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THE DEPLETION DEDUCTION IN THE OIL AND GAS INDUSTRY FOR FEDERAL INCOME TAX PURPOSES

THE NATURE AND CLASSIFICATION OF THE DEPLETION DEDUCTION

It is often heard in tax circles that the people in the oil and gas industry are being subsidized by the Federal Government through the allowance of the depletion deduction in the form of cost depletion or percentage depletion, at the rate of 27 1/2 per cent of gross income, whichever is the greater of the two. This being the charge, it becomes essential to understand the establishment and continuance of this allowance as a deduction from income for tax purposes, and the basic reasons why the deduction is allowed at all. Such an understanding can be acquired only through some acquaintance with the statutes and decisions dealing with the deduction.

Mr. Justice Brandeis stated the reason for the allowance of the depletion deduction as follows:

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. Thus the depletion deduction is only granted in favor of those whose reserve of their capital asset is being depleted through the extraction of the oil and gas. Generally speaking, this can be held to be a true statement of the allowance.

The Supreme Court again likened the depletion deduction to the consumption of raw materials in manufacturing:

Oil and gas reserves like other minerals in place, are recognized as wasting assets. The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance.2

The depletion deduction is a matter of legislative grace by which Congress allows the oil and gas producer a deduction from his gross income

as a compensation for his capital assets consumed in the production of income through their severance from their places in the earth.

THE HISTORY OF THE DEPLETION DEDUCTION

Since the depletion deduction is a statutory matter, tracing the present depletion deduction provisions through the various Internal Revenue Acts which preceded the Internal Revenue Code should result in a better understanding of said provisions.

Under the Corporation Tax Act of August 5, 1909, the Supreme Court held that no allowance for depletion was to be accorded to a mining corporation for the purpose of determining its net income. This decision was rendered against the taxpayer corporation even though the deduction against the gross proceeds from the mining and treatment of ores to the extent of the cost value of the ore in the mine before it was mined, had been ascertained in accordance with Treasury Decision 1675. Thus, both Congress and the Treasury Department had evidently presumed that the 1909 Act as written had allowed a deduction for depletion, but the Supreme Court thought otherwise.

To remedy this confused situation, in passing the Internal Revenue Act of 1913 Congress allowed for a deduction for depletion by the following provisions, “in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made.” This section was later held to include oil and gas wells.

The 1913 Act came under fire in Stanton v. Baltic Mining Co., in which Stanton, a stockholder of the mining company, sought to enjoin the voluntary payment by the corporation and its officers of the tax assessed against it under the 1913 Act, because an inadequate allowance by way of deduction was made for the exhaustion of the ore body; claiming the tax was in the nature of things one on property because of its ownership, and therefore a direct tax subject to apportionment. Mr. Chief Justice White stated:

This merely asserts a right to take the taxation of mining corporations out of the rule established by the 16th Amendment when there is no authority for so doing. It moreover rests upon the wholly fallacious assumption that, looked at from the point of view of substance, a tax on the product of a mine is necessarily in its essence and nature in every case a direct tax on property because of its ownership unless adequate allowance be made for the exhaustion of the ore body to result from working the mine. We say wholly fallacious

3 36 Stat. 112 (1909).
5 Internal Revenue Act of 1913, § 2 G(b) (as to corporations).
6 240 U.S. 103 (1916).
assumption because, independently of the effect of the operation of the 16th Amendment, it was settled in Stratton's Independence v. Howbert, 231 U.S. 399, 34 S. Ct. 136, that such tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations. 7

That the depletion deduction is not required by the 16th Amendment itself, but is merely allowed as a matter of legislative grace of Congress will become quite apparent when it is seen how Congress from time to time has changed and rechanged, clarified and in many cases discarded provisions for depletion deduction under the various Internal Revenue Acts.

Change in the provisions of the 1913 Act were soon made for the oil and gas industry. In 1916 the Congress provided:

In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; . . . such reasonable allowance to be made . . . under rules and regulations to be prescribed by the Secretary of the Treasury: Provided, That when the allowance authorized . . . shall equal the capital originally invested, or in the case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made. . . . 8

Under this Act the total depletion deductions allowed over the years were to be limited to the capital originally invested, or to the fair market value as of March 1, 1913. This limitation provision is to disappear ten years later with the introduction of the “percentage depletion” concept. 9

The depletion deduction became unlimited as long as income continued to be derived from the operation of the oil or gas well. This lack of a limitation is one of the points that is criticized adversely by those people who would have Congress abolish the depletion deduction.

