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Internal Revenue - Deductions and Credits - Depletion Allowances with Respect to Oil and Gas Interests

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was issued in an action or special proceeding or pursuant to the provisions of section 35-2204;[117]

5. An order which sets aside or dismisses a writ of attachment for irregularity;[118]

6. An order which grants a new trial or sustains a demurrer;[119]

7. An order which denies a new trial when such order is entered after the order for judgment;[120]

8. An order which involves the merits of the action or some part thereof;[121]

9. An order made by the district court or county court of increased jurisdiction is not appealable if made without notice; but an order made by such court, after a hearing upon notice, ruling upon the correctness of the original order may be appealed to the supreme court when by the provisions of this section an appeal might have been taken from the original order had it been made upon notice."[122]

LAVERN C. NEFF

INTERNAL REVENUE — DEDUCTIONS AND CREDITS — DEPLETION ALLOWANCES WITH RESPECT TO OIL AND GAS INTERESTS. — The underground reserves of oil and gas are wasting assets which are consumed and exhausted by drilling operations.[1] Therefore, when money is invested in the production of oil and gas, it is invested in the sum total of the oil which is discovered or purchased and the sale of this product reduces the investment. To make an allowance for the return of such capital, the income tax law permits the owner of an economic interest in oil and gas in place to take a depletion allowance when he reports his

117. This proposed subsection merely rephrases for clarity and shortness subsection 3 of the present statute.

118. Attachment is a provisional remedy and thus is rightfully included within subsection 4 above. However, because the language of this subsection has always been in the statute it is here placed in a separate subsection merely to simplify the language of the proposed statute.

119. This retains the rule of the present reviewable orders statute.

120. This modifies the rule of the present statute by making an order denying a new trial appealable only when entered after the order for judgment. The change is believed desirable because in all but the most exceptional cases, the appeal should be from the order or action of the court which terminates the case, and for the reason that appeals should be discouraged while the trial is in progress.

121. The language of the present statute has hesitantly been retained here. It would be more accurate and more logical to say that "An order which effects a substantive right" is appealable. But the court has not always confined appeals under this subsection to cases where purely substantive rights are involved. This could be solved perhaps by using the language here suggested and then making orders granting or denying a change of venue separately appealable. This would be declaratory of the existing case law, for which a substantial justification exists.

122. This subsection preserves unchanged the language of the present statute but has been rephrased to achieve clarity.

1. *See* Anderson v. Helvering, 310 U. S. 404, 407 (1940).

income for the year.[2] This depletion allowance can be based either on an allocated portion of cost[3] or an arbitrary charge of 27½% of gross income, exclusive of royalty payments.[4] All geological, geophysical, and developmental costs incidental to production of oil and gas can be capitalized and recovered by way of depletion, because they are considered intangible costs.[5] Permissible allowances for plant and equipment expenditures, however, must be recovered by way of depreciation.[6]

The granting of depletion allowances for the consumption of oil and gas reserves has become a controversial issue in recent years. Essentially, the production of oil and gas is a manufacturing business which produces through the use of the soil, but the products sold are actually a sale of the investment, and the allowance for depletion has been justified by its supporters on the ground that it is given to approximately repay the impaired capital of the investor.

A. The Requirement of an Economic Interest

To qualify for the depletion allowance under the federal tax statutes, it is necessary to have an economic interest in the oil and gas in place.[7] This interest is defined as a right to share in the proceeds from the sale of the oil and gas produced.[8] It is not necessary to own legal title to the land or the mineral estate to qualify so long as the interest is dependent on the extraction of the mineral.[9]

To insure uniformity of application throughout states which may vary widely in their interpretation of the interests created by oil and gas transactions, the tax statutes do not require that the economic interest which is a prerequisite to the allowance of the depletion deduction be dependent upon the concept of legal title, but they do require something more than a mere

