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John W. Beveridge
Member of the Texas bar; Formerly Assistant United States Attorney, Northern District of Texas

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*John W. Beveridge**

THE Revenue Act of 1936 provides that in computing net income from oil and gas properties there shall be allowed as a deduction from gross income a reasonable allowance for depletion, according to the peculiar conditions in each case.[1] The allowance is made under regulations prescribed by the Commissioner of Internal Revenue.[2]

The first problem is to fix the amount the taxpayer is entitled to recover before he is considered as earning income which is not in essence a mere return of his capital investment. The difficulty of clearly defining the difference between a return of capital and of income has often been discussed.

Today the taxpayer may use either the adjusted basis of cost or fair market value as of March 1st, 1913 (Section 113(b), Revenue Act of 1936), or he may use the percentage depletion (27½ percent of gross income but not to exceed 50 per cent of net income) as permitted under Section 114(b) (3). Every taxpayer claiming a deduction for depletion must keep accurate accounts in which the cost of the property, or its fair market value, is recorded with subsequent allowable capital additions to each account. If the method of depletion accounting adopted by the taxpayer has been approved by the Commissioner, it cannot be changed without the latter's consent. When the sum of the credits for depletion equals the cost or other basis of the property, plus subsequent allowable capital additions, no further deductions for depletion are allowed. However, if the taxpayer has been using the percentage method of depletion deduction, he may continue to take the full 27½ per cent deduction from gross income each year, even though the cost or other basis of the property has been fully recovered in depletion allowances.[3]

* A.B., Carleton; LL.B., Minnesota; member of the Texas bar. Formerly Assistant United States Attorney, Northern District of Texas.—*Ed.*

[1] 49 Stat. L. 1660, § 23 (m); 26 U. S. C., § 23 (m).

[2] Treas. Reg. 94, art. 23 (m).

[3] Reg. 94, art. 23 (m)-11.

I

DETERMINATION OF DEPLETION ALLOWANCE

A. *Cost as Basis*

1. *Cost Value*

If the taxpayer is not taking as his depletion deduction 27½ per cent of his gross income, he must use the plan of depletion allowance which is based on the cost of the property or in some instances on value.

For most purposes, the cost of the property to the taxpayer is taken as the measure of his capital investment. When the cost has been returned to him by the operation of the properties, all amounts in excess of the cost are then considered as income within the meaning of the income tax law, subject, of course, to other permitted deductions. The law states that the basis upon which depletion is to be allowed is the same adjusted basis as that used to determine the gain upon a sale or other disposition of the properties.[4] The basis is usually the cost of the property with certain adjustments. For instance, if the purchase price of an oil and gas lease is $10,000 and $6,000 is expended for capital improvements, the total cost or "adjusted basis" is $16,000. This latter figure is the basis for computing the depletion deduction as well as the basis for computing the gain or loss on a sale of the lease.

In determining the adjusted basis, amounts representing the cost or value of the land for purposes other than for mineral production, amounts recoverable through depreciation, and the value of the property at the conclusion of production of oil or gas are excluded.[5]

Certain intangible drilling and development costs may be charged to capital account or be deducted from gross income as an expense at the option of the taxpayer.[6] The option does not apply to expenditures by which tangible property having a salvage value is acquired. Labor, fuel, repairs, hauling and supplies in connection with the operation of the well, must be charged off as expense; but amounts paid for such items when used in the drilling, shooting, and cleaning of wells, in clearing ground, surveying, geological work, construction of derricks,

[4] 49 Stat. L. 1686, § 114 (b) (1), refers to § 113 (b) for the adjusted basis.

[5] Reg. 94, art. 23 (m)-2.

[6] Reg. 94, art. 23 (m)-16. Where a holding corporation owned all of the stock of an operating oil company, and upon the liquidation of the oil company the holding corporation for the first time became an operating company, it is entitled to exercise the option provided by article 23 (m)-16, Reg. 94, with respect to charging intangible drilling costs to expense. Cum. Bull., 1937-1, p. 83.

tanks, pipe lines, and other physical structures which are necessary for the drilling of wells and the preparation of the wells for the production of oil or gas may be charged either to expense or capital account. If a well proves unproductive, even though the taxpayer has charged the cost of drilling to capital account, he may charge off the amount capitalized as an expense. These options are available to the owner of the property even in those cases in which drilling is done under contract, but do not apply to one who drills a well upon land of another in performance of a contract by which he will be given an interest in the land or minerals.[7]

Where the taxpayer has elected to charge cost of development and drilling to capital account, the cost of putting the hole in the ground, in so far as such cost is not represented by physical property, is not subject to depreciation, and can be recovered only through the depletion allowance.[8] However, the amounts so capitalized, in so far as they are represented by physical property, are returnable through depreciation. The necessity of allocating the different items of expenditures to their respective classes or accounts is apparent.[9]

B. *Fair Market Value as Basis*

If the fair market value on a certain date is to be determined for ascertaining the basis for the depletion allowance, the value must be determined by the owner in the light of conditions and circumstances known at that date regardless of later discoveries or developments or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established by assuming a transfer between a willing seller and a willing buyer as of a particular date. Consideration will be given by the commissioner to all evidence having a bearing on the market value, such as cost, actual

[7] State Consolidated Oil Co. v. Commissioner, (C. C. A. 9th, 1933) 66 F. (2d) 648.

