Supreme Court of the United States

In the Matter of:

UNITED STATES OF AMERICA, Petitioner, vs. SKELLY OIL COMPANY Respondent	Docket No. 280

Place Washington, D. C.

Date January 15, 1969

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1968

UNITED STATES OF AMERICA,

Petitioner,

vs. No. 280

SKELLY OIL COMPANY,

Respondent

Washington, D. C.

January 15, 1969

The above-entitled matter came on for argument at 11:55 a.m.

BEFORE:

EARL WARREN, Chief Justice
HUGO L. BLACK, Associate Justice
WILLIAM O. DOUGLAS, Associate Justice
JOHN M. HARLAN, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
ABE FORTAS, Associate Justice
THURGOOD MARSHALL, Associate Justice

APPEARANCES:

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Counsel for Respondent

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P R O C E E D I N G S

MR. CHIEF JUSTICE WARREN: No. 280, United States of America, Petitioner, versus Skelly Oil Company.

Mr. Solicitor General.

ARGUMENT OF ERWIN N. GRISWOLD, ESQ.

ON BEHALF OF THE PETITIONER

MR. GRISWOLD: Mr. Chief Justice, may it please the Court:

This is a Federal tax case here on a writ of certiorari from the United States Court of Appeals for the Tenth Circuit. Although it is a tax case, it is a sequel or consequence of a decision rendered by this court in 1958 in Wisconsin Pipeline Company against the Corporation Commission of Oklahoma, where this court held the Corporation Commission of Oklahoma had no power to fix minimum rates for the sale of gas.

The respondent taxpayer here produces and sells a natural gas. During the years 1952 through 1957 it charged its customers those increased rates pursuant to the order of the Oklahoma Corporation Commission. And, naturally, the amounts which it received were income to it. They entered into the computation of the "gross income from the property," against which it took in each of those years, '52 to '57, a deduction of 27-1/2 percent as percentage depletion, pursuant to Section 613 of the Internal Revenue Code.

There is no doubt that it was entitled to this deduction for depletion, as it clearly received the gross income under a claim of right and the statute provided that where income is received from oil and gas there is a depletion deduction. The taxpayer has his option to take either cost depletion or percentage depletion. In this case percentage depletion was advantageous, and that was what was taken.

Following this court's decision in the pipeline case the Respondent was sued by several of its customers on the ground that they had been overcharged. It promptly, having no defense to that case, in 1958, settled that controversy with two of them and paid to them an aggregate of $505,536 in 1958.

It is the company's tax year 1958 and only that year which is before the Court. The question is the consequence or the way it should be treated of that repayment made in 1958. The taxpayer deducted the repayment in full.

We say the deduction allowed in 1958 should be reduced by the amounts previously allowed as deductions for percentage depletion in the years '52 through '57, that is, by 27-1/2 percent.

That is the issue to which I will return after the recess.

MR. CHIEF JUSTICE WARREN: We will recess now.

(Whereupon, at 12:00 p.m. the hearing in the above-entitled matter recessed, to reconvene at 12:30 p.m. the same day.)

(The argument in the above-entitled matter was resumed at 12:30 p.m.)

MR. CHIEF JUSTICE WARREN: Mr. Solicitor General, you may continue with your argument.

FURTHER ARGUMENT OF ERWIN N. GRISWOLD, ESQ.

ON BEHALF OF THE PETITIONER

MR. GRISWOLD: As I was saying before the recess, this case involves two payments, aggregating $505,000, made by the Respondent in 1958, which represented repayments of excess charges for gas which it had sold in the years 1952 to 1957, for which it had received payment and against which payments it had deducted the statutory precentage depletion in the amount of 27-1/2 percent.

The taxpayer's contention is it is entitled to deduct the entire amount of the repayments made in 1958, despite the fact that depletion had already been deducted with respect to them.

There is some discussion in the briefs as to whether this deduction is under the deduction for a loss or the deduction for business expense. There is a suggestion made that the Government has changed its ground on that. I do not think that that is the case. The stipulation in the matter, at page 18, the last line on the page, of the Appendix, simply says that they took a deduction.

But I spend no time on this, because I do not think

it is important or of any consequence, in any event.

The District Court agreed with the Government's argument and entered judgment for the Government, based on the position that the deduction for 1958 would be reduced by the amount of the percentage depletion which had already been allowed as a deduction with respect to the payments.

