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Legislative Note - Federal Taxation - Oil and Gas De-Aggregations

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Congressional action is needed to correct the inequities that exist in the law as a result of the *Jackson* decision. It is suggested that discrimination among the states would be avoided to some degree by the adoption of a provision allowing a deduction for allowances reasonably required and actually expended, subject to a limitation on the amount that may be deducted. Until Congress sees fit to change this situation by federal legislation, the only relief available is at the state level through enactment of statutes providing that the right to a widow's allowance indefeasibly vests upon the decedent's death.

*John David Tobin, Jr.*

**Legislative Note—Federal Taxation—Oil and Gas De-Aggregations**

**I. INTRODUCTION**

Oil and gas, like other natural deposits, is a wasting asset. When it is removed from its natural state, the original amount available is depleted. In order to provide for this reduction, the law permits a deduction in computing taxable income earned from the removal. One of the purposes of this deduction is to allow the owner of a depletable asset to recover his capital investment tax-free, and to tax only the income therefrom. For example, when oil is taken from a well and sold, the well is being depleted and a part of the proceeds from the sale represents a return of capital investment rather than of income.

In the case of mineral properties, depletion allowances are computed either by the cost depletion method or the percentage depletion method. Both cost and percentage depletion computations should be the allowance to be terminable in the California and Georgia cases. The allowances terminate in those two states upon the death or remarriage of the widow. Both are situations which are incapable of determination either at the time of the decedent's death or at the time of the court award. In Texas, the contingencies which may defeat the widow's right to an allowance are finally determinable from facts in existence at the spouse's death. It is immaterial that the existence of these facts are recognized in a subsequent court award.

A limitation on the amount allowed as a deduction will avoid the discrimination that Congress found to exist under § 812(b) of the 1939 Internal Revenue Code. See note 2 *supra*. The suggested provision would re-establish the criteria for a deduction that existed under the 1939 code. See note 2 *supra*.

\(^1\) For an excellent analysis of the history of legislative developments in this area see *Freeman, Percentage Depletion for Oil—A Policy Issue, 30 Ind. L.J. 399, 404-11 (1955).* See also *Blaise, What Every Tax Man Should Know About Percentage Depletion, 36 Taxes 395, 417-26 (1958); Galvin, The "Ought" and "Its" of Oil-and-Gas Taxation, 73 Harv. L. Rev. 1441, 1458-65 (1960); Kent, Tax Problems Affecting Lessors and Royalty Owners,*
made for each particular mineral property because the computation producing the larger deduction is allowed and is used to reduce the basis of the property for future calculations. The cost depletion deduction is computed by dividing the adjusted basis of the property by the number of units, i.e., barrels of oil, remaining to be recovered, and multiplying this quotient by the number of units sold during the period. The percentage depletion deduction, in the case of oil and gas, is computed as twenty-seven and one-half per cent of the gross income from the property, not to exceed fifty per cent of the taxable income from the property. Therefore, the definition of the property is of vital significance in determining the depletion deduction available.

An oil and gas "property" for depletion purposes is defined as each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. For purposes of this definition, a tract or parcel of land may be separated either geographically or by conveyancing. A tract also may be separated by a lease, sublease or sale of an interest in the tract. Assume, for example, that the owner of an entire block of land leases, subleases or sells a portion of such block. A separate interest is thereby created for each portion so transferred. Historically, each such separate mineral interest has been treated as a separate property.

II. HISTORICAL PERSPECTIVE

Under the Internal Revenue Code of 1939, through administrative

Southwestern Legal Foundation, First Annual Institute on Oil and Gas Law and Taxation 355, 361-68 (1949).


The term tract or parcel of land means an area delineated by metes and bounds, lot the block description or otherwise. Treas. Reg. § 1.614-1(a) (3) (1961).

