

PROPOSED NEW REGULATIONS FOR OIL AND GAS AND MINES UNDER SECTION 613

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On July 26, 1968 new proposed regulations for oil and gas and mines under Section 613 of the Internal Revenue Code were issued in which especially drastic changes were proposed for oil and gas. Interested taxpayers were given 45 days within which to present comments and objections to the proposals.

I. OBJECTIONABLE FEATURES OF THE ORIGINAL PROPOSED REGULATIONS

The general objection raised was that the Commissioner had exceeded his authority in attempting to overrule existing Court decisions, to legislate in areas where Congress has refused to act, and to change long standing administrative practices where there has been no change in the statute but it has been re-enacted without change in the interim. Further the regulation changes represent an effort to reduce the depletion allowance by regulation instead of asking Congress for new legislation on the subject.

Some of the more specific objections to the proposed regulations (as originally proposed) are discussed below.

Present regulations provide for depletion on oil and gas wells¹ but give no definition of oil and gas wells. The proposed regulations define gas wells as those producing predominantly natural hydrocarbon gases and oil wells as those producing predominantly natural petroleum liquids.² Excluded are wells producing liquid petroleum which has been obtained by heating the producing formation with steam or other heat.³ If the product is liquid petroleum, there appears to be no statutory authority to refuse to classify the well as an oil well because it was necessary to first heat the formation to liquefy the product.

Existing regulations provide for a 15 percent rate on marble unless sold for use as concrete aggregates or similar uses, in which case the rate is 5 percent.⁴ In the proposed regulations it is provided that crushed marble sold for terrazzo floors shall be considered for use as a concrete ag-

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¹ Treas. Reg. § 1.613-2(a)(1)(i) (1960).

² Proposed Treas. Reg. § 1.613-2(a)(1)(i), 33 Fed. Reg. 10700 (1968).

³ Proposed Treas. Reg. § 1.613-2(c)(6), 33 Fed. Reg. 10702 (1968).

⁴ Treas. Reg. § 1.613-2(a)(3), T. D. 6841, 1965-2 CUM. BULL. 201.

gregate.⁵ This is not true, for the crushed marble is used as a topping for the concrete to produce a marble floor and not as an aggregate. Present regulations provide a 23 percent depletion rate for sulphur produced from a metal mine.⁶ The new proposed regulations propose to limit the depletion allowance for sulphur produced from metal mines to 15 percent.⁷ There appears to be no statutory authority for this change in administrative position.

In 1967 the 10th Circuit Court of Appeals decided *Skelly Oil Co. v. United States*⁸ holding that if gross income from oil and gas, on which depletion has been claimed, is later refunded the deduction of the full refund is allowable and need not be reduced by the depletion. At the time the proposed regulations were issued this case was pending before the United States Supreme Court on the Government's application for certiorari. The proposed regulations provide that the deduction shall be limited to the amount refunded reduced by the depletion previously allowed.⁹ This was an attempt to reverse the Circuit Court by regulation, without waiting for action by the Supreme Court. Later the Supreme Court reversed the Circuit and held that the refund must be reduced by the depletion.¹⁰ The regulation thus now correctly reflects the law, although at the time it was issued it did not. Further, it is issued under the wrong section. Instead of Section 613, it should be issued under Section 1341.

In the present regulations it is provided that, for oil and gas wells, gross income from the property means the amount for which the production is sold in the immediate vicinity of the well.¹¹ The proposed regulations changed this to the immediate vicinity of the wellhead. It is further provided that desulphurization, separation, scrubbing and absorption shall be treated as non-mining processes. If there is an established market price at the wellhead, it may be used; otherwise, the gross income at the wellhead shall be determined by the proportionate profits method, apportioning income in accordance with costs. It is further provided that if the sale of oil and gas is between members of a controlled group the gross income shall be determined by the proportionate profits method.¹²

This proposed change in long standing administrative practice was the most serious change proposed for the oil and gas industry. Oil is never

⁵ Proposed Treas. Reg. § 1.613-2(a)(3), 33 Fed. Reg. 10701 (1968).

⁶ Treas. Reg. § 1.613-2(c)(2) (1960).

⁷ Proposed Treas. Reg. § 1.613-2(c)(2)(v) and (vi), 33 Fed. Reg. 10702 (1968).

⁸ 392 F.2d 128 (10th Cir. 1967).

⁹ Proposed Treas. Reg. § 1.613-2(c)(8), 33 Fed. Reg. 10702 (1968).

¹⁰ *United States v. Skelly Oil Co.*, 69-1 U.S. Tax Cas. 9343 (Sup. Ct.).

¹¹ Treas. Reg. § 1.613-3(a) (1960).

