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DEPLETION OF OIL AND GAS WELL BY-PRODUCTS: OIL, GAS, SPECIFIC MINERAL, OR OTHER MINERALS?

I. INTRODUCTION

With a single stroke of its legislative pen in 1975, Congress virtually eliminated percentage depletion of oil and gas wells so that most oil and gas producers¹ are now limited to depletion deductions² based on the adjusted cost of their property.³ This congressional action ended a forty-nine consecutive year tradition of depletion based on the property's income⁴ and an even longer period of "more-than-adjusted-cost-basis" depletion.⁵ Most persons obtain property prior to the discovery of minerals when the property price does not reflect the value of those minerals. Consequently, depletion quickly reduces the "adjusted cost basis," and the producer is left without deductions.

Independent producers and royalty owners have attempted to salvage some deductions including percentage depletion allowances based on advance royalties and lease bonuses.⁶ One example of such an attempt occurred in *Commissioner v. Engle*.⁷ In this case, the Supreme

1. Percentage depletion remains an option for the small independent producer (and royalty owner) to the extent that his average daily production does not exceed his "depletable oil quantity" and "depletable natural gas quantity." I.R.C. § 613A(c) (1986). Since 1980, these depletable quantity limitations have been 1000 barrels of oil per day (depletable oil quantity) or 6,000,000 cubic feet of natural gas per day (depletable natural gas quantity). § 613A(c)(3)-(4). An election must be made by the taxpayer between the two options since for every 6000 cubic feet of natural gas claimed under the depletable natural gas quantity, the depletable oil quantity must be reduced by one barrel. § 613A(c)(4).

2. I.R.C. § 611 (1986).

3. I.R.C. §§ 613(d), 613A (1986).

4. See *infra* notes 21-30 and accompanying text.

5. *Id.*

6. See *Commissioner v. Engle*, 464 U.S. 206 (1984), *aff'g* 677 F.2d 594 (7th Cir. 1982); *Louisiana Land and Exploration Co. v. Commissioner*, T.C. Docket No. 30292-85 (Houston).

7. 464 U.S. 206 (1984), *aff'g* 677 F.2d 594 (7th Cir. 1982). However, the result in *Engle* would be different under I.R.C. § 613A(d)(5) (1986) which was added to the Code by the Tax Reform Act of 1986. I.R.C. § 613A(d)(5) provides:

PERCENTAGE DEPLETION NOT ALLOWED FOR LEASE BONUSES, ETC.—In the case of any oil or gas property to which subsection (c) [EXEMPTION FOR INDEPENDENT PRODUCERS AND ROYALTY OWNERS] applies, for purposes of section 613, the term "gross income from the property" [upon which percentage depletion is based] shall not include any lease bonus, advance royalty, or other amount payable without regard to production from property.

Id.

Court affirmed the Seventh Circuit Court ruling which allowed the small independent lessor⁸ a percentage depletion allowance on advance royalties and lease bonuses under the independent producers and royalty owners exemption.⁹ Practical problems created by the need to eventually tie advance payments to production were surmountable and did not justify a total ban on deductions against advance payments.¹⁰ The lack of "average daily production"¹¹ proved to be no obstacle to the deduction. Thus, *Engle* was able to use percentage depletion to offset advance royalties agreed to in the lease.¹²

Another area in which producers have attempted to gain a larger percentage depletion allowance is the classification of by-products of an oil or gas well under the constituent mineral.¹³ This would allow percentage depletion for that portion of the gross income attributable to the constituent mineral under different Internal Revenue Code (I.R.C.) sections.¹⁴ However, the reference in I.R.C. sections 613(d)¹⁵ and 613A¹⁶ to "oil and gas wells," rather than to "oil and gas," seems to treat all production from such wells as subject to the oil and gas well depletion rates. References to specific minerals and other minerals contained in I.R.C. section 613(b) do not add the word "wells."¹⁷ Thus, it appears from a

8. The lessor is the party who grants a lease. BLACK'S LAW DICTIONARY 812 (5th ed. 1979).

9. *Engle*, 464 U.S. at 227-28. In this case, *Engle* had assigned oil and gas leases in 1975, but retained the overriding royalties. *Id.* at 212. "A royalty is a share of production free of the costs of production, when and if there is oil and gas production on the property." J. LOWE, OIL AND GAS LAW IN A NUTSHELL 37-38 (West 1983). The suit was caused by *Engle's* attempts to use percentage depletion to offset advance royalties (paid before any production from the property) agreed to in the lease. *Engle*, 464 U.S. at 212. See *supra* note 1 and accompanying text.

