Potts v. Commissioner, 90 T. C. 995 (1988)

The percentage depletion rate for oil and gas income is determined by the year the income is reported, not the year of extraction.

Summary

In Potts v. Commissioner, the U. S. Tax Court ruled that the percentage depletion rate for oil and gas income must be based on the year the income is reported, rather than the year of extraction. Ray and Patricia Potts extracted oil and gas in 1981 but reported the income in 1982. They claimed a 20% depletion rate applicable to 1981, but the court held that the 18% rate for 1982 should apply. The decision hinged on the interpretation of Section 613A(c)(5) of the Internal Revenue Code, emphasizing that depletion allowances are tied to the year of income reporting, consistent with the Supreme Court's ruling in Commissioner v. Engle.

Facts

Ray H. and Patricia Potts, independent oil and gas producers, extracted oil and gas in 1981. They reported the gross income from this extraction on their 1982 federal income tax return. In calculating their percentage depletion allowance under Section 613A of the Internal Revenue Code, the Potts used a 20% rate, which was the applicable rate for 1981. The Commissioner of Internal Revenue determined a deficiency in their 1982 tax return, asserting that the correct rate to use was 18%, the applicable rate for 1982.

Procedural History

The Commissioner issued a notice of deficiency dated November 12, 1986, for the Potts' 1982 federal income tax, claiming a deficiency of $1,565. 21. The Potts petitioned the U. S. Tax Court to contest this deficiency. The case was submitted on fully stipulated facts, and the court reassigned it to the Chief Judge for opinion and decision.

Issue(s)

1. Whether the Potts must use the percentage depletion rate of 18% applicable to 1982, rather than the 20% rate applicable to 1981, for their oil and gas income reported in 1982.

Holding

1. Yes, because the percentage depletion rate under Section 613A(c)(5) is determined by the year in which the taxpayer reports gross income from oil and gas production, not the year of extraction.

Court's Reasoning

The Tax Court relied on the interpretation of Section 613A(c)(5) of the Internal Revenue Code, which specifies depletion rates based on the calendar year of production. The court emphasized the Supreme Court's ruling in Commissioner v. Engle, which clarified that percentage depletion allowances are not dependent on the year of actual production but on the year the income is reported. The court rejected the Potts' argument that the term "production" in the statute referred to the year of extraction, stating that the legislative intent was to tie the depletion rate to the year of income reporting to prevent deferrals and higher depletion offsets. The court noted that Congress aimed to ensure that depletion allowances align with income reporting, as highlighted in the legislative history of the Tax Reduction Act of 1975.

Practical Implications

This decision clarifies that oil and gas producers must use the depletion rate corresponding to the year they report income, regardless of when the extraction occurred. This ruling impacts how producers calculate their tax liabilities, ensuring consistency in depletion allowances across different years of income reporting. It prevents taxpayers from deferring income to later years while claiming higher depletion rates from earlier years, aligning with the policy of the Internal Revenue Code. The decision may affect how future cases involving similar tax issues are analyzed, particularly in the context of percentage depletion allowances. It also underscores the importance of understanding the timing of income reporting in tax planning for oil and gas producers.

