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COMMISSIONER v. ENGLE: DEPLETION ON PREPRODUCTION RECEIPTS—SUPREME COURT REVIVES FEDERAL SUBSIDY FOR NONPRODUCING OIL AND GAS LEASES

I. INTRODUCTION

The tax law allows producers of oil and gas an annual depletion[1] deduction against the income generated from oil and gas property.[2] Taxpayers may deduct from their taxable incomes the larger of two depletion allowances: cost or percentage.[3] Under the cost method, taxpayers recover their adjusted basis[4] in an oil and gas interest over its productive life.[5] Under the percentage method, taxpayers deduct a statutory per-

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1. Depletion is the exhaustion of a natural resource usually by severance or production. *See* United States v. Ludey, 274 U.S. 295, 302 (1927) (cost depletion permitted as a deduction from gross income even though such depletion is necessarily a rough estimate); Lynch v. Alworth-Stephens Co., 267 U.S. 364, 368-70 (1925) (leasehold interest held sufficient property interest to give rise to depletion allowance). Oil and gas reserves are generally depleted by drilling wells followed by production. *See generally* 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW 211-12 (1984).

2. I.R.C. §§ 611, 612, 613, 613A (1982).

Federal tax law provides taxpayers with a depletion allowance as a means of cost recovery corresponding to the production of income from their mineral interests. In Anderson v. Helvering, 310 U.S. 404, 407-08 (1940) (proceeds from oil and gas production paid to lease vendor in connection with sale of lease includable in vendee's gross income), the Supreme Court stated:

> Oil and gas reserves like other minerals in place, are recognized as wasting assets. The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. . . . 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 emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed by the production of gross income through severance.

See also, e.g., Lee v. Commissioner, 126 F.2d 825, 825 (5th Cir. 1942); Badger Oil Co. v. Commissioner, 118 F.2d 791, 793 (5th Cir. 1941); Burke v. Commissioner, 5 T.C. 1167, 1174 (1945); Nelson Land & Oil Co., 3 B.T.A. 315, 325-26 (1926); Missouri-Lincoln Trust Co. v. Commissioner, 2 T.C.M. (CCH) 427, 429 (1943).

3. I.R.C. § 613(a) (1982).

4. *Id.* § 612. Section 612 provides that "the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis . . . for the purpose of determining the gain upon the sale or other disposition of such property." *Id.* For the statutory provisions defining "adjusted basis," see *id.* §§ 1011-1016 (1982 & Supp. 1984).

5. *Id.* § 611(a). Treas. Reg. § 1.611-2(a)(1) (1960) provides the following rule for computing cost depletion:

The basis upon which cost depletion is to be allowed in respect of any mineral prop-

centage of the gross income generated by their oil and gas interest.[6]

Two theories underlie the depletion deduction scheme. One theory is that the taxpayer is gradually selling his interest in the property, thereby recovering his invested capital[7] as the oil and gas are extracted and sold.[8] This theory applies to cost depletion because the deduction is limited to the historic cost of the taxpayer's investment. The second theory is that the deduction functions as a federal subsidy stimulating additional exploration and production of oil and gas.[9] This theory applies to

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> erty is the basis provided for in section 612 . . . . After the amount of such basis applicable to the mineral property has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year . . . , and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year . . . .

Id. Thus, in summary, cost depletion is calculated by a unit of sale method in which the adjusted basis of the mineral interest is divided by the estimated recoverable reserves. This amount is then multiplied by the number of units sold during the taxable year.

6. I.R.C. § 613(a) (1982). Section 613(a) provides, in pertinent part:

> In the case of . . . mines, wells, and other natural deposits . . . , the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion).

Id. For oil and gas production occurring during the 1984 calendar year and beyond, the statutory percentage rate is 15%. *Id.* § 613A(c)(5).

Prior to the Tax Reduction Act of 1975, *infra* note 15, all taxpayers owning an interest in oil and gas property were entitled to deduct percentage depletion under I.R.C. § 613. Under the 1975 Act, which added § 613A to the Internal Revenue Code, the percentage depletion allowance was limited to a narrow range of taxpayers, most notably, independent producers and royalty owners. The Act also limited the quantity of oil and gas production which is available for percentage depletion and reduced the oil and gas percentage depletion rate. For further discussion of § 613A, see *infra* notes 17-19.

7. Under I.R.C. § 612, a taxpayer recovers his invested capital by means of depleting a portion of his "adjusted basis," *supra* note 4, in the property. I.R.C. § 612 (1982).

8. United States v. Ludey, 274 U.S. 295, 302 (1927); *see also supra* note 1. In Commissioner v. I. A. O'Shaughnessy, Inc., 124 F.2d 33 (10th Cir. 1941) (vendor's contractual right to proceed with sale of oil and gas interest contingent upon future oil and gas production held depletable economic oil and gas interest in hands of vendor), the court found that Congress granted to taxpayers the depletion deduction to avoid the taxation of capital. The court stated that "[i]t is clear that it was the Congressional purpose to allow return of capital through statutory depletion from the date of the acquisition of the depletable interest, so long as gross income is realized dependent upon the production of oil or gas." *Id.* at 37. *Cf.* Anderson v. Helvering, 310 U.S. 404, 407-08 (1940); *see also supra* note 2.

Although cost depletion is limited to the taxpayer's adjusted basis in his oil and gas interest, percentage depletion usually exceeds the amount of capital invested, and therefore does not support the return of capital theory. For further discussion, see *infra* notes 9-11 and accompanying text.

9. *See* Landis, *The Impact of the Income Tax Laws on the Energy Crisis: Oil and Congress Don't Mix*, 64 CALIF. L. REV. 1040, 1060-61 (1976); Baker, *The Nature of Depletable Income*, 7 TAX. L. REV. 267, 270-71 (1952).

percentage depletion because the taxpayer is allowed a deduction in excess of his investment cost recovery. In effect, the taxpayer receives income free of tax to the extent that the percentage depletion amount exceeds the amount otherwise allowable under cost depletion.[10] Thus, percentage depletion subsidizes exploration and development of oil and gas by providing producers with tax-free income, thereby increasing the availability of capital for reinvestment.[11]

For many years, the percentage depletion deduction had come under congressional attack because the major oil companies, availing themselves of the deduction, were reaping significant amounts of tax-free income.[12] Numerous economic studies were published indicating that the incentive to develop new oil was not significantly enhanced by percentage depletion.[13] In 1969, Congress reduced the percentage depletion rate from 27.5% to 22%.[14] Finally, in its Tax Reduction Act of 1975,[15] Congress added section 613A to the Internal Revenue Code[16] which repealed the percentage depletion deduction on foreign oil and gas produc-

10. The percentage depletion deduction, however, reduces the taxpayer's adjusted basis in his oil and gas interest. I.R.C. § 1016(a)(2) (1982); Treas. Reg. § 1.1016-3(a)(1) (1957). Thus, the deduction may result in increasing the taxpayer's gain, or reducing his loss, upon disposition of his oil and gas interest. Further, the excess of the allowable depletion deduction over the taxpayer's adjusted basis is a tax preference item under I.R.C. § 57(a)(8) (1982). Thus, the deduction may trigger or increase a noncorporate taxpayer's alternative minimum tax under I.R.C. § 55 or a corporate taxpayer's minimum tax under I.R.C. § 56.

As a tax preference item, the percentage depletion deduction may have a curious multiplying effect when combined with the tax preference on excess intangible drilling costs (IDC). Excess IDC is calculated on net income from an oil and gas interest after the depletion allowance is deducted. I.R.C. § 57(a)(11)(C) (1982). Hence, percentage depletion as a tax preference item will, in turn, increase a taxpayer's IDC. The overall effect is that one additional dollar of percentage depletion preference may result in two additional dollars of total preferences. It is appropriate that the tax benefit rule under I.R.C. § 58(h) be applied under these circumstances since "the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax . . . ." I.R.C. § 58(h) (1982); ARTHUR YOUNG'S OIL & GAS FEDERAL INCOME TAXATION 356 (J. Houghton 22d ed. 1984).

11. *See* Landis, *supra* note 9, at 1060; Baker, *supra* note 9, at 270-71. The subsidy theory presumes that the taxpayer will reinvest the additional cash flow generated by his tax-free income in further exploration and development of oil and gas. The Internal Revenue Code, however, requires no such reinvestment as a requirement for deducting the percentage depletion allowance. To the extent that percentage depletion is allowed on preproduction receipts, percentage depletion may actually result in a deferral of oil and gas production by subsidizing the holding costs of an oil and gas lease. For further discussion, see *infra* note 217 and accompanying text.

12. *See* Landis, *supra* note 9, at 1061.

13. Landis, *supra* note 9, at 1062.

14. Pub. L. No. 91-172 § 501, 83 Stat. 487, 629 (1969).

15. Pub. L. No. 94-12, 89 Stat. 26 (1975) (applying to taxable years ending after December 31, 1974).

16. All references are to the Internal Revenue Code of 1954, as amended.

tion and severely restricted the deduction on domestic oil and gas production.[17]

Although section 613A preserved percentage depletion for independent producers and royalty owners, it required that the deduction be computed "with respect to so much of the taxpayer's average daily production" as does not exceed the taxpayer's depletable oil and gas quantity.[18] The statute limited the taxpayer's depletable oil quantity to an average daily production amount of 2,000 barrels declining to 1,000 barrels over a five year period.[19] The statute's provision of allowing per-

17. I.R.C. § 613A (1982 & Supp. 1984). Section 613A(a) provides for a general repeal of percentage depletion on oil and gas receipts. *Id.* § 613A(a) (1982). This subsection states: "Except as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613." *Id.*

Section 613A(b)-(c) provides for specific exemptions from the repeal with respect to domestic oil and gas production. *Id.* § 613A(b)-(c) (1982 & Supp. 1984). Subsection 613A(b) exempts production from domestic wells with respect to regulated natural gas, natural gas sold under fixed contract and natural gas from geopressured brine. *Id.* § 613A(b) (1982). Subsection 613A(c) exempts independent producers and royalty owners. *Id.* § 613A(c) (1982 & Supp. 1984).

Section 613A(c) grants to all producers of oil and gas the status of independent producer or royalty owner other than those producers specifically excluded from this status under § 613A(d). *Id.* § 613A(c)-(d). Those excluded under § 613A(d) include oil and gas retailers and refiners. *Id.* § 613A(d)(2), 613A(d)(4). Section 613A(d)(2) defines retailers as those

> who directly, or through a related person, [sell] oil or natural gas . . . , or any product derived from oil or natural gas . . .
> (A) through any retail outlet operated by the taxpayer or a related person, or
> (B) to any person—
> (i) obligated under an agreement . . . with the taxpayer . . . to use a trademark . . . owned by such taxpayer . . . or
> (ii) given authority, pursuant to an agreement . . . with the taxpayer . . . to occupy any retail outlet owned . . . by the taxpayer . . . .

Id. § 613A(d)(2). However, retailers with gross receipts not exceeding $5,000,000 from their retail operations during the taxable year are specifically not excluded from the § 613A(c) exemption. *Id.*

Section 613A(d)(4) defines refiners as those who engage "in the refining of crude oil . . . if on any day during the taxable year the refinery runs of the taxpayer . . . exceed 50,000 barrels." *Id.* § 613A(d)(4) (1982).

Hereinafter, retailers and refiners satisfying the requirements of § 613A(d) will be collectively referred to as the major integrated oil companies.

18. *Id.* § 613A(c)(1). The full text of § 613A(c)(1) provides the following:

> Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—
> (A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and
> (B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;
> and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

Id.

19. *Id.* § 613A(c)(3) (1982 & Supp. 1984). The depletable quantity limitation of 2,000

centage depletion "with respect to . . . average daily production" immediately raised the following issue: Does the Act allow a percentage depletion deduction during a taxable year where the taxpayer has received advance royalty[20] and lease bonus[21] income even though there has been no actual oil and gas production?

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barrels applies to the aggregate production of both oil and gas. *Id.* § 613A(c)(4) (1982). Under § 613A(d), gas volume is equated to barrels in a ratio of 6,000 cubic feet of gas to one barrel. *Id.* The statute further limited the percentage depletion allowance by gradually reducing the percentage depletion rate on primary oil and gas production from 22% to 15% over a 10 year period. *Id.* § 613A(c)(5). The percentage depletion allowance on secondary/tertiary production remained at a 22% rate through the end of 1983. *Id.* § 613A(c)(6)(C). Beginning in 1984, the percentage depletion rate on secondary/tertiary production dropped to 15%, which is equal to the 1984 percentage depletion rate on primary production. *Id.* § 613A(c)(3)(A)(ii) (1982 & Supp. 1984). For an illustration of the tax impact of the declining depletable quantity limitation and percentage depletion rates, see Table I *infra* note 213.

20. An advance royalty is a prepayment collected by a mineral lessor from the lessee prior to mineral production. The lessee offsets this prepayment against future royalty payments owing to the lessor. 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, 24-25 (1984). For further discussion and comparison with lease bonus payments, see *infra* note 21.

21. A lease bonus payment is typically cash in consideration for the execution of a mineral lease paid by the lessee to the lessor. 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, 80 (1984).

In federal income taxation, the terms "advance royalty" and "lease bonus" are not precisely defined and, at times, have been used interchangeably. Note, *Taxation—Percentage Depletion Not Available With Regard to Advance Royalties Received on Non-Producing Oil and Gas Lease,* 56 TULANE L. REV. 1082, 1087 n.33 (1982). One author recently provided an excellent comparative analysis of lease bonus and advance royalty receipts as follows:

> Lease bonuses are amounts received by a lessor . . . in consideration for entering into a mineral lease, which is a transaction whereby minerals in place and the right to exploit the minerals are conveyed to a lessee . . . . The lessor reserves a right to share in mineral production for the life of the property free of cost, expense and liability. The interest conveyed to the lessee in a mineral leasing transaction is referred to as the working interest (which is burdened with the costs of exploration, development and production), and the interest reserved by the lessor is a royalty.
>
> An advance royalty is . . . an amount that is paid in advance to a mineral lessor against future entitlements to royalty payments. As the minerals actually are produced and the prescribed royalties become payable, the amounts paid as advance royalties are offset against the lessee's obligation to pay the prescribed royalty. The offset may be based on dollar amounts or units of production. For example, a lessor might retain a one-eighth royalty in an oil and gas leasing transaction payable in advance each year to the extent of $10,000, recoupable out of production attributable to the royalty in the succeeding year or years. If the offset is measured in dollars, then the first $10,000 of royalty production in each year (and perhaps more if the recoupment is cumulative) would be retained by the lessee to recoup his advance payment. In the alternative, the advance royalty could be stated in terms of a number of barrels, or the $10,000 amount could be converted to barrels at a stipulated price, and the recoupment each year could relate to a number of barrels of oil rather than a dollar amount. It is this recoupment by the lessee of prepaid amounts that distinguishes an advance royalty from a [lease] bonus, as to which there is no specific recoupment.

DeBerry, *Supreme Court in* Engle *allows percentage depletion on bonuses and advance royalties,* 60 J. TAX'N 274, 274 (1984).

Addressing this issue, the Internal Revenue Service[22] took the position that advance royalty and lease bonus receipts are eligible for percentage depletion only to the extent that these receipts are attributable to contemporaneous oil and gas production.[23] Thus, according to the IRS, section 613A's depletable quantity clause rendered actual oil and gas production during the taxable year a prerequisite to any percentage depletion deduction.

