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## PERCENTAGE DEPLETION FOR OIL—A POLICY ISSUE

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Although it has always been recognized that lawyers were "policy makers"<sup>1</sup> and that, on the solid foundation of training in jurisprudence, principles of law, and tools of the trade, law school graduates were expected to guide public or private clients in policy choices,<sup>2</sup> Yale Law School has more recently urged that policy formation be made the pole-star of the academic curriculum.<sup>3</sup> But, when such suggestions are made, we are forcefully reminded that we lack adequate material for such study, and at no point is this more true than in the study of taxation.<sup>4</sup> Yet, professors

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1. BROWN, *LAWYERS, LAW SCHOOLS AND THE PUBLIC SERVICE* (1948); Frey, *Some Thoughts on Law Teaching and the Social Sciences*, 82 U. OF PA. L. REV. 463 (1934); Harno, *The Correlation of Law and College Subjects*, 5 AM. L. SCHOOL REV. 85 (1923).

2. BROWN, *op. cit. supra* note 1; CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* (1932); FRANK, *COURTS ON TRIAL* 240 (1949); FULLER, *THE LAW IN QUEST OF ITSELF* (1940); HOLMES, *The Profession of the Law, The Use of Law Schools, and Law and the Courts* in *COLLECTED LEGAL PAPERS* (1920).

3. McDUGAL AND HABER, *PROPERTY, WEALTH, LAND: ALLOCATION, PLANNING AND DEVELOPMENT* (1948); Hale, *Economics and Law* in *THE SOCIAL SCIENCES AND THEIR INTERRELATIONS*, c. 12 (Ogburn and Goldenweiser eds. 1927); ROSTOW, *A NATIONAL POLICY FOR THE OIL INDUSTRY* (1948) and other publications of Yale University Seminar on National Policy. And see the following articles: Harno, *Ideas and the Law*, 26 A.B.A.J. 651 (1940); Katz, *Economics and the Study of Law—The Contribution of Henry C. Simons*, 14 U. OF CHI. L. REV. 1 (1946). Lasswell and McDougal, *Legal Education and Public Policy: Professional Training in the Public Interest*, 52 YALE L.J. 203 (1943); Llewellyn, *On What Is Wrong With So-Called Legal Education*, 35 COL. L. REV. 651 (1935); McDougal, *The Law School of the Future: From Legal Realism to Policy Science in the World Community*, 56 YALE L.J. 1345 (1947); Rostow, *The Study of Economics in Relation to Education in Law*, 2 J. LEGAL EDUC. 335 (1950); and see tax recognition BITTKER, *ESTATE AND GIFT TAXATION, CASES AND MATERIALS* p. vi (1951).

4. Chommie, *Teaching "Policy" in Federal Taxation*, 7 J. LEGAL EDUC. 349 (1955); PAUL, *TAXATION IN THE UNITED STATES* 773 (1954); Symposium, *What Makes a Successful Tax Lawyer?*, 7 TAX L. REV. 1, 13 (1952); Ass'n of Amer. Law Schools, *Report of Committee on Feasibility of Publishing Social Science Materials*, 1947 HANDBOOK 209; *Report of the Committee on Curriculum*, 1948 HANDBOOK 125; *Report of Committee on Auxiliary Business and Social Materials*, 1953 PROCEEDINGS 180; Llewellyn, *supra* note 3.

More studies are needed such as those of the Harvard Graduate School of Business Administration: BUTTERS, *EFFECTS OF TAXATION—INVENTORY ACCOUNTING AND POLICIES* (1949); BUTTERS AND LINTNER, *EFFECT OF FEDERAL TAXATION ON GROWING ENTERPRISES* (1945); GROVES, *VIEWPOINTS ON PUBLIC FINANCE* (1947).

are properly exhorted toward teaching policy in federal taxation;<sup>5</sup> thus, toward the production of some taxation policy materials—an area that most acutely needs policy consideration—this article is committed.

For frankness it may be said at the outset that this material will espouse the belief that the time has come to change the depletion and related deduction allowances for oil and gas production and will propose an alternative plan.<sup>6</sup> The recent Congressional denial of a twenty dollar

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5. Chommie, *supra* note 4. Perhaps one answer to this suggestion is found in a recent article by William L. Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955).

6. Objectivity was, of course, sought in the research behind this article, but it will, however, be necessary to give more attention to the material favoring change, because a careful examination of all the literature shows clearly that this is an area in which no funds are available to develop the case for change, where virtually no one rises to represent the public generally, and where many are the voices and great the financial resources behind the oil interests. The industry has numerous publications, geared solely to the tax problems and others frequently dealing with tax issues. Much excellent material will be found in the following sources; I shall not, except in unusual instances, cite special articles or page references to these in the article or footnotes: SOUTHWESTERN LEGAL FOUNDATION, ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION; ARTHUR ANDERSON & Co., OIL AND GAS FEDERAL INCOME TAX MANUAL (1955); OIL AND GAS TAX QUARTERLY; BULLETIN OF AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS; MILLER, OIL AND GAS INCOME TAXATION (1951); OIL AND GAS JOURNAL; THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; PETROLEUM PRESS SERVICE; AMERICAN PETROLEUM INSTITUTE. See also, PROCEEDINGS, Tax Institute of American University, New York University, Southern California, and Tulane University.

In each of the major hearings on depletion those speaking for change included the President, the Secretary or Assistant Secretary of Treasury, a statistical employee, the C.I.O. or A.F. of L., The American Farm Bureau Federation, and the combined material did not exceed fifty pages. On the other hand, the oil interests produced statements and briefs by most of the Congressmen from the twenty-five oil producing states, the perennial witness—General Thompson of the Texas Railroad Commission, attorneys, and officers of the major producing associations and companies, military personnel, geologists, stripper well associations, and so on. Their testimony and statements run over 1000 pages.

Aside from the materials produced by the industry, there are few treatises on policy for the oil industry and none that ably explore the tax policy problem. Some partial studies may be mentioned. BAIN, THE ECONOMICS OF THE PACIFIC COAST PETROLEUM INDUSTRY (three volumes) (1944-1947); FANNING, OUR OIL RESOURCES (2d ed. 1950); ISE, THE UNITED STATES OIL POLICY (1926); ROSTOW, A NATIONAL POLICY FOR THE OIL INDUSTRY (1948); see also Rostow and Sachs, *Entry into the Oil Refining Business: Vertical Integration Re-examined*, 61 YALE L.J. 856 (1952); STOCKING, THE OIL INDUSTRY AND THE COMPETITIVE SYSTEM (1925); WATKINS, OIL: STABILIZATION OR CONSERVATION? (1937).

There are various Congressional studies, not dealing specifically with depletion, which form a background for policy decisions as to oil and gas: *Hearings before Special Committee Investigating Petroleum Resources*, pursuant to Sen. Res. 36, 79th Cong., 1st & 2d Sess. (1945-1946) (the O'Mahoney Hearings); TNEC Hearings and Monographs pursuant to Pub. Res. No. 113 (75th Cong.); Cook, *Control of the Petroleum Industry by the Major Oil Companies*, (TNEC Monograph No. 39 1941); *Hearings before Subcommittee of the Committee on Interstate and Foreign Commerce on H.R. Res. 290 and H.R. 7372*, 76th Cong., 1st Sess. (1939).

See also many of the law reviews (there were over 30 articles from August 1952 to July 1953) on oil depletion including: Appleman, *Taxation of Sales and Assignments of Leases and Other Interests in Oil and Gas*, 28 TEXAS L. REV. 340 (1949):

credit to each taxpayer has brought into sharper focus the policy issues in all tax provisions.<sup>7</sup> Placed alongside the percentage depletion of oil, gas, and like properties, which now annually results in loss of federal revenue of one billion dollars,<sup>8</sup> it drives us to a reconsideration of the allowance for percentage depletion. But it is not on the basis of inequities alone—though it is well known that these can be more costly in psycho-

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Baker, *The Nature of Depletable Income*, 7 TAX L. REV. 267 (1951); Baker and Griswold, *Percentage Depletion—A Correspondence*, 64 HARV. L. REV. 361 (1951); Bergen, *Oil and Taxes—Some Problems and Proposals*, 26 SO. CALIF. L. REV. 396 (1953); Judge, *Tax Considerations of the Oil and Gas Royalty Owner*, 31 TAXES 828 (1953); Jackson, *Federal Income Tax Problems Involved in Typical Oil and Gas Transactions in Texas*, 25 TEXAS L. REV. 347 (1947); Kruse, Mattson, and Milliken, *Special Problems in Oil and Gas Taxation*, 26 ROCKY MT. L. REV. 242 (1954); Krystal, *Depletion of Net Profit Participations in Oil Leases*, 21 CALIF. STATE B.J., 83 (1946); Mahin, *Legal Problems in Connection with Percentage Depletion*, 21 U. OF KAN. CITY L. REV. 31 (1952); Moyers, *Federal Income Tax Aspects of Oil and Gas Transactions*, 28 N. DAK. L. REV. 277 (1952); Ross, *Depletion on Oil and Gas Leases*, 21 TAXES 73 (1943); Comment, *Depletion of Oil and Gas Properties Under Federal Income Tax Law*, 24 TULANE L. REV. 112 (1949). See also the articles cited later in these notes.

Typical titles in some of the Oil Publications listed above are: Hill, *Recent Developments in Oil and Gas Taxation*, PROCEEDINGS THIRD ANNUAL TULANE TAX INST. 317 (1954); Jackson, *The Need for a Restatement of Tax Laws Relating to Oil and Gas*, PROCEEDINGS FIRST ANNUAL INST. ON OIL AND GAS LAW, SOUTHWESTERN LEGAL FOUNDATION 343 (1949); Johnson, *Maximum Tax Benefits from Percentage Depletion*, PROCEEDINGS THIRD ANNUAL TULANE TAX INST. 373 (1954); Miller, *Recent Developments in the Taxation of Oil and Gas Interests*, PROCEEDINGS FIFTH ANNUAL INST. ON OIL AND GAS LAW AND TAXATION, SOUTHWESTERN LEGAL FOUNDATION 585 (1954); Randolph, *Problems of the Oil and Gas Industry*, PROCEEDINGS, N.Y.U. NINTH ANNUAL INST. ON FED. TAXATION 491 (1951); Rosenman, *Types of Oil and Gas Interests and Their Tax Treatment*, 6 AM. U. TAX INST. LECTURES 289 (1954).

7. The author is not to be understood as favoring the twenty dollar credit. Inflation control may require continued taxation of low income taxpayers at current rates. And it is easily recognized that lost revenues might total such an amount that other sources for replacing this income could not be found. But, the rejection of this relief for the "little man," particularly since it is by the same coalition of Congressmen who approve the largest single relief or subsidy provision in the tax law, the percentage depletion of oil and like properties, for the "big man," does put the serious policy questions in the foreground.

It must also be borne in mind that of the 3 billion dollar tax reduction last year, the Joint Committee on Internal Revenue has estimated, about 900 million, or thirty percent, will be reflected in returns of taxpayers with adjusted gross incomes under 5000 dollars and seventy percent, or 2,100,000,000, in returns showing an annual income over 5000 dollars.

