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IN THE SUPREME COURT OF THE UNITED STATES

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UNITED STATES, :
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Petitioner, :
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v. : No. 79-1515
 :
ELWOOD SWANK ET AL., :
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Respondents. :
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Washington, D. C.
Tuesday, December 9, 1980

The above-entitled matter came on for oral ar-
gument before the Supreme Court of the United States
at 2:09 o'clock p.m.

APPEARANCES:

STUART A. SMITH, ESQ., Office of the Solicitor General,
U. S. Department of Justice, Washington, D.C. 20530;
on behalf of the Petitioner.

LeROY KATZ, ESQ., P.O. Box 727, Bluefield, West Virginia
24701; on behalf of the Respondents.

MILLERS FALLS
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COTTON CONTENT

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C O N T E N T S

<u>ORAL ARGUMENT OF</u>	<u>PAGE</u>
STUART A. SMITH, ESQ., on behalf of the Petitioner	3
LeROY KATZ, ESQ., on behalf of the Respondents	22
STUART A SMITH, ESQ., on behalf of the Petitioner -- Rebuttal	36

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in United States v. Swank.

Mr. Smith, you may proceed whenever you are ready.

MR. SMITH: Thank you.

ORAL ARGUMENT BY STUART A. SMITH, ESQ.,

ON BEHALF OF THE PETITIONER

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

These three cases are here on writ of certiorari to the United States Court of Claims. They involve an important question of taxation in the mineral area, as to which there is a conflict of decisions in the lower courts.

Specifically, the question presented is whether a provision in a mineral lease permitting the lessor to terminate the lease on 30 days' notice without any cause deprives the lessee of an economic interest in the minerals in place so that the lessee is not entitled to the depletion deduction permitted under Section 611(a) of the Internal Revenue Code.

The facts of all three cases are virtually identical and can be summarized briefly as follows: respondents are all direct --

QUESTION: But there are some differences, aren't there, Mr. Smith?

1 MR. SMITH: There are some differences, Mr. Justice
2 Blackmun, for the purposes, I think, that the case has come here.
3 -- I think neither party thinks the differences are germane,
4 But, you're right, there are some minor differences.

5 Principally, the respondents are all lessees under
6 coal leases and as under these leases they were authorized to
7 remove coal, in consideration of a stated royalty per ton.
8 The leases each permitted respondents to sell coal, the coal
9 that was extracted, to anyone at any price.

10 QUESTION: Could I interrupt you at that point?

11 MR. SMITH: Surely.

12 QUESTION: There is talk in one of the briefs --
13 I think it's Swank -- that the county agreed not to terminate
14 the lease. Do you agree or concede that point, or do you not?

15 MR. SMITH: No, we don't concede that point,
16 Mr. Justice Blackmun, and we think it's a little late in the
17 day for the Respondent Swank to be raising it, because while
18 -- may I refer the Court to pages 54a and 55a of the Appendix,
19 which discusses this problem and specifically paragraph (c)
20 on page 55a which says:

21 "Statements to the effect that Northumberland
22 County would not terminate a lease except for cause
23 were made to various individual mine operators (in-
24 cluding taxpayer), in public meetings of the commis-
25 sioners, and reported in the press."

1 But then it goes on to say, and this is from
2 the stipulation of facts: "However, no assurance was given
3 that the county commissioners could not cancel a lease without
4 cause."

5 I think that the Court of Claims assumed for pur-
6 poses of its decision that the Swank lease was a termination
7 without cause. Respondent Swank never took exception to that
8 finding and I think that for purposes -- as the case comes
9 here, I think that is agreed, that must be agreed, that the
10 Swank lease as well as the Bull Run and Black Hawk lease all
11 provided for termination without cause.

12 QUESTION: And it's only if they did that the issue
13 is here at all.

14 MR. SMITH: Exactly. Exactly.

15 QUESTION: And you wouldn't be here if they had --
16 if you accepted --

17 MR. SMITH: We wouldn't be here on that -- because
18 if the lease were terminated for cause -- and in fact, there
19 were other provisions of these leases that were terminable, be-
20 cause, for example, if the respondents didn't pay their rent
21 or their royalties, the leases were terminable. We're not
22 contending that that deprives the lessee of the depletion
23 deduction.

