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The Property Unit and the Aggregation of Oil and Gas Interests under the Technical Amendments Act of 1958

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COMMENTS

THE PROPERTY UNIT AND THE AGGREGATION OF OIL AND GAS INTERESTS UNDER THE TECHNICAL AMENDMENTS ACT OF 1958

I. INTRODUCTION

The migratory nature of oil and gas and the complexities of modern mineral conveyancing lend confusion to any attempt to define precisely the property unit for tax purposes. Yet, the depletion allowance granted by statute to the owners of certain oil and gas interests is prescribed by statute to be 27½ per cent of gross income from "the property," and the amount deducted cannot exceed fifty per cent of the net taxable income from that property.[1] Similarly, the statutes refer directly or indirectly to "the property" when prescribing the rules for determining abandonment losses and for computing capital gains or losses upon the sale of oil and gas interests.[2] Despite this manifest importance of the term, the pre-1954 codes contained no definition of "the property" and, as will be seen, the 1954 Code definition was quite unrealistic.

This Comment concerns the effect of a single subsection, inserted in the 1954 Code by the Technical Amendments Act of 1958,[3] upon the definition of an oil and gas "property" and upon the taxpayer's right to aggregate his separate properties into one tax unit for depletion purposes. The pertinent section of the 1954 Code is section 614,[4] and the newly inserted subsection is subsection (d). A majority of the amending sections are outside the scope of this Comment, as they deal with the aggregation of mineral interests other than oil and gas and specifically except fluid deposits from their effect.[5] With respect to oil and gas interests, however, the 1958 act adds to the 1954 Code the following subsection:

> (d) 1939 Code Treatment With Respect to Operating Mineral Interests in Case of Oil and Gas Wells—In the case of oil and gas wells, any taxpayer may treat any property (determined as if the Internal Revenue Code of 1939 continued to apply) as if subsections (a) and (b) had not been enacted. If any such treatment would constitute

[1] Int. Rev. Code of 1954, § 613(a).
[2] Int. Rev. Code of 1954, §§ 167(f), 612, 1011-12, 1231.
[3] Technical Amendments Act of 1958, § 37(c), 72 Stat. 1606, 26 U.S.C.A. 726.
[4] Int. Rev. Code of 1954, § 614(a), (b).
[5] Int. Rev. Code of 1954, § 614(c), as amended by Technical Amendments Act of 1958, § 37(c), 26 U.S.C.A. 726.

an aggregation under subsection (b), such treatment shall be taken into account in applying subsection (b) to other property of the taxpayer.[6]

To provide a focal point for this analysis, we assume that a taxpayer owns three separate oil and gas leases, two of which are quite profitable, and the third of which is only a marginal producer. It is apparent that the depletion allowance on the third lease will be unavailable due to the statutory restriction of the allowance to fifty per cent of net income. If, however, the taxpayer may combine his properties as a unit for tax purposes, the averaging of costs and income will result in a substantially greater depletion deduction.[7] The taxpayer must therefore determine (1) what "properties" he owns, (2) his privilege, if any, to aggregate them, and (3) under which code he will obtain the more favorable tax treatment, since a literal reading of the 1958 act indicates that he may have an election to proceed under either the 1954 or the 1939 Code. This paper will examine, in order, the definition of "the property" under the 1939 Code, the relationship of aggregation and definition under the 1939 Code, the definition and aggregation of property under the 1954 Code, and the effect of the 1958 amendment.

II. Definition of "The Property" Under The 1939 Code

Prior to 1954, the various codes contained no definition of "the property," but a concept of its nature was soon developed by the Internal Revenue Service. The Service's position was first promulgated in 1941 when General Counsel Memorandum No. 22106 con-

[6] Int. Rev. Code of 1954, § 614(d), as added by Technical Amendments Act of 1958, § 37(c), 26 U.S.C.A. 726.

[7] Comparison of individual and aggregate methods of depletion computation:

	I. Individual			II. Aggregated
Leases:	A	B	C	ABC
Total Income	$ 500,000	500,000	500,000	1,500,000
Royalties	(100,000)	(100,000)	(100,000)	(300,000)
Gross Income	400,000	400,000	400,000	1,200,000
For 50% rule computation:				
Total Income	500,000	500,000	500,000	1,500,000
Royalties	(100,000)	(100,000)	(100,000)	(300,000)
Expenses	(150,000)	(150,000)	(350,000)	(650,000)
Taxable Income	250,000	250,000	50,000	550,000
Percentage Depletion Allowable:				
Lesser of:				
(a) 27½% of gross income	110,000	110,000	110,000	330,000
(b) 50% of taxable income	125,000	125,000	25,000	275,000
Depletion allowed if leases considered separate properties:				$245,000
Depletion allowed if leases considered a single property:				$275,000

cluded, "Accordingly, the term property may be defined as *each separate interest* owned by the taxpayer in *each separate tract or parcel* of land."[8] (Emphasis added.) To the two concepts of "separate interest" and "separate tract or parcel of land" was added a third by G.C.M. 24094 in 1944, when it stated that ". . . the term property should properly be defined as each separate interest owned by the taxpayer *in each mineral deposit* in each separate tract or parcel of land."[9] (Emphasis added.)