In *Commissioner v. Engle*[24] the Supreme Court held in a five to four decision that advance royalty and lease bonus receipts are eligible for the percentage depletion allowance under section 613A(c) despite the absence of actual oil and gas production during the taxable year.[25] Pointing out that percentage depletion was allowable on advance royalties and lease bonuses prior to the enactment of section 613A, the majority stated that "it [is] clear . . . that Congress did not mean . . . to withdraw the percentage depletion allowance on lease bonus or advance royalty income arising from oil and gas properties."[26]

In reaching its decision, the Court emphasized that "[s]ection 613A's goal . . . was to subsidize the combined efforts of small producers and royalty owners in the exploration and production of the Nation's oil and gas resources,"[27] thereby increasing domestic production.[28] The percentage depletion allowance on advance royalty and lease bonus receipts would also enhance domestic production by means of risk spread-

22. Hereinafter referred to as "the IRS."

23. Prop. Treas. Reg. § 1.613A-7(f), 42 Fed. Reg. 24,287 (1977), *see infra* note 160; Rev. Rul. 81-44, 1981-1 C.B. 384, *see infra* note 161. This is in stark contrast to prior Supreme Court decisions which held that advance royalty and lease bonus receipts were eligible for the percentage depletion allowance. *See infra* notes 144-50 and accompanying text.

24. 464 U.S. 206 (1984), *aff'g* 677 F.2d 594 (7th Cir. 1982), *rev'g* 76 T.C. 915 (1981), *rev'g and remanding* Farmar v. United States, 689 F.2d 1017 (Ct. Cl. 1982).

25. *Engle*, 464 U.S. at 224. The Court stated, however, that it would not render a decision on the timing of the deduction because the issue was not raised by any of the parties. *Id.* at 227. The Court deferred to the Commissioner to determine the timing of the deduction, suggesting that the deduction could be deferred until a taxable year within which actual production occurs. *Id.* at 226-27. Alternatively, the Court observed that the deduction could be taken within the current year and then adjusted in future years by means of amended income tax returns. *Id.* at 226.

26. *Id.* at 223-24. Because the Court split five to four in its decision, in the opinion of at least four Supreme Court Justices it is not "clear" that "Congress did not mean . . . to withdraw the percentage depletion allowance on lease bonus or advance royalty income." *Id.*

27. *Id.* at 218. The majority also acknowledged that Congress' repeal of percentage depletion under § 613A was in response to "the alleged excessive profits that major integrated oil companies were earning." *Id.* at 217. However, the majority emphasized that the "goal" of § 613A was to subsidize small producers and royalty owners. *Id.* at 218.

28. *Id.* at 217-18 & n.15.

ing between small and large producers.[29] In turn, increased domestic production would help to counteract the United States' growing dependence on foreign energy sources.[30]

This Note will challenge the Court's view that section 613A's essential purpose was to provide a subsidy for small producers and royalty owners, thereby increasing domestic production. Further, any risk spreading between small and large producers resulting from the percentage depletion allowance on advance royalties and lease bonuses would defeat a prevailing goal of the statute, namely, denying percentage depletion to large integrated oil companies. Finally, contrary to the intent of the Court, the decision may provide significant financial incentive for deferring domestic oil and gas production.

II. *COMMISSIONER V. ENGLE*

A. Statement of the Case

The *Engle* decision consolidates two cases: *Commissioner v. Engle* and *Farmar v. United States.*[31]

During 1975, Fred Engle and his wife assigned their oil and gas lease to third parties, while retaining overriding royalties. As partial consideration of these assignments, the Engles received $7,600 in advance royalties. These royalties constituted the entire income that the Engles received from the property in 1975 because there was no oil and gas production that year. On their joint federal income tax return for 1975, the Engles claimed a percentage depletion deduction equal to 22% of the advance royalties.[32] The Commissioner of the Internal Revenue[33] disallowed the deduction because the advance royalties were not received "with respect to" any "average daily production" of oil and gas.[34] The Tax Court upheld the determination of the Commissioner.[35] The Seventh Circuit Court of Appeals reversed in favor of the Engles.[36] The United States Supreme Court affirmed.[37]

Also during 1975, the families of Philip D. Farmar and A. A. Sugg leased as joint owners their oil and gas interests to various lessees. Under

29. *Id.* at 218-19 & n.17. For a discussion of risk spreading, see *infra* note 61 and accompanying text.
30. *Engle*, 464 U.S. at 217.
31. 464 U.S. 206 (1984).
32. *Id.* at 212.
33. Hereinafter referred to as "the Commissioner."
34. *Engle*, 464 U.S. at 212.
35. Engle v. Commissioner, 76 T.C. 915, 927 (1981).
36. Engle v. Commissioner, 677 F.2d 594, 602 (7th Cir. 1982).
37. *Engle*, 464 U.S. at 227-28.

the leases, Farmar and Sugg were to receive both royalties from oil and gas produced and annual cash bonuses even if no oil and gas were produced. In 1976, oil and gas were discovered and produced in substantial amounts on the property covered by the lessees. Farmar and Sugg claimed percentage depletion deductions on both the bonuses and royalties received in that year.[38] The Commissioner disallowed the percentage depletion deduction on the lease bonuses, because income of this type was not received "with respect to" any "average daily production."[39] After paying the assessed tax deficiencies, Farmar and Sugg filed suit for refund in the United States Court of Claims, which held for the Commissioner.[40] The United States Supreme Court reversed and remanded.[41]

B. The Reasoning of the Majority

In reaching the conclusion that advance royalty and lease bonus receipts are available for percentage depletion, Justice O'Connor, writing for the majority,[42] first examined the language of section 613A. The majority observed that the statute's language authorizes independent producers and royalty owners to take an allowance for percentage depletion in accordance with section 613's "gross income from property"[43] concept.[44] Section 613A further provides that the allowance must be "with respect to . . . so much of the taxpayer's average daily production . . . as does not exceed the taxpayer's depletable . . . quantity."[45] Finally, the statute repeatedly refers to "production" during the "taxable year."[46] Noting that these references could not have been completely inadvertent, the majority explored three possible interpretations of the statute.

1. Three possible interpretations of section 613A

The first interpretation of section 613A reflects the position of the Commissioner. The statute's repeated references to the taxpayer's "aver-

38. *Id.* at 213.
39. *Id.*
40. Farmar v. United States, 689 F.2d 1017, 1025 (Ct. Cl. 1982).
41. *Engle*, 464 U.S. at 228.
42. *Id.* at 208. Justice O'Connor was joined by Chief Justice Burger and Justices Powell, Rehnquist and Stevens. *Id.*
43. *Supra* note 6 (citing pertinent part of I.R.C. § 613(a) (1982)).
44. Commissioner v. Engle, 464 U.S. 206, 214-15 (1984). Section 613A(c)(1) provides that "the allowance for depletion under section 611 shall be computed in accordance with section 613." I.R.C. § 613A(c)(1) (1982). Section 613(a), *supra* note 6, provides the general rule for percentage depletion with respect to all eligible natural resources.
45. I.R.C. § 613A(c)(1) (1982). The depletable quantity limitation is provided under I.R.C. § 613A(c)(3) (1982 & Supp. 1984). *See supra* notes 18-19 and accompanying text.
46. *Engle*, 464 U.S. at 215; *see infra* notes 47-48.

age daily production,"[47] "aggregate production," "production during the taxable year" and "production during the calendar year"[48] redefines and limits depletable "gross income from property" to income attributable to oil and gas production during the taxable year.[49] Therefore, because advance royalty and lease bonus receipts are not attributable to "*specific*" production during any taxable year, Congress could not have intended that such receipts would be eligible for percentage depletion under section 613A.[50]

The second and third interpretations of section 613A favor the view of the taxpayers. These interpretations share the common ground that the statute's reference to "average daily production" constitutes "a limitation on the amount of, rather than a prerequisite to, the deduction a taxpayer may claim."[51] The statute's requirement that the depletion deduction be calculated "with respect to . . . average daily production" is "simply the pre-1975 recapture requirement reenacted: depletion deductions must always 'be with respect to' actual or prospective extraction."[52] Because advance royalty and lease bonus receipts constitute "income arising from the property,"[53] these receipts are eligible for percentage depletion as long as they do not exceed section 613A's depletable quantity limitation and production eventually occurs on the property.[54]

Although the second and third interpretations of the statute support the eligibility of preproduction receipts for percentage depletion, they differ from one another with respect to the timing of the deduction. Under the second interpretation, the percentage depletion deduction attributable to preproduction receipts would be available during the taxable year in which such payments are received.[55] Under the third interpretation, the percentage depletion deduction attributable to preproduction receipts would be deferred to a year in which it could be attributed to actual production. The deferred deduction "would be capitalized and amortized against income in years of actual extraction, subject to the rates and

47. I.R.C. § 613A(c)(1) (1982).

48. *Id.* § 613A(c)(2)-(10) (1982 & Supp. 1984).

49. *Engle*, 464 U.S. at 215.

50. *Id.* at 215-16 (emphasis in original) (citation omitted).

51. *Id.* at 216.

52. *Id.*

53. *Id.* Section 613, providing the general rule for percentage depletion, does not incorporate the phrase "income arising from the property" but rather the phrase "gross income from the property." I.R.C. § 613(a) (1982). Presumably, the majority is referring to this latter phrase as found in the statute.

54. *Engle*, 464 U.S. at 216.

55. *Id.*

depletable quantities limitations applicable in those subsequent years."[56]

The majority noted that all of these interpretations may be reconciled with the language of the statute as a whole and provide meaning to the statute's repeated references to "production" during the "taxable year."[57] In light of these alternative interpretations, the majority stated that the Court's "duty then is 'to find that interpretation which can most fairly be said to be imbedded in the statute, in the sense of being most harmonious with its scheme and with the general purposes that Congress manifested.' "[58] Thus, the majority considered whether the statute is more harmonious with the Commissioner's interpretation which completely denies percentage depletion on advance royalty and lease bonus receipts, or with the second and third interpretations which allow percentage depletion on such receipts but differ as to the timing of the deduction. To this end, the majority analyzed the statute in terms of its purpose and historic context, the legislative process leading to its enactment, the statutory language itself and the practical problems of administration.

2. Purpose and historic context

First the majority examined section 613A's purpose and historic context. The majority observed that section 613A was enacted in response to the nation's growing dependence on foreign oil and to the alleged excessive profits accruing to the major integrated oil companies. Congress sought to encourage both domestic oil and gas production and to improve the competitive position of the small oil and gas producers vis-a-vis the major integrated oil companies.[59] Thus, the majority concluded that any reasonable interpretation of section 613A must harmonize with the statute's goal of "subsidiz[ing] the combined efforts of small producers and royalty owners in the exploration and production of the Nation's oil and gas resources," thereby increasing domestic production.[60]

The majority contended that the Commissioner's interpretation frustrates the statute's goal of increasing domestic oil and gas production by small producers. By eliminating percentage depletion on advance royalty and lease bonus receipts, "lessors and lessees interested in favorable

56. *Id.* at 217 (footnote omitted).

57. *Id.*

58. *Id.* (quoting NLRB v. Lion Oil Co., 352 U.S. 282, 297 (1957) (Frankfurter, J., concurring in part and dissenting in part)). *See infra* note 168.

59. *Engle*, 464 U.S. at 217-18.

60. *Id.* at 218.

tax benefits [would] not use financing arrangements that provide for prepayments on production, that spread income to nonproduction periods or, more importantly, that shift the risks of nonproduction to the parties better able to bear them."[61] Accordingly, lessors would begin demanding increased production royalties to offset increased expenses related to delayed receipts, income bunching and risk bearing. Lessees, burdened with increased preproduction lease payments, would have less available capital for exploration and development. In the long run, domestic oil and gas production would decrease. Therefore, the Commissioner's interpretation fails to comport with the statute's goal of increasing domestic oil and gas production by small producers.[62]

In contrast, the majority pointed out that the second and third interpretations, which allow percentage depletion on preproduction receipts, "makes available the maximum public subsidy that Congress was willing to provide."[63] Maximizing the depletion subsidy, in turn, maximizes the incentive for increased oil and gas exploration and development. In the long run, domestic oil and gas production would increase. Therefore, the Court found that only the second and third interpretations harmonize with the statute's goal.[64]

3. Legislative process

The majority next examined the legislative process by which section 613A was enacted. When the legislation resulting in the addition of section 613A to the Internal Revenue Code first was introduced, neither the bill, H.R. 2166,[65] nor the accompanying House Ways and Means Committee report[66] provided for the repeal of the percentage depletion deduction for oil and gas production.[67] It was only when H.R. 2166 reached

61. *Id.* (footnote omitted). In a footnote, the majority expanded this argument as follows:

> Lease bonuses generally are not refundable to lessees even if no oil or gas is produced from the property. . . . Smaller risk averse lessors, therefore, are likely to prefer these sums certain to uncertain sums, like advance royalties or royalty streams, that either may not materialize or may have to be returned. . . . Conversely, lessees prefer to condition their advance payments on eventual production. . . . But since lessees can spread their risks over many leased properties, they predictably will be willing to pay nonrefundable lease bonuses in exchange for reduced prices on the overall lease arrangements. By pooling risks in this fashion, lessors and lessees, like insurers and insureds, optimize the allocation of resources in the production of oil and gas from the property.

Id. at 218 n.17 (citations omitted).

62. *Id.* at 219.

63. *Id.*

64. *Id.*

65. H.R. 2166, 94th Cong., 1st Sess. (1975).

66. H.R. REP. No. 19, 94th Cong., 1st Sess. (1975).

67. *Engle*, 464 U.S. at 220.

the House floor that the bill was amended to repeal percentage depletion for all classes of producers of oil and gas.[68] When H.R. 2166 subsequently reached the Senate floor, the bill was further amended to exempt independent producers and royalty owners from the repeal of the percentage depletion deduction.[69] With "slight alteration" by the Conference Committee, Congress then enacted H.R. 2166 as amended by the Senate.[70]

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68. 121 CONG. REC. 4651-52 (1975). The majority stated that the House floor amendment "did not contain any of the exemptions ultimately enacted as part of § 613A." *Engle*, 464 U.S. at 220. This is not the case. The House amendment provided an exemption from the percentage depletion repeal for natural gas sold under a fixed contract which eventually became codified at I.R.C. § 613A(b)(1)(B), 613A(b)(3)(A). H.R. CONF. REP. No. 120, 94th Cong., 1st Sess., 67-68 (1975), *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 54, 132-34.

The Conference Committee report elegantly summarizes the legislative history of H.R. 2166, stating in pertinent part:

> PERCENTAGE DEPLETION FOR OIL AND GAS
>
> *House bill.*—The House bill repeals percentage depletion generally for oil or gas produced on or after January 1, 1975. Depletion is continued for natural gas sold under a fixed price contract in effect February 1, 1975, which does not permit price adjustment after that date to reflect repeal of depletion.
>
> . . . .
>
> *Senate amendment.*—Under the Senate amendment, the deduction for percentage depletion is generally eliminated with respect to oil and gas produced on or after January 1, 1975, with certain exceptions. These include the exceptions provided under the House bill. In addition, the Senate amendment retains percentage depletion at 22 percent on a permanent basis for the small independent producer to the extent that his average daily production of oil does not exceed 2,000 barrels a day, or his average daily production of natural gas does not exceed 12,000,000 cubic feet. Where the independent producer has both oil and natural gas production, the exemption must be allocated between the two types of production.
>
> . . . .
>
> *Conference substitute.*—The conference substitute follows the Senate amendment in providing a small producer exemption from the repeal of percentage depletion for oil and gas. Initially the exemption ("depletable oil quantity") is 2,000 barrels of average daily production (or 12,000,000 cubic feet of natural gas). However, the exemption is to be phased down gradually, but not eliminated, so as to minimize the impact of the reduction on small independent producers.
>
> Under the substitute, the exemption is to be reduced 200 barrels a year for 5 years from 1976 through 1980, when the permanent exemption of 1,000 barrels per day will be reached. The depletion rate for oil and gas covered under the small producer exemption will also be phased down gradually from 22 percent. In 1981, the rate will be 20 percent; in 1982, 18 percent; in 1983, 16 percent; and in 1984 the rate will be reduced to a permanent level of 15 percent. . . .
>
> The deduction resulting from the small producer exemption may not exceed 65 percent of the taxpayer's net income from all sources (computed without regard to depletion allowed under the small producer exemption, net operating loss carrybacks and capital loss carrybacks).