¹² Proposed Treas. Reg. § 1.613-3(a), 33 Fed. Reg. 10703. See also Proposed Treas. Reg. § 1.613-3(j), 33 Fed. Reg. 10707 (1968).

sold at the wellhead but at the stock tanks after first separating out gas, hydrogen sulphide, water and sediment. Clean oil at the stock tank in the United States is then sold on the basis of a standard price for each grade, posted by the various pipeline companies. It is only in the case of foreign oil that there is no posted price.

For the entire fifty-six years of the income tax, depletion on oil has been based on the posted prices. The proposed regulation would void this practice. Under the proposed regulation, every oil producer in the United States would have to compute his gross income at the wellhead by the proportionate profits method or some other method approved by the Commissioner.

With respect to gas, the Commissioner has always permitted separation of oil and water and sale at the separators. Further, in a cycling operation, the 5th Circuit Court has held that absorption is a mining process necessary to separate the oil from the gas.¹³ To exclude as non-mining processes those which are necessary to produce a salable raw mineral product violates the ruling of the Supreme Court that the cut-off point for extractive operations is the point at which a non-integrated producer normally sells his crude product.¹⁴

Under the proposed regulation, mining ends when the oil and gas is brought to the wellhead. Since there is no posted price at that point, gross income at the well must be computed by apportioning income between mining and non-mining. The proportionate profits method, to be used unless a different method is approved by the Commissioner, was contained in regulations proposed in 1966 applicable solely to mines. On July 26, 1968 this regulation was made final.¹⁵ For the first time it is now proposed to use this regulation for oil and gas. Thus the oil industry has never had an opportunity to object to it.

The method is wholly inapplicable to oil and gas because operating expense of oil wells is low and of gas wells is negligible. The method allocates nearly all income to non-mining activities. For years, gross income for gas has been determined by the Commissioner by use of the Fiske Formula.¹⁶ In 1959, the Treasury sent a bill to Congress proposing to enact the Fiske Formula into law, but the bill was not enacted. Why should

¹³ Scofield v. La Gloria Oil and Gas Co., 268 F.2d 699 (5th Cir. 1959).

¹⁴ United States v. Cannelton Sewer Pipe Co., 364 U. S. 76 (1960).

¹⁵ Treas. Reg. § 1.613-3(d), T. D. 6965, 1968, 2 CUM. BULL. 265.

¹⁶ This is a formula developed by the author (while he was Chief Oil and Gas Engineer in the Dallas Region of the Internal Revenue Service) to compute gross income subject to depletion for cycling plants. In a cycling plant, the gas and heavier hydrocarbons such as gasoline are produced together and run through a plant, where the heavy hydrocarbons are separated out and sold, and the gas is reinjected into the producing formation. Under the formula, there is deducted from the sale price of the products the operating expense of the plant, the depreciation on the plant, and a reasonable return on the investment in the plant, usually considered to be 10 percent.

this method now be abandoned and the wholly inappropriate proportionate methods substituted?

The new regulations provide that sales between related entities should be disregarded in all cases. This dogmatic position is not warranted however, for there is no basis for questioning the price when a subsidiary sells oil to its parent at the same posted price that is paid to other producers. It would be proper to ignore the transaction when the sales are not at arm's length.

There is a provision in the proposed regulations for a method other than the proportionate profits method, but this alternative must be approved by the Commissioner.¹⁷ Several alternate methods are suggested, but the Fiske Formula is not one of them. The statement in the proposed regulation that the cases where the proportionate profits method fails will be infrequent¹⁸ indicates that approval of other methods will be difficult to obtain.

Section 613(C)(4)(H) grants authority to the Commissioner to issue regulations designating which treatment processes shall be considered as mining. The proposed regulation under this section provides that in order to get a process declared a mining process the taxpayer must petition for a change in the regulation.¹⁹ This is unworkable because, in practice, it has been found easier to have a statute amended than a regulation. The proposed regulation states that the Commissioner has flexibility in applying Section 613(C)(4)(H) and then lists items which will not be declared mining processes.²⁰ This is a misinterpretation of the statute, which does not grant flexibility, but only confers authority to interpret. The prohibition of a physical or chemical change would preclude (H) processes for minerals listed in Section 613(C)(4)(D) as to which nearly all processes produce either a physical or chemical change.

It is provided in the proposed regulations that in order for processes applied at a plant, removed from the mine, to be treated as mining processes it must be shown that it was not feasible to apply the processes at the mine.²¹ This position relies upon no authority in the statute, and the lack of a definition of feasibility will lead to litigation. The proposed regulations treat thermal drying as a non-mining process unless it occurs to facilitate a mining process.²² This regulation makes no distinction between the removal of free water and water of crystalization. Removal of free water has always been treated as a mining process. Blending with other

¹⁷ Proposed Treas. Reg. § 1.613-3(d)(2), 33 Fed. Reg. 10703 (1968).