Of the 1916 Act provision, an Ohio federal district court in Ohio Oil Co. v. United States stated:

The statute states that there may be deducted a reasonable allowance for the actual reduction in flow and production to be ascertained not by the flush flow but by the settled production or regular flow. “Flush flow” indicates that flow of the oil when it is forced by natural pressures out of the ground from wells commonly known as gushers, or it may refer to the natural flow of other wells before they have reached the state where it is necessary that the oil be pumped. “Settled production” refers to the period in the life of an oil well which follows immediately after the flush flow. At that stage the oil must be pumped and the yield is called “settled production.” “Regular flow” is perhaps a misnomer, for it seems upon this record that it is generally recognized in the industry that the flow is never regular. Its tendency is to be irregular. This was recognized by members of Congress.

7 Ibid., at 113.
8 Internal Revenue Act of 1916, § 12(b) second (b) (as to corporations).
9 Internal Revenue Act of 1926, § 204(c) (2).
I have concluded that in using the term "regular flow," Congress intended to use the term synonymously with the term "settled production," which had a rigid and fixed meaning in the industry.\(^{10}\)

The court then viewed the practices within the oil industry:

At the time the 1916 Act became law, two methods for the computation of depletion were being considered, namely, (1) the decline in flow method also known as "reduction in flow" and "inventory of production" methods; and (2) the ultimate production method also known as the "unit method." The decline of flow method contrasted the daily average production of the last day of the year with the last day of the previous year, thus determining the decrease in the daily average production.

The ultimate production method is predicated upon the assumption that it is possible to determine with reasonable accuracy the total amount of oil or gas which is under ground and which will be produced from a given lease or other unit of oil producing property during its commercially productive life. The initial step in this method is the estimation of the number of barrels of oil that will be ultimately extracted from a specified property. The investment in the property is divided by the number of barrels estimated, giving the unit cost or value attributable to each barrel of oil under ground. As the oil is extracted, an allowance of such unit is made for each barrel recovered, so that the depletion allowance for the year is the unit multiplied by the number of barrels of oil produced.

For many years prior to the time that the Income Tax Act of 1916 was under consideration by Congress, it had been the practice in the oil industry to buy and sell oil properties on the basis of their daily average production. Such properties were sold and the price fixed at a given price per barrel for such daily average production. The decline in flow method of determining depletion or exhaustion in its narrower sense grew naturally out of this practice. It was generally regarded as an accurate method of determining depletion especially by operators who did not long retain properties and whose purpose was to sell them as soon as they reached settled production. In the absence of any more accurate method, it was natural to arrive at the conclusion that the decrease in the daily average production measured the exhaustion and decline of the reserves of oil for given properties.

The ultimate production method came later. It was based upon the supposition that the amount of oil underlying a particular property could be measured with sufficient accuracy to serve as a basis for a determination or ascertainment of the exhaustion and depletion of the reserves.

The decline in flow method proceeded upon the theory that the amount of recoverable oil could more accurately be determined by the regular flow as settled production, which indicated the amount of oil which had actually been recovered from the reserves. The ultimate production method was predicated upon the thought that the amount of the reserves could be determined in advance of the recovery of the oil from the reserves.\(^{11}\)

With these accepted methods of computing depletion in use in the industry at the time of the drafting and subsequent passage of the 1916

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\(^{10}\) Ohio Oil Co. v. United States, 17 A.F.T.R. 1114 (1936).

\(^{11}\) Ibid.
Act it is interesting to view the proceedings in Congress as of that time to see what method the Congress thought it had employed in the passage of the statute. Senator Chilton, of West Virginia, was largely responsible for the phraseology of the bill. He stated that the expressions “flush flow” and “settled production” were perfectly well understood among oil men and producers. “They are well known to the operators and to the men who own the land...” From the Senate discussions it appeared that the senators had in mind permitting the deduction of depletion as the decline in the flow after the wells had reached settled production or regular flow, but, they regarded the provisions of the 1913 Act (5 per centum of the gross value at the mine) as arbitrary and as not permitting a sufficient allowance for depletion. Congress appreciated that a provision must be applied in the case of oil and gas properties different from that which was to be applied in metallic and other mining properties. This appreciation evidenced itself in the form of the final adoption of the 1916 Act separating oil and gas from the other mining properties. This separation has continued in existence through all subsequent acts.

Congress thus based the depletion deduction on the “decline in flow method.” Depletion was not allowed upon a method which presupposed that the reserve of oil or gas under ground could be accurately estimated so that a fixed unit depletion could be allowed upon each barrel produced, but the depletion deduction was allowed on the basis of a known average daily production computed from the actual oil taken from the well. That the confused rules for the computation of the depletion deduction still bothered the Congress can be seen from the wording of the 1918 Act, in which Congress shifted the burden of prescribing a formula to the Commissioner of Internal Revenue.

