2 T.C. 1258 (1943)

A taxpayer who retains a net profits interest in an oil and gas lease is entitled to a percentage depletion deduction on the income received from that interest.

Summary

Kirby Petroleum Company leased land for oil exploration, retaining a one-sixth royalty and a 20% net profits interest. The Commissioner of Internal Revenue allowed percentage depletion on the royalty income but disallowed it on the net profits income. The Tax Court held that Kirby was entitled to percentage depletion on the 20% net profits because it represented a retained economic interest in the oil in place, distinguishing the case from situations where the taxpayer had disposed of their entire interest in the property.

Facts

Kirby Petroleum Company owned two tracts of land. They leased the land to Humble Oil & Refining Co. and Marland Oil Co. for oil and gas exploration. The lease agreement reserved a one-sixth oil royalty to Kirby. Contemporaneously, Kirby and the lessees agreed in writing that Kirby would receive 20% of the net profits from the lessees' operations under the lease. The lessees drilled a well in 1932 and continuously produced oil. Kirby received payments under the profits agreement from 1935 through 1940, including $26,223.70 in 1940.

Procedural History

Kirby deducted 27.5% of the $26,223.70 as depletion on its 1940 income tax return. The Commissioner disallowed this deduction, leading to a deficiency assessment. Kirby appealed to the Tax Court.

Issue(s)

Whether Kirby Petroleum Company is entitled to a percentage depletion deduction on the income it received as its share of the net profits from the oil and gas operations on its leased land.

Holding

Yes, because Kirby retained an economic interest in the oil in place by reserving a right to a portion of the net profits derived from the oil extraction.

Court's Reasoning

The court relied on 26 U.S.C. § 114(b)(3), which allows a percentage depletion for oil and gas wells based on the "gross income from the property." The court distinguished *Helvering v. O'Donnell*, 303 U.S. 370 (1938), *Helvering v. Elbe Oil*

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Land Development Co., 303 U.S. 372 (1938), and *Anderson v. Helvering*, 310 U.S. 404 (1940), because in those cases, the taxpayers had disposed of their entire interest in the oil and gas properties. Here, Kirby retained a one-sixth oil royalty and a 20% net profits interest. The court quoted its prior decision in *Marrs McLean*, 41 B.T.A. 565, stating that even though the payments were measured by net profits, "this contract did not effect a sale of McLean's interest... It is more like the contracts in the *Palmer, Perkins*, and *Harmel* cases. Consequently, we hold that the petitioners are entitled to depletion in connection with the Gray leases." The court determined that Kirby's "gross income from the property" included the proceeds from the one-sixth oil royalty and the 20% net profits. Therefore, it was entitled to percentage depletion on both.

Practical Implications

This case clarifies that a retained net profits interest in an oil and gas lease qualifies for a percentage depletion deduction. It distinguishes situations where the taxpayer retains an economic interest from those where they sell their entire interest. Legal practitioners should analyze whether the taxpayer has retained a continuing economic interest tied to the extraction of the resource. Later cases have cited *Kirby Petroleum* to support the principle that depletion deductions are allowed when the taxpayer has a capital investment in the mineral in place and the income is derived from the extraction of that mineral. The lessees cannot include the royalty and profit payments to the petitioner in their own gross income calculation for depletion purposes.

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