Id. at 67-68 (1975), *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 54, 132-34.

69. *Engle*, 464 U.S. at 220. The Senate, however, imposed a limit of 2,000 barrels of average daily oil and gas production that would be eligible for percentage depletion. The Senate left intact the statutory percentage depletion rate of 22%. *See supra* note 68.

70. *Engle*, 464 U.S. at 220. The Conference Committee modified the proposed legislation as follows: (1) the 2,000 barrel per day depletable quantity limitation was reduced by 200

The majority pointed out that neither the Senate nor the Conference Committee, when considering H.R. 2166, suggested that percentage depletion on advance royalties and lease bonuses should be repealed.[71] Rather, both the Senate and the conferees agreed to maintain percentage depletion "in its entirety" for independent producers and royalty owners, subject to the annual depletable quantity limitation.[72] Noting that the Conference Committee in its report stated that the proposed legislation " '*retains* percentage depletion . . . for the small independent producer,' "[73] the Senate and Conference Committee "expressed a clear intent to *retain* the percentage depletion rules as they then existed."[74]

Further, for the past fifty years, under the rule adopted in *Herring v. Commissioner*,[75] advance royalty and lease bonus receipts have been eligible for percentage depletion.[76] The majority professed the principle that " 'Congress is . . . aware of [our long-standing] interpretation of [the] statute and . . . adopt[s] that interpretation when it re-enacts [the] statute without [explicit] change . . . .' "[77] Thus, had Congress intended to eliminate percentage depletion on preproduction receipts it would have addressed more explicitly the Court's prior decisions to the contrary.[78]

Therefore, the majority reasoned that the legislative process by which section 613A was enacted undermines the Commissioner's interpretation which would deny percentage depletion on preproduction receipts. Rather, the legislative process harmonizes only with the second and third interpretations of the statute, which allow percentage depletion on preproduction receipts.[79]

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barrels a year over a five year period to 1,000 barrels of average daily production and (2) the 22% depletion rate was gradually reduced to 15%. These modifications became part of the final version of the legislation, *supra* note 68, codified at I.R.C. § 613A(c)(1)-(3), 613A(c)(5). Although the majority describes these modifications as "slight," Table I *infra* note 213 suggests otherwise, indicating that the Conference Committee's modifications reduce the maximum percentage depletion allowance by 65.9% over a 10 year period.

71. *Engle*, 464 U.S. at 220.

72. *Id.* at 221.

73. *Id.* (quoting H. CONFERENCE REPORT NO. 120, 94th Cong., 1st Sess., 67 (1975) *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 54, 132) (emphasis added by the majority)). *See supra* note 68.

74. *Engle*, 464 U.S. at 221 (emphasis in original). *See supra* note 68.

75. 293 U.S. 322, 324 (1934).

76. For further discussion of *Herring*, see *infra* text accompanying notes 149-50.

77. 464 U.S. at 225 (quoting Lorillard, a Division of Loew's Theatres v. Pons, 434 U.S. 575, 580 (1978) (bracketed portions provided by the *Engle* Court)).

78. *Id.*

79. *Id.* at 224.

4. Statutory language

The majority next examined the text of section 613A itself. With respect to methodology, the majority adopted the principle that

> [t]he true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part.[80]

The majority observed that Congress defined the class of taxpayers exempted from the repeal of percentage depletion in terms of certain production levels.[81] Although section 613A clearly denies percentage depletion attributable to production in excess of the depletable quantity limitation, "nothing in the statute bars percentage depletion on income received prior to actual production."[82] The majority concluded that as long as oil and gas receipts can be allocated to production below the annual depletable quantity limitation, "lease bonus and advance royalty income come within the four corners of the percentage depletion provisions" of section 613A.[83] Therefore, the Commissioner's interpretation of the statute, which denies percentage depletion on preproduction receipts, conflicts with the text of the statute itself. The Court found that, again, only the second and third interpretations of the statute, which allow percentage depletion on preproduction receipts, harmonize with the text of the statute.[84]

5. Practical problems of administration

Finally, the majority considered the practical problems related to the administration of the statute. The majority acknowledged that section 613A's various limitations render accurate calculation of the percentage depletion allowance "difficult" in the absence of actual production during the taxable year.[85] The majority asserted, however, that the Commissioner can resolve these problems by requiring taxpayers to defer percentage depletion deductions to years of actual production or by requiring taxpayers to adjust percentage depletion deductions taken during nonproduction years by filing amended returns in later tax

80. *Id.* at 223 (quoting Helvering v. Morgan's, Inc., 293 U.S. 121, 126 (1934)).
81. *Id.* at 224. For further discussion, see *infra* note 191.
82. *Engle,* 464 U.S. at 224.
83. *Id.*
84. *Id.*
85. *Id.* at 226.

years.[86] The majority further acknowledged that the Commissioner's interpretation "might" render the statute "simpler to administer" by entirely eliminating percentage depletion on preproduction receipts.[87] Simpler administration, however, does not justify adopting a fundamentally "unreasonable" interpretation of statutory language given its history and purpose.[88]

The majority concluded that the Commissioner's interpretation of the statute failed to harmonize with its purpose and historic context, with the legislative process leading to its enactment, and with the text of the statute itself.[89] Acknowledging that the " 'choice among reasonable interpretations [of the statute] is for the Commissioner, not the courts,' " the majority nonetheless found the Commissioner's interpretation unreasonable and therefore would not defer to it.[90] Further, the purpose, legislative history and text of section 613A disclose a clear congressional intent to retain percentage depletion on preproduction receipts. Whatever the practical problems may be in calculating the deduction, these problems may be overcome by appropriate regulations prescribed by the Commissioner.[91] Therefore, the majority held that advance royalty and lease bonus receipts are eligible for percentage depletion under section 613A despite the absence of any actual oil and gas production during the taxable year.[92] Further, the majority declined to render a decision on the timing of the deduction because none of the parties directly raised the issue for the Court's review.[93] Rather, the majority deferred the timing decision to the Commissioner, suggesting that the deduction may be taken currently or deferred until the years of actual production.[94]

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86. *Id.* The majority pointed out that under I.R.C. § 7805(a) (1982), Congress granted the Commissioner "broad authority to prescribe all 'needful rules and regulations' for the enforcement of the [federal] tax laws." *Engle*, 464 U.S. at 227 (citation omitted). Apparently, for the majority, the authority vested in the Commissioner is not so broad as to allow the Commissioner to prescribe the rule of disallowing percentage depletion on preproduction oil and gas receipts.

87. *Engle*, 464 U.S. at 227 (citation omitted).

88. *Id.* The majority stated that although the Commissioner's interpretation "might make the statute 'simpler to administer,' . . . it does so by *ignoring* the language of the statute . . . ." *Id.* (citation omitted) (emphasis added). Curiously, the majority earlier acknowledged that the Commissioner's interpretation could be "*reconciled* with the language of the statute." *Id.* at 217 (emphasis added).

89. *Id.* at 224.

90. *Id.* (quoting National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 488 (1979)).

91. *Id.* at 226.

92. *Id.* at 227-28.

93. *Id.* at 227.

94. *Id.* at 226-27. The majority found support for its suggestion that the percentage depletion deduction may be deferred until the years of actual production in Treas. Reg. § 1.461-1,

C. The Reasoning of the Dissent

Justice Blackmun, writing for the dissent,[95] sided with the Commissioner in asserting that section 613A renders advance royalty and lease bonus receipts ineligible for percentage depletion.[96] The dissent adopted the standard of review that the Commissioner's administrative interpretation is entitled to prevail as long as it is not " 'unreasonable and plainly inconsistent with the revenue statutes.' "[97] The dissent found that the Commissioner's interpretation was consistent with section 613A's language, legislative history and purpose, and that his interpretation was at least as reasonable as the rival interpretations adopted by the majority.[98]

The dissent criticized the majority's conclusion of law as well as its methodological approach to interpreting the Internal Revenue Code. In Part I of its analysis, the dissent examined the statute's language, related administrative problems, legislative history and congressional purpose.[99] The dissent made its own case in support of the Commissioner's position as well as exposing the weaknesses inherent in the majority's argument. In Part II of its analysis, the dissent criticized the majority's methodological approach to interpreting federal tax law.[100]

T.D. 6520, 1961-1 C.B. 52, 62. *Engle*, 464 U.S. at 227. This regulation provides, *inter alia*, that "[i]f an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible . . . for the taxable year in which [it is] made." Treas. Reg. § 1.461-1(a)(1), T.D. 6520, 1961-1 C.B. 52, 62. Although the analogy may be apt, the majority's suggestion nonetheless represents an overturning of the well settled prior law that percentage depletion in the absence of production is currently deductible. Herring v. Commissioner, 293 U.S. 322, 328 (1934). Curiously, the Court failed to note any explicit indication in the language, legislative history or congressional purpose of the 1975 Act which would support this change. In contrast, when refuting the Commissioner's position, the Court observed that, precisely because there was no indication in the language, legislative history or congressional purpose of the 1975 law repealing the allowance for percentage depletion on advance royalties and lease bonuses, the Commissioner's interpretation of the 1975 law overturning prior law was unreasonable. *Engle*, 464 U.S. at 224.

95. Engle v. Commissioner, 464 U.S. 206, 228 (1984) (Blackmun, J., dissenting). Justice Blackmun was joined by Justices Brennan, White, and Marshall. *Id.* (Blackmun, J., dissenting).

96. *Id.* (Blackmun, J., dissenting).

97. *Id.* (Blackmun, J., dissenting) (quoting Bingler v. Johnson, 394 U.S. 741, 750 (1969); Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948)). For further discussion, see *infra* notes 170-71 and accompanying text.

98. *Engle*, 464 U.S. at 228 (Blackmun, J., dissenting).

99. *Id.* at 228-36 (Blackmun, J., dissenting).

100. *Id.* at 236-37 (Blackmun, J., dissenting).

1. Statutory language, administrative problems, legislative history and congressional purpose

In Part I of its analysis, the dissent first examined the language of the statute itself. The dissent observed that section 613A provides that the percentage depletion allowance must be calculated with respect to "average daily production"[101] which the statute defines in terms of "aggregate production of domestic crude oil or natural gas [produced] . . . *during the taxable year*."[102] The dissent pointed out that "taxable year" is defined under section 7701(a)(23) in terms of the calendar or fiscal year "upon the basis of which the taxable income is computed" with respect to income taxes.[103] Where percentage depletion on preproduction receipts is claimed in a calendar or fiscal year in which there is no actual production, as the majority has allowed, the term "taxable year" must "be given a meaning in § 613A(c) different from the one assigned to it by § 7701(23) [sic], because the 'taxable year' defined by § 7701(23) [sic] is one during which no 'aggregate production,' and hence no 'average daily production,' has occurred."[104] Although the majority's interpretation is problematic with respect to the combined reading of sections 613A(c) and 7701(a)(23), the Commissioner's interpretation encounters no such problems. Because the Commissioner would allow no percentage depletion on income received during a taxable year in which there is no production, the meaning of "taxable year" in section 613A remains consistent with section 7701(a)(23)'s definition of "taxable year." Therefore, the majority's interpretation "does not fit the language of § 613A so closely that the Commissioner's interpretation becomes unreasonable on textual grounds."[105]

The dissent next considered the practical administrative problems posed by the majority's interpretation of the statute. Section 613A's depletion limitations are based on factors of actual production quantities, the type of mineral produced, and the nature of the extraction process.[106] Because these factors cannot be determined prior to actual production, a taxpayer who claims percentage depletion on preproduction receipts "cannot possibly establish *ex ante* how many barrels of oil or cubic feet of gas his advance payment represents."[107] In contrast, the Commis-

101. I.R.C. § 613A(c)(2) (1982).

102. *Id.* § 613A(c)(2)(A); *Engle*, 464 U.S. at 229 (Blackmun, J., dissenting) (emphasis provided by the dissent).

103. I.R.C. § 7701(a)(23) (1982); *Engle*, 464 U.S. at 229 (Blackmun, J., dissenting).

104. *Engle*, 464 U.S. at 229 (Blackmun, J., dissenting).

105. *Id.* (Blackmun, J., dissenting).

106. I.R.C. § 613A(b)-(c) (1982). *See supra* notes 17-19.

107. *Engle*, 464 U.S. at 229 (Blackmun, J., dissenting).

sioner's interpretation which would eliminate percentage depletion on preproduction receipts poses no such practical administrative problems.[108]

The majority has asserted that the Commissioner can overcome the problem of calculating section 613A's production limitation with respect to preproduction receipts "in a number of reasonable ways,"[109] such as by requiring taxpayers to defer percentage depletion deductions to years of actual production or by requiring taxpayers to adjust percentage depletion deductions taken during nonproduction years by filing amended returns in later tax years.[110] The dissent provided two responses. First, the dissent contended that deferring the deduction entails its own practical problems with respect to the income limitations of sections 613(a) and 613A(d)(1).[111] Section 613(a) limits percentage depletion to 50% of the taxpayer's taxable income from the property.[112] Section 613A(d)(1) further limits percentage depletion to 65% of the taxpayer's overall taxable income.[113] The dissent stated that it was "unclear" how a taxpayer

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108. *See infra* text following note 222.

109. *Engle*, 464 U.S. at 226.

110. *Id. See supra* notes 85-88 and accompanying text.

111. I.R.C. §§ 613(a), 613A(d)(1) (1982); *Engle*, 464 U.S. at 230 (Blackmun, J., dissenting).

The Internal Revenue Code imposes two separate income limitations upon the oil and gas percentage depletion allowance. First, § 613(a), *supra* note 6, limits a taxpayer's percentage depletion allowance to 50% of his adjusted taxable income derived from any particular oil and gas interest. Section 613(a) does not provide for a carryover or carryback of any percentage depletion in excess of this limitation. Thus, if the taxpayer exceeds this limitation in any taxable year, the excess percentage depletion amount is lost.

Second, § 613A(d)(1), *infra* note 113, limits a taxpayer's percentage depletion allowance to 65% of his overall adjusted taxable income. Unlike § 613(a)'s 50% limitation, § 613A(d)(1) provides that the percentage depletion in excess of the 65% limitation is allowable as a percentage depletion deduction in the following taxable year. The statute does not state whether this excess amount carried over to the following taxable year would once again be subject to the 50% limitation of § 613(a) or whether the taxpayer must produce oil and gas in the following year as a prerequisite to deducting this excess amount. *See generally* ARTHUR YOUNG'S OIL & GAS FEDERAL INCOME TAXATION, 642-43 (J. Houghton 22d ed. 1984).

