Volume 59 | Issue 2 Article 5

February 1957

The Depletion Deduction as Applied to Strip Mining

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West Virginia Law Review

Published by the College of Law of West Virginia University. Official publication of The West Virginia Bar Association.

STUDENT NOTES

THE DEPLETION DEDUCTION AS APPLIED TO STRIP MINING

Since its inception in 1913,[1] the depletion deduction has been the subject of much litigation, not all of which has helped to clarify the application of the statutes.[2] By far the greater part of the case law on the subject concerns oil and gas, but perhaps that can be explained on the basis of the applicable depletion percentage, 27½%.[3] However, the same basic principles apply in those cases as in mining and such decisions have been cited interchangeably by the courts.[4]

The original purpose of the deduction was to return to the taxpayer the capital that is exhausted by production of the natural resource,[5] but this view does not now prevail as to percentage de-

[1] Tariff Act of 1913, 38 STAT. 114.

[2] MERTENS, FEDERAL INCOME TAXATION § 24.21 (1954 ed.) (hereinafter cited as MERTENS).

[3] INT. REV. CODE OF 1954, § 613(b)(1) (hereinafter cited as 1954 CODE). For a discussion of the justification (or lack of same) for this rate, see Baker and Griswold, *Percentage Depletion—A Correspondence*, 64 HARV. L. REV. 361 (1951).

[4] Eastern Coal Corp. v. Yoke, 67 F. Supp. 166 (N.D.W. Va. 1946); G.C.M. 26290, 1950-1 CUM. BULL. 42.

[5] Austin, *Percentage Depletions: Its Background and Legislative History*, 21 U. KAN. CITY L. REV. 31 (1952).

pletion.[6] The present allowance bears little relation to capital investment and the taxpayer is not limited to recoupment of his original investment; the allowance continues so long as minerals are extracted.[7]

Computing the Deduction

The basic depletion section of the *Code*[8] provides that in computing taxable income, there shall be allowed as a deduction a reasonable allowance for depletion, according to the peculiar conditions of each case. Such allowance is to be made under regulations prescribed by the secretary or his delegate. At the present time, two[9] methods are used: "cost depletion" and "percentage depletion." These will be treated in that order.

Cost depletion depends on two factors: (1) the adjusted basis of the property, which is the same as that used for determining gain or loss upon sale or other disposition of the property;[10] and (2) an estimate of the number of recoverable units therein,[11] which must be made according to the method current in the industry.[12] To compute the allowance, the basis is divided by the number of units remaining as of the taxable year, and this figure is multiplied by the number of units sold within the taxable year:[13]

$$\frac{\text{Basis}}{\text{Remaining Units}} \times \text{Units Sold} = \text{Depletion Deduction}^{14}$$

If the estimate of recoverable units is too high or too low, the revised estimate is not applied retroactively, but is used to spread the unrecovered portion of the basis over the remaining life of the property.[15]

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[6] 4 MERTENS § 24.31.

[7] Commissioner v. Southwest Exploration Co., 350 U.S. 308, 312 (1956).

[8] 1954 CODE § 611.

[9] A third method, eliminated from the 1954 CODE, is "discovery depletion" which has been completely superceded by the percentage method.

[10] 1954 CODE § 612, with cross reference to *id.* § 1011. However, the cost or value of the land for purposes other than mineral production, and the residual value of the property, must be excluded from the basis. U.S. Treas. Reg. 118, § 39.23(m)-2 (d) (1953) (hereinafter cited as Reg. 118).

[11] 1954 CODE § 612; Reg. 118, § 39.23(m)-2 (1953).

[12] Reg. 118, § 39.23(m)-9(a) (1953).

[13] *Id.* § 39.23(m)-2(a) (1953).

[14] For technical discussions of the accounting procedures involved, see Goulette, *Depletion for Tax Purposes,* 4 J. TAXATION 258 (May 1956); Thurston, *Depletion Deductions for Lessor and Lessee,* N.Y.U. 7TH INST. ON FED. TAX 1297 (1949).

[15] Reg. 118, § 39.23(m)-9(b) (1953); 4 MERTENS § 24.31.

