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Neil J. O'Brien

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COMMENTS

THE DEPLETABLE STATUS OF AN ASSIGNED NET PROFIT PAYMENT

In 1933 Mr. Justice Stone defined the necessary elements of a depletable economic interest. In subsequent cases the courts, frequently citing that well-reasoned opinion, have clarified the depletable status of most of the varied oil and gas interests. Two 1938 Supreme Court decisions held that one of these varied interests, a net profit payment, was not depletable. That result was later modified in Kirby Petroleum Co. v. Commissioner, wherein the Supreme Court held that if the net profit interest is reserved, it is depletable. Presumably the two 1938 decisions still control an assigned net profit interest, but these two cases have been seriously criticized and distinguished, and the trend of subsequent cases indicates that the assigned net profit payment may be depletable too. The recent decision in Commissioner v. Southwest Exploration Co. merits particular attention, and justifies re-examining the depletable status of the assigned net profit payment.

CASE LAW

The Supreme Court has held that a person is entitled to take depletion if by investment he has acquired any interest in oil in place, and if he must look to the extraction of that oil for the return of his capital. One should keep in mind, when examining the case law, that the foregoing definition of an "economic interest" in setting out the elements of a depletable interest makes no mention of the

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2 Burton-Sutton Co. v. Commissioner, 328 U.S. 25 (1946); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Thomas v. Perkins, 301 U.S. 653 (1937); Hagan v. Commissioner, 141 F. 2d 92 (1st Cir. 1944), cert. denied, 323 U.S. 710 (1944); Greensboro Gas Co. v. Commissioner, 79 F. 2d 701 (3rd Cir. 1935), cert. denied, 296 U.S. 639 (1934); Kiesau Petroleum Corp. v. Commissioner, 42 B.T.A. 69 (1940) acq.
4 326 U.S. 599 (1946).
7 350 U.S. 308 (1956).
manner in which the interest is acquired. The definition does not distinguish a reserved interest from an interest acquired by assignment.

The principal case holding that the assignee of a net profit payment is not entitled to take depletion is *Helvering v. O'Donnel.* In that case the taxpayer, a controlling shareholder of corporation A, sold his stock to corporation B; corporation B agreed to dissolve corporation A, and to make net profit payments to the taxpayer from the oil properties formerly held by corporation A. The Court denied depletion for the reason that the agreement contained the personal covenant of the vendor of the net profit payments, and did not give the taxpayer any interest in the properties. In the * Kirby* case, distinguishing *Helvering v. O'Donnel,* the Court said that the taxpayer in the *O'Donnel* case was denied depletion because he was a "stranger to the lease." Since the assignee of a net profit payment is generally a "stranger to the lease," the *O'Donnel* case, as interpreted, directly supports the proposition that he is not entitled to the depletion allowance. However, subsequent cases indicate a definite trend to overrule the "stranger to the lease" doctrine, although it seems unlikely that the courts will formally overrule the case itself.

Denying the vendee of a net profit payment the right to take depletion on the ground that he is a "stranger to the lease" emphasizes the manner of acquisition. The courts have subsequently shifted their considerations from the mode of acquisition to the nature of the interest acquired. In *Burton-Sutton Oil Co. v. Commissioner* the Supreme Court said: "It (depletion) is the lessor's, lessee's, or transferee's 'possibility of profit' from the use of his 'rights over production'." (Emphasis added). In *T. W. Lee* the Tax Court said

10 328 U.S. 25 (1946). Inclusion of transferee's implied that the basis for depletion does not depend on acquiring as a party to the lease. Use of the words right over production placed the emphasis of this opinion on the nature of the interest acquired. See also 328 U.S. at 33.
11 328 U.S. 370 (1938).
12 326 U.S. at 606.
that it is the "economic consequences" of the contract, not the means of acquisition, which determines the depletable status.

There are several cases in the mining industry where the miner, who was paid on a percentage basis, was entitled to take depletion. The courts seem to allow depletion where the miner has control over the extraction; but where the right over production is controlled by a third party, the miner apparently is considered a mere employee who is not entitled to the depletion allowance. These cases, where the holder of the percentage interest is performing the actual extraction, are distinguishable on their facts from an assigned net profit payment where the holder may be an investor who has never seen an oil well, but to the extent they were decided on the nature of the interest acquired they have shown the tendency of the Courts to move away from the "stranger to the lease" doctrine.