The 1918 Act provided for the depletion deduction as follows:

In the case of oil and gas wells, a reasonable allowance for depletion according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: Provided, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer’s interest therein) on that date shall be taken in lieu of cost up to that date: Provided further, That in the case of oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair

12 Internal Revenue Act of 1916, § 12 (b) second (b) (as to corporations).
14 Internal Revenue Act of 1913, § 2 G (b) (as to corporations).
15 Today what is known as “cost depletion” or “unit depletion” is allowed as an alternative to “percentage depletion.” It seems that as science progressed and oil and gas reserves could be quite accurately estimated, the Congress has recognized this fact and allowed depletion to be computed based upon such an estimated reserve.
market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.\(^\text{16}\)

In comparing the language of the 1916 and 1918 Acts in the *Ohio Oil Company* case the court stated:

Under the 1918 Act it was open to the Commissioner and the Secretary of the Treasury to adopt either the decline in flow or the ultimate production method, but the 1918 Act did not contain the language "in the case of oil and gas wells a reasonable allowance for the actual reduction in flow and production, to be ascertained not by the flush flow, but by the settled production or regular flow." . . . It may be said in passing, however, that while there may have been weaknesses in the decline in flow method the ultimate production method was not free from criticism. There was grave doubt as to whether or not the reserves could be reasonably accurately estimated for income tax purposes. It was adopted by the Bureau, but in the Revenue Acts of 1926, 1928, 1932, 1934 [1936, 1938, and the Internal Revenue Code] Congress again resorted to the percentage method as an alternative.\(^\text{17}\)

Even under the 1918 Act, Congress, although agreed that a depletion deduction should be granted in the oil and gas industry, still had not agreed as to how to compute said deduction. The Congress under this Act very definitely shifted the burden of prescribing a formula for computing the depletion deduction to the Commissioner of Internal Revenue and the Secretary of the Treasury. Mr. Justice Roberts put the matter in these words:

It is clear that Congress intended that the lessee of an oil well should be entitled to a reasonable allowance for depletion based upon cost or March 1, 1913 value. It did not however attempt to prescribe a formula for ascertaining it, but expressly delegated that function to the Commissioner of Internal Revenue, who was to make rules and regulations to that end.\(^\text{18}\)

The proviso allowing for "discovery depletion" in this Act was to have a hectic existence, to cause untold administrative troubles and confusion and ultimately was to be discarded for the more simple administrative method known as "percentage depletion."

It is because of the administrative problems created by "discovery depletion," that Congress began to limit the provision allowing for "discovery depletion." These limitations manifest themselves in the 1921 Act which provides:

In the case of . . . oil and gas wells, . . . a reasonable allowance for depletion . . . according to the peculiar conditions in each case, based upon cost includ-

\(^{\text{16}}\) Internal Revenue Act of 1918, § 234 (a) (9) (as to corporations).

\(^{\text{17}}\) Ohio Oil Co. v. United States, 17 A.F.T.R. 1114 (1936).

\(^{\text{18}}\) Burnet v. Thompson Oil and Gas Co., 283 U.S. 301, 304 (1931).
ing cost of development not otherwise deducted: Provided, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: Provided further, That in the case of . . . oil and gas wells discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery or within thirty days thereafter: And provided further, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.\(^\text{19}\)

The Conference Committee reported on this section of the Act as follows:

Amendment No. 189: This Amendment inserts . . . the paragraph of the existing law relating to depletion allowance in the case of . . . oil and gas wells . . ., adding a proviso that the depletion allowance based on discovery value shall not exceed the net income from property upon which the discovery is made except where such net income is less than the depletion allowance based on cost or fair market value as of March 1, 1913.\(^\text{20}\)

This proviso limiting the depletion allowable based on discovery value, prevented a corporation engaged in any other business from taking any part of its depletion allowance against its income from other sources. The depletion allowance based on discovery value was now such that it would not exceed the net income from the oil property upon which the discovery was made. Under the law prior to the 1921 Act there was no such limitation.

The Circuit Court of Appeals, Second Circuit, in discussing the depletion provision of the 1921 Act held that depletion is regarded for tax purposes as a return of capital, and not as a special bonus for enterprise.\(^\text{21}\)

It was the provision for "discovery depletion" which continued to cause administrative problems, and as these problems grew, Congress revamped the depletion deduction section to clarify and further limit the "discovery depletion" allowance.

This revamped section on depletion appeared as part of the 1924 Act. The 1924 Act separated, for the first time, into separate sections\(^\text{22}\) the deple-

\(^\text{19}\) Internal Revenue Act of 1921, § 234(a) (9) (as to corporations).
\(^\text{22}\) Internal Revenue Act of 1924, §§ 204(c) and 234(a) (8).
tion deduction allowance provision from the provision which set forth the
*basis* upon which the depletion deduction was to be allowed. Thus Section
234(a)(8) (as to corporations) dealing with the allowance itself reads:

In the case of . . . , oil and gas wells, . . . a reasonable allowance for depletion
. . . , according to the peculiar conditions in each case; such reasonable allow-
ance in all cases to be made under rules and regulations to be prescribed by
the Commissioner with the approval of the Secretary. In the case of leases
the deductions allowed by this paragraph shall be equitably apportioned be-
tween the lessor and lessee.