10. *Engle*, 464 U.S. at 226-27.

11. I.R.C. § 613A(c)(1) (1986).

12. But see I.R.C. § 613A(d)(5), *supra* note 7.

13. See *Louisiana Land and Exploration Co. v. Commissioner*, T.C. Docket No. 30292-85 (Houston). This case has not been decided as of this writing. The issue is whether the depletion rate of sulfur recovered as a by-product of a gas well should be classified as "sulfur," "other minerals," or "oil and gas wells" under I.R.C. §§ 613(b)(1)(A), 613(d), & 613A (1986). The Louisiana producer is attempting to classify the sulfur by-product of gas wells as sulfur under I.R.C. § 613(b)(1)(A) in an attempt to claim a twenty-two percent depletion on the value of sulfur.

14. See I.R.C. § 613(b) (1986).

15. I.R.C. § 613(d) (1986) provides: "Except as provided in section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section [on percentage depletion]." *Id.*

16. I.R.C. § 613A(a) (1986) provides: "Except as otherwise provided in this section, the allowance for depletion under section 611 [either cost or percentage depletion] with respect to any oil or gas well shall be computed without regard to section 613 [percentage depletion]." *Id.*

17. I.R.C. § 613(b) (1986). This statute provides, in part:

(b) PERCENTAGE DEPLETION RATES—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) [relating to allowance for depletion] are as follows:

(1) 22 PERCENT—

(A) sulphur and uranium; . . .

literal reading of the I.R.C. that all products of an oil or gas well should be subject to the percentage depletion rates and rules for oil and gas wells. Due to the more favorable rates of percentage depletion under the constituent minerals, the classification of oil and gas well by-products under the oil and gas wells provision is an undesirable solution for producers. Subjecting oil and gas well by-products to the percentage depletion rates of I.R.C. section 613(b), relating to constituent minerals, or to sections 613(d) and 613A, relating to oil and gas wells, could mean the difference between substantial deductions or almost no deductions.

II. HISTORY OF PERCENTAGE DEPLETION

Depletion of natural resources is one of the few areas of tax law where the taxpayer may be allowed to deduct more than the property's original cost.¹⁸ If the producer's deductions are limited to the cost of property purchased prior to the discovery of valuable minerals, his depletion deductions will quickly dissipate, leaving him no further deductions even though his mineral interest will steadily lose value through removal of the minerals.¹⁹ As stated by one commentator: "[T]he real purpose of depletion is that a deduction from income must be made to allow for the return of the capital that is exhausted by production of the natural resource."²⁰

Congress first allowed percentage depletion for mines in 1913 and extended this allowance to oil and gas wells in 1916. Under the Tariff of 1913,²¹ Congress permitted "a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made."²² In the Revenue Act of 1916,²³ Congress recognized the depletion of oil and gas wells by authorizing "a reasonable allowance for actual reduction in flow and production."²⁴

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- (7) 14 PERCENT— all other minerals, For purposes of this paragraph, the term "all other minerals" does not include—
 (A) soil, sod, dirt, turf, water, or mosses;
 (B) minerals from sea water, the air, or similar inexhaustible sources, or
 (C) oil and gas wells.

Id.

18. See I.R.C. § 613 (1986).

19. See I.R.C. § 612 (1986).

20. Austin, *Percentage Depletion: Its Background and Legislative History*, 21 U. KAN. CITY L. REV. 22, 23 (1952).

21. Tariff of 1913, ch. 16, 38 Stat. 114.

22. *Id.* at § 2(G)(b).

23. Revenue Act of 1916, ch. 463, 39 Stat. 756.

24. *Id.* at § 5(a)(8)(a).

When World War I necessitated vast supplies of oil, Congress attempted to stimulate the discovery and development of natural resources by enacting the Revenue Act of 1918.²⁵ This Act replaced percentage depletion with a depletion allowance based on the fair market value of the property on the date of discovery or within thirty days.²⁶ This depletion based on the value of the property near the date of discovery of minerals was known as discovery depletion.