On appeal the Court of Appeals for the Tenth Circuit reversed. It then granted the Government's petition for rehearing, but after the rehearing the Court adhered to its earlier decision by a 2-to-1 vote, Judge Hill writing an extensive dissenting opinion.

Now, with respect to the law, I think that it can fairly be said that what is really involved here is basic questions of proper tax accounting, and it was because of the undesirability of having clear principles already established by this court made confusing that we felt it was important to seek a review here.

The case involves Section 1341 of the Internal Revenue Code, and I will turn to that in a moment.

I think it fair to say, though, that even though Section 1341 must be considered, the proper conclusion is that on consideration one could come to the conclusion that Section 1341 is in fact bypassed in this case and that the case should be decided exactly as it would be decided if Section 1341 had never been enacted.

Now, the relevant portion of Section 1341 is set out on pages 10 and 11 of our brief. It is also in the Appendixes to both briefs and elsewhere. Looking at page 10 of the Government's brief we find that it starts out with "If--," and then there are five numbered paragraphs. The first three are conditions to the application of the section.

I would point out that paragraphs (1) says:

"If an item" -- and I would call attention to those words, "an item" -- "was included in gross income for a prior taxable year (or years) because it appeared that the taypayer had an unrestricted right to such item" -- now, that is the payments which the Respondent received in the years '52 to '57 --

"(2) a deduction" -- now, I call your attention to the fact that that is not the same word. It is a different word. It does not follow that the deduction is in the same amount as the item. The deduction is whatever is the appropriate amount of the deduction, in the light of the fact that an item was received -- "a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item" -- and that condition is met here --

And "(3) the amount of such deduction exceeds $3,000" -- that condition is met --

"then the tax imposed by this chapter for the taxable year shall be the lesser of the following" -- and now there are the two numbered paragraphs, (4) and (5).

I think it is convenient to say the taxpayer has his option of proceeding under one or the other. Actually, the statute says that the tax shall be the lesser of these two.

"(4) the tax for the taxable year computed with such deduction" and you notice the deduction goes back to the item in -- the word in paragraph (2).

"(5)" -- and (5) is fairly long, but it says in substance that the other matter which is to be computed determining which is the lesser is, in effect, to take the amount out of the prior taxable year, reducing the taxes for this year by the taxes which were, as it now develops, improperly paid in the earlier year.

Now, the fact is that Section 1341(a)(5), the language on page 11 of the Government's brief, was not utilized by the taxpayer here. This cases arises with respect to Section 1341(a)(4), which provides that the tax for the taxable year computed with such deduction is the amount which is to be taken into account. I suggest that that leaves the situation exactly where it would have been if Section 1341 had never been enacted, because the tax for the taxable year would be computed with such deduction prior to the enactment of Section 1341

The taxpayer here simply found it desirable not to use the relief which Section 1341 provided through paragraph (5) because that would have been less advantageous than its claim under paragraph (a)(4).

Interestingly enough, this was expressly recognized by the court below in its first opinion. This is on page 42 of the Appendix in Judge Seth's opinion, beginning the first full paragraph on that page:

"Thus, it appears that Congress by Section 1341 enacted the existing rule as to current-year deductions and added another and new provision. But 1341(a)(4) is simply the existing rule, the rule that would have been applicable if 1341 had never been passed."

Then later in the same paragraph, a little below the middle of the paragraph:

"Thus, it must be concluded that Congress sought to make no change in the current-year deduction remedy but only added the recomputation provision."

In our view the Court was thoroughly sound in saying that, but simply did not pursue it through to its conclusion, because the majority of the court below reached its result, in effect, by construing Section 1341 and saying that the word "deduction" in those several provisions must be read as having the same meaning as the word "item" in paragraph (1).

Q Mr. Solicitor General, is the law there that if

the other alternative that has been used, namely, recomputing the prior year's tax, that in computing that tax you would have just excluded the item of income but still retained the depletion?

A Mr. Justice, I think it is clear, and I hope that it will be after this court has decided this case---

Q But you mean it isn't clear---

A At the present time it is somewhat clouded by the decision of the Tenth Circuit.

Q That is under a different way of approaching it, isn't it? I mean at least, as you say, there are two ways of approaching it. The taxpayer had an alternative. It didn't choose the recomputation route.

A It didn't choose paragraph (5)---

Q That is what I mean.