Section 204(c), dealing with *basis* reads:

The basis upon which depletion, . . . are (is) to be allowed in respect of any
property shall be the same as provided in subdivision (a) or (b) for the pur-
pose of determining the gain or loss upon the sale or other disposition of such
property, except that in the case of . . . oil and gas wells, discovered by the
taxpayer after February 28, 1913, and not acquired as the result of purchase
of a proven tract or lease, where the fair market value of the property is
materially disproportionate to the cost, the basis for depletion shall be the fair
market value of the property at the date of discovery or within thirty days
thereafter; but such depletion allowance based on discovery value shall not
exceed 50 per centum of the net income (computed without allowance for
depletion) from the property upon which the discovery was made, except that
in no case shall the depletion allowance be less than it would be if computed
without reference to discovery value.

Section 234(a)(8) in setting forth that the depletion allowance under
this Act shall be in accord with rules and regulations prescribed by the
Commissioner with the approval of the Secretary was the same as in the
then existing law. As to section 204(c), however, the Committee Reports
of the Ways and Means Committee stated:

(9) The first part of subdivision (c) of the bill, that is, the part preceding
the exceptions, does not correspond to any provision of the existing law, but
is the same as the interpretation placed upon the existing law by the depart-
ment. It provides that the basis of computing depreciation and depletion shall
be the same as the basis of computing gain or loss from the sale of property,
and represents what is obviously the correct rule, since the theory in setting
a basis for depreciation and depletion is the same as in setting one for de-
termining gain or loss from sale; that is, to insure a taxpayer a return of his
capital free from tax. (10) The last part of subdivision (c) supersedes the
second and third provisos of section . . . 234 (a)(9) of the existing law. The
existing law limits discovery depletion to the operating profits from the prop-
erty upon which the discovery is made. The bill limits discovery depletion to
50 per cent of the operating profit upon which the discovery has been made.28

The Treasury Department, in explanation of proposed changes in the
Act of 1921, prepared a statement for the use of the Senate Finance Com-
mittee which read in part:

Experience in administering the law has shown that the limitation imposed by the existing law is not a sufficient limitation, and it has been concluded that 50 per cent of the operating profit from the property represents a fair limitation upon discovery depletion.

It was the 1924 Act, then, that for the first time tied in the allowance for depletion with the basis of the property for the purpose of determining gain or loss upon the sale or other disposition of such property, with the exception of the basis for discovery depletion which remained as it had been. This act also further limited the allowance for discovery depletion, and it is in this Act that discovery depletion last appears in the law.

The 1926 Act\(^\text{24}\) was the first in this series of acts to provide for percentage depletion in the case of oil and gas properties. In so doing the Act did away with discovery depletion. Cost depletion continued the same as it had been in the 1924 Act.

Section 234(a)(8) (as to corporations) of the 1926 Act remained exactly the same as Section 234(a)(8) of the 1924 Act.

Section 204(C)(2) of the 1926 Act sets forth the following:

In the case of oil and gas wells the allowance for depletion shall be 27\(\frac{3}{4}\) per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

The question has been asked as to why the figure 27\(\frac{3}{4}\) was chosen as the percentage of gross income to be allowed as the depletion deduction. The Senate and House reports show that it was a compromise figure as one might readily suspect. The Senate Finance Committee Report read in part:

The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall be 25 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained.\(^\text{25}\)

The Conference Committee Report contains this statement of the House's view:

The administration of the discovery provision of the existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of

\(^{24}\) Internal Revenue Act of 1926, §§ 204(c)(2) and 234(a)(8).

simplicity and certainty in administration the Senate amendment provides that
in the case of oil and gas wells the allowance for depletion shall be 30 per
cent of the gross income from the property during the taxable year. The pro-
vision of existing law limiting this amount to an amount not in excess of 50
per cent of the net income of the taxpayer from the property is retained.

The House recedes with an amendment providing that the depletion de-
duction based upon gross income in the case of an oil and gas well shall be
27½ per cent of that income instead of 30 per cent,. . .26

This then is how the 27½ per cent figure came into being; the Senate
Finance Committee recommending a 25 per cent figure as a rule of
thumb, the Senate setting up a 30 per cent figure and the House striking
the happy medium of 27½ per cent of gross income as the percentage
depletion deduction to be allowed.

From these Congressional records it is seen that the reason for allow-
ing percentage depletion instead of discovery depletion was based upon
the need for simplicity and certainty in administration. It can be implied
from this that Congress was confused as to the manner of determining
discovery value depletion and, dissatisfied with the then existing adminis-
tration of the law and in search of a simple and certain law, struck upon
percentage depletion as the answer.