The Revenue Act of 1926²⁷ reintroduced percentage depletion and replaced discovery depletion for oil and gas wells. After eight years of dealing with the value determination uncertainties of discovery depletion, a reversion to percentage depletion was the next logical step because the value of the oil in the ground was uniformly related to the current market price of the oil.²⁸ This predictable relationship "indicated that an approximately equivalent result [to discovery depletion] could be achieved by simply allowing depletion as a percentage of income."²⁹ The benefit of percentage depletion was extended to coal mines, metal mines, and sulfur in the Revenue Act of 1932.³⁰ Thus, percentage depletion became the widely accepted method of depletion deductions by the early 1930's.

Producers soon began jockeying for the most favorable percentage. In fact, during the congressional hearings which preceded the Revenue

25. Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919).

26. *Id.* at § 214(a)(10).

27. Revenue Act of 1926, tit. 26, ch. 19, § 935(11)(c), 44 Stat. 723, 812.

Some of the pitfalls of discovery depletion and Congress' reasoning behind the switch can be garnered from the following excerpt from the legislative history of the bill:

If Senators will stop to think for a moment about the application of that rule (discovery depletion) to an oil well, it will be realized that the owner of the well is exhausting his capital every time he draws a barrel of oil out of the well, so part of the value of that oil is in there and part of it is a mere return of his capital. In order to calculate what part of it he can charge off to depletion the Bureau (Internal Revenue Service) has been estimating the quantity of oil in the property, which is just about as hard as estimating the quantity of air over the property. Then, on top of that estimate, they try to estimate what that oil will be worth in the market in future years, which multiplies the first uncertainty. . . .

67 CONG. REC. 3018 (daily ed. Jan. 30, 1926) (statement of Sen. Reed).

28. Austin, *supra* note 20 at 27. Austin made an interesting observation in his article which seems to have current application:

[T]he Ways and Means Committee [House of Representatives] and the Finance Committee [Senate] have made thorough studies of the percentage depletion provisions of the Code several times, notably in 1942, 1950 and in 1951. Many well-informed witnesses were heard upon each occasion. In every instance these committees have concluded that their effectiveness as incentives has been demonstrated and that they are essential to a national petroleum policy *if this Country is not to become dependent upon another for our supply of liquid fuel.*

Id. at 29 (emphasis added).

29. *Id.* at 27.

30. Revenue Act of 1932, tit. 1, ch. 209, § 114(b)(3)-(4), 47 Stat. 169, 202-03.

Act of 1932, sulfur producers argued that the production of sulfur through "wells" was conducted in essentially the same manner as the production of oil. Congress was considering extending percentage depletion to sulfur; therefore, the sulfur producers requested the same depletion rate³¹ as oil and gas. The sulfur producers received percentage depletion for sulfur but failed in their attempt to receive the same depletion rate as oil and gas.³² Similarly, producers are currently attempting to obtain the most favorable percentage depletion through litigation.³³ Jockeying for the most favorable percentage will continue, no doubt, until all minerals are subject to the same percentage depletion rates and rules. Since the issue has been raised in the context of a case involving sulfur by-products, focusing on the sulfur mineral might provide some insight.

III. SULFUR PRODUCTION AND PERCENTAGE DEPLETION

A. Profitability of Sulfur Production

Historically, percentage depletion rates for oil and gas wells have generally been higher than percentage rates for sulfur, but this difference was insignificant until the late 1960's because gas producers rarely could profit from separating and selling the sulfur content of their gas stream.³⁴ Profitability depended on the circumstances of each individual deposit such as the concentration of hydrogen sulfide gas, the size of the deposit, the nearness to markets, and the selling price of the sulfur.³⁵ In 1967 and 1968, the price of sulfur rose dramatically,³⁶ making separation and separation plants more profitable. An equally dramatic drop followed,³⁷ making previously profitable plants unprofitable, but the price of sulfur began to increase again in 1973.³⁸ Therefore, it was not until the mid-1970's that most producers found it consistently profitable to separate and sell the sulfur.