A ---which would have meant throwing it back into the earlier year and reducing the tax for this year by the amount of tax which it had paid.

Q If it had done that, though, would it -- you say the law is unclear that in so doing all it would have done was to exclude the item of income for the prior year?

A No, Mr. Justice, paragraph (5) might have been very advantageous to them. Suppose, for example, they had had a loss in 1958. Then they would have wanted to use paragraph (5).

Q Then they wouldn't have paid any tax at all.

A Suppose they had had a smaller loss. Or, putting it another way, Section 1341 is very much a consequence of this court's decision in the Arrowsmith case.

The Arrowsmith case involved a situation where the taxpayer received an amount in liquidation of a corporation in one year and returned that as income as a capital gain. In a later year it was required to make a payment with respect to that on the ground that it was a transferee from the corporation and the corporation owed money.

There was no suggestion that they were not entitled to deduct the amount in the later year. The only question in the Arrowsmith case was whether the deduction was as a capital loss or as an ordinary loss. And this court held that since the repayment in the later year arose out of the capital transaction, it was to be treated as a capital loss.

That is a case which we think supports our position here. But the problem which it presented was that capital losses are subject to severe restriction as to their deductibility, and they might have included the amount in the earlier year in income, be entitled to deduct it as a capital loss in the later year but get very little benefit from it.

It was for that reason that 1341(a)(5) was enacted, to say that if they got little benefit from it in the later year, they could reduce their tax for the later year by the

amount of tax which they paid in the earlier year.

You also get similar situations where there are changes in the tax rates. In this particular case the tax rates were exactly the same in each year. There were no losses that affected the situation, no carry-overs, so that the only reason the taxpayer wanted to use 1341(a)(4) was because it thought, as the Tenth Circuit held, that such deduction in 1341(a)(4) meant the same thing as "the item" or "an item" in 1341(a)(1) and allowed the taxpayer to deduct the entire amount of the payment, despite the fact that 27-1/2 percent had already been deducted with respect to the same payment.

Now, we contend that that is wrong as a matter of principle, that this is in the area of proper tax accounting long since established by decisions of this court, that Section 1341 was wrongly construed by the court below and that when it is rightly construed, it leaves the well known decision of this court in full operation, which would require the adjustment for which the Government contends.

Now, in some ways the closest of these cases is one that was decided long ago, United States against Ludey, decided in 1927, opinion by Mr. Justice Brandeis, who had a very excellent grasp of the accounting background and problems in this area. Brief for the United States was written in the time of Solicitor General Mitchell, and I was much interested in reading that brief to find that the argument which he then

made is essentially the argument which we are trying to present here, and it was the argument which was accepted by the Court.

The Ludey case involved the determination of the amount of gain on the sale of a mining property. It arose with respect to the year 1917, which was before there was any provision in the statute providing for the adjustment of basis of property on the sale of property. The statute provided explicitly that the basis of property shall be its cost or its March 13, 1913 value.

In that case the taxpayer had deducted depreciation on its machinery. It had deducted depletion with respect to its oil which had been taken out.

When they came to sell the property, they computed their loss by taking the full cost with no adjustment for the depreciation and depletion which had been sustained. And the Court of Claims supported the taxpayer in that and said that there was no basis in the statute for the adjustment. There was some controvery as to the amount of the adjustment if it was to be made, namely, whether it was the amount which the taxpayer had actually deducted or depletion and depreciation or whether the adjustment to basis should be the amount which they could have deducted if they had taken all that they could and should have taken.

This court, in the opinion by Justice Brandeis -- and let me emphasize again, without any explicit statutory

provision, simply as a matter of general principles of tax accounting -- held that in computing the gain or loss on the sale, the basis must be adjusted by the amount of depreciation and depletion sustained, and remanded the case to the Court of Claims to determine that amount.

Now, the next case chronologically which provides a part of this basis for determining sound principles of tax accounting is Charles Ilfeld Company against Hernandez in 292 U. S. That is a case where a parent company had some subsidiaries, and it filed consolidated returns with those subsidiaries. The subsidiaries had losses in nearly all of the years involved, and the effect of the consolidated return was that the subsidiaries' losses were deducted against the parent's income, which was entirely right and appropriate and is the function of a consolidated return.