For example, tracts are separated geographically if the taxpayer acquires a lease covering two tracts which do not have at least one common side, i.e., the tracts are joined at a corner. Tracts are separated by conveyancing if the taxpayer acquires an interest in a tract from one grantor and another interest in the same tract from another grantor. In both of these instances, the taxpayer has acquired two properties. The acquisition of noncontiguous tracts in a single transaction creates a separate property for each such area acquired, and the acquisition of separate interests in the same tract from different grantors creates a property for each interest acquired.

See note 5 supra.
rulings and regulations, a taxpayer was permitted to combine properties for depletion purposes, if they were located in a single tract or parcel of land. The regulations provided as follows: "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." 

Also, as a general rule, each lease was considered to be a separate tract or parcel of land. A new concept, however, was established by the Internal Revenue Code of 1954, which permitted the combination or aggregation of properties across lease lines if all the properties were in one operating unit. These rules provided that it was not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land, or in contiguous tracts or parcels of land, so long as the interests were a part of the same operating unit. Only one aggregation could be formed within each operating unit, however, and this aggregation was not required to include all of the interests within the operating unit. The definition of an operating unit was to be determined for each taxpayer on the basis of his individual operations. Thus, the taxpayer could aggregate two or more separate operating mineral interests and treat them as one property, regardless of whether such interests were located in tracts or parcels of land which were contiguous or in close proximity to each other, but was required to treat as a separate property each such interest in the operating unit that he did not include in the combination. The

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8 See note 5 supra.
9 Treas. Reg. 118, § 39.23(m)-1(i) (1953).
10 Ibid.
11 Ibid.
12 This new concept did not change the definition of property which had been established under the 1939 Code. However, it did provide that separate properties or mineral deposits could be treated as one property under the regulations provided that certain conditions existed and the proper elections were made. Int. Rev. Code of 1954, ch. 736, § 614(b), (c), and (d), 68A Stat. 210 (1954). This area of natural resources legislation has been the subject of much controversy. The reader's further review is directed to Fiske, Depletion Problems: The Unit of Property, Aggregating Property Interests, 10 Oil & Gas Tax Q. 66 (1961); Fiske, The "Property" Under the Internal Revenue Code of 1954, 4 Oil & Gas Tax Q. 214 (1957); French, The Oil and Gas Property and Aggregation, 36 Tex. L. Rev. 745 (1958), merely to mention a few.
13 Operating unit referred to mineral interests operated together for production purposes. Treas. Reg. § 1.614-2(c) (1961) provided that the following factors would serve to indicate that the mineral interests were operated as a unit:
   i) common field or operating personnel,
   ii) common supply and maintenance facilities,
   iii) common processing or treatment plants, and
   iv) common storage facilities.
15 Ibid.
passage of this legislation was intended primarily to benefit the hard minerals industry,17 but the provisions applied equally to the oil and gas industry. The Technical Amendments Act of 195818 continued the rules established under the Internal Revenue Code of 1954, and, in addition, provided oil and gas producers with an option for each operating unit to use the operating unit rules or to return to the rules which had been in effect under the Internal Revenue Code of 1939,19 i.e., combining properties within a single tract or parcel of land.

As a result of the broad language used in the Internal Revenue Code of 1954 and the Technical Amendments Act of 1958, oil and gas producers were able to combine any number of oil and gas leases provided that they were in a single operating unit, a term which prior to these amendments had no fixed meaning in the oil and gas industry.20 Certain oil and gas producers21 were able to increase substantially their depletion deductions through a careful combination of properties for tax purposes. This objective was accomplished by combining high net income properties with low net income properties, which were affected by the fifty per cent of taxable income limitation, so that the overall percentage depletion deduction on the aggregation more closely approximated the full twenty-seven and one-half per cent of gross income.22 Of course, those properties upon

