11 T.C. 1042 (1948)

A taxpayer who owns an economic interest in minerals in place, such as heavier hydrocarbons within natural gas reserves, is entitled to percentage depletion deductions on income derived from their production and sale.

Summary

Hudson v. Commissioner addresses the tax implications of extracting heavier hydrocarbons from natural gas. The Tax Court held that the petitioners, who had been assigned interests in the heavier hydrocarbons (propanes, butanes, etc.) contained within natural gas reserves, were entitled to claim percentage depletion deductions. The court reasoned that these assignments conveyed an economic interest in the minerals in place, entitling them to the deduction. The court also addressed issues regarding the accrual of income for a construction company and the valuation of non-negotiable notes.

Facts

Several lease owners in the North Houston Field, which contained natural gas with a mix of lighter (methane, ethane) and heavier hydrocarbons, sought to improve production. They assigned E.J. Hudson a one-half interest in the heavier hydrocarbons in place in exchange for constructing and operating a recycling plant. Hudson, in turn, assigned portions of his interest to other parties, including the petitioners. These assignments were subject to a processing contract and unitization agreement. The IRS disallowed depletion deductions claimed by Hudson and his assigns, arguing they held no economic interest.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax for 1944 and 1945, disallowing claimed depletion deductions. The petitioners appealed to the United States Tax Court.

Issue(s)

1. Whether the petitioners (other than Hudson Engineering Corporation) were entitled to percentage depletion deductions in 1944 and 1945 based on income derived from the production and sale of heavier hydrocarbons removed from natural gas.
2. Whether Hudson Engineering Corporation should have accrued a portion of its fee for constructing the processing plant as income during its fiscal year ending July 31, 1944.
3. Whether the face value of non-negotiable promissory notes received by Hudson in 1944 should be included in his gross income for that year.

Holding

1. Yes, because the assignments granted to Hudson and subsequently to the petitioners conveyed an economic interest in the heavier hydrocarbons in place.
2. Yes, because Hudson Engineering Corporation failed to prove collection of the fee was subject to reasonable uncertainty at the end of the fiscal year.
3. No, because the non-negotiable notes were subject to complex agreements and conditions, and thus were not the equivalent of cash.

Court's Reasoning

The court emphasized the language of the assignments, which