Percentage depletion allows the deduction of a specified percentage (10% for coal[16]) of gross income from the property, but any rents or royalties paid or incurred in respect to such property are excluded from gross income.[17] "Gross income from the property" is that part of the sale price that is based on profit and the expenses of extracting the mineral from the ground, the ordinary treatment processes normally applied to obtain the commercially marketable product, and the transportation of the mineral from point of extraction to place of treatment, not in excess of 50 miles.[18]

It is often the case that the owner of a mineral deposit is unable or unwilling to develop the property, so he leases it, retaining a right to share in future production, and often getting an initial cash payment known as a "bonus."[19] If the payment is in reality an advance royalty,[20] then it too is depletable. If cost depletion is used, the deduction is computed by the following formula:

$$\frac{\text{Bonus}}{\text{Bonus} + \text{Expected Royalty}} \times \text{Basis} = \text{Depletion Allowance}^{21}$$

Such allowance must be deducted from the basis, the remainder of which is recoverable through depletion based on royalties thereafter received.[22] If percentage depletion is used, the allowance for coal is 10 percent of the bonus, but this amount cannot exceed 50 percent of the taxpayer's net income from the property, computed without allowance for depletion.[23]

Who Is Entitled to Depletion

Although the mechanics of computing the deduction may prove vexatious, the most troublesome problem in this field is to determine *who is entitled* to the allowance and in what proportion. The great bulk of litigation centers on this point.

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[16] 1954 CODE § 613(b)(4).

[17] Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property, computed without allowance for depletion. *Id.* § 613(a); Reg. 118, § 39.23(m)-1(e)(5) (1953).

[18] 1954 CODE § 613(c). However, if necessary, transportation over 50 miles may be allowed by the Secretary or his delegate. *Ibid.*

[19] Baker, *The Nature of Depletable Income,* 7 TAX L. REV. 267 (1952).

[20] For a discussion of the tests for determining this question, see G.C.M. 22730, 1941-1 CUM. BULL. 214.

[21] Reg. 118, § 39.23(m)-10(a) (1953).

[22] *Ibid.*

[23] Reg. 118, § 39.23(m)-10(d) (1953).

If the taxpayer has an "economic interest" in the mineral in place, he is entitled to depletion based on his proportionate share of ownership. The economic interest test was formulated in *Palmer v. Bender*,[24] which said that "the language of the statute is broad enough to provide, at least, for every case in which 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 return of his capital."[25] Although the application of the rule has not always been consistent, even in the Supreme Court,[26] it is still the basis for allocating the deduction,[27] whether the taxpayer seeks the deduction or not, and without regard to the "formalities of the conveyancer's art"[28] or the "characterization of the transaction in the local law."[29] An economic interest has been found where (1) the Commissioner claimed the transaction was a sale and the taxpayer maintained it was a lease, and therefore taxpayer was entitled to the entire depletion deduction;[30] (2) the Commissioner claimed that the transaction was a lease and therefore the deduction should be apportioned, and the taxpayer claimed the entire deduction;[31] (3) the commissioner asserted that taxpayer was a lessor and thus received ordinary income minus depletion, and taxpayer claimed he had sold the property, for a capital gain;[32] and (4) the Commissioner denied that taxpayer had an economic interest and was therefore not entitled to any deduction.[33] But the search for an interest cannot be carried too far: ". . . the phrase 'economic interest' is not to be taken as embracing a mere economic advantage, derived from production,

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[24] 287 U.S. 551 (1932).

[25] *Id.* at 557. This test is embodied in Reg. 118, § 39.23(m)-1(b) (1953).

[26] See 4 MERTENS § 24.21.

[27] In the case of a lease, the deduction is equitably apportioned between the lessor and lessee. 1954 CODE § 611(b)(1).

[28] Anderson v. Helvering, 310 U.S. 404, 411 (1940).

[29] Bankers Pocahantas Coal Co. v. Burnet, 278 U.S. 308, 311 (1932). But *cf.* Massey v. Commissioner, 143 F.2d 429 (5th Cir. 1944).

[30] Commissioner v. Fleming 82 F.2d 324 (5th Cir. 1936). In this case, part of the transaction was held a sale and part a lease.