The Service adhered to a mechanical interpretation of these memoranda which, when strictly applied to the oil and gas industry, resulted in "the property" becoming the smallest conceivable unit within an operation. The courts, on the other hand, simply did not approve a universal application of the General Counsel Memoranda quoted above.

A majority of the decisions dealing with the definition of property under the 1939 Code concerned hard minerals. The courts drew no distinction between hard minerals and fluid deposits for purposes of definition, and repeatedly referred to hard mineral decisions for guidance in defining oil and gas properties. A brief review of these decisions is thus in order, categorized under the factors of "separate interest," "separate tract or parcel," and "each mineral deposit" contained in the memoranda quoted above.

The factor of "separate interest" was in issue in *William H. Cree*.[10] The taxpayer had acquired two oil and gas leases. Both before and after this acquisition, he had purchased various participating interests, each limited to certain wells drilled upon these leases. In his return, the taxpayer reported the income from the participating interests as royalties and separately reported the income from the leases as income from a business or profession. Depletion was claimed on both interests. The Commissioner argued that the depletion allowance to taxpayer as lessee should be computed as if each lease was a separate property. The taxpayer contended that the interests he owned in each well should be treated as a separate property, citing G.C.M. 22106 in support of his position. The Board of Tax Appeals held (1) that the participating interests and the leaseholds *merged*, and that (2) the taxpayer owned two separate properties, viz., the two leases. The Board, in regard to the taxpayer's contention, stated:

> The petitioner cites G.C.M. 22106 wherein it is stated, *inter alia*, that a single tract or parcel of land may be divided into two or more

[8] G.C.M. 22106, 1941-1 Cum. Bull. 245.
[9] G.C.M. 24094, 1944 Cum. Bull. 250.
[10] 47 B.T.A. 868 (1942), nonacq., 1943 Cum. Bull. 29.

> separate tracts or parcels by means of conveyances of leases "carving up the original 'tract or parcel'," and that a taxpayer with several interests in a tract has several properties therein. But we do not think the idea soundly applied here, where the whole leasehold is acquired by one formerly owning only certain limited rights with respect thereto.[11]

In *Herndon Drilling Co. v. Commissioner*,[12] the taxpayer owned an undivided one-half interest in fee in a lease and an oil payment interest in the remaining undivided one-half interest. Since it was to the taxpayer's advantage, he treated the properties as separate and deducted one half of the intangible costs and treated the remaining one half as oil payment costs. The Tax Court upheld this position, stating:

> We think that under the facts here, the two interests in each lease must be held to be two properties, and we so hold. They are *inherently separate and different in character*. One is an outright ownership in fee of an undivided part of the leasehold estate. The other is less than a fee title interest in the remaining undivided part of the leasehold. There is no merger of the titles to the two interests. See G.C.M. 24094, 1944 C.B. 250. *Cf. Wm. H. Cree*, 47 B.T.A. 868.[13]

Although the court paid lip service to G.C.M. 24094, the rationale for the decision lay in the dissimilarity of the interests in issue. Similarly, in *Helvering v. Jewell Mining Co.*,[14] a leasehold interest and a fractional over-riding royalty interest (retained from a grant to a sub-lessee) were held inherently different in character, precluding a merger of interests. The mining operation of the taxpayer and the sub-lessee were distinct and separate in nature.

Thus, as to the "separate interest" factor, pre-1954 decisions turned on whether or not the interests were inherently different in character. If they were, two properties existed; if not, there was a merger of interests.

The factor of "separate tract of parcel of land" fared somewhat better in the courts, chiefly because it was early agreed that each separate *well* is not a separate property and also because there was no dispute as to the definition of a "tract" or "parcel."[15] It was the issue of what made a tract or parcel *separate* that gave rise to litigation.

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[11] Id. at 872.
[12] 6 T.C. 628 (1946), nonacq., 1946-2 Cum. Bull. 6.
[13] Id. at 637.
[14] 126 F.2d 1011 (9th Cir. 1942).
[15] William H. Cree, 47 B.T.A. 868 (1942), nonacq., 1943 Cum. Bull. 29; Frank Lyons, 10 T.C. 634 (1946).