¹⁸ Proposed Treas. Reg. § 1.613-3(d)(2)(i), 33 Fed. Reg. 10703 (1968).

¹⁹ Proposed Treas. Reg. § 1.613-3(f)(5)(i), 33 Fed. Reg. 10704 (1968).

²⁰ Proposed Treas. Reg. § 1.613-3(f)(5)(i)(b), (c), (d), and (e), 33 Fed. Reg. 10704, 10705 (1968).

²¹ Proposed Treas. Reg. § 1.613-3(f)(5)(iii)(g), 33 Fed. Reg. 10705 (1968).

²² Proposed Treas. Reg. § 1.613-(f)(5)(iv)(d), 33 Fed. Reg. 10706 (1968).

materials is made a non-mining process by the proposed regulations.²³ This is too broad and would preclude blending minerals extracted from the same deposit to achieve a uniform product. Processes effecting a chemical change are treated as non-mining processes.²⁴ This regulation is too broad. If the purpose is only to make a separation, the process should be treated as a mining process.

It is provided in the proposed regulations that in computing taxable income subject to depletion, net operating losses shall be deducted from gross income.²⁵ This is a complete about face since in 1960 the Commissioner issued a Revenue Ruling holding that net operating losses should not be so deducted.²⁶ There has been no change in the statute to warrant such an about face. To apply the net operating loss deduction in this manner is to limit depletion twice or more for the same loss, once in the year of loss and again in each year to which the loss is carried. This violates the concept of annual accounting which is well settled.²⁷ In the President's Tax Message to Congress in 1963 he proposed that deductions for a mineral property in excess of income should be carried to other years, but Congress rejected this proposal. Testimony at the hearings showed that such action would violate the concept of annual accounting. In view of the rejection of the proposal by Congress the Commissioner is without authority to promulgate it by regulation.

The proposed regulations prohibit the inclusion of cash discounts in gross income from the property.²⁸ This provision is contrary to case law²⁹ and to the previously announced position of the Commissioner.³⁰ Since the proposed regulation is contrary to case law, it amounts to an attempt by the Commissioner to reverse the decisions of the Courts by regulation.

It is proposed that in computing taxable income from the property development expense shall be used, unreduced by dry and bottom hole contributions.³¹ This is a departure from a practice of 30 years' standing. Ever since the Supreme Court decided the *Wilshire* case,³² holding that

²³ Proposed Treas. Reg. § 1.613-3(g)(6)(vi), 33 Fed. Reg. 10706 (1968).

²⁴ Proposed Treas. Reg. § 1.613-3(g)(6)(vii), 33 Fed. Reg. 10706 (1968).

²⁵ Proposed Treas. Reg. § 1.613-4(a) and Proposed Treas. Reg. § 1.613-4(c)(7), 33 Fed. Reg. 10707, 10708 (1968).

²⁶ Rev. Rul. 60-164, 1960-1 CUM. BULL. 254.

²⁷ *Commissioner v. Gordon*, 391 U.S. 83 (1968); *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *Hugoton Prod. Co. v. United States*, 349 F.2d 418 (Ct. Cl. 1965).

²⁸ Treas. Reg. § 1.613-3(e)(1), T. D. 6965, 1968-2 CUM. BULL. 273 made applicable to oil and gas by Proposed Treas. Reg. § 1.613-4(c)(1), 33 Fed. Reg. 10707 (1968).

²⁹ *Montreal Mining Co.*, 2 T.C. 688 (1943); *Standard Lime and Cement Co. v. United States*, 329 F.2d 939 (Ct. Cl. 1964); *California Portland Cement Co. v. United States*, 67-1 U.S. T.C. 9458 (D. C. Cal. 1967); *California Portland Cement Co. v. Riddell*, 59-1 U.S.T.C. 9156 (S. D. Cal. 1959).

³⁰ Rev. Rul. 55-13, 1955-1 CUM. BULL. 285 as modified by Rev. Rul. 60-257, 1960-2 CUM. BULL. 197.

³¹ Proposed Treas. Reg. § 1.613-4(c)(2), 33 Fed. Reg. 10707 (1968).