112. I.R.C. § 613(a) (1982). *See supra* note 6.

113. I.R.C. § 613A(d)(1) (1982). Section 613A(d)(1) (1982) provides, in pertinent part:

> The deduction for the taxable year attributable to the application of subsection (c) shall not exceed 65 percent of the taxpayer's taxable income (reduced in the case of an individual by the zero bracket amount) for the year computed without regard to—
>
> (A) any depletion on production from an oil or gas property which is subject to the provisions of subsection (c),
>
> (B) any net operating loss carryback to the taxable year under section 172,
>
> (C) any capital loss carryback to the taxable year under section 1212, and
>
> (D) in the case of a trust, any distributions to its beneficiary . . . .

If an amount is disallowed as a deduction for the taxable year by reason of application of the preceding sentence, the disallowed amount shall be treated as an amount

would apply these income limitations when the percentage depletion allowance is reported in a year subsequent to the income that gave rise to it.[114]

Second, the majority's assertion that the Commissioner can resolve such practical problems inverts "the normal rationale for judicial deference to" the Commissioner.[115] One rationale for the deference rule is that the Commissioner "is better able than any court, including this one, to assess the practical consequences of particular interpretations and to resolve statutory ambiguities in ways that minimize administrative difficulties."[116] This rationale notwithstanding, the majority "has embraced an interpretation whose practical complications the Court itself recognizes and has left the Commissioner to bring order to the confusion that the Court now has created."[117]

The dissent next examined section 613A's legislative history. In a direct challenge to the majority's view, the dissent found that there is nothing in the statute's legislative history which would render the Commissioner's interpretation unreasonable.[118] Initially, H.R. 2166[119] did not repeal percentage depletion. On the House floor, the bill was amended to repeal percentage depletion in its entirety. When the bill reached the Senate, H.R. 2166 was further amended to exempt small producers from the repeal of percentage depletion.[120] Although some senators sought to completely abolish percentage depletion for small producers over a five year period,[121] the Senate's final version of the bill

allowable as a deduction under subsection (c) for the following taxable year, subject to the application of the preceding sentence to such taxable year.

114. *Engle*, 464 U.S. at 230 (Blackmun, J., dissenting). In making this point, Justice Blackmun quoted Judge Fay, who wrote the dissenting opinion (favorable to the taxpayers) at the Tax Court level. *Id.* at 230 n.1 (Blackmun, J., dissenting). In his opinion, Judge Fay wrote that "if income were recognized in one year and percentage depletion deductions calculated on that income were taken in other years, the amount of deduction limits based on taxable income found in secs. 613(a) and 613(d)(1) would be nonsensical." Engle v. Commissioner, 76 T.C. 915, 945 n.10 (1981) (Fay, J., dissenting), *aff'd*, 677 F.2d 594 (7th Cir. 1982), *rev'd*, 46 U.S. 206 (1984). Justice Blackmun added that "[a]t a minimum, the administrative problems would seem to be multiplied by the allowance carryforward provision of § 613A(d)(1), under which an allowance that is disallowed by the 65 percent ceiling in one taxable year is carried forward to subsequent years." *Engle*, 464 U.S. at 230 n.1 (Blackmun, J., dissenting).

For further discussion of the practical administrative problems related to these income limitations, see *infra* text accompanying notes 238-41.

115. *Engle*, 464 U.S. at 230 (Blackmun, J., dissenting).

116. *Id.* (Blackmun, J., dissenting).

117. *Id.* (Blackmun, J., dissenting).

118. *Id.* (Blackmun, J., dissenting).

119. H.R. 2166, 94th Cong., 1st Sess. (1975).

120. 121 CONG. REC. 4651-52, 4657-58 (1975).

121. *Id.* at 7238-39.

perpetuated percentage depletion for small producers subject to an annual depletable quantity limitation.[122] Subsequently, as a compromise between the House and Senate versions of the bill, the Conference Committee retained the Senate's exemption for small producers but scaled back both the depletable quantity limitation and the depletion rate.[123] Thus, section 613A is the "product" of a major effort by Congress to completely abolish the percentage depletion allowance on oil and gas.[124] The silence of the legislative record regarding the continued availability of percentage depletion on preproduction receipts "is hardly compelling evidence that Congress meant to preserve the status quo in this one incidental respect."[125]

The dissent marshalled three responses to the majority's analysis of the legislative history. First, the majority relied on the Conference Committee's use of the word *"retains"* to conclude that the Senate and the Conference Committee "expressed a clear intent to *retain* the percentage depletion rules as they then existed."[126] The dissent, however, pointed out that the use of the word "retains" fails to clarify whether preproduction receipts are eligible for percentage depletion under section 613A because section 613A(c) "retains" the percentage depletion allowance for independent producers and royalty owners regardless of whether physical extraction is a precondition for the allowance.[127]

Second, the majority stated that the Senate and Conference Committee agreed to maintain percentage depletion "in its entirety" for independent producers and royalty owners who satisfied the various production limitations of section 613A.[128] The dissent emphatically pointed out, however, that the majority had merely observed that Congress preserved percentage depletion for those who were not affected by the changes—"a truism that casts no light on the scope of those changes."[129]

Finally, the majority contended that had Congress intended to eliminate the pre-1975 rule of allowing percentage depletion on preproduction receipts it would have explicitly expressed such an intention.[130] The

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122. *Id.* at 7807-08.

123. H. CONF. REP. NO. 120, 94th Cong., 1st Sess., 68 (1975), *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 54, 133-34. For text of report, see *supra* note 68.

124. *Engle*, 464 U.S. at 231 (Blackmun, J., dissenting).

125. *Id.* at 232 (Blackmun, J., dissenting).

126. *Id.* at 221 (emphasis in original). *See supra* notes 73-74 and accompanying text.

127. *Engle*, 464 U.S. at 232 (Blackmun, J., dissenting) (citation omitted).

128. *Id.* at 221. *See supra* notes 71-72 and accompanying text.

129. *Engle*, 464 U.S. at 232 (Blackmun, J., dissenting).

130. *Id.* at 225. *See supra* notes 75-78 and accompanying text.

dissent, however, retorted that the majority "overlooks not only the haste in which Congress acted but the extent to which § 613A dismantles the entire structure of percentage depletion allowances" upon which the pre-1975 rule rested.[131]

The dissent next examined the congressional purpose underlying section 613A. The dissent did not assert that the Commissioner's interpretation is consistent with the purpose of the statute. Rather, the dissent contended that the Commissioner's interpretation, which would limit the total subsidy available to small producers, is at least not "unreasonable or incorrect [because] § 613A on its face achieves the same result."[132] The dissent developed this argument by briefly summarizing and refuting the majority's analysis.

The majority contended that because section 613A was enacted during a period of national concern over energy shortages and dependence upon foreign oil sources, Congress' fundamental purpose was to increase domestic production of oil and gas by independent producers and royalty owners.[133] The Commissioner's interpretation of the statute, however, would ultimately result in less production than that of the rival interpretations because the Commissioner would completely deny the percentage depletion subsidy related to preproduction receipts. Therefore, according to the majority, the Commissioner's interpretation is inconsistent with the congressional purpose underlying the statute.[134]

The dissent asserted that the majority's analysis "simply ignores the terms and structure of the statute that it purports to construe."[135] Congress could not have intended the statute to induce independent producers to increase production. First, the statute merely preserved an old tax subsidy rather than creating a new one.[136] Second, the subsidy preserved by the statute was not left intact but rather was deliberately scaled

131. *Engle*, 464 U.S. at 233 (Blackmun, J., dissenting) (footnote omitted).

132. *Id.* at 235 (Blackmun, J., dissenting) (footnote omitted). In a footnote, the dissent further clarified this point. The dissent noted that it was not suggesting that simply because Congress limited the percentage depletion allowance for independent producers and royalty owners with respect to quantity, production processes and rates, Congress must also have intended to repeal percentage depletion on preproduction receipts. Rather, the dissent was contending that the fact that Congress substantially limited percentage depletion for independent producers and royalty owners "makes it impossible to dismiss the Commissioner's interpretation of § 613A as 'unreasonable' on the ground that it provides a smaller incentive than rival interpretations." *Id.* at 235 n.5 (Blackmun, J., dissenting).

133. *Id.* at 217-18. *See supra* text accompanying notes 59-60.

134. *Engle*, 464 U.S. at 218-19. *See supra* notes 61-62 and accompanying text.

135. *Engle*, 464 U.S. at 234 (Blackmun, J., dissenting).

136. *Id.* (Blackmun, J., dissenting).

back.[137] Therefore, the dissent concluded, "the fact that Congress substantially limited pre-existing incentives for independent producers makes it impossible to dismiss the Commissioner's interpretation of § 613A as 'unreasonable' on the ground that it provides a smaller incentive than rival interpretations."[138]

2. Methodology

In Part II of its analysis, the dissent criticized the majority's methodological approach to interpreting federal tax law. Although the majority purported to uphold the rule that the " 'choice among reasonable interpretations [of federal tax law] is for the Commissioner, not the courts,' " the majority's rejection of the Commissioner's interpretation fails to comply with this rule on two counts.[139] First, Justice Blackmun observed that the Commissioner's interpretation is compatible with the statute's language and history of legislative compromise, and with the percentage depletion restrictions placed on small producers.[140] Second, the Commissioner's interpretation does not produce the kinds of practical complications produced by the rival interpretations embraced by the majority.[141] Thus, the dissent asserted, the majority "has chosen to honor the rule in the breach."[142] Therefore, the dissent opposed the decision of the majority not simply with respect to "an interpretation of a discrete section of the Internal Revenue Code but . . . [also with respect to] the Court's willingness to displace the Commissioner's interpretation of the tax laws with its own views of tax policy."[143]

III. ANALYSIS

A. *Historical Framework*

Over fifty years ago, the Supreme Court held in *Burnet v. Harmel*[144] that advance royalty and lease bonus receipts constituted depletable income.[145] The Court deemed that such income was attributable to future production of minerals rather than to amounts realized from the sale or

137. *Id.* (Blackmun, J., dissenting). *See infra* notes 208-14 and accompanying text.
138. *Engle*, 464 U.S. at 235 n.5 (Blackmun, J., dissenting).
139. *Id.* at 224 (quoting National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 488 (1979)). *See supra* text accompanying note 90.
140. *Engle*, 464 U.S. at 236 (Blackmun, J., dissenting).
141. *Id.* (Blackmun, J., dissenting).
142. *Id.* at 228 (Blackmun, J., dissenting).
143. *Id.* at 236-37 (Blackmun, J., dissenting).
144. 287 U.S. 103 (1932).
145. *Id.* at 111-12. For a discussion of the historic background of the depletion allowance in general, see Note, *supra* note 21, at 1083-89; Baker, *supra* note 9, at 268-71.

exchange of minerals in place.[146] Prior to the enactment of section 613A by the Tax Reduction Act of 1975, it was well settled that the depletable income arising from advance royalties and lease bonuses was eligible for either cost depletion or percentage depletion. In *Palmer v. Bender*,[147] the Court allowed percentage depletion on an advance royalty, noting that the advance royalty was "a return *pro-tanto* of [the lessor's] capital investment in the oil, in anticipation of its extraction."[148] In *Herring v. Commissioner*,[149] the Court allowed percentage depletion on a lease bonus, noting that the bonus was a "payment in advance for oil and gas to be extracted."[150]

Under the pre-1975 law, however, percentage depletion on advance royalty and lease bonus receipts eventually had to be attributed to actual production by both lessors and lessees. The Treasury Department promulgated regulations by which lessors would restore depletion allowances previously deducted to income in the event that the lessee failed to extract minerals or left minerals remaining in the ground.[151] The Treasury promulgated additional regulations requiring lessees to exclude advance royalty and lease bonus amounts previously paid to lessors from

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146. *Burnet*, 287 U.S. at 111-12.

147. 287 U.S. 551 (1933).

148. *Id.* at 559.

149. 293 U.S. 322 (1934).

150. *Id.* at 324.

151. Treas. Reg. § 1.612-3(a)(2), -3(b)(2) (1960).

Treas. Reg. § 1.612-3(a)(2) (1960), concerning the restoration of bonus lease payments, provides in pertinent part:

> If the grant of an economic interest in a mineral deposit . . . with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral . . . , the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination, or abandonment.

Thus, in the case of percentage depletion taken on lease bonuses, the lessor avoids restoring any portion of the depletion deduction under this regulation as long as some amount of actual mineral production occurs.

Treas. Reg. § 1.612-3(b)(2) (1960), concerning the restoration of advance royalty payments, provides in pertinent part:

> If the right to extract minerals . . . against which the advanced royalties may be applied expires, terminates, or is abandoned before all such minerals . . . have been extracted . . . , the payee shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of any units of mineral . . . paid for in advance but not extracted . . . , and a corresponding amount must be returned as income for the year of such expiration, termination or abandonment.

Thus, in the case of percentage depletion taken on advance royalties, the Treasury Regulations provide that the lessor must restore to income the portion of his depletion deduction corresponding to the amount of mineral units remaining in the ground during the year that the right to extract minerals expires or is abandoned. *See* Douglas v. Commissioner, 322 U.S. 275, 284 (1944).

their depletable income arising from mineral production. By means of this exclusion, the total income produced by an oil and gas interest would be available for only one percentage depletion deduction.[152]

The Tax Reduction Act of 1975 added section 613A to the Internal Revenue Code.[153] Section 613A generally repealed percentage depletion on oil and gas production except for certain "independent producers and royalty owners."[154] For this favored class of producers, the statute al-

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152. Treas. Reg. § 1.613-2(c)(5)(ii), T.D. 7261, 1973-1 C.B. 309, 317, -2(c)(5)(iii) (1960).

Treas. Reg. § 1.613-2(c)(5)(ii), T.D. 7261, 1973-1 C.B. 309, 317, concerning an exclusion generated by a lease bonus, provides in pertinent part:

> If bonus payments have been paid in respect of the property in any taxable year or any prior taxable years, there shall be excluded in determining the "gross income from the property," an amount equal to that part of such payments which is allocable to the product sold (or otherwise giving rise to gross income) for the taxable year.

Treas. Reg. § 1.613-2(c)(5)(ii), T.D. 7261, 1973-1 C.B. 309, 317 provides the following example to illustrate this rule:

> In 1956, A leases oil bearing lands to B, receiving $200,000 as a bonus and reserving a royalty of one-eighth of the proceeds of all oil produced and sold. It is estimated at the time the lease is entered into that there are 1,000,000 barrels of oil recoverable. In 1956, B produces and sells 100,000 barrels for $240,000. In computing his "gross income from the property" [with respect to calculating B's allowable percentage depletion] for the year 1956, B will exclude $30,000 (1/8 of $240,000), the royalty paid to A, and $20,000 (100,000 bbls. sold/1,000,000 bbls. estimated to be available X $200,000 bonus), the portion of the bonus allocable to the oil produced and sold during the year. However, in computing B's taxable income under section 63, the $20,000 attributable to the bonus payment shall not be either excluded or deducted from B's gross income computed under section 61.

Id. § 1.613-2(c)(5)(ii) (Example (1)).

Treas. Reg. § 1.613-2(c)(5)(iii) (1960), dealing with an exclusion generated by an advance royalty, provides in pertinent part:

> If advanced royalties have been paid in respect of the property in any taxable year, the amount excluded from "gross income from the property" of the payor for the current taxable year on account of such payment, shall be an amount equal to the deduction for such taxable year taken on account of such payment . . . .