But in the year 1927, which was involved in that case, the parent liquidated the subsidiaries. And since the subsidiaries had had consistent losses, the parent got very little out of the subsidiaries when it liquidated them. It sought to deduct on its tax return the amount of the loss which it sustained on the liquidation of the subsidiaries.

Here again there was nothing in the statute which dealt expressly with it. There was a statutory provision giving the Commissioner the broad power to make regulations in this area. The Commissioner had made regulations, but none of

them really quite fit this particular situ uation.

In the Ilfeld case, in an opinion by Justice Butler, the Court held that the loss could not be taken because, in the Court's language -- and this is quoted on page 19 of the Government's brief:

"If allowed, this would be the practical equivalent of double deduction."

That, of course, is exactly the situation which is involved here. If the taxpayer here is allowed to deduct the entire amount paid in 1958, it will with respect to this transaction have deducted an aggregate of 127-1/2 percent of the amount paid, because it has already deducted 27-1/2 percent as percentage depletion.

Q Is it also accurate to say, in effect, that the depletion which was actually taken in the prior year with respect to a certain amount of income from mining, if you then deduct some of the income in a later year and leave that depletion taken in the prior year, you will have taken a much higher percentage of depletion as against the remaining income? Is that the same idea?

A You can say, in effect, that they have deducted 27-1/2 percent twice with respect to the same mineral. This is a little complicated to answer because we are dealing with percentage depletion, and it has----

Q I understand that.

A It has nothing to do with the amount that was lost, where cost depletion---

Q And the amount of percentage depletion depended on what the gross income from mining---

A The gross income from mining was -- and we contend that the 505,000 repaid in 1958 reduced the gross income---

Q And, therefore, the depletion allowance in the prior return was unjustified?

A As it now turns out, the depletion allowance in the prior return was not justified. However, under decisions of this court, like Arrowsmith, without Section 1341, you don't go back and correct the earlier year. You make the proper correction in this year.

We suggest that the proper adjustment is to allow the deduction of the $505,000 paid, less 27-1/2 percent for percentage depletion, which has already been deducted.

Q I really have difficulty in understanding why 1341(a)(4) is not controlling here. It seems to me that at the moment that is a central question. I have difficulty with your suggestion that the court below construed the word "deduction" as meaning "item" in paragraph (1), because it seems pretty clear that "deduction" refers to paragraph (2), and paragraph (2) defines "deduction" here as the amount that was deducted for the year '52 for the repayment of payments

received in '52-'57.

If that is so, 1341(a)(4), read simply and literally, seems to say that for '58 the tax would be computed with the deduction, namely, the deduction described in paragraph (2), which would mean the amount that this taxpayer had to refund to its customers.

A Mr. Justice, that is pretty close to the taxpayer's contention in this case.

Q But tell me what is wrong with it. I didn't follow you.

A That seems to me, begging your pardon, clearly wrong.

Q I want you to tell me why. It seems to me that maybe the results are a little startling. But, to my mind, I am not sure how you get around the statutory language.

A Let me just take the language, 1341(a)(4): "the tax for the taxable year computed with such deduction." That doesn't say how much. It says "such deduction." That obviously refers back to 1341(a)(2) as "a deduction."

Q Then what is the deduction under (a)(2)?

A It seems to me that in the statement which you have made, you have taken the next leap, which is to say that "a deduction" means in this case $505,000. I suggest that there is nothing in 1341(a)(2) which says that "the deduction" to which "a deduction" refers is $505,000.

Q Well, of course, I am not saying "$505,000." I am suggesting to you that -- and asking your help -- that if you disagree with this -- I gather you do, and I don't understand why.

Under (4) there are the words "such deduction" -- two words, "such deduction." Just reading this literally it seems to refer to subparagraph (2).

A Clearly it does.

Q And subparagraph (2) would mean that the amount of $505,000, if -- is that the amount of the overpayment?

A That is the amount of the overpayment.

Q Then it would seem to refer to that amount here. Can you tell me why it doesn't?

A Because I think that "a deduction" does not have the same meaning as the words "the amount repaid," does not have same meaning as the words "an item" in paragraph (1).

Now the "item" was $505,000. That was what was taken into income.

Q But, Mr. Solicitor General, paragraph (2) defines "a deduction" as being the amount allowable for the taxable year, because the taxpayer did not have an unrestricted right to such item or to a portion to such item. Now, that here would be, literally, as I read it, regardless of whether the results it served are not -- as I read it literally, that would seem to refer to this precise $505,000. I still don't follow you.