2. Int. Rev. Code §23 (m).
3. Int. Rev. Code §113 (b) 1 (B); U.S. Treas. Reg. 111, §29.23 (m) 2 (1943).
4. Int. Rev. Code §114 (b) 3; U.S. Treas. Reg. 111, §29.23 (m) 4 (1943) (the reason why royalties are excluded is because the lessee is also entitled to a deduction for depletion).
5. U.S. Treas. Reg. 111, §29.23 (m) 16 (b) 1 (i) (1943); U.S. Treas. Reg. 111, §29.23 (m) 16 (b) 2 (i) (1943) (depletable only when charged to capital account).
6. U.S. Treas. Reg. 111, §29.23 (m) 16 (b) 3 (i) (1943). The Regulations make a distinction between tangible and intangible developmental costs. All costs incurred by buying, as incident to production, tangible property which has a salvage value, must be recovered by way of depreciation; while all costs incurred for intangible items can be recovered by way of depletion or amortization at the option of the taxpayer.
7. U.S. Treas. Reg. 111, §29.23 (m) 1 (1945). See also Palmer v. Bender, 287 U.S. 551 (1933) (lessee's retained economic interest in oil was depletable because of retention of royalties, even though operating rights were transferred).
8. Palmer v. Bender, 287 U.S. 551, 557 (1933).
9. Thomas v. Perkins, 301 U.S. 655 (1937) (owner of an interest in the deposit is entitled to deduct for depletion the part producing his income, but may not deduct for depletion the share belonging to another).

"economic advantage" gained from the production of oil and gas [10]—*e.g.*, when a contractor receives oil payments for drilling wells for others there is no depletable interest,[11] nor would a stockholder of a corporation be entitled to depletion,[12] although the corporation itself can take a depletion allowance if it is engaged in the production of oil and gas in place. Similarly, a processor who contracts on a royalty basis to manufacture casinghead gas from the wet gas emanating from oil wells has been held not to have a depletable interest,[13] on the theory that the interest of the processor—as well as the other interests mentioned above—are too remote from the production of the oil and gas while it is in place.[14] However, a producer who is required to make a capital investment in equipment necessary for production has a depletable interest.[15]

Among the more immediate interests with which the law is concerned are those of the lessor and lessee. If a land owner grants a lease to another and retains a royalty, he has a depletable interest in oil and gas in place.[16] The owner of the leasehold can also claim depletion on his gross income from the sale of the oil he produces.[17] If the lessee sells the lease for a cash sum and retains an overriding royalty, he can still claim depletion on the cash payment and on his royalty payments.[18] In this case

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10. Helvering v. Bankline Oil Co., 303 U.S. 362 (1938); Pearl Oil Co., 40 B.T.A. 147 (1939) (foreclosure of a judgment lien on a percentage of the gross production of oil was held here not to be subject to depletion. The court apparently distinguished bewteen a lienholder against the oil properties and one who withholds a percentage of oil to be produced by grant); United States v. Spalding, 97 F.2d 701 (9th Cir.), *cert. denied,* 305 U.S. 644 (1938).

11. Cook Drilling Co., 38 B.T.A. 291 (1938).

12. M. C. Garber, 11 B.T.A. 979 (1928). *See* Helvering v. O'Donnell, 303 U.S. 370, 371 (1938); Helvering v. Elbe Oil Land Co., 303 U.S. 372, 375 (1938) (the court construed "gross income from the property" as term is used in the statute to mean gross income received from operation of oil and gas wells by one who has a capital investment therein—not income from the sale of the oil and gas properties themselves).

13. Helvering v. Bankline Oil Co., 303 U.S. 362 (1938) (the controlling fact, the court pointed out, was that the company had no interest in the gas in place. There was no depletable interest in the gas at the mouth of the well).

14. Massey v. Commissioner, 143 F.2d 429 (5th Cir. 1944) (cash received by an attorney for services rendered to an oil company is not subject to depletion); Pearl Oil Co., 40 B.T.A. 147 (1939) (where judgment creditor agreed to have his claim satisfied out of oil payments, it was held the interest was not subject to depletion).

15. *See* Helvering v. Producers Corporation, 303 U.S. 376, 382 (1938); G.C.M. 22730, 1941-1 Cum. Bull. 214, 220.

