***31 T.C. 320 (1958)***

A taxpayer who owns a mineral interest and receives proceeds from a trespasser's extraction of oil and gas is entitled to a percentage depletion deduction, even if the proceeds are received through litigation and the trespasser was considered an innocent trespasser.

**Summary**

The Estate of Arnett sought a redetermination of tax liability, challenging the Commissioner's disallowance of a depletion deduction. Thomas Arnett owned the mineral rights to land in Kentucky. Oil companies trespassed on the land, extracting oil and gas. Arnett sued, and the court awarded him the net profits from the trespassers' operations, interest, and discounts. The Tax Court held that Arnett was entitled to a percentage depletion deduction based on the gross income from the oil extracted by the trespassers, even though the income was received through a court award. The court also addressed the deductibility of legal fees and the inclusion of interest and discounts in the calculation of depletion.

**Facts**

- Thomas E. Arnett owned mineral rights to land in Kentucky.
- Oil companies trespassed on the land, extracting oil and gas.
- Arnett sued the oil companies for trespass and an accounting.
- The District Court determined that the oil companies were innocent trespassers and entitled to a setoff for their operating expenses.
- Arnett received a judgment in 1951, including net profits, interest, and discounts.
- Arnett paid attorneys' fees related to the litigation.
- Arnett claimed a percentage depletion deduction on his income tax return, which the Commissioner disallowed.

**Procedural History**

- The Commissioner of Internal Revenue issued a notice of deficiency, disallowing Arnett's claimed deduction for a farm loss and depletion.
- The Estate of Arnett filed a petition with the U.S. Tax Court, challenging the deficiency determination.
- The Commissioner filed an amended answer, asserting an increased deficiency.
- The Tax Court heard the case and ruled in favor of the Estate, allowing the depletion deduction.

**Issue(s)**

1. Whether the Tax Court had jurisdiction over the case.
2. Whether the decedents were entitled to a percentage depletion deduction for amounts recovered from trespassers on the mineral interest.

3. Whether the depletion deduction should be computed on gross receipts or the net recovery from the trespassers.
4. Whether the legal expenses of the decedents were deductible.
5. Whether interest and discounts should be included in the income for computing the depletion deduction.

**Holding**

1. Yes, the Tax Court had jurisdiction.
2. Yes, the decedents were entitled to a percentage depletion deduction.
3. The depletion deduction should be computed on the gross income from the oil, without reduction for the trespassers' expenses.
4. One-half of the legal fees was deductible.
5. No, interest and discounts should not be included in the gross income for computing the depletion deduction.

**Court's Reasoning**

The court first addressed the jurisdictional challenge, finding that the administrator's authority to file the petition stemmed from their status as administrator and from the Internal Revenue Code, regardless of any specific state court order. The court then addressed the substantive issues. The court stated the general rule that when the owner of a capital investment in oil and gas in place receives proceeds from the sale of the oil and gas, the owner is entitled to a percentage depletion deduction. The court distinguished the case from prior cases such as Massey and Parr where the owners did not have an ownership interest that pre-dated the litigation. "The depletion deduction available for oil and gas is for the benefit of "the taxpayer [who] has a capital investment in the oil in place which is necessarily reduced as the oil is extracted." The court concluded that Arnett was entitled to a percentage depletion allowance. The court determined that Arnett's gross income for depletion purposes should include all expenses paid by the conservators during their operation of the property. Finally, the court determined that legal expenses are deductible to the extent they relate to income collection, so they allowed Arnett to deduct half of the fees. The court held that interest on the judgment and discounts earned by the trespassers should not be included in the gross income for depletion calculation.

**Practical Implications**

This case is critical for cases involving mineral rights and depletion deductions. The decision clarifies that the right to a depletion deduction for oil and gas is not contingent on a voluntary extraction and sale. This case confirms that the depletion deduction applies to recoveries from trespassers as long as the taxpayer owns the mineral interest.

This case highlights the importance of establishing the ownership of a mineral interest and determining the nature of the income received. When representing a client who has received an award for oil and gas extracted by a trespasser, an attorney should consider the following:

- Determine if the taxpayer has a capital investment in the oil and gas.
- Ascertain the nature of the income received (e.g., damages, profits).
- Calculate the depletion deduction based on the gross income received, excluding interest and discounts.
- Consider the deductibility of legal expenses, allocating them between income collection and quieting title, if applicable.

Later cases may rely on this precedent for situations where a party has ownership of mineral rights and is suing to protect those rights from extraction by trespassers.