The Supreme Court restricted that doctrine further in Commissioner v. Southwest Exploration Co. when it again emphasized the nature of the interest acquired. In that case a California statute requiring wells drilled into the state's off-shore oil lands be slanted from the adjacent shores gave the upland owners a strategic advantage. The Court held that an easement assigned by the upland owner in exchange for a net profit payment from the lessee drilling company constituted an "indispensable" investment, and that the upland owner could take depletion as the assignee of the net profit payment.

In the Southwest Exploration case the taxpayer had no legal interest in the lease, nor any realistic interest in the actual extraction as in the mining cases; his interest was solely that of an outside investor, with the important additional characteristic of being indispensable. The Court had no direct authority for holding that an interest was depletable if it was indispensable to production; thus, the Supreme Court created a new rule in this most recent and furthest departure from the O'Donnell holding, another indication that the Court is shying away from the "stranger to the lease" doctrine.

Considering the question whether the Court would find the requisite economic interest if confronted with the assignee of a net profit payment who neither has the "right over production," nor has made an "indispensable" contribution to the production, one should

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16 Usibelli v. Commissioner, 229 F. 2d 539 (9th Cir. 1955); Morrisdale Coal Mining Co., 19 T.C. 208 (1952).
remember a holding that the “stranger to the lease” is not entitled to take depletion is contrary to the fundamental rule of property law that a vendee acquires the same interest as his vendor. It was a useful device formulated in the *Kirby* case to distinguish the prior holding of *Helvering v. O'Donnell*, but it should not be employed to expand the simple rule *O'Donnell* stated, that where the agreement contains the personal covenant of the vendor, the assignee of the net profit payment may not take depletion. The courts have subsequently limited the “stranger to the lease” rule by emphasizing the nature of the interest acquired. The logical conclusion would be for the Court to establish that the net profit payment, whether reserved or assigned, is depletatable in both instances.

In the other 1938 decision, *Helvering v. Elbe Oil Land Development Co.*, the Supreme Court held that a reserved net profit interest was non-depletatable if the transaction was found to be a sale. In that case the tax payer conveyed his interest in producing wells for $\frac{3}{4}$ cash consideration, and reserved a net profit interest from which the remaining $\frac{1}{2}$ would be paid. Disallowing depletion, the Court held that the net profit payment was the personal covenant of the vendee, and that the vendor, having disposed of the properties, retained no investment in them. His interest was nothing more than that of any other creditor in the resources of his debtor.

Although the *Elbe* case has been followed; its scope has been limited by subsequent cases. In the *Kirby* case, the government, citing *Elbe*, argued that a reserved net profit payment alone would not be depletatable. The Court rejected that view, and ruled that the reserved interest was depletatable, thus limiting *Elbe* to the instances where the transaction has been characterized a sale.

If the vendor is relying on the personal covenant of the vendee then he is not relying solely on the extraction of oil, so his interest does not qualify within the terms of an “economic interest.” Furthermore, *Elbe* dealt with the assignor, and is not direct support for

13 See note 11 *supra*. Note the order of *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938), *O'Donnell*, and *Helvering v. Elbe Oil Land Development Co.*, 303 U.S. 372 (1938). *Bankline*, where the taxpayer had no interest in the oil in place, was a strong case for the Commissioner. *O'Donnell* was also a fairly strong case for the Commissioner because the taxpayer was the shareholder of the corporation that had formerly held the oil properties, and not the owner himself. *Elbe Oil* on its facts was the weakest, because the taxpayer was formerly the owner of the properties. It appears that the Court decided the cases in this order so that the earlier cases could be authority for the later ones.

14 303 U.S. 372 (1938).


16 Cases cited note 6 *supra*. 
disallowing the deduction to the assignee. It cannot be overlooked, however, because it is the principal case cited as authority denying depletion to the holder of a net profit payment.

**COMPARISON OF A NET PROFIT PAYMENT TO OTHER DEPLETABLE INTERESTS**

The Internal Revenue Code provides "a reasonable allowance for depletion . . . according to the peculiar conditions in each case."\(^{21}\) The definition of an "economic interest,"\(^{22}\) as promulgated by the Court and the Commissioner interpreting this statute, contains the generally accepted elements of a depletable interest. A net profit payment clearly satisfies that definition, and should therefore be accorded the depletion allowance. The consideration advanced for a net profit payment is the required investment.\(^{23}\) The interest is in oil in the ground, and does not depend on future processing or transportation for profits.\(^{24}\) The investor is dependent solely upon production and realization of profits for return of his capital.\(^{25}\)

Disallowing the deduction where the taxpayer has acquired his net profit payment as a "stranger to the lease," the Court has rested its decision on a factor which is not one of the basic elements in the definition of an "economic interest." This position would be tenable if the net profit payment were an unusual type of interest; but comparing it to other depletable economic interests such a conclusion is not sound.