[8] United States v. Dakota-Montana Oil Co., 288 U. S. 459, 53 S. Ct. 435 (1933). Cum. Bull. XIII-2, p. 72 (1932), states: "Accordingly, it is the opinion of this office that the capital to be recovered through depletion allowance under the general rule set forth in section 114 (b)-1 of the Revenue Acts of 1932 and 1934, which the percentage depletion allowances under such Acts are to be taken in lieu of, is composed in part of the capitalized development expenditures during the development stage of the mine; and that so-called capitalized development costs after the mine has reached the producing status should not be treated as capital charges recoverable through depletion, but as operating expenses deductible in the year in which the ore benefited by such expenditures is produced and sold."

[9] Freeman-Hampton Oil Corp. v. Commissioner, (C. C. A. 5th, 1933) 65 F. (2d) 456.

sales and transfers of similar properties, value of shares of stock, and royalties paid. Analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method. Mineral deposits of different grades and locations should be valued separately.[10]

Value is, of course, based largely upon estimates of reserve deposits of oil and gas. Development of the properties may indicate that previous estimates of the extent of the deposits were erroneous. The value on the basic date cannot be changed nor can there be a revision of depletion allowances for past years.[11] But a new depletion unit may be established by dividing the capital sum returnable by the remaining units of mineral in the property according to the new estimate.[12] An illustration of the proper adjustment when a new estimate of the recoverable units is made is given in the report of the Senate Committee on Finance on the 1932 Revenue Act.

> "A purchased for $1,000 an ore body which estimated recoverable units of 1,000. He removes 500 units and takes depletion deductions aggregating one-half of his cost, or $500. Subsequently it is ascertained that there remain in the mine 1,500 recoverable units and the original estimate of 1,000 recoverable units is revised. Under the amendment, his unrecovered cost ($1,000 less $500) would be spread over the revised estimate of the recoverable units (1,500) with the result that on each unit thereafter removed he would be allowed a depletion deduction of 33 1/3 cents per unit instead of $1 per unit."[13]

In estimating the total number of recoverable units of oil or cubic feet of gas, the estimate is to be made according to the method current in the industry and by the use of the most accurate information obtainable.[14]

C. *Capital Investment per Unit of Oil or Gas*

As the income tax is paid on an annual basis and as the oil or gas field is made up of barrels of oil or thousands of cubic feet of gas, an attempt is made to fix the amount of the capital invested in each barrel of oil or in each thousand cubic feet of gas; then as each unit of oil or gas is produced and marketed, the capital investment in the unit is

[10] Reg. 94, art. 23 (m)-7.
[11] Reg. 94, art. 23 (m)-8.
[12] Reg. 94, art. 23 (m)-9.
[13] S. Rep. 665, 72d Cong., 1st. sess. (1932), p. 16.
[14] Reg. 94, art. 23 (m)-9.

deducted from the proceeds of the sale.[15] The cost of each barrel of oil withdrawn during the year is fixed by dividing the cost of the whole lease by the estimated number of barrels of oil in the ground within the area covered by the lease. Then the cost of each barrel is multiplied by the number of barrels sold during the year to get the total cost of all the oil sold during the year. This represents the capital invested in the oil which has been produced during the year; or, in other words, the depletion deduction. The taxpayer is entitled to deduct this from his income; that is, he is entitled to recover the capital he invested in each barrel of oil and he is required to pay an income tax on the price he received for each barrel only in so far as that price exceeds the amount that each barrel cost him.

An example will illustrate the above method of calculation. A taxpayer purchases an oil and gas lease for $25,000. An estimate made of the oil reserve within the confines of the lease shows that there are 100,000 barrels of oil which can be recovered from the lease. If, within the taxable year, 10,000 barrels were withdrawn at a cost of $8,000, this would make the capital investment $33,000. Assuming that the $8,000 is properly chargeable to capital account, we would divide $33,000 by 100,000 barrels of oil to find the basis for depletion of each barrel of oil. The result of the computation in this particular case is that each one of the 10,000 barrels of oil which was withdrawn during the year represents a capital investment of 33 cents each. The allowable depletion deduction is, therefore, 33 cents per barrel.

D. *Percentage of Gross Income*

A depletion deduction of 27½ per cent of the gross income from oil or gas lands was first permitted by the Revenue Act of 1926. The same act omitted the provisions for depletion based on discovery value. The particular merit of the percentage method is that it eliminates controversies as to value and estimates as to the extent of reserves.

