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FEDERAL TAX SYMPOSIUM

A TAX INCENTIVE APPROACH TO THE DEPLETION ALLOWANCE DILEMMA

THOMAS E. BULLEIT, JR.*

I. INTRODUCTION

As early as 1913,1 Congress acknowledged that mineral deposits, like capital base machinery, are wasting assets which require preservation through tax benefits. Because the nation's current dependence on unstable, foreign sources of oil is universally viewed as undesirable, and even dangerous, it would now seem particularly important to maintain an economic attractiveness for the mining of coal so that energy and economic independence could be regained. However, the deduction for depletion in one of the most significant coal production arrangements, contract mining, continues to flounder in a state of turmoil that has endured for decades.2 The Internal Revenue Service, by its restrictive regulations, and the courts in their interpretation of these regulations, are compromising this basic tax incentive in coal production. In addition, the inconsistent position of the Service and

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1 The Income Tax Act of 1913, ch. 16, 62, para. B, 38 Stat. 166, provided for deductibility of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business," and made specific reference to deduction for exhaustion of mines. Current federal income tax statutes, although allowing a deduction for exhaustion of property used in trade or business or held for the production of income, treat this deduction as distinct from the deduction for depletion of mineral deposits.

diverse interpretations of the Treasury regulations\(^3\) in the area of depletion have substantially obfuscated the application and operation of the tax laws as they affect these contractual arrangements.

The factual setting in which this confusion arises involves an owner of coal, whether in fee or as lessor or sublessee, and an entity authorized by some contractual arrangement to mine the coal (a "contract miner"). For decades the courts have had difficulty in interpreting the tax law with regard to depletion as between these parties. Early decisions of the Supreme Court established the concept of an "economic interest in the coal in place" as the primary element upon which a depletable interest should be based and developed a set of guidelines to supplement a bare authorizing statute,\(^4\) but unfortunately the courts have tended to emphasize the objective but economically unrealistic criterion of the terminability of the contract in determining whether an economic interest is held. This test has been supplemented and expanded by subsequent guidelines, many of which have been adopted by the Treasury regulations.\(^5\)

Thus, as the law now stands, the existence of a depletable interest in the mineral is determined by the nature of the termination provision in the contract between the parties. This method of determining a deduction for depletion ignores the economic realities of the capital intensive surface mining industry by forcing the parties in a mining development program to select between tax considerations and economic considerations. If for economic reasons the owner wishes to retain the depletion allowance, he must use a license, lease, or contractual arrangement which may be terminated without cause on short notice. If the miner is to produce coal under this arrangement, he must make an enormous investment in equipment, purchase insurance, and build haul roads, silt dams and ponds in reliance upon a contractual relationship which may be terminated in this abrupt fashion—an economically unrealistic posture. And, unfortunately, if the parties attempt to find some middle contractual ground, they are faced


\(^4\) See, e.g., Palmer v. Bender, 287 U.S. 551 (1933).

with the almost impossible task of determining the allocation of the allowance in the current milieu of increasingly diverse application of law and regulations.

In matters as significant as domestic energy production, surely tax considerations and economic requirements should be consistent. This article offers model drafts of contract clauses which should assist tax planners in clarifying this relationship and proposes regulatory modifications which would bring our oldest mineral development tax benefit into a tax incentive posture.

II. DEVELOPMENT OF THE DEPLETION CONCEPT

The "reasonable allowance for depletion," currently authorized by section 611 of the Internal Revenue Code, is entirely a matter of legislative grace\(^7\) which was first provided by Congress in the Revenue Act of 1913 and then adopted in various forms in all subsequent revenue acts.\(^8\) The analysis of the allowance for depletion as stated in United States v. Ludey\(^9\) by Mr. Justice Brandeis is the accepted interpretation of the legislative intent and purpose for the deduction:\(^10\)

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\(^6\) While the argument is often propounded by advocates attempting to realize the benefits of the depletion allowance, there is no legislative history indicating conclusively that the intent of Congress in authorizing the allowance for depletion was to stimulate the development of natural resources. The primary purpose for the legislation, as indicated below in the text of this article, seems to have been to compensate the mineral owner for the wasting of a capital resource. See note 10 \textit{infra}. However, it would be unfortunate not to utilize the traditional concept of depletion as a tax incentive for mineral production.


\(^9\) 274 U.S. 295 (1927).

The depletion charge permitted as a deduction from gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. That fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn in any year and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion . . . . In essence, the deduction for depletion does not differ from the deduction for depreciation. 11

Section 611(a) of the Internal Revenue Code in its present form permits a "reasonable allowance for depletion and for depreciation of improvements" in the case of mines. The Treasury regulations refer to section 167 and regulations thereunder for the determination of the allowance for depreciation of improvements in mines. 12 The present juxtaposition of the concepts of depletion and depreciation in the statutory scheme and the analysis of statutory intent by Mr. Justice Brandeis seem to equate the ideas of depletion and depreciation as tools to preserve the capital base in our economic system. 23

11 274 U.S. at 302-03.
13 Mr. Justice Clark stated the capital recoupment theory of the depletion allowance in the following manner:

[The allowance for depletion] is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit. Presently, the depletion allowance is a fixed percentage of gross income which Congress allows to be excluded; this exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired.