Some producers were forced to recover the sulfur even when it was

31. The final bill, however, kept percentage depletion of oil and gas at the twenty-seven and one half percent level and allowed sulfur only twenty-three percent. Revenue Act of 1932, tit. 1, ch. 209, § 114(b)(3)-(4), 47 Stat. 169, 202-03.

32. Revenue Act of 1932, tit. 1, ch. 209, § 114(b)(3)-(4), 47 Stat. 169, 202-03.

33. See cases cited *supra* note 6.

34. See Morse, *Sulfur*, 1 MINERALS YEARBOOK 863 (1984); see generally R. MERWIN, MINERAL FACTS AND PROBLEMS, BICENTENNIAL EDITION (U.S. Dept. of Interior 1976).

35. See *supra* note 34.

36. R. MERWIN, *supra* note 34, at 1072-73.

37. *Id.*

38. *Id.*

not profitable because the federal government and some state legislatures enacted various clean air acts which prohibited flaring of hydrogen sulfide gas by operators.³⁹ Since few gas purchasers would accept sour gas,⁴⁰ operators were forced to separate out the hydrogen sulfide in order to sell the natural gas. Thus, although it was generally unprofitable to separate and sell the sulfur prior to the mid-1970's, producers were often forced to do so.

B. *No Percentage Depletion Available for Sulfur Production*

Despite the express provisions in I.R.C. section 613(b)(1)(A), most sulfur production is not subject to percentage depletion because there is no allowance for percentage depletion of sulfur recovered from an oil or gas well.⁴¹ The reason behind this apparent inequity is that recovery production has been increasing since 1960, while direct production has been declining since 1974.⁴² Since 1982, more sulfur has been produced through sulfur recovery from oil or gas wells than from direct mining or drilling.⁴³ Therefore, producers of sulfur recovered from oil and gas wells cannot benefit from percentage depletion under the current system. Thus, the producer is limited to cost depletion.⁴⁴

Until recently, oil and gas wells were generally subject to a higher percentage rate than sulfur; therefore, producers were not concerned with depleting the sulfur separately. From 1926 until 1969, oil and gas wells benefited from more favorable percentage depletion treatment than sulfur.⁴⁵ From 1969 to 1975, producers received a twenty-two percent depletion rate for both oil and gas wells and sulfur.⁴⁶ From 1975 to the present, producers have frequently received a higher percentage depletion for sulfur than for oil and gas wells. In some cases, both have received twenty-two percent, but in many cases, oil and gas wells have

39. Clean Air Act, 42 U.S.C. § 7401 (1982); *see, e.g.*, Air Resources Act, CAL. HEALTH & SAFETY CODE § 39000 (West 1985); Air Quality Control Act, KAN. STAT. ANN. § 65-3001 (1985); Oklahoma Clean Air Act, OKLA. STAT. tit. 63, § 1-1802 (1985); Texas Clean Air Act, TEX. REV. CIV. STAT. ANN. § 4477-5 (Vernon 1985).

40. Sour gas is natural gas which contains hydrogen sulfide.

41. I.R.C. §§ 613(d), 613A (1986).

42. Morse, *Sulfur*, 1 MINERALS YEARBOOK 863, 868 (1984).

43. *Id.* Direct production of sulfur is called "frasch."

44. *See supra* text accompanying notes 2-5.

45. Oil and gas wells benefited from twenty-seven and one half percent depletion rate while sulfur had a depletion rate of twenty-three percent. Revenue Act of 1932, Pub. L. No. 72-154, § 114(b)(3)-(4), 47 Stat. 169, 202.

46. The Tax Reform Act of 1969 reduced the percentage depletion rate for oil and gas wells from twenty-seven and one half percent to twenty-two percent. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 629.

received zero or fifteen percent.⁴⁷ Thus, if sulfur were depleted under "sulfur" rather than "oil and gas wells," producers would benefit from a higher percentage depletion rate.

Because it was not economically feasible to recover the sulfur until 1968, and percentage depletion rates were identical for oil and gas wells and sulfur from 1969 to 1975, the question of separate depletion of the sulfur did not arise prior to 1975.⁴⁸ From 1926 to 1975, all production, including sulfur, from a well that primarily produced oil or gas was treated as the product of an oil or gas well. Therefore, by-products were depleted under the oil and gas well percentage depletion rates because the rates were favorable and because it was easier to lump all production together.