A Only, Mr. Justice, if you take the position, which I think is not warranted, that the "deduction" referred to in 1341(a)(2) is the same in amount as the amount of the "item" which was paid out, what I have been trying to suggest is that the amount of the deduction to which the taxpayer is entitled, under cases like like Ludey -- and I repeat that Ludey is the closest case of all -- is not the amount paid but is the amount which is properly deductible.

Q I beg your pardon, sir, but if you will bear with me a moment, look at (2). That defines the purposes of 1341, what is meant by the Congress by the allowable deduction. It defines it, as I read this, as the amount to which the taxpayer did not have an unrestricted right.

A I think you have shortened the language, and perhaps unduly. Paragraph (2) says "a deduction." There is nothing there to indicate how much the deduction is.

Q Well, go on. You have to read the whole paragraph.

A But I am trying to suggest that "a deduction" is colorless as to the amount. "A deduction," whatever the amount is -- and we contend that it is the amount paid, less 27-1/2 percent. "A deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item."

Now, "item" is not the same thing as "deduction."

Q To what amount did the taxpayer here not have an unrestricted right? To what amount? Just give it to me simple. To what amount?

A $505,000. And that is the "item." But our position is Congress has deliberately used different words and that "deduction" is a different word than "item" and that we still have left to determine what is the appropriate amount of the deduction.

On that I suggest that the Ludey, Ilfeld and Arrowsmith cases appoint the way.

Q Then you say that subsection (2) here is not a definition of the amount of the deduction?

A Exactly, Mr. Justice. That is exactly the point, and I am concerned that I am not able to make my position clearer.

Q What is its function, though? Could you help me there? Tell me, what is its function? What is the function of the verbiage subsection (2) if it is not to define the amount which taxpayer may deduct in the defined circumstances?

A It is to define one of the three conditions upon which Section 1341 becomes operative.

Q You mean it defines the circumstances, that is to say, if you find that the taxpayer did not have an unrestricted right to the item that he included in his income

in a prior year---

A "A deduction"---

Q Then he is entitled to a deduction?

A Right.

Q Then you find out what the amount of the deduction is, not by reference to the amount to which he did not have an unrestricted right, but by reference to the existing case law?

A That is exactly our position.

Q Are you saying that the taxpayer never did pay taxes in the previous year on the entire amount of the item?

A No, Mr. Justice, he paid taxes on the entire amount, less 27-1/2 percent.

MR. CHIEF JUSTICE WARREN: Mr. Casey.

ARGUMENT OF ROBERT J. CASEY, ESQ.

ON BEHALF OF THE RESPONDENT

MR. CASEY: May it please the Court:

I think that this present discussion points up exactly the problem between the Solicitor General and myself. The "deduction" allowable under subsection 1341(a)(4) is in fact described in 1341(a)(2). It is the amount which was included by the taxpayer in gross income in the year of receipt.

We agree with the answer to Mr. Justice White that, in fact, the taxpayer had a percentage depletion allowance,

but with respect to this $505,000, and therefore the $505,000 did not drop down in tax into taxable income. That is true. But 1341 says it is the amount included in gross income which prevails.

Now, we have heard argument here looking to the Ludey and Ilfeld cases, which further point up the problem which percentage depletion introduces into this specific area.

Mr. Justice White asked a question which I thought was going to lead to a discussion of whether there is any given amount which will be recovered from the mineral property. My answer to that would be, if the question were asked of me: "No, there is no amount to be recovered."

Now, our attention was directed to the Ludey case, where there was in fact a specific dollar basis for property. Ludey dealt with the cost depletion---

Q If this so-called "item" had not been included in the previous year's income, would your percentage depletion taken in that year have been the same?

A No, sir, it would not.

Q It would have been 27-1/2 percent of the item left?

A That is absolutely true. But the problem which that question brings in is, in fact, the finally determined principles of tax accounting which this court has laid down, that is, the annual accounting concept.

Q Do you think Congress actually thought in these terms and decided to give a full deduction for the item and leave the depreciation in the previous year intact?

A I can't tell you that Congress was looking specifically to a depletable income item. But I can tell you that in their own words Congress said if the item is included in gross income---

Q But do you think these words, construed as you say they should be construed, mean that it actually had in mind the situation that is before the Court?