If the taxpayer is using the percentage depletion method, it is apparent that it is important to determine what shall be included within gross income. Gross income for the purpose of the percentage depletion allowance is the amount for which the taxpayer sells the crude mineral product, not to exceed the market or field price on the date of sale of similar products at the well.[16] Regulations 94 contain this new provision:

[15] Reg. 94, art. 23 (m)-2.

[16] Reg. 94, art. 23 (m)-1 (g). In Greensboro Gas Co. v. Commissioner, (C. C. A.

> "In the case of oil and gas, if the crude mineral product is not sold on the property but is manufactured or converted into a refined product or is transported from the property prior to the sale, then the 'gross income from the property' shall be assumed to be equivalent to the market or field price of the oil or gas before conversion or transportation."[17]

The fixed percentage deduction for depletion cannot exceed 50 per cent of the net income from the property.[18] The net income for this purpose is computed by deducting from the gross income as above defined operating expenses, depreciation, taxes, losses, overhead and general expenses. Development expenses should not be deducted in determining this limitation under the decisions in *Ambassador Petroleum Co. v. Commissioner*[19] and *Rocky Mountain Oil Co. v. Commissioner*.[20]

Section 114(b)(3) of the 1936 Act provides that the rents or royalties paid or incurred under the lease shall be excluded in determining gross income. This statement, of course, applies only to the lessee, for to the lessor the royalties are of course income.[21]

II

THE APPLICATION BY THE COURTS OF THE STATUTORY RULES AND TREASURY REGULATIONS

A. *Supreme Court Decisions*

The Supreme Court, within the last few years, has decided several cases which present oft recurring problems of depletion of oil and gas properties. A statement of the facts and decision in each case may

3d, 1935) 79 F. (2d) 701, cert. denied 296 U. S. 639, 56 S. Ct. 172 (1935), the taxpayer was engaged in producing natural gas from properties leased by it and selling the gas to consumers after transporting the same through its distribution system. Held, the total proceeds of sales do not constitute "the gross income from the property" under Sec. 204 (c) (2) of the Act of 1926, but the gross income is that portion of the total receipts which represents the fair market or field price of the gas at the wells prior to transportation. To same effect, see Consumers Natural Gas Co. v. Commissioner, (C. C. A. 2d, 1935) 78 F. (2d) 161.

[17] Reg. 94, art. 23 (m)-1 (g) (4).

[18] Reg. 94, art. 23 (m)-3.

[19] (C. C. A. 9th, 1936) 81 F. (2d) 474.

[20] 36 B. T. A., No. 60 (1937).

[21] Delay rentals are not to be included in the gross income of the lessor for the purpose of the depletion deduction. They are not income from the production of oil or gas but are paid for additional time in which to commence operations. Commissioner v. Wilson, (C. C. A. 5th, 1935) 76 F. (2d) 766; Continental Oil Co. v. Commissioner, 36 B. T. A., No. 119 (1937).

serve to clarify the basic theory of depletion and its application to typical situations.

Justice Brandeis, in *United States v. Ludey*,[22] stated the purpose of the depletion allowance in these words:

> "The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed."

In *Burnet v. Harmel*,[23] the taxpayer owned Texas lands and executed an oil and gas lease on the lands. He received a cash or bonus payment of $57,000 and a stipulated royalty. The taxable years 1924 and 1925 were involved and the taxpayer wanted to return the cash payment as gain from the sale of a capital asset, this being taxable at a lower rate than other income under the 1924 Act. Under Texas law, an oil and gas lease is considered to create a determinable fee in the minerals and is a present conveyance of the oil and gas in place. But even though title to the oil and gas passed from the lessor, the Court held that the bonus payment did not represent a gain from the sale of a capital asset, and was taxable as ordinary income.

> "Bonus and royalties are both consideration for the lease and are income of the lessor. We cannot say that such payments by the lessee to the lessor, to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production."[24]

Murphy Oil Co. v. Burnet[25] was decided December 5th, 1932. It involved royalties received in 1919 and 1920 under an oil and gas lease. The lease was executed in 1913, and the lessee, the taxpayer, received, prior to 1919, bonus payments of more than $5,000,000. The tax on the bonus was not directly under consideration in this case; it was rather the effect of the bonus on the tax on the royalty. The

[22] 274 U. S. 295 at 302, 47 S. Ct. 608 (1927).

[23] 287 U. S. 103, 53 S. Ct. 74 (1932).

[24] Ibid., 287 U. S. at 112.