Treas. Reg. § 1.613-2(c)(5)(iii) (1960) provides the following example to illustrate this rule:

> If B . . . elects to deduct in 1956 the $10,000 paid [as an advance royalty] to A in that year, [B] must exclude the same amount from "gross income from the property" [with respect to calculating B's allowable percentage depletion] in 1956; however, if B elects to defer the deduction [for the advance royalty payment] until 1957 when he mined and sold the mineral, he must exclude the $10,000 from "gross income from the property" [with respect to calculating B's allowable percentage depletion] in 1957.

Id. § 1.613-2(c)(5)(iii) (Example). *See* Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312, 321 (1934).

153. Pub. L. No. 94-12, 89 Stat. 26 (1975) (applying to taxable years ending after December 31, 1974).

154. As a result of the 1973 OPEC oil embargo and four-fold increase in the price of crude oil, the major integrated oil companies were reaping excessive oil and gas profits. These companies were reinvesting little of their concomitant tax depletion subsidies in domestic energy exploration and production. Landis, *supra* note 9, at 1061-62. Congress responded to the situation in the Tax Reduction Act of 1975 by adding section 613A to the Internal Revenue Code. *Id.*

lows a percentage depletion deduction only with respect to a "depletable oil quantity" limitation which is a specified annual volume of production.[155] In defining the depletable oil quantity, the statute repeatedly refers to "production."[156] Section 613A imposes a further limitation on taxpayers who are eligible for the allowance. Section 613A(d)(1) provides that the allowable depletion deduction "shall not exceed 65 percent of the taxpayer's taxable income."[157]

These new limitations along with the statute's repeated reference to "production" raised the issue as to whether percentage depletion is allowable during a taxable year within which payments for oil and gas production are received in advance of any actual production. In the case of an advance royalty, the actual production for which prepayment is received often occurs in a later taxable year.[158] In the case of a lease bonus, there is no actual production requirement under the lease.[159]

In Proposed Treasury Regulations section 1.613A-7(f)(1)[160] and Revenue Ruling 81-44,[161] the IRS construed section 613A to preclude percentage depletion on advance royalty and lease bonus receipts.[162] On

155. I.R.C. § 613A(c)(3) (1982 & Supp. 1984).

156. *Id.* § 613A(c).

157. *Id.* § 613A(d)(1) (1982). *See supra* note 113.

158. For further discussion of advance royalties, see *supra* note 20.

159. For further discussion of lease bonuses, see *supra* note 21.

160. Prop. Treas. Reg. § 1.613A-7(f)(1), 42 Fed. Reg. 24,287 (1977) provides, in pertinent part:

> [I]n computing the average daily production for a taxable year only oil or gas which has been produced by the close of such taxable year shall be taken into account. For example, advanced royalties (to the extent that actual production during the taxable year is insufficient to earn such royalties) and lease bonuses, while taken into account for purposes of sections 61 and 612 (relating to the definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance pursuant to section 613A(c).

161. Rev. Rul. 81-44, 1981-1 C.B. 384 provides, in pertinent part:

> ISSUE
>
> Under the exemption for independent producers and royalty owners in section 613A(c) of the Internal Revenue Code is percentage depletion allowable on an oil and gas lease bonus?
>
> . . . .
>
> Percentage depletion under section 613A(c) of the Code is allowable only with respect to *production*. The payment of the described lease bonus was independent of whether there was production from the lease.
>
> Lease bonuses, while taken into account for purposes of section [sic] 61 and 612 of the Code (relating to the definition of gross income and cost depletion, respectively), are not to be taken into account in computing the percentage depletion allowance pursuant to section 613A(c).

Id. (emphasis in original).

162. A concise exposition of the position of the IRS is restated by the Tax Court in *Engle* as follows:

> In support of his position, [the Commissioner] emphasizes the language in section 613A(c)(1) stating that the allowance for depletion . . . shall be computed in accord-

several occasions taxpayers challenged the IRS's position in the federal courts.[163] Finally, in October, 1983, the United States Supreme Court granted certiorari in the consolidated case of *Commissioner v. Engle.*[164]

B. Analysis of the Decision

The first issue before the *Engle* Court was whether the language of section 613A limiting percentage depletion to stated quantities of production was intended to (1) establish a limit on the amount of such depletion which the taxpayer may claim or (2) establish production within the taxable year as a prerequisite to any deduction.[165] The taxpayers adopted the former viewpoint.[166] The Commissioner adopted the latter viewpoint.[167] Both the majority and the dissent analyzed this issue in terms of section 613A's language, legislative history, purpose and practical problems of administration.

A second issue of equal importance was one of methodology in adjudicating tax law disputes. Relying on a dissenting opinion,[168] the majority stated that the Court's "duty then is 'to find that interpretation which

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> ance with section 613 only "with respect to . . . so much of the taxpayer's average daily production" of domestic crude oil or natural gas as does not exceed the depletable oil and natural gas quantities specified in section 613A(c)(3) and (4). [The Commissioner] reasons that petitioners, having *no* "average daily production" of oil or natural gas for 1975, have nothing with respect to which percentage depletion may be computed in accordance with section 613.

Engle v. Commissioner, 76 T.C. 915, 920 (1981) (emphasis in original).

163. Engle v. Commissioner, 677 F.2d 594 (7th Cir. 1982); Farmar v. United States, 689 F.2d 1017 (Ct. Cl. 1982); Glass v. Commissioner, 76 T.C. 949 (1981).

164. 459 U.S. 1102 (1983).

165. Commissioner v. Engle, 464 U.S. 206, 215-16 (1984).

166. *Id.* at 216.

167. *Id.* at 215-16.

168. NLRB v. Lion Oil Co., 352 U.S. 282, 297 (1957) (Frankfurter, J., concurring in part and dissenting in part). The majority's reliance upon Justice Frankfurter's principle of "find[ing] that interpretation which can most fairly be said to be embedded in the statute, in the sense of being most harmonious with its scheme and . . . general purposes" is problematic. *Id.* (Frankfurter, J., concurring in part and dissenting in part). In *Lion Oil,* the Court was construing § 8(d) of the National Labor Relations Act under Title 29 of the United States Code. *Id.* at 283. The task before the *Engle* Court was that of construing a discrete section of the Internal Revenue Code. The Internal Revenue Code has its own body of principles of construction, separate from other Titles of the United States Code. For further discussion, see *infra* notes 170-71 and accompanying text.

Further, Justice Frankfurter in *Lion Oil* set forth this principle in the dissenting portion of his opinion while noting that the National Labor Relations Board itself was divided three ways with respect to interpreting § 8(d) of the National Labor Relations Act. *Lion Oil,* 352 U.S. at 297 (Frankfurter, J., concurring in part and dissenting in part). Thus, "[s]uch diverse interpretations, *particularly by the authorities charged with the administration of the Act,*" mandate the "judicial responsibility to find that interpretation which can most fairly be said to be embedded in the statute." *Id.* (Frankfurter, J., concurring in part and dissenting in part) (emphasis added). In *Engle,* however, there was no evidence of disagreement within the Internal Reve-

can most fairly be said to be imbedded in the statute, in the sense of being most harmonious with its scheme and with the general purposes that Congress manifested.' "[169] Thus, the majority took upon itself the task of discovering which interpretation, that of the Commissioner's or that of the taxpayers', most reasonably fits the statute.

The majority's approach is at odds with the Court's traditional approach to adjudicating tax law disputes. Under the traditional approach, the Court has repeatedly affirmed the principle that "the 'choice among reasonable interpretations is for the Commissioner, not the courts.' "[170] Thus, even if other interpretations of a tax statute are more reasonable than that of the Commissioner's, as long as the Commissioner's interpretation is not *un*reasonable, the Court, under its traditional approach, will defer to the Commissioner's interpretation.[171] Although the majority

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nue Service, the authority charged with the administration of federal tax law, that § 613A repealed percentage depletion on preproduction oil and gas receipts.

169. *Engle*, 464 U.S. at 217 (quoting NLRB v. Lion Oil Co., 352 U.S. 292, 297 (1957) (Frankfurter, J., concurring in part and dissenting in part)).

170. *Id.* at 224 (quoting National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 488 (1979)).

Under I.R.C. § 7805(a) (1982), Congress delegated to the Commissioner, and therefore not to the courts, the role of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. The Court has stated that this delegation was intended to insure that the taxation rules and regulations will be written by the " 'masters of the subject' " who will be enforcing them. National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979) (quoting United States v. Moore, 95 U.S. 760, 763 (1878)). The Court has firmly established the well settled principle that "Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948). The Court will presume that Treasury regulations are valid if they "implement the congressional mandate in some reasonable manner." United States v. Correll, 389 U.S. 299, 307 (1967). In *National Muffler*, the Court set forth the following test when evaluating the validity of a particular Treasury regulation:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.

National Muffler, 440 U.S. at 477 (citing Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948); Helvering v. Winmill, 305 U.S. 79, 83 (1938)).

171. This principle is stated in terms of a negative test of the Court finding whether the Commissioner's interpretation is *un*reasonable. Thus, the Commissioner's interpretation is entitled to prevail as long as it is *not* "unreasonable and plainly inconsistent" with the federal tax statutes. Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948). The difference between stating this principle in a positive versus a negative test lies in the nature of the task facing the Court. Must the Court find the Commissioner's interpretation unreasonable and

later purported to accept the principle of deference to the Commissioner's interpretation,[172] the majority failed to address the conflict between the Court's traditional approach and the majority's professed duty of discovering that interpretation which is most harmonious with the statute.

The dissent unequivocally embraced the principle that "the 'choice among reasonable interpretations is for the Commissioner, not for the courts.' "[173] Thus the dissent did not compare the reasonableness of each possible interpretation of the statute. Rather, the dissent merely sought to determine whether the Commissioner's interpretation was unreasonable. Hence, the dissent's chief contention against the majority was that the majority simply failed to establish that the Commissioner's interpretation was, in fact, "unreasonable and plainly inconsistent" with the statute.[174] All considerations, including the statute's language, legislative history, purpose and practical problems of administration reasonably support the Commissioner's interpretation of the statute. Although these four considerations could be read to support the taxpayers' interpretation, none of these considerations mandates invalidation of the Commissioner's interpretation. This provides the conceptual basis for the dissent's observation that the majority's decision is "a sign of the Court's willingness to displace the Commissioner's interpretation of the tax laws with its own views of tax policy."[175]

1. Statutory language

The majority explored the following three possible interpretations of section 613A, noting that each interpretation may be reconciled with the language of the statute: (1) the statute's repeated reference to "production" and "taxable year" supports the Commissioner's interpretation that the statute requires production within the taxable year as a prerequisite to taking the percentage depletion allowance; (2) the statute's reference to "average daily production" supports the taxpayers' interpretation by establishing a limitation on the amount rather than a prerequisite to the

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plainly inconsistent with the statute before displacing the Commissioner's interpretation of the statute with the Court's interpretation? Or, more easily, must the Court fail to find the Commissioner's interpretation reasonable, but short of finding the Commissioner's interpretation "unreasonable and plainly inconsistent" with the statute? Under the traditional approach, the Court has taken upon itself the former task.

172. *Engle*, 464 U.S. at 224.

173. *Id.* at 236 (Blackmun, J., dissenting) (quoting National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 488 (1979)).

174. *Id.* at 228 (Blackmun, J., dissenting).

175. *Id.* at 236-37 (Blackmun, J., dissenting).

deduction and allows the depletion deduction during the taxable year within which the income is received rather than in the taxable year of actual oil and gas production; and (3) the statute's reference to "average daily production," while limiting the amount of the deduction, defers the deduction to the taxable year of actual oil and gas production.[176]

In the Court's search for that interpretation which is most harmonious with the statute, the majority pointed out that although the statute bars percentage depletion on income attributable to production over certain levels, nothing in the statute bars percentage depletion attributable to preproduction receipts.[177] Based on this observation, the majority concluded that percentage depletion on preproduction receipts falls "within the four corners" of the statute.[178] Thus, because the statute's language does not *expressly* bar percentage depletion on preproduction receipts, the statute must permit it.

The statute's silence with respect to percentage depletion on preproduction receipts, however, may just as plausibly indicate the opposite conclusion. Congress had initially intended to repeal completely percentage depletion on oil and gas production.[179] The final version of the bill provided for several specific exemptions from the broad repeal.[180] Hence, it is at least equally logical to conclude that because there was no specific provision for percentage depletion on preproduction receipts in the final version of the bill, Congress must have intended to bar percentage depletion on preproduction receipts as part of a broad legislative repeal of percentage depletion on oil and gas production. Therefore, the majority's pregnant silence argument is not persuasive.[181]

The majority's analysis is troubled by two additional weaknesses.

176. *See supra* notes 47-58 and accompanying text.

177. *Engle*, 464 U.S. at 224.

178. *Id.*

179. *See* 121 Cong. Rec. 4651-52, 4657-58 (1975).

180. *See supra* notes 17-19 and accompanying text. The structure of § 613A reflects this history. Section 613A(a) (1982) begins with the general rule of repealing percentage depletion on oil and gas production by providing that "[e]xcept as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613." Sections 613A(b) and (c) then provide for specific exemptions from this broad repeal. *Id.* § 613A(b)-(c) (1982 & Supp. 1984).

181. The majority later buttressed its position by stating that "[h]ad Congress meant to eliminate the percentage depletion allowance on lease bonus and advance royalty income, we believe it would have addressed our decisions to the contrary more explicitly." *Engle*, 464 U.S. at 225 (citing Mastro Plastics Corp. v. NLRB, 350 U.S. 270, 289 (1956)). Still, given the broad scope of the repeal of percentage depletion under § 613A and the congressional haste under which the statute was enacted, it is reasonable that Congress intended to accomplish an across the board repeal of percentage depletion with the exception of the selective exemptions specifically provided by the statute.

First, the majority purports to read the statute within the context of the "related sections" of the Internal Revenue Code.[182] However, the majority fails to accomplish this end. When reading the statute's requirement that percentage depletion on oil and gas will be calculated with respect to "average daily production" defined in terms of "aggregate production . . . during the *taxable year*,"[183] the majority ignores the Internal Revenue Code's explicit definition of "taxable year." As the dissent has observed,[184] Internal Revenue Code section 7701(a)(23) defines "taxable year" in terms of "the calendar year, or the fiscal year . . . upon the basis of which the taxable income is computed" with respect to income taxes.[185] Therefore, under section 613A, in the absence of "aggregate production . . . during the *taxable year*," the statute provides no basis upon which to compute any percentage depletion.

Second, the majority creates a paradox by acknowledging that the Commissioner's interpretation is reconcilable with the language of the statute[186] while later concluding that the Commissioner's interpretation is unreasonable.[187] Nowhere does the majority explain how the Commissioner's interpretation is reconcilable with the language of the statute, yet still unreasonable.[188]

2. Legislative history

The majority and the dissent extensively reviewed the legislative his-

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182. *Id.* at 223.

183. I.R.C. § 613A(c)(1)-(2) (1982) (emphasis added).

184. *Engle*, 464 U.S. at 229 (Blackmun, J., dissenting).

185. I.R.C. § 7701(a)(23) (1982).

186. *Engle*, 464 U.S. at 217.

187. *Id.* at 224. With respect to analyzing the statute's language, the majority focused its efforts on discovering that interpretation which is in greatest harmony with the language of the statute. The majority offered no evidence indicating that the Commissioner's interpretation was unreasonable. Hence, the most that can be concluded from the majority's analysis is that the Commissioner's interpretation is reasonable though less harmonious with the language of the statute than that of the taxpayers' interpretation.

