Mesa Petroleum Co. v. Commissioner, 57 T. C. 387 (1971)

The gross income from the property for depletion purposes must be computed using the representative market or field price of gas at the wellhead, not the price after processing and marketing.

Summary

In Mesa Petroleum Co. v. Commissioner, the court addressed how to calculate the percentage depletion deduction for gas production. The case involved Mesa Petroleum, which merged with Hugoton Production Co. , and sought to compute its depletion deduction based on gas sales after processing. The court ruled that the gross income from the property should be based on the representative market or field price at the wellhead, not the proceeds from processed gas sales. This decision upheld the IRS's method of calculating the deduction, emphasizing that depletion deductions must be equitably apportioned between lessors and lessees based on the actual royalties paid, not on a hypothetical value.

Facts

Mesa Petroleum Co. merged with Hugoton Production Co. , which operated in the Hugoton Gas Field in Kansas. Hugoton extracted gas from wells, transported it through a gathering system to a processing plant, and sold the processed gas and byproducts. Royalties were paid to lessors based on the Matzen formula, which included the costs of transportation, processing, and marketing. The IRS determined a tax deficiency for 1965, calculating Mesa's depletion deduction using the representative market or field price of 14 cents per MCF, reduced by royalties paid to lessors.

Procedural History

The IRS issued a notice of deficiency to Mesa Petroleum for the 1965 tax year. Mesa contested the calculation of its percentage depletion deduction. The case was heard by the Tax Court, which upheld the IRS's method of calculating the depletion deduction based on the representative market or field price.

Issue(s)

1. Whether the gross income from the property for depletion purposes should be calculated using the representative market or field price at the wellhead.
2. Whether the Matzen formula used for calculating royalties should also be used to compute the lessee's gross income from the property for depletion purposes.

Holding

1. Yes, because the gross income from the property for depletion purposes must be based on the representative market or field price of gas at the wellhead, as

stipulated by the regulations.
2. No, because using the Matzen formula, which includes processing and marketing profits, would improperly allow depletion deductions on these profits.

Court's Reasoning

The court applied the Internal Revenue Code's section 613, which specifies that the gross income from the property for depletion purposes should be the representative market or field price of gas before conversion or transportation. The court rejected Mesa's argument to use the Matzen formula, which included profits from processing and marketing, as it would allow depletion on non-depletable income. The court emphasized that depletion deductions must be equitably apportioned between lessors and lessees, with the lessor's deduction based on actual royalties received and the lessee's based on the remaining income after royalties. The decision was supported by prior cases like Shamrock Oil & Gas Corp. and Hugoton Production Co. v. United States, which established the use of the field price method. The court quoted Kirby Petroleum Co. v. Commissioner to underline that an equitable apportionment requires excluding royalties from the lessee's gross income before calculating depletion.

Practical Implications

This decision clarifies that depletion deductions for gas must be calculated using the representative market or field price at the wellhead, not the price after processing or marketing. Legal practitioners should ensure clients compute depletion based on this method to avoid tax deficiencies. The ruling impacts how oil and gas companies structure their royalty agreements and calculate their tax obligations, emphasizing the importance of the wellhead price. Subsequent cases, such as those involving similar depletion issues, have followed this precedent, reinforcing the need to distinguish between income from mineral extraction and income from processing or marketing activities.