C. Louisiana Land and Exploration Co. v. Commissioner

Although the Internal Revenue Service has maintained that all products of an oil or gas well should be depleted under the oil and gas well provisions,⁴⁹ at least one taxpayer has argued that by-products should be separately depletable.⁵⁰ The position of the Internal Revenue Service has been that sulfur and other products of an oil or gas well should be depleted under the oil and gas well provisions of the Code. This generally would not allow any percentage depletion deduction for by-products of an oil or gas well because those provisions refer to "oil and gas wells" instead of just to the specific minerals.⁵¹ Other depletion provisions specifically identify certain minerals without any reference to "wells" or "mines."⁵² A taxpayer is challenging this position in *Louisiana Land and Exploration Co. v. Commissioner*,⁵³ where Louisiana Land maintains it should be allowed a twenty-two percent depletion for sulfur content in its natural gas stream.

47. The Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26, 47 essentially eliminated percentage depletion for most oil and gas producers. *See supra* notes 1-5 and accompanying text.

48. A thorough search for pre-1975 cases dealing with this issue did not uncover case law dealing with this specific question.

49. Tech. Adv. Mem. 85-01-008 (Sept. 21, 1984).

50. *Louisiana Land and Exploration Co. v. Commissioner*, T.C. Docket No. 30292-85 (Houston). *See supra* note 13.

51. Tech. Adv. Mem. 85-01-008 (Sept. 21, 1984).

52. *See* I.R.C. § 613(b) (1986).

53. 90 T.C. 38 (1988). Just prior to this publication, it was held the sulfur by-product of an oil or gas well is separately depletable. *Id.*

IV. EXPLORATION, INTANGIBLE DRILLING COSTS, AND OTHER DEDUCTIONS

Producers who argue that by-products of an oil or gas well should be separately depletable may be surprised at the effect such a resolution of the by-product issue would have on other potential deductions. Some of the deductions which would be affected include exploration deductions and deductions for intangible drilling costs. Many problems would arise in trying to determine the amount of the deduction.

Although I.R.C. section 617⁵⁴ permits a current year deduction of amounts paid in the exploration of mineral properties, other than oil and gas, expenses incurred for oil and gas exploration must be capitalized and recovered through depletion.⁵⁵ A question arises as to whether such costs should be allocated partially to oil and gas exploration and partially to sulfur exploration,⁵⁶ even though the usual purpose for such expenditures is to discover oil and gas. This problem would be further complicated because I.R.C. section 617 allows deductions for amounts paid for exploration of minerals other than oil and gas before there is any production from which an allocation determination could be made. Thus, allocation for depletion purposes may increase the current deductions for exploration, decrease the capitalized amount, and cause problems for producers who must allocate before there is any production to determine allocation.⁵⁷

Expensing of intangible drilling costs would also be affected by resolution of the by-products issue. Expensing allows the producer to take a current-year deduction, while capitalizing adds the amount of the expense to the basis for purposes of depletion.⁵⁸ Under I.R.C. section

54. I.R.C. § 617(a)(1) (1986) provides, in part:

At the election of the taxpayer, expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine, shall be allowed as a deduction in computing taxable income. . . . In no case shall this subsection apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas or of any mineral with respect to which a deduction for percentage depletion is not allowable under section 613.

If the taxpayer elects not to expense the exploration expenditures, the expenditures are treated as deferred expenses and deducted on a ratable basis as the units of produced minerals benefited by the expenditures are sold.

I.R.C. § 616(b) (1986).

55. *Id.* See Rev. Rul. 83-105, 1983-2 C.B. 51; Rev. Rul. 77-188, 1977-1 C.B. 76.