A It is difficult for me to imagine that this would have escaped the attention of the Congress. When 1341 was passed by the House, it did not include the exception that brings us here under its umbrella.

Q But you don't think it is surprising that Congress would say you may reduce your income, in effect, the previous year without reducing your depletion?

A I think that is the office of percentage depletion. The difficulty that we have in applying Ludey and Ilfeld to this case is that in this case talk about two separate and distinct deductions. The deduction with respect to percentage depletion which occurred in the years '52 through '57 had to do with a recovery of the taxpayer's interest in the mineral property.

It is admitted that the mineral was severed and sold

in those years and that in fact the property was depleted.

Now, Congress has told us how to measure that year's depletion of the property for purposes of Section 613. They have said it very clearly, and the distinguished Solicitor General has agreed that as of the facts known at the end of each of the years of receipt the percentage depletion allowance claimed and allowed to the taxpayer was proper.

Q What would have happened if you had elected to use (a)(5)? Then you would have recomputed your tax for the prior year, wouldn't you?

A We would have recomputed the tax for the prior year by excluding the amount from gross income?

Q You don't think you would have had to change your depletion deduction?

A This case isn't before us, but in my opinion we would not, because percentage depletion is predicated upon gross income from the property, which is an entirely different concept of gross income.

Q If you had made the refunds in the same taxable year, then you would not have gotten the benefit of the depletion allowance on those. Isn't that right?

A That is exactly right.

Q Isn't it a little difficult to think the Congress really intended to establish a different rule just because the refunds were made in a subsequent year?

A I don't think so.

Q There isn't anything in the legislative history that I have noticed in your brief.

A We know that Congress enacted Lewis and Healy. They codified it. This is the annual accounting principle, which says that as of the end of any given taxable period the tax is imposed regardless of advantage or disadvantage to either the Government or the taxpayer.

We also know that there are other areas where the time sequence has to some taxpayers and sometimes to the Government disastrous results. The Gordon case, which this court decided in the fall, I believe -- if the distributions involved in the Gordon case had taken place within one calendar year, the distributions would have qualified for tax retreatment under the code. But a time factor fell, the end of the taxable year. There were distributions made in separate years, and the tax results were disastrously different for the taxpayer.

This is the problem which is always inhered in the annual accounting method. It always has been the subject of conjecture whether we wouldn't all be better off using a transactional or an open-account approach to tax computation. But this court has decided, and rightly, that the needs of the Government for annual income preclude that.

Now, it is not unusual -- in fact, it is rather

usual, and it is what prompted the enactment of 1341 -- that when a taxpayer receives claim-of-right income and is required to restore it in the context where in fact he incurs a deductible expense, the deductible expense incurred in this case in the year 1958, which, as the Solicitor General says, is the only year before the Court, was not percentage depletion expense. It was the payment of a lawsuit of the damages in litigation, the settlement of a lawsuit.

Now, if you will look at the settlement of a lawsuit---

Q Would you really treat this as though it had been prosecuted?

A If it had been -- well, it is hard for me to address myself to that.

Q As though the depletion were an allowance based on the amount by which physically a reserve is exhausted?

A No, sir. You shouldn't compute it that way because that is not the thrust of the percentage depletion allowance.

Q I know, but you are asking us to treat as though the percentage depletion allowance was a fixed amount, based upon, say, the tonnage or the gallons, or something.

A No, that is not my position. I hope I have not left you with that impression. I am saying that this taxpayer incurred a business expense in the years 1952 through 1957,

that is, the reduction of his mineral properties by reason of the severance and sale of the mineral.

That deduction in those years was computed not on the basis of the taxpayer's cost, not on the basis of a discovery value, but on an ad hoc formula basis which the Congress has proposed. And the Congress has said that you take 27-1/2 percent of your gross income from the property, limited by 50 percent of your taxable income from the property. That is a separately and completely different business expense from the settlement of the litigation, which occurred in the year before this court.

Q But, again, as Mr. Justice Fortas suggests, if this settlement had been made in the year, your income from mining would have been reduced?

A Yes, sir.

Q And your depletion would have been reduced?

A Yes, sir.

Q Do you believe that if this matter had been specifically presented to the Congress that the Congress would have said that in these circumstances you are entitled to take a double 27-1/2 percent as depletion allowance?

A I don't think, Mr. Chief Justice, that we can assume for a minute that Congress was unaware of this possibility.