16. Helvering v. Twin Bell Syndicate, 293 U.S. 312 (1934).

17. Commissioner v. Happold, 141 F.2d 199 (5th Cir. 1944); G.C.M. 22730, 1941-1 Cum. Bull. 214, 224.

18. Herring v. Commissioner, 293 U.S. 322 (1934). A safe definition of the term "overriding royalty" is to say that it is a Fractional interest in the gross production of the oil and gas in addition to the usual royalties paid to the lessor. Perhaps the most common use of the term is to indicate a share of the oil and gas produced reserved in an assignment, part assignment, or sublease of an oil and gas lease, and payable to the assignor by the assignee, over and above the royalty reserved in the lease payable to the lessor. 3 Summers, Law of Oil and Gas §554 (Perm. ed. 1938).

the cash payment is considered depletable because looked at as an advance royalty.[19] However, if the lessee does not retain an overriding royalty, his interest is considered as sold and no depletion is allowed on the cash payment incident to the transfer.[20] The same effect would occur in some cases if the assignor of a lease retained only an in-oil payment.[21] The in-oil payments are different than a royalty in that they do not apply to the lessee's entire interest in oil and gas in place, but only to the proportion which the payment bears to the whole deposit.[22] While the courts consider an in-oil payment as a depletable interest,[23] if the assignee personally binds himself to make the in-oil payments or if they can be made out of other assets of the assignee, then the interest of the assignor is not considered depletable.[24]

In many cases a lessor receives a bonus for granting a lease in addition to a royalty. This bonus is considered an advance royalty and subject to depletion.[25] The lessor can also bargain for a percentage of gross profits or net profits, and in both cases he has a depletable interest, although it is only relatively recently that it has been held that a percentage of net profits is depletable.[26]

In an early ruling, the Bureau of Internal Revenue took the position that a life tenant loses nothing by mineral extraction and thus is not entitled to depletion.[27] However, the more recent rulings treat the life tenant as owning the entire interest and allow him the depletion allowance.[28] The remainderman gets no allowance until his interest becomes possessory.

If property is held in trust, the depletion allowance is appar-

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19. Hogan v. Commissioner, 141 F.2d 92 (5th Cir.), *cert. denied,* 323 U.S. 710 (1944) (retention of an overriding royalty is a sufficient economic interest in the retained oil and gas to be a depletable interest).

20. Badger Oil Co. v. Commissioner, 118 F.2d 791 (5th Cir.), *cert. denied,* 314 U.S. 634 (1941).

21. Columbia Oil and Gas Co. v. Commissioner, 118 F.2d 459 (5th Cir. 1941).

22. Murphy Oil Co. v. Burnet, 287 U.S. 299 (1932); *See* Thomas v. Perkins, 301 U.S. 655, 661 (1937).

23. Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946) (each partial assignor of exploitation rights retains a depletable economic interest); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946). In Kirby Petroleum Co. v. Commissioner, the court drew a distinction between the situation where a "net profit" payment flows directly from the lessor's economic interest in the oil and partakes of the quality of a royalty, and the situation where a net profit payment is made on the basis of an absolute sale of the land and mineral rights, and no economic interest in the minerals is retained. In the former situation, the payments received are depletable; in the latter, they are not. See also G.C.M. 22730, 1941-1 Cum. Bull. 214.

24. Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Anderson v. Helvering, 310 U.S. 404 (1940). *See* Commissioner v. Elliott Corp., 82 F.2d 193, 194 (9th Cir. 1936).

25. Burnet v. Hormel, 287 U.S. 103 (1932); Hogan v. Commissioner, 141 F.2d 92 (5th Cir.), *cert. denied,* 323 U.S. 710 (1944).

26. Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946).

27. I.T. 1919, III-1 Cum. Bull. 1329 (1924).

28. Int. Rev. Code §23 (m); U.S. Treas. Reg. 111, §29.23 (m) 1 (1945); U.S. Treas. Reg. 111, §29.23 (l) 1 (1943).

ently allocated proportionately between the trustee and the beneficiaries as their interests appear in the trust indenture.[29]

B. Percentage Depletion

The most popular method of computing the allowance for depletion is to use the percentage depletion method. Percentage depletion is an arbitrary statutory rate set by Congress in the Revenue Act of 1926,[30] after an exhaustive study was made concerning the actual cost of oil exploration and discovery. The rate was set at 27½% of the gross income from the sale of oil and gas produced, not to exceed 50% of net income, nor to be less than that amount which would be allowed under the cost depletion method of computing the allowance.[31] In recent years surveys have been made regarding this rate, and they indicate that the costs of exploration and discovery come within 6 to 10% of the percentage depletion rate.[32] Apparently for this reason Congress has not seen fit to change it.