8. In 1937 the estimated annual revenue loss from percentage compared to cost depletion was seventy-five million dollars. H.R. Doc. No. 337, 75:1:1937, p. 4. In 1950 the loss was estimated at 400 to 500 million dollars. *Hearings before Committee on Ways and Means on Revenue Revision*, H.R., 82d Cong., 1st Sess., p. 148; *Hearings before Committee on Ways and Means on Revenue Revision*, H.R., 81st Cong., 2d Sess., pp. 18, 215. Hereafter hearings before the House Ways and Means Committee on this matter will be cited, "H.R. Hearings 83:1:1953, [indicating the Congress, Session, and year respectively] p. 2000," and those before the Senate Finance Committee as "Sen. Hearings 83:1:1953, p. 2000." By 1953 it was estimated at over 700 million dollars (see one figure of one and a half billion, H.R. Hearings 83:1:1953, p. 1992), and it has recently been estimated at approximately one billion on the basis of gross sales and increased price.

logical resistance to tax collection than the direct loss of revenue from the unfairness—but rather on the needs of the revenue system as a whole and a consistent tax policy that our study should progress. It is well that this material be presented in the academic atmosphere at a time when it is not up for Congressional action, for one has only to examine Congressional hearings on percentage depletion in 1950 or 1953 to see how great are the forces mustered against any change.<sup>9</sup>

The assumption that readers are familiar with the method of taxing the oil and gas industry, will permit a brief summary of the process to suffice. Oil and gas producers may elect either to expense and deduct or to capitalize intangible development costs, and almost without exception these are expensed. All other costs except current operating costs may be recovered through depreciation, and the current operating costs are deductible as business expenses. At this point the taxpayer has provided for recovering nearly all his costs before taxes; then he may deduct for depletion 27 1/2 percent of the gross income (that is, income prior to deduction of the above costs) but not exceeding 50 percent of the net income (after these deductions but before taxes). These deductions may be taken against the income from this or other businesses, and the depletion allowances apply to oil and gas wells outside the United States as well as within. Moreover, anyone who has an "economic interest" in the oil and its production can qualify for this treatment; if oil or gas properties or any interest in them are sold at a profit, the tax rate on gains from the sale shall not exceed 30 percent.<sup>10</sup>

It seems fair and worthwhile to set out briefly at this early point the scheme which is advanced as a replacement for the present provisions so that the reader will be enabled to test it against the ensuing material. (a) There should be no change in the taxpayer's option to capitalize or deduct as an expense so-called "intangible" costs (and spreading the deduction over several years, if desired, will be permitted). (b) Nor

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9. See notes 6 and 8 *supra*. House Ways and Means Committee Chairman Robert Doughton of North Carolina has stated how strong and successful were Speaker Sam Rayburn's efforts within the Committee to prevent reduction of the allowance from 27 1/2 to 15 percent. See also the following statement by George Sawtelle, president of the Texas Mid-Continent Oil and Gas Association, quoted at Galvin, *Federal Income Tax—Percentage Depletion of Oil and Gas Wells*, 21 TEXAS L. REV. 410, 413 n.15 (1942). "Resisting their [enemies in the Treasury Department] efforts has been a constant struggle for the oil companies. . . . Since Texas represents one-half of the oil industry, it has been essential that we maintain a strong organized effort in doing our part in the fight. We have had twenty-one active committees of twenty-five men in each congressional district of Texas who have given much of their time to the depletion problem. Thus nearly five hundred men, prominent in their communities all over Texas, working closely with our office, have maintained contact with their senators and congressmen throughout the year."

10. INT. REV. CODE §§ 611-632.

will the provision permitting the taxpayer to deduct depreciation on equipment and other tangibles used in production be changed. (c) If the taxpayer has capitalized any costs not recoverable through depreciation, he will be allowed to recover these through depletion by one of two methods. Either, first, fifteen percent of gross income, but not exceeding twenty-five percent of the taxable income, from the property, or, second, at a percentage of the capitalized costs equal to the number of units extracted divided by the number of units which are estimated to be recoverable from the property. (d) After the total capitalized costs are recovered, no further depletion will be allowed. (e) If the property is sold or transferred, the gain or loss shall be treated as ordinary, rather than capital, gain or loss, but the tax rate for individuals or corporations shall not exceed thirty percent. (f) If incentive for exploration, discovery, research, or development is at any time needed, the inducement shall not be geared to production and income but shall be provided by outright subsidies or grants-in-aid. (g) If, in the interests of full production from the marginal, stripper, or secondary recovery well, an inducement is required beyond those suggested above, then outright production subsidies or grants-in-aid shall be furnished. (h) Either, or both, (b) and (c) could be modified to permit amortization of cost over a five year period in a national emergency, as was done by the Defense Production Act for war facilities. (i) Oil should be considered to be in a different category from gas, and further studies should be undertaken to determine whether different rates or inducements are needed. (j) Deductions under (a) and (c) shall not be used to offset income not from oil and gas. None of the provisions in (a) through (h) shall apply to oil and gas outside the United States, pending a new study as to the proper foreign policy.<sup>11</sup>

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11. Oil in place and purchased for extraction and sale would seem to bear more similarity to inventory than to permanent, fixed, or "capital" assets. This is a recognized engineering view (McGrath, *ENGINEERING AND MINING JOUR.*, June 6, 1932, 903). The nature of inventory is that the units themselves are the product, or become a part of the product, sold. A fixed or capital asset, on the other hand, does not become a part of the item sold; it is used up in the process of manufacturing the product and is an overhead cost. There is essentially no difference between oil in a proved reserve and cans of beans on the storekeeper's shelf, iron ingots at a steel fabricator's plant, or motors to be assembled into refrigerators. Consequently, the real problem is to determine the "cost or market" of the inventory and the portion used up each year. I should prefer to approach oil taxation in this way as a new problem, but, in the light of previous percentage depletion and intangible cost deductions, I believe that either percentage depletion or cost depletion can approximate proper inventory procedure, and the former is quite comparable to the "retail method" of computing inventories. See U.S. Treas. Reg. 118, § 39.22(c)-8 (1953) and earlier similar regulations; for a thorough discussion see T. D. 3296, 1 CUM. BULL. 40 (1922).

Until the 1954 Code made percentage depletion a deduction item (INT. REV. CODE § 613), that is, while percentage depletion was a part of basis rather than deduction provisions (§ 114 rather than § 23 of the 1939 Code), I proposed that depletion should

## THE BACKGROUND

*The Statutes*

While a brief history of the treatment of oil and gas depletion is desirable, no detailed review will be made, for several treatises have extensively reviewed the history.<sup>12</sup> In addition, only those portions of the history that have a marked policy bearing will be enlarged.

In spite of Treasury Decision 1675 to the contrary, the Supreme Court found that the Corporation Tax Act of 1909 (which was treated as an excise) did not allow deduction of depletion in determining net income.<sup>13</sup> The 1913 Internal Revenue Act permitted a "reasonable allowance for depletion . . . not to exceed 5 per centum of the gross value at

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be allowed until the basis was depleted to zero. If further depletion were taken, the basis should become a deficit or negative basis (below zero), and when the taxpayer ceased to produce oil and disposed of the property, he should be taxed on his complete profit. Thus, if cost were 100 dollars and 200 dollars of depreciation were taken, the basis would be minus 100 dollars. If the property were then sold for 50 dollars, the profit would be 150 dollars, the difference between a minus 100 and a plus 50. This seemed to fit with the plan of comparing cost and percentage depletion, and it carried out a theory which the Board of Tax Appeals expressed thus: "Section 114 is primarily one which prescribes the basis not only for depreciation and depletion, but also for future determination of gain or loss from sale or other disposition. Thus the larger depletion serves to reduce the remaining basis and to increase a taxable gain or reduce a tax-reducing loss in the future." *Producers Oil Corp. v. Commr.*, 43 B.T.A. 9 (1940).

This argument might still be made as to pre-1954 deductions in order to prevent "a double deduction for the loss of the same capital asset." *United States v. Ludey*, 274 U.S. 295, 300 (1927).

Other proposals which have been made either partially parallel those above or are rejected as inadequate. One writer suggests, not as a total pattern but as alternatives, the following: 1) Outright subsidization of strippers and wildcatters. 2) Reversion to cost depletion. 3) Elimination of depletion in favor of an amortization of all capital costs over a five year period. 4) Continuance of percentage depletion but only long enough to recover capital costs. 5) Permission to continue deducting percentage depletion, if incentive is needed, until "discovery value" is recovered. 6) Continuance of percentage depletion but with a reduction to fifteen percent of gross income for all who include operation as well as exploration and development. Adamanian, *The Oil Industry and the Tax Depletion Allowance*, 32 B.U.L. REV. 389, 404-405 (1932). These also have been urged: 7) Reduction of the rate from 27 1/2 to 15 percent. H.R. Hearings 81:2:1950, p. 18. 8) Allowance of no depletion until intangible development costs had been recovered out of income. *Ibid.* (Opposed by the oil industry, H.R. Hearings 83:1:1953, p. 2017.)

12. One of the best is 4 MERTENS, *LAW OF FEDERAL INCOME TAXATION* §§ 24.04-24.16 (1954); see also Comment, *The Depletion Deduction in the Oil and Gas Industry for Federal Income Tax Purposes*, 3 DEPAUL L. REV. 233, 234-251 (1954); McClure, *The Tax Depletion Allowance of the Oil Industry*, 23 GEO. WASH. L. REV. 1, 4-6 (1954); Baker, *The Nature of Depletable Income*, 7 TAX L. REV. 267 (1952).

13. *Goldfield Consolidated Mines Co. v. Scott*, 247 U.S. 126 (1918); *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503 (1917); *Stratton's Independence v. Howbert*, 231 U.S. 399 (1913); see Cairns, *A Note on Legal Definitions*, 36 COL. L. REV. 1099, 1101 (1936).

the mine of the output.”<sup>14</sup> Against an attack that the amount allowed was too small and that not to allow depletion was to tax capital rather than income under the Sixteenth Amendment, the Court made it clear that depletion and its amount were matters of legislative grace, not constitutional requirement.<sup>15</sup> In 1916 “a reasonable allowance for actual reduction in flow,” in the total years, not to exceed “capital originally invested” or the March 1, 1913, “fair market value” was provided.<sup>16</sup>

Depletion has been allowed since 1918 on one of three bases: (1) “cost,” by which the actual cost can be recovered over the life of the property, (2) “discovery,” by which the value of the property within thirty days of its discovery, which may be several times its cost, was recoverable over its life, and (3) “percentage,” by which a flat percentage of 27 1/2 percent of the gross income (but not exceeding 50 percent of net income) was deductible each year without any relationship to cost or value of the property. By the cost method only the actual investment was recovered; under discovery procedure the value (as compared to cost) was recovered but recovery was limited at least by original value; under the percentage method the more that is extracted from the property and the greater the profit the larger will be the depletion, which may exceed either cost or discovery value by many times. In the 1918 act Congress authorized “a reasonable allowance for depletion . . . based upon cost” and, as to wells discovered after 1913, on the basis of the fair market value at or within thirty days of discovery. Unwilling to cope with the method of computation, Congress shifted the problem to the Secretary of Treasury.<sup>17</sup> In 1921 the same provisions were continued, but with the limitation that the depletion should not exceed net income computed without the depletion allowance (to ease the administrative problem and pre-

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14. 38 STAT. 172-173 (1913).

15. *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916); *Stratton's Independence v. Howbert*, 231 U.S. 399 (1913); nor did the allowance for depreciation include depletion, *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503 (1917); the deduction allowed might be less than the actual depletion, *Burnet v. Thompson Oil & Gas Company*, 283 U.S. 301 (1931).