188. A passage from English literature may aid in resolving such paradoxes:

> "I don't know what you mean by 'glory,' " Alice said.
>
> Humpty Dumpty smiled contemptuously. "Of course you don't—till I tell you. I meant 'there's a nice knock-down argument for you!' "
>
> "But 'glory' doesn't mean 'a nice knock-down argument,' " Alice objected.
>
> "When *I* use a word," Humpty Dumpty said, in a rather scornful tone, "it means just what I choose it to mean—neither more nor less."
>
> "The question is," said Alice, "whether you *can* make words mean so many different things."
>
> "The question is," said Humpty Dumpty, "which is to be the master—that's all."

L. CARROLL, THROUGH THE LOOKING-GLASS 245 (Rainbow Classics ed. 1946) (emphasis in original).

tory of section 613A. They both observed that Congress, in enacting the Tax Reduction Act of 1975, acted in haste.[189] From their similar observations, they drew diametrically opposed conclusions.

The majority contended that because most depletion deductions are based on actual production, "Congress, in its haste,"[190] imposed upon that class of taxpayers exempted from the percentage depletion repeal a maximum depletable allowance defined in terms of ceiling levels of production.[191] The majority thus implied that but for the haste under which Congress was acting, Congress would have also expressly provided, either in the statute or in the committee reports, a percentage depletion allowance for the comparatively smaller amount of depletion deductions based upon preproduction receipts. The dissent retorted that the fact that Congress failed to specifically bar percentage depletion on preproduction receipts overlooks "the haste" in which Congress acted.[192] The dissent thus implied that had Congress acted with less haste it would have expressly repealed percentage depletion on preproduction receipts. Because the argument of congressional haste supports the positions of both the majority and the dissent, the argument ultimately proves inconclusive.

The majority probed the legislative history further, looking for any indication that Congress intended to retain percentage depletion on preproduction receipts. In examining the committee reports, the majority noted that the repeal of percentage depletion on preproduction receipts was *never* suggested.[193] Further, the majority found significance in the Conference Committee's report that stated that the proposed legisla-

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189. *Engle*, 464 U.S. at 224; *id.* at 233 (Blackmun, J., dissenting).

190. *Id.* at 204.

191. *See supra* note 19 and accompanying text.

The majority wrote that Congress "defined the class of taxpayers exempted from the percentage depletion repeal in terms of *certain production levels*." *Engle*, 464 U.S. at 224 (emphasis added). This is not the case. I.R.C. § 613A(b) (1982) defines those taxpayers exempted from the repeal in terms of the *type* of oil and gas produced irrespective of production levels. I.R.C. § 613A(c) (1982) defines those taxpayers exempted from the repeal in terms of their status as independent producer or royalty owner. The statute does not define independent producers or royalty owners in terms of production levels. Rather, the statute provides that all oil and gas producers shall have the status of independent producer or royalty owner other than those producers who are also gas retailers and refiners as defined under I.R.C. § 613A(d)(2) (1982). Once a taxpayer has acquired the exempt status of independent producer or royalty owner by refraining from or ceasing retail and refinery operations, then the taxpayer is subject to a production level limitation. If the taxpayer exceeds the production level limitation, the taxpayer still retains his exempt status. The taxpayer's percentage depletion allowance is simply limited by the production level ceiling.

192. *Engle*, 464 U.S. at 233 (Blackmun, J., dissenting).

193. *Id.* at 220.

tion "*retains* percentage depletion . . . for the small independent producer."[194] The majority interpreted the use of the word "retains" as implying that Congress intended to retain percentage depletion "in its entirety" for independent producers and royalty owners.[195]

The use of the word "retains" in the Conference Committee report sheds no light on precisely what Congress intended to retain.[196] The fact that the broad scope of the legislation was intended to repeal percentage depletion on oil and gas production while providing for only two specific exemptions from the repeal[197] indicates that the scope of the exemptions should be construed narrowly.

The majority found further support for its position by contending that had Congress intended to eliminate percentage depletion on preproduction receipts it would have addressed the Court's prior decisions to the contrary more explicitly.[198] This argument has two weaknesses. First, the majority implies that Congress failed to expressly address the issue of percentage depletion on preproduction receipts in the 1975 Act. However, the majority earlier observed that Congress "expressed a clear intent to *retain* the percentage depletion rules" on preproduction receipts by the use of the word "retains" in the Conference Committee report.[199] The majority cannot logically argue the issue of expressed congressional intent from all directions. If Congress expressed its intent to retain percentage depletion on preproduction receipts by means of the word "retains," as asserted by the majority, then it is not logical for the majority also to contend that Congress would have addressed the Court's prior decisions to the contrary more explicitly.

Second, the majority once again found Congress' silence as a persuasive indicator of congressional intent to preserve the status quo. This view presumes that the enactment of section 613A represents only a small increment of change to the body of percentage depletion law. The broad scope of the repeal, however, suggests otherwise.[200] As the dissent has noted, section 613A actually "dismantles the entire structure of percentage depletion allowances" with respect to oil and gas production

194. *Id.* at 221 (quoting H.R. CONF. REP. No. 120, 94th Cong., 1st Sess., 67-68 (1975) *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 54, 132 (emphasis added by the Court)). For text of report, see *supra* note 68.

195. *Engle*, 464 U.S. at 221.

196. Indeed, one author has concluded that the "Conference Report . . . is of no real assistance in interpreting . . . section [613A]." Bravenec, *Continued Availability of Percentage Depletion on Oil and Gas*, 23 OIL & GAS TAX Q. 204, 204 (1975).

197. *See supra* notes 68-69 and accompanying text.

198. *Engle*, 464 U.S. at 225.

199. *Id.* at 221.

200. *See supra* note 17 and accompanying text.

upon which the prior law rested.[201]

3. Congressional purpose

On its face, Congress' purpose in enacting section 613A was to repeal percentage depletion on oil and gas production with the exceptions of production generated by certain domestic gas wells and by independent producers and royalty owners.[202] Although the dissent suggested no other purpose for the legislation beyond this point,[203] the majority maintained that Congress had in mind an additional purpose.

The majority asserted that Congress sought to spur domestic oil and gas production by retaining the percentage depletion allowance for independent producers and royalty owners.[204] The allowance would thus "subsidize . . . the exploration and production of the Nation's oil and gas resources," thereby increasing domestic production and severing the nation's dependence on imported oil.[205] Furthermore, because section 613A rendered the percentage depletion allowance no longer available to the major integrated oil companies, the majority asserted that Congress intended to improve the competitive position of independent producers and royalty owners vis-a-vis the major integrated oil companies.[206] The majority concluded that because the Commissioner's position would result in a smaller amount of percentage depletion available to independent producers and royalty owners,[207] his position conflicted with Congress' purpose in enacting the statute.

The majority's assertion is at odds with the practical implications of the statute. Prior to the enactment of section 613A, the percentage depletion allowance was available to all oil and gas producers under section 613.[208] With the passage of section 613A, Congress eliminated the percentage depletion allowance for the major integrated oil companies which accounted for more than 70% of all oil and gas production.[209] With respect to independent producers and royalty owners who remained eligible for the percentage depletion allowance, section 613A(c) limited their deduction in 1975 to a maximum average daily production

201. *Engle*, 464 U.S. at 233 (Blackmun, J., dissenting).
202. *See supra* note 17 and accompanying text.
203. *Engle*, 464 U.S. at 233-36 (Blackmun, J., dissenting).
204. *Id.* at 217-18.
205. *Id.* at 218.
206. *Id.*
207. *Id.* at 218-19.
208. Landis, *supra* note 9, at 1060-61. For further discussion, see *supra* note 154 and accompanying text.
209. Landis, *supra* note 9, at 1062.

of depletable oil of 2,000 barrels.[210] This depletable quantity limitation was scaled back even further over a five year period, beginning with 1976, to a maximum average daily production of 1,000 barrels for the year 1980 and thereafter.[211] The percentage depletion rate was also scaled back over a ten year period from 22% in 1975 to 15% in 1984 and thereafter.[212] Hence, the practical impact of section 613A was to severely reduce the amount of percentage depletion subsidy available to all oil and gas producers with the greatest portion of the reduction occurring in 1975.

Given the total repeal of the percentage depletion subsidy for major integrated oil companies and the severe reduction of the subsidy for independent producers and royalty owners, Congress could not have rationally expected to increase domestic production through the enactment of section 613A.[213] Therefore, the Commissioner's position does not fail

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210. I.R.C. § 613A(c)(3)(B) (1982).

211. *Id.*

212. *Id.* § 613A(c)(5) (1982).

213. For example, suppose that in 1974 an independent producer was pumping oil from the ground at the average rate of 5,000 barrels per day with a fair market value of $20 per barrel. Further, assume that for the years beyond 1974, the market value of the producer's oil held steady in terms of 1974 dollars. Table I, below, illustrates the declining percentage depletion subsidy available to such an independent producer before and after the enactment of section 613A.

Table I: Analysis of the Declining Percentage Depletion Subsidy Available to Independent Producers and Royalty Owners

Year	Barrels per day allowable	×	Days per year	×	Fair Market Value	×	Percentage Depletion Rate	=	Depletion Subsidy
1974	*5000		365		$20.00		.22		$8,030,000
1975	2000		365		20.00		.22		3,212,000
1976	1800		365		20.00		.22		2,890,800
1977	1600		365		20.00		.22		2,569,600
1978	1400		365		20.00		.22		2,248,400
1979	1200		365		20.00		.22		1,927,200
1980	1000		365		20.00		.22		1,606,000
1981	1000		365		20.00		.20		1,460,000
1982	1000		365		20.00		.18		1,314,000
1983	1000		365		20.00		.16		1,168,000
1984	1000		365		20.00		.15		1,095,000

* There is no statutory depletable quantity limitation with respect to 1974.

As the table indicates, an independent producer, who produced oil and gas at an average barrel per day rate in excess of the amount allowed by section 613A during the years 1974 through 1984, would experience a substantial reduction in the maximum allowable percentage depletion subsidy. The greatest decrease in the annual allowable percentage depletion subsidy

on the grounds that it resulted in a smaller subsidy available to independent producers and royalty owners because the statute itself accomplishes this same end.[214]

The majority further argued that percentage depletion on preproduction receipts is an essential component of the risk spreading arrangement between lessors and lessees. Under this arrangement, lessors, who are generally risk averse, would be willing to accept smaller preproduction payments from lessees on oil and gas leases because of the subsidy provided by percentage depletion. The majority thus observed that, in effect, lessors pass through to lessees a portion of the economic benefit arising from the percentage depletion allowance on preproduction receipts. With lessees making smaller preproduction payments on leases, lessees would have more available capital to finance their exploration and development, which in turn would result in increased domestic production.[215] Conversely, the Commissioner's position of denying percentage depletion on preproduction receipts would force lessors to require larger payments from lessees which ultimately would result in lessees devoting less capital to domestic exploration and development.[216] Thus, according to the majority, the Commissioner's position once again fails to harmonize with Congress' purpose of increasing domestic production.

To the extent that major integrated oil companies are included among the lessees who enter into the risk spreading arrangements envisioned by the majority, these arrangements would result in passing through to major integrated oil companies the benefits of the percentage depletion allowance. Such a result is clearly not in harmony with the congressional purpose behind the statute. As the majority acknowledged at the outset of its opinion, the primary purpose of the statute was to deny the benefits of percentage depletion to the major integrated oil companies.[217] Thus, the majority's interpretation—which promotes risk spreading arrangements between small lessors and large lessees—would defeat the statute's primary purpose of denying percentage depletion to major integrated oil companies. Conversely, the Commissioner's interpretation—which discourages risk spreading arrangements—would en-

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would occur between the transition from the years 1974 to 1975. The average annual rate of decrease provided by the statute during the years 1975 to 1984 computes to 12.7%. The overall percentage decrease of the percentage depletion allowance from 1975 to 1984 computes to 65.9%.

214. *See generally* Bravenec, *Decreased Significance of Percentage Depletion on Oil and Gas,* 23 OIL & GAS TAX Q. 193 (1975).

215. *Engle,* 464 U.S. at 218-19.

216. *Id.*

217. *Id.* at 211. *See supra* notes 12-17 and accompanying text.

hance the statute's primary purpose of denying percentage depletion to major integrated oil companies by preventing the economic benefits of percentage depletion on preproduction receipts from passing through to major integrated oil companies.

Furthermore, contrary to the majority's analysis, allowing percentage depletion on preproduction receipts may actually result in less domestic production. Because the subsidy makes it less expensive for lessees to enter into leasing arrangements that provide for deferred production, percentage depletion on preproduction receipts would subsidize the lessees' holding costs of the lease. Lessees thus would be provided with an incentive to defer production in hopes that the market value of oil and gas left in the ground would appreciate. Lessees would proceed with production of oil and gas only at such time when the present value of the additional holding costs of the preproduction payments exceeds the present value of the additional profit potential from future appreciation of the oil and gas in the ground.[218] Therefore, assuming arguendo that Congress, by means of enacting section 613A, sought to immediately increase domestic production by means of the percentage depletion subsidy, it is not at all clear that allowing percentage depletion on preproduction receipts would accomplish this end.

4. Practical problems of administration

Both the majority and the dissent recognized the practical problems of administration related to allowing percentage depletion on preproduction receipts.[219] The administrative problems arise from attempting to relate preproduction receipts received in earlier taxable years to depletable quantity limitations, percentage of income limitations, rates of percentage depletion and types of production processes arising in later

218. For example, suppose in 1980 a lessee entered into a 20 year lease with respect to oil and gas property containing an estimated one million barrels of oil reserves in the ground. At that time, the fair market value of the oil, once in the pipeline, was $20 per barrel for a total amount of $20,000,000. Further, assume the lessee obligated himself to pay the lessor an advance royalty of $50,000 per year for each year in which the lessee failed to produce oil from the ground. Hence, the holding cost of the lease for the lessee would be $50,000 per year. If the lessee expected the oil in the ground to appreciate at the rate of 5% per year, then the lessee would experience a $50,000 gain from the appreciation value of the oil in the ground which would be offset by the $50,000 holding cost of the lease. Hence, the lessee would be indifferent as to whether he should produce oil currently or defer production. If, however, the lessee expected the oil in the ground to appreciate at a rate of 10% per year, then the lessee would experience a $100,000 gain from the appreciation value of the oil in the ground. Since the lessee's holding cost of the lease is only $50,000 per year, the lessee would have a strong financial incentive to defer production for as long as possible under the lease in order to maximize his profit potential from the appreciation value of the oil in the ground.

219. *See supra* notes 85-88 & 106-17 and accompanying texts.

taxable years.[220] The majority asserted that the administrative problems could be overcome by the Commissioner promulgating regulations requiring taxpayers to defer percentage depletion deductions to years of actual production or by requiring taxpayers to adjust percentage depletion deductions taken during nonproduction years by filing amended returns in later taxable years.[221] The dissent was less optimistic than the majority, indicating that it was unclear how a taxpayer would apply the 50% and 65% income limitations provided under sections 613(a) and 613A(d)(1) when the percentage depletion allowance is reported in a year subsequent to the income that gave rise to it.[222]

The dissent ultimately sided with the Commissioner, who would deny percentage depletion on preproduction receipts. Thus, for the dissent, all administrative problems are immediately resolved because there is no necessity of relating preproduction receipts in earlier taxable years to actual production in later taxable years. For the majority, however, the practical problems of administration abound. The following discussion analyzes these problems in two parts: (a) a presentation of three alternative methods of calculating and deducting percentage depletion on preproduction receipts, and (b) a consideration of the practical administrative problems related to allowing percentage depletion on preproduction receipts.

a. three alternative methods of calculating and deducting percentage depletion on preproduction receipts

There are at least three alternative methods of calculating and deducting percentage depletion on preproduction receipts.[223] These methods are:

(1) calculate and deduct the percentage depletion allowance in the taxable year that preproduction revenue is received,
(2) calculate the percentage depletion allowance in the taxable year that preproduction revenue is received and deduct the allowance in taxable years of actual production, and
(3) calculate and deduct the percentage depletion allowance in taxable years of actual production.