Commissioner v. Southwest Exploration Co., 350 U.S. 308, 312 (1956). Earlier, the Court had stated that "[t]he granting of an arbitrary deduction . . . of a percent-
With this capital recoupment purpose in mind, the courts have had to develop their own conceptual guidelines to fill the void left by the terse authorizing statute and lack of legislative history. Further complicating any judicial interpretation of the depletion statutes, section 611 and its predecessors expansively authorize depletion in a field that includes "mines, oil and gas wells, other material deposits and timber." The courts have been required to superimpose a single set of conceptual guidelines (developed by the following cases and ultimately adopted by Treasury regulation) upon all of these various industries.

The development of judicial guidelines by which the courts have permitted or denied a deduction for depletion began with *Lynch v. Alworth-Stephens Co.*,\(^\text{14}\) in which a lessee of an iron ore deposit was deemed to possess a sufficient interest in the deposit to be permitted to share the depletion allowance with the fee owner. The 1916 Revenue Act under which the case was litigated contained no such apportionment rule, but the Court permitted the deduction to any owner of a "real and substantial interest"\(^\text{15}\) in the mineral deposit.\(^\text{16}\) While the lessee did not hold legal title to the ore deposits, his lease was deemed to have vested the requisite "real and substantial interest." Thus, the particular legal form of the taxpayer's interest in the depletable property was held not to be the determinative factor in the allocation of the depletion allowance.

\(^{14}\) 267 U.S. 364 (1925).

\(^{15}\) Id. at 369.

\(^{16}\) I.R.C. § 611(b)(1) provides that, in the case of a lease, the depletion deduction shall be equitably apportioned between the lessor and the lessee. When read in conjunction with I.R.C. § 631(c), which authorizes a capital gain on royalties received by the owner of coal under any form of contract by virtue of which such owner retains an economic interest but also prohibits such owner from taking any allowance for percentage depletion, § 611(b)(1) results in the apportionment between the lessor and lessee of the depletion allowance until the lessor achieves the § 631(c) one year holding period, after which the lessor is required to report the royalties under the capital gains rules as authorized by that section. This then leaves the lessee with the entire depletion allowance. Deduction of the royalty paid to a lessor by a lessee (as authorized by *Lynch v. Alworth-Stephens Co.* for the purposes of depletion) is now authorized for royalties paid pursuant to I.R.C. § 631(c). Treas. Reg. § 1.631-3(b)(3)(i), T.D. 6841, 1965-2 C.B. 200.
The trend away from the traditional common law real property analysis continued in *Palmer v. Bender*, in which the Supreme Court established the judicial concept of an "economic interest" in a mineral deposit. The Court held that the right to the depletion allowance was not dependent on "retention of ownership or any other particular form of legal interest in the mineral content of the land." Instead, the Court ruled that an "economic interest in the minerals in place" was required, stating that an economic interest exists when "the taxpayer has acquired, by investment, any interest in the [mineral] in place and secures, by any form of legal relationship, income derived from the extraction of the [mineral], to which he must look for a return of capital."

The Court in propounding these guidelines acknowledged the preservation of capital philosophy basic to the statute but drew what have been called gossamer lines between the taxpayer permitted the allowance for depletion and the taxpayer denied it by replacing the criterion of real property estates with "any form of legal relationship."

In *Commissioner v. Bankline Oil Co.* the Court denied a taxpayer a deduction for the depletion allowance, stating that "the phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit." The *Bankline Oil Co.* judicial guideline of "economic advantage," together with the guidelines established in *Palmer v. Bender*, constitutes what is now the current Treasury regulation defining an "economic interest" in a mineral.

A second tier of judicial guidelines has developed in the area of contract mining. In the cases of *Parsons v. Smith* and *Paran..."
The Supreme Court established, by application of factual background, guidelines relating to the existence or nonexistence of an economic interest in the context of depletion deductions for contract miners. In *Parsons v. Smith* the petitioners were partnerships engaged in the surface mining of coal in Pennsylvania. The Court found the following facts applicable:

1. that petitioners' investments were in their equipment, all of which was movable — not in the coal in place;
2. that their investments in equipment were recoverable through depreciation — not depletion;
3. that the contracts were completely terminable without cause on short notice;
4. that the landowners did not agree to surrender and did not actually surrender to petitioners any captial interest in the coal in place;
5. that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners;
6. that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, to be in 'full compensation for full performance of all work and for the furnishing of all [labor] and equipment required for the work;' and
7. that petitioners, thus, agreed to look only to the landowners for all sums to be due them under their contracts.