[25] 287 U. S. 299, 53 S. Ct. 161 (1932). Accord: Fink v. Commissioner, (C. C. A. 10th, 1935) 76 F. (2d) 335.

commissioner ruled that the deduction for depletion on the royalties which the lessor received in 1919 and 1920 should be calculated by treating the bonus previously received as a return of capital and by reducing pro tanto the depletion allowed on the royalties received in 1919 and 1920. The Court adhered to its position that both bonus and royalties are a return of capital invested in oil in the ground for which a depletion allowance must be made. The taxpayer here was taking his depletion on the basis of value as of March 1st, 1913. The per barrel capital investment in oil in the ground had been fixed by an estimate of the total reserves at the date of the lease and the value as of March 1st, 1913. Capital investment adjustments were made for withdrawals of oil each year and the per barrel capital investment in 1919 and 1920 calculated. The total amount of the bonus received was divided by the total number of barrels of oil in the ground which represented his royalty share (in this case one-fourth). The result was the amount to be deducted from the per barrel depletion allowance of oil which his royalty would receive in 1919 and 1920.

In *Palmer v. Bender*,[26] decided in January, 1933, an assignor of an oil and gas lease was paid a cash bonus, and as additional consideration a future payment was stipulated of $1,000,000 out of one-half of the first oil produced and saved, and an "excess royalty" of one-eighth of all the oil produced and saved. The taxpayer was taking a depletion allowance on the basis of value of the oil in place at the date of discovery. He claimed a depletion deduction for the years 1921 and 1922 on the income derived from the bonus, from the oil payment, and from the one-eighth royalty. The commissioner took the position that the assignments were sales of the leases and that the only allowable deductions in calculating gain were those based upon the cost of the property to the taxpayer. The cost of both leases was considerably less than their value at the dates of the discovery of oil. The Court permitted the taxpayer to take a depletion deduction on all three items of income. The bonus was a partial return of his capital investment in the oil in anticipation of its extraction. If the payment of $1,000,000 had not been reserved out of one-half of the oil produced, or if the one-eighth royalty had not been reserved, the taxpayer would not have been entitled to a depletion allowance on the bonus.

[26] 287 U. S. 551, 53 S. Ct. 225 (1933).

> "When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor."[27]

We cannot infer from the opinion that the fact that both an oil payment and a royalty were reserved was considered an important factor in the decision. The reservation of either would have given the requisite economic interest in the oil in place, and would have entitled the assignor to a depletion allowance on the bonus, as well as on the oil payment or royalty.

The taxpayer happened to be using the discovery value as the basis for his depletion deduction. This is not mentioned by the Court as being of any special importance; and we cannot say that the decision means that only when depletion is taken on a basis of cost or value would the Court permit the deduction from the bonus. The decision is based upon the fact that the taxpayer had an economic interest in the oil in place, not on the depletion method that he happened to be using. On the same facts, if the taxpayer were using the percentage depletion method the result should be the same even though he secured an advantage by this method that he would not have had were he using cost or value as a basis.

This decision ended any distinction for tax purposes between an assignment and a sublease.

> "But there is nothing in the statute or regulations which confines depletion allowances to those who are technically lessors. . . . The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. . . .
>
> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production."[28]

Since he is allowed to take depletion on the bonus, there will be a diminution in the depletion allowance upon each barrel of oil which he

[27] Ibid., 287 U. S. at 558.

[28] Ibid., 287 U. S. at 556, 557.

receives as royalty. This is illustrated by *Murphy Oil Co. v. Burnet*, discussed above.

In *Herring v. Commissioner*,[29] the taxpayer owned a tract of land near Amarillo, Texas, and in 1926 executed an oil and gas lease upon portions of it for a primary term of five years. No wells were drilled upon the land until 1930, when four commercial gas wells were completed. When the lease was executed there were no wells within three and one-half miles of the land. The lessee paid $683,793.75 in 1926 as advance royalties or bonus, and the lessor claimed a depletion allowance of 27½ per cent of the bonus payment. The Supreme Court held that such a deduction was proper. A bonus is not a receipt from the sale of a capital asset, but is "payment in advance for oil and gas to be extracted, and is therefore taxable income."[30]

In *Helvering v. Twin Bell Oil Syndicate*[31] the Court met the problem of apportioning the percentage depletion deduction between the lessor and the lessee. The lessee of an oil and gas lease contended that as he sold all the oil and paid the one-fourth royalty in cash he was entitled to a depletion deduction of 27½ per cent of the entire gross income. But the Court held that gross income from the property meant gross income from production less the amounts which the

[29] 293 U. S. 322, 55 S. Ct. 179 (1934). Note that in the last paragraph of the opinion the Court says that it expresses no opinion as to income tax liability in the year of termination of the lease on account of bonus paid at the execution of the lease if no mineral has been extracted. The regulations state that if the lease should terminate without any oil or gas ever having been produced, the taxpayer must return the depletion deductions as income for the year in which the lease terminates or is abandoned. Reg. 94, art. 23 (m)-10 (c). Cf. Security-First Nat. Bank v. Welch, (C. C. A. 9th, 1937) 92 F. (2d) 357, with the Herring case on depletion on bonus.