In *Berkshire Oil Co. v. Commissioner*,[16] the property involved consisted of four lots which were acquired simultaneously. Two of these lots were contiguous; the other two touched at only one common corner. The instrument of conveyance provided that "for all of the purposes of this lease, the property above described shall be deemed to be one single, contiguous, and continuous body or tract of land." A dry hole was drilled on one of the two contiguous lots. The taxpayer released to the lessor all rights in the two contiguous lots. In its tax return, the taxpayer deducted the intangible drilling expenses and also an amount representing the cash cost applicable to the acreage surrendered by the release. The Commissioner allowed deduction only of the drilling costs. It was the taxpayer's theory that each of the lots constituted a single property and that, therefore, an abandonment loss could be claimed upon the disposition of any lot or lots. The Commissioner, however, contended that there was only one property, having a unitary basis, and that the loss deduction could be taken only upon final disposition of the entire lease. The quoted lease provision was held not to be determinative of the facts or the law, and each lot was held to be a separate property. The court cited with approval the following case law of Louisiana: ". . . to constitute a single tract of land, the lands must be so situated that one may pass from one part to another without passing over the lands of another . . . ."[17]

In *Black Mountain Corporation*,[18] the taxpayer acquired two contiguous properties at different times and assigned each of them to different mines which it already owned and had consistently treated as separate for tax purposes. The Commissioner contended that the two mines constituted a single property for depletion purposes. One mine had been quite profitable; the other had shown a loss. Combining the profit of one and the loss of the other reduced net income and, due to the fifty per cent limitation, the depletion allowance also.[19]

The taxpayer argued that "the property," as used in the code, meant the economic and practical unit in which the taxpayer must conduct his operations. The court, on the authority of the regulations, upheld the taxpayer:

> We are unable to see the necessity for the commissioner's contention that every separate acquisition of coal lands must be treated as a

[16] 9 T.C. 903 (1947).
[17] Ibid.
[18] 5 T.C. 1117 (1945), nonacq., 1946-2 Cum. Bull. 6.
[19] Thus demonstrating that aggregation is not always to the taxpayer's advantage.

> separate property for the purpose of computing percentage depletion. Separate acquisitions can, under proper circumstances, be combined to form one property, and likewise, under proper circumstances, one acquisition may become a part of two different properties for this purpose. We hold for the petitioner on this point.[20]

The possibility of combining separate acquisitions "under proper circumstances," is a collateral reference to regulation 29.23(m)-1(i).[21] The court here, in effect, subordinates the content of G.C.M. 22106 and 24094 to that regulation. Thus, the case is noteworthy from two aspects: (1) a rejection of G.C.M. 22106 and (2) the recognition that under the 1939 Regulations, a taxpayer *could* treat two separate properties as one. The second point is discussed *infra*.[22]

In *Amherst Coal Company*,[23] five "interests" in "the property" were involved. Underlying the land subject to the five interests were three separate seams of coal. The first interest consisted of two tracts of land owned by the taxpayer in fee and acquired in two separate acquisitions. The second interest consisted of five tracts which were acquired in one transaction. The third consisted of five tracts acquired as a unit. Each of the fourth and fifth interests was a single tract separately acquired. The Commissioner contended that seventeen different properties existed, on the basis that each acquisition of an *interest in each* seam of coal in the lands acquired constituted a property.[24]

The taxpayer contended that it had but one property within the meaning of the code. The court, citing the *Black Mountain* decision, upheld the taxpayer's contention, relying upon the fact that operations were conducted on all properties as a unit and that all lands were contained within a single boundary.[25]

In *Sneed v. Commissioner*,[26] the taxpayer owned a tract of eighty thousand acres. He leased this land in many separate parcels to different lessees. The Commissioner "restored to income"[27]

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[20] 5 T.C. at 1121.

[21] Treas. Reg. 111, § 29.23(m)-1(i) (1943); Treas. Reg. 118, § 39.23(m)-1(i) (1953). Treasury Regulations 118 re-enacted this section of Regulations 111 without change.

[22] See note 34 infra and accompanying text.

[23] 11 T.C. 209 (1948), nonacq., 1949-1 Cum. Bull. 5.

[24] This case demonstrates the Commissioner's attempt at a literal application of G.C.M. 24094 and the court's rejection of all three factors described in that memorandum.

[25] The "single boundary" to which the court referred was a natural boundary.

[26] 119 F.2d 767 (5th Cir.), rehearing denied, 121 F.2d 725, cert. denied sub nom., Thompson v. Commissioner, 314 U.S. 686 (1941).

[27] When a bonus is received in consideration for the execution of a lease, depletion is allowed on the bonus in the year it is received, and the basis of the property is reduced accordingly. If the lease is allowed to expire without production, the depletion allowed or allowable must be restored to taxable income in the year the lease expires, and the basis is restored to its previous amount. Int. Rev. Code of 1954, § 612; Proposed Treas. Reg. § 1.614-3(a)(2), 21 Fed. Reg. 8452; Treas. Reg. 111, 29.23(m)-10(b) (1943).

depletion allowances on certain bonuses received by the taxpayer on certain of the leases which failed to produce. The entire area except for the leases in question, which covered approximately five thousand acres, had produced oil and gas. Since there can be no restoration to income of depletion taken on bonus payments if there is any production from the property,[28] the taxpayer contended he had but one property and, therefore, was not required to restore any of the depletion to income. The court, however, held that by leasing the land in separate parcels to many different persons, he separated it into as many different properties as there were leases made.