56. See *supra* notes 54 & 55.

57. See *supra* note 54.

58. Treas. Reg. § 1.612-4(a) (1965) provides:

(a) *Option with respect to intangible drilling and development costs.* In accordance with the

263(c) and the regulations, an operator of an oil or gas well may elect to expense intangible drilling costs. No such election is available for intangible drilling costs related to the production of sulfur; such expenses must be capitalized.⁵⁹ However, I.R.C. section 616 allows the taxpayer to elect between expensing and capitalizing development expenditures, which includes some costs that would be intangible drilling costs on an oil or gas well, for development of mines or natural deposits other than oil or gas wells. Nevertheless, treatment of these overlapping costs would still be different because the intangible drilling costs election is a one-time election,⁶⁰ while the development expense election is an annual election.⁶¹ Again, an allocation would have to be made. Therefore, allocation for depletion purposes would decrease the amount of intangible drilling costs which would be expensed, and an election would have to be made annually for development expenditures.

provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used—

(1) In the drilling, shooting, and cleaning of wells,

(2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

Id.

59. *Id.*

60. Treas. Reg. 1.612-4(d) (1965).

61. Treas. Reg. 1.616-2(e)(1) (1965).

Allowing separate depletion of oil and gas well by-products would affect deductions under I.R.C. sections dealing with net income limitations, determination of mining costs under the proportionate profits computation, and exclusion of amounts paid to royalty owners from the operator's gross income. Independent producers and royalty owners would need to allocate operational and capital costs between oil or gas and sulfur for purposes of net income limitations under I.R.C. sections 613(a)⁶² and 613A(d)(1).⁶³ This allocation would be necessary because I.R.C. section 613(a) limits percentage depletion allowances to fifty percent of the taxpayer's taxable income from the particular mineral property, while I.R.C. section 613A(d) imposes an additional limit on percentage depletion of sixty-five percent of the tax payer's total taxable income. Allocation would also be necessary for the determination of mining costs if a proportionate profits computation must be made.⁶⁴ An additional allocation must be made between amounts paid for sulfur royalties and for oil and gas royalties for purposes of excluding the royalty payments from the gross income of the operator.⁶⁵ Thus, allowing separate depletion of oil and gas well by-products would affect more than percentage depletion.

V. THE POSITION OF THE INTERNAL REVENUE SERVICE

The position of the Internal Revenue Service is that the sulfur by-product of an oil or gas well should be depleted under the oil and gas well

62. The percentage depletion allowance for minerals other than oil and gas cannot "exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion)." I.R.C. § 613(a) (1986).

63. The percentage depletion allowance for oil and gas cannot exceed sixty-five percent of the taxpayer's taxable income for the year (other computations modify the taxable income). I.R.C. § 613A(d)(1) (1986).

64. Treas. Reg. 1.613-4(d) (1972). The "proportionate profits method" is one of three methods used to determine the gross income from the property for purposes of applying the percentage depletion rules of I.R.C. § 613 (1986). The other methods detailed in Treas. Reg. 1.613-4 (1972) are: (1) actual sales of minerals before the application of any nonmining processes (Treas. Reg. 1.613-4(b) (1972)), and (2) representative market or field price (Treas. Reg. 1.613-4(c) (1972)).

If the sulfur is separately depletable and no representative field or market price can be ascertained, the depletion base (gross income from property) will be determined, in part, by a determination of whether the hydrogen sulfide separation process is a nonmining process. In *Shamrock Oil & Gas Corp. v. Commissioner*, 346 F.2d 377 (5th Cir. 1965), *aff'g* 35 T.C. 979 (1961), *cert. denied*, 382 U.S. 892 (1965), the court concluded that a treatment process used in part to remove hydrogen sulfide from gas was a manufacturing process (nonmining) rather than a production process (mining) and, therefore, was not includable in the depletion base. *Id.* at 380.

65. See *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312 (1934). A well-known treatise on the subject of federal income taxation of oil and gas states that the *Twin Bell* case contains six important principles pertaining to the deduction for percentage depletion:

provisions of the I.R.C..⁶⁶ The plain language of the statute would seem to support this position⁶⁷ because section 613A(a) states that the allowance for depletion of any "oil or gas well" under I.R.C. section 611 (which, along with the regulations, allows the taxpayer a deduction for the greater of cost depletion or percentage depletion) should be computed without regard to I.R.C. section 613 (which relates to percentage depletion).⁶⁸ Neither "oil well" nor "gas well" are defined in either the statute or the regulations, but sulfur recovered from an oil or gas well would come under the definition of "natural gas" in I.R.C. section 613A(e).⁶⁹ The position of the Internal Revenue Service can be supported with a line of cases which defines gross income from a well as the amount for which the taxpayer sells the gas or oil at the wellhead.⁷⁰ Since this gas stream would necessarily contain hydrogen sulfide, the sulfur constitutes part of the gross income from the "gas well" and, therefore, is not separately depletable.⁷¹

1. The owner of the working interest, *i.e.*, the lessee, is entitled to percentage depletion on oil and gas income belonging to him.