[30] Herring v. Commissioner, 293 U. S. 322 at 324, 55 S. Ct. 179 (1934).

[31] 293 U. S. 312, 55 S. Ct. 174 (1934). If the property is held by one person for life with remainder to another person, the deduction for depletion is to be computed as if the life tenant were the absolute owner of the property, and is to be allowed to the life tenant. 49 Stat. L. 1660, § 23 (m). As to property held in trust, the allowable deduction is apportioned between the income beneficiaries and the trustee in accordance with the terms of the trust instrument, or, in the absence of such provisions, on the basis of the trust income allocable to each. Ibid. In Helvering v. Falk, 291 U. S. 183, 54 S. Ct. 353 (1934), the lessor of a mine created a trust and authorized the trustees to collect the cash royalties and distribute them to the beneficiaries. The beneficiaries were given no other interest in the trust property or its income. The income received by them was held to be taxable subject to a depletion deduction. The same decision was reached in Reynolds v. Cooper, 291 U. S. 192, 54 S. Ct. 356 (1934), which involved a trust of royalties from an oil and gas lease, the beneficiaries there, however, having a remainder interest by the terms of the trust instrument. See Commissioner v. Laird, (C. C. A. 5th, 1937) 91 F. (2d) 498, for decision on taxation of oil royalties and oil payments on beneficiary under will.

lessee had to pay as royalty. The Court took the position that there should be only a single allowance of 27½ per cent of the gross income from the whole property; the lessee could take 27½ per cent of his gross income from the working interest, and the lessor 27½ per cent of his gross income from his royalty interest.

In *Thomas v. Perkins*,[32] the owners of oil and gas leases on undeveloped lands assigned them to Perkins by an instrument which recited a consideration of ten dollars cash and $395,000 to be paid out of one-fourth of all the oil if, as, and when produced. The assignment expressly negatived any personal obligation. The assignee drilled wells on the land and produced oil. He paid immediately to the assignors one-fourth of the money which he received from the sale of oil to be applied to the $395,000 oil payment. The Court decided that Perkins, the assignee, did not have to report this one-fourth as his income, and he was not entitled to a depletion deduction on it. It was taxable income of the assignors and they were entitled to the depletion deduction.

B. *Decisions of Circuit Courts of Appeals*

Different transactions have been presented to the lower federal courts for consideration. The decisions fill some of the lacunae and reveal the difficulty of applying the principles stated by the Supreme Court to only slightly different facts.

In *Comar Oil Co. v. Burnet*,[33] the Comar Oil Company was assignee of oil and gas leases under three different forms of assignment. One of them provided for the payment of $100,000 out of one-eighth of the gross production of oil and gas and retained a lien on the one-eighth until the money was paid. Another provided for the payment of $50,000 out of one-half of the first oil and gas produced; and the third provided for payment of $1,250,000 out of 50 per cent of the oil produced, title to all the oil, however, to be in the assignee. During 1923 the Comar Oil Company paid $1,390,105.24 on the oil payments retained by the assignments. The Circuit Court of Appeals for the Eighth Circuit held that these payments should not be deducted from the gross income of the Comar Oil Company, for the reason that title to the property had passed to the Comar Oil Company. The court suggested that the assignee was entitled to a depletion deduction on the amount it had paid on account of the oil payment, but this

[32] 301 U. S. 655, 57 S. Ct. 911 (1937).
[33] (C. C. A. 8th, 1933) 64 F. (2d) 965.

question was not directly involved in the case. In so far as the case indicated that the assignee could take the depletion deduction on the "overriding royalties," it was inconsistent with *Palmer v. Bender*, decided by the Supreme Court a few months earlier, allowing the depletion deduction to the assignor. *Thomas v. Perkins* has now definitely decided that the assignee is not entitled to a depletion deduction in respect to royalties paid to the assignor.

The case of *Alexander v. Continental Petroleum Co.*[34] was decided in the Fifth Circuit, March 28, 1933; the decision is in accord with the later holding of the Supreme Court in *Thomas v. Perkins*. In the *Alexander* case certain oil and gas leases were assigned and in the assignment the assignor reserved one-half the lessee's share of the oil when produced until it should be credited with $2,471,241. The court held that this was a sale of the lease, but that the assignor still had an interest in the production of the oil and was entitled to a depletion allowance on the oil payment.

The Circuit Court of Appeals for the Fifth Circuit decided the case of *Commissioner v. Fleming*[35] on March 7, 1936. Fleming owned an undivided interest in two oil and gas leases. In 1928 he joined in the execution of an assignment in which the owners of the lease sold and conveyed all their interest in the lease in consideration of $1,000,000 in cash and $1,000,000 out of one-fourth of the oil, gas and other minerals produced from the working interest of this lease. The assignment expressly provided that the $1,000,000 oil payment was not and never should be a personal obligation or liability, but should be paid only out of the products if, as, and when produced and sold from the premises. In 1929 a similar assignment was made of another lease providing for $225,000 to be paid out of one-half of seven-eighths of the first crude oil produced, saved and marketed from the premises if, as, and when produced and not otherwise.