The Court further found that the agreements between the petitioners and the owners of the coal were "personal covenant[s], and did not purport to grant [petitioners] an interest in the [coal in place]." The taxpayers were deemed to have received a mere economic advantage from their production of the coal, as con-
trasted to an economic interest in the coal in place.\textsuperscript{30} This was based on the finding that the petitioners had no "capital investment in the mineral deposit which suffered depletion,"\textsuperscript{31} and they were thus precluded from the depletion allowance.

These factors were cited with approval in \textit{Paragon Jewel Coal Co. v. Commissioner}.\textsuperscript{32} In \textit{Paragon Jewel} the mining contractors contended that they had made a capital investment in the coal in place because of the nature and extent of their expenditures in preparation for and in the performance of oral agreements which they claimed granted them the right to mine certain designated areas to exhaustion. They maintained that they could look only to the extraction and sale of the coal for a return on their investment and that the test of \textit{Parsons v. Smith} was thus satisfied.\textsuperscript{33} It is interesting to note that the petitioners were asserting the economic realities of the independent contractor situation indicated previously, which require intensive capital investment throughout the period of mining, particularly in the start-up (or development) stage.

The Tax Court had found, based on the guidelines of \textit{Parsons v. Smith}, that the contract miners were not entitled to the depletion allowance.\textsuperscript{34} However, the Fourth Circuit, agreeing with the taxpayers, held that the contracts under which they mined were not terminable at the will of Paragon but instead gave the contractors "a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price."\textsuperscript{35} It based its decision on the fact that the operators made "large expenditures of time and money in preparation for their respective sites for mining" and observed that "it would be inequitable indeed to hold that Paragon might . . . then take benefit of the operators' efforts at will and without cause."\textsuperscript{36}

The Supreme Court, siding with the Tax Court, reversed. Significantly, Mr. Justice Goldberg's dissenting opinion, in which

\textsuperscript{30} Id. at 226.
\textsuperscript{31} Id.
\textsuperscript{33} 380 U.S. at 627.
\textsuperscript{34} 39 T.C. 257 (1962).
\textsuperscript{35} 330 F.2d 161, 163 (1964).
\textsuperscript{36} Id.
Mr. Justice Black joined, suggested that "[a] look through the formal legal arrangements to the underlying economic realities makes clear that the position of the miners is far closer to that of the entrepreneur participating in a joint venture than to the seller of services."³⁷ Using this reasoning, the minority argued that the depletion allowance should be apportioned between the lessee and the contract miners.³⁸

Finally, in Commissioner v. Southwest Exploration Co.³⁹ an oil company engaged in drilling for state-owned offshore oil from a private surface owner's adjacent lands paid to the owner a percentage of the net profits from the extraction and sale of the oil in return for the right to maintain a well on the site. The Court there held that, while the taxpayer-adjacent property owner possessed neither a fee nor leasehold interest in the oil in place, he was entitled to the depletion allowance.⁴⁰ However, the Court was careful to limit the extension of the Palmer concept to the specific facts of the case. The Court stated "we decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an indispensable contribution to the use of the real property adjacent to the oil deposits in return for a share of the net profits from the production of the oil, that party has an economic interest which entitled him to depletion on the income thus received."⁴¹

The Supreme Court thus allowed, in a case limited to its facts, a taxpayer to take the deduction for depletion in a situation which would appear to be analogous to that of the payment of a wheelage fee in the coal mining industry.

III. PRESENT STATUS OF THE DEPLETION ALLOWANCE

Section 611 authorizes, in the case of mines, a deduction for depletion of the mineral and a deduction for depreciation of improvements.⁴² The Treasury regulations limit annual depletion

³⁷ 380 U.S. at 639.
³⁸ Id. at 648.
³⁹ 350 U.S. 308 (1956).
⁴⁰ Id. at 316-17.
⁴¹ Id. at 317.
⁴² I.R.C. § 611 provides in pertinent part:

[a] general rule.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in com-
deductions to the owner of an economic interest in coal and define economic interest under the guidelines set forth in Palmer v. Bender. The taxpayer has acquired by investment an interest in the coal in place by any form of legal relationship in which income is derived from the extraction of the coal, and to which the taxpayer must look for a return of his capital investment, the taxpayer has such an economic interest. The present regulations further adopt the test of Commissioner v. Bankline Oil Co., which provides that the taxpayer with no capital investment in the coal deposit does not acquire an economic interest through a contractual relation which yields a mere economic or pecuniary advantage derived from the mining of the coal.