³² *Helvering v. Wilshire Oil Co.*, 308 U.S. 90 (1939).

development expense is a deduction in computing taxable income from the property, bottom hole and dry hole payments have always been applied by the Commissioner to reduce drilling costs. These payments are made by adjoining operators to the driller of a well as a contribution to the cost of his well. The well in such a case has two purposes: (1) to test the owner's property and (2) to test the property of the adjoining owner. Dry hole payments are made only if the well, when drilled, is a dry hole. Bottom hole payments are made on completion of the well, even though it is a producer. In the case of a dry or bottom hole agreement the costs of the well are shared. The owner's part is paid by him and the adjoining owner's part is paid by such adjoining owner. Only the part paid by the owner is a proper charge against his oil property. Further, this regulation is inconsistent with the one immediately preceding it, permitting discounts to be credited to costs.³³ It is also inconsistent with Revenue Rulings permitting miscellaneous lease earnings to be applied as credits to operating expense.³⁴ To fail to apply the credits against the drilling expense will result in charging the taxpayer with an expense he did not incur. The Supreme Court has held that payments made by another do not result in a cost incurred by the owner of the property.³⁵

The proposed regulations require that there shall be subtracted from gross income in computing taxable income, a reasonable portion of the selling expenses and trade association dues applicable to refining and manufacturing, incurred by an integrated producer.³⁶ Differing results will flow from this proposal, as between integrated and non-integrated producers, for identical oil in the same field. The non-integrated producer will have none of this expense; the integrated producer will have it. The regulations are not specific enough and will encourage revenue agents to allocate substantial amounts of selling expense and trade association dues to production where none should in fact be allocated. The test should be, what would the selling expense and trade association dues amount to if the taxpayer marketed only the raw mineral production?

A significant example is oil and gas. If the raw mineral is marketed, there is no selling expense; the pipeline "comes and gets it." But, if refined products are produced and marketed, there is substantial expense. Clearly, none of this selling expense belongs to production. The same thing is true of trade association dues. If the association is one having non-integrated producers as members, part of the dues belongs to production. But no part of the dues paid to an association, all of whose members are refiners, would belong to production. The regulation should rec-

³³ Proposed Treas. Reg. § 1.613-4(c)(1), 33 Fed. Reg. 10707 (1968).

³⁴ Rev. Rul. 66-226, 1966-2 CUM. BULL. 239; Rev. Rul. 68-214, 1968-1 CUM. BULL. 299.

³⁵ *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943).

³⁶ Proposed Treas. Reg. § 1.613-4(c)(4) and (6), 33 Fed. Reg. 10707 (1968).

ognize these facts and apply to production only those charges properly belonging to production.

It is thus seen that the proposed regulations contain many sweeping and radical changes which are without foundation in law.

II. WITHDRAWAL AND REISSUE OF PROPOSED OIL AND GAS REGULATIONS

As a result of the receipt of a veritable avalanche of protests from the oil industry, the oil and gas regulations, as originally proposed on July 26, 1968, were withdrawn and new proposed regulations substituted therefor on October 2, 1968. These new proposed regulations met most of the serious objections for oil and gas. The important changes are examined below.

The phrase "immediate vicinity of the wellhead" was abandoned and there was substituted therefor the "immediate vicinity of the well", as in the present regulations. It was also provided that the price used for determining gross income shall be the sale price after the application of production processes associated with extraction.³⁷ It is provided that for related groups the sale shall be recognized if the price is shown to be at arm's length.³⁸

Production processes associated with extraction are listed, for oil wells, as including gathering by use of flow lines, operation of mechanical separators, treatment to separate out water, removal of hydrogen sulphide, storage in stock tanks, gauging, disposal of water and assistance of production by the injection of water, gas, steam or miscible materials or use of a fireflood. For gas the processes include gathering, mechanical separators, control of hydrogen sulphide, removal of water, measurement, storage of condensate, and injection of water or gas into the formation to assist production.³⁹

Non-mining processes for oil are defined as removal and recovery of sulphur, barge transportation and pipeline transportation. For gas the processes are recovery of helium and sulphur, compression to introduce into a pipeline, and processes applied in natural gasoline and cycling plants.⁴⁰ It is provided, however, that if the process is a production process, such as mechanical separation, it will be treated as a production process even though performed at a cycling plant after transportation of the gas from the well to the plant.⁴¹

The reissued regulations provide for the use of the Fiske Formula in

³⁷ Proposed Treas. Reg. § 1.613-3(a)(1)(i)(a), 33 Fed. Reg. 14707 (1968).

³⁸ Proposed Treas. Reg. § 1.613-3(a)(1)(i)(b) and Proposed Treas. Reg. § 1.613-3(b)(2)(ii), 33 Fed. Reg. 14707, 14708 (1968).

³⁹ Proposed Treas. Reg. § 1.613-3(a)(2), 33 Fed. Reg. 14707 (1968).

⁴⁰ Proposed Treas. Reg. § 1.613-3(a)(3)(i), 33 Fed. Reg. 14708 (1968).