The court held that the cash payment was income from the sale of a capital asset, and was not subject to the depletion allowance; but that the oil payments were subject to the depletion allowance. The decision as to the oil payment is in accord with *Thomas v. Perkins*; but the decision as to the cash or bonus payment seems contrary to several of the Supreme Court cases.

The court said that a lessee's interest is everywhere regarded as vendible real property and the lessee may sell his estate or

[34] (C. C. A. 10th, 1933) 63 F. (2d) 927.
[35] (C. C. A. 5th, 1936) 82 F. (2d) 324.

any interest in it, and thus realize income in the way of profit on the sale. This is correct as applied to a lessee and is also correct as applied to the working interest at the time the lessor executes the lease. The Supreme Court has said that when the lessor sells the minerals in place, by the execution of the lease, he is entitled to a depletion deduction on the cash bonus. There is no reason why the lessee, when he sells the same interest, should not be entitled to a depletion on the cash bonus. The circuit court of appeals said such income was not subject to be reduced by the percentage depletion allowance, which applied only to income arising from the operation of the oil and gas wells. The court followed the reasoning in an earlier decision in the Tenth Circuit,[36] instead of the ruling of the Supreme Court in *Herring v. Commissioner.*

The court was troubled by the fact that the oil and gas lease might be sold several different times without any oil or gas being removed or produced. But *Herring v. Commissioner* should have settled these doubts, for it says

> "A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income. . . . That, under the law and the regulations, a lessor is entitled to a depletion allowance on bonus payments is settled by the decisions of this court. It has never been held here that the existence of a well conditioned the right to depletion."[37]

Palmer v. Bender had already decided that a lessee who assigned his lease was entitled to a depletion allowance on the cash bonus which he received when he assigned the lease. And the language of that opinion is emphatic that the depletion allowance is not to be confined to those who are technically lessors.

Commissioner v. Fleming was not taken to the Supreme Court. When the Government takes the position that a bonus payment is not subject to a depletion allowance, it in effect states that this bonus is not ordinary taxable income, but is to be considered as gain or loss on the sale of a capital asset. If this is done, there is no tax at all unless the sale price or the bonus is greater than the cost or other basis of the property. If the commissioner contends that the bonus is subject to depletion, there would be income remaining subject to tax after the bonus had been reduced by the depletion deduction and

[36] Darby-Lynde Co. v. Alexander, (C. C. A. 10th, 1931) 51 F. (2d) 56.

[37] Herring v. Commissioner, 293 U. S. 322 at 325-326, 55 S. Ct. 179 (1934).

other deductions permitted by law. To adopt the position that the bonus represents merely a gain on a sale of a capital asset may result in many instances in the imposition of no tax at all, for the reason that the cost or other basis is greater than the bonus. Perhaps this is why the taxpayer in the *Fleming* case did not appeal to the Supreme Court. It is to be noted that in a dissenting opinion Circuit Judge Foster states that he thinks the deduction for depletion should be allowed on the cash payment, as well as on the income received out of the proceeds of oil produced.

A few days later, on March 11th, 1936, the same court rendered its decision in the case of *Commissioner v. Williams*[38] and permitted a depletion deduction of 27½ per cent on amounts which were paid on an oil payment in 1927 and 1928. The assignor of the oil and gas lease on Texas lands was permitted to take the allowance. The assignment provided for the payment of $110,000 cash and, after the assignees received $160,000 from the gross sales of oil from the working interest, for the payment to the assignor of one-half of the proceeds of the next oil produced until $192,500 was paid. The question of depletion allowance on the cash payment was not before the court.

In *Elbe Oil Land Development Co. v. Commissioner*[39] decided in the Ninth Circuit, the taxpayer owned various oil and gas leases and permits, and assigned these under an agreement with the Honolulu Consolidated Oil Company. An initial payment of $357,000 was made in 1928, and according to the terms of the agreement this was to be followed by a payment of $400,000 on March 14th, 1928 and a payment of like amount on March 14th, 1929. The oil company was to take possession of the property and drill for oil as required by the various leases. It reserved the right to surrender the property without making the 1928 payment, or if it made that payment it still had the right to surrender the property before March 14th, 1929; and if it so surrendered the property, it would not be obligated to make the payment of $400,000 on that date. If it surrendered the property under this clause, it would be entitled to keep any wells it had drilled or was drilling at the time until it was reimbursed for all expenditures and payments made to the assignor, the taxpayer. If the oil company did not surrender the property before March 14th, 1929, it agreed to continue payments aggregating $2,000,000. When the oil company by operation of the property should be reimbursed for all payments

[38] (C. C. A. 5th, 1936) 82 F. (2d) 328.
[39] (C. C. A. 9th, 1937) 91 F. (2d) 127.

and expenditures, including all of the money paid to the assignor, then the assignor was to receive one-third of all the oil produced.