[31] Eastern Coal Corp. v. Yoke, 67 F. Supp. 166 (N.D.W. Va. 1946).

[32] Hamme v. Commissioner, 209 F.2d 29 (4th Cir. 1953). This situation would not arise if taxpayer came within the scope of 1954 CODE § 631(c) (disposal of coal with a retained economic interest). For the application of this section, see Reg. 118, § 39.117(k)-1 (1953); 3 CCH 1956 STAND. FED. TAX REP. § 3592; 2 MERTENS § 18.13; 4 *id.* § 24.23.

[33] Weirton Ice and Coal Supply Co. v. Commissioner, 231 F.2d 531 (4th Cir. 1956).

through a contractual relation to the owner, by one who has no capital investment in the mineral deposit."[34]

As in all tax law, the Supreme Court rulings form only the general outlines of the law, and the lower courts must apply them to the infinite variety of factual situations which arise. Because of this truism, the decisions of the various circuits are sometimes, to say the least, slightly at variance.[35] That the economic interest test is not perfect[36] can easily be seen by the numerous cases interpreting it. It would appear that the general rule to be drawn from the decisions is that if the taxpayer must look to production for the return of his capital, then he has an economic interest in the mineral.[37] Conversely, if an owner-lessor has security for payment other than production, he has *not* retained the requisite interest.[38] In the case of strip mining, Internal Revenue policy is that ". . . the allowance is warranted only where, under the agreement between the parties, the stripping contractor obtains a capital interest in the mineral in place and must look to severance and sale of the mineral for capital consumed in that process."[39] This opinion further states that if the contract between the parties is terminable at will, or upon "nominal" notice (less than one year), the necessary interest has not vested in the stripping contractor and therefore he is not allowed any depletion deduction.

With this background in mind, it is interesting to see its application in two recent cases, *Commissioner v. Mammoth Coal Co.*,[40] and *Weirton Ice and Coal Supply Co. v. Commissioner*.[41] In the *Mammoth* case, taxpayer entered a contract with *X*, giving *X* the exclusive right to mine coal for an indefinite period. All extracted coal had

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[34] Helvering v. Bankline Oil Co., 303 U.S. 362, 367 (1938). This holding is reflected in Reg. 118, § 39.23(m)-1(b) (1953).

[35] *Compare* Blankenship v. United States, 95 F.2d 507 (5th Cir. 1938), *with* Night Hawk Leasing Co. v. Burnet, 57 F.2d 612 (D.C. Cir. 1932).

[36] *Quaere* as to the soundness of the rule, but it is firmly established. 4 MERTENS § 24.24.

[37] See Burton Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946); Commissioner v. Mammoth Coal Co., 229 F.2d 535 (3d Cir. 1956), *cert. denied*, 25 U.S.L. WEEK 3104 (U.S. Oct. 9, 1956); Commissioner v. Gregory Run Coal Co., 212 F.2d 52 (4th Cir. 1954), *cert. denied*, 348 U.S. 828 (1954); H. W. Findley, 10 CCH TAX CT. MEM. 363 (1951).

[38] Anderson v. Helvering, 310 U.S. 404 (1940). *Cf.* Commissioner v. Fleming, 82 F.2d 324 (5th Cir. 1936).

[39] G.C.M. 26290, 1950-1 CUM. BULL. 42

[40] 229 F.2d 535 (3d Cir. 1956), *cert. denied*, 25 U.S.L. WEEK 3104 (U.S. Oct. 9, 1956).

[41] 231 F.2d 531 (4th Cir. 1956).

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to be offered to taxpayer for an agreed price, but any or all could be rejected. In such case, *X* could sell elsewhere. The Tax Court held[42] that *X* was an independent contractor with no economic interest in the coal, and that taxpayer was entitled to depletion on its gross income from the property, without excluding the payments to *X*.[43]

The Tax Court based its result on the terms of the contract. Taxpayer had the right to suspend operations indefinitely but could not terminate without good cause. However, the amount paid to *X* per unit was not dependent on the sale price received by taxpayer or even on whether taxpayer sold the coal. If operations were suspended under the contract longer than a certain period, *X* could only elect to terminate. Taxpayer therefore had complete control of the amount of coal *X* could mine. This was reversed by the third circuit,[44] which held that taxpayers must exclude from gross income the payments made to *X*, in computing the deduction. The court reasoned that since the contract gave *X* the exclusive right to mine the coal, and taxpayer could not give such right to another until *X* elected to terminate the contract, *X*'s interest was sufficiently significant to entitle it to percentage depletion. *X* had to look to the coal it mined for a return of its investment and profit.