2. Likewise, the royalty owner is entitled to percentage depletion on his royalty oil and gas.

3. In computing percentage depletion, the operator includes in his gross income only the proceeds of the oil and gas which he may retain.

4. The foregoing apportionment has regard to the economic interest of the parties.

5. The fact that the operator sells the oil and gas produced and then pays cash as royalty makes no difference in the apportionment depletion deduction.

6. The gross income for purposes of the depletion deduction taken by several parties on production of oil and gas can in no event exceed gross income from 100 percent of production from the property.

ARTHUR YOUNG'S OIL AND GAS FEDERAL INCOME TAXATION 33-34 (J. Houghton, J. Gaar, J. Braden & J. Morris 24th ed. 1986) (footnotes omitted).

66. *See supra* notes 51-52 and accompanying text.

67. I.R.C. § 613A (1986).

68. *Id.* at (a).

69. I.R.C. § 613A(e) (1986). The statute provides, in part:

(e) Definitions — For purposes of this section—

(1) Crude oil — The term "crude oil" includes a natural gas liquid recovered from a gas well in lease separators or field facilities.

(2) Natural gas — The term "natural gas" means any product (other than crude oil) of an oil or gas well if a deduction for depletion is allowable under section 611 with respect to such product.

Id.

70. *See Shamrock Oil & Gas Corp. v. Commissioner*, 35 T.C. 979 (1961), *aff'd*, 346 F.2d 377 (5th Cir.), *cert. denied*, 382 U.S. 892 (1965). The court held that gross income from a sour well (natural gas containing sulfur) is the amount for which the taxpayer sells the sour oil or gas in the immediate vicinity of the well, or, if his production is manufactured, converted or transported from the immediate vicinity of the well before the sale, the representative market or field price of the sour oil or gas. *Id.* at 1036. *See also Consumers Natural Gas Co. v. Commissioner*, 78 F.2d 161 (2d Cir. 1935); *Greensboro Gas Co. v. Commissioner*, 79 F.2d 701 (3d Cir. 1935); *Signal Gasoline Corp. v. Commissioner*, 77 F.2d 728 (9th Cir. 1935).

71. By-products are defined as "something produced . . . in addition to the principal product."

The position of the Internal Revenue Service would simplify the depletion calculation as well as the calculation of other deductions⁷² but would complicate deduction calculations for a sulfur well which also produces small amounts of natural gas. The position of the Internal Revenue Service effectively denies that a producing well should be treated as two wells when oil or natural gas, and another mineral are produced.⁷³ Therefore, the taxpayer could not separate the two minerals, depleting the sulfur under I.R.C. section 613(b) and the oil under section 612,⁷⁴ because that would indicate that the sulfur is separately depletable. However, I.R.C. sections 613(d) and 613A do not allow percentage depletion of oil and gas for most producers, so the taxpayer could not deplete the entire "sulfur well" under the sulfur rates of I.R.C. section 613(b).⁷⁵ The only conceivable solution would be to allow depletion of the natural gas portion of the well under the "all other minerals" category of section 613.⁷⁶ This solution is far from perfect, however, since it treats natural gas produced from a "sulfur well," which would be depletable, differently than natural gas produced from a gas well, which is not generally depletable.

VI. SUGGESTIONS

One potential solution to the problems caused by separately depleting the by-products or by depleting all by-products under the oil and gas well provisions would be to classify all well production in a gaseous phase as "gas" for purposes of I.R.C. sections 263(c), 611, 613, and 613A. Although some disagreement might arise over what constitutes a "gas," a statutory definition would easily eliminate this hurdle. For example, "gas" could be defined as all matter occurring naturally in a gaseous phase at a certain temperature and elevation. Classifying all gas as "gas" could greatly simplify the accounting chore necessary to benefit from various tax deductions.

