6 T.C. 294 (1946)

A taxpayer who retains an economic interest in oil and gas in place is entitled to a depletion allowance, even if their compensation is based on a share of net profits from the oil production.

Summary

Wm. R. Murphy and Mary Murphy, along with other individuals, owned fractional interests in oil leaseholds. They assigned these interests to the Adams Oil & Gas Co. under an agreement where Adams would operate the properties and pay the owners 25% of the net profits. The Tax Court held that the Murphys retained an economic interest in the oil, entitling them to depletion allowances because their income was directly tied to oil production, and the arrangement was designed for efficient operation rather than a complete sale of their interest.

Facts

The Murphys, along with thirteen others, owned oil and gas leases in Clinton County, Illinois, held in the name of Carl Willi. They entered into an "Operating Agreement" with Adams Oil & Gas Co., assigning their leasehold estates to Adams. Adams agreed to drill a test well. If productive, Adams would complete the well, with costs charged to a "Net Profits Account." The Murphys and others would receive one-fourth of the net profits from the venture. Adams had sole management of oil sales but had to account for the owners' share of profits. The agreement specified that nothing in it constituted a partnership and that all contact between Adams and the individual assignors would be through William R. Murphy as trustee.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Murphys' income tax, disallowing depletion allowances claimed on income received under the operating agreement. The Murphys petitioned the Tax Court for review.

Issue(s)

1. Whether the Murphys retained an economic interest in the oil and gas in place after assigning their leaseholds to Adams Oil & Gas Co., entitling them to depletion allowances on the income received from the net profits of oil production.

Holding

1. Yes, because the Murphys' right to receive payments was tied directly to the extraction and sale of oil, representing a continuing capital investment in the oil in place.

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Court’s Reasoning

The Tax Court emphasized that the key factor in determining depletion allowances is whether the taxpayer has a capital investment in the oil in place and looks to the oil as the source of the return of that investment. The court reviewed the operating agreement, noting that despite language suggesting a complete transfer of interest to Adams, the agreement’s overall structure indicated a joint venture for the exploration and development of the leases. The court highlighted terms like

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