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Income Taxation--Basis for Depletion Allowance

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Taxpayer, a mining and development company, entered into a written contract with lessee of coal mines, the lessee having entered into a long-term lease with owner of coal lands to mine the coal, whereby taxpayer would auger mine in certain areas of lessee's leasehold. Taxpayer worked as an independent contractor, using his own equipment and machinery which was movable and usuable elsewhere. Title to all coal mined remained in the lessee, all coal was delivered to the lessee, and taxpayer retained no right to sell coal elsewhere. Taxpayer received a set price per ton for coal delivered to lessee, subject to adjustments for general wage increases, and lessee had the right to cancel the lease only if the operation became unprofitable or if taxpayer defaulted. Tax Court held that taxpayer did not have a sufficient "economic interest" to entitle him to a depletion allowance based on amounts received for mining coal under the contract since taxpayer looked for his payment to the personal covenant of lessee and not to severance and sale of coal, and there was reasonable expectancy that cancellation clause might be enforced. *Held,* reversed. Taxpayer had sufficient "economic interest" entitling him to a depletion allowance, as his right to mine was not subject to control or termination by the lessee save for default or unprofitability. *Elm Dev. Co. v. Commissioner,* 315 F.2d 488 (4th Cir. 1963).

The Internal Revenue Code of 1954 provides that there shall be, in case of mines, oil and gas wells, timber and other natural resources, a "reasonable allowance for depletion" in computing taxable income. INT. REV. CODE OF 1954, § 611 (a). The Code does not, however, define who is entitled to a depletion allowance. This information is found in TREAS. REG. § 1.611-1(b)(1) (1960), which requires a person to have an "economic interest" in the mineral in place before claiming a depletion allowance. This ambiguous phrase was first coined in *Palmer v. Bender,* 287 U.S. 551 (1933), when the court stated that a taxpayer had an "economic interest", entitling him to a depletion allowance, when (1) he had acquired an interest in the mineral in place by investment, and (2) his income from the legal relationship was derived from extraction and sale of the mineral, to which he must look for a return of his capital.

The Treasury Regulations incorporated language similar to that of the *Palmer* case, *supra,* and then included a statement that a person does not have an "economic interest" merely because through a contractual relation he possesses a mere "economic or pecuniary advantage" derived from production. TREAS. REG. § 1.611-1(b)(1) (1960). The phrase "economic advantage" orginated in *Helvering v. Bankline Oil Co.,* 303 U.S. 362 (1938), when the Court said that it was not sufficient for taxpayer to claim a depletion allowance, when it had no interest in the mineral in place, simply because through its contracts it had gained an "economic advantage" from the production of the mineral. The term "economic interest" and "economic advantage" are of no assistance in determining whether the necessary relationship exists to give a depletion allowance. They merely describe the result once the basic determination has been completed. 18 N.Y.U. INST. ON FED. TAX 517 (1960). Therefore, a history of court decisions concerning depletion allowance is necessary to determine why the court has arrived at its present decision.

A depletion allowance was allowed in the earliest cases as long as the taxpayer had a property right and interest in the mineral which had been depleted by extraction and sale during the year. *Lynch v. Alworth Stephens Co.,* 267 U.S. 364 (1925). In accord with this broad rule, lessees of oil producing properties, by reserving from an assignment one-eight of all oil produced, had an "economic interest" sufficient to allow a depletion allowance. The taxpayer's right to depletion did not depend on ownership or on any other form of legal interest in the land. It was enough if he had a contractual right to share in the mineral produced by the leasing transaction. *Palmer v. Bender, supra.*

Depletion allowance problems in recent years have been primarily concerned with mining companies claiming depletion allowances because of their contractual relationship with the owners or lessees of mines to mine the coal. In 1950 the General Counsel's office promulgated a ruling concerning depletion allowance to contractors. Coal stripping and mining companies were entitled to a depletion allowance when (1) the contract is not terminable at will or upon nominal notice by either party, and (2) the coal stripper must rely wholly or partially upon extraction and sale of the coal for his compensation or right to receive compensation. G.C.M. 26290, 1950-1 CUM. BULL. 42. A contract is not terminable within the meaning of this ruling if it cannot be terminated within a year or provides for only suspension of the work. The failure of the courts to agree on the proper emphasis to be given the two parts of the ruling, and their further failure to recognize factual distinctions in the cases have created problems in the application of the ruling.