In discussing the 1926 Act along with the prior Acts dealing with
depletion, Mr. Justice Stone said:

There is no ground for supposing that Congress, by providing a new method
for computing the allowance for depletion, intended to break with the past
and narrow the function of that allowance. The reasonable inference is that
it did not, and that depletion includes under the 1926 Act precisely what it
included under the earlier acts.27

From the same opinion comes this statement by Mr. Justice Stone:

But the “discovery value” provision was eliminated from the Act of 1926,
which is applicable here, and the taxpayer was permitted to calculate depletion
on the basis of cost alone, section 204(c), . . . or else to deduct an arbitrary
allowance, fixed by the statute, without reference to cost or discovery value,
at 27½ per cent of gross income from the well.28

Mr. Justice Roberts, in discussing the wording of the 1926 Act, said
that in authorizing the allowance, for depletion, of 27½ per cent of
“gross income from the property” during the taxable year in the case
of oil and gas wells, the words “gross income from property” mean only
gross income from oil and gas.29

Mr. Chief Justice Hughes had this to say of the then new depletion
provision:

28 Ibid., at 461.
29 Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934).
The evident purpose of the statutory provision controls. It is a unique provision to meet a special case. Analogies sought to be drawn from other applications of the revenue acts may be delusive and lead us far from the intent of Congress in this instance. Congress has recognized that in fairness there should be compensation to the owner for the exhaustion of the mineral deposits in the course of production. But to appraise the actual extent of depletion on the particular facts in relation to each taxpayer would give rise to problems of considerable perplexity and would create administrative difficulties which it was intended to overcome by laying down a simple rule which could be easily applied. To this end, the taxpayer was permitted to deduct a specified percentage of his gross income from the property. Congress was free to give such an arbitrary allowance as the deduction was an act of grace. In answer to the contention that the provision may produce "unjust and unequal results," we have remarked that this is likely to be so "wherever a rule of thumb is applied without a detailed examination of the facts affecting each taxpayer."

It is clear that the courts were going to follow the intent of Congress as to the application of the provision allowing 27 1/2 per cent of gross income from the property as the depletion deduction. The gross income was to be limited to the income derived from the extraction of oil and gas from the well, and the application was going to be made as simple as possible to enable the law to be more easily administered. Congress had laid down what to it was a simple rule and the courts as evidenced by the opinions of the Supreme Court of the United States were going to limit the application of the law as much as possible to be sure that the rule remained simple. This Act furnished the basic rules for depletion for all subsequent statutes.

The 1928 Act31 followed the language of the 1926 Act,32 and set out methods for computing depletion in the cases of life estates followed by a remainder and of property being held in trust.

The wording of the Revenue Act of 193233 followed that of 1928 with an added sentence in Section 23(1) which dealt with cost depletion:

In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate.

Section 114(b)(3) used the same language as the 192634 and 1928 Acts35 but added to the first sentence

30 Helvering v. Mountain Producers Corporation, 303 U.S. 376, 381 (1938).
31 Internal Revenue Act of 1928, §§ 23 (1), (m) and 114(b) (3).
32 Internal Revenue Act of 1926, §§ 204(c) (2) and 234(a) (8).
33 Internal Revenue Act of 1932, §§ 23 (1) and 114(b) (3).
34 Internal Revenue Act of 1926, §§ 204(c) (2) and 234(a) (8).
35 Internal Revenue Act of 1928, §§ 23 (1), (m) and 114(b) (3).
excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.

On the addition to Section 23(1) the Senate Finance Committee reported:

The House bill requires a change in the annual depletion allowance where a new estimate of the number of the recoverable units is made in the light of subsequent events. The effect of the amendment is shown by the following example:

A purchased for $1,000 an ore body with 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\(\frac{1}{3}\) cents per unit instead of $1 per unit.

The provision in the House bill has been amended so as to make it clear that it is also to apply where the revision of the estimate of recoverable units results from day-to-day operations.\(^{86}\)

As to the addition to Section 114(b)(3) the Conference Committee Report reads:

Amendment No. 53: This amendment makes it clear that in computing the gross income from the property, for the purpose of determining the allowance for percentage depletion in the case of oil and gas wells, there shall be excluded from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. . . .\(^{87}\)

The allowance for depletion is intended to return the loss of capital which enters into the sale price of the oil produced. It deals with income realized by production. It has no application to sales in whole or in part of the capital investment, the oil reserve itself.\(^{88}\)

It seems that at this point the basic law (1926 Act) pertaining to the depletion deduction as it is today had begun to crystallize as Congress made no sweeping revisions of the 1926 Act, but merely added clarifying provisions. The administration of the law was apparently meeting with the approval of the Congress as the Commissioner still retained the power to prescribe the rules and regulations for computing the depletion deduction.