Q I didn't ask you that. I asked you, if it had

been specifically presented to them and discussed in their committees, do you think that they would have arrived at any such conclusion.

A Yes, I do. Number one---

Q Can you tell me why they would give 55 percent deduction in circumstances of this kind?

A If I could amend the question to be asked of the Congress, not to say, "Would you allow a double percentage depletion allowance," because they haven't. We have taken one percentage depletion allowance in each of the years of the receipt of the money.

Now, that percentage depletion allowance came to us not because of a successful lawsuit, not because of any other business operation except the severance and sale of our minerals.

Now, Congress clearly had before it a right to do what the Government would propose in its case, and that is equalize the tax. If all it wanted to do was to make the parties hold, it had in fact before it a Court of Claims decision which had been decided in 1953, in the Perry case, in which the Court said the only fair way to handle matters of this kind is to go back to the year of receipt and recompute the tax. And that is the measure of the deduction in the current year.

It had before the possibility of not allowing the

Government or the taxpayer to take potluck, to go with the Healy and Lewis rules, which said: "No matter what happened in the year of receipt, no matter what tax benefit you had, we are going to strike the balance in the year of restoration. If it is a disadvantage to either side, that's the way it is going to be." But they didn't do that.

Q I would like to ask you this. By amending the question that I asked you, does that lead you to the conclusion that this is not a double taking?

A Yes, indeed it does, sir. Yes it does, because what the Government would propose to do here is take dollars which this taxpayer garnered in the ordinary course of its business and trace those dollars to the settlement of a lawsuit which took place, in some instances, six years later.

Q What does this deduction amount to in the current year, $505,000, according to you? And what do you deduct that from?

A We deduct it from ordinary income---

Q Gross income?

A From gross income.

Q Will they let you deduct it from gross income from mining for the current year?

A I don't think it is properly deductible from gross income.

Q If it were, of course, you would have the

same -- your percentage depletion would go down this year?

A Yes, it would. But, of course, it isn't really an expense of the current year's operation of that particular property.

Q I suppose if you were permitted or required to deduct the income from mining for this year, you would have the same effect, roughly, that the Government is contending for.

A I guess---

Q You would reduce---

A Yes, you would reduce---

Q ---percentage depletion?

A Percentage depletion, yes, sir.

Q But accounting-wise you may not do that in this year, or you don't want to do it?

A Well, accounting-wise it really isn't a factor that goes into bringing gross income from the property down to taxable income from the property. It is an expense of the business generally, the settlement of a lawsuit, just like compensation to---

Q In any event, in this particular case the way you deducted it for the 1958 taxes did not go to reduce income from mining, income from the property for purposes of figuring depletion in 1958?

A That is true. That is right. Yes, sir.

Q And you would not welcome that suggestion?

A I would resist it if I could. I don't that it is really a proper charge against the operation of that property.

I also would suggest that if Congress wanted to put the parties back where they were without the receipt and restoration, it could so easily have done so.

It is very difficult for me to see how an argument could be made, as the District Court found in this case, that all Congress wanted to do was equalize the tax burden, because it specifically requires that the current year's deduction, as in Lewis and Healy, or the recomputation of the prior year's tax was occasioned solely by excluding the amount from gross income. It gives the taxpayer the better of those two worlds.

Q May I ask you, Mr. Casey, the Solicitor General has for the moment, anyway, clarified my view of the meaning of subparagraph (2). Is there anything that you want to say about that? In other words, the Solicitor General has now explained to me that paragraph (2) states the circumstances in which the deduction may be allowed, but it does not purport to describe or define the amount of the deduction.

I take it you disagree with that.

A Yes, I do.

Q Is there any authority one way or the other, or what do you have to say about it?

A When you look to deductions -- and the

Government's brief in this case notes -- you can't take a deduction for an item unless you have included it in gross income. The pre-1341 case law was clear on that.

There was a suggestion in a Tax Court case that perhaps taxable income might be the criterion, in other words, a tax-benefit rule with the benefit running to the Government.

It is our position that 1341 makes it perfectly plain that the basis for the deduction here is only inclusion of the item in gross income. The fact that that inclusion gave rise to a tax is immaterial. The fact that the inclusion in gross income was the Government's reward from that inclusion was derogated from because of deductible expense is immaterial.