The case is interesting for the reason that the $350,000 which was paid in 1927 as an initial payment was considered in its entirety as a return of capital and no depletion allowance was taken on it. The cost of the property was less than $350,000 and the cost had been allowed as a deduction in calculating the taxable gain derived from the payment. But the treatment of this initial payment was not before the court and the court was concerned only with the payments made in 1928 and 1929 of $400,000 each.

In an unexceptionable analysis of the result of the contract Circuit Judge Wilbur concluded that the taxpayer had at all times an economic interest in the oil produced from the premises and was entitled to a depletion allowance upon the payments made in 1927 and 1928. He stated that it was difficult to distinguish the situation presented by the contract from the case of an ordinary lease providing for bonus payments and royalties, so frequently dealt with in the decisions involving the right to a depletion allowance for income tax purposes. The opinion followed the Supreme Court's decision in *Palmer v. Bender* and declined to follow the Fifth Circuit case of *Commissioner v. Fleming*.

The same court on March 9th, 1936, decided a similar question. In *Commissioner v. Elliott Petroleum Corp.*,[40] the taxpayer had purchased an oil and gas lease in 1922 for $156,944.58. In 1928 he sold it for $275,000, one-half payable in cash and the balance payable out of one-half of the net proceeds of all production from the leased premises. In 1926 and 1927, he had received amounts which equalled the amount he had paid for the lease, and the commissioner gave him credit against these amounts for the cost of his lease. In other words, the amounts received in 1926 and 1927 equalled his capital investment in the property, that is, were a return of capital, and were therefore not taxable as income. The court said that it would not decide the question as to whether or not the commissioner was correct in the manner in which he handled this matter. In 1929 the taxpayer received $69,699.81 from the oil payment. The commissioner held that all this amount was profit, but the court held that the taxpayer was entitled to a depletion deduction of 27½ per cent on the oil payment.

Most of the cases involve questions of depletion on amounts earned

[40] (C. C. A. 9th, 1936) 82 F. (2d) 193.

and paid out of the working interest or lessee's interest. The lessor's interest was involved in *Pugh v. Commissioner*[41] where the taxpayer owned a one-eighth royalty interest under an oil and gas lease. He transferred half of this one-eighth to Eastham for the total sum of $250,000—$50,000 of which was paid in cash and the balance of $200,000 was to be paid out of the royalty interest conveyed to Eastham. The assignment stipulated that the assignor was to receive the entire one-eighth royalty until the unpaid balance of $200,000 had been received by him out of the proceeds belonging to the share which he had sold to Eastham. It was stipulated that Eastham, the assignee, was not personally obligated to pay the $200,000.

The parties had agreed that the assignor should be entitled to the depletion allowance on the amounts that were applied to the $200,000 oil payment. But the court would not consider this agreement as binding and said that one-half the royalty belonged to Eastham immediately on the date of the assignment, and that his right in the oil was being depleted by the removal of the oil and that he and not the assignor was entitled to the depletion allowance. The arrangement whereby the assignor received and kept the entire proceeds of the royalty interest to apply to the oil payment was held merely a pledge of the proceeds.

This case was decided April 20th, 1931, prior to *Palmer v. Bender*. The United States Circuit Court of Appeals for the Fifth Circuit decided the case; in its later opinion in *Commissioner v. Fleming* the court implied that the *Pugh* decision was incorrect. In *Commissioner v. Elliott Petroleum Co.* the *Pugh* case also received adverse comment and cannot now be considered an authority.

Let us assume a slightly different set of facts in regard to a royalty interest. The owner of a one-eighth royalty under an ordinary oil and gas lease conveys a part of this royalty for $10,000 and reserves a lien and takes a note to cover the sale price, which is due and payable $2,000 each year. The assignment does not recite that the assignor is to retain the proceeds earned by the entire one-eighth royalty, but the note recites that the assignor is to retain the proceeds and apply them to the payment of the note. The note is worded so that payment is not limited to the royalty interest, but it is payable in any event and is a negotiable instrument. It appears that the courts today would hold that the assignor is entitled to a depletion deduction on all of the

[41] (C. C. A. 5th, 1931) 49 F. (2d) 76.

one-eighth royalty interest and, as stated below, this right should not be denied him because he has also taken a personal obligation to pay the amount in addition to the economic interest which he has retained in the oil and gas in place.