When this rate was first adopted, it was the exception to use it, but it has since become the most common method of computing depletion. It is not necessary to compute the cost basis of the property when this method is used. It is merely applied against the gross income of the sale of the oil or gas exclusive of any payments made to other owners of interests of oil and gas in place.[33] Under this method, it is possible to receive more than a 100% return of capital. However, the total extent of the investment is at best only an estimate and the "50% of net income" limitation has some tendency to prevent excessive tax deduction.

C. Cost Depletion

The other method of computing the depletion allowance is by the so-called cost method.[34] To use this method it is necessary to determine the cost basis of the mineral property. This can be computed by using the actual cost of the property or the property can be appraised by competent appraisers so as

29. Fleming v. Commissioner, 121 F.2d 7 (5th Cir. 1941) (the court pointed out that prior to the Revenue Act of 1928 only the trust could take a deduction for depletion. However, this has been changed by statute); *cf.* Helvering v. Falk, 291 U.S. 183 (1934) (beneficiaries of the trust owned the entire economic interest and they alone were allowed the deduction for depletion).

30. Revenue Act of 1926, §204, 44 Stat. 10, 16 (1926).

31. Int. Rev. Code §114 (b) 3.

32. Baker and Griswold, *Percentage Depletion—A Correspondence,* 64 Harv. L. Rev. 361, 366 (1951).

33. Helvering v. Twin Bell Syndicate, 293 U.S. 312 (1934).

34. U.S. Treas. Reg. 111, §29.23 (m) 2 (1943); U.S. Treas. Reg. 111, §§29.113 (a) 1 to 29.114 (1) (1944).

to arrive at the replacement or present value of the property. Once the cost basis is established the number of recoverable barrels of oil or thousand cubic feet of gas must be properly estimated. The cost is then divided by the recoverable units to arrive at the unit cost. The depletion allowance is then computed by multiplying the unit cost by the number of units sold.

In measuring the cost basis of the mineral property, the value of land used for other purposes than oil production must be excluded, and so must the value of all property recovered by way of depreciation.[35] If the owner of the working interests elects to treat intangible developmental and discovery costs as capital assets they can be included in figuring the cost basis, but if treated as expenses they also will be excluded.

A bonus paid by the lessee for the acquisition of the leasehold interest can be capitalized and included in figuring the cost basis, but if the lessor receives a bonus plus royalties, the depletion deduction for the bonus is computed on the adjusted basis multiplied by that percentage which the bonus bears to the total of the bonus and expected royalty—*e.g.*, a lessor receives a bonus of $1,000 and he expects to get royalties from the production of oil of $7,000. If his basis for depletion is $2,000, then the allowable deduction for depletion because of the receipt of the bonus would be $250.

$$\text{Adjusted Basis—\$2,000} \times \frac{\text{Bonus—\$1,000}}{\text{Bonus plus expected royalties—\$8,000}} = \$250$$

Cost depletion is not often used in areas that are unproven because of the difficulty and sometimes impossibility of computing the cost basis. If the cost cannot be satisfactorily proved, the depletion deduction will not be allowed, and the burden rests on the taxpayer to prove cost. However, even if cost depletion cannot be used, the taxpayer can still use his percentage depletion allowance.[36]

D. Computation

To fully illustrate how to apply the depletion allowance in filing a tax return, it is necessary to consider a hypothetical example.

Assume, for instance, that the owner of a leasehold interest sells $50,000 worth of oil during the taxable year. He has paid royalties in the amount of $10,000 and he has deductible expenses

35. U.S. Treas. Reg. 111, §29.23 (m) 2 (1943).
36. U.S. Treas. Reg. 111, §29.23 (m) 1 (1945).

and depreciation of $20,000. If he uses the percentage method, his deduction for depletion will be $10,000.