16. Internal Revenue Act of 1916, § 5(a) Eighth (a), and 12(b) second (b), 39 STAT. 759, 769 (1916). The decline in flow method was consistent with the then practice of the oil industry, but was later superceded by the ultimate production method by which you estimate the total amount of oil underlying the property, *Ohio Oil Co. v. United States*, 17 Am. Fed. Tax R. 1114 (1936); 53 CONG. REC. 13, 285-13,288 (1916). Congress did not seem clear as to its purpose, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, 968-972 (1938).

17. Internal Revenue Act of 1918, §§ 214(a)(10) and 234(a)(9), 40 STAT. 1067-1068, 1078-1079 (1918). MANUAL FOR THE OIL AND GAS INDUSTRY (Treas. Dept. 1919).

vent offsetting non-oil income with the deduction).<sup>18</sup> In the 1924 act Congress separated the allowance provisions from the basis provisions, further limited the discovery depletion to fifty percent of net income, and made the total amount to be recovered by depletion (except discovery) the same as the basis for computing gain or loss.<sup>19</sup> From 1924 cost depletion remained in this form. Beginning in 1926 discovery depletion was abandoned, allegedly because it proved difficult to administer; the same provisions for a "reasonable allowance" to recover cost were continued, and for the sake of simplicity there was added permission to deduct percentage depletion of 27 1/2 percent of gross income but not to exceed 50 percent of net income.<sup>20</sup> This percentage was, of course, a percentage of the annual income and was in no way related to investment or discovery value of the well. Yet an examination of the reports shows no determinations of policy, no extended discussion of theory, no decision to take care of stripper wells, nor any finding that the oil industry should be given a subsidy.<sup>21</sup> Percentage depletion was intended only to equal, not exceed, depletion *previously allowed*.<sup>22</sup> The Revenue Acts of 1928 to 1938 made no substantial alterations and the same provisions were incorporated into

18. Internal Revenue Act of 1921, §§ 214(a)(10) and 234(a)(9), 42 STAT. 241, 256 (1921); and see H.R. Rep. No. 486, 67:1:1921, p. 25. This was to assure return of capital, not grant a subsidy, *Untermeyer v. Commr.*, 59 F.2d 1004 (2d Cir. 1932).

19. Internal Revenue Act of 1924, §§ 204(c), 214(a)(9), and 234(a)(8), 43 STAT. 260, 270, 284 (1924). The purpose for using the basis provision is shown to be, "to insure a taxpayer a return of his capital free from tax." H.R. Rep. No. 179, 68:1:1923, p. 18.

20. Internal Revenue Act of 1926, §§ 204(c)(1), 214(a)(9), and 234(a)(8), 44 STAT. 16, 27, 42 (1926).

21. The House, Senate, and Conference reports show that the House suggested 25 percent, the Senate 30 percent, and the compromise was 27 1/2 percent of gross income. The reason for change was: "The administration of the discovery provisions of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that has to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends. . . ." Sen. Rep. No. 52, 69:1:1925, p. 18; H.R. Rep. No. 356, 69:1:1925, pp. 31-32. The courts interpreted this as including "under the 1926 Act precisely what it included under the earlier acts," *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459, 467 (1933), as "compensation to the owner for the exhaustion of . . . deposits in the course of production" for which the percentage depletion was a "rule of thumb," *Helvering v. Mountain Producers Corp.*, 303 U.S. 376, 381 (1938), and not as a bonus or subsidy, *Untermeyer v. Commr.*, 59 F.2d 1004 (2d Cir. 1932). The Supreme Court recognized that, "the granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasized the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance," *Anderson v. Helvering*, 310 U.S. 404, 408 (1940), and that percentage depletion "was in the interest of convenience and in no way altered the fundamental theory of the allowance," *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 367 (1938).

22. Sen. Hearings Rev. Act 1926, pp. 202ff., Joint Comm. Prel. Rep. on Depl. (1929) p. 14; H.R. Hearings 77:2:1942, p. 1016; SEIDMAN'S LEGISLATIVE HISTORY OF THE FEDERAL INCOME TAX LAWS, 1938-1861, pp. 583ff.



the 1939 Internal Revenue Code and remained basically unchanged as to oil and gas wells (some new types of mines were added and percentages were changed).<sup>23</sup> The 1954 Code does not change the basic provisions, but by redistributing the sections it makes percentage depletion (under § 613) the allowance offered by the general rule (§ 611) rather than a provision as to "basis," and it makes apparent that the oil and gas depletion provisions apply to resources outside the United States as well as those within.<sup>24</sup>

A brief resumé of the material permitting deduction as expenses of intangible drilling and development costs (which, economically speaking, are clearly capital expenditures) would indicate that, beginning with the regulations under the 1918 act, for which there was no express statutory authorization<sup>25</sup> and which were possibly invalid, the taxpayer was granted the option of expensing or capitalizing such costs, and as depletion was changed from discovery to percentage a new election was permitted.<sup>26</sup> The Supreme Court never passed on the validity of these regulations,<sup>27</sup> but in 1945 the Fifth Circuit, in *F.H.E. Oil Co. v. Commissioner*,<sup>28</sup> held the grant of the option to expense or capitalize contrary to law, and this

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23. See §§ 23(1) and (m) and 114(b) of the Internal Revenue Act of 1928, 44 STAT. 800-801, 821-822 (1928); of 1932, 47 STAT. 181, 202-203 (1932); of 1934, 48 STAT. 689-690, 710 (1934); of 1936, 49 STAT. 1660, 1686 (1936); of 1938, 52 STAT. 462, 495 (1938); see Act of 1942, § 145, 56 STAT. 840-841 (1942); Act of 1943, § 124, 58 STAT. 44 (1944); Pub. Law 384, 80:1:1947, § 15, 61 STAT. 919-920 (1947); Act of 1950, § 207, 64 STAT. 931 (1950); Act of 1951, § 319, 65 STAT. 497-498 (1951).

24. This comes from comparison of INT. REV. CODE § 613(b)(1) with § 613(b)(2)(B). One cannot be quite clear how our foreign policy is affected—how well it is "oiled"—when these benefits are given those who develop oil abroad. Nor is it by any means clear that the same considerations (assuming them valid) which dictate these concessions or inducements to developing American oil also apply to developing oil in the Middle East.

25. The regulation may have been invalid as treating as an expense what was in fact a capital expenditure, 1939 INT. REV. CODE § 24(a)(2) and (3). *Sanford's Estate v. Commr.*, 308 U.S. 39 (1939); *Manhattan General Equipment Co. v. Commr.*, 297 U.S. 129, *rehearing denied*, 297 U.S. 728 (1936); *Koshland v. Helvering*, 298 U.S. 441 (1936); *Lynch v. Tilden Produce Co.*, 265 U.S. 315 (1924); *International Ry. v. Davidson*, 257 U.S. 514 (1922); *Morrill v. Jones*, 106 U.S. 466 (1883); *Titsworth v. Commr.*, 73 F.2d 385 (3d Cir. 1934); *F.H.E. Oil Co. v. Commr.*, 147 F.2d 1002, *rehearing denied*, 149 F.2d 238, 150 F.2d 857 (5th Cir. 1945). This is conceded in part by 1954 Code § 263(c). The Supreme Court has recognized that these intangible development costs were precisely the items returnable by depletion, *Choate v. Commr.*, 324 U.S. 1 (1945).

26. U.S. Treas. Reg. 69, Art. 223, 28 TREAS. DEC. INT. REV. 558, 635 (1926); U.S. Treas. Reg. 74, Art. 243; U.S. Treas. Reg. 77, Art. 236; U.S. Treas. Reg. 86, Art. 23(m)-16; U.S. Treas. Reg. 94, Art. 23(m)-16; U.S. Treas. Reg. 101, Art. 23(m)-16; U.S. Treas. Reg. 103, § 19.23(m)-16 (1940); U.S. Treas. Reg. 111, § 29.23(m)-16 (1941); U.S. Treas. Reg. 118, § 39.23(m)-16 (1953).

27. Some see recognition of them in *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459 (1933).

28. 147 F.2d 1002, *rehearing denied*, 149 F.2d 238 (5th Cir. 1945); *cf.* *Ramsey v. Commr.*, 66 F.2d 316 (10th Cir. 1933), *cert. denied*, 290 U.S. 673 (1935).

position was continued after Congress by a concurrent resolution approved the regulations.<sup>29</sup> The 1954 Code has expressly authorized the regulations but still has not made the option a part of the statute.<sup>30</sup>

### *The Cases*

The Supreme Court, as well as the Congress, has, of course, contributed to the development of the law on this matter. In theory both depreciation and depletion are means by which the owner of property devoted to producing income recovers his original capital outlay from the income, on the rationale that the capital is consumed in producing the income.<sup>31</sup> While percentage depletion is geared to income,<sup>32</sup> it is "production and sale of the oil [which] . . . result[s] in its depletion and also in a return of capital investment."<sup>33</sup> Therefore, if depletion is deducted and no production occurs, the depletion must be restored to income so as not to "deflect income into the capital account without any corresponding capital loss."<sup>34</sup> We need not examine the cases as to what "economic interest," as compared to "economic advantage," is entitled to the depletion deduction; the distinction Mr. Justice Frankfurter viewed as drawing "gossamer lines" "which hardly can be held in mind longer than it takes to state them."<sup>35</sup> It is sufficient for us to note that the interest must be a producing interest involving a capital investment which needs to be

29. House Concurrent Resolution 50, 79:1:1945, CUM. BULL. 545 (1945); F.H.E. Oil Co. v. Commr., *second motion for rehearing denied*, 150 F.2d 857, 858 (5th Cir. 1945).

30. INT. REV. CODE § 263(c); Sen. Rep. No. 1622, 83:2:1954, p. 225. A study of how to exercise the option and the optional and non-optional items will be found in 4 MERTENS, *op. cit. supra* note 12, §§ 24.48c-24.52.

31. See notes 12, 19-25 *supra*; *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 366 (1938); *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932); *United States v. Ludey*, 274 U.S. 295, 302 (1927); *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364, 369 (1925); *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503 (1917). "The depletion effected by production is likened to the depreciation of machinery, or the using up of raw materials in manufacturing. . . . The deduction is therefore permitted as an act of grace and is intended as compensation for the capital assets consumed in the production of income through the severance of the minerals." *Anderson v. Helvering*, 310 U.S. 404, 407 (1940).

32. *Herring v. Commr.*, 293 U.S. 322 (1934), holding that percentage depletion was allowable against advance royalties and bonuses though no oil was yet produced; see criticism, Baker, *supra* note 12.

33. *Thomas v. Perkins*, 301 U.S. 655, 659 (1937); *Palmer v. Bender*, 287 U.S. 551 (1933).

34. *Douglas v. Commr.*, 322 U.S. 275, 284 (1944), approving U.S. Treas. Reg. 118, § 39.23(m)-10; see Judge, *Tax Considerations of the Oil and Gas Royalty Owner*, 31 TAXES 828, 830 (1953).

