***Killam v. Commissioner*, 39 T.C. 680 (1963)**

Unitization agreements for oil and gas leases do not automatically create a new, single property interest for depletion purposes; taxpayers can continue to treat their pre-unitization separate lease interests for depletion calculations.

Summary

Killam & Hurd partnership owned interests in three oil and gas leases, taking percentage depletion on one and cost depletion on the others. They entered a voluntary unitization agreement, forming the Quien Sabe Unit. The IRS argued that unitization created a single new property interest, requiring depletion to be calculated on the unit income as a whole. The Tax Court held that unitization did not extinguish the separate lease interests for depletion purposes, allowing Killam & Hurd to continue using their pre-unitization depletion methods for each lease. This decision aligns with the principle that unitization is a cooperative operating agreement, not a property exchange.

Facts

Killam & Hurd partnership held working interests in three oil and gas leases: Bruni 77, Bruni 128, and Blanco-McLean, all in the Quien Sabe Field.

For tax purposes, Killam & Hurd used percentage depletion for the Bruni 77 Lease and cost depletion for the Bruni 128 and Blanco-McLean Leases.

On March 10, 1954, Killam & Hurd entered into a voluntary unitization agreement with other lease owners to form the Quien Sabe Unit, effective April 1, 1954.

This agreement pooled the leases for more efficient operation of the entire field, assigning participating factors to each lease based on estimated oil in place and future production.

Under the unitization, Killam & Hurd received a proportionate share of the unit’s total production income based on their lease interests and the assigned participating factors.

Killam & Hurd continued to calculate depletion separately for each of the three original leases.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax against the petitioners, partners in Killam & Hurd.

The Commissioner disallowed separate lease depletion, arguing for depletion on the income from the unitized interest only.

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Petitioners contested this determination in the United States Tax Court.

Issue(s)

Whether the voluntary unitization agreement entered into by Killam & Hurd resulted in the creation of a new, single property interest for depletion purposes, thereby precluding the partnership from calculating depletion separately for each of the original leases contributed to the unit.

Holding

No, because the unitization agreement did not extinguish Killam & Hurd's separate economic interests in the original leases for depletion purposes. The partnership could continue to calculate depletion for each lease as separate properties.

Court's Reasoning

The Tax Court relied on its prior decisions in *Belridge Oil Co.* and *Earl V. Whitwell*, which held that unitization is essentially a cooperative operating agreement, not a taxable exchange of properties.

The court quoted *Belridge Oil Co.*, stating, "Hence, we think each participant had exactly the same interests and rights in its respective properties after unitization as before, except that by mutual consent they had agreed to limit their production and operate their wells in the most economically feasible way from the standpoint of conservation considerations."

The court emphasized that the statute grants taxpayers the election to use percentage or cost depletion, whichever is greater, for each "property." Depriving the petitioners of this election by forcing them to treat the unit as a single property would contradict the statute's intent.

The court rejected the argument that the legal effect of unitization under Texas law (where an exchange theory might apply in property law) should dictate federal tax consequences. Citing *Burnet v. Harmel*, the court asserted that federal tax law should have uniform nationwide application, independent of varying state property law interpretations unless Congress explicitly makes it dependent on state law.

The court concluded that regardless of state law property concepts, for federal income tax depletion purposes, unitization in this case did not merge the separate lease interests into a single property.

Practical Implications

Killam v. Commissioner reinforces the principle that voluntary unitization agreements, common in the oil and gas industry for efficient field operations, generally do not trigger a taxable exchange or consolidation of property interests for

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federal income tax depletion purposes.

This case allows oil and gas operators to maintain their pre-unitization depletion methods (percentage or cost) for each lease contributed to a unit, potentially maximizing depletion deductions.

Legal professionals analyzing similar cases should focus on the nature of the unitization agreement – whether it is a true pooling of interests or merely a cooperative operating arrangement. Voluntary agreements, like in *Killam*, are less likely to be treated as property exchanges than compulsory unitization under state law, although *Whitwell* suggests even compulsory unitization may not automatically trigger an exchange for depletion purposes.

Later cases and IRS rulings continue to apply this principle, though specific terms of unitization agreements and state law can still be relevant factors in determining tax consequences. Taxpayers should carefully document the separate lease interests and depletion methods used before unitization to support their claims.

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