⁴¹ Proposed Treas. Reg. § 1.613-3(a)(3)(ii), 33 Fed. Reg. 14708 (1968).

determining gross income for the computation of depletion, subject to the approval of the Commissioner.⁴² Since the Commissioner now recognizes that the proportionate profits method is inapplicable to oil and gas, it can be assumed that the approval will be granted.

A. *Hearings on the Proposed Regulations*

Beginning on October 11, 1968, hearings were held in Washington on the proposed regulations at which a large number of interested industry representatives appeared. As a result of these hearings, further changes in the proposed regulations were made, and all of these changes were incorporated into what was designated as a Discussion Draft.

B. *Reissue of Entire Proposed Regulations*

The regulations as originally proposed were prepared by the officers of the Johnson administration. Changes proposed by those officers were incorporated into the Discussion Draft described above. The officers of the Nixon administration, who had not yet had a chance to make a careful study of the Draft, decided to resubmit it to the public for comments before putting it in final form. Accordingly, the Discussion Draft was published in the Federal Register on March 27, 1969. The significant changes in the Draft from the regulations as originally proposed on July 26, 1968, and as reissued for oil and gas on October 2, 1968, are discussed below.

The definition of natural hydrocarbon gases has been changed to exclude gases produced from natural deposits of other minerals including asphalt, coal, rock asphalt, tar sands, bituminous sands, kerogen, oil shale or gilsonite.⁴³ A definition of asphalt, bituminous sands, tar sands and rock asphalt has also been added, which defines them as naturally occurring in a solid or semi-solid state.⁴⁴

In the section which increases the rate on sulphur to 27½ percent if produced from an oil and gas well and reduces it to 15 percent if produced from a metal mine, a sentence is added to provide that if the sulphur is obtained from other minerals which are not natural sulphur in place, the depletion rate shall be that of such other mineral.⁴⁵ Example (2) in the original regulations pertaining to sulphur produced from a metal mine has been deleted from the reissued regulations.⁴⁶ A sentence has been inserted to provide that the rate of depletion on gypsum and anhydrite is 15 percent even though sulphur may be produced from them, because they are not sulphur in their natural state.⁴⁷

⁴² Proposed Treas. Reg. § 1.613-3(d)(2)(viii)(d), 33 Fed. Reg. 14709 (1968).

⁴³ Proposed Treas. Reg. § 1.613-2(a)(1)(i), 34 Fed. Reg. 5729 (1969).

⁴⁴ Proposed Treas. Reg. § 1.613-2(b)(8), 33 Fed. Reg. 5730 (1968).

⁴⁵ Proposed Treas. Reg. § 1.613-2(c)(2)(v), 33 Fed. Reg. 5730 (1968).

⁴⁶ Proposed Treas. Reg. § 1.613-2(c)(2)(vi), 33 Fed. Reg. 5730, 5731 (1968).

⁴⁷ Proposed Treas. Reg. § 1.613-2(c)(7), 33 Fed. Reg. 5731 (1968).

The term "condensate" has been added to the words "oil and gas" in discussing the determination of the price to be used in computing gross income.⁴⁸ The definition of mining and non-mining processes contained in the reissued oil and gas regulations has been omitted, although the section number is shown at the bottom of the page.⁴⁹ The rules for computing gross income by means of a representative field price for mines have been expanded to include rules for oil and gas wells.⁵⁰ The rules stating the criteria to be used in determining whether a mineral is of like kind and grade have also been expanded to include rules for oil and gas.⁵¹

The requirement for attaching price support data to the return has been modified by providing that if the material is bulky a summary may be attached to the return, and the detailed information made available for examination by a revenue agent.⁵² In the discussion of the limitation on gross income where the mineral price plus costs of non-mining activities exceeds the selling price of the product, an example has been added for oil produced from an off-shore operation.⁵³ In connection with cases where the proportionate profits method is inappropriate, it is provided that when costs paid to produce and market the product are not substantial as compared to the sale price, the proportionate profits method is inapplicable.⁵⁴

With respect to the submission of information to accompany a request to use an alternate method of gross income computation, it is provided that computations by the proportionate profits method need not be submitted where such method is inappropriate.⁵⁵ The provision for reducing sales prices of minerals by purchased transportation is expanded to include oil and gas.⁵⁶

In the section dealing with the definition of purchased transportation, it is now provided that the fact that the seller does not bill the transportation separately shall not be controlling.⁵⁷ The definition of shipping grade of a mineral has been expanded to provide that a major portion has been converted to this grade when more than 50 percent has been so converted.⁵⁸

The regulations have been changed so as to relist the processes approved as mining under Secs. 613(C)(4)(C) and (H) of the Internal

⁴⁸ Proposed Treas. Reg. § 1.613-3(a)(1)(iii), 33 Fed. Reg. 5731 (1968).