In the *Weirton* case, taxpayer originally owned the property in fee. In 1940, taxpayer conveyed the fee to *Y*, and at the same time contracted to strip mine it for *Y*. Under the terms of this agreement, taxpayer agreed to mine, clean and deliver coal in such quantities and sizes as *Y* would direct, at a certain price per ton, to build and maintain roads and to furnish necessary equipment, machinery and labor. Either party could terminate the contract on 90 days written notice.[45] The entire operation during the period in question was conducted by taxpayer without advice or direction by *Y* and taxpayer was never told to cut production. Under these facts, the Tax Court held[46] that taxpayer had only an economic advantage, was just an employee of *Y*, because *Y* could direct the quantity of coal mined and could terminate the contract at will.

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42 Mammoth Coal Co., 22 T.C. 571 (1954).

43 *Supra* note 17.

44 *Supra* note 40.

45 If G.C.M. 26290, *supra* note 39, is accepted as a correct interpretation of the law, the circuit court's decision is clearly wrong on this point.

46 Weirton Ice and Coal Supply Co., 24 T.C. 374 (1956).

The fourth circuit reversed the Tax Court and allowed taxpayer to take the depletion deduction. The court relied heavily on the *Mammoth* case as being on all fours with the instant case, and to strengthen the holding, stated that "no stronger proof that Weirton had in effect the right to mine the coal could be found than in its willingness to invest $500,000 in the enterprise. It is of no moment that the owner of the mineral . . . had the option to terminate the arrangement at any time, for *as the event proved,* Weirton actually mined the coal during all of the taxable years."[47]

Have the transactions in these two cases met the classical "economic interest" test of *Palmer v. Bender?* It is submitted that they have not. That test requires that for a taxpayer to be entitled to the deduction, he must acquire his interest *by investment.* Have the stripping contractors in either case invested capital in the *mineral deposit?* It is again submitted that they have not. In neither case is there any mention of a bonus or advance royalty being paid to the owner for the right to mine the coal. The only "investment" mentioned is for roads, equipment, buildings, etc.[48] It would seem that all of the capital invested by the strippers could be returned to them by *depreciation,*[49] and no depletion allowance is necessary. Depreciation deductions on such assets are contemplated by the Regulations, in which are used such terms as "buildings, machinery, apparatus, roads, railroads and other equipment."[50] Since the owner's capital *is* being diminished, it is logical to give the allowance to such owner, even though percentage depletion is not directly related to investment. In severing and selling the coal, the stripping contractor has no "capital consumed in that process."[51] No depletion is allowed on equipment sold to a lessee,[52] and *a fortiori* it should not be allowed on equipment if it is being depreciated at the same time.

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[47] 231 F.2d at 535. Emphasis supplied.

[48] In Mammoth, equipment and buildings were valued at almost a million dollars; in Weirton, the figure was over one-half million.

[49] There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business or of property held for the production of income. 1954 CODE § 167(a); U.S. Treas. Reg. 1.167(a) through (h) (1956).

[50] Reg. 118, § 39.23(m)-17(c) (1953).

[51] G.C.M. 26290, 1950-1 CUM. BULL. 42, 44.

[52] Choate v. Commisioner, 293 U.S. 1 (1934). But *cf.* dictum in Cullen v. Commissioner, 118 F.2d 651, 653 (5th Cir. 1941): "The cost of equipment located upon the . . . leases which were not sold may be recovered by percentage depletion allowances."