The statutory structure further provides for the apportionment of the depletion allowance between the lessor and the lessee. However, this apportionment will end when the lessor or sublessor attains a requisite holding period, after which he must forego the depletion allowance under a provision that, in turn,
treats the income from coal royalties as capital gains.\textsuperscript{48}

Revenue Rulings, which reflect the position of the Service but do not carry the weight of the law, have in the past emphasized the third test as stated in \textit{Parsons v. Smith}\textsuperscript{49} (i.e., whether the contracts are completely terminable without cause on short notice). In these rulings, the Service has looked primarily to the term of the contractual relationship between the owner and the miner to determine whether the miner has a sufficient economic interest in the coal in place to justify a deduction for depletion.\textsuperscript{50} In a relatively recent ruling, however, the Service has broken this pattern and adopted the common law real property test. There the Service denied to a contract miner a deduction for depletion because the contract with the owner of the land was an oral contract, invalid under the Kentucky Statute of Frauds.\textsuperscript{51} This decision was rendered despite the fact that the miner was paying the owner a specified royalty per ton of coal mined and sold.

A survey of federal tax cases demonstrates that the courts have had difficulty\textsuperscript{52} in applying the \textit{Palmer v. Bender}\textsuperscript{53} requirements of investment in the coal in place and income derived from its extraction and in applying the economic interest versus economic advantage tests of \textit{Commissioner v. Bankline Oil Co.}\textsuperscript{54} To resolve this dilemma the courts have turned to the more specific guidelines of \textit{Parsons v. Smith}\textsuperscript{55} and have applied the seven factors enumerated therein according to the facts of each case. However, the factors most emphasized are the duration of the contract, factually addressed by clauses indicating an exclusive right to mine or short-notice, no-cause termination clauses, and the method by which the miner's compensation is based (i.e., whether

\begin{itemize}
\item\textsuperscript{48} See I.R.C. § 631(c). For a thorough examination of this provision, see Coggin, \textit{Federal Income Tax Treatment of the Acquisition and Disposition of Coal Interests: An Examination of I.R.C. § 631(c)}, in this issue, infra.
\item\textsuperscript{49} 359 U.S. 215 (1959). See note 28 \textit{supra} and accompanying text.
\item\textsuperscript{51} Rev. Rul. 77-341, 1977-2 C.B. 204.
\item\textsuperscript{52} See Commissioner v. Gregory Run Coal Co., 212 F.2d 52 (4th Cir.), \textit{cert. denied}, 348 U.S. 828 (1954); Weirton Ice & Coal Supply Co. v. Commissioner, 231 F.2d 531 (4th Cir. 1956).
\item\textsuperscript{53} 287 U.S. 551 (1933). See note 20 \textit{supra}.
\item\textsuperscript{54} 303 U.S. 362 (1938).
\item\textsuperscript{55} 359 U.S. 215 (1959).
\end{itemize}
it is based upon a fixed rate per ton or is geared to the selling or market price of coal).\(^{56}\)

Although the case law exhibits some trends, with an emphasis on the guideline of terminability or capacity to mine to exhaustion, there exists even within these trends a diversity of approach and emphasis. This not only causes drafting problems for the tax planner but, more significantly, it retards development of domestic energy resources by forcing taxpayers into the Hobson's choice of selecting between economic considerations and tax considerations in designing their contractual and business relationships.

For example, in *Boiling v. Commissioner*\(^{57}\) the Tax Court found that a taxpayer mining under a valid lease agreement containing a thirty day written notice cancellation clause had merely an economic advantage and thus was denied the deduction for depletion. Aside from the fact that the lease was subject to cancellation on thirty days' written notice, and the fact that the contractor agreed to sell coal to the lessor, the lease appeared to convey an interest in realty. It contained the typical provisions of minimum land rent, payment of all taxes assessed on the property, the conveyance clause "lesser does hereby let, lease and demise unto lessee for strip mining purposes," and a recitation of the source of title.\(^1\)

This case, and the document which is partially reprinted in the opinion, demonstrates the risks and difficulty encountered by drafters and developers of mineral properties in their attempt to design a contract that is consistent with the economic realities of the situation but, at the same time, retains or conveys an economic interest in the mineral in place for tax purposes. Whether the document will be construed as conveying or retaining an economic interest in the coal in place indefinitely depends upon the weight given the various guidelines in *Parsons v. Smith*.\(^{59}\)

\(^{56}\) See, e.g., Contantino v. Commissioner, 445 F.2d 405 (3d Cir. 1971); Whitmer v. Commissioner, 443 F.2d 170 (3d Cir. 1971); McCall v. Commissioner, 312 F.2d 699 (4th Cir. 1963); Elm Dev. Co. v. Commissioner, 315 F.2d 488 (4th Cir. 1963); United States v. Stallard, 273 F.2d 847 (4th Cir. 1959); Bolling v. Commissioner, 37 T.C. 754 (1962); Fink v. Commissioner, 29 T.C. 1119 (1958).

\(^{57}\) 37 T.C. 754 (1962).

\(^{58}\) Id. at 756-57.

\(^{59}\) See note 28 supra and accompanying text.
In *Bolling* the petitioners argued that their acquisition of surface rights and construction of haul roads were essential to the production of coal and created an economic interest in the coal in place under the rationale of *Commissioner v. Southwest Exploration Co.* Disagreeing, the Tax Court was of the opinion that the acquisition of the surface rights, access rights, wheelage rights, and the payments for surface damage were only expense items necessary to a successful surface mining operation.