In *Vinton Petroleum Co. v. Commissioner*,[29] the court held that a taxpayer who produced oil from eight "different but neighboring" tracts, acquired at different times in various manners, must treat each lease as a separate property.

The inconsistency between the *Vinton* and *Sneed* cases and the decisions in *Amherst* and *Black Mountain* indicates the hesitancy of the courts to apply strictly the concept of G.C.M. 22106 and G.C.M. 24094, and the cases are difficult to reconcile if we concern ourselves solely with the courts' theories of "separate tract or parcels," and "separate interest." However, when it is recognized that different regulatory provisions were in effect at the time of the *Amherst* and *Black Mountain* decisions, the cases are easily distinguished.[30] In both *Amherst* and *Black Mountain*, the taxpayers argued alternatively that (1) there was but one property or (2) if the properties were held to be separate, then under the current Regulations they could *consider* them as one property where the treatment was consistent.

No case has been found defining the third factor, viz., "each mineral deposit." The Regulations under the 1939 Code "defined" a mineral deposit quite inadequately in this fashion: "(c) The term 'mineral deposit' refers to minerals in place. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase."[31] This formula for computing cost implies that each horizon or reservoir should be regarded as a separate mineral deposit, hence as a separate property. This theory is essentially that urged by the Commissioner in the *Sneed* case.[32]

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[28] Ibid.

[29] 71 F.2d 420 (5th Cir.), cert. denied, 293 U.S. 601 (1934).

[30] Treas. Reg. 111, § 29.23(m)-1(i) (1943); See Aikman, Depletable Properties and Aggregation, Southwestern Legal Foundation Eighth Annual Inst. on Oil and Gas L. & Tax. 511, 533 (1957).

[31] Treas. Reg. 111, § 29.23(m)-1(c) (1943).

[32] See Sneed v. Commissioner, 119 F.2d 767 (5th Cir.), rehearing denied, 121 F.2d 725, cert. denied sub. nom., Thompson v. Commissioner, 314 U.S. 686 (1941).

Any attempt to classify the cases according to the three factors listed in G.C.M. 24094 and 22106 inevitably leads to confusion. One authority, in an article written before the 1954 Code was enacted, argues persuasively that the definition of "the property" can be expected to vary according to the purpose for which the definition is sought.[33] With references limited exclusively to the regulations under the 1939 Code, the author argues that the definition of property is controlled by section 29.23(m)-1(i),[34] which, due to congressional re-enactment without change, has the force and effect of law.[35] That section provides:

> "The Property," as used in section 114(b)(2),(3), and (4), and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.

Thus, property is defined in terms of a "mineral property." Mineral property is defined in section 29.23(m)-1(b)[36] as: ". . . the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction." In subsection (c), "mineral deposit" is held to refer " . . . to minerals in place." Mr. Borden contends that since the code reference in section 29.23(m)-1(i) is to section 114(b) (2), (3), and (4), this definition of property pertains only to the definition for purposes of *discovery and percentage depletion.* From this thesis, the author argues that the "mineral deposit" is determinative of "the property" for purposes of determining percentage depletion and that "tract or parcel of land" is determinative of "the property" for determining gain or loss, abandonment losses, and other non-depletion computations.[37] As a corollary, therefore, "the boundaries of the parcel, lease or tract are matters of consideration only in connection with cases where the taxpayer elects to consolidate two or more mineral properties within a single parcel, lease or tract into one percentage depletable property."[38] From the stand-

[33] Borden, A Survey of "The Property" as Referred to in Section 114(b)(3) of the Internal Revenue Code, 8 Oil & Gas Tax Q. 15 (1953).
[34] Treas. Reg. 111, § 29.23(m)-1(i) (1943).
[35] 1 Mertens, Law of Federal Income Taxation, §§ 3.20, 3.22.
[36] Treas. Reg. 111, § 29.23(m)-1(b) (1943).
[37] Borden, op. cit. supra note 33, at 18.
[38] Id. at 23.

point of literal construction, Mr. Borden's thesis is virtually unassailable. Moreover, dictum in the *Black Mountain* case supports his position by rejecting an Internal Revenue Service contention that the property unit is the same for all tax purposes.[39] The possibilities of an application of this theory under the 1958 act are analyzed *infra*.[40]

Thus, under the 1939 Code, there simply is no satisfactory definition of property, statutory or otherwise. Some light is cast upon the problem, however, by a consideration of the relationship between the definition of property and aggregation under the 1939 Code.