In *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 252 (4th Cir. 1954), a strip miner entered into a contract with the lessee of coal mines whereby the stripper was to mine the coal with his own labor and deliver the coal to the lessee who furnished the equipment and machinery. The contract was terminable by the lessee upon thirty days notice and the stripper was to receive compensation fixed by the selling price of coal, adjustable to changes in the market. The court held that the stripper was entitled to a depletion allowance because his right to compensation was completely dependent upon extraction and sale of the salable product. An "economic interest" was also found in a taxpayer who transferred its mines to another party and reserved the exclusive right to mine the coal for the other party. The taxpayer received a set price per ton of coal mined, subject to increase or decrease by labor costs, and either party could terminate on ninety days notice. Taxpayer's right was dependent solely upon extraction and delivery of the coal, and this was sufficient to give it an "economic interest" in the coal in place. *Weirton Ice & Coal Co. v. Commissioner*, 231 F.2d 531 (4th Cir. 1956).

In *Commissioner v. Hamill Coal Corp.*, 239 F.2d 347 (4th Cir. 1956), the lessee of certain coal mines entered into a contract with a mining company to mine the coal. The contract could be terminated by either party on ninety days notice and the company was paid a certain amount per ton, subject to increase if wages were increased but not dependent on fluctuations of market price. The company did furnish some large and expensive equipment for the mining. The court allowed the company a depletion allowance not on the basis of the terminability of the contract nor on the amount received being dependent on market conditions, but on the fact that the company had made large investments in roads and other buildings and could look only to amounts paid under the contract for a return of its investment. Thus, these three cases of the Fourth Circuit all allowed depletion allowance regardless of the ruling by the General Counsel's office.

The Tax Court has complied with the General Counsel's ruling. The court denied a depletion allowance when strip miners were to receive an amount not dependent upon the market price nor the price received for sale of coal. *Morrisdale Coal Mining Co. v. Commissioner,* 19 T.C. 208 (1952). The Tax Court, however, allowed depletion when the stripper looked solely or partly to the sale of the coal for his remuneration. *Rustin v. Commissioner,* 19 T.C. 284 (1952). In *Stilwell v. United States,* 250 F.2d 736 (4th Cir. 1957), a depletion allowance was given where the price taxpayer received for mining the coal would be modified from time to time as a result of increases or decreases in the market price of coal.

The question of whether the taxpayer has a depletable interest in the mineral in place depends upon the varied incidents of the contractual relation under which he works. The courts had held prior to 1959 that the primary test was whether the extractor looked for his compensation to the severance and sale of the mineral ("economic interest") or whether his compensation was dependent upon the personal covenant of those with whom he had contracted (no "economic interest"). It was only a secondary test whether the contract was terminable at will or on short notice by either party. *Usibelli v. Commissioner,* 229 F.2d 539 (9th Cir. 1956).

In 1959, against this background of precedent, the Supreme Court determined that a most important factor as to whether a strip miner engaged in strip mining coal by virtue of his contract with the owner of coal lands was entitled to depletion allowance depended on whether their contract was terminable without cause on short notice. *Parsons v. Smith,* 359 U.S. 215 (1959). The contract in the *Parsons* case called for the strip miner to receive a certain amount of money, subject to increases to cover higher costs for labor and material. All that was necessary to terminate the oral contract by either party was ten days notice. The strip miner furnished his own equipment but it was movable and usable at other sites. The Court held that the strip miner received an "economic advantage" and profit from the production of coal but no interest in the coal in place because (1) the strip miner's investment was in movable equipment, not in the coal in place, (2) his investment was recoverable through depreciation, not depletion, (3) the contract was completely terminable without cause on short notice, (4) the landowners didn't surrenders any capital interest in the coal in place, (5) the coal after it was mined always belonged to the landowner and the strip miner could not sell it, (6) the strip miner was not paid any part of the proceeds from the sale of the coal, but was paid a fixed sum for each ton mined, and (7) the strip miners looked only to the landowners for all sums due them under their contracts.