In contrast, the Fifth Circuit held in *Winters Coal Co. v. Commissioner* that, since strip mining contracts required the contract miner to obtain the surface rights, the contractor thereby acquired an economic interest in the coal in place which would allow a deduction for depletion, notwithstanding the fact that either party could terminate the lease with thirty days' notice. The court followed the *Southwest Exploration Co.* case, stating that:

The case at bar is factually close to *Southwest Exploration*. Coal could only be extracted from ABC's deposits by strip mining. The law of real property required the permission of the surface owners before the overburden could be removed to reach the coal. The lease according to its terms, did not become effective until the taxpayer had obtained that permission. Like *Southwest Exploration*, the state law and the leasing arrangement required that the producer cooperate with certain property owners. Once the taxpayer had acquired the interest it purchased from the surface owners it was in the same position as the upland property owners in *Southwest Exploration*.

The court, in addressing the *Parsons v. Smith* guidelines, found four factors in favor of an economic interest: that the investment could not be recovered by depreciation; that after mining the coal belonged to the contract miner; that the contract miner was to have all the proceeds of the sale of the coal; and that petitioner did not agree to look only to the lessor for all income. The court found one *Parsons v. Smith* guideline indicating

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61 37 T.C. 754, 764 (1962).
62 496 F.2d 995 (5th Cir. 1974).
63 Id. at 1001.
64 Id. at 996-1000.
only an economic advantage: that the leases were terminable on short notice. With regard to the first and the fourth guidelines of Parsons v. Smith (that the contract miners’ investments were in their equipment, not in the coal in place, and that the landowners did not agree to surrender and did not actually surrender to the contract miners any capital investment in the coal in place), the judges indicated that they were uncertain whether the lease, terminable on short notice, constituted a capital investment in the coal in place but declined to decide the case solely on that point. This exemplifies the classic difficulty in applying the two-part capital investment guidelines set out in Palmer v. Bender. It is also of interest to note that the pre-Supreme Court guideline structure test, relating to common law real property interest, was given weight and applied here by the Fifth Circuit in 1974.

A further example of the difficulty in the judicial application of the guidelines stated in Parsons v. Smith is Holbrook v. Commissioner, in which the taxpayer mining under a document (termed a license) was granted permission to mine the owner’s coal and sell it in whatever market he could establish. The Tax Court denied the miner-licensee a deduction for depletion because a termination clause in the license provided a ten day notice cancellation option to the licensor.

However, a majority of the Parsons v. Smith guidelines favored a finding of an economic interest in the miner. Prior to commencing mining operations it was necessary for the miner, at the expense of five thousand dollars, to improve the roof support in the mines and to erect several buildings on the area covered by the license, some of which were salvageable and others not. The miner used a newly-purchased coal loader along with other equipment previously obtained. Thus, the contract miner’s investments were not all in depreciable equipment, and a substantial portion of these investments were not movable from the mining site. The contracts were terminable on short notice. It is not known whether the landowners agreed to surrender to the contract miners any capital interest in the coal in place. The contract miner not only was allowed to keep the coal, but also to sell it in whatever third-party markets he was able to establish. He looked directly to the proceeds of the sale of the coal for reimbursement

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65 65 T.C. 415 (1975).
and was not paid a fixed sum by the owner for each ton mined. The contract miner was not required to look to the landowners for assignments in order to be due them under his contract. In sum, an application of four of the *Parsons v. Smith* factors would favor the finding of an economic interest in the contract miner, one would disfavor it, and two cannot be resolved.

As indicated previously, the courts have looked primarily to the guideline of contract terminability in finding the existence or absence of a depletable interest. A significant exception to that philosophy is found in the Court of Claims decision of *Bakertown Coal Co. v. United States*, in which the court found an economic interest in a coal property lessee and discounted the fact that the lease contained a clause allowing termination on thirty days' notice. The *Bakertown Coal Co.* case, a significant example of the diverse and inconsistent approaches used in determining the presence of an economic interest, develops a persuasive argument that property rights are more significant than terminability.

The Court of Claims, citing the premise of *Palmer v. Bender* that the acquisition of a lease constituted a capital investment by which the requisite economic interest in the mineral could be obtained, went on to analyze the government's preoccupation with terminability. The court stated:

> Though predicating its denial of plaintiffs' depletion rights solely on the presence of a short-term terminability provision in the subject mining leases, the Government makes no claim that this feature of the agreements either nullifies them (as, for example, sham) or otherwise operates to impart to their remaining terms a meaning or significance materially differing from that conveyed by a natural reading of the language employed. Thus, defendant does not dispute either that these agreements were bona fide mineral leases or that, while in force, they gave plaintiffs essentially the same autonomous authority over extraction and sale of the underlying mineral as did the leases in *Palmer* and *Alworth-Stephens*, where such authority was held to constitute an ample basis for a depletable interest. The property interest represented by that authority is not varied or diminished simply because the author-