III. Relationship Between the Definition of Property and Aggregation Under the 1939 Code

Besides the factors of "separate interest," "separate tract or parcel of land," and "mineral deposit," the courts were concerned with the units in which mining companies conducted their operations. In *Commissioner v. Gifford-Hill & Co.*,[41] the corporation was engaged in sand and gravel mining operations in three areas of Texas and Louisiana. The lands and minerals were acquired at different times, were of different character, and were not, in all cases, contiguous. The Commissioner insisted that each separate tract or parcel of land must be considered a separate property. The court went into some detail concerning the economics of the mining industry and the necessity in that industry for unitization of operations. An excerpt from the opinion indicates the policy behind the decision.

> Due to the fact that extensive and expensive equipment are essential to the taking out and development of the mineral deposit, and to the fact that the deposits were shown in the present case not to be coterminous with the boundaries of any single tract of land, and to the fact that there would in prudent operation, never be a development of a sand and gravel deposit so small as to be unprofitable, we conclude that the Tax Court correctly held that the regulation was contrary to statute and that the term "mineral property" should not be applied in the taxpayer's mining operation to each single tract of land, but to the development of the operation as a whole.[42]

The *Gifford-Hill* definition of "the property" results, of course, in an informal aggregation, although there is no provision for aggregation *per se* in the 1939 Code. Thus, the whole procedure re-

[39] 5 T.C. at 1120.
[40] See parts IV and VI of this Comment.
[41] 11 T.C. 802, aff'd, 180 F.2d 655 (5th Cir. 1950).
[42] Id. at 658.

garding aggregation under the 1939 Code was quite informal. It should be noted that section 29.23(m)-1(i) was not in effect at the time of the *Vinton* and *Sneed* cases,[43] but it was in effect at the time of the *Amherst* and *Black Mountain* cases, thus permitting an informal aggregation of mineral properties within a single tract or parcel of land, and resolving the conflict between those decisions.

While the courts were rejecting the philosophy behind G.C.M. 24904, field agents were also disregarding the strict interpretation of it when tax consequences were minor.[44] As a practical matter, local revenue offices "knew" which properties the oil companies in their jurisdictions had "aggregated" and acquiesced unofficially as long as the treatment was followed consistently. But the "official" Revenue Service policy of adhering strictly to the mechanical definition of "property" gave rise to the possibility of extended litigation. The mining industry, desiring more definite treatment, made a proposal to Congress[45] which would provide treatment consistent with their operating practices. Congress, in the 1954 enactment, in section 614, defined "the property" as it was defined in G.C.M. 24094, but subsection (b) furnished an election to aggregate those properties.

IV. Aggregation Under the 1954 Code

Subsection (a) of section 614 defines "the property" in the smallest conceivable unit. Assuming for the sake of argument that this definition overruled contrary case law under the 1939 Code[46] and abolished the informal practice thereunder, we may consider the aggregation provisions of subsection (b).

Section 614(b) introduced several new concepts into the Code. The first of these is the distinction between an "operating" and "non-operating" mineral interest.[47] As mentioned earlier, the term "mineral interest" is synonymous with "the property." An "operating" mineral interest is defined by the Code itself to include:

> . . . only an interest in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer

[43] See note 30 supra and accompanying text.

[44] See Amherst Coal Co. v. Commissioner, 11 T.C. 209, 221 (1948), nonacq., 1949-1 Cum. Bull. 5.

[45] Hearings Before the House Committee on Ways and Means on the General Revision of the Internal Revenue Code, 83d. Cong., 1st. Sess., topic 38, pt. 1, at 1985 (1954).

[46] See Aikman, supra note 30, at 519-20; cf. Breeding and Burton, Taxation of Oil and Gas Income 198 (1954).

[47] Int. Rev. Code of 1954, § 614(b), (c)(2). The term "mineral interest" must be considered as synonymous with "The Property." S. Fin. Comm. Rep. No. 1622, 83d Cong., 2d Sess. 80 (1954); S. Rep. No. 1983, 85th Cong., 2d Sess. 184 (1958).

> for purposes of computing the 50 per cent limitation provided for in section 613, or would be so required if the mine, well, or other natural deposit were in the production state.[48]

The regulations provide:

> . . . The term [operating mineral interests] does not include royalty interests or similar interests, such as production payments or net profits interests. "Costs of production" for this purpose do not include intangible drilling and development costs, exploration expenditures under section 615, or development expenditures under section 616. . . . A taxpayer may not aggregate operating mineral interests and non-operating mineral interests such as royalty interests.[49]

After thus defining an "operating mineral interest," the regulations expressly prohibit aggregation of such an interest with "non-operating" interests, but allow aggregation by non-operating interests with other "non-operating" interests upon a showing of undue hardship and the securing of approval by the Secretary of the Treasury or his delegate.[50]

Another concept, that of the "operating unit," was added by the 1954 Code:

> The term "operating unit" refers to operating mineral interests operated together for the purpose of producing minerals. The presence of the following factors indicates that mineral interests are operated as a unit:
> (1) Common field or operating personnel.
> (2) Common supply and maintenance facilities.
> (3) Common processing or treatment plants.
> (4) Common storage facilities.[51]