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17 This legislation followed a series of Tax Court decisions which held that producers of hard minerals were permitted to treat an entire mine or several mines as a single property even though the mine or mines covered a number of tracts of land. For example, see Buffalo Chilton Coal Co., 20 T.C. 398 (1953); Morrisdale Coal Mining Co., 13 T.C. 448 (1949); Amherst Coal Co., 11 T.C. 209 (1948), nonacq. 1949-1 Cum. Bull.; and Black Mountain Corp., 5 T.C. 1117 (1941), nonacq. 1946-2 Cum. Bull.
19 Many producers were desirous of returning to the rules which had been in effect under the 1939 Code. In this regard, see Johnson, 1958 Amendment to Subchapter I (Natural Resources) Affecting Oil and Gas Interests, Southwestern Legal Foundation, Tenth Annual Institute on Oil and Gas Law and Taxation 493 (1959); Schoenbaum, Mineral "Property" as Defined by Technical Amendments Act of 1958, 8 Oil & Gas Tax Q. 13 (1958).
20 Assume an operator owns properties A and B and realizes $100,000 gross income from each. However, property A shows a net income of $80,000 and property B shows a net income of $40,000. As separate properties, although 27 1/2% of the gross income from each property equals $27,750 for a total of $55,500, the allowable depletion is limited to $47,500 because the depletion allowed on property B is limited to 50% of the net income of $40,000, or $20,000. If these two properties had been aggregated so as to have been treated as a single property, there would have been no net income limitation on depletion. The total gross income would have been $200,000, which at 27 1/2% would produce depletion of $55,000. The aggregated net income would have been $120,000 and 50% of such net income would be $60,000, or $5,000 in excess of the percentage depletion allowable. Therefore, the
which cost depletion was higher than percentage depletion would be excluded from the aggregation.

The Treasury objected to aggregations primarily on two grounds. First, it was administratively difficult, if not impossible, to determine an operating unit which was mutually agreeable to both the taxpayer and the Internal Revenue Service. The taxpayer sought to use the largest possible units in order to achieve combinations of properties over extremely widespread and naturally advantageous areas, and the Internal Revenue Service, on the other hand, attempted to curb such an approach. Second, the Treasury felt that the law provided an unintended tax advantage to oil and gas producers by permitting them an unusual amount of freedom to combine properties, primarily for tax rather than business purposes, and thereby to obtain a maximum depletion allowance.

With this historical background of apparently frustrated legislative intent before it, and at the insistence of the Treasury Department and President Kennedy, Congress eliminated the operating unit aggregation rule for oil and gas properties and established rules which it thought to be more in accord with business procedures.

aggregation of the two properties would have increased the taxpayer's depletion deduction by $7,500.


24 An analysis such as this may have identified a result of the prior legislation; however, it also uncovers a much more complex problem which the Treasury has apparently chosen to ignore. At the time of its enactment, the operating-unit concept of aggregations created a very small economic impact on Treasury revenues—e.g., domestic exploration was approaching its peak, production allowables were at or near maximum capacity, and percentage depletion, in general, was based on 27 1/2% of gross income rather than 50% of net income. In the latter part of 1957, however, foreign import oil began to become a serious competitive factor to domestic producers because of the Government's position in regard to such imports. As a result of this influx of foreign oil, the various state authorities began a consistent cutting back of allowable producing days so that more properties became marginal operations and the advantages of the operating-unit concept of aggregations became more apparent. Faced with these increasing problems, the domestic producers were required to spread out their operations in order to devise more economic production methods—e.g., field or operating personnel were required to cover a larger geographical area and provide common supply and maintenance facilities. Thus, these business considerations provided a greater base for determining those properties which could be aggregated and operated together for the purpose of producing minerals. As a result of these economic factors, the 50% of net income limitation on percentage depletion had to be considered and the aggregation of marginal properties with high income producing properties became a tax advantage.

25 S. Rep. No. 830, 88th Cong., 2d Sess. (1964). See also Hearings Before the Committee on Ways and Means on Tax Recommendations of the President Contained in his Message Transmitted to Congress January 24, 1963, 88th Cong., 1st Sess. (1963), in particular the statement of Douglas Dillon, Secretary of the Treasury, and the questions by members of the Committee addressed to Mr. Dillon beginning on page 38. In this same regard, the adversary position is ably presented by Robert J. Casey, counsel for Union Pacific Railroad Company, on page 3969 and by Texaco on page 4026.