Gross Income	$50,000
Less: Royalties	10,000
Adjusted Gross Income	$40,000
Less: Expenses and Depreciation	20,000
Net Income	$20,000

Twenty-seven and one-half per cent of his gross income exclusive of royalty payments is $11,000 ($40,00 X 27½%), but the $11,000 figure exceeds 50% of his net income, so his depletion allowance is 50% of net income or $10,000. At the same time, this amount cannot be less than if the depletion were figured according to the cost method, as illustrated below.

Assume that the adjusted basis of the mineral property was $1,000,000 and the recoverable units were 2,000,000 barrels. The estimated unit cost would be 50¢ a barrel. If the oil was sold at $5 per barrel, the total units sold, exclusive of royalty payments, would be 8,000 barrels in the illustration above. The 8,000 barrel figure, multiplied by 50¢, would give the owner a depletion allowance of $4,000, which is less than the $10,000 allowed under the percentage deduction, so the $10,000 deduction would be allowed.

Adjusted Basis	$1,000,000	
Recoverable Units	2,000,000	barrels
$1,000,00 ÷ 2,000,000 barrels =	50¢	per barrel

Units Sold	10,000
Less Royalty Interest	2,000
Remaining Units Subject to Depletion	8,000

8,000 X 50¢ = $4,000
Depletion Deduction under Cost Method is then $4,000

As to the royalty interest, a deduction of $2,750 is allowed under the percentage method ($10,000 X 27½%), and under the cost method, $1,000 is deductible (2,000 units X 50¢).

In this example, the percentage method permits the greater deduction and no doubt the taxpayer would use that procedure. However, in some cases the deduction under the cost method would be greater, and if so the taxpayer would use that method.

He can use either method at any time and does not have to elect either one or the other.[37]

E. Gross Income

The question of which amounts can and which cannot be included in gross income for the percentage depletion allowance is important because the statutory rate of 27½% can only be applied against gross income.[38]

Gross income from the sale of oil and gas is the amount received for the raw mineral in the vicinity of the well.[39] Income received for refining or transporting the raw mineral must be excluded from gross income.[40]

The holder of the working interest can include in gross income all amounts received for the sale of oil or gas exclusive of those amounts which he pays to other persons who hold an economic interest therein.[41] He can also include developmental and drilling costs in gross income if he elects to capitalize them.[42] However, if any of these costs are represented by tangible property, they are returnable through depreciation and not through depletion.[43]

If the holder of the working interest is a lessee who assigns his interest for cash, he has made a sale of an investment, and his income is subject to capital gains tax.[44] However, if he retains an overriding royalty in the production of oil and gas in place, he can include in his gross income the full amount of the cash received because it is considered an advance royalty and subject to depletion.[45] This assignment is considered a sublease and not a sale for tax purposes.[46] However, if the lessee retains a specific number of barrels to be produced as his royalty in

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37. U.S. Treas. Reg. 111, §29.23 (m) 5 (1948); Producers Oil Corp., 43 B.T.A. 9 (1940). However one using the percentage method of depletion must also always compute by the unit method, since the allowance can never be less than the unit allowance.
38. U.S. Treas. Reg. 111, §29.23 (m) 4 (1943); Int. Rev. Code §114 (b) 3.
39. U.S. Treas. Reg. 111, §29.23 (m) 1 (f) (1945).
40. Greensboro Gas Co. v. Commissioner, 79 F.2d 701 (3d Cir.), *cert. denied*, 296 U.S. 639 (1935) (taxpayer who was both a producer and a distributor could not claim depletion based upon gross value of gas when delivered to the consumer); Consumers Natural Gas Co. v. Commissioner, 78 F.2d 161 (2d Cir.) *cert. denied*, 296 U.S. 634 (1935).
41. Thomas v. Perkins, 301 U.S. 655 (1937).
42. Vinton Petroleum Co. v. Commissioner, 71 F.2d 420 (5th Cir.), *cert. denied*, 293 U.S. 601 (1934); U.S. Treas. Reg. 111, §29.23 (m) 16 (1943).
43. U.S. Treas. Reg. 111, §29.23 (m) 16 (b) 3 (i) (1943).
44. Int. Rev. Code §117; U.S. Treas. Reg. 111, §29.117 (1944); U.S. Treas. Reg. 111, §29.23 (m) (1945); Alice G .K. Kleberg, 43 B.T.A. 277 (1941).
45. Hogan v. Commissioner, 141 F.2d 92 (5th Cir.), *cert. denied*, 323 U.S. 710 (1944); McLean v. Commissioner, 120 F.2d 942 (5th Cir. 1941); G.C.M. 22730, 1941-1 Cum. Bull. 214.
46. McLean v. Commissioner, 120 F.2d 942 (5th Cir. 1941); Cullen v. Commissioner, 118 F.2d 651 (5th Cir. 1941).