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66 See notes 50 and 56 supra and accompanying text.
67 485 F.2d 633 (Ct. Cl. 1973).
ity is subject to the possibility of extinction in the future by a termination of the leases on short notice. The legal effect of a termination on these leases is no less prospective because the advance-notice requirement is only 30 days, than it would be if the specified period were one year. 69

With regard to the government's argument based on terminability, the court stated, "[i]t seems to us that the Government is here attempting to remove transactions from the traditional ambit of economic interest by resort to a principle that it sponsored to liberalize and expand that established concept to encompass transactions not theretofore within it." 70

The Internal Revenue Service has indicated that it will not follow the Bakertown Coal Co. case. 71

Two conclusions may be drawn from this survey of the case law. First, there is no single factor or concrete set of factors upon which a tax planner could rely to assure the allowance or disallowance of a deduction for depletion; and second, there has been a revival of the traditional approach for determining that issue which examines common law property principles in addition to the statutory constructions propounded by the courts and by the Internal Revenue Service. 72

IV. DRAFTING TECHNIQUES FOR THE CONTRACT MINING AGREEMENT

In this atmosphere of conflicting interpretation of Treasury regulations and Supreme Court guidelines, attention to drafting detail is crucial. Although a desired allocation of the depletion allowance should be obtainable by exercising the requisite care, some of these contractual clauses will be difficult to negotiate. There are ten elements, as developed by the regulations and cases, which should be addressed in drafting mining contracts.

69 485 F.2d at 636. As authority for the last proposition, with regard to the legal effect of the disparity between a thirty day and one year notice, the court cited H. TIFFANY, REAL PROPERTY § 159, 588 (3d ed. 1939).
70 485 F.2d at 636.
72 See Thornberry Constr. Co. v. United States, 576 F.2d 346 (Ct. Cl. 1978), and Chief Tax Court Judge Drennon's dissenting opinion in Mullins v. Commissioner, 48 T.C. 571 (1967), the case upon which the rationale of Bakertown Coal Co. is based.
These elements consist, first, of the Palmer v. Bender guidelines, which were adopted by Treasury regulation, second, the seven guidelines set out in Parsons v. Smith, and finally, the real property considerations, which have been revitalized by the Court of Claims in Bakertown Coal Co. These elements may be restated in the form of drafting considerations as follows:

(1) Will the contractual arrangement be a conveyance of a real property interest under state law?
(2) Will the miner have a capital investment in the coal in place?
(3) Will the miner depend solely upon the extraction of the coal for a return on his investment?
(4) Will the miner's investment be primarily in movable equipment?
(5) Will the miner's investment in equipment be recoverable through depreciation?
(6) Will the contract be terminable without cause on short notice?
(7) Will the owner agree to surrender any capital interest in the coal in place?
(8) Will the miner have the right to sell or keep any of the coal, or will he be required to deliver the coal to the owner?
(9) Will the miner participate directly in the proceeds of sale of the coal, or will he be paid a fixed sum for each ton mined?
(10) Will the miner look only to the owner for payment under the contract?

The primary consideration in drafting a contract designed to retain or create a depletable interest is the form of the relationship between the owner of coal and the miner. It is presumed that the parties to the venture have negotiated the allotment of a depletion allowance and have decided which party is to realize its benefit. If the coal owner is to retain his economic interest in the coal in place, the form of the contract should establish the contract miner as an independent contractor. If an economic interest is instead to be conveyed to the miner, the contract should

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73 In this context the term “owner” is defined as an entity having title to the mineral estate, including a fee simple owner, a lessee, sublessee, assignee, or other entity which has acquired by investment an economic interest in coal.

74 In this context the term “miner” is defined as an entity which will do the actual mining and which does not have an economic interest in the coal in place prior to the drafting of the contract.
take the form of a lease or sublease — an interest arising from the law of real property. Drafting to establish the miner as an independent contractor is governed by the common law of employer-independent contractor and is achieved by providing contractually certain indicia which create a lack of control by the owner. The relationship of the parties should be established in the introductory clauses\textsuperscript{75} and maintained in the body of the contract by clauses providing that the independent contractor supply the equipment, tools, materials, and labor to perform the mining.\textsuperscript{76} In addition to the specific provision of indicia establishing the miner as an independent contractor, a general acknowledgement of the relationship by the parties to the contract is appropriate.\textsuperscript{77}

In the event owner and miner agree that the miner should have the benefit of the depletion allowance, an instrument conveying title to the minerals is appropriate. A lease or sublease from the owner to the miner will create an economic interest in the coal in place in the miner and preserve an economic interest in the owner, resulting in an allocation of depletion to the miner and capital gain royalties to the owner. The lease or sublease should contain granting, habendum, and description clauses, provide a fixed and/or percentage tonnage royalty, have a term sufficient to mine the coal to exhaustion, and convey exclusive mining rights. The format of the lease should be consistent with local filing requirements (i.e., it should contain addresses of the parties, acknowledgements, prepared-by statements, etc).

