Glass v. Commissioner, 76 T. C. 949 (1981)

Percentage depletion under section 613A(c) is not allowable for oil and gas lease bonuses because they are not received with respect to actual production of oil or gas during the taxable year.

Summary

In Glass v. Commissioner, the petitioners sought percentage depletion deductions for bonuses received from oil and gas leases executed in 1975. The Tax Court held that such bonuses did not qualify for percentage depletion under section 613A(c) because they were not tied to actual production of oil or gas in the taxable year. The court emphasized that bonuses are payments for the right to explore, not for oil or gas produced, and thus are only eligible for cost depletion. The decision highlights a significant shift from prior law, which allowed percentage depletion on bonuses, and underscores the importance of actual production for percentage depletion eligibility.

Facts

In 1975, James David Glass and Willie Glass received lease bonuses totaling $139,940 for executing oil and gas leases on their properties. Production occurred on all but one lease, from which they received $19,200. They also received $24,811 in royalties from the producing leases. The petitioners claimed percentage depletion on their lease bonuses and royalties but were denied by the Commissioner for the bonuses. The issue before the court was whether these bonuses qualified for percentage depletion under the newly amended section 613A(c).

Procedural History

The Commissioner determined a deficiency in the petitioners’ 1975 federal income tax and disallowed the percentage depletion deduction on the lease bonuses. The petitioners contested this determination in the United States Tax Court, which upheld the Commissioner’s decision, ruling that lease bonuses did not qualify for percentage depletion under section 613A(c).

Issue(s)

1. Whether oil and gas lease bonuses received in 1975 qualify for percentage depletion under section 613A(c).

Holding

1. No, because lease bonuses are not received with respect to actual production of oil or gas during the taxable year, as required by section 613A(c).

Court’s Reasoning

The court reasoned that section 613A(c) allows percentage depletion only for income derived from actual production of oil or gas during the taxable year. Lease bonuses, which are payments for the right to explore and are received regardless of production, do not meet this criterion. The court rejected the petitioners' argument that bonuses should be treated as advance royalties for future production, stating that the statute's language clearly requires actual production. The court also noted the absence of legislative history supporting the petitioners' interpretation and highlighted practical problems with allowing percentage depletion on bonuses, such as the difficulty in converting bonus dollars into units of production. The majority opinion was supported by Judge Goffe's concurrence, while Judge Fay dissented, arguing that bonuses represent future production and should qualify for percentage depletion.

Practical Implications

This decision has significant implications for how oil and gas lease bonuses are treated for tax purposes. It clarifies that under current law, percentage depletion is not available for lease bonuses, limiting deductions to cost depletion. This ruling affects how taxpayers in the oil and gas industry structure their leases and calculate their tax liabilities. It also impacts the financial planning of independent producers and royalty owners, who must now rely solely on cost depletion for lease bonuses. The decision has been followed in subsequent cases, reinforcing the principle that percentage depletion requires actual production. Tax practitioners must advise clients accordingly, ensuring that lease agreements and tax planning reflect this distinction between cost and percentage depletion.