The 1954 statute was far from satisfactory to either the oil and gas or the hard-mining industry, since there was no provision for dividing a single tract into separate properties. Furthermore, only one aggregation of interests within an operating unit was allowed,[52] and the election to aggregate had to be made in the first year in which exploration expenditures were incurred, which precluded intelligent planning.[53] The proposed regulations further confused the issue with respect to the "operating unit" in section 1.614-2(c) by restricting the unit to an area in which there were actual operations: "While a taxpayer may operate an operating mineral interest through

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[48] Int. Rev. Code of 1954, § 614(b), (e).
[49] Proposed Treas. Reg. § 1.614-2(b); 21 Fed. Reg. 8453.
[50] Proposed Treas. Reg. § 1.614-2(c); 21 Fed. Reg. 8453.
[51] Ibid.
[52] Int. Rev. Code of 1954, § 614(b)(1)(B).
[53] Int. Rev. Code of 1954, § 614(b)(2).

an agent, a co-owner may only aggregate his operating mineral interests that are *actually operated* as a unit."[54] By this proviso, confusion was injected into virtually every case involving the co-ownership of mineral interests and the splitting of authority for actual operations. The Tax Division of the Southwestern Legal Foundation recommended that the pertinent sentences of regulation 1.614-2(c) be stricken, on the grounds of general impracticability and probable conflict with the Senate Finance Committee Report on that section of the Code.[55]

Still another difficulty with the 1954 Code was the import of one section of the Proposed Regulations:

> Each separate mineral interest which in accordance with paragraph (a) of this section is a separate property shall be so treated, notwithstanding the fact that the taxpayer under § 29.23(m)-1(i) of Regulations 118 . . . and corresponding provisions of prior regulations may have treated more than one of such interests as a "single property." The basis of each such separate property must be established by a reasonable method. See however sections 614(b) and (c) and §§ 1.614-2 and 1.614-3 for special rules relating to the election to aggregate separate mineral interests.[56]

This regulation could be interpreted to mean that all previous aggregations under the 1939 Code were invalid. Many taxpayers who had aggregated properties informally under the 1939 Code probably failed to make formal elections to aggregate those properties under the 1954 Code, and probably would be precluded from aggregating anew by the time limit.[57] Further, adjusting the bases of the properties would be an immense task in view of the depletion claimed during the informal aggregation.[58]

The above problems represent only a few of those facing the extractive industries under the 1954 Code. Since the 1954 Code created more problems than it solved, the hard-mining industry again appealed to Congress, and section 37 of the Technical Amendments Act, as it relates to minerals other than oil or gas, admirably reflects their work. A discussion of these provisions is, of course, beyond the scope of this Comment.[59]

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[54] Proposed Treas. Reg. § 1.614-2(c), 21 Fed. Reg. 8453.

[55] By letter in Summer of 1957, Comment on Proposed Income Tax Regulations, Tax Division, Southwestern Legal Foundation, on file in Faculty Law Library, Southern Methodist University School of Law.

[56] Proposed Treas. Reg. § 1.614-1(b), 21 Fed. Reg. 8453.

[57] Int. Rev. Code of 1954, § 614(b)(2); Proposed Treas. Reg. § 1.614-2(d), 21 Fed. Reg. 8453.

[58] Proposed Treas. Reg. § 1.614-1(b), 21 Fed. Reg. 8453.

[59] For a discussion of the effect of the 1958 Act upon the hard mining industry, see Schoenbaum, Mineral "Property" As Defined by Technical Amendments Act of 1958, 8 Oil & Gas Tax Q. 13 (1958).

V. Aggregation Under the Technical Amendments Act of 1958

The Technical Amendments Act contains no new procedure *eo nomine* for the aggregation of oil and gas properties, but it does provide (in extremely ambiguous fashion) what is apparently an election for the taxpayer to define "the property" under the 1939 Code and its pertinent regulations and the case law thereunder. For clarity, it must be reiterated that the 1939 Code did not contain a specific provision for aggregation, but that an aggregation resulted when "the property" was "defined" by a judicial decision, or by the application of the regulations.

Is the oil and gas operator in any better position by virtue of the 1958 amendment than he was under the original 1954 Code provisions? A literal reading of the statute indicates that the operator may ignore the requirements and restrictions of subsections (a) and (b) of section 614 for the purpose of "aggregation" under the 1939 Code. But if the resultant depletable unit *would have been* an aggregation under subsection (b), the provisions of that subsection will be applied to his other property.

Two separate operations are thus involved when proceeding under the new act. First, "property" is "defined" (aggregated under the 1939 Code). Secondly, after this informal aggregation is accomplished, subsection (b) is applied to other property of the taxpayer if the informal aggregation would have been a valid aggregation under subsection (b). The restriction of aggregations to properties within an operating unit which, as previously discussed,[60] was a major disadvantage to the taxpayer under the 1954 Code, is found in subsection (b). Although this restriction is not found in the present subsection (d), it may in effect be placed there through the secondary application of subsection (b). Since the only application of subsection (b) is *after* aggregation, it is arguable that properties aggregated under the 1958 Act need not be within a single operating unit! To carry this reasoning one step further, since such an aggregation, *i.e.*, of properties not within an operating unit, would be invalid under subsection (b), subsection (b) would not be applied to his other interests.