We feel that 1341 tells us specifically, if an item is included in gross income, if the repayment of that item in a subsequent year is a deductible event, as opposed to a non-deductible event, a personal item, for example, if it is deductible, then the measure of the deduction is the amount included in gross income. And if there was any question in case law prior to the enactment of 1341, that question must now be taken be laid at rest.

Q I understand your position, and I have understood it. But what do you do about subparagraph (2) specifically, recalling my colloquy with the Solicitor General?

A Subparagraph (2) to us makes it plain that if there is an allowable deduction -- I don't care. As the Solicitor General said, we have had some exchanges as to whether the deduction in the current year is ordinary and necessary business expense under 162 or a loss under 165. We don't care. If it is deductible, because it is determined that part of that amount included in gross income must be restored because it turned out that the taxpayer did not have the unrestricted right there to, that the measure of the deduction is in 1341(a)(1) and (a)(2) taken together, that there is no room for argument any more, then the inclusion in gross income must have been of some revenue-producing benefit to the Government.

The difficulty inherent in this case is the confusion of the percentage-depletion deduction in the prior year, with the ordinary and necessary business expense or loss, whichever, in the year 1958, which is before this court.

If you follow the Government's reasoning, you are led to the conclusion that when you have -- when the taxpayer in the years of receipt of the income severed and sold $505,000 worth of gas, he suffered two depletions, one, the depletion of the property, but then also some other depletion amount which attached to the $505,000 and served to reduce the tax impact of those dollars when paid out in the subsequent year in a deductible amount.

There is no authority for that. There is no way, it seems to us, that its results can be accommodated.

Q Do you have an election in the oil business as to how to figure your depletion?

A Yes, sir, you take cost depletion or percentage depletion.

Q And you elected percentage?

A Yes, sir. And I must say that the election of percentage depletion, of course, results in a tax benefit to the taxpayer.

But there is no way, it seems to us, that the payment of money, which is what happened to the taxpayer here, can give rise to a reduction in any basis. There is no way we can add to the basis of our property, because we didn't acquire them. We never got the minerals back. We are not talking about the double deduction of the Ludey or Ilfeld cases here. They are separate and are completely unrelated deductions. Settlement of the lawsuit and the payment of the dollars involved in that had no more to do with the prior year's production, except as a basis of the claim against us, than the payment of compensation or interest in the later year.

We also find it difficult to accommodate the line of cases which the Government has cited, in which the thrust is that previously deducted items become income in the year of recapture or restoration.

We would point out to you that in the year 1958 the taxpayer never recovered anything. The mineral which it produced and sold was long gone. It is the impact of the settlement of the lawsuit on its operations for that year was entirely disadvantageous. There was no recovery, no restoration. Those cases are therefore, we submit, inapplicable here.

It seems to us that the percentage depletion allowance, because of its peculiar impact on the taxpayer, because it doesn't relate to cost or discovery value or any other stated amount, gives rise to conditions which are probably not reconcilable with established doctrine in other areas, with Ludey, who had a cost basis for its property and who recovered that cost through cost depletion and depreciation, with Ilfeld, who had a cost basis in the stock for its subsidiary companies and effectively recovered that basis through the absorption of the subsidiaries' losses against its income.

That is the thrust of our argument. If Congress had intended the results contended for by the Government here, it would have been simply done.

I referred earlier to the Court of Claims case decided in 1953 which showed how simply it could be done, United States against Perry. In that case the taxpayer donated property to a charity, deducted the amount on its return in

the year of the donation and recovered the property in a later year, to a tax detriment.

The Court of Claims thought that the fair way to do it would be to look back and see what tax advantage did he get from the donation in the year he made the donation, and it said that should be the measure of his tax detriment in the year of recovery.

But the very Government that is here urging that approach to the Skelly case prevailed upon the Coourt of claims to overrule the Perry decision, pointing out that the annual accounting concept so ingrained in the tax law by the decisions of this court made that result impossible under the law. And on the urging of the Government, the Court of Claims recognized its error, went to the annual accounting concept, even though the taxpayer in the Alice Phelan Sullivan case suffered tax-wise drastically.

It is a two-way street. If there is going to be tax equalization, it has got to be equalization for the Government and for the taxpayer. Under the law as enacted by Congress there cannot be tax equalization. The arguments advanced to this court to overrule the decision below are more properly advanced, we submit, to the Congress.

Thank you.

(Whereupon, at 1:35 p.m., the hearing in the above-entitled matter was concluded.)