III. 1964 Revenue Act

Section 226 of the Revenue Act of 1964 makes material changes in the property unit rules relating to the grouping of oil and gas operating interests for depletion purposes. The effect of the new rules is to eliminate the operating-unit concept of aggregation of mineral interests formerly provided in section 614 of the Internal Revenue Code of 1954 and to return, with the exception of unitization of such interests, to the lease concept in effect under the Internal Revenue Code of 1939, with several modifications and clarifications.

A. Aggregation Of Interests

The new rules state that an owner of oil and gas operating interests cannot aggregate such interests, as a general rule, beyond the boundaries of each separate lease. Further, all operating interests within a separate tract or parcel of land are combined and treated as one property, unless an election is made to treat such interests as separate properties. The result is that an operating interest in one tract of land cannot be combined with an operating interest in another tract. Of course, as under prior law, an operating interest cannot be combined with a nonoperating interest, whether in the same or another tract or parcel of land.

If a taxpayer owns all or any portion of the operating rights in a tract or parcel of land, but has made expenditures for the development or operation of only a single operating mineral interest in the tract, a subsequently acquired or discovered operating mineral interest in the same tract will be combined with the original interest unless a timely election is made to separate the two interests. On the other hand, if several operating mineral interests in the same tract or parcel of land are owned during the first year for which elections are required under the new provisions, the taxpayer may elect to treat one or more or all of his interests as separate, but may not have more than one combination in a single tract. If the taxpayer elects to treat one or more interests in the same tract as separate properties, his remain-

39 See notes 31-33 infra.
40 See notes 10 and 11 supra.
46 Ibid.
ing interests in that tract are automatically combined and treated as a single property. The election must be made for the first taxable year beginning after December 31, 1963, and once made the election is binding for all future years.

If an election is in effect for any year when the taxpayer acquires an additional interest or discovers a new deposit in the same tract, he has an additional election as to the new interest or deposit. If all interests in the tract have been treated as separate properties, the new interest or deposit shall be considered a separate property unless the taxpayer elects to combine it with another interest in the same tract. If, however, there is a combination of interests in the tract, the new interests will be considered to be a part of such combination unless the taxpayer elects to treat it as a separate property.

The new rules do not provide an election to separate interests which originally were combined under the 1939 Code rules. Instead, they provide that these combinations will be recognized and treated as combinations of properties under the new rules and cannot be separated by an election. However, the election to combine or keep separate subsequently discovered or acquired interests in the same tract will apply to such combinations. Aggregations previously formed under the 1954 Code rules must be discontinued and separated into their component mineral interests. The taxpayer may then elect to treat these interests as separate properties or to combine them according to the new rules.

B. Allocation Of Basis

The new rules state that the taxpayer must allocate the total basis of the aggregation to the separated interests by one of two methods. The first method, the fair market value method, provides that the allocation must be made in the ratio that the fair market value of each property bears to the total fair market value of the aggregation. For many taxpayers the use of this method as the basis for dissolving existing aggregations will create an extremely difficult valuation problem involving many properties. The alternative, the allocation of

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37 Ibid.
44 See notes 31-33 supra.
46 There is also a distinct possibility that this method of de-aggregation could lead to a potential loss of cost depletion. Assume for example, that the taxpayer has been required to aggregate two properties—i.e., property A with a high cost basis, but which proves to
adjustments method," provides that the taxpayer may ascribe to each property the basis which it had prior to the aggregation, adjusted by its share of depletion and other items reasonably attributable to it during the time the aggregation was in existence. The use of this method for de-aggregating properties will require a difficult apportionment, between the various properties, of depletion taken during the existence of the aggregation. Such an apportionment will be impossible unless the taxpayer's records are adequate because a separate election is necessary for each aggregation. If the existing aggregations affected by these provisions have no basis remaining to allocate, as well may be the case, then the problems incident to the use of this method will be academic. The total basis of the separated properties cannot, however, regardless of the method used, exceed the adjusted basis of the aggregation prior to its dissolution. As is apparent, the discontinuance and dissolution of presently existing aggregations will create complex problems for many taxpayers.