From the foregoing discussion, the question arises: is *Palmer v. Bender* still the law? Perhaps an examination of the latest Supreme Court depletion cases will be helpful. In the companion cases of *Commissioner v. Southwest Exploration Co.,* and *United States v. Huntington Beach Co.,*[53] the state had accepted bids for the right to extract offshore oil, but drilling had to be from filled lands or on a slant from upland drill sites. As a condition precedent to consideration of a bid, the bidder had to show present ability to furnish the required sites. Southwest did not control any uplands adjacent to the area of oil deposits, so it entered agreements with Huntington, the owner of such property. Consideration for the use of the land was the payment of a certain percentage of net profits to Huntington. Both parties claimed depletion on this amount. The Court held that Huntington could take depletion on the payments, and that Southwest must exclude this amount from its gross income in computing depletion. Southwest unsuccessfully argued that there could be no economic interest separate from the right to enter and drill for oil on the land itself. This was answered by basing the decision on the fact that the proximity of the oil and the effect of the state law combined to enhance greatly the value of Huntington's land, and contribution of the land to this operation instead of selling it was a sufficient investment to establish the landowner's economic interest.

In discussing the principles of depletion, the Court said that it is allowed even though no money is actually invested in *the deposit.*[54] It is submitted that this statement must be read in context with the fact that Huntington made an investment in the *operation* by allowing use of its land, and therefore there has been no refutation of *Palmer v. Bender,* as the Court cited that case and used the reasoning above to make the present situation fit the requirements.

Supose that A owns the surface of a tract and *B* owns or leases the subsurface minerals, but has no right of ingress or egress over *A*'s land and cannot acquire any adjacent land. In order to get a right of way from *A, B* agrees to pay him a percentage of gross income from the coal sold. Would *A* have a depletable interest? The court of claims apparently would answer in the affirmative.[55] This

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[53] 350 U.S. 308 (1956).

[54] For the other statements in this discussion, see note 7 *supra.*

[55] Huntington Beach Co. v. United States, 132 Ct. Cl. 427, 433 (1955).

situation might be distinguished because there is no comparable state law here, but it would be a very close question.

Apparently, the third and fourth circuits, while ostensibly applying the economic interest test, have actually evolved a test of "production" unconnected with investment. It matters not that the contract is terminable for any reason[56] or that the owner has full control of the amount of coal to be mined[57] or that the contractor is not dependent on market price for the amount of his compensation.[58] In these two circuits, an owner who does not actually produce the mineral may as well resign himself to the fact that no depletion will be allowed on payments made to a stripper, regardless of the contractual arrangement between the parties. The Tax Court has been consistent in basing its results on just these factors.[59] However, since the lower courts have not enforced the requirement of investment, is that element no longer necessary? Perhaps not. But in any event, until the Supreme Court accepts a strip mining case for review, the borderline between "economic interest" and "economic advantage" in this field will remain clouded.

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IRREGULARITIES IN THE SELECTION OF GRAND JURIES*

The procedure for selection of grand juries is specifically set forth in various statutes. Any slight deviation from this procedure is quickly pounced upon by the defense as a means to obtain reversal of criminal convictions. Whether such irregularities require a reversal depends upon the language in the statute. If it is mandatory, the irregularity is fatal; if directory, substantial compliance is suffi-

[56] *Supra* note 47.

[57] *Supra* notes 42, 46.

[58] Weirton Ice and Coal Supply Co., *supra* note 41.

[59] Economic interest was absent in Morrisdale Coal Mining Co., 19 T.C. 208 (1952) (*inter alia,* owner controlled amount mined); C. A. Hughes & Co., 14 CCH TAX CT. MEM. 172 (1955) (contract terminable on 60 days' notice); Hamill Coal Corp., 14 CCH TAX CT. MEM. 218 (1955) (payment to contractor not dependent on market price). Economic interest was found in James Ruston, 19 T.C. 284 (1952) (contract not terminable at will, and it gave contractor exclusive right to mine all the coal); Lincoln D. Godshall, 13 T.C. 681 (1949) (contractor to be paid only from proceeds); H. W. Findley, 10 CCH TAX CT. MEM. 363 (1951) (contractor obligated to develop mineral and was dependent on market price for compensation).

* In order to facilitate the consideration of this subject, citations for materials used in the statutory discussion are embodied in the text rather than in footnotes.