220. *See infra* notes 231-51 and accompanying text.

221. *Engle*, 464 U.S. at 226. *See supra* note 86.

222. *Engle*, 464 U.S. at 230 (Blackmun, J., dissenting). *See supra* note 114.

223. *See* ARTHUR YOUNG'S OIL & GAS FEDERAL INCOME TAXATION, 565 (J. Houghton 22d ed. 1984); Note, *Percentage Depletion on Oil and Gas Lease Bonuses and Advance Royalties:* Engle v. Commissioner, Glass v. Commissioner, *and* Farmar v. United States *Reviewed*, 35 BAYLOR L. REV. 97, 122 (1983); Jones, *Analysis of CA-7* Engle *decision allowing percentage depletion absent abstraction*, 57 J. TAX'N 230, 233 (1982); Bravenec, *supra* note 196, at 211-14.

The first two alternative methods entail calculating the percentage depletion allowance in the year that preproduction revenue is received. Under these methods, the allowable depletion deduction would be calculated in the following manner. The preproduction receipts would be allocated in accordance with an estimated ratio of primary and secondary/tertiary oil and gas production levels.[224] Each allocated amount relating to primary and secondary/tertiary oil and gas would then be divided by a respective estimated average per barrel royalty amount to arrive at quantities of production. The statutory depletable quantity limitation applicable to that year would then be applied to determine whether the depletable quantity limitation had been reached. The allocated preproduction receipts, as limited by the statutory depletable quantity, would then be multiplied by the applicable depletion rates for primary and secondary/tertiary oil and gas production for that year to arrive at the allowable percentage depletion deduction.[225]

The first two methods differ with respect to the timing of the percentage depletion deduction. Under the first method, the depletion allowance would be deducted in the taxable year that preproduction revenue is received.[226] Under the second method, the depletion allowance would be amortized and deducted over the productive life of the lease using a unit of production method.[227]

Under the third method, preproduction receipts would be amortized, by means of a unit of production method,[228] into gross income

224. This allocation is necessary for preproduction payments received in years prior to 1984 because of the different percentage depletion rates for primary and secondary/tertiary oil and gas production. Beginning in 1984, this allocation is no longer necessary because the percentage depletion rates for both primary and secondary/tertiary production have been equalized. *See supra* note 19.

225. Appendices I and II illustrate the calculation of the percentage depletion allowance on preproduction receipts under the first and second methods in which the allowance is calculated in the taxable year that preproduction revenue is received. Appendix I is for the taxable year 1985. Thus, there is no allocation of preproduction receipts between estimated primary and secondary/tertiary production levels. Appendix II is for the taxable year 1983. Thus, preproduction receipts are allocated between estimated primary and secondary/tertiary production levels.

226. This percentage depletion deduction would still be subject to the 50% taxable income from the property limitation of I.R.C. § 613A(a) (1982), *supra* note 6, and the 65% taxable income limitation of I.R.C. § 613A(d)(1) (1982), *supra* note 113.

227. A unit of production method of allocation involves allocating in proportion to a production ratio. The production ratio constitutes a fraction in which the numerator is the total actual units of mineral production and the denominator is the total estimated units of minerals remaining in the ground as of the beginning of the taxable year. 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, 940 (1984). A unit of production method is currently used to compute cost depletion. I.R.C. § 611(a) (1982); Treas. Reg. § 1.611-2(a) (1960). *See supra* note 5.

228. *See supra* note 227.

from the property over the productive life of the property for the sole purpose of computing the depletion allowance. The depletable quantity limitation applicable for the year of production would be applied with respect to the actual number of units produced. The amortized portion of preproduction receipts, as limited by the statutory depletable quantity, would be allocated in accordance with the actual ratio of primary oil and gas and secondary/tertiary oil and gas production levels.[229] These allocated amounts of preproduction receipts, plus the gross income from property generated by actual production for that year, would then be multiplied by the applicable depletion rates for primary and secondary/tertiary oil and gas production for that year in order to arrive at the percentage depletion deduction available for that year.[230]

b. practical administrative problems related to allowing percentage depletion on preproduction receipts

Various administrative difficulties accompany the three alternative methods of computing percentage depletion on preproduction receipts.[231]

First, the reliance of the first and second methods upon an estimated ratio of primary and secondary/tertiary oil and gas production levels,[232] would likely become a point of controversy between taxpayers and the IRS. Taxpayers who have exceeded the depletable quantity limitation would tend to estimate the production ratio in favor of the type of production commanding the highest market price. In doing so, taxpayers would arrive at smaller estimated quantities of production with respect to preproduction receipts, thus maximizing the amount of production income eligible for percentage depletion. This problem could only be resolved on a case-by-case basis by means of government administrative review.[233] This problem does not accompany the third method because

229. *See supra* note 224.

230. *See supra* note 226.

Appendices III and IV illustrate the calculation of the percentage depletion allowance on preproduction receipts under the third method in which the allowance is calculated in a taxable year of actual production. Both of these appendices are for the taxable year 1983. Thus, the preproduction receipts are allocated between estimated primary and secondary/tertiary production levels.

231. Appendix V provides a crosscutting analysis of the practical administrative problems and their resolutions for each of the three alternative methods of calculating and deducting percentage depletion on preproduction receipts.

232. *See supra* note 224.

233. The IRS would likely take the opposing position of estimating the production ratio in favor of the type of production commanding the lowest market price in order to maximize the amount of income tax that could be presently collected. Presumably, upon review, the IRS and the taxpayer would negotiate a fair estimate.

that method relies on an actual, rather than estimated, ratio of primary and secondary/tertiary oil and gas production levels.

Second, amortizing the allowable percentage depletion deduction (method two) or the preproduction receipts (method three) over the productive life of the property entails estimating the property's mineral reserve. This reserve estimate would likely become a point of controversy between taxpayers and the IRS. Taxpayers, desiring to maximize the deductible amount of percentage depletion, would likely minimize the estimated reserve, thus maximizing the amortized allowable amount of percentage depletion.[234] This problem could only be resolved on a case-by-case basis by means of government administrative review.[235] This problem does not accompany the first method because that method does not amortize either the percentage depletion allowance or preproduction receipts over the productive life of the property.

Third, with respect to the first and second methods, there is a possibility that taxpayers could avail themselves of multiple depletable quantity limitations with respect to one production run. Taxpayers would be subject to one set of depletable quantity limitations during preproduction years and a second set of depletable quantity limitations during actual production years. This problem could be resolved by reducing the depletable quantity limitations applicable during taxable years of actual production by the depletable quantity amounts computed with respect to the preproduction taxable years. This problem does not accompany the third method because that method utilizes the depletable quantity limitation applicable to the year of production in computing the deferred percentage depletion deduction.

Fourth, with respect to the second and third methods, if the property is transferred by sale, exchange, gift, death or other disposition, nothing in section 613A or in prior case law indicates what would become of the deferred percentage depletion amount. There are at least two logical possibilities: (1) the deferred amount carries over to the new owner of the property, or (2) the deferred amount does not carry over and is therefore lost because the original owner would no longer have a production or income flow over which to amortize the deferred deduction.[236] This problem does not accompany the first method because that

234. Under present law, this problem accompanies cost depletion, which is based upon estimating the property's mineral reserves. Treas. Reg. § 1.611-2(a) (1960). *See supra* note 5.

235. The IRS would likely take the opposing position of maximizing the estimated reserve in order to maximize the amount of income tax that presently could be collected. Presumably, upon review, the IRS and the taxpayer would negotiate a fair estimate.

236. A third possibility involves deducting the remaining deferred deduction during the year of disposition. This possibility is not logical because the deferred deduction is attributable

method does not defer any portion of the percentage depletion deduction on preproduction receipts.[237]

Fifth, the 50% taxable income from property limitation of section 613(a)[238] and the 65% taxable income limitation of section 613A(d)(1)[239] would become distorted.[240]

Under the first method, these limitations would be distorted because taxpayers could avail themselves of multiple applications of these limitations. This would occur because percentage depletion deductions related to a single oil and gas interest would be taken in both preproduction and actual production taxable years. Deducting percentage depletion in preproduction years would significantly increase the total amount of allowable percentage depletion for taxpayers who may have otherwise exceeded the 50% and 65% limitations during production years. This distortion could be corrected by taxpayers amortizing both net income from preproduction receipts and preproduction percentage depletion deductions over the productive life of the property, by a unit of production method.[241] During each taxable year of actual production, a portion of the preproduction receipts and preproduction percentage depletion deductions, proportionate to the actual units produced, would be added back into taxable income for the sole purpose of computing the 50% and 65% limitations.

Under the second and third methods, the 50% and 65% limitations

to the taxpayer's future mineral production which would have never occurred due to the taxpayer's disposition of the property.

237. However, upon early disposition of the property, it would be appropriate for the taxpayer to reduce the amount of percentage depletion allowances previously deducted. This could be accomplished by the taxpayer amending preproduction taxable year returns or by the taxpayer restoring some portion of the percentage depletion allowances previously deducted to income in the year of disposition of the property. For a discussion of income restoration, see *supra* note 151 and accompanying text.

238. I.R.C. § 613(a) (1982). *See supra* note 6.

239. I.R.C. § 613A(d)(1). *See supra* note 6.

240. It has been suggested, without further explanation, that the 90% net income limitation of I.R.C. § 4988(b) pertaining to the windfall profit tax on domestic crude oil would also be distorted. ARTHUR YOUNG'S OIL & GAS FEDERAL INCOME TAXATION, 565 (J. Houghton 22d ed. 1984). I.R.C. § 4986 (1982), enacted by Congress in connection with the decontrol of domestic oil prices, imposes a temporary excise tax on the windfall profit from the production and sale of domestic crude oil. I.R.C. § 4988(b) (1982) limits the amount of windfall profit tax on any barrel of oil to 90% of the net income attributable to each barrel of oil. In calculating the net income attributable to a barrel of oil, I.R.C. § 4988(b)(3)(B)(i) (1982) provides that no deduction shall be allowed for depletion. Because no deduction for depletion is allowed, the presence or absence of depletion does not affect the calculation of the 90% net income limitation. Thus, the percentage depletion allowance on preproduction receipts, whether deducted in a preproduction or in a subsequent taxable year, should not affect the calculation of the 90% net income limitation of § 4988(b).

241. *See supra* note 227.

would be distorted because the income related to these limitations already would have been reported in a preproduction year. This distortion could be corrected by adding back to taxable income, for the sole purpose of computing these various limitations, a portion of net income from preproduction receipts reported in prior years proportionate to the amortized amount of percentage depletion deducted in the year of actual production.

Sixth, the noncorporate taxpayer's alternative minimum tax under section 55[242] and the corporate taxpayer's minimum tax under section 56[243] would become distorted. In calculating the alternative minimum tax, section 55(a)(1) provides for an annual exemption amount which reduces the taxable income base upon which the alternative minimum tax is imposed.[244] In a similar fashion, section 56(a) provides for an annual exclusion amount which reduces the preference base upon which the minimum tax is imposed.[245] Under the first method, these two taxes would become distorted because taxpayers could avail themselves of multiple exemptions or exclusions. This would occur because percentage depletion tax preferences related to a single oil and gas interest would be reported in both preproduction and actual production taxable years. Thus, taxpayers would avail themselves of the exemptions or exclusions related to preproduction years which would otherwise not have been available if the percentage depletion allowance were deferred. As a result, the alternative minimum tax and the minimum tax could be reduced or completely avoided. There is no obvious way to correct this distortion without producing other alternative minimum tax and minimum tax distortions of equal or greater magnitude. This distortion does not arise in connection with the second and third methods because percentage depletion tax preferences related to a single oil and gas interest would be reported only in actual production taxable years.

242. I.R.C. § 55 (1982 & Supp. 1984). Section 55 imposes on a noncorporate taxpayer a 20% tax on a taxpayer's alternative minimum taxable income, less an exemption amount. *Id.* § 55(a)(1). The taxpayer must pay this tax only to the extent that the alternative minimum tax liability exceeds the taxpayer's regular tax liability. *Id.* § 55(a).

243. *Id.* § 56. Section 56 imposes on a corporate taxpayer a 15% tax on a taxpayer's total tax preference items in excess of the greater of a $10,000 exclusion or the corporation's regular tax liability for the taxable years. *Id.* § 56(a) (1982). Unlike the alternative minimum tax, *supra* note 242, which is imposed on noncorporate taxpayers only to the extent that it *exceeds* the regular tax, the corporate minimum tax is imposed *in addition* to the corporation's regular tax. I.R.C. § 56(a) (1982).

244. I.R.C. § 55(a)(1) (1982). The exemption for the alternative minimum tax ranges between $20,000 to $40,000. *Id.* § 55(f).

245. *Id.* § 56(a). The exclusion for the minimum tax is the greater of $10,000 or the corporation's regular tax liability for the taxable year. *Id.*

Seventh, the second and third methods would also distort the noncorporate taxpayer's alternative minimum tax under section 55.[246] The alternative minimum tax involves adding back tax preference items, including excess percentage depletion,[247] to a taxpayer's adjusted gross income, which includes oil and gas net income,[248] to arrive at alternative minimum taxable income. Because deferred percentage depletion tax preferences would be added back to alternative minimum taxable income in taxable years subsequent to the inclusion of the preproduction receipts in such income, the calculation would not properly match oil and gas income with the tax preferences generated by the income.[249] This distortion could be corrected by adding back to alternative minimum taxable income in actual production years an allocable portion of net income from preproduction receipts reported in prior years proportionate to the amortized amount of percentage depletion deducted in the year of actual production. This distortion does not arise in connection with the first method because under that method the percentage depletion tax preference and its related preproduction oil and gas net income would both be included in the same alternative minimum tax calculation.

Finally, in the event that the taxpayer failed to extract oil and gas, or left oil and gas remaining in the ground, the first method would have yielded the taxpayer a percentage depletion deduction which could not be matched, in part or in whole, with actual oil and gas production that failed to occur in later years. This problem would arise because under the first method the taxpayer deducts percentage depletion during preproduction taxable years whether or not production occurs in later taxable years. When it becomes certain that future production will not occur, this problem could be resolved in one of two ways. First, the taxpayer could amend his preproduction taxable year returns in later taxable years, thereby reducing or eliminating the percentage depletion deductions allowed based upon preproduction receipts.[250] Secondly, the

246. *Id.* § 55 (1982 & Supp. 1984). *See supra* note 242.

247. I.R.C. § 57(a)(8) (1982). Section 57(a)(8) treats the percentage depletion deduction as a tax preference item to the extent that percentage depletion exceeds both cost depletion and the adjusted basis of the property, determined without regard to the depletion deduction, at the end of the taxable year. *Id.*

248. *Id.* §§ 61(a)(6), 62(5) (1982 & Supp. 1984).

249. This distortion does not arise in connection with a corporate taxpayer's calculation of the minimum tax under I.R.C. § 56 (1982 & Supp. 1984) because the minimum tax formula does not include as a primary factor the income that generated the preference items. Thus, the fact that the percentage depletion allowance is deducted in years subsequent to the reporting of the preproduction income would not materially distort the outcome of the corporate minimum tax calculation.