In *F. K. Land Co. v. Commissioner*,[42] the taxpayer executed an oil lease in 1930 and received a bonus of $130,000 at the time of the execution of the lease. The royalty was one-seventh if the oil production was 500 barrels or less per day, and one-sixth if the production was more than 500 barrels per day. The fair market value of the land on March 1st, 1913, was $140,000. Rather than take 27½ per cent of the $130,000 bonus as his depletion allowance, the taxpayer elected to determine his depletion allowance by taking the sum of the bonus and the royalties expected to be received from the property as his gross return, prorating the cost of the properties between the bonus and the estimated royalties, and making proportionate deductions from the bonus and the royalties when received. He said that, since it was impossible to estimate the expected royalties, the entire cost of the property should be deducted from the bonus in determining the taxable gain. The court noted that this was land in developed territory and held that the taxpayer could not rely upon the failure of the commissioner to prove the value of the prospective royalties, as the burden was on the taxpayer to establish their value or lack of value. Since he failed to show his correct depletion deduction, he must be content with the deduction which the commissioner allowed him under the alternate rule; that is, 27½ per cent of gross income.

CONCLUSIONS

Without attempting an exhaustive enumeration the following propositions may be deduced from the cases discussed.

1. No particular form of words is required to vest one with the necessary economic interest which is the basis for the depletion deduction.

2. A cash payment or bonus payment is subject to a depletion allowance if the person receiving the bonus retains some economic interest in the oil or gas, whether it be a royalty or an oil and gas payment.

3. Proposition two applies to the original lessor and to any owner of an oil and gas lease who assigns it to another person.

4. There need be no retention of a lien to confer the requisite economic interest in the oil or gas in place.

[42] (C. C. A. 9th, 1937) 90 F. (2d) 484.

5. In none of the cases discussed in this article did the opinion indicate that there was a personal obligation upon the assignee to pay the reserved oil payment; however, in *Commissioner v. Elliott Petroleum Co.*[43] there is a dictum to the effect that the existence of a personal obligation would change the result. The court said that if the amounts payable to the assignor were due in any event, the depletion allowance would go to the assignee; but when the oil payment is contingent upon production and there is no personal obligation to make payment, the assignor has an economic interest in the oil which entitles him to the depletion allowance. This conclusion ignores the premise that the depletion deduction belongs to anyone who has an economic interest in the oil or gas. An oil payment is an equitable lien or charge which binds the land in the same manner as a personal obligation binds a person. An oil payment creates a charge on land and designates the person to whom the amount of the charge is to be paid. Can it be argued that by the addition of a personal obligation to pay the debt or charge that the interest in the land is destroyed with the resultant loss of the right to the depletion deduction? Assignments are often drawn with a provision for an oil payment which is to be made out of the production of oil and gas, and if the payment is not made in full within a stated number of years out of production then the assignee agrees to make this payment on a certain date. It seems that the proper way to handle such agreements is to allow the assignor a depletion deduction on the payments that are actually made out of production; and if the total agreed price has not been paid at the time stipulated and the assignee pays the remainder, this remainder is not subject to the depletion allowance.

6. If the taxpayer is entitled to depletion, the court will not deny it to him because the method he has chosen gives him an advantage he would not have if he were using another method.

7. A depletion allowance on the bonus or cash payment is not dependent on actual production of oil or gas or even upon the existence of a well on the land or near the land.[44]

[43] (C. C. A. 9th, 1936) 82 F. (2d) 193, discussed at note 40, supra.

[44] The ordinary casinghead gas contract under which the owner of a well sells a part or all of his casinghead gas production to a casinghead gasoline plant does not seem to give the purchaser of the gas an interest in the gas in place so as to entitle him to a depletion deduction. Under the ordinary contract the lessee has complete charge of the lease and the production of gas and sells the gas to the gasoline plant after it is severed from the soil. Some casinghead gas contracts are for a period corresponding with the life of the lease, others are for a stated time and

Our survey of the decisions has indicated considerable dissimilarity in the results reached by the various courts. There is no such accord concerning even basic principles that traders in oil and gas properties can be advised on depletion questions with certainty. It is unfortunate that the profit or loss from a business transaction should depend upon a tax, or deduction, whose incidence cannot be exactly predicted prior to the trade.

many are subject to concellation by either party on thirty days' notice. The lessee, the seller of the gas, is paid for the gas according to the gasoline content in the gas and the market price of gasoline during the month the gas is run. Cf. Signal Gasoline Corp. v. Commissioner, (C. C. A. 9th, 1933) 66 F. (2d) 886; Hurley v. United States, (D. C. Okla. 1935) 10 F. Supp. 365; Bankline Oil Co. v. Commissioner, (C. C. A. 9th, 1937) 90 F. (2d) 899, cert. granted 58 S. Ct. 119 (1937). In Brea Cannon Oil Co. v. Commissioner, (C. C. A. 9th, 1935) 77 F. (2d) 67, the court held that the percentage depletion is properly based on the market value of the wet gas, not on the amount received for casinghead gasoline manufactured from the gas.