addition to a cash payment, he has sold his interest and the cash received is not subject to depletion, but is a capital gain.[47] However, all in-oil payments made subsequently are depletable interests.[48]

This practice will allow a person in a high income bracket to sell a lease and retain only a limited override in oil payments, and thereby obtain capital gain treatment on the cash payment instead of paying ordinary income tax on it. The Treasury Department has attempted to remedy this situation by subjecting such agreements to close scrutiny. If the in-oil payments are too large, and there is no reasonable chance that they will be paid from the production of that specific mineral property, they may well hold the payments to be essentially a sublease and thus not subject to capital gains tax. Also, if the in-oil payments extend over a period longer than two years, they would probably hold that the transaction is a sublease rather than a sale.[49] In fact, there is essentially no difference in the two transactions, and they should be construed alike, but apparently if a person retains reasonable in-oil payments rather than a cash royalty, the cash payment will be considered a sale of an investment rather than an advance royalty.[50]

In some cases an assignor may wish to retain a fractional working interest. He may assign to another a sum of money or a lease for the purpose of developing the land for oil production. The assignee agrees to assume responsibility for all costs of production and sale, and after he has recouped his costs from production, the assignor will share some fractional percentage of profits in the business. This type of an assignment is called a "carried interest." [51] The assignee charges the assignor on his books with his proportionate share of the costs and credits his accounts with his share of the income. Any net income in the assignor's account goes to the assignee until his original cost is recouped, and after that is given to the assignor. The courts have held that this arrangement is essentially a partnership and have taxed the assignor's net income on the assignee's books as ordinary income

47. Commissioner v. Roeser and Pendleton, 118 F.2d 462 (5th Cir. 1941); Laird v. Commissioner, 97 F.2d 730 (5th Cir. 1938). The questions involved in such transfers are discussed in Jackson, *Federal Income Tax Problems involved in Typical Oil and Gas Transactions in Texas,* 25 Tex. L. Rev. 343, 355 (1947).

48. Cullen v. Commissioner, 118 F.2d 651 (5th Cir. 1941); Hammonds v. Commissioner, 106 F.2d 420 (10th Cir. 1939); American Liberty Oil Co., 43 B.T.A. 76 (1940).

49. G.C.M. 24849, 1946-1 Cum.Bull. 66. See Jackson, *supra* note 47, at 356.

50. See Jackson, *supra* note 47, at 353.

51. T. K. Harris Co. v. Commissioner, 112 F.2d 76 (6th Cir. 1940); Helvering v. Armstrong, 69 F.2d 370 (9th Cir. 1934).

even if he didn't receive any cash at all, on the theory that the assignor was getting an increase in his investment in the enterprise.[52]

The Bureau of Internal Revenue has taken the view that the assignor does not receive any income until the assignee recoups his costs because the assignor may never receive any income from his investment. The Bureau therefore wants to tax the assignee to the full extent because he is actually receiving the income.[53] However, the courts have rejected this view and hold that the assignor is a partner and so his proportionate share of net income is taxable in the year that it was credited to his account.[54]

Another type of assignment is a transfer by the lessor of his entire interest under a contract whereby he retains a fixed percentage of net profits from the operation of the enterprise. This is called a "net profits" contract and the income received by the lessor is included in gross income and subject to depletion.[55] This is a relatively recent view. Originally, the courts held that all the assignor retained was an "economic advantage" rather than an "economic interest" in the oil and gas in place.[56] It is now considered an "economic interest" in the oil and gas in place and thus is includible in the assignor's gross income for purposes of depletion.[57]

Any money received from the interest which a lessor retains when he grants his lease is included in his gross income and is subject to depletion if the retained interest is a royalty.[58] Royalties are not merely rents but interests in production, and therefore depletable. However, rents and delay rentals received for the sale of the lease are not subject to depletion.[59] Bonuses are considered advance royalties and so included in the lessor's gross income.