Although the Court in the *Parsons* case did not specifically assign one guide-line with a top priority, it twice referred to the fact that the strip miner's contract was "completely terminable without cause on short notice". The courts in their later decisions have laid much emphasis on this point. In *United States v. Stallard*, 273 F.2d 847 (4th Cir. 1959), the court held that the most important factor in determining whether the operator was entitled to a depletion allowance was the terminability of the contract. The depletion allowance was disallowed because the contract was terminable on thirty days notice even though the price paid to the operator for the mining of the coal was geared to the general market price and the operator had built permanent roads.

In *McCall v. Commissioner*, 312 F.2d 699 (4th Cir. 1963), the *Parsons* case was held to be controlling. The taxpayers were under contract to mine coal for the lessee of coal mines. The taxpayers' right to compensation was dependent on the fluctuation of market price, and the contract was terminable by either party on thirty days notice. The Tax Court had held in 1956 that the taxpayer had an "economic interest" in the coal in place and was entitled to a depletion allowance. *McCall v. Commissioner*, 27 T.C. 133 (1956). The Fourth Circuit held, however, that collateral estoppel was inapplicable since the *Parsons* case constituted a marked shift in emphasis by the Supreme Court as to circumstances where a depletion allowance could lawfully be allowed. The court, relying squarely on the *Parsons* case refused to allow depletion allowance because of the terminable nature of taxpayer's interest. Thus, under the same contract, it was held in 1956 by the Tax Court that taxpayer had an "economic interest", while in 1963, due solely to the change brought about by the *Parsons* case, the taxpayer no longer retained this "economic interest".

Other cases disallowing depletion allowance relying on the terminability factor are *Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3rd Cir. 1959) (yearly contracts but could be terminated on sixty days notice), *Bolling v. Commissioner*, 37 T.C. 754

(1962) (contract cancelable upon thirty days notice by either party), and *Desrosiers v. Commissioner,* 21 CCH TAX CT. MEM. 264 (1962) (contract terminable by either party on thirty days notice after the first one hundred twenty days). In *Utah Alloy Ores, Inc. v. Commissioner,* 33 T.C. 917 (1960), the contracts were for terms of one year unless the operator failed to work the claim but depletion was disallowed since a term of one year was not sufficient to mine the claims to exhaustion. Thus, it would appear that there must be a reasonable probability that coal will be mined to exhaustion under the contract before the courts will allow a depletion allowance to taxpayer mining under the contract.

The *Parsons* case, *supra,* laid down seven guide-lines for aid in interperting an "economic interest". Subsequent decisions have interpreted the *Parsons* case to mean that stripping rights terminable on minimal notice are not a sufficient interest to support depletion, and that the factor of terminability should be given top priority in the court's determination of an "economic interest". In accord with this interpretation, the court held in the principal case that a contract conferring the right to terminate the contract only on grounds of default by the strip miner or lack of profitability to the lessee was not an agreement terminable at will or on short notice. The court based its decision almost entirely on terminability as the *Parsons* case was similar in every instance except for the limited right of termination. In the future, the courts will look to the terminability of the contract to determine if the strip miner has an "economic interest". It would appear that the test of terminability of a contract to depletion cases may eliminate much of the vagueness and uncertainty that has previously existed.

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Income Taxation—Contribution to Employees' Savings Trust

Action for refund of income tax. *P* sought deduction from gross income as a business expense money contributed by transfer to employee savings trust fund. The three year trust, established in 1950, permitted employees to join through wage withholdings with *P* matching all contributions equally. Under no circumstance was *P* to receive back sums contributed. If his employment was terminated because of death, retirement, disability, or layoff, the em-