35. See *Burton-Sutton Oil Co. v. Commr.*, 328 U.S. 25, 37-38 (1946) (dissenting opinion).

recovered from the oil being used up.<sup>36</sup> It is consistently recognized that depletion allowances are matters of grace and could be abolished without constitutional objection.<sup>37</sup> Finally, we may properly point out that the theory of inventories and inventory accounting, which this writer has viewed as more adequately describing the process of extracting and selling oil, would bring about these same results and equally guide policy.<sup>38</sup>

### *The Hearings*

Although it is often assumed that percentage depletion was adopted in 1926 to satisfy the Treasury Department's need for simplification, an examination of the record shows the contrary.<sup>39</sup> The Treasury considered

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36. Kirby Petroleum Co. v. Commr., 326 U.S. 599 (1946); Helvering v. Bankline Oil Co., 303 U.S. 362 (1938); Helvering v. Elbe Oil Land Development Co., 303 U.S. 372, rehearing denied, 303 U.S. 669 (1938); Helvering v. O'Donnell, 303 U.S. 370, rehearing denied, 303 U.S. 669 (1938); Palmer v. Bender, 287 U.S. 551 (1933). See also Burton-Sutton Oil Co. v. Commr., 328 U.S. 25 (1943); Anderson v. Helvering, 310 U.S. 404 (1940); Thomas v. Perkins, 301 U.S. 655 (1937). "[T]he depletion allowances thereon are regarded as designed to permit tax-free recovery of at least their capital investments in such property rights." G.C.M. 22730, 1 CUM. BULL. 214, 219 (1941). The numerous fine distinctions between interests are reviewed in 4 MERTENS, *op. cit. supra* note 12, §§ 24.19a-24.27, 24.57-24.58a; see also McClure, *The Tax Depletion Allowance of the Oil Industry*, 23 GEO. WASH. L. REV. 1 (1954); MILLER, OIL AND GAS: FEDERAL INCOME TAXATION, c. III-VII, XII-XXI (2d ed. 1951); see articles cited in note 6 *supra*.

37. Burnet v. Thompson Oil and Gas Co., 283 U.S. 301 (1931); Stanton v. Baltic Mining Co., 240 U.S. 103 (1916); United States v. Biwabik Min. Co., 247 U.S. 116 (1918); *cf.* Lykes v. United States, 343 U.S. 118, 120 n.4 (1952).

38. See notes 11 and 31 *supra*. This is in accord with the theory stated in general in the regulations and the interpretation in the cases: "The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. . . . Merchandise should be included in inventory only if title thereto is vested in the taxpayer. . . . A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession." U.S. Treas. Reg. 118, § 39.22(c)-1 (1953); earlier found in U.S. Treas. Reg. 103, § 19.22(c)-1 (1940); U.S. Treas. Reg. 101, Art. 22(c)-1; U.S. Treas. Reg. 94, Art. 22(c)-1; U.S. Treas. Reg. 86, Art. 22(c)-1; U.S. Treas. Reg. 77, Art. 101; U.S. Treas. Reg. 74, Art. 101; U.S. Treas. Reg. 69, Art. 1611, 28 TREAS. DEC. INT. REV. 558, 877 (1926); U.S. Treas. Reg. 65, Art. 1611, 26 TREAS. DEC. INT. REV. 745, 1030 (1924); U.S. Treas. Reg. 62, Art. 1581, 24 TREAS. DEC. INT. REV. 207, 504 (1922); U.S. Treas. Reg. 45, Art. 1581, 21 TREAS. DEC. INT. REV. 170, 396 (1921).

See also, as to livestock raisers and recognition that previously expensed items were not to be inventoried, U.S. Treas. Reg. 118, § 39.22(c)-6 (1953) and earlier similar provisions.

39. Randolph Paul, in his TAXATION FOR PROSPERITY 305 (1947), has said:

The original theory was that mineral properties were exhausted in the process of producing financial return, and that part of every dollar received was not taxable because it was not profit, but only a return of capital invested. World War I carried this theory to new outposts. The geologic experts of the day bemoaned our scant supply of oil which, they predicted, would hardly last ten years. The incentive tax experts of 1918 took up the chorus. They proposed that something should be done to stimulate production

that the purpose of discovery depletion was, "to encourage the wildcatter or pioneer, [and] should be limited to those who make an actual discovery."<sup>40</sup> The department urged the elimination of discovery in favor of a return to cost and opposed percentage depletion;<sup>41</sup> the oil industry criticized discovery and urged percentage depletion.<sup>42</sup> Consistently since 1930, after there had been opportunity for observation of the way in which percentage depletion worked, the Treasury Department and the President have urged elimination or reduction of percentage depletion.<sup>43</sup>

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and protect the prospector or wildcatter who risked drilling in unknown territory.

Congress responded in 1919 with a provision for "extraordinary" treatment of taxpayers discovering oil and mineral properties, giving them the right to base their depletion not on original cost, as previously, but on the fair market value of the property at the time of discovery. The extraordinary became ordinary, and this provision remained in the statute with some modifications for many years, notwithstanding the fact that our oil reserves appeared to be increasing rather than diminishing.

The 1918 Act extended a benefit to the owners of mines and oil and gas wells which other property owners did not have. Insofar as oil was concerned this provision had a good deal of sense to it in the light of its premise—scarcity of oil. It may have been a desirable subsidy at the time, but the provision required the valuation of every discovered well and every newly discovered mine in the United States, which turned out to be a great administrative burden. *When the administrative job was largely done, the labor it involved was used as an excuse for changing the statute.* [Emphasis supplied.]

Although anyone can make his own appraisal of the forces securing these concessions, it has been noted in Congress that they resulted from successful pressure, 88 CONG. REC. 8017ff. (1942); see also note 9 *supra*.

40. H.R. Rep. No. 1, 69:1:1926, p. 6.

41. H.R. Hearings 69:1:1926, pp. 161-164, 197-208.

42. *Id.* at 147-185.

43. Joint Comm. on Internal Rev. Tax., 71:3:1930, pp. 104ff. (1930); Statement, Acting Sec. Treas., Subcommittee of Committee on Ways and Means, Dec. 15, 1933, p. 3; Statements pro and con, 78 CONG. REC. 2922, 6170-6183, 6211-6217, 6239-6240 (1934); H.R. Hearings 74:1:1935; H.R. Doc. No. 337, 75:1:1937, p. 4; H.R. Hearings 77:2:1942, pp. 8-9, 84; Sen. Hearings 78:1:1943, pp. 66-68; H.R. Hearings 80:1:1947, p. 2669; H.R. Hearings 81:2:1950, p. 4; H.R. Hearings 82:1:1951; Sen. Hearings 82:1:1951; 97 CONG. REC. 6891, 11697, 11723-11742, 12218-12220, 12322-12336, 12432, 12555-12583 (1951). H.R. Rep. No. 1337, 83:2:1954; Sen. Rep. No. 1662, 83:2:1954.

Examples of the many statements are the following:

Our experience shows that the percentage depletion rates set up in the law do not represent reasonable depletion rates in the case of the designated properties, but are much higher than the true depletion to which the taxpayer is fairly entitled. Moreover, these provisions enable a taxpayer to obtain annual depletion deductions, notwithstanding the fact that he has already recovered the full cost of the property. The deduction is, therefore, a pure subsidy to a special class of taxpayers. For this reason the Treasury recommends that these provisions be eliminated, in order to put all taxpayers upon the same footing. H.R. Hearings 83:1:1953, p. 1997, quoting from Statement, Acting Sec. Treas., Subcommittee of Committee on Ways and Means, Dec. 15, 1933, p. 4.

And see the message of the President transmitting the 1950 request for revision: "I know of no loophole in the tax laws so inequitable as the excessive depletion exemptions now enjoyed by oil and mining interests." H.R. Doc. No. 451, 81:2:1950, p. 4.

Randolph Paul outlines part of this history as follows:

It will not be possible to quote or even outline the large amount of testimony or material produced; the fullest hearings are those of 1950; the most complete congressional discussion is in volume 97 of the *Congressional Record* (1951); other studies such as those of TNEC contain additional data; the reader will find it essential to refer to all of these for completeness.<sup>44</sup> Typical cases can be presented to show where the tax advantages are going, as a basis for determining whether operation under the act is accomplishing the purposes intended, and next to consider the arguments urged for and against change, and finally to relate economic data and other material forming the basis for judgment on the arguments and selection of policy.

## THE SITUATION, PRESENT AND PROSPECTIVE

### *Where Are The Tax Benefits Going?*

We have already assessed the amount of the tax benefits from percentage depletion compared to cost depletion (disregarding the additional advantage from expensing intangible development costs, which amounts to about another two-thirds of the depletion saving) at nearly one billion dollars annually.<sup>45</sup> The oil industry is composed of a few large, integrated

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In 1933 the Treasury recommended the elimination of percentage depletion on mines and oil wells on the ground that it was a "subsidy" to a special class of taxpayers. President Roosevelt and the Treasury followed with a similar recommendation in 1937. In 1942 Secretary Morgenthau cited percentage depletion as an "example of special privilege." Before the House Ways and Means Committee and the Senate Finance Committee he and I presented a detailed case both for striking out the statutory provision allowing percentage depletion and for eliminating an option given by the regulations to deduct capital expenditures for so-called "intangible" drilling expenses, which consist mostly of the labor cost of drilling wells. The Treasury estimated that the annual loss of revenue involved \$200,000,000. But both committees voted to retain the provision allowing percentage depletion and not to disturb the practice of permitting the deduction of intangible drilling expenses. PAUL, *op. cit. supra* note 39, at 304.

44. See notes 6, 13-26 *supra*.

45. See note 8 *supra*. Since the oil industry as a whole (not just producers) is said to constitute an investment of twenty-eight billion dollars (Moyers, *Federal Income Tax Aspects of Oil and Gas Transactions*, 28 N. DAK. L. REV. 277, 278 (1952).), the saving represents about a four percent return on investment annually. It was said that in 1947 the oil companies deducted thirteen times as much through percentage depletion as they could have through cost depletion. H.R. Hearings 81:2:1950, p. 182, see also pp. 17, 52, 215. Senator Hubert Humphrey of Minnesota in the 1951 Congressional discussions estimated that if percentage was replaced by cost depletion the whole 1951 tax increase on those earning less than 4000 dollars would have been avoided. 97 CONG. REC. 11724ff. (1951).

Secretary Snyder, in 1950, said, "for every \$3,000,000 allowed as percentage depletion, another \$2,000,000 was deducted as development costs." H.R. Hearings 81:2:1950, p. 17. The oil industry has on occasion claimed these deductions equal depletion. H.R. Hearings 83:1:1953, pp. 2008, 2021; Baker and Griswold, *Percentage Depletion—A Correspondence*, 64 HARV. L. REV. 361, 366 (1951).

companies engaged in production, transport, and refining, a few large individual operators, a center core of smaller companies and individuals, and a relatively large and mildly successful marginal, stripper, and wild-catter group. The twenty large companies own eighty percent of the refinery capacity, ninety percent of the crude oil transport, and fifty percent of the crude oil output; the top five companies own forty, sixty, and twenty-five percent of these same aspects.<sup>46</sup> Thirty-seven oil companies, each with assets of over one million dollars, received eighty-seven percent of all depletion allowances in 1946-1947, and out of that those over 100 million dollars received seventy-five percent.<sup>47</sup> The greatest savings are to the large integrated oil companies, which show an effective tax rate of twenty to twenty-five percent, rather than the regular fifty-two percent corporate rate.<sup>48</sup> *Fortune* magazine in January, 1946, told of the tax plum of Amerada Petroleum Corporation, thus:

Amerada's tax situation is a businessman's dream. The corporation quite literally does not have to pay any Federal income tax if it does not want to. This is due to the highly reasonable provisions of the internal-revenue law designed for producers of crude oil. Amerada pays so little in Federal income

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46. Bain, *Rostow's Proposals for Petroleum Policy*, 57 J. OF POL. ECON. 55, 59 and n.5 (1949). A few of the large companies may be mentioned: Esso's Humble, Gulf, Socony's Magnolia, Texaco and the somewhat smaller Argo, Louisiana Land and Exploration, Midwest, Pacific Western, and Texas Gulf Producing. The described composition of the oil industry is well recognized. Rostow and Sachs, *Entry into the Oil-Refining Business: Vertical Integration Re-examined*, 61 YALE L.J. 856, 911 (1952).

