NATURAL RESOURCES JOURNAL

Volume 22
Issue 1 *Winter 1982*

Winter 1982

Percentage Depletion Allowance Not Dependent on Duration of Lease Interest Tax Law

Jay D. Rosenblum

PERCENTAGE DEPLETION ALLOWANCE NOT DEPENDENT ON DURATION OF LEASE INTEREST TAX LAW

TAX LAW: The percentage depletion allowance granted under §§ 611 and 613 of the Internal Revenue Code of 1954 may not be denied to lessees engaged in coal extraction because their leases are subject to termination by the lessor on 30 days notice. *United States v. Swank,* 101 S.Ct. 1931 (1981).

Three separate lessees of coal mines in Kentucky,[1] Pennsylvania[2] and West Virginia[3] brought tax refund suits claiming entitlement to the percentage depletion allowance.[4] The tax refund suits covered separate tax years but were consolidated in the Court of Claims.[5] In each case, the taxpayers operated as lessees under written contracts. The contracts gave the lessees the right to extract coal and to determine its sale price. The lessors received a fixed royalty per ton of extracted coal. Each lease provided a termination clause whereby the lessor could cancel the agreement upon 30 days notice.[6]

In the Kentucky case, the lessee, Black Hawk, was required to pay a royalty of 25 cents per ton of coal or $5,000.00 per year, whichever was larger. Black Hawk was also responsible for all taxes on the coal, its plant and equipment. Black Hawk paid independent contractors a fixed price per ton to extract the coal.[7]

In Pennsylvania, the lessee, Swank, operated under two separate leases with Northumberland County, Pennsylvania. Swank made royalty payments of 35 cents per ton to the county, and also invested heavily in roads and equipment.[8]

---

1. Black Hawk Coal Company, Incorporated, operated mines in Hike County, Kentucky.
2. Swank was an independent coal mine operator mining in Northumberland County, Pennsylvania. Swank v. United States, 602 F.2d 348, 352 (1979).
3. Bull Run Mining Company operated in West Virginia.
4. The percentage depletion allowance is codified in the Internal Revenue Code of 1954, Sections 611 and 613. Generally, the allowance is computed as a percentage of gross income from the property. Gross income does not include rents or royalties paid by the taxpayer. Section 613 contains other limitations on the allowance. In United States v. Swank, 101 S.Ct. 1931 (1981), the I.R.S. denied the percentage depletion allowance to the lessees because their legal interest in the coal was subject to cancellation, or terminable, on short notice. United States v. Swank, 101 S.Ct. 1931, 1936 (1981).
5. Black Hawk's refund suit covered tax years 1970-1972; Swank's, 1966-1967; Bull Run's, 1974. United States v. Swank, 101 S.Ct. 1931, 1933, 1934 (1981).
6. United States v. Swank, 101 S.Ct. 1931, 1933 (1981).
7. *Id.* at 1934.
8. *Id.*

The West Virginia lessee, Bull Run, operated under a renewable five-year lease. The lease provided for royalties of 25 cents per ton and, unlike the other leases, gave the lessor the right of first purchase if it met the lessee's price.[9]

Only the lessees made claim to the percentage depletion allowance. Lessors of coal and iron ore are required to treat royalty income as capital gains and may not claim the percentage depletion allowance under the Internal Revenue Code.[10]

The United States Court of Claims held that the termination clause in the leases, allowing the lessor to cancel on 30 days notice, did not deprive the lessors of sufficient economic interest so as to preclude them from claiming the percentage depletion allowance.[11] The United States Supreme Court affirmed.[12]

The opinion began by noting that Congress had modified the original purpose behind the depletion allowance. While the allowance originally contemplated capital recoupment,[13] a shift to a percentage allowance more clearly reflected an emphasis on mineral development.[14] As a result, eligibility for the allowance presently depends on the parties' economic interest in the coal, not on their capital investment.[15] Since the lessors are barred from claiming the allowance, an insufficient economic interest by the lessees in the coal meant no party could benefit from the allowance.[16] The government recognized this, but argued that the allowance should not be granted to any party if the lessee's economic interest was terminable on short notice.[17]

The government challenged the lessees' eligibility for the allowance

---

9. *Id.*

10. I.R.C. § 631(c) requires the lessor to treat royalty income as a capital gain. The lessor is not entitled to the percentage depletion deduction. United States v. Swank, 101 S.Ct. 1931, 1936 n. 11 (1981), notes that because the lessor's gain is measured by the difference between his cost per ton and his royalty, he receives a direct recoupment of his capital investment through cost depletion.

11. Swank v. United States, 602 F.2d 348 (1979).

12. United States v. Swank, 101 S.Ct. 1931 (1981).

13. *Id.* at 1935, *citing* Commissioner v. Southwest Exploration Co., 350 U.S. 308, 312 (1956).