⁴⁹ Proposed Treas. Reg. § 1.613-3(a)(1)(iv), 33 Fed. Reg. 14707 (1968).

⁵⁰ Proposed Treas. Reg. § 1.613-3(c)(1), 34 Fed. Reg. 5732 (1969).

⁵¹ Proposed Treas. Reg. § 1.613-3(c)(2)(ii) and (iii), 33 Fed. Reg. 5733 (1968).

⁵² Proposed Treas. Reg. § 1.613-3(c)(5), 33 Fed. Reg. 5733 (1968).

⁵³ Proposed Treas. Reg. § 1.613-3(c)(6), 33 Fed. Reg. 5733, 5734 (1968).

⁵⁴ Proposed Treas. Reg. § 1.613-3(d)(2)(ii), 33 Fed. Reg. 5734 (1968).

⁵⁵ Proposed Treas. Reg. § 1.613-3(d)(2)(iv)(1), Fed. Reg. 5735 (1968).

⁵⁶ Proposed Treas. Reg. § 1.613-3(e)(2)(i), 33 Fed. Reg. 5736 (1968).

⁵⁷ Proposed Treas. Reg. § 1.613-3(e)(2)(iii), 33 Fed. Reg. 5736 (1968).

⁵⁸ Proposed Treas. Reg. § 1.613-3(f)(3)(iii), 33 Fed. Reg. 5736 (1968).

Revenue Code. These are listed as crushing, coarse grinding, screening, drying to remove free water, washing and cleaning, processes equivalent to sintering and transportation from mine to plant.⁵⁹ Definitions of some of these terms are given in the next section.⁶⁰

The requirement that the taxpayer prove that it is not feasible to conduct treatment processes at the mine has been changed to provide that the transportation will be allowed as a mining process unless the facts show that the location of the processes has been established at the place where they are located for the purpose of increasing the depletion allowance and not for a sound business purpose.⁶¹

The rules for computing gross income for a controlled group have been deleted and a definition of a controlled group has been substituted.⁶² The provision in the originally proposed regulations that dry and bottom hole payments shall not be used to reduce intangible drilling and development expense has been deleted.⁶³ The regulations have been revised to provide that selling expenses to be deducted from gross income shall be limited to those applicable to sale of the raw mineral product. Selling expenses of a refined product shall be allocated to the raw mineral only insofar as they would apply to a non-integrated producer. If the amount can not be reasonably determined then one-half of the selling expense as apportioned on operating expenses shall be so applied.⁶⁴

The requirement for allocating part of the trade association dues of an integrated producer to production is retained and while the original regulation stated that allocation in proportion to expense was not necessarily required, the reissued regulation changes this to read that an allocation in this manner is an acceptable method.⁶⁵ The proposal in the first revision of the regulations to use a net operating loss to limit depletion in the year to which the loss is carried⁶⁶ has been deleted from the reissued regulations.

C. *Objections to the Reissued Regulations*

The changes which have been made in the regulations as originally proposed have gone a long way toward meeting the objections raised thereto. However, the regulations are not yet fully acceptable. Objections can still be raised.

The revised regulations still hold that marble used for a terrazzo floor

⁵⁹ Proposed Treas. Reg. § 1.613-3(f)(5)(ii), 33 Fed. Reg. 5737 (1968).

⁶⁰ Proposed Treas. Reg. § 1.613-3(f)(5)(iii), 33 Fed. Reg. 5737 (1968).

⁶¹ Proposed Treas. Reg. § 1.613-3(f)(5)(ii)(g), 33 Fed. Reg. 5737 (1968).

⁶² Proposed Treas. Reg. § 1.613-3(j), 33 Fed. Reg. 5738 (1968).

⁶³ Proposed Treas. Reg. § 1.613-4(c)(2), 33 Fed. Reg. 5739 (1968).

⁶⁴ Proposed Treas. Reg. § 1.613-4(c)(4)(i) and (ii), 33 Fed. Reg. 5739 (1968).

⁶⁵ Proposed Treas. Reg. § 1.613-4(c)(6), 33 Fed. Reg. 5739 (1968).