C. Pooled Or Unitized Interests

With regard to operating mineral interests that are pooled or unitized, the new rules make an exception to the general rule established for determining the property unit. The rules state that all the taxpayer's operating interests in a unitized or pooled area shall be treated as a single property so long as they remain in the unitization or pooling. If, however, they are later removed from the unitization or pooling, they resume whatever status they had prior to such contribution. This provision applies to all compulsory unitizations

have low production and low reserves so that percentage depletion is always smaller than cost depletion; and property B with a low cost basis, but which proves to have high production and high reserves so that percentage depletion will always be in excess of cost depletion. Obviously, when the aggregation is discontinued, property B will have a higher fair market value than property A and will require a higher adjusted basis. In all likelihood, both properties will continue to produce at such a level that they will retain their old characteristics as to the depletion deduction, but property A will have a considerably smaller basis upon which to compute cost depletion and a certain amount of such depletion will have been lost. This is the same method, however, that has been followed by the Treasury if a taxpayer sells his interest in a presently existing aggregation. Treas. Reg. § 1.614-6(a) (2) (1961), provides that if a portion of the aggregated property is disposed of, then an allocation of total costs between the portion disposed of and the portion retained on the basis of their relative fair market value at the date of disposition is required.


However, a taxpayer may use the fair market value rule for some aggregations and the allocation of adjustments rule for others.


Ibid.

Compulsory unitization is the combination, as required by law, of separately owned interests into a unit constituting all or part of a producing pool or reservoir and the joint operation of such unit.

Ibid.
and to a voluntary unitization if the interests covered by the unitization agreement are in the same deposit or are in two or more deposits, the joint development of which is logical from the standpoint of geology, convenience, economy or conservation, and are in tracts or parcels of land which are contiguous or in close proximity. The practical result of this new section is to overrule several cases in which the courts allowed the taxpayer, who contributed both high-basis and low-basis properties to a unitization, to maintain the contributed properties separate and thereby obtain a higher depletion allowance. However, the section further provides that if a property was unitized before 1964, and the taxpayer treated his interests in such unitization as two or more separate properties, then he may continue to do so provided that such treatment is ultimately upheld as proper under the prior rules.

IV. Conclusion

Although the new rules are similar to the rules and administrative practices under the 1939 Code, there are several principal differences and distinctions which should be noted. First, the treatment under the 1939 Code provided that each mineral interest in a tract or parcel of land was treated as a separate property unless the taxpayer elected to combine such interests. By contrast, under the Revenue Act of 1964, the taxpayer is deemed to have combined all of his mineral interests in a separate tract or parcel of land unless he elects to treat such interests as separate properties. Thus, the 1939 Code rules provided for a maximum number of properties in each tract absent affirmative action on the part of the taxpayer, and the 1964 Revenue Act treatment provides for a minimum number of properties under the same circumstances. Second, the 1939 Code rules required that the election necessary to combine mineral properties must be made

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53 Voluntary unitization is the development and operation of an oil pool or reservoir as a unit, involving the consolidation or merger of all interests in the pool and the designation of one or more of the parties as operator for the benefit of all the owners, per their mutual agreement. In this regard, see French, Natural Resources Regulations, N.Y.U. 20th Institute on Fed. Tax. 1147, 1175-82 (1962).


55 This paradox was created by providing that the taxpayer could take percentage depletion on one property and cost depletion on another property, although both properties were included in the unitization, by allocating a portion of his share of the unitized oil production to each property. See Winfield Killam, 39 T.C. 680 (1963); Earl V. Whitwell, 28 T.C. 372 (1957), rev'd on other grounds, 237 F.2d 548 (5th Cir. 1958); Belridge Oil Co., 27 T.C. 1044 (1957), nonacq. 1958-1 Cum. Bull. 7, aff'd, 267 F.2d 291 (9th Cir. 1959).


57 See note 10 supra.

58 Int. Rev. Code of 1934, § 614(b) (1) and (2), as amended, 78 Stat. 94 (1964).