24 In any event, each lease provided, as I said, that
25 the lessor could terminate without cause on 30 days' notice,

1 and it was on this basis that the Internal Revenue Service
2 disallowed the respondents' depletion deductions on the
3 ground that none of the respondents had an economic interest
4 in the minerals covered by their leases. The Court of Claims
5 decided otherwise on the authority of its earlier decision in
6 Bakertown Coal Company, which essentially presents the same
7 question.

8 QUESTION: Mr. Smith, what would be your view if it
9 was cancellable on one year's notice?

10 MR. SMITH: Well, the Internal Revenue Service's
11 position, and it is our position, that one year is the line.
12 In other words, a cancellation on one year's notice and beyond
13 is all right, but anything less than a year violates or under-
14 mines --

15 QUESTION: It's not a matter of whether or not it's
16 all right or whether it violates something. It is a --

17 MR. SMITH: No, no; essentially, it does deprive the
18 lessee of the economic interest in the coal in place, because --

19 QUESTION: Whether or not he can take the deduction.

20 MR. SMITH: Exactly.

21 QUESTION: And is that a one-year, on the basis of
22 a regulation?

23 MR. SMITH: That is on the basis, Mr. Justice Rehn-
24 quist, of a long-standing published position of the Internal
25 Revenue Service, so-called GCM.

QUESTION: Well, it's an announced --

1 MR. SMITH: Yes, it's an announced position which is
2 30 years --

3 QUESTION: Well, I've heard of ID's and Treasury
4 Regionations, but GCM?

5 MR. SMITH: A GCM is an old form of ruling called
6 General Counsel's Memorandum.

7 QUESTION: GCMs.

8 MR. SMITH: And this is a classic statement in the
9 depletion area because what it did was, to permit lessees like
10 an operator in this situation, but announced that if the
11 lease -- the lease had to be for more than a nominal period.
12 It could only be terminable on more than nominal notice, and
13 the Service announced in that case that generally one year was
14 the rule. And in fact, the Service has ruled subsequently,
15 more recently -- as a matter of fact, I can cite the Court to
16 two Revenue Rulings that I think bring this matter up to date:
17 Revenue Ruling 74-506 and 74-507, which were cited at 1974-2,
18 Cumulative Bulletin 178 and 179. which more or less reaffirmed
19 the one-year rule.

20 QUESTION: Are they in the Appendix?

21 MR. SMITH: They are not. I just discovered these
22 two rulings in preparation for the argument.

23 QUESTION: Now, these rulings have to do --

24 MR. SMITH: With the one-year rule.

25 QUESTION: Well, only with coal?

1 MR. SMITH: Well, no, they don't.

2 QUESTION: Because the percentage depletions are
3 quite different --

4 MR. SMITH: Exactly.

5 QUESTION: Depending upon different presumptions as
6 to how long it's going to take to exhaust the resource.

7 MR. SMITH: Exactly.

8 QUESTION: And maybe one year would be right for
9 some minerals, and quite wrong for others.

10 MR. SMITH: Well, the particular ruling that in-
11 volves coal, particular ruling that talks about the one-year
12 rule, involves coal, 74-507. 74-506 deals with phosphate
13 rock deposits, and in that particular instance the taxpayer-
14 lessee had a five-year lease and then he renewed it for ano-
15 ther six months.

16 QUESTION: What are those, GCMs?

17 MR. SMITH: No, these are Revenue Rulings.

18 QUESTION: Does the Service take the position that
19 one year is the cut-off line on every type of case?

20 MR. SMITH: No. The Service takes the position that
21 one year is the general rule of thumb, and the taxpayer --
22 the general principle is that the taxpayer has to have the
23 right to mine the deposit to exhaustion in order to have an
24 economic interest in minerals in place.

25 QUESTION: You might have an allowable depletion

allowance deduction of, say, 25 percent and that would be based upon the presumption that the asset is going to be fully depletable in four years. You might have an allowable depletion allowance deduction of ten percent, which would be based upon the presumption that the asset is going to be fully depletable in ten years. And this rate is one year.

MR. SMITH: The coal rate is ten percent, and these two rulings that I've adverted to, which talk about the one-year rule, are in the context of coal.

QUESTION: But, Mr. Smith, the one year isn't based on the anticipated period of mining out a coal seam, is it? That has nothing to do with the ten-year presumed life of --

MR. SMITH: No, that's simply a rate that's negotiated between industries and the Congress, I think, and the Treasury.