47. H.R. Hearings 81:2:1950, p. 52. This compares to ninety-three percent of all corporate depletion (oil and mineral) going to corporations of over 1 million dollars and fifty-seven percent to 100 million dollar corporations. Eldridge, *Tax Incentives for Mineral Enterprise*, 58 J. OF POL. ECON. 222, 238 (1950); Treasury Dept., Press Service, No. S-1051, Apr. 21, 1949.

48. Some examples of these savings appears in the 1953 hearings:

The depletion claimed on the tax return for 1952 with respect to domestic crude-oil production was \$28,477,000. The tax reduction by reason of this depletion was 52 percent or \$14,808,000 or \$0.327 per barrel.

The above figures of Phillips Petroleum Co. only refer to the depletion allowance. But there were some other revealing figures submitted at those hearings before Congressman Wolverton's committee [House Interstate and Foreign Commerce Committee].

Take the case of a very large oil-producing company, the Humble Oil & Refining Co. In the year 1951 this company made net after taxes some \$169 million and paid Federal income taxes of only \$51 million.

Standard Oil Co. of California revealed that for its domestic operations in 1952 it took a depletion allowance of over \$64 million.

Recently figures were published in the newspapers concerning the profitable operations of Tidewater Oil. For the first 6 months of 1952 this company made \$15,355,000 and allowed \$2,544,000 for Federal income taxes. In the first 6 months of 1953 Tidewater made net after taxes \$17,591,000 and allowed \$4,600,000 for Federal income taxes.

Those are only samples of what this gigantic tax subsidy means to the integrated oil companies. . . . H.R. Hearings 83:1:1953, p. 1997.

taxes that it does not even segregate the tax item in its annual reports. In wartime, though Amerada's profits soared, it made no provision for excess-profit taxes, and from 1943 to 1944, its normal Federal income tax actually declined. In 1944, on a gross of \$26 million, a gross profit of \$17 million, and a net after all charges of \$5 million, Amerada's allowance for its Federal income tax was only \$200,000.<sup>49</sup>

This report parallels two much wider surveys of the oil companies submitted by the Treasury in 1950.<sup>50</sup> A similar story appears if we ex-

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49. Quoted at H.R. Hearings 83:1:1953, p. 1996.

50. See H.R. Hearings 81:2:1950:

The allowable depletion deducted by the corporations included in this survey amounted to \$555,000,000 in 1946 and \$839,000,000 in 1947. Of these amounts only 10 to 15 percent represented adjusted-basis depletion which would have been required to recover original investment cost.

. . . Total deductions for development costs by the selected corporations were \$394,000,000 in 1946 and \$486,000,000 in 1947. Comparison of the development cost deductions with the excess of percentage over basis depletion for these 2 years indicates that for every \$3 allowed as percentage over basis depletion another \$2 was deducted as development costs. In addition, substantial deductions were taken for exploration costs and losses on abandonment, amounting to \$204,000,000 in 1946 and \$255,000,000 in 1947.

. . . About three-fourths of the total depletion allowances and of the excess of percentage over basis depletion was received by very large corporations, with assets of at least \$100,000,000. *Id.* at 51-52.

. . . Frequently, these [intangible drilling and development costs] amount to as much as 90 percent or more of the original capital outlay, exclusive of depreciable property. When this is deducted as a current expense, and thus recovered tax free at the outset, only 10 percent of the investment remains to be recovered through depletion allowances.

. . . Firms with assets of \$100,000,000 and over had depletion allowances of 20 percent of their gross and 38 percent of their net income, as against 9 percent of gross income and 34.5 percent of net income for corporations with assets between \$100,000 and \$1,000,000. . . . the allowable depletion of corporations with assets of \$100,000,000 and over was 13 times their basis depletion as compared with about 8 times for corporations with assets between \$1,000,000 and \$10,000,000. *Id.* at 179-182.

. . . The number of corporations included in this (the) survey was 163, and the gross income subject to depletion was \$1,837,600,000. The net was \$904,200,000. The depletion, the allowable depletion was \$447,100,000. If it had been computed on the basis of the depletion, necessary to recover their investment, it would be \$41,900,000, or approximately \$42,000,000, whereas the allowable depletion was approximately \$450,000,000. *Id.* at 215.

See also the 1942 case outlined by PAUL, *op. cit. supra* note 39, at 306:

The Treasury showed that one company in a Texas field had secured depletion of \$3,600,000 on properties only about 25 percent exhausted which originally had cost about \$3,000,000; it had recovered more than 100 percent of its cost with 75 percent of its oil left in the ground. The Treasury also showed that it would have cost the government about one-third as much to have paid the entire cost of all wildcat dry holes in 1941 as to have allowed percentage depletion to all wells, including wells in proven areas.

amine the cases of individuals.<sup>51</sup> One example of such an individual is given in the President's message transmitting his 1950 request for tax revision; there are many others.

At the present time these exemptions, together with another preferential provision which permits oil-well investment costs to be immediately deducted from income regardless of source, are allowing individuals to build up vast fortunes, with little more than token contributions to tax revenues.

For example, during the 5 years 1943-47, during which it was necessary to collect an income tax from people earning less than \$20 a week, one oil operator was able, because of these loopholes, to develop properties yielding nearly \$5,000,000 in a single year without payment of any income tax. In addition to escaping the payment of tax on his large income from oil operations, he was also able through the use of his oil-tax exemption to escape payment of tax on most of his income from other sources. For the 5 years his income taxes totalled less than \$100,000, although his income from nonoil sources alone averaged almost \$1,000,000 each year.<sup>52</sup>

It is, as indicated in the above quotation, a usual process to offset non-oil income by the oil advantages. In 1949 *Time* magazine outlined how Hollywood actors were becoming oil men to relieve the tax on their

51. The names of some of these men who are reputed to have built up fortunes of between a quarter and a half billion dollars each within about twenty-five years (this requires an average net income after taxes of ten to twenty million dollars per year) are known in most households: Hugh Cullen (and his personal corporation, Quintana), Harold Hunt, Clinton Murchison (Delhi), and Sid Richardson.

52. H.R. Doc. No. 451, 81:2:1950, p. 4. The illustration was not denied when discussed by the oil industry. *Id.* at 256. See also H.R. Hearings 80:1:1947, p. 2669.

A further analysis appears in the 1950 proceedings:

. . . In 10 illustrative cases [of individuals] in which the taxpayer's income history was traced over the 5-year period 1943-47, the effective rate of tax on net income—based on cost or basis depletion—varied from 63.5 percent to less than 1 percent. These taxpayers, who on the average had annual incomes in excess of \$1,000,000 each, paid an average tax of only 22 1/2 percent. This represents a striking difference between the effective rates of tax actually paid and the general statutory rates on such income, which ranged as high as 90 percent in these years.

During the 5-year period these 10 individual taxpayers received a total net income of 52.6 million dollars from oil and gas properties. This net income was computed after all deductions for operating expenses, depreciation, basis depletion, exploration costs and losses on unsuccessful ventures. These taxpayers also received a total of 9.3 million dollars of net income from other sources. Of their aggregate net income from all sources, totaling 61.9 million dollars, 77 percent was eliminated for tax purposes through the special deductions. H.R. Doc. No. 451, 81:2:1950, p. 182.



high salaries.<sup>53</sup>

*Arguments For And Against Change*

The arguments of the oil industry in favor of the continuance of the 27 1/2 percent depletion have become fairly standardized, as appears from the testimony of General Ernest O. Thompson, chairman of the Texas Railroad Commission, given at both the 1950 and 1953 hearings.<sup>54</sup> In 1950 he began by pointing out, "Russia has the atomic bomb," by quoting from Secretaries Symington and Forrestal on the need for oil, by surveying Persian oil and its nearness to Russia, and he concluded "oil, gentlemen, is ammunition." He included several charts, statistical tables, and text from other authors. There emerges from his material these arguments: (1) "[T]he 27 1/2 percent depletion allowance . . . is getting the job done. . . ."<sup>55</sup> (2) "Production of oil and gas . . . involves the sale of a basic asset which . . . the operator must replace at considerable risk and at a highly uncertain cost. . . ." (3) "Percentage depletion is a simple and equitable method of recognizing discovery value in the production of oil and gas, to carry out the original intent of Congress. . . ." (4) "[T]he rate of return on the investment in petroleum operations has generally been less than that for business as a whole. . . ." (5) "[I]t would be expected that the return on petroleum operations should be larger because of the additional hazard." (6) "The prevailing rate of percentage depletion allowance has become a part of the economic structure of the industry over the past quarter century."<sup>56</sup> (7) "[O]ur State is already suffering from the shut-down because of the fact that we are producing more than market demand. Now if you cut off the depletion allowance, drilling will stop and we will again be faced with a shortage of oil."<sup>57</sup> (8) Eight to ten million people depend on oil for a livelihood.<sup>58</sup> (9) "Out of 439,000 wells in this Nation, 200,000 of them produce less than 6 barrels per day, but they are the backlog of our oil supply of the Nation because every well will be a stripper by and by."<sup>59</sup>

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53. *The Hollywood Wildcats*, Time, Oct. 10, 1949, 93-94. Ordinance, brewing, and other corporations have made similar use of oil investments to offset large non-oil incomes and avoid normal and excess profits taxes. H.R. Hearings 81:2:1950, p. 182-183. And see the remarks of Senator Humphrey, 97 CONG. REC. 11724ff. (1951).

54. H.R. Hearings 81:2:1950, pp. 222-255; H.R. Hearings 83:1:1953, pp. 2001-2026.

55. H.R. Hearings 81:2:1950, pp. 224, 253.

56. *Id.* at 247.

57. *Id.* at 249.

58. *Id.* at 250.

59. *Id.* at 253.

Compare this approach with his testimony in 1953.<sup>60</sup>

From an examination of various testimony and supporting documents, Gregory Adamanian summarizes the arguments of proponents quite similarly:

(a) The exploration and development of oil is so costly and risky that substantial incentives must be provided to attract new explorers and additional capital.

(b) Thus far, this method has proved to be exceptionally successful in that the industry has more than adequately met the increasing needs of the nation.

(c) More than double the estimated loss to the Treasury is invested in further development.

(d) In contrast to other attempted methods of depletion computation, the one in existence is by far the easiest to administer.