Several cases support this "all gas is gas" approach,⁷⁷ but the Internal Revenue Service is effectively precluded from making this argument

WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 152 (1983). Since sulfur is a by-product of some gas wells, it would necessarily constitute part of the gas stream produced at the well head.

72. See *supra* notes 54-65 and accompanying text.

73. Tech. Adv. Mem. 85-01-008 (Sept. 21, 1984).

74. Oil and gas generally cannot benefit from percentage depletion under I.R.C. § 613 (1986). See *supra* notes 1-5 and accompanying text.

75. See *supra* notes 1-3 and accompanying text; *supra* note 17.

76. I.R.C. § 613(b)(7) (1986).

77. See, e.g., *Northern Natural Gas Co. v. Grounds*, 292 F. Supp. 619 (D. Kan. 1968), *aff'd in*

unless it retracts a 1982 Revenue Ruling.⁷⁸ The Internal Revenue Service stated in that ruling that carbon dioxide produced from a well is subject to percentage depletion for "all other minerals" under I.R.C. section 613(b)(7) and not percentage depletion for natural gas.⁷⁹ The cases preceding the 1982 Revenue Ruling generally held that wells which produced gases such as carbon dioxide and helium should be governed by statutes dealing with gas wells. Thus, any well containing products that naturally occur in a gaseous phase would be entirely subject to the I.R.C. gas well provisions.⁸⁰

While depleting all wells which contain gaseous products under the gas well provisions of the I.R.C. would provide for simplification, such treatment would not be advantageous for most producers because their depletion deductions would be further restricted. Other gases such as carbon dioxide and helium which are currently depletable would fall under the general classification of "oil and gas wells" and would generally be no longer depletable.⁸¹

VII. CONCLUSION

The "all gas is gas" approach would appear to be acceptable except that producers would lose percentage depletion deductions available to them under the current system. Classification of by-products of an oil or gas well under their separate mineral classifications of I.R.C. section 613(b) would further complicate an already complex area of tax law, causing producers and operators to allocate between the two minerals the amounts paid for exploration and intangible drilling costs. Other allocations would be necessary for other deductions. The position of the Internal Revenue Service is untenable in the case of a sulfur well which also produces some natural gas. Thus, no solution appears to address all the

part, rev'd in part, 441 F.2d 704 (10th Cir.), *cert. denied*, 404 U.S. 951 (1971); *Reich v. Commissioner* 52 T.C. 700 (1969), *aff'd*, 454 F.2d 1157 (9th Cir. 1972); *Navajo Tribe of Indians v. United States*, 364 F.2d 320 (Ct. Cl. 1966).

78. Rev. Rul. 82-17, 1982-1 C.B. 95. The Internal Revenue Service stated that carbon dioxide "produced from a well is subject to percentage depletion at the rate of 14 percent as a mineral described in the term 'all other minerals'" in I.R.C. § 613(b)(7) (1986). The reasoning of the Internal Revenue Service is obvious in the following excerpt: "Although in a physical sense CO₂ [carbon dioxide] is a gas, it is not the gas referred to in the term 'oil and gas wells' in sections 263(c), 611, 613 and 613A of the Code. The gas referred to in these sections is hydrocarbon gas." *Id.*

79. *Id.*

80. *See supra* note 77.

81. For example, carbon dioxide is currently depletable under the "all other minerals" category of I.R.C. § 613(b)(7) (1986). *See supra* note 78 and accompanying text.

problems in the area of percentage depletion of oil and gas well by-products.

Perhaps the best solution would be an "all gas is gas" approach coupled with legislation which would increase the availability of percentage depletion for oil and gas wells to every producer. At present, percentage depletion is generally available only for small independent producers. If this availability were widened to include all producers, the "all gas is gas" approach would face little argument. The producer would still benefit from percentage depletion and would not face the task of numerous allocations for various deductions. One of the original congressional justifications for the percentage depletion for oil and gas was to protect this country from dependency on foreign oil. This reasoning would appear to have some merit. In an era in which many wells have been shut-in or plugged due to declining oil prices, some producers may need tax incentives to keep them in business. Domestic production is necessary to protect this country from dependency on foreign oil. Such a dependency was dramatically illustrated in the mid-1970's. Thus, Congress should address this and similar issues affecting oil and gas producers with the goal of domestic self-sufficiency in mind.

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