The courts, however, probably would be reluctant to "define" the properties into an aggregation unless those properties were *substantially* within an operating unit.[61] Further, the intent of Congress in

[60] See note 52 supra and accompanying text.

[61] See Commissioner v. Gifford-Hill & Co., 11 T.C. 802, aff'd, 180 F.2d 655 (5th Cir. 1950).

continuing the effect of subsection (b) is easily construed as an intent to restrain aggregations to those within an operating unit, even though the pertinent section is mentioned secondarily. Nevertheless, the *strict* requirements of section 1.614 defining the "operating unit" may now be impliedly overruled.

Procedure under the new subsection (d) can be shown best by example. (We assume that the nebulous restriction of aggregations to those within an operating unit is still in effect.) Assume three leases operated as a unit on a single tract or parcel of land. The taxpayer can "elect" to "aggregate" two of these leases under the 1939 regulations. Since such an aggregation would be an aggregation under subsection (b) of the 1954 Code, that subsection is applied to the third lease, which therefore must be considered as a separate property. Further, no second aggregation will be allowed within the operating unit. Similarly, the taxpayer may, the writer believes, rely on the case law prior to 1954 instead of the 1939 Regulations. If he does so, he may, for example, choose the *Cree*[62] case as precedent, since that decision would allow an aggregation of interests "inherently the same in character" by merger. If this would result in an aggregation under subsection (b), that subsection is likewise applicable to his other property. But what if the decision relied on would constitute an aggregation of interests *not* within a single operating unit—would this aggregation be valid? The writer believes that it would be invalid because he is convinced that the 1958 amendments in effect engraft upon the pre-1954 Code decisions the requirement that the properties to be aggregated be within an operating unit. In addition, the act does away with the narrow definition of property under section 614(a) and gives impetus to decisions such as *Cree, Amherst,* and *Berkshire,* and the courts should therefore ignore the relevant G.C.M.'s under the 1939 Code.

In the event that Mr. Borden's strong argument[63] finds support in the courts, it is believed that while *mineral deposits* would be determinative of the depletable unit, in order to aggregate two or more of these units, they would have to be within a single operating unit.

A quite recent Tax Court decision may be valuable as authority in a future controversy concerning subsection (d). In *Island Creek Coal Co. v. Commissioner,*[64] the company's mineral interests consisted of two leasehold estates and other freehold estates. Its two mines were located within one tract of land. Of the estates owned

[62] See note 10 supra and accompanying text.
[63] See note 33 supra and accompanying text.
[64] 30 T.C. 370 (1958).

in the seams of coal located under the land, some were fee estates and others were leasehold. In its returns from 1932 to 1941, the company treated all its property as a single property. Later, the company divided the single interest into three "separate economic interests," and computed percentage depletion on that basis. Depletion allowance for 1939 was reduced; the other years were unaffected. In 1943 and 1944, the company computed depletion on the former single-property basis. The company attached schedules indicating that the company elected to compute depletion on a single-property basis. Schedules were also attached showing what the depletion would have been on a "separate economic interest" basis. In 1945, 1946, and 1947, the company reverted to the "separate economic interest" basis, and the amounts claimed were less than would have been allowed under a single-property basis. In 1948, 1949, and 1950, the amounts determined under both methods were the same. In 1951, the company used the single-property basis. The Commissioner determined a deficiency for the year 1951 based on the difference between the claimed depletion and that which would have resulted from a "separate economic interest" basis. The principal issue was the consistency of the taxpayer's treatment of its basis. The court indicated that a single-property computation (*i.e.*, an aggregation) was allowed when three factors were present: (1) ownership of interest in properties; (2) location of properties within a single tract or parcel of land; and (3) consistent treatment of income from properties as arising from a single property.

These requirements are substantially those of Regulations 111, § 29.23(m)-1(i). It is believed that the court would have added the requirement that the interests be within an operating unit if this case had originated under the 1958 act.

It should be noted that the newly enacted subsection (d) applies only to *operating* mineral interests. "Non-operating" interests, with but two exceptions, are still governed by the 1954 Code provisions.[65] The requirement in the 1954 Code that "undue hardship"[66] be shown in order to aggregate non-operating interests has been deleted from the statute in deference to the new requirement that the taxpayer show that the aggregation does not have as its sole purpose the avoidance of tax.[67] Also, non-operating interests in adjacent tracts may now be aggregated even though they are not contiguous.[68]

[65] Int. Rev. Code of 1954, § 614(b), and (e) as adopted by Technical Amendments Act of 1958.
[66] Int. Rev. Code of 1954, § 614(c).
[67] Int. Rev. Code of 1954, § 614(e).
[68] Ibid.