⁶⁶ Proposed Treas. Reg. § 1.613-4(c)(7), 33 Fed. Reg. 10708 (1968).

is used as a concrete aggregate. As has been previously pointed out, the marble is not used as an aggregate, but as a topping to produce a marble floor.⁶⁷

The regulations still limit depletion on sulphur produced from a metal mine to 15 percent. As has been stated, this is an administrative change for which there appears to be no statutory authority.⁶⁸

The regulations as now written exclude as a non-mining process, in computing gross income, the recovery of distillate in a cycling plant from a gas well by absorption.⁶⁹ In the *La Gloria* case⁷⁰ the 5th Circuit Court of Appeals held that absorption was a production process necessary to separate the distillate from the gas. The regulation in its present form will, therefore, result in further litigation. In a cycling plant the distillate is removed from the gas and marketed, while the dry gas is reinjected into the formation to maintain reservoir pressure and avoid condensation in the sand. The absorption process is an indispensable part of the severance of the distillate from the gas produced from the lease and is, therefore, a production process. Because it is extractive in nature, it is a production process and not a manufacturing process.

The rules contained in the regulations for the determination of a representative market or field price are not entirely satisfactory when applied to foreign oil and gas operations. The rules are primarily based on the principles involved in the taxation of hard minerals.⁷¹ They state that the weighted average of competitive selling prices of minerals of like kind and grade as the taxpayer's, benefited only by mining and extraction processes, in the taxpayer's "actual or potential lines of commerce", and in his "relevant markets", is an important factor in determining his price. No definition is given of either "actual or potential lines of commerce" or "relevant markets" and these terms are unfamiliar to oil and gas producers. Clarification is needed. The regulations also refer to the "geographical extent of the taxpayer's relevant markets", another unfamiliar term which is not defined. There is also a reference to "functional product markets" unfamiliar to the oil man. All of these terms need definition.

In computing the representative market or field price for foreign oil and gas the provision permitting the sale price to be reduced by purchased transportation will be very helpful.⁷² But this will not help in a situation where there is production in a foreign country with transportation to a

⁶⁷ Proposed Treas. Reg. § 1.613-2(a) (3), 34 Fed. Reg. 5730 (1969).

⁶⁸ Proposed Treas. Reg. § 1.613-2(c) (2) (v), 33 Fed. Reg. 5730 (1968).

⁶⁹ Proposed Treas. Reg. § 1.613-3(a) (3) (i), 33 Fed. Reg. 5732 (1968).

⁷⁰ *Scofield v. La Gloria Oil & Gas Co.*, 268 F.2d 699 (5th Cir. 1959). See also *Weinert's Estate v. Commissioner*, 294 F.2d 750 (5th Cir. 1961), where operation of a cycling plant was held to be a production operation. See also *Shamrock Oil & Gas Corp. v. Commissioner*, 346 F.2d 377 (5th Cir. 1965) for a discussion of the *La Gloria* and *Weinert* cases.

⁷¹ Proposed Treas. Reg. § 1.613-3(c) (3), 33 Fed. Reg. 5733 (1968).

⁷² Proposed Treas. Reg. § 1.613-3(e) (2) (i), 33 Fed. Reg. 5736 (1968).

port by the taxpayer's own transportation facilities. In such a case, the taxpayer should be allowed to establish his field price by reducing the sale price at the port by the costs of transporting the oil plus a reasonable return on his investment in transportation facilities, under the Fiske Formula incorporated in the regulations as the Rate of Return on Investment Method.⁷³

What is considered to be the proper method of pricing sales in foreign operations can be shown by the following examples:

Example 1. The taxpayer produces oil in Libya and has an arm's length sale at the port. The oil is transported to the port by purchased transportation. The regulations permit the field price to be determined by reducing the sale price at the port by the cost of purchased transportation.⁷⁴

Example 2. Assume the same facts as Example 1 except that transportation is in the taxpayer's own pipeline. But other producers sell oil at the same port after using purchased transportation. The regulations permit the taxpayer to use the other producer's sale price reduced by the purchased transportation.⁷⁵

Example 3. Assume the same facts as Example 2 except that the taxpayer does not sell at the port but sells at a later point after refining the oil. Under the regulations the field price for the taxpayer is still the other producer's price reduced by purchased transportation.⁷⁶

Example 4. Assume that the taxpayer has a sale at the port but there is no purchased transportation, either by the taxpayer or others. Here, the taxpayer should be allowed to establish his field price by reducing his sales price by the costs of transportation and a reasonable return on his investment in transportation facilities.⁷⁷

Example 5. Neither the taxpayer nor any other producer has a sale at the port, but the taxpayer has a sale after further tanker transportation. Here again, the taxpayer should be able to establish his field price by reducing his final sales price by his transportation costs and a reasonable return on his investment in transportation facilities.⁷⁸

Example 6. The taxpayer has no sale at the port but another operator does but there is no purchased transportation. Here, the taxpayer should be permitted to use the other operator's sale price reduced by the costs of transportation and a reasonable return on the investment in transportation facilities.⁷⁹

⁷³ Proposed Treas. Reg. § 1.613-3(d)(2)(viii)(d), 33 Fed. Reg. 5735 (1968).