Drafting to establish affirmatively the criteria of Palmer v. Bender (i.e., to create a depletable interest in the miner) is accomplished by leasing the mineral estate to the miner. The lease itself constitutes a capital investment in the coal in place,\textsuperscript{78} and if the miner pays the owner a royalty based upon coal mined and sold, he will be dependent upon extraction of the coal for a return on his investment.

If the owner desires to retain the depletion allowance, the Palmer v. Bender criteria are established in the negative by con-

\textsuperscript{75} See Appendix, cls. 1, 2.
\textsuperscript{76} See Appendix, cls. 3, 4.
\textsuperscript{77} See Appendix, cl. 5.
\textsuperscript{78} Palmer v. Bender, 287 U.S. 511 (1933); Bakertown Coal Co. v. United States, 485 F.2d 633 (Ct. Cl. 1973).
tract clauses requiring the miner to furnish equipment, tools, etc.," and by acknowledgements that he has no investment in the coal in place. The miner's dependence upon the extraction of the coal for a return on his investment may be negated by a clause providing for a fixed fee payment to the miner as the sole consideration for services rendered under the contract.\textsuperscript{81}

Under the guidelines developed in \textit{Parsons v. Smith}, a depletable interest may be conveyed to the miner by lease clauses providing a term of duration sufficient to mine all of the coal in place, or providing for mining to exhaustion of the mineral, and by provision for a fixed or percentage tonnage royalty. The lease should not call for delivery of the coal to the owner, sale of the coal by the owner, nor payment for the coal by the owner.

Observing the guidelines of \textit{Parsons v. Smith}, the retention of the depletable interest in the owner is achieved through the specific and general drafting approaches suggested previously. Specifically, the contract should contain clauses reciting the miner's responsibility to furnish equipment, machinery, etc.,\textsuperscript{82} a clause providing for short-term, no-cause cancellation of the contract,\textsuperscript{83} a requirement that the mined coal be delivered to the owner,\textsuperscript{84} and a payment term stated as a fixed sum per ton of coal mined as exclusive compensation for services rendered.\textsuperscript{85} The contract should also contain a general statement of the owner's intention to retain the depletion allowance.\textsuperscript{86}

While attention to drafting detail should result in the desired allocation of the depletion allowance, the contract weighted to effectuate the tax deductions will be inconsistent with the economic realities of a mining venture. This practical inconsistency between tax and economic consideration arises in the situation, described above, in which the owner intends to retain the depletion deduction and establish the miner as an independent contractor. As discussed previously the Service and many of the courts stress the

\textsuperscript{79} See \textit{APPENDIX}, cl. 3.  
\textsuperscript{80} See \textit{APPENDIX}, cl. 6.  
\textsuperscript{81} See \textit{APPENDIX}, cl. 7.  
\textsuperscript{82} See \textit{APPENDIX}, cl. 3.  
\textsuperscript{83} See \textit{APPENDIX}, cl. 8.  
\textsuperscript{84} See \textit{APPENDIX}, cl. 9.  
\textsuperscript{85} See \textit{APPENDIX}, cl. 7.  
\textsuperscript{86} See \textit{APPENDIX}, cl. 6.
no-cause, short-notice terminability test in the construction of mining contracts. This type of clause places the miner in the precarious position of making a considerable investment in equipment, access and haul roads, silt dams and ponds, and such other facilities as may be required by the mining activity in order to perform a contract which may be terminated on short notice without breach or lack of performance by the miner. In contract negotiations between owner and miner it is not surprising that the term clause is almost inevitably one of the most difficult matters to resolve.

In many instances the owner will desire to employ an independent contract miner and retain the depletion allowance, but will authorize the miner to sell the mined coal. This arrangement, which may be the only manner in which the coal may practicably be sold, achieves economic goals, but the owner's retention of the deduction for depletion may be questioned by the Service since it would conflict with the Parsons v. Smith guidelines.

V. A PROPOSAL FOR REGULATORY MODIFICATIONS

As explained above, the most skillful drafting cannot maximize depletion tax benefits without creating an unfavorable posture for the contract miner. At this time, that result could only be brought about by modification of the Treasury regulations.

Treasury Regulation section 1.611-1 may be modified or supplemented to alleviate the problems by the addition of a real property interest test to establish the existence of "an economic interest in the coal in place." The real property test, established in 1925 and revitalized by the Court of Claims in 1973, is the most straightforward and justiciable indicator of a depletable interest. In most of the coal producing states, the real property mineral estate is defined by law, and the existence of a depletable interest should be considered established if the taxpayer is deter-

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87 If the owner elects to cancel the contract on short notice and without cause after the miner has built haul roads, silt dams, etc., the miner may be able to recoup his losses on the theory of quantum meruit. See Kelly v. Rainelle Coal Co., 135 W. Va. 594, 64 S.E.2d 606 (1951). However, the mere existence of a possible remedy, which would require the institution of litigation, is certainly not an incentive to the miner. 88 Lynch v. Alworth-Stephens Co., 267 U.S. 364 (1925). 89 Bakertown Coal Co. v. United States, 485 F.2d 633 (Ct. Cl. 1973).
mined to own a mineral estate under this criterion, where applicable.