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60. "I have no financial interest in oil. . . . My sole interest in oil is that of a citizen-soldier, and that of a conservation official." ". . . oil is truly a munition of war." ". . . every time you take out a hundred barrels of oil, there is that much less oil [capital] in the reserve. . . ." He next quotes from the Secretary of Navy on oil needs. ". . . we do not have enough oil for national security." "These great Middle East fields, gentlemen, around the Persian Gulf, lie under the very shadow of the Russian bear. . . ." "The system is working; it is producing the oil." Reviewing our use of 7 million barrels a day, that 100 million barrels is a major discovery, and that it is difficult to ". . . compete in the world market with foreign oil," he concludes, "we are not now in any position to see our oil supply diminished." He then outlines that oil is hard to find, showing that "of all the wells drilled in 1952, 39.9 percent were dry holes." He goes on to point out that from 1926 to 1953 known reserves were increased from eight to twenty-eight billion barrels and gives credit to the 27 1/2 percent depletion, "it works. It furnishes the proper incentive. It is dependable." Mr. Thompson then turns to "the consumer's interest" for "gasoline cheaper and better" and states: "Two gallons of today's gasoline does the work of 3 gallons of 1926 gasoline," and the price is no more than it was in 1926" though "wholesale commodity prices generally increased 55 percent. . . ." He outlines cost of wildcat wells (\$100,000) and their chance of success, one in nine, and concludes that reduction of percentage depletion will produce these serious consequences:

1. The price of gasoline and other petroleum products will increase. . . .
2. The incentive for risking capital . . . will be dangerously diminished.
3. The diminishing of discovered underground oil reserves will jeopardize America's program of defense and military preparedness.
4. The small "stripper well" operator will be forced to curtail operations. . . . [or] liquidate.
5. . . . suppliers to the oil and gas industry will suffer; and thereby less income will be available for taxation to the Government.
6. Reduction of the industry's payroll will materially reduce individual income subject to taxation.
7. The millions of industry stockholders will not only get smaller dividends, but their incentive to invest in oil stock will be destroyed, resulting in a further reduction of income available for taxation.

He submits charts or memoranda to show increase in reserves, twenty-four oil states, number of wells completed, increased cost of developing and drilling, profits of oil industry about same as manufacturing and trade. H.R. Hearings 83:1:1953, pp. 2001-2026.

(e) Marginal producers such as stripper well operators and small wildcatters will be forced out of business.

(f) If percentage depletion is abandoned, the ultimate prices of oil and its derivative products to the consumer will be higher.<sup>61</sup>

The arguments above may properly be taken as those to be tested; so it becomes essential to examine the material which is readily available on these issues. A great deal has been made of the need for oil in the national war effort and of the probability of inadequate oil if the percentage depletion subsidy is withdrawn, and brief attention must be given to this. It is doubtful whether the oil industry is as unpatriotic as is represented by the threat that essential war materials will be stopped, absent percentage depletion. War thinking cannot dominate our economy forever; it is well known that the military has an insatiable demand for manpower, material, and budget. Other essential industries had to and did operate throughout the war with as much as seventy-five percent of their income devoted to excess profits taxes. The Government has

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61. Adamanian, *supra* note 11, at 401. The Mid-Continent Oil and Gas Association has prepared a monograph of nine points accepted generally by the oil industry; these are listed and discussed pro and con by Charles O. Galvin, *supra* note 9, at 414-421 as:

- 1) Unsuccessful Prospecting and Exploration,
- 2) Wasted Natural Deposits Must Be Replenished,
- 3) Percentage Depletion Stimulates and Rewards Discoveries of Unknown National Wealth and Income,
- 4) Depletion Based on Discovery Values Is Recognized as Fair and Reasonable,
- 5) Speculative Enterprises Should Not Be Taxed Until There Are Assurances of Redemption of Capital,
- 6) Simplicity, Equity and Economy in Administration,
- 7) Percentage Depletion Promotes a More Stable Source of Revenue to the United States,
- 8) Increased Taxes on These Industries Will Merely Aggravate an Existing Inequality,
- 9) Loss of Revenue and National Wealth Will Result From Elimination of Marginal Producers.

It may be pointed out that the government has usually not submitted adequate statistical policy material, preferring to rest its argument on the inequities occasioned and the loss of federal revenue. For an example see the four arguments of Secretary Snyder:

First, the estimated revenue loss is between 400 and 500 million dollars annually.

Second, the allowance is especially excessive in the case of oil and gas and exempts a higher proportion of the earnings of this industry which may expense more of its development costs than the other mineral industries.

Third, the provision has been found to be of little benefit to small prospectors on whose behalf it is so frequently supported.

Fourth, these deductions enable high-income individuals to reduce to negligible proportions taxes on income from sources totally unrelated to these industries. H.R. Hearings 81:2:1950, p. 18.

the power to seize industries in time of emergency, and has done so. The type of incentive to industry which permitted deduction by five year amortization of unusual expenditures for defense facilities proved adequate. Finally, there is little proof that percentage depletion is essential to national defense.<sup>62</sup>

The first argument asserts that the oil industry is peculiarly subject to risks and that it cannot attract capital without the percentage depletion subsidy in addition to the right to deduct, as expense, intangible costs. Are the risks unusual? The oil companies submit that one in five wells is successful and that twenty-eight to thirty-nine percent of all wells are dry holes. But they are talking of exploratory, discovery, and wildcatter wells.<sup>63</sup> Is this the way to measure capital risks? *Dun's Review* gives running statistics of business failures. The pre-war rate was fifty-five failures to 10,000 businesses per month, and it has run (in 1932) as high as 154.1. The breakdown for January, 1954, and January, 1955, was 4 for coal, oil, gas, and mining both times, 19 and 20 for food, 46 and 53 for apparel, 21 and 23 for lumber products, 450 and 456 for retail trade, 86 and 87 for construction, and 79 and 114 for wholesale. Oil in every year from 1925 to 1954 has had the lowest ratio.<sup>64</sup> Oil ranks first in value of all mineral production.<sup>65</sup> It is consistently advertised that backing oil well drilling is a good business risk and is now being financed by commercial banks.<sup>66</sup> A survey of the fifty favorite common stock investments of trusts shows that seven out of the first ten were oil and gas producers.<sup>67</sup>

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62. It must be recognized that semi-government bodies during the war did go on record as favoring retention of percentage depletion in the interests of national defense: *e.g.*, the Petroleum Coordinator, H.R. Hearings 77:2:1942, pp. 65, 156, 163, and the Petroleum Industry War Council, the Interstate Oil Compact Commission, and the National Conference of Petroleum Regulation Authorities, *id.* at 159-161.

63. H.R. Hearings 83:1:1953, pp. 2012, 2018, and 2118; H.R. Hearings 82:1:1951, p. 1702.

64. *Dun's Review and Modern Industry*, Mar., 1955, 33-35, yearly computations; ECONOMIC STATISTICS BUREAU, Wash., D.C., IX, No. 3 THE HANDBOOK OF BASIC ECONOMIC STATISTICS 150 (1955); 1955 WORLD ALMANAC 764.

65. 1955 WORLD ALMANAC 698.

66. Robert Spann, *Wall Street Journal*, Aug. 9, 1948; many of the problems of oil and gas financing have never been adequately examined, Bloomenthal, *SEC Aspects of Oil and Gas Financing*, 7 Wyo. L.J. 49 (1953).

67. May, *A Closer Look at the Funds*, *Commercial and Financial Chronicle*, Jan. 19, 1950, p. 5, col. 2. In one issue of *Trusts & Estates* appear two articles encouraging trust investment in oil and gas which is, "gaining a well-deserved reputation as a sound long term investment." Rosan, *Natural Gas Goes to Town*, 91 TRUSTS & ESTATES 830, 834 (1952); Huff and Hammett, *Investments in Oil Industry—Five Types Analyzed For Trust Suitability*, *id.* at 908. And more than one writer has concluded his article by showing "situations in which such investments [oil and gas] probably represent the most attractive means of employing available excess funds." Murray, *Intangible Drilling and Development Costs of Oil and Gas Wells*, 26 TAXES 312, 316 (1948); an examination of the New York Times financial section or the *Wall Street Journal* will show oil stocks among most favored.

It would appear that the risks are not as high as in other businesses; certainly no higher. There is relatively little capital invested because intangible costs, dry holes, and exploration are expensed and thus immediately recovered out of income. Even if their expenses exceed income in a year, the Government absorbs a further part of the risk by the loss carry-back and carry-forward provisions.<sup>68</sup> And provisions such as those permitting unrecovered capital investments in an exhausted or abandoned well to be written off as worthless and the practice whereby several in one area share risks by "bottom-hole" agreements further cushion the risk.<sup>69</sup> Although the oil industry has, from time to time, submitted tables to show that oil profits just about equal or only slightly exceed manufacturing profits,<sup>70</sup> it must be remembered that oil company deductions used in arriving at these figures include some of the very items under consideration and particularly that these are profits before taxes. Any statistical comparison of oil, gas, and mining profits (as they are usually grouped) against manufacturing or wholesale and retail profits both before and after taxes is revealing; the following chart is a sample of the years 1939, 1949, and 1953, from a much larger table.<sup>71</sup>

Profits (in millions of dollars) of Companies Before and After Taxes

	1939		1949		1953	
	<i>Before</i>	<i>After</i>	<i>Before</i>	<i>After</i>	<i>Before</i>	<i>After</i>
All companies	6,403	4,962	26,198	15,787	39,430	18,286
Agriculture			99	40	74	2
Oil-mines	296	253	925	673	1,254	849
Manufacturing	3,637	2,896	14,140	8,411	21,798	9,594
Whlse-retail	830	635	3,833	2,241	5,156	2,477
Public utilities	861	689	1,674	993	3,417	1,596

From these figures it can be seen that the mining, oil, and gas group has an average retention of earnings after taxes of seventy-five percent compared to sixty-one percent for all companies, sixty percent for manufacturing, sixty-one percent for wholesale and retail, sixty-two percent for public utilities, and twenty-one percent for agriculture. These various figures, as well as the earlier survey of the benefits received would seem

68. INT. REV. CODE §§ 172(b), 381-382, 642(h), 1212, 6164, 6411; U.S. Treas. Reg. 118, § 39.122 (1953); Domar and Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 QUARTERLY J. OF ECON. 388 (1943); O'Neil, *Do High Corporate Taxes Deter Investment?*, 22 HARV. BUS. REV. 433 (1944).

69. INT. REV. CODE § 165; Eldridge, *supra* note 47, 237 and n.55.

70. H.R. Hearings 83:1:1953, pp. 2021-2023.

71. HANDBOOK, *supra* note 64, at 94. A higher percentage (79%) of profits retained after taxes by oil refiners is shown in the FTC and SEC figures, 1955 WORLD ALMANAC 690.

to more than justify the conclusion of Douglas Eldridge that "for many taxpayers who are exploiting depletable assets . . . the types and degrees of risk incurred seem to differ little from those in general manufacturing enterprises."<sup>72</sup>

The second and third arguments assume that it is the percentage depletion allowance which has been responsible for money being put into exploration, development, and production. It seems to be true that the oil industry has plowed back into exploration and development about as much as it deducted for depletion,<sup>73</sup> but it must be remembered that criticism is leveled precisely at the combined practice of deducting 27 1/2 percent of gross income for depletion and then avoiding the tax on the balance by investing in new wells, seventy-five to ninety percent of the cost of which is deducted from income for the second tax saving.<sup>74</sup> It is a novel argument that a taxpayer is induced to take advantage of a second tax saving only because he got the first one. How can it be shown that depletion allowances are responsible for the reinvestment? Any manufacturing company would be glad for an opportunity to reinvest profits in an additional plant tax-free; yet they do expand without this inducement. The record of the mining industry (including again oil, gas, and minerals) as to expenditures for new installations does not compare favorably to other industries: .33 billion in 1939 rising to 1.02 billion in 1954 for mining, 1.94 billion in 1939 rising to 11.24 billion in 1954 for manufacturing, .52 billion in 1939 rising to 4.21 billion in 1954 for public utilities.<sup>75</sup> A series of careful studies rather clearly show that adequate exploration, development, and production are reflections of price, technique and the deduction granted for intangible drilling costs.<sup>76</sup>

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72. Eldridge, *supra* note 47, at 235; see also Blum, *How to Get All (But All) the Tax Advantages of Dabbling in Oil*, 31 TAXES 343, 347 (1953).