250. *Engle*, 464 U.S. at 226. *See* Note, *supra* note 223, at 122; Jones, *supra* note 223, at 233.

taxpayer could restore to income in a later taxable year the percentage depletion allowances previously deducted based upon preproduction receipts.[251] This problem does not accompany the second or third methods because they defer deducting percentage depletion on preproduction receipts until taxable years of actual production.

IV. AFTERMATH

In May, 1984, the IRS announced that, in light of the Supreme Court's decision in *Commissioner v. Engle*, independent producers and royalty owners who receive advance royalties and lease bonuses will be allowed to deduct percentage depletion in the year that such receipts are includable in gross income.[252] The applicable depletion rate and depletable quantity limitation will also be determined with respect to the year that the preproduction receipts are includable in gross income. The IRS further stated that the depletable quantity limitation of section 613A(c) must be applied by attributing a specific number of barrels to the advanced royalty or lease bonus. This calculation must be based on the average price of oil or gas produced from the property during the taxable year. If oil or gas is not produced from the property during the taxable year, the barrel calculation must be based on the representative market price. Finally, the IRS will promulgate regulations providing for appropriate reductions to the depletable quantity limitations applicable in future years in order to prevent taxpayers from availing themselves of multiple depletable quantity limitations related to the same production run.[253]

V. CONCLUSION

The Supreme Court in *Commissioner v. Engle* addressed the issue of whether the language of section 613A, limiting percentage depletion to stated quantities of production, was intended to (1) establish a limit on the amount of such depletion which the taxpayer may claim, or (2) establish production within the taxable year as a prerequisite to any deduction. Both the majority and the dissent analyzed this issue in terms of the statute's language, legislative history, congressional purpose and practical problems of administration.

The key presumption of the majority's argument is that section

251. *Cf.* restoration rules under Treas. Reg. § 1.612-3(a)(2), -3(b)(2) (1960), *supra* note 151 and accompanying text.
252. I.R.S. Announcement 84-59, 1984-23 I.R.B. 58.
253. *Id.*

613A was enacted with the dual purpose of repealing the percentage depletion allowance for the major integrated oil companies and simultaneously spurring domestic production. There is no disagreement within the Court regarding the statute's purpose of repealing percentage depletion for the major integrated oil companies because the statute, on its face, accomplishes this purpose. The majority's assertion, however, that section 613A was also intended to spur domestic production, is tenuous. Given the repeal of the percentage depletion subsidy for the major integrated oil companies and the severe reduction of the subsidy for the independent producers and royalty owners, Congress could not have rationally expected to increase domestic production by enacting the statute.

Thus, the majority's assertion that the statute was intended to spur domestic production must fail. Likewise, the majority's arguments that the Commissioner's interpretation is unreasonable must fail. Although the Commissioner's interpretation might have discouraged domestic production, such discouragement is simply not contrary to any intended purpose of the statute. Ironically, contrary to the majority's intent, their decision may induce oil and gas producers to defer domestic production because the allowance of percentage depletion on preproduction receipts, in effect, subsidizes the holding costs of oil and gas leases.

Ultimately, the majority's decision rests on its determination that the taxpayers' interpretation of the statute is *more* reasonable than the Commissioner's interpretation. At least with respect to practical problems of administration, that finding is doubtful. While the Commissioner's interpretation creates no practical administrative problems, the taxpayers' interpretation gives rise to complex and abundant administrative problems.

Finally, assuming arguendo that the taxpayers' interpretation is the more reasonable one, the majority has clearly stepped outside the boundaries of the Court's traditional approach that "[t]he choice among reasonable interpretations is for the Commissioner, not the courts."[254] Although departing from traditional principles of law is not inherently wrong, such departure should be supported by acknowledgment and reason. The majority, however, failed to acknowledge or account for its departure from the Court's well trodden path. Thus, in the final analysis, the majority's argument remains severely deficient. The Court, there-

254. National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 488 (1979). *See supra* notes 170-71 and accompanying text.

fore, should have deferred to the Commissioner's interpretation of the statute.

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Tax Year: 1985 Appendix I: Calculation of the Percentage Depletion Allowance in the Year that Preproduction Revenue Is Received

Column No.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Estimated Recoverable Units of Production	Preproduction Revenue Received	Estimated Average Per Barrel Revenue (in current dollars)	Estimated Quantity of Production (column 2 divided by column 3)	Statutory Depletable Quantity Limitation (IRC § 613A(c)(3))	Depletable Quantity Allowable (lesser of column 4 or column 5)	Allocable Preproduction Receipts Available for Percentage Depletion (column 3 × column 6)	Statutory Depletion Rate (IRC § 613A(c)(5) - (6))	Allowable Percentage Depletion Deduction (column 7 × column 8)
Total oil and gas production	1,000,000	$350,000	$ 5	70,000	365,000	70,000	$350,000	15%	$52,500
**	*	*	*						***

* Assumed amounts.

** Because the preproduction receipts (column 2) are received in the 1985 tax year, the percentage depletion calculation is not applied separately to receipts related to secondary and tertiary production. I.R.C. § 613A(c)(6) (1982 & Supp. 1984).

*** This amount is subject to the 50% taxable income from the property limitation of I.R.C. § 613(a) (1982) and the 65% taxable income limitation of I.R.C. § 613A(d)(1) (1982). *See supra* notes 6 & 113.

Tax Year: 1983

Appendix II: Calculation of the Percentage Depletion Allowance in the Year that Preproduction Revenue Is Received

Column No.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Estimated Recoverable Units of Production	Ratio	Preproduction Revenue Received	Estimated Average Per Barrel Revenue (in current dollars)	Estimated Quantity of Production (column 3 divided by column 4)	Statutory Depletable Quantity Limitation (IRC § 613A(c)(3))	Depletable Quantity Allowable (lesser of column 5 or column 6)	Allocable Preproduction Receipts Available for Percentage Depletion (column 4 × column 7)	Statutory Depletion Rate (IRC § 613A(c)(5) -(6))	Allowable Percentage Depletion Deduction (column 8 × column 9)
Primary Production	700,000	70%	$350,000	$ 5	70,000		70,000	$350,000	16%	$56,000
Secondary/ Tertiary Production	300,000	30%	150,000	$ 5	30,000		30,000	150,000	22%	33,000
Total	1,000,000 *	100%	$500,000 *	*	100,000	365,000	100,000	$500,000		$89,000 **

* Assumed amounts.

** This amount is subject to the 50% taxable income from the property limitation of I.R.C. § 613(a) (1982) and the 65% taxable income limitation of I.R.C. § 613A(d)(1) (1982). *See supra* notes 6 & 113.

Tax Year: 1983	Appendix III: Calculation of the Percentage Depletion Allowance in a Taxable Year of Actual Production							
Column No.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Estimated Recoverable Units of Production	Ratio	Total Preproduction Revenue Received in Prior Years	Actual Units Produced in Current Taxable Year	Ratio of Actual Units Produced in Current Year to Estimated Recoverable Units of Production (column 4 divided by column 1)	Amount of Preproduction Revenue Available for Percentage Depletion in current year (column 3 × column 5)	Per Barrel Royalty Revenue Received with Respect to Actual Production in Current Year	Royalty Revenue Received with Respect to Actual Production in Current Year (column 4 × column 7)
Primary Production	800,000	80%	$640,000	240,000	30%	$192,000	$ 5	$1,200,000
Secondary/ Tertiary Production	200,000	20%	160,000	-0-	-0-	-0-	-0-	-0-
Total	1,000,000	100%	$800,000	240,000		$192,000		$1,200,000
	*		*	*			*	

Tax Year: 1983			Appendix III (continued)				
Column No.	(9)	(10)	(11)	(12)	(13)	(14)	(15)
	Total Allocated Revenue with Respect to Current Production (column 6 + column 8)	Average Per Barrel Revenue Received with Respect to Current Production (column 9 divided by column 4)	Statutory Depletable Quantity Limitation (IRC § 613A(c)(3))	Depletable Quantity Allowable (lesser of column 4 or column 11)	Revenue Available for Percentage Depletion (column 10 × column 12)	Statutory Depletion Rate (IRC § 613A(c)(5)-(6))	Allowable Percentage Depletion Deduction (column 13 × column 14)
Primary Production	$1,392,000	$ 5.80		240,000	$1,392,000	16%	$222,720
Secondary/ Tertiary Production	-0-			-0-	-0-	22%	-0-
Total	$1,392,000		365,000	240,000	$1,392,000		$222,720 **

* Assumed amounts.

** This amount is subject to the 50% taxable income from the property limitation of I.R.C. § 613(a) (1982) and the 65% taxable income limitation of I.R.C. § 613A(d)(1) (1982). *See supra* notes 6 & 113.

Tax Year: 1983	Appendix IV: Calculation of the Percentage Depletion Allowance in a Taxable Year of Actual Production							
Column No.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Estimated Recoverable Units of Production	Ratio	Total Preproduction Revenue Received in Prior Years	Actual Units Produced in Current Taxable Year	Ratio of Actual Units Produced in Current Year to Estimated Recoverable Units of Production (column 4 divided by column 1)	Amount of Preproduction Revenue Available for Percentage Depletion in current year (column 3 × column 5)	Per Barrel Royalty Revenue Received with Respect to Actual Production in Current Year	Royalty Revenue Received with Respect to Actual Production in Current Year (column 4 × column 7)
Primary Production	1,600,000	80%	$1,280,000	400,000	25%	$320,000	$ 5	$2,000,000
Secondary/ Tertiary Production	400,000	20%	320,000	80,000	20%	64,000	$ 5	400,000
Total	2,000,000	100%	$1,600,000	480,000		$384,000		$2,400,000
	*		*	*			*	

Tax Year: 1983 — Appendix IV (continued)

Column No.	(9)	(10)	(11)	(12)	(13)	(14)	(15)
	Total Allocated Revenue with Respect to Current Production (column 6 + column 8)	Average Per Barrel Revenue Received with Respect to Current Production (column 9 divided by column 4)	Statutory Depletable Quantity Limitation (IRC § 613A(c)(3))	Depletable Quantity Allowable (lesser of column 4 or column 11)	Revenue Available for Percentage Depletion (column 10 × column 12)	Statutory Depletion Rate (IRC § 613A(c)(5)-(6))	Allowable Percentage Depletion Deduction (column 13 × column 14)
Primary Production	$2,320,000	$ 5.80		285,000	$1,653,000	16%	$264,480
Secondary/ Tertiary Production	464,000	$ 5.80		80,000	464,000	22%	$102,080
Total	$2,784,000		365,000	365,000 **			$366,560 ***

* Assumed amounts.

** Under I.R.C. § 613A(c)(3) (1982 & Supp. 1984), the pre-1984 depletable quantity allowable is first allocated to secondary/tertiary production and then to primary production.

*** This amount is subject to the 50% taxable income from the property limitation of I.R.C. § 613(a) (1982) and the 65% taxable income limitation of I.R.C. § 613A(d)(1) (1982). *See supra* notes 6 & 113.

Appendix V: Analysis of Practical Administrative Problems	(1) *Estimating ratio of primary and secondary/ tertiary oil and gas production*		(2) Estimating the property's mineral reserve		(3) Multiple depletable quantity limitations ("DQL's")	
	Problem	Resolution	Problem	Resolution	Problem	Resolution
Method One: calculate and deduct percentage depletion allowance in the taxable year that preproduction payments are received	Taxpayers likely to estimate ratio in favor of type of production commanding highest market price to maximize income eligible for percentage depletion	Case-by-case government administrative review	Not applicable	Not applicable	Taxpayers subject to two sets of DQL's: one set during preproduction years and a second set during actual production years	Reduce DQL's of actual production years by depletable quantity amounts of preproduction years
Method Two: calculate the percentage depletion allowance in year that preproduction payments are received and deduct allowance in taxable years of actual production	Taxpayers likely to estimate ratio in favor of type of production commanding highest market price in order to maximize income eligible for percentage depletion	Case-by case government administrative review	Taxpayers likely to minimize reserve estimate to maximize the amortized allowable amount of percentage depletion	Case-by-case government administrative review	Taxpayers subject to two sets of DQL's: one set during preproduction years and a second set during actual production years	Reduce DQL's of actual production years by depletable quantity amounts of preproduction years
Method Three: calculate and deduct percentage depletion allowance in taxable years of actual production	Not applicable	Not applicable	Taxpayers likely to minimize reserve estimate to maximize the amortized allowable amount of percentage depletion	Case-by-case government administrative review	Not applicable	Not applicable

Appendix V (continued) Analysis of Practical Administrative Problems	(4) Transfer of property by reason of sale, exchange, gift, death or other disposition		(5) Distortion of 50% and 65% income limitations		(6) Distortion of alternative minimum tax (AMT) and minimum tax (MT): multiple exemptions and exclusions	
	Problem	Resolution	Problem	Resolution	Problem	Resolution
Method One: calculate and deduct percentage depletion allowance in the taxable year that preproduction payments are received	Not applicable	Not applicable	Limitations distorted because percentage depletion deductions related to a single oil and gas interest taken in both preproduction and actual production taxable years	Amortize preproduction receipts and preproduction percentage depletion deductions over productive life of property	AMT and MT distorted because percentage depletion tax preferences related to a single oil and gas interest are reported in both preproduction and actual production taxable years	No obvious way to correct distortion without producing other AMT and MT distortions of equal or greater magnitude
Method Two: calculate the percentage depletion allowance in year that preproduction payments are received and deduct allowance in taxable years of actual production	What becomes of the deferred percentage depletion amount?	Two possibilities: (a) deferred amount carries over to new owner or (b) deferred amount does not carry over and is lost	Limitations distorted because income giving rise to the percentage depletion deduction was previously reported in a preproduction year	Add back to taxable income, solely for the purpose of computing the limitations, an allocable portion of preproduction receipts	Not applicable	Not applicable
Method Three: calculate and deduct percentage depletion allowance in taxable years of actual production	What becomes of the deferred percentage depletion amount?	Two possibilities: (a) deferred amount carries over to new owner or (b) deferred amount does not carry over and is lost	Limitations distorted because income giving rise to the percentage depletion deduction was previously reported in a preproduction year	Add back to taxable income, solely for the purpose of computing the limitations, an allocable portion of preproduction receipts	Not applicable	Not applicable

Appendix V (continued) Analysis of Practical Administrative Problems	(7) Distortion of alternative minimum tax: mismatching of excess percentage depletion with related royalty revenue		(8) Production failure in later years	
	Problem	Resolution	Problem	Resolution
Method One: calculate and deduct percentage depletion allowance in the taxable year that preproduction payments are received	Not applicable	Not applicable	Taxpayer takes percentage depletion deduction on preproduction receipts despite partial or no production in subsequent years	*Two possibilities:* (a) amend preproduction taxable year returns or (b) restore to income in a later taxable year depletion allowances previously deducted
Method Two: calculate the percentage depletion allowance in year that preproduction payments are received and deduct allowance in taxable years of actual production	AMT distorted because deferred percentage depletion tax preferences are added back into AMT income in taxable years subsequent to the inclusion of preproduction receipts in such income	Add back to AMT income in subsequent productive years an allocable portion of preproduction receipts	Not applicable	Not applicable
Method Three: calculate and deduct percentage depletion allowance in taxable years of actual production	AMT distorted because deferred percentage depletion tax preferences are added back into AMT income in taxable years subsequent to the inclusion of preproduction receipts in such income	Add back to AMT income in subsequent productive years an allocable portion of preproduction receipts	Not applicable	Not applicable