14. *Id.*

15. The "economic interest" test was developed in Palmer v. Bender, 287 U.S. 551, 557 (1933). *See also* Lynch v. Alworth Stephens Co., 267 U.S. 364, 369 (1925). The "economic interest" test is presently required by Treasury Regulation, 26 C.F.R. § 1.611-1(b) (1980), which reads:

> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital.

16. United States v. Swank, 101 S.Ct. 1931, 1936 and n. 11, 12, p. 1936 (1981).

17. *Id.* at 1936.

on two grounds. First, the government contended that the lessees possessed a mere economic advantage over the coal, not an economic interest in it, because their leases were terminable upon 30 days notice.[18] The government relied on two prior Supreme Court decisions which held that contract miners lacked sufficient economic interest in coal to entitle them to the allowance. The Court distinguished both cases on the basis of the contractor's interest in the coal. In *Parsons v. Smith,*[19] the mining contractors had no interest in the coal before and after mining it and no right to sell it to third parties. In *Paragon Jewel Coal Co. v. Commissioner,*[20] the contractors had no control over the coal after delivery, no responsibility for its sale and no knowledge of its subsequent sale price. In both cases terminability of the lease was only one factor among many the Court considered in holding the contractors ineligible for the allowance.[21] The Court noted that the lessees in the *Swank* case possessed a legal interest in the coal both before and after it was mined, as well as the freedom to dispose of it in the market place.[22]

Second, the government argued that terminability made the lessee's interest too tenuous to sustain eligibility for the allowance.[23] If the price of coal increased, "practical economics" would force the lessor to terminate the lease interest in favor of a more advantageous disposition of the coal.[24] The Court rejected this argument on three grounds.[25] First, royalty rates constitute a small percentage of total cost in coal mining. Other factors, such as quantity of coal extracted and a satisfactory business relationship, are equally important. The fact that no actual termination occurred under any of the leases, even though coal went up in value, defeated the government's argument. Second, the Court, considering congressional intent, stated that the allowance was not limited to mining operations with enough bargaining power to avoid termination clauses. Third, the Court emphasized that no rational basis existed for tying the allowance to the time the

18. *Id.* at 1937.

19. Parsons v. Smith, 359 U.S. 215 (1959).

20. Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624 (1965).

21. Parsons, 359 U.S. 215 (1959), lists seven factors to consider, including (1) whether the investment is in equipment or in the coal in place; (2) whether the equipment investment is recoverable through depreciation, not depletion; (3) whether terminability of the lease was provided; (4) whether capital interest was surrendered to the lessees by the landowners; (5) whether the landowners had complete control over the coal's disposition; (6) whether the contractors recovered part of the proceeds or a fixed sum per ton; and (7) whether the contractors looked only to the landowners for sums due them.

22. United States v. Swank, 101 S.Ct. 1931, 1938 (1981).

23. *Id.*

24. *Id.* at 1939.

25. *Id.*

taxpayer operates the mine. Congressional policy favoring coal extraction through allowances is not dependent on "whether the entire operation is conducted by one taxpayer over a prolonged period of time or by a series of taxpayers operating for successive shorter periods."[26]

Thus, the Court ruled directly on terminability, holding that the unexercised right of termination does not destroy the lessee's economic interest in the coal.

In a vigorous dissent, Justice White, joined by Justice Stewart, criticized the majority for overstepping the proper role of the judiciary. White said determination of entitlement to the allowance rested with the Internal Revenue Service. The Court should limit review to considering whether the Service's interpretation of the statute was responsible.[27] According to White, entitlement to the allowance still depends on capital investment, tested by the parties' economic interest in the coal. The Service has consistently concluded that duration of a leasehold interest is critical in determining allowance eligibility.[28] This conclusion is reasonable and merits deference from the Court. White also asserted that the right to mine to exhaustion is a mere economic advantage and the costs of coal mining do not alone create an economic interest in coal.[29] Finally, White claimed that the right to sell coal in the market place is "illusory" because the lease can be terminated at will by the lessor.[30]

This case is important not only for the rule of tax law it expounds but also because the case illustrates differing perspectives on the Court's proper role in reviewing agency decisions. Whether the Court will continue to follow an activist role when dealing with the Internal Revenue Service or will adopt the more passive and limited role advocated by Justice White remains to be seen.

JAY D. ROSENBLUM

26. *Id.*

27. *Id.* at 1940.

28. *Id.* at 1941, *citing* in n. 1 (of dissent) to Rev. Rul. 74-506, 1974-2 C. B. 178-179 and Rev. Rul. 77-341, 1977-2 C. B. 204-205.

29. United States v. Swank, 101 S.Ct. 1931, 1943 (1981).

30. *Id.* at 1944.