The 1934 Act,\(^{89}\) much the same in text as the preceding acts, contained clarifying changes to make it plain that depletion is actually allowed

\(^{88}\) Badger Oil Co. v. Commissioner of Int. Rev., 118 F. 2d 791 (C.A. 5th, 1941).
\(^{89}\) Internal Revenue Act of 1934, §§ 23(m) and 114(b)(3).
under Section 23(m) instead of under Section 114(b)(3). It is interesting to note that an amendment proposed a 1935 Act to eliminate the depletion deduction from the law; this amendment was rejected by both the House and the Senate. It became evident then that certain "pressure groups" were beginning to "howl" about the subsidizing of the minerals industries through the allowance of the depletion deduction, but fortunately common sense prevailed in the Congress and the law as set up was allowed to continue in force.\(^4\)

In interpreting the 1934 Act, Judge Murrah wrote:

Historically, the depletion statutes are arbitrary allowances to the recipients of gross income by reason of their capital investment in the oil and gas in place. The percentage allowance or "reasonable allowance" is of the gross income from the property which points only to the income from oil and gas and is correlated to an investment in oil and gas in place. The formula prescribed by Sections 23(m), 114(b)(3), having direct relationship to gross income from sources within its scope (oil and gas wells), is exclusive in its application and to that extent it is an arbitrary substitute for the fundamental rule against the taxing of gross income before recovery of capital cost. The taxpayer contends for a rule which would allow 100% depletion until the cost is returned, then a "reasonable allowance" or 271/2%, whichever is greater, on the realization of income, thereafter. Obviously, it was not the intention of Congress in providing the depletion allowance to grant any such advantage over those not falling within this category.

Statutory depletion is a "rule of thumb" to meet a special case. It is clear that it was the Congressional purpose to allow return of capital through statutory depletion from the date of the acquisition of the depletable interest, so long as gross income is realized dependent upon the production of oil or gas. Likewise, it is plain that the taxpayer may not be deprived of this privilege, although the Commissioner may have erroneously permitted a deduction for cost recovery by some other formula not now subject to adjustment by reason of the statute of limitations.\(^4\)

From this opinion it can easily be seen that as the statutes allowing depletion began to crystallize from one Revenue Act to the next, so did the rulings of the courts and so did the language of the courts. The courts speak of the arbitrary allowance of percentage (statutory) depletion, they speak always of the congressional intent, and likewise of the return of the capital investment, this latter even though the allowance of percentage depletion does not cease once the original capital investment has been fully recovered.\(^2\)

\(^4\) For some enlightening reading on this point see 78 Cong. Rec.


\(^2\) See: Alphonso E. Bell Corporation v. Commissioner, 145 F. 2d 157 (C.A. 9th, 1944) as an interpretation of the Internal Revenue Act of 1938, to note the similarity in rulings and language which the courts have adopted in passing on issues dealing with the depletion deduction.
The 1936 Act, the 1938 Act, and later the Internal Revenue Code all copied the wording of the 1934 Act verbatim, and this language has remained unchanged to date. It might be well then to set out Sections 23(m) and 114(b)(3) to show the wording as it appears today.

Section 23(m) Depletion—In the case of . . . , oil and gas wells, . . . , a reasonable allowance for depletion . . . , according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

Section 114(b)(3)—Percentage depletion for Oil and Gas Wells—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 273 per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

These, then, are the various acts which were promulgated, revised, discarded, clarified, elaborated upon, and otherwise worked over until the law as it is today came into being. They reflect the uneasiness of mind and the discontent of Congress with the early provisions for depletion and also with the administration or lack thereof of each statute in turn. This is shown by the discarding of one method of computing the deduction for another in the earlier acts until the 1926 Act which was the basic act to which the subsequent acts looked for their substance and language. That statute was clarified and elaborated upon by subsequent acts but never was it changed. Even this seemingly steady state of the

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43 Internal Revenue Act of 1936, §§ 23 (m) and 114 (b) (3).
44 Internal Revenue Act of 1938, §§ 23 (m) and 114 (b) (3).
45 Internal Revenue Code, §§ 23 (m) and 114(b) (3); 26 U.S.C.A. §§ 23(m) and 114(b) (3) (1949).
46 Internal Revenue Act of 1934, §§ 23(m) and 114(b) (3).
47 Internal Revenue Act of 1926, §§ 204(c) (2) and 234(a) (8).
law was attacked in 1935 when an amendment was sought which would have disallowed the depletion deduction in its entirety. It is the legislative grace of the Congress which has established the depletion deduction based upon the risks inherent in the industry as to the chances of drilling a producing well and also allowing for the return of the capital which has been invested in a wasting asset. It can well be that some day Congress may see fit to withdraw its legislative grace and this then will leave the industry without the inducement of a tax benefit as compensation for the further exploration and subsequent extraction of these vital natural resources, oil and gas.