QUESTION: You mean the one-year is?

MR. SMITH: No, no.

QUESTION: Or the ten-year?

MR. SMITH: The rates in the Code.

QUESTION: Yes, but what I'm saying, the one-year is not related to any prediction about how long it takes to exhaust a coal mine; maybe ten years would be.

MR. SMITH: Well, but it's a general rule of thumb that if you had -- basically, since the general principle is that you have to have something substantial, you have to

1 have a capital interest in minerals in place. And simply to
2 say, you know, if you have like a one- -- a right to do some-
3 thing for one day, it wouldn't be a terribly significant right.

4 QUESTION: There aren't very many coal mines that
5 operate for one day, are there?

6 MR. SMITH: No, but in fact, the rhetorical question
7 that the Court of Claims asked in Bakertown about it, saying
8 that this is not a one-day case, apparently there is a case
9 now pending before the Court of Claims involving a one-day
10 termination in turquoise mining. But anyway, the basic point
11 is that in order to have this right to mine a deposit to ex-
12 haustion -- and it's basically what the Court talked about in
13 Paragon and in Parsons.--

14 QUESTION: From the point of view of the Government's
15 interest, I mean, the whole purpose of a depletion allowance,
16 what difference does it make to the Government whether --
17 say it takes 20 years to mine out a coal, or ten years to
18 exhaust a coal mine, what difference would it make if there
19 were 20 different operators, each of whom succeeded one
20 another at six-month intervals or ten at one-year intervals,
21 or one for working the whole 20 years? Why isn't there the
22 same amount of coal being mined and depleted and the same rea-
23 son for the depletion allowance, regardless of the period that
24 the lease is in effect?

25 MR. SMITH: Well, simply, Mr. Justice Stevens,

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1 the question of who has it, since the general rule --

2 QUESTION: Well, the person who is the miner at the
3 time mines it and sells it. He has the title to the coal and
4 he sells it.

5 MR. SMITH: Exactly, exactly. But there are a lot
6 of people involved in mining operations, extracting of miner-
7 als who have something much less than an economic interest
8 to satisfy.

9 QUESTION: But only one person has a right to sell
10 the coal.

11 MR. SMITH: Only one person has a right to sell the
12 coal, but indeed, in Parsons and in Paragon, the taxpayers
13 before the court -- those are the two decisions that we think
14 bear very heavily on the question before the Court -- in both
15 those cases the miners there were the only persons who had the
16 right to have the coal, and the Court held that they didn't
17 get the depletion allowance because they didn't satisfy the
18 economic interests.

19 QUESTION: They didn't have the right to sell the
20 coal. They had to sell it to the lessor at a fixed price.

21 MR. SMITH: Oh, they -- yes; indeed, they had to
22 sell --

23 QUESTION: They mined on a contract.

24 MR. SMITH: Exactly. But they were selling the
25 coal. Here, of course -- that's true; they did have the

1 right to sell the coal to anyone they pleased, at any price.
2 But we submit that the terminability clause, that that right
3 has to be viewed in the context of the terminability clause.
4 It's simply like saying, I have a five-year lease on an
5 apartment and my landlord --

6 QUESTION: I don't think you're responding to my
7 question. In terms of tax policy, say you have a 20-year life
8 of a mine and one, say one person was going to mine it out and
9 get the full depletion allowance. What difference does it
10 make to the government whether one person does it for 20 years
11 four people do it for five years each, or 40 people do it for
12 three months?

13 MR. SMITH: I don't think it makes any difference,
14 but essentially, the reason this case is here, in order to
15 have the Court announce a rule that both lessors and lessees
16 and the Treasury will honor as the uniform rule. As matters
17 now stand, in the Court of Claims the rule is one way, and
18 in the 3rd Circuit the rule is another.

