income as the basis of the deduction."

The taxpayers in Farmar interpreted section 613A as establishing only a quantity limitation and not a production precondition. This interpretation would permit percentage depletion of lease bonuses provided there was production during the life of the lease. The Court of Claims, however, thought that such an interpretation would present problems unanswered by the statute. One such problem was that the statute does not provide a method of converting bonus income into "average daily production." Interestingly, this same court would allow cost depletion on lease bonus income. The cost depletion computation requires that the taxpayer allocate the adjusted basis of the property between the lease bonus and the estimated future royalties.

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115. Id. at 1021-22.
116. Id. at 1022 (emphasis in original).
117. Id.
118. 677 F.2d at 600.
119. 689 F.2d at 1019.
120. Id. at 1021 n.7.
121. Id. at 1018 n.2.
122. Cost depletion on bonus income is computed by multiplying the taxpayer's adjusted depletable basis by a ratio, the numerator of which is the lease bonus and the denominator of which is the sum of the lease bonus and royalties expected to be received. The formula can be illustrated as follows:
The theory of this computation is that the sum of the lease bonuses and the future royalties represents the total compensation to be received from the property. The theory considers the taxpayer as receiving two payments—a royalty and a proportionate share of the lease bonus—for each unit extracted from the lease and allows the deduction when the payment is received. The court did not explain why numerous estimates and allocations can be made for purposes of cost depletion, but are insurmountable for purposes of percentage depletion.

Another concern of the court was that lease bonuses are payable whether or not there is production. Under prior law, lease bonuses were eligible for depletion only if there was actual production on the property. Where the taxpayer received the lease bonus prior to production, he was allowed to deplete this income in the year of receipt. However, if the lease later proved to be unproductive, the taxpayer was required to include the depletion previously claimed as income in the year the lease was terminated. The Court of Claims did not explain why the recapture rule could not be applied to section 613A.

The Court of Claims' conclusion that lease bonuses do not qualify for percentage depletion under section 613A was supported by several reasons. One of the reasons was that the Commissioner "consistently" had advanced the same arguments in his various administrative pronouncements. The court did not consider the bonus exclusion rule of Revenue Ruling 81-266 to be inconsistent with either the Commissioner's position in Farmar or Revenue Ruling 81-44. The court also considered proposed regulation sections 1.613A-3(a)(4) example 5 and 1.613A-7(f)(1) to be examples of the consistent approach taken by the Commissioner. These regulations disallow percentage depletion on advance royalties and lease bonuses because the payments are not

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\text{Cost depletion} = \frac{\text{adjusted basis} \times \text{lease bonus}}{\text{lease bonus} + \text{estimated future royalty}}
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Future royalties can be estimated to be zero where the lease is in a "wildcat" area, and there is no evidence of conditions favorable to production. Collums v. United States, 480 F. Supp. 864 (D. Wyo. 1979).

Cost depletion can be claimed only where the taxpayer has a depletable cost basis in the property. The taxpayer's depletable basis is the adjusted basis of the property less the residual value of the land and improvements at the end of operations. Treas. Reg. § 1.1612-1 (1960).

123. 689 F.2d at 1021.
126. 689 F.2d at 1025.
127. Id. at 1025.
128. Id. at 1025 n.13.
received in the same year as physical extraction. The court, however, did not attempt to reconcile these proposed regulations with regulation 1.613-3(a)(4) example 7, which allows percentage depletion when physical extraction occurs in a year different than the year in which payment is received.

Percentage depletion also was denied on lease bonuses since the court did not consider the payments to be based on actual production. The payments in *Farmar* were due whether or not there was production on the lease. The implication of this interpretation is that if a payment is not computed on actual production, it is not given for actual production. This implication, however, conflicts with the historical definition of lease bonuses. They have been defined as compensation for the exploitation of minerals, even though computed on a per-acre basis. The conflict created by the court's statement can be resolved if "actual production" is read to mean actual production occurring during the same taxable year payments are received. This reading, however, would be inconsistent with the court's statement that percentage depletion possibly may be available on an advance royalty, because the advance royalty payment and physical extraction typically would occur in different years.

The reasoning of the Court of Claims, therefore, appears to consider the method of computing the payment as the key factor in determining the availability of percentage depletion. This reasoning would allow a payment to qualify for percentage depletion if it is based on the number of units produced, regardless of when physical extraction occurs. Percentage depletion, however, would not be available when the payment is computed on some method other than actual production, such as a lease bonus computed on an acreage basis. This result would not be changed by production under the lease during the year. The court did not explain why the method of computing the payment should produce a different result under section 613A when the nature of the payment is the same.