73. H.R. Hearings 83:1:1953, pp. 2008, 2021; Baker and Griswold, *supra* note 45, at 366.

74. H.R. Hearings 81:2:1950, pp. 17, 52, 181, 215; a typical article showing the many strings to the saving bow is Bloomenthal, *A Guide to Federal Oil and Gas Income Taxation*, 8 WYO. L.J. 83 (1954).

75. HANDBOOK, *supra* note 64, at 152.

76. See the excellent review of these factors by Eldridge, *supra* note 47, at 228-229. This conclusion has recently been stated by an oil attorney as follows:

The right to charge-off intangible development expense is the most valuable right accorded the oil operator under the tax laws. To a developer of oil properties it is more important than the more publicized depletion allowance. As an encouragement to risk capital it has been a major contributing factor in the discovery and development of the vast oil and gas reserves of the nation. Jackson, *Tax Planning Before Drilling: The Operator's Problem*, 27 TULANE L. REV. 21 (1952).

See his reiteration of this position, Jackson, *Federal Income Tax—Percentage Depletion of Oil and Gas Wells—Another View*, 21 TEXAS L. REV. 798, 807 (1942).

But the problem cannot be treated as solely one of tax economics or even capital and business inducement. We are discussing here the relation of tax policy to development and wise use of oil and gas reserves. A fuller treatment of this important matter will be found below, but suffice it to say at this point that, granted America once needed to encourage rapid extraction, there is now serious question whether the time has not come when, faced with an exhaustible supply, we must begin to discourage rapid extraction and improvident use and begin to encourage technical research, experimentation, and high quality uses.<sup>77</sup>

Ease of administration, the fourth argument, is appealing, and this is often represented as the original reason behind substituting percentage for discovery depletion. Granting for the moment that it is most simple, two thoughts must be suggested. First, simplicity does not excuse unfairness or inaptness; it would be the acme of simplicity to allow no depletion or to have no tax on oil producers. But the unfairness to the oil man on the one hand or to all other taxpayers on the other could not be tolerated solely for the sake of simplicity, and our extremely complex Internal Revenue Code reveals a general motif that the tax plan shall be apt rather than easy. Second, even greater simplicity, would be achieved by the proposal to allow depletion as at present but only up to the point where cost is recovered. Such a resolution would bring the two tax methods, percentage and cost, substantially into harmony. It would relieve the oil companies of keeping two sets of books, one for themselves based on cost, and one for tax purposes based on percentage.<sup>78</sup> It would allow the government and oil producers to know exactly how much was going to be recovered on an investment, avoiding much speculation that exists in this field.

Actually, the notion that the argument of simplicity was the prime cause in the origin of percentage depletion is contrary to fact. Randolph Paul points out that "when the administrative job was largely done, the labor it involved was used as an excuse for changing the statute."<sup>79</sup> The law review articles on oil depletion before and after 1926 stand in a ratio of about one to seventy-five; the litigation for the same periods increased at about twice that rate. Writers sell their specialized books on the basis that "no industry has more difficult technical tax problems than the oil and gas industry."<sup>80</sup> And no one can read the cases and the literature on

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77. Eldridge, *supra* note 47, at 234-235; Rostow, *A Reply*, 57 J. OF POL. ECON. 60, 62 (1949).

78. See the remark of Mr. W. W. Keeler of Phillips Petroleum Co., quoted in H.R. Hearings 83:1:1953, p. 1996.

79. PAUL, *op. cit. supra* note 39, at 305.

80. Miller, *op. cit. supra* note 36, at 6.

such issues as the "economic interest" test, an issue growing almost wholly out of various forms of agreements seeking to take the greatest advantage of percentage depletion, without being aware of its complexity.<sup>81</sup>

That the marginal producer would be forced out of business by abrogation of percentage depletion, argument number five, has the advantage of diverting attention to the small man. It is reasonably clear that one-fifth of our developed oil reserves can be recovered only by strippers (less than ten barrels per day), and one-tenth of the oil reserves can be recovered only by secondary methods (injection of air, gas, or water for instance).<sup>82</sup> Marginal operators continue to urge the 27 1/2 percent depletion, but they show by their testimony that they rarely use this percentage depletion, being driven to cost depletion because of their lack of income.<sup>83</sup> Yet the large operator insists that he buys proved properties at so high a price that cost depletion is also more profitable for him than percentage depletion.<sup>84</sup> If no one needs percentage depletion, you are led to wonder why anyone opposes its deletion from the Code. Actually what the stripper opposes is a reduction below fifteen percent. He shows that he actually receives about a fifteen percent allowance over the life of the property by combining percentage depletion in the profitable years and cost in the less profitable.<sup>85</sup> We have previously seen how the large integrated oil companies, rather than the explorers, wildcatters, or strippers, get ninety percent of the depletion.<sup>86</sup> These companies will not cease developing with or without percentage depletion; their integrated operations in refineries and pipe lines depend upon continuous production. Assuming that the marginal operator needs high depletion to make his operation profitable, is it wise to allow ninety percent of the depletion where it is not needed in order to get the benefit of the remainder? Perhaps a fairer and simpler way of providing incentive to the marginal

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81. Appleman, *Taxation of Sales and Assignments of Leases and Other Interests in Oil and Gas*, 28 TEXAS L. REV. 340 (1949); Bergen, *Oil and Taxes—Some Problems and Proposals*, 26 SO. CALIF. L. REV. 396 (1953); Bloomenthal, *supra* note 74, at 131. Comment, 24 TULANE L. REV. 112 (1949). 4 MERTENS, *op. cit. supra* note 12, has 207 pages on depletion deductions for the oil, gas, and mining industry, which accounts for 1.8 percent of the national income, compared to 65 pages for interest deduction, a problem common to all business and provided in the law from the very beginning. Even the list of interest demanding depletion is impressive: service payments, oil and gas payments, royalties (regular, minimum, overriding, for example), bonuses, working interests, participating interests, net profit payments, lease and sublease, option, delay rentals, impounded production, and "carried interests." This last, to mention only one, is "still unresolved" according to Miller (*op. cit. supra* note 36, at 5), and "in considerable doubt" according to Mertens (4 MERTENS, *op. cit. supra* note 12, § 24.25b).

82. H.R. Hearings 83:1:1953, p. 2026; Jackson, *supra* note 76, at 809.

83. H.R. Hearings 83:1:1953, p. 2029.

84. Baker and Griswold, *supra* note 45, at 368.

85. H.R. Hearings 83:1:1953, p. 2029.

86. Eldridge, *supra* note 47, at 238.



and wildcat operator would be to give an outright subsidy.<sup>87</sup> Small operators (defined either as those having a low ratio of earnings to unrecovered capital investment or low daily quantity production) might be allowed to recover two times their cost through cost depletion. In fact, there may be some question whether the present percentage depletion does not unduly encourage the marginal operator to close his well where he cannot utilize full percentage depletion and move on to larger production where he can.<sup>88</sup> There is a considerable question whether, in the general national interest, this stripping process should be continued under the present somewhat wasteful processes or deferred until technological improvements make the operation more economical and productive.

The sixth argument is directed where good arguments are often directed—to the reader's pocket-book. But there is no proof that prices of oil and its derivatives will rise if percentage depletion is abandoned. Prices can rise, or the industry can learn to be more efficient or take less profit. Oil is a competitive product even though monopolistic within the industry, and it can price itself out of the market. American oil presently enjoys a protective tariff against oil from abroad,<sup>89</sup> this could be abandoned to provide the consumer cheaper oil. It must also be borne in mind that a large part of the cost to the consumer is in state taxes, transportation, and like items, and no good argument can be advanced why consumers, rather than the general taxpayer, should not bear any added cost. The only authoritative recent studies on pricing in the oil industry may differ somewhat in theory and may not find adequate material available for definitive conclusions, but on the issue now before us they are clear; it is not depletion or lack of depletion but such factors as controlled production, competitive or monopoly practices, costly distribution and integration of production, transport, refining, and retailing that determines pricing.<sup>90</sup>

#### *Other National and State Treatment*

A comparison of the treatment accorded oil and gas producers by other than the United States Government shows some influence of our federal practice on neighboring countries, but that generally depletion is

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87. Subsidy bills have been proposed, see, *e.g.*, S.2105, 81:1:1949; see also Simons, *Federal Tax Reform*, 14 U. OF CHI. L. REV. 20, 39-42 (1952); Adamanian, *supra* note 11, at 404.

88. At present rates it will take these wells twenty years to recover their reserves. Stripper wells are now being abandoned at the rate of 3 1/2 percent per year. H.R. Hearings 83:1:1953, p. 2031.

89. INT. REV. CODE § 4521.

90. Dirlam and Kahn, *Leadership and Conflict in the Pricing of Gasoline*, 61 YALE L.J. 818 (1952); Rostow and Sachs, *supra* note 46, at 913-914.

much more restricted elsewhere. In Canada depletion was first recognized simply by a lower tax rate for "wasting asset" companies; next the Minister of National Revenues was authorized to make reasonable allowances in his discretion, and he varied the practice from one instance to the next but restricted the allowance to recovering cost. In the 1940's the rate of depletion was fixed at  $33 \frac{1}{3}$  or 24 percent of net profit from all wells operated by the taxpayer, net profit being computed *after* deduction of drilling and development costs. While these provisions are much more restricted than in the United States, they have nevertheless come under severe attack.<sup>91</sup> English practice is even more stringent, for no right to deduct full exploration, development, and similar costs in the year spent is provided. The taxpayer in substance deducts ten percent of these in the first year and then recovers his cost over the remaining life; there is no percentage depletion, and no more than cost is recovered. England has specifically rejected proposals for our type depletion.<sup>92</sup> Australia makes no provision for deduction of development costs or percentage or other depletion but does grant an exemption of one-fifth of the net income from certain mining.<sup>93</sup> Those South American countries which make any provision comparable to depletion do so on the basis of recovery of costs only, and where percentages are used, they are much lower than in the United States.<sup>94</sup> A few of these countries do grant other forms of subsidy.<sup>95</sup>

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91. McDonald, *Preferential Taxation of the Natural Resources Industries in Canada*, 30 CAN. B. REV. 119 (1952); *Canadian Income Taxation and the Search for Oil in Canada*, 1 OIL AND GAS TAX Q. 1 (1952). See also *National Petroleum Corp. v. Minister*, [1942] 3 D.L.R. 109, Exch. C.R. 102; *Income War Tax Act*, CAN. REV. STAT. c. 97 [1927] as amended. A much more restrictive view of the "interest" entitled to profit by the allowance and of the right to offset other income is shown by the recent Canadian cases. See, *e.g.*, *American Metal Co. of Canada v. Minister*, [1952] Can. Tax Cas. Ann. 302, [1952] Dom. Tax Cas. 1180; *Flack v. Minister*, 6 Can. Tax App. Bd. 331, [1952] Dom. Tax Cas. 208; *Pickle Crow Gold Mines Ltd. v. Minister*, 7 Can Tax App. Bd. 348, [1953] Dom. Tax Cas. 23; *Okalta Oils Lt. v. Minister*, 9 Can. Tax App. Bd. 65, [1953] Dom. Tax Cas. 323; *Ross v. Minister*, [1950] Exch. C. R. 411, [1950] Can. Tax Cas. Ann. 169.