Even if no oil is extracted during the taxable year, the receiver of the bonus for the assignment of an oil lease is entitled to a depletion allowance on the bonus.[60] This is true even if there

52. Reynolds v. McMurray, 77 F.2d 740 (10th Cir.), *cert. denied,* 287 U.S. 664 (1935).
53. T. K. Harris Co. v. Commissioner, 112 F.2d 76 (6th Cir. 1940).
54. Commissioner v. J. S. Abercrombie Co., 162 F.2d 338 (5th Cir. 1947). See Jackson, *supra* note 47, at 369.
55. Commissioner v. Crawford, 148 F.2d 776 (9th Cir. 1945); Commissioner v. Felix Oil Co., 144 F.2d 276 (9th Cir. 1944). *But cf.* Quintana Petroleum Co. v. Comissioner, 143 F.2d 588 (5th Cir. 1944).
56. See note 12, *supra.*
57. See note 20, *supra.*
58. Helvering v. Twin Bell Syndicate, 293 U.S. 312 (1934).
59. Commissioner v. Wilson, 76 F.2d 767 (5th Cir. 1935).
60. Herring v. Commissioner, 293 U.S. 322 (1934); American National Realty Co., 47 B.T.A. 653 (1942).

has been no production during the year, and no practical assurance of production in the future.[61] However, in such a case, if there is no production from the leased premises, the taxpayer must restore the amount of the deduction to income as of the year of the termination of the lease.[62] The courts have not determined how much extraction is necessary to sustain the depletion allowance taken on the bonus. It may be that the extraction of 10 barrels will sustain it, but probably a much larger figure would be necessary. In all likelihood, each case would be decided individually when it came before the courts.[63]

In each case the income received must be scrutinized carefully to see whether a complete sale of the economic interest has been made or whether part of this interest has been retained. One who retains a mere economic advantage from the sale of his interest has no depletable interest, whereas the retention of an interest in oil and gas in place permits the holder to apply a depletion deduction against the gross income received from this interest.[64]

F. Net Income

To prevent any excessive tax deduction, the statutes provide that the percentage depletion deduction cannot be in excess of 50% of the net income from the property exclusive of the depletion allowance.[65] Net income from the property is that amount received from the sale of the oil at the well less all legitimate business deductions such as depreciation on the physical plant, drilling costs properly charged to expense, taxes, administrative expenses, interest, wages, and any other deductions usually allowed in a business to arrive at net income for tax purposes.[66]

Any expenses not directly attributable to oil and gas produc-

61. G.C.M. 14448, XIV-1 Cum. Bull. 98 (1935); Herring v. Commissioner, 293 U.S. 322 (1934); Marrs McLean, 41 B.T.A. 565 (1940).

62. G.C.M. 14448, XIV-1 Cum.Bull. 98 (1935); Lamont v. Commissioner, 120 F.2d 996 (8th Cir. 1941). This case involved an iron ore mine and the lease here provided for stipulated royalties whether or not ore was extracted. See also Sneed v. Commissioner, 119 F.2d 767 (5th Cir.), *cert. denied*, 314 U.S. 686 (1941). *Cf.* Commissioner v. Seeligson, 141 F.2d 358 (5th Cir. 1944) (lessor died before lease terminated and the court held that the decedent's depletion allowance, previously taken, was not returnable to income at her death because the lease had not yet been abandoned). For a particularly harsh result of this rule, see Douglas v. Commissioner, 322 U.S. 275, 287 (1944) (dissenting opinion).

63. Dolores Crabb, 41 B.T.A. 686 (1940), *aff'd*, 119 F.2d 772, *rev'd on other grounds*, 121 F.2d 1015 (5th Cir. 1941). In this case a small amount of actual production was held sufficient to allow the use of the depletion deduction.