**COST DEPLETION AND PERCENTAGE DEPLETION**

Before proceeding with a discussion of the law as it is today, it might be helpful to those readers unfamiliar with the methods of computing cost or percentage depletion to run through an example computation for each of the two methods. Cost depletion is allowed under Section 39.23(m) of the Internal Revenue Code,\(4^8\) Regulations 118 and computed under Section 39.23(m)(2) which reads as follows:

The basis upon which depletion, other than . . . percentage depletion, is to be allowed in respect of any property is the basis provided in section 113(a), adjusted as provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property. If the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

**Example Problem:**

Suppose that "X" purchases an interest in a producing oil well for $1,000.00; it is estimated that the recoverable oil is 10,000 barrels. The oil sells for $2.50 per barrel, and there is recovered for the current year 1,200 barrels of oil which are all sold. Expenses plus depreciation on equipment equal $1,500.00. The following computation is necessary to determine the cost depletion to be deducted:

**Formula:**

\[
\text{Cost depletion} = \frac{\text{Cost of interest to "X"}}{\text{Estimated barrels recoverable}} \times \text{barrels recovered}
\]

\[
\text{Cost depletion} = \frac{1,000.00}{10,000} \times 1200 = 120.00
\]

\(4^8\) Also, 26 U.S.C.A. § 23 (m) (1949).
In determining cost depletion, there are three essential elements that enter into the computation, namely (1) the basis, (2) number of barrels sold during the taxable year, and (3) the estimated oil reserve under ground. This is the information necessary to make the computation.

Percentage depletion is allowable under Section 39.23(m) and is set forth under Section 39.114(b)(3) and is computed under Section 39.23(m)(4) which reads:

Under section 114(b)(3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27% per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of “gross income from the property” and “net income of the taxpayer (computed without allowance for depletion) from the property,” see section 39.23(m)(1) (f) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

Example Problem

Taking the set of facts set out in the above example on cost depletion, then the percentage depletion deduction computation follows:

Formula:

\[
\text{Percentage depletion} = \text{Barrels sold} \times \text{Selling price per barrel} \times 27\frac{1}{2}\% \\
\text{Net income for limitation} = \text{Barrels sold} \times \text{Selling price per barrel} - (\text{expenses} + \text{depreciation}) \\
\text{Net income} = (1200 \times \$2.50) - \$1500.00 = \$1500.00 \\
50\% \text{ of net income} = \$750.00
\]

In computing percentage depletion allowable, we look to the gross income from the property, and as a limitation of the allowable depletion we look to the net income.

THE STATUS OF THE LAW TODAY

Present statutes permit the deduction from gross income of the higher of cost or percentage depletion. In the problem above we would then have to compare the cost and percentage depletion figures to determine which one is the higher and so deductible from the gross income. The figures follow:

\[
\text{Cost depletion} = \$120.00 \\
\text{Percentage depletion} = \$825.00 \\
\text{Limited to 50\% of net income} = \$750.00
\]
The proper deduction under the law would be $750.00, which is the limitation of the percentage depletion to 50 per cent of net income.

The necessity for a comparison between cost and percentage depletion has been put in these words:

From the stipulation it appears that the return contained the usual facts for computation by both methods and it also appears that the return shows that the unit (cost) method deduction would be lower than the percentage method. The stipulation contains all the facts and among them is a statement showing as to each property the figures in separate columns of gross sales, net income, unit depletion, 27% per cent of sales, 50 per cent of income, and the allowable depletion resulting from the applicable method, being sometimes one and sometimes the other. This is because under the last clause of section 114(b)(3) the allowance under the percentage method may in no case be less than under the unit method. To one using the percentage method a computation by the unit method is always necessary, for “in no case shall” the allowance be less than such a computation shows. This is mandatory.

And it is important that it should be mandatory. Section 114 is primarily one which prescribes the basis not only for depreciation and depletion, but also for future determination of gain or loss from sale or other disposition. Thus the larger depletion serves to reduce the remaining basis and to increase a taxable gain or reduce a tax reducing loss in the future.49

It can be seen that in every case the comparison between cost (unit) depletion and percentage depletion must be made and the higher of the two will apply as the deduction from gross income. The taxpayer has no choice in the matter as to which of the two methods he will use, after making the computations under each method; he is then obliged to use the higher of the two methods in taking his deduction.50

Mr. Justice Brandeis in United States v. Ludey51 likened depletion to depreciation in requiring that the depletion allowed or allowable is chargeable to a reserve to be used in computing the cost basis of the property at any time and especially at the time of sale of the property. Justice Brandeis said:

We are of the opinion that the revenue acts should be construed as requiring deductions for both depreciation and depletion when determining the original cost of oil properties sold. Congress, in providing that the basis for determining gain or loss should be the cost or the 1913 value, was not attempting to provide an exclusive formula for the computation. The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital

49 Producers Oil Corp. v. Commissioner, 43 B.T.A. 9 (1940).
50 On this see also, Sabine Royalty Corp. v. Commissioner, 17 T.C. 1071 (1951), where the petitioner erroneously used percentage depletion as a deduction for a number of years and the respondent computed the petitioner's new cost basis by using the greater cost depletion which was allowable in those years but unclaimed by the petitioner.
51 274 U.S. 295 (1927).
assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets.

Such being the rule applicable to manufacturing and mercantile business, no good reason appears why the business of mining should be treated differently. The reasons urged for refusing to apply the rule specifically to oil mining properties seems to us unsound.\textsuperscript{52}

This then is the depletion deduction today: it is an arbitrary deduction allowed by the Congress to allow for the recovery of capital invested in the oil or gas in the earth; it also allows a deduction to continue after the total capital invested has been recovered; this was probably allowed as a reward for an extrahazardous enterprise in order to encourage new production. The taxpayer is obliged to compute both the cost and percentage depletion deductions, and then claim the higher of the two on his return. Once having claimed the proper amount allowable the taxpayer must set up that amount in a reserve account, such amount to be used in computing his cost basis of the property upon the sale of the same at some subsequent date.

What would likely occur in the industry were the Congress to deny the depletion deduction as some interests still clamor that it do? If Congress were to reduce or completely deny the depletion deduction, it would constitute a serious curtailment of the incentive to search for more oil, with a resulting reduction of crude oil reserves in this country. Under normal times, this would be serious enough, but with today's international unrest any reduction in oil reserves might well be disastrous.

The effect upon the consumers of oil or gas or their by-products would be quite heavily felt, as the price of oil and gas products is largely made up of corporate taxes and to tax such corporations more heavily will result in a substantial increase in the price of all oil and gas products. So there is a fairness to the public in general which would be impaired by increasing the taxes of oil and gas corporations through the reduction in or doing away with the depletion deduction.

Congress has to date seen fit to go along with the industry and allow the depletion deduction which developed out of much turmoil, but, as

\textsuperscript{52} Ibid., at 300.
it has developed, has been upheld and even lauded by the courts. To those who seek to have the depletion deduction abolished, it can be said that if the government has seen fit to give the oil and gas industries a tax benefit in the form of the depletion deduction, then that benefit has also inured to the government itself through increased oil reserves which are so vital to the economy and the defense of the nation, and to the general public in the form of lower prices on oil and gas products and in the abundance of these products. Any benefit that the government might derive from increased revenues through the decreasing or abolishing of the depletion deduction allowance seems to be greatly outweighed by the existence of a thriving and expanding oil and gas industry.

DISINTERMENT

The basis for disinterment is fairness, human emotion and reasonableness. Hence, as is apparent, the issue of exhumation is relegated for determination to courts of equity. By early English law ecclesiastical courts had jurisdiction over questions relating to the disposition of a dead body. This view, however, has never been accepted in the United States, where equity jurisdiction prevails over questions of this type. Ecclesiastical law neither governs nor determines equitable rights. The court will not order a body to be disinterred without a very strong showing by the petitioner that disinterment is necessary and required for the furtherance and in the interests of justice.

1 Slifman v. Polotzker Workingmen's Benevolent Assn., 198 Misc. 373, 101 N.Y.S. 2d 826 (1950); Koon v. Doan, 300 Mich. 662, 2 N.W. 2d 878 (1942); Uram v. St. Mary's Russian Orthodox Church, 207 Minn. 569, 292 N.W. 200 (1940); King v. Frame, 204 Iowa 1074, 216 N.W. 360 (1926).
3 Yome v. Gorman, 242 N.Y. 345, 152 N.E. 110 (1926); In re Donn, 14 N.Y.S. Supp. 189 (1891): "While we grant to all religious organizations the largest and broadest latitude and liberty to adopt all or any proper rules or regulations, to the end that their votaries may worship God according to the dictates of their conscience, we have jealously watched and resented any and all attempts on their part to usurp powers or authority outside or beyond their legitimate functions of caring for and administering spiritual affairs. While it cannot be said that a corpse is property in the sense that it is subject to barter and sale, the courts of this country have recognized the right and authority of the next of kin, in proper cases, to control and possess it; and when an ecclesiastical body assumes jurisdiction and control over a corpse its acts are of a temporal and judicial character, and not in any sense spiritual and, under our laws and institutions, when it attempts so to do it is acting outside its proper jurisdiction and doman."