92. *Income Tax Act*, 1945, 8 & 9 GEO. 6, c. 32, §§ 25-31, 12 HALSBURY'S STATUTES OF ENGLAND (2d ed.) 636-642 and cases cited; *Finance Act*, 1949, 12 & 13 GEO. 6, c. 47, §§ 18-26; 1952 *Income Tax Act*, 15 & 16 GEO. 6, c. 10, §§ 305-312 and regulations thereunder. See the recommendation of the Tucker Committee for depletion rejected, *Murphy, Tax Reform Proposals in Great Britain*, 18 TAX POLICY, No. 3, 7-8, 10-15 (1951).

93. Act No. 45 of 1953 and previous Acts amended as shown in footnote to Act No. 45, 1953 COMMONWEALTH ACTS 161 (Australia).

94. The only worthwhile study of these laws is Young, *Depreciation and Depletion—An Inter-American Comparison*, 30 TAXES 278 (1952).

95. I find no depletion allowances provided in other oil countries whose laws I have been able to examine. Foreign Tax Law Associates, Inc., French, German, Indian Tax Services. Also Burma and Iran. Koch, *Tax Problems of Oil and Gas Operation in Latin America and Middle East*, FIFTH ANNUAL INSTITUTE SOUTHWEST LEGAL FOUNDATION, PROCEEDINGS 483 (1954).

The practice in the states is far from uniform. In some, since there is a tendency to carry over into state law the federal provisions generally, the depletion allowance is the same as the federal, even when oil and gas is not an important industry.<sup>96</sup> Most provide a reasonable non-percentage allowance for depletion limited, by statute or regulation, to the recovery of cost,<sup>97</sup> or to a percentage of net income.<sup>98</sup> In other states, even where oil production is the central industry, the tax structure does not contain any depletion allowance.<sup>99</sup>

### SUMMARY

From what has been said certain observations seem justified. The oil and gas industry presents a situation involving matter somewhere between our usual concepts of capital assets and inventory. It bears some resemblance to land and, in non-tax law, is treated like land. It also becomes part of the actual product sold, just like inventory of raw materials. The important characteristic for tax purposes is that it is consumed in the sale and must be replaced out of the sale. Depletion—either cost, or discovery, or percentage—is one way of accomplishing this. But it is not the only way, nor is it a constitutional requirement, but a matter of grace. Nearly all other countries and several of the states having large oil industries give no depletion allowance, restrict it to cost recovery, or otherwise more stringently limit it. In the light of these laws outside the country, there is no reason why our allowances should apply to oil outside the United States. Nor is there justification for allowing oil deductions to relieve non-oil incomes of tax. Measured by results, the depletion allowance permits oil investors, both individual and corporate, to avoid their fair share of taxes. Taxation should seek uniformity of treatment. Collection of taxes depends on taxpayer belief in equity of treatment. Percentage depletion is a subsidy, the one most frequently mentioned and condemned by other taxpayers. Subsidies are dangerous, for, as a committee of policy experts has remarked, “the introduction of . . . subsidy payments, at any point, inevitably creates a case for extension to other areas, and there is thus substituted a system of rigidities in economic relations, often established by political influences, for the balances that would otherwise be established by the operation of market forces and

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96. ARK. STAT. ANN. § 84-2016(g) (1947); CAL. REV. AND TAX. CODE ANN. § 17816 (1952); LA. REV. STAT. ANN. §§ 47:66-67, 47:158 (1950); N.Y. TAX LAW § 360(9).

97. ARIZ. CODE ANN. § 73-1510(c) (1939); OKLA. STAT., tit. 68, § 880(g) (1951); PA. STAT. ANN., tit. 72, § 3402-307(I) (1949).

98. N.M. STAT. ANN. § 72-15-7(j) (1953).

99. TEX. CIV. STAT., tit. 102, art. 6032, tit. 122, art. 7047b, 7058ff. (1948).

relationships."<sup>100</sup> If warranted at all, the percentage depletion subsidy should be taken away from the large integrated oil companies and related individuals, who account for nearly ninety percent of the depletion allowed and who are enabled to reduce their effective tax rate twenty to twenty-five percent from the fifty-two to ninety-five percent paid by others in the same brackets. No valid reason for this subsidy can be advanced. The marginal explorer, developer, or producer can be otherwise cared for, better and at less cost. There is no greater risk in oil than in business generally, and the industry has a favored position in the money market. Its return on the investment after taxes is high, and its investment (that part unrecovered from income) is low. If there is fear for oil reserves as "munitions for war" or if there is concern about our oil reserves, then we need to ask whether we need a new policy and whether the old policy was originally valid or not.

The story of depletion policy may be outlined briefly in three phases. In 1918 we sought to induce exploration or "discovery." In 1926 our aim was to encourage exploitation or "production." Exploration in recent years has become more scientific and has been carried on by the large organizations which are able to offset losses against profits. Depletion geared to income has little exploration-inducement value; instead, it induces exploitation and production. It, in fact, over-compensates a prosperous operator for losses incurred by another operator and already deducted by him as a loss.<sup>101</sup> But even production needs less inducement than formerly, because the integrated organizations need production to keep their transport, refineries, and sales outlets going.

### PROGNOSIS AND PLAN

What is needed in 1955? To answer that question requires the best prognosis we can make as to the needs of this country related to oil and gas, the likely international situation, business trends, technological problems, tax needs—in short, the nature of the future. In the few paragraphs available this survey cannot be undertaken, but an outline of its nature can be sketched.

National income is likely to stay near 300 billions, federal taxes and budget near 70 billions. International tension will probably lessen; military

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100. COMMITTEE ON POSTWAR TAX POLICY, *A TAX PROGRAM FOR A SOLVENT AMERICA*, 26 (1945). This study contains other interesting material on where risk capital comes from and how investments occur. Alexander and Grant, *Mine Development and Exploration Expenditures*, 8 TAX L. REV. 401 (1953), shows the mine companies asking for the same subsidies, and they have been getting them, 4 MERTENS, *op. cit. supra* note 12, §§ 24.14-24.16.

101. VICKREY, *AGENDA FOR PROGRESSIVE TAXATION* 116 (1947).

expenses may be reduced; the way seems to have been found to convert back toward a peacetime economy without undue maladjustment. The underdeveloped areas will come into their own; a market for manufactured products will develop; and new sources of raw materials and energy will be utilized. These views are those of an optimist. They seem likely, but, are not essential to our basic conclusions, for the same policies for oil and gas would seem required, perhaps be more required, if this rosy picture does not obtain. For the tax policy as to oil and gas should depend largely upon the present condition of oil and gas in America.

All studies seem to agree that the American petroleum industry has "suffered both from what was apparently an excessively rapid use of available oil and from the fact that our production practices and output rates have seriously lessened the aggregate amount of oil recoverable at reasonable cost."<sup>102</sup> About sixty percent of the nation's energy requirements are now met by oil and gas. The proration programs of the states and Federal Government have not met the problem. Some unitization of fields is probably needed. The integrated company is the key to the industry, from exploration to marketing. The existing proved American reserves of oil, that is, those known and commercially exploitable at current prices, equal eleven or twelve years of use at present rates, and the reserves of gas equal forty to fifty years. The Association of Petroleum Geologists reports that the areas of future prospective oil development in the United States are one hundred times those presently being exploited. The potential recoverable oil and reserves can further be enhanced by such factors as submarine oil and gas,<sup>103</sup> oil from shale and tar sands,<sup>104</sup> synthesis from coal or other substitutes, and technological improvements. The situation may also be eased by importing oil, by restricting low value uses such as fuel consumption, or by realizing atomic or other new sources of power.<sup>105</sup>

This, it would seem, brings us to a point where we may answer the question of what policy for the future. Where 1918 stood for exploration and discovery and 1926 for exploitation and production, 1955 must be keynoted by an emphasis on conservation and research. It is submitted that the time has come when, faced with an exhaustible proved supply but with new horizons of discovery and use before us, we must discourage

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102. Bain, *supra* note 46.

103. Child, *Natural Gas from the Gulf*, 51 PUB. UTIL. FORTNIGHTLY 95 (1953).

104. Eldridge, *supra* note 47, at 230-234; Rostow, *supra* note 77, at 62.

105. The above material is taken from the excellent analyses of petroleum policy in the following: Bain, *supra* note 46; Dirlam and Kahn, *supra* note 90; Eldridge, *supra* note 47, at 222-240; Moyers, *supra* note 45, at 278; Rostow, *supra* note 77; Rostow and Sachs, *supra* note 46; and see the materials cited in note 6 *supra*.

rapid, unplanned, prodigal use and encourage technological research, social engineering, experimentation, and high quality use.

Whether it is because all truth is in unity cannot be said, but the economic, social, conservation, and tax policies all seem to unite in proposing change in the percentage depletion allowance. The proposed alternatives<sup>106</sup> take any artificial stimulus of a subsidy on production off the market and permit demand to dictate supply. They encourage exploration and experimentation by continuing the right to expense drilling costs. They restrict depletion to its proper function, the recovery of cost, and leave open the possibility of even greater incentive to exploration, research,<sup>107</sup> technological improvement, and secondary and improved extraction. They propose studies where more data are needed, and, in the end, restore equity to the tax structure.

In conclusion the author again proposes the plan outlined in the introduction: (a) There should be no change in the taxpayer's option to capitalize or deduct as an expense so-called "intangible" costs (and spreading the deduction over several years, if desired, will be permitted). (b) Nor will the provision permitting the taxpayer to deduct depreciation on equipment and other tangibles used in production changed. (c) If the taxpayer has capitalized any costs not recoverable through depreciation, he will be allowed to recover these through depletion by one of two methods. Either, first, fifteen percent of gross income, but not exceeding twenty-five percent of the taxable income, from the property, or, second, at a percentage of the capitalized costs equal to the number of units extracted divided by the number of units which are estimated to be recoverable from the property. (d) After the total capitalized costs are recovered, no further depletion will be allowed. (e) If the property is sold or transferred, the gain or loss shall be treated as ordinary, rather than capital, gain or loss, but the tax rate for individuals or corporations shall not exceed thirty percent. (f) If incentive for exploration, discovery, research, or development is at any time needed, the inducement shall not be geared to production and income but shall be provided by outright subsidies or grants-in-aid. (g) If, in the interests of full production from the marginal, stripper, or secondary recovery well, an inducement is required beyond those suggested above, then outright production subsidies or grants-in-aid shall be furnished. (h) Either, or both, (b) and (c) could be modified to permit amortization of cost over a five year period in a national emergency, as was done by the Defense Production Act for war facilities. (i) Oil should be considered to be in a different

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106. See *supra* p. —.

107. See INT. REV. CODE § 174.

category from gas, and further studies should be undertaken to determine whether different rates or inducements are needed. (j) Deductions under (a) and (c) shall not be used to offset income not from oil and gas. None of the provisions in (a) through (h) shall apply to oil and gas outside the United States, pending a new study as to the proper foreign policy.