⁷⁴ Proposed Treas. Reg. § 1.613-3(e)(2)(i), 33 Fed. Reg. 5736 (1968).

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ Proposed Treas. Reg. § 1.613-3(d)(2)(viii)(d), 33 Fed. Reg. 5735 (1968).

⁷⁸ *Id.*

⁷⁹ *Id.*

Example 7. There are no sales at the port and no purchased transportation, but another operator has a sale at another port after further transportation. Here the taxpayer should be permitted to use the other operator's price reduced by the costs of transportation and a reasonable return on the investment in transportation facilities.⁸⁰

Prices for oil are posted periodically by the various pipeline companies which posted prices establish the field price for each grade of oil. No similar system is maintained for gas. But many contracts are entered into between producers and purchasers for the sale of gas and its liquid content. These contracts should be accepted by the Internal Revenue Service as establishing the field price.

It is provided that if the field price used plus subsequent costs prior to sale exceed the sale price, it will be assumed that the field price is too high unless a loss on subsequent processes due to an act of God is demonstrated.⁸¹ This is too narrow. A loss on a plant during the start-up period should be recognized because the plant has not yet reached full capacity.

In order for the oil and gas industry to use the Fiske Formula to compute the field price, (listed as the rate of return on the investment method), permission must first be secured from the Commissioner, which will be granted on a showing that the proportionate profits method is inapplicable.⁸² The regulations recognize that the proportionate profits method is inapplicable if the costs are small in comparison with the sale price of the product.⁸³ Since in oil and gas production the costs are always small in comparison with the selling price, it should not be necessary for the taxpayer to prove this fact to the Commissioner, nor should he need permission to use the Fiske Formula. He should be permitted to use the formula as a matter of right. No request for permission should be required.

The regulations require that in using the Fiske Formula, the rate of return must be approved by the Commissioner.⁸⁴ Oil and gas operators have been using the Fiske Formula for more than 20 years, with the rate of return determined by agreement with the revenue agent. There appears to be no valid reason why this procedure should not be continued.

The regulation with respect to trade association dues is still very objectionable.⁸⁵ It requires that in all cases a part of the dues paid to a trade association by an integrated operator shall be allocated to production. This penalizes the integrated operator. If the integrated operator refines

⁸⁰ *Id.*

⁸¹ Proposed Treas. Reg. § 1.613-3(c) (6), 33 Fed. Reg. 5733 (1968).

⁸² Proposed Treas. Reg. § 1.613-3(d) (2) (ii), (iii) and (viii) (d), 33 Fed. Reg. 5734, 5735 (1968).

⁸³ Proposed Treas. Reg. § 1.613-3(d) (2) (ii), 33 Fed. Reg. 5734 (1968).

⁸⁴ Proposed Treas. Reg. § 1.613-3(d) (2) (viii) (d), 33 Fed. Reg. 5735 (1968).

⁸⁵ Proposed Treas. Reg. § 1.613-4(c) (6), 33 Fed. Reg. 5739 (1968).

oil, he will belong to a refiners' association and part of the dues will be allocated to production. The non-integrated producer will not belong to the association so he will have no charge and his income from the same field will be higher than that of the integrated producer. It is suggested that the regulation should be revised to read somewhat as follows:

With respect to trade association dues paid by a taxpayer selling a refined, manufactured or fabricated product, a reasonable portion thereof shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property, if such trade association dues would normally have been incurred by a taxpayer engaged in marketing only the raw mineral product. Such portion shall be the estimated dues which would have been paid if the raw mineral product alone had been sold.

As has been previously stated, the section in the original regulations discussing the requirement that net operating losses be used to limit depletion has been deleted from the reissued regulations.⁸⁶ However, the section in the regulations listing the items to be deducted still lists net operating losses as one of the required deductions.⁸⁷ It is not known whether the retention of this item was intentional or an oversight. The reason for excluding net operating losses in computing depletion has been fully discussed above. Such a use of net operating losses has been rejected by Congress as violating annual accounting. The provision should be deleted.

III. CONCLUSION

It can be seen from the above discussion that the reissued regulations are much more acceptable than those originally proposed. However, there are still a number of objectionable features. It is to be hoped that before the regulations are made final the Treasury will make further revisions to meet these objections and thus avoid unnecessary litigation.

⁸⁶ Proposed Treas. Reg. § 1.613-4(c) (7), 33 Fed. Reg. 10708 (1968).

⁸⁷ Proposed Treas. Reg. § 1.613-4(a), 34 Fed. Reg. 5738 (1969).