When reserved, a royalty,\(^{26}\) oil payment,\(^{27}\) or net profit payment\(^{28}\) is depletable; both the royalty\(^{29}\) and oil payments\(^{30}\) are also depletable when assigned; but the depletable status of an assigned net profit payment depends on the factual determination of whether or not the assignee is a "stranger to the lease," has a "right over production," or

\(^{22}\) See note 8 supra.
\(^{23}\) The nature of the interest acquired, not the cost, is the important element. Burton-Sutton Co. v. Commissioner, 128 U.S. 25, 34 (1946).
\(^{24}\) Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938). For cases involving depletion after the mineral has been extracted see Helvering v. Bankline Oil Co., 303 U.S. 562 (1938); Hudson Engineering Corp. v. Commissioner, 183 F. 2d 180 (5th Cir. 1950), affirning 11 T.C. 1042 (1948); Signal Gasoline Corp. v. Commissioner, 66 F. 2d 886 (9th Cir. 1933), second appeal 77 F. 2d 728 (9th Cir. 1935) cert. denied, 296 U.S. 657 (1935).
\(^{25}\) Cases cited note 19 supra.
\(^{26}\) Kirby Petroleum Corp. v. Commissioner, 326 U.S. 599 (1946).
\(^{27}\) Thomas v. Perkins, 301 U.S. 655 (1937).
\(^{30}\) Anderson v. Helvering, 310 U.S. 404 (1940); Ortiz Oil Co. v. Commissioner, 102 F. 2d 508 (5th Cir. 1939), cert. denied., 308 U.S. 566 (1939).
makes an "indispensable" contribution to production. The differences between the assigned royalty or oil payment, and the assigned net profit payment do not justify special treatment in the case of the latter.

A royalty, for depletion purposes,\textsuperscript{31} may be defined as a share of the product reserved by the owner who permits another to use his property. A net profit payment is a contractual right to a payment from the receipts of an oil operation after deducting prescribed expenses. Although there is an element of privilege in the royalty interest which the net profit payment does not necessarily contain,\textsuperscript{34} the courts, when discussing reserved royalties and reserved net profit payments, have not resorted to this difference for the purpose of distinguishing the two interests. An oil payment is the right to receive a portion of oil produced, or proceeds derived therefrom.\textsuperscript{36} The oil payment expires after stipulated payments have been made, whereas the net profit interest usually runs for the life of the lease. The courts have not cited this distinction as a distinguishing characteristic for depletion purposes. Both royalty and oil payments are usually payable from gross receipts immediately upon production. Since the net profit payment is not made until expenses, including liens and charges, have been met, the problem clearly exists of determining what amounts are to be deducted prior to payment of the net profit interest.\textsuperscript{38} However, since the net profit interest is depletable if reserved, this accounting argument would not be reason for disallowing depletion simply because the net profit interest is assigned.\textsuperscript{37} Furthermore in \textit{Caldwell v. Commissioner}\textsuperscript{38} the Fifth Circuit held that a payment after deducting operating and maintenance expenses

\textsuperscript{31} A complete definition of a royalty, oil payment, or net profit payment would take several pages; for the purposes of analysis for depletion, these shorter definitions should be adequate.


\textsuperscript{33} An accounting schedule attached to the net profit agreement provides which items shall be charged to expenses, which to capital. MILLER, op. cit. supra note 4, at 181.

\textsuperscript{34} But see Kirby Petroleum Co. v. Commissioner, 326 U.S. 199 (1946).

\textsuperscript{35} Commissioner v. Fleming, 82 F. 2d 324 (5th Cir. 1936); T. W. Lee, 42 B.T.A. 1217 (1940), aff'd 126 F. 2d 825 (5th Cir. 1952).

\textsuperscript{36} The 27\%/2\% depletion deduction in no event can exceed 27\%/2\% of the total 100\% production. Twin Bell Oil Synd. v. Helvering, 293 U.S. 312 (1914).

\textsuperscript{37} See note 32 supra.

\textsuperscript{38} 141 F. 2d 559 (5th Cir. 1944), affirming 47 B.T.A. 707 (1942), distinguishing Elbe Oil. Of course the holder of an oil payment is less likely to object to charges which reduce the net income, because the payments will terminate when his fixed sum has been satisfied; but the problem does exist in the case of oil payments, the difference being only one of intensity.
could be considered and handled as an oil payment; so, the problem can be solved.