Definition of the term "mere economic or pecuniary advantage" used in Treasury Regulation section 1.611-1(b)(1) would also assist in the administrative and judicial allocation of the depletion allowance. To that regulation should be added a definition of the term "economic advantage" (currently distinguished from an "economic interest," indicating a depletable interest) which would apply to the holder of a mining permit, mining license, and reclamation bond. This definition would broaden the scope of the existing regulatory term, which is primarily directed to the contractual relationship between the owner and miner, to include a statement of position with regard to the significance of relationships between the miner and third parties or regulatory agencies. Although an economic interest in the mineral based upon these factors would be somewhat artificial in a legal sense, they do represent a practical economic interest often maintained by contract miners.

The third proposal is for the Service to modify its position by emphasizing the affirmative investment in the mineral in place and the return of capital concepts found in current Treasury Regulation section 1.611-1(b)(1) and Parsons v. Smith, and by no longer considering as determinative the Parsons v. Smith tests of no-cause, short-notice terminability, delivery of coal to the owner, right to sell coal by the miner, payment for the coal by the owner, and payment for the coal based upon a fixed sum per ton mined.

The final proposal is for the Service to define by discrete examples the legal relationships in which the depletion allowance may be shared by the owner and miner. These examples should include a vehicle by which the owner can contribute the mineral (whether held in fee or by leasehold) to the capital of a partnership, owned in some proportion by both owner and miner, in which the deduction for depletion may be allocated between the partners.

These proposals should facilitate the drafting of mining agreements and, more significantly, equate the tax considerations
VI. Conclusion

Although the legislative history of the deduction for depletion is devoid of any affirmative indication that its purpose is to encourage the production of natural resources, such an incentive is inherent in the statute itself, and that incentive could be realized if the governmental bodies were to apply the deduction uniformly, with a logic consistent with the basic nature of the provision. The least that is required under the current state of the law is a more definite guide for tax planners involved in contract mining arrangements, and the creation of a clear-cut incentive in that definitive process would seem to be particularly desirable in this era of energy concern.
APPENDIX

1. Whereas, owner has the right to mine certain coal-bearing properties pursuant to certain deeds, leases, subleases, or contractual arrangements; and

2. Whereas, owner desires to engage miner in the capacity of an independent contract miner to mine certain coal from the property for a fixed sum cash payment per ton, and miner desires to accept such engagement;

3. Miner agrees to furnish adequate and sufficient equipment, machinery, tools, power, fuel, explosives, water, materials and supplies to perform the mining operation herein contemplated.

4. Owner agrees to furnish all personnel and labor to perform the mining operations and shall be solely responsible in all respects for the employment and working conditions of all those persons so employed.

5. It is expressly agreed that miner will carry out the services contemplated by this agreement as an independent contractor. It is the intention of the parties that owner has engaged miner to mine, load, and deliver certain coal pursuant to this agreement. It is understood by the parties that the miner shall exercise complete and exclusive control over the mining activity and over his employees. Nothing herein shall be construed as creating a single enterprise, joint venture, or employer-employee relationship between miner and owner. Miner is not and shall not represent itself to be a partner, agent, or representative of owner.

6. It is expressly understood and agreed by and between the parties that miner has no economic interest, legal or beneficial, or any title to the coal in place as mined hereunder; that the economic interest in said coal is hereby reserved and retained by owner exclusively; that the miner shall look to owner alone for any payment for all services rendered by miner hereunder, and in no event to the proceeds received from the sale of said coal; that miner undertakes the performance of the
provisions of this agreement as independent contractor; that the miner’s investment is in his equipment and not in the coal in place; and that miner agrees that for federal income tax purposes, he shall not claim a deduction for mineral depletion.

7. Owner will pay to miner, as the sole and exclusive consideration payable to miner for the services to be performed by miner under this agreement, a payment of ___ dollars per net ton of merchantable coal of two thousand pounds (2,000 lbs.) delivered by miner to owner or its assignee as compensation for extraction of coal mined by the strip mining method.

8. Owner shall have the right to terminate this agreement without cause, at any time, by giving thirty (30) days’ prior written notice of such termination to miner. The termination of this agreement shall not, however, invalidate or waive any of the indemnities, warranties, or representations of the parties hereto, and all of said indemnities, warranties, and representations shall survive any termination of this agreement, but only as to acts or events occurring prior to the termination of the agreement.

9. Coal mined hereunder shall be delivered by the miner at its expense to owner by the miner loading same on trucks designated by owner at the mine site, or delivered to owner’s tipple or processing plant.