Despite the reasons advanced by the court explaining why lease bonuses do not qualify for percentage depletion under section 613A, the court's ultimate conclusion was that the taxpayer had failed to carry his burden of establishing that the deduction clearly was allowed. The court had relied primarily on the statutory language and, to a lesser extent, the legislative history and administrative pro-

129. *Id.* at 1021.
130. *Id.* at 1025.
131. *Id.*
nouncements in finding that the statute required a direct link between payment and physical extraction. The Court of Claims was not persuaded by the taxpayer's argument that the statute does not contain such a requirement or by his alternative argument that there was a sufficient link between payment and physical extraction.

The Tax Court also has addressed the problems of section 613A. In Glass, the Tax Court agreed with the Court of Claims and the Seventh Circuit that the legislative history was not especially helpful. However, unlike the other two courts, which found the statutory language to be ambiguous, the Tax Court found the language to be clear.

The Tax Court interpreted production as used in section 613A to mean the actual physical severance of the mineral from the soil. The court stated that the exemption from the general repeal is available only if the payment is received "with respect to actual production during the taxable year." As lease bonuses are not paid "with respect to actual production," but for "execution of the lease," the court believed that these payments did not fall within the exemption of section 613A. In dicta, the court stated that the same rule applies to advance royalties because these amounts are not paid "with respect to actual production" as that term is used in the oil and gas industry.

The Tax Court would allow cost depletion, but not percentage depletion, on lease bonuses. The court attempted to reconcile the different positions by stating that cost depletion is available to compensate the taxpayer for the diminution in the value of his mineral interest that is sustained by reducing his royalty share in future production. According to the court, nothing in section 613A(c) changed this rationale. Section 613A(c), however, did change the rationale of the percentage depletion deduction. The court's interpretation of this statute requires that there be actual production during the taxable year for the exemption to apply. Under this reasoning, the allowance of cost depletion on lease bonuses does not conflict with the denial of percentage depletion on these items.

The court's statement that cost depletion continues to be available
on lease bonuses is inconsistent with its statement that lease bonuses are paid for the execution of the lease. The statement also is inconsistent with the historical definition of lease bonuses. Lease bonuses have been defined by the United States Supreme Court as payments for the exploitation of the minerals on the lease, yet not payments for the execution of the lease. The court cited neither statutory language nor legislative history to support its novel definition.

The Tax Court decided Glass on the basis of a statutory analysis of section 613A. The court supported its interpretation by stating that there is no legislative policy supporting the taxpayer's position and by citing the practical problems involved in computing the limitation. The court did not address the treatment of income when production precedes income.

**Conclusion**

The key to solving the riddle of section 613A is defining the term "production." This term, however, is not defined in either the statute or the legislative history. The courts in the three cases analyzed herein agree that production includes past and current physical extraction. The courts do not agree on whether production also includes future physical extraction.

The Tax Court, in Glass, defined production as requiring physical extraction during the taxable year in which payment is received. This narrow definition does not allow percentage depletion with respect to payments received in advance of physical extraction, for it requires both physical extraction and payment in the same year. Denying percentage depletion on royalties when physical extraction occurs on December 31, but payment is not received until January 1, produces a result Congress clearly did not intend. Additionally, defining lease bonuses as payment for the execution of the lease conflicts with prior jurisprudence. Therefore, the Glass decision should not be followed.

The Court of Claims and the Seventh Circuit, however, each presented reasonable interpretations. The Court of Claims considers production to require a direct link between the payment received and physical extraction. The court does not consider this direct link to exist between a lease bonus and future extraction. This definition is broad enough to allow percentage depletion on advance royalties. The problem with the Court of Claims decision is not with the interpreta-

140. See text at notes 19-20, supra.
141. 96 T.C. at 954-55.
142. Id. at 959.
tion of the statute, but with the court's treatment of lease bonuses as being unrelated to production. A lease bonus, although paid at the time of the execution of the lease, is not given for the execution of the lease. The bonus is considered as given for the exploitation of minerals, even though it is not traceable to a specific unit of production. The result of the Court of Claims decision, therefore, cannot be justified unless lease bonuses are redefined by the United States Supreme Court or by legislative enactment.

The Seventh Circuit's interpretation is the broadest of the three cases analyzed. That court holds that production includes future, as well as current and past, production. The court regards section 613A as merely placing a limitation on production measured by gross income. This interpretation presents the fewest practical problems. Physical extraction and receipt of income rarely occur at the same time, especially in the case of a cash basis taxpayer. If production is linked to gross income, the timing problem is avoided. This approach also avoids the problem of distinguishing between past production and future production. An interpretation which allows percentage depletion in the former case, but not the latter, is not based on logic, but on public policy.

Although no approach is flawless, the approach of the Seventh Circuit should be adopted. This approach logically interprets section 613A and creates the fewest practical problems. This interpretation also avoids the problem of redefining a lease bonus or any hybrid arrangements which a clever draftsman may create.

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