Each of these three interests fulfills the requisites of an economic interest. Each investor is looking to the extraction of oil for the return of his investment. His possibility of return ends when the oil is exhausted. The net profit payment, therefore, cannot be classified differently from the other two on the premise that it is an exceptional or peculiar interest. It not only is similar to other interests which are depletable, but is itself depletable in certain circumstances.

**The Legislative Policy**

Even if the net profit payment satisfies both the terms of the statutes and the definition interpreting the statutes, one might argue that allowing the holder of this interest depletion violates the legislative policy. The history of the depletion section, however, does not support this argument.

Whether the legislature intended depletion to provide a return of capital or a subsidy to the investor has been the subject of scholarly works. Although the legislative history of percentage depletion seems to support the subsidy approach, there have been a few scattered and indecisive opinions which favor the return of capital approach. However, whether the basic policy is to subsidize the in-

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39 Cases cited note 8 supra.
40 The net profit interest is depletable when it is reserved. Burton-Sutton Co. v. Commissioner, 328 U.S. 25 (1946).
41 See note 5 supra.

Congress did not pass legislation for specific interests, such as royalty or working interests, but, in more general terms seemed to provide for the person who takes the risks; "... discovery depletion, the purpose of which was to encourage the wildcatter or pioneer..."; "it was going to be a great help to help owners of those little wells which barely pay the cost of pumping"; SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAXATION 1913-1861, at 968-972 (1st ed. 1938); "... to stimulate the discovery of mineral properties and to compensate for hazards of prospecting." S. Rep. No. 617, 65th Cong., 3rd Sess. 6 (1919). See also, INT. REV. CODE OF 1954, § 261 (c), on deductions for intangible drilling costs.

The 27½% is not an arbitrary figure, but is a percentage which should compensate the investor for the expense of all the wells he has drilled, whether wet or dry. If the percentage is shown to provide recovery in excess of cost, then it is arguable that from the continuous passage of this provision, the legislature intends to create a subsidy. See note 45 infra.

43 Herring v. Commissioner, 293 U.S. 322 (1934); Murphy Oil Co. v. Burnet, 387 U.S. 299 (1932); Commissioner v. O'Shaughnessy, Inc., 124 F. 2d 33 (10th Cir. 1941); Herndon Drilling Co. v. Commissioner, 6 T.C. 628 (1946).
vestor or to return him his capital, the assignee of a net profit payment should be entitled to take the percentage depletion.

If the purpose of the statute is to subsidize the general investor, any person in the industry whose properties come within the terms of an economic interest should be entitled to depletion. If the subsidy is intended for the individual wildcatter who takes the risks, as the legislative history seems to imply, limiting depletion to the interest while the wildcatter holds it tends to restrain the alienation, thereby excluding a method of obtaining funds for further exploration, and frustrating the legislative intent.

Assuming, on the other hand, that the basic reason for allowing depletion is that it furnishes the best workable method for returning the investor's capital, there is no personal element involved, as in the individual subsidy case, and all persons coming within the statute and judicial definition should be treated similarly.

**CONCLUSION**

Since the assigned net profit payment satisfies the requirements of an economic interest, logically the assignee should be entitled to the depletion allowance. However, the *O'Donnell* case with its "stranger to the lease" interpretation is too well established to be ignored, and the Court will be hard pressed to allow depletion without overruling that aging misfit. Notwithstanding that difficulty, reasoning from the trend of subsequent decisions, one may conclude that the "stranger to the lease" doctrine is no longer operative; furthermore, one may reasonably predict that the Court, if presented the case of an assigned net profit payment, will find that satisfying the necessary elements of an economic interest, it is depletable.

*Neil J. O'Brien*

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44 For an example see Southwest Exploration Co. v. Commissioner, 350 U.S. 308 (1956).
45 The depletion allowance also attracts into the search for oil some capital that otherwise would never be risked. Baker and Griswold; *Percentage Depletion—A Correspondence*, 64 Harv. L. Rev. 361 (1951); Rogan v. Blue Ridge Oil Co., Ltd., 83 F. 2d 420 (9th Cir. 1936).
46 See note 42, paragraph 3, *supra.*
47 It is arguable that the cost to the investor in proved oil wells is so high that percentage depletion will ordinarily not yield recovery in excess of cost depletion.
48 Proposed regulations have been published by the Commissioner indicating that there will no longer be a distinction between assigned and reserved net profit payments. 21 Fed. Reg. 8439 (1956), amending 26 C.F.R. § 30.23(m)-1(a) (1954).