The above paragraphs relating to the aggregation of operating mineral interests under the 1958 Act are predicated upon a literal reading of the statute. Upon reading the Senate Report[69] on the section, however, one gets the impression that an election "*de novo*" was not intended. In the case of a taxpayer who filed returns under the 1939 Code, the Senate Report states that if that taxpayer proceeds under subsection (d), he must now treat the properties as he *had* elected under the 1939 Code. Thus, there is apparently no election to make a *de novo* aggregation as to properties on which depletion was taken under the 1939 Code despite the wording of the statute! But what of a taxpayer who has acquired his property since 1953? Is the statute then to be interpreted for one class of taxpayer differently than for another? The question is unresolved by the Senate Report and must await publication of the Proposed Regulations.

Another difficulty with the new statute is that if a taxpayer elects to proceed under the 1939 rules, he must reallocate the adjusted basis of the properties accordingly.[70] This is not required of the mining taxpayer under the new amendments pertaining to the hard-mining industry.[71]

VI. Conclusion

The 1958 Technical Amendments Act is of little benefit to the oil and gas operator. If aggregations made under the 1939 Code have become disadvantageous, presumably he is bound by those elections.[72] In the case of a taxpayer who acquired property after 1953, if an election is permitted,[73] difficult adjustments to basis are required. The troublesome and ambiguous requirements that aggregations must be of properties within an operating unit, and that only one aggregation may be made within that unit, are still in effect, engrafted upon the relatively favorable pre-1954 Code decisions.

The genesis of the entire problem can be traced to the inadequate

[69] S. Rep. No. 1983, 85th Cong., 2d Sess. 185 (1958). The pertinent section reads as follows: "If the taxpayer desires to treat any such property in accordance with the rules applicable under the 1939 Code, there is no provision in § 614(d) with respect to any taxable year subject to the 1954 Code which will permit the taxpayer to treat such property in a manner inconsistent with the manner in which it was treated under the 1939 Code. Therefore, if a taxpayer's treatment of any property or properties for taxable years to which the 1939 Code was applicable would have been binding upon him for all future years but for the enactment of section 614(a) and (b) of the 1954 Code, his application of the rule in section 614(d) permitting him to treat such property or properties as though section 614(a) and (b) had never been enacted *has the effect of continuing the effect of his 1939 Code treatment,* for taxable years beginning after December 31, 1953, and ending after August 16, 1954, insofar as those properties are concerned." (Emphasis added.)

[70] S. Rep. No. 1983, 85th Cong., 2d Sess. 185, 186 (1958).

[71] Ibid.

[72] Assuming no change of taxpayer entity is involved.

[73] See note 69 supra and accompanying text.

and illogical definition of "the property" contained in the early G.C.M.'s and in the 1954 Code. The writer believes that a definition along the following lines would be consistent with operating practices, and without prejudice to the collection of revenue.

(a) "The property" is defined as each separate economic interest of a taxpayer in minerals in place.[74]
(b) Such properties of a like nature may be deemed to merge without the necessity of a formal election to aggregate those interests by the taxpayer, as long as the extraction of the minerals in which the economic interests are owned is conducted within one operating unit.
(c) An "operating unit" is defined as that unit within which a reasonable and prudent operator would carry out the drilling, lifting, and preliminary storage operations prior to the transportation of the minerals for processing or marketing.
(d) "Non-operating mineral interests" as defined in the 1954 Code may be merged or aggregated with other "non-operating mineral interests" upon formal application of the taxpayer to aggregate or merge those interests and approval by the Secretary of the Treasury or his delegate. In no event shall "operating" mineral interests be aggregated with "non-operating" mineral interests, and in no event shall there be more than one aggregation of "non-operating" interests within the same operating unit.

This definition would allow any number of aggregations of similar economic interests within an operating unit if those interests are of an "operating" nature. The question of what constitutes an "operating unit" becomes a fact issue (as it is, in reality, under the present regulations).

While this proposed definition certainly would not settle all of the problems of the present law, it would reduce the number of issues in an aggregation problem so that the questions could be solved by the application of familiar concepts.

The 1958 Act results literally in confusion, twice confounded. Although aggregation today is considered a minor problem, being relegated to a secondary position behind percentage depletion and the election to expense intangibles, it may conceivably become very important in the event legislation is passed reducing the present percentage depletion allowed to the oil and gas industry. It would therefore be to the interest of that industry to attempt immediately to obtain an adequate definition of property in the Internal Revenue Code.[75]

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[74] As defined in Palmer v. Bender, 287 U.S. 551 (1933).

[75] For an extended treatment of other problems relating to the definition of "The Property" and Aggregation, see French, Oil and Gas Property and Aggregation, 36 Texas L. Rev. 745 (1958); Fiske, Federal Taxation of Oil and Gas Transactions, §§ 4.01, 4.07 (1958).