64. See Note, 51 Harv. L. Rev. 1424, 1429 (1938).

65. Int. Rev. Code §114 (b) 3; U.S. Treas. Reg. 111, §29.23 (m) 1 (g) (1945).

66. Int. Rev. Code §23; U.S. Treas. Reg. 111, §29.23 (m) 1 (g) (1945).

tion cannot be deducted.[67] However, if the owner is operating several related activities, he can apportion a fair share of certain costs to the mineral property.[68] The net income from each mineral property must be figured separately.[69]

G. THE MINERAL PROPERTY

In the field of oil and gas law, the mineral property is defined as the interest of the owner of oil and gas in place.[70] Because of the net income limitation, an allowance for depletion must be computed on each separate property.[71]

A lease covering a tract of land is a single mineral property, but if the lease covers several non-contiguous parcels, each single parcel is a separate mineral property.[72] The Bureau of Internal Revenue has taken the position that several leases in a single tract of land constitute only one property,[73] but if they are acquired from different owners, each one is a separate property.[74] However, if several contiguous properties are conveyed to another by a single deed, the purchaser has only one property for depletion purposes, even though the transferor may have had several properties.[75] A donee of an interest also acquires a single property.[76]

It is therefore apparently possible to divide a single tract of land into several mineral properties by giving several leases to different persons.[77] If one of the leases is forfeited, that parcel would still retain its separate property status even in the hands of the original owner.[78] The same effect occurs if a lease expires or if the land owner repurchases the lease.[79] Every separate mineral interest, whether it is a leasehold or a royalty interest, is a

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67. F.H.E. Oil Co., 3 T.C. 13 (1944) (charitable deductions were not allowed as deductions attributable to the mineral property upon which depletion was claimed.

68. Rocky Mountain Oil Co., 36 B.T.A. 365 (1937); G.C.M. 22689, 1941-1 Cum.Bull. 225.

69. Vinton Petroleum Co. v. Commissioner, 71 F.2d 420 (5th Cir.), *cert. denied*, 293 U.S. 601 (1934).

70. U.S. Treas. Reg. 111, §29.23 (m) 1 (i) (1945).

71. See note 69, *supra*.

72. Berkshire Oil Co., 9 T.C. 903 (1947) (two contiguous tracts held "one property" while two tracts touching only at corner point were held to be separate); G.C.M. 22106, 1941-1 Cum.Bull. 245.

73. U.S. Treas. Reg. 111, §29.23 (m) 1 (i) (1945).

74. G.C.M. 22106, 1941-1 Cum.Bull. 245, 249.

75. *Ibid.*

76. United States v. Spalding, 97 F.2d 701 (9th Cir.), *cert. denied*, 305 U.S. 644 (1938).

77. *Cf.* Sneed v. Commissioner, 119 F.2d 767 (5th Cir.), *cert. denied*, 314 U.S. 686 (1941).

78. *Ibid.*

79. Helvering v. O'Donnell, 303 U.S. 370 (1938); Sneed v. Commissioner, 119 F.2d 767 (5th Cir.), *cert. denied*, 314 U.S. 686 (1941).

separate property for depletion purposes. This is also true if a person receives a royalty and a fractional working interest from a single mineral property.[80] However, if a person has two or more interests—*e.g.*, leasehold interests on different portions of a single tract—he cannot combine them for depletion purposes.[81]

From the foregoing brief survey it is apparent that the statutes and regulations regarding oil and gas depletion allowances present a complicated and sometimes quite confusing picture. It would appear to the advantage of all holders of interests in oil and gas in place to obtain careful and well-researched advice regarding taxation problems in this field.[82]

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80. Herndon Drilling Co., 6 T.C. 628 (1946).

81. Helvering v. Jewel Mining Co., 126 F.2d 1011 (8th Cir. 1942).

82. For further treatment of this subject, see Beveridge, *Depletion of Oil and Gas Properties for Income Tax Purposes*, 36 Mich. L. Rev. 568 (1938); Rabkin and Johnson, *The Income Tax on Oil and Gas Interests*, 90 U. of Pa. L. Rev. 383 (1942); Appleman, *Taxation of Net Profits from Oil and Gas Properties*, 23 Tex. L. Rev. 347 (1945); Ray and Hammonds, *The Income Tax on Proceeds from the Sale of Oil Payments: The Validity of G.C.M. 24849*, 25 Tex. L. Rev. 121 (1946); 4 La. L. Rev. 586 (1942).