

A GEOLOGIST DISCUSSES DEPLETION

THOMAS C. HIESTAND

Landowners maintain adverse possession of their real property insofar as the length and breadth of their land surface is surveyed and fenced. But geologically real property has a third dimension, the vertical which extends downward to the center of the earth, almost 4,000 miles. If held aloft it would be like a plug cut in a watermelon from which we could bite off its valuable contents and discard the undesirable parts. By means of shafts and wells the extractive, mining industries obtain the earth's valuable contents such as tile and cement, coal, salt, oil and gas, iron, aluminum and gold. Centuries ago in early English law these were established as capital assets and belonged with the title to the land.

Landowners today (jointly with any mineral interest owners) grant oil and gas leases and usually retain ownership of 12½ percent of oil and gas produced, saved and sold. The lessee (jointly with over riding royalty interest owners) owns usually the 87½ percent of oil and gas produced, saved and sold after bearing all cost and expense. Both lessor and lessee comprise the petroleum producer. Forty years ago a Supreme Court decision stated “. . . the sale of oil results in reduction of a capital asset and . . . this reduction must be considered in computing taxable income ‘just as the cost of raw material must be deducted from gross income before the net income can be determined.’”

The owner of any interest whatsoever in real property to which oil and gas production and sale is attributable, is liable to declare the tax he owes on his share, division or fraction of the sales value accruing during his taxable year. Legality of depletion was established by the Supreme Court decision aforementioned. In 1918, a federal statute provided that depletion could be based upon a fair market value of a newly discovered pool instead of its actual cost. In 1926, after the Treasury Department had learned it was too difficult to pass on a fair discovery value rapidly enough to collect income taxes annually, another federal statute provided that 27½ percent of annual sales value of oil and gas could be deducted but not to exceed 50 percent of the net income in lieu of establishing the fair market value of the newly discovered pool. The 1926 Act re-confirmed the intent of the 1918 Act, and alleviated work in computing tax returns so the tax could be collected annually.

Legality of depreciation had its origin in a federal statute in 1909, which provided “. . . A reasonable allowance for depreciation of property.” However, a Supreme Court decision prevented a group of mining companies from recovering taxes paid on ore sold from their properties because, as decided by the Court, “in no accurate sense can such exhaustion of the body of ore be deemed depreciation.”

Gordon Jones, C.P.A. has ably presented the accounting theory by which the sales value of real property has to be taxed only on the basis of capital gain and loss. (In Great Britain capital gain cannot be taxed.) He calls attention to the fact that oil sold at the stock tanks and gas at the casinghead is completely real property the same as when oil and gas are sold in the ground (when an entire property's title is transferred on the county records.) He cites a former Internal Revenue Service reviewing engineer's paper establishing 33½ percent of oil and gas sales value as a reasonable and proper deduction on account of depletion. Jones advocates treating all capital gain on one com-

mon basis, deducting 50 percent of capital gain plus all capital loss, on account of depletion.

Depletion is legally established in America, going back to 1909. And in accounting theory depletion was established centuries before an income tax was imposed on the nation. Depletion goes with the title to the land; it is a part of property rights which landowners must learn before their rights are usurped and confiscated. Corporations and associations cannot vote; only through civic minded efforts as individuals can we preserve our property rights given to us proudly but with great sacrifice by our forefathers.