11 T.C. 726 (1948)

For the purpose of calculating percentage depletion on oil and gas wells, “gross income from the property” is determined by the amount the taxpayer receives for the crude product at the wellhead, excluding any costs associated with transportation or processing after production.

Summary

The Tax Court addressed whether oil producers could include transportation and gathering charges, deducted by the purchaser, in their “gross income from the property” calculation for percentage depletion purposes. The producers sold their oil to a pipeline company, which deducted a “freight equalization charge” and a “gathering charge” under their agreement. The court held that these charges, representing post-production transportation costs, could not be included in the gross income calculation because percentage depletion is based on the value of the crude oil at the wellhead, before transportation or processing.

Facts

James P. Evans, Sr., and his family owned an oil and gas lease in Mississippi. They sold the oil produced to Allied Pipe Line Corporation under a contract where Allied deducted a “freight equalization charge” and a “gathering charge” from the price paid to the Evans family. These charges were intended to cover Allied’s costs of transporting the oil from the well to a refinery. The Evans family argued that these charges should be added back into their gross income from the property for calculating percentage depletion.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Evans family’s income tax. The Evans family petitioned the Tax Court for a redetermination of these deficiencies, arguing that they were entitled to include the transportation and gathering charges in their gross income calculation. The Tax Court consolidated the cases for James P. Evans, Sr., Edith S. Evans, William S. Evans, Catherine M. Evans, and James P. Evans, Jr.

Issue(s)

Whether amounts deducted by the purchaser of crude oil from the sale price, representing transportation and gathering charges, can be included in the seller’s “gross income from the property” for the purpose of calculating percentage depletion under Internal Revenue Code section 114(b)(3).

Holding

No, because “gross income from the property” is defined as the amount the taxpayer receives for the crude mineral product in the immediate vicinity of the well, and does not include costs associated with transportation or processing after production.

Court's Reasoning

The court relied on Treasury Regulations defining "gross income from the property" as the amount received for the crude mineral product at the wellhead. The court emphasized that if the product is transported or processed before sale, these costs must be excluded from the gross income calculation. The court stated: "That regulation employs as a definition of 'gross income from the property'…the principle that the crude product itself at the source is determinative…and that if other items are included in the ultimate sale, such as refining, processing, or transportation, they are to be eliminated as nearly as may be in arriving at the figure sought." The court found that the agreement between the parties clearly indicated that the deducted charges were for transportation costs, not for the value of the oil itself. The court distinguished between costs of producing the crude product and costs of transporting it after production.

Practical Implications

This case clarifies the method for calculating percentage depletion for oil and gas wells. It establishes that only the income derived from the sale of the crude product at the wellhead is considered when calculating the 27 1/2% depletion allowance. Legal practitioners must carefully analyze contracts for the sale of oil and gas to determine whether any deductions from the gross price represent post-production transportation or processing costs. These costs must be excluded from the calculation of "gross income from the property." This ruling ensures a uniform method for determining depletion across various oil producers, regardless of their individual transportation arrangements. Later cases have consistently applied this principle, focusing on the location and nature of the income-generating activity to determine its includability in the gross income calculation for depletion purposes. The core principle remains that depletion is an allowance for the extraction of the resource itself, not for activities performed after the resource has been brought to the surface.

