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TAXATION-INCOME TAX-DEPLETION-LESSOR'S SHARE IN NET INCOME AS SUBJECT TO DEPLETION

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TAXATION—INCOME TAX—DEPLETION—LESSOR'S SHARE IN NET INCOME AS SUBJECT TO DEPLETION—Taxpayer which owned certain lands leased the same to companies for production of oil and other minerals for a cash bonus, a royalty in the usual form, and an agreement that lessor should receive a percentage of the net money profits realized by the lessees from their operation under the lease. Lessor claimed a right to deduct depletion allowance from the receipts which were a percentage of the net income arising from operating

the properties.¹ *Held*, lessor had a right to depletion deduction in respect to the percentage of net income because it had an "economic interest" in the oil in place. *Kirby Petroleum Co. v. Commissioner of Internal Revenue* and *Commissioner of Internal Revenue v. Crawford*, (U.S. 1946) 66 S.Ct. 409.

Because of the variety of contractual relationships which are entered into between owners of land and oil companies,² a great amount of uncertainty has arisen concerning the proper person to take the statutory deduction for depletion³ in computing the federal income tax. Before the decision in the principal case, decisions covering most situations had already been handed down,⁴ but there was still uncertainty as to the right to take the depletion deduction when the lessor reserved a proportion of the net profits from the lessee's operation of oil wells on the property. For a number of years the ultimate test has been: has the taxpayer retained an economic interest in the oil,⁵ or, in other words, must he look to the oil in place as the source of the return of his capital investment?⁶ However, there was a conflict between the Tax Court and the Treasury Department in cases where an interest in *net* profits was retained. The Tax Court ruled that such an interest was an economic interest,⁷ while the Treasury Department ruled that a depletable interest had been converted by sale into a contractual right to receive payments from the operator.⁸ The result of this conflict was that when the tax based on the Tax Court's rule was greater, the Treasury Department might take a position contrary to its own ruling,⁹ with the effect of inconsistent treatment of taxpayers in the same class.¹⁰ Inasmuch as there is no question that the receipt of an oil royalty, i.e., a portion of the *gross* receipts from the sale of the oil extracted by the lessees, is subject to the depletion allowance,¹¹ the fact that the return to the lessor is based upon *net* receipts should make no difference since "in both situations the lessor's possibility of return depends upon oil extraction and ends with the exhaustion of the supply."¹² The holding in the principal case represents a common sense approach to the problem and will eliminate the possibility of inconsistent treatment of taxpayers by the Treasury Department in cases of this kind.

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¹ There was no question as to the deductibility of the depletion allowance from the rents and royalties, this having been decided in the lessor's favor by earlier decisions. *Burnet v. Harmel*, 287 U.S. 103, 53 S. Ct. 74 (1932); *Anderson v. Helvering*, 310 U.S. 404, 60 S. Ct. 952 (1940).

² For examples of such contracts, see ANDERSON, OIL AND GAS FEDERAL INCOME TAX MANUAL, Section II, p. 37 et seq. (1944).

³ Internal Revenue Code, §§ 23(m), 114(b)(3).

⁴ See ANDERSEN, OIL AND GAS FEDERAL INCOME TAX MANUAL, Section II, p. 37 et seq. and cases there cited (1944).

⁵ *Burnet v. Harmel*, 287 U.S. 103 at 111, 57 S. Ct. 911 (1932).

⁶ *Palmer v. Bender*, 287 U.S. 551 at 557, 53 S. Ct. 225 (1933).

⁷ *Felix Oil Company, I.C. Memo.*, December 18, 1942.

⁸ G.C.M. 22730, 1941 INT. REV. BUL. 214; TREAS. REG. 103, Sec. 19.23 (m)-1, as amended by T.D. 5413, 1944 INT. REV. BUL. 124 at 129.

⁹ ANDERSEN, OIL AND GAS FEDERAL INCOME TAX MANUAL 47 (1944).

¹⁰ That such inconsistent treatment is far from being improbable, see *Sanford's Estate v. Comm.*, 308 U.S. 39, 60 S. Ct. 51 (1939).

¹¹ *Burnet v. Harmel*, 287 U.S. 103, 111, 53 S. Ct. 74, 77 (1932); *Anderson v. Helvering*, 310 U.S. 404 at 409, 60 S. Ct. 952 (1940).

¹² Principal case at 411.