19 QUESTION: You don't care how it's decided, so long
20 as you get a ruling?

21 MR. SMITH: Well, I'd like to -- I would not stand
22 here and tell you that this was an overwhelmingly important
23 question of tax policy, except to the extent that the Bar
24 and the Treasury depend upon the application of uniform rules,
25 and we think that the uniform rule in this case ought to be

1 that the termination clause should be regarded as a powerful
2 right against which all other rights must be subordinated.
3 And indeed, this concept is not foreign to the tax law
4 Although the respondent suggests that this is a terrible
5 thing that the Treasury is imposing upon this in the area of
6 trusts, in the area of estate taxes, the right to revoke or
7 the right to pull back something is extremely important, and
8 we submit that here, where the lessor has the right to cancel
9 a lease without any cause at all, essentially saying, get out
10 in 30 days, really reduces these respondents to having nothing
11 more than a right to mine an additional 30 days of coal.

12 QUESTION: Well, of course, in these cases, maybe it
13 doesn't fit the theory, but certainly the cutting edge of the
14 cases are these: in Swank, if the operator doesn't get the
15 allowance, nobody does, because the lessor is a tax-free
16 municipality. So the government benefits.

17 In the other two, I think the facts are that each
18 operator mined to exhaustion.

19 MR. SMITH: Well, if each operator -- okay. Well,
20 I think that the fact that Swank, that the lessor in Swank
21 is a municipality or a county is simply a fortuity and I'm
22 not really sure that the depreciation --

23 QUESTION: If it weren't for the Government's advan-
24 tage, just as in the old days when a taxpayer tried to prove
25 the year of loss of a bad debt, he always guessed wrong.

1 MR. SMITH: Right. Well, the answer, I suppose, is
2 to have appropriate counsel and claim it in a variety of years
3 so that when it gets disallowed in one year you don't lose it
4 completely.

5 QUESTION: Well, Mr. Smith, I understand your posi-
6 tion, I'm just --

7 MR. SMITH: Okay.

8 QUESTION: Thinking of the --

9 MR. SMITH: But on the question of the other two
10 respondents which were taxpayers, those respondents get
11 cost depreciation and capital gains under Section 631.

12 QUESTION: The owners do. The owners do.

13 MR. SMITH: The owners. And the capital gains -- in
14 fact, that's one of the points that the Court of Claims made
15 that we think is so ill taken, that they said, my goodness,
16 we've got to give it to these respondents because otherwise
17 nobody will get it, and that's simply not the case. The owners
18 in those cases will get 631(c) capital gains treatment, which
19 is a special provision in the Code only for coal and iron ore,
20 and it's really quite beneficial; and it's really hard, it's
21 really hard to accept the force of the Court of Claims' point
22 on that.

23 QUESTION: So depletion to the operator is giving
24 an additional allowance?

25 MR. SMITH: Exactly. Exactly. Now, getting back

1 to what I think is -- to be sure, the Court in Parsons and in
2 Paragon did talk about the fact that the contractors in those
3 cases had the right to sell coal to anyone they chose. But I
4 think that that doesn't diminish the force of the Court's "em-
5 phasis" in both those cases on the termination provisions in those
6 contracts. In both -- in fact, in Parsons, the Court men-
7 tioned it on three different occasions. It talks about it
8 every time it described the contracts. It talked about them
9 being --

10 QUESTION: One of the seven factors.

11 MR. SMITH: What?

12 QUESTION: As one of the seven factors?

13 MR. SMITH: That was one of the times it mentioned it
14 but on pages 224, 225, and 226 -- I think 225 is where the
15 seven factors are sketched out. The Court talked about termi-
16 nation, and indeed, the Court talked about termination in
17 Paragon as well, and referred back to Swank.

18 QUESTION: Mr. Smith, are you finished?

19 MR. SMITH: Yes.

20 QUESTION: I just want to go back to your argument
21 that in the two cases the owner was in effect getting the
22 allowance. Suppose it were held that this lessee here did
23 have an economic interest in the minerals in place, my exper-
24 ience always was that the depletion allowance is going to go
25 to one or the other but not to both.

1 MR. SMITH: The depletion allowance does not go to
2 both people on the same income; that is true. That is what
3 the Court has said.

4 QUESTION: Well, now, what if this Court ruled that
5 -- with the Court of Claims -- but, said, well, we don't
6 need to decide whether the owner is getting depletion or not,
7 could the Service do anything about it? Could they deny the
8 capitals gains treatment to the lessor?

9 MR. SMITH: In fact, I don't think they could,
10 because I think that the transaction would still fit Section
11 631(c). It would be a transfer with a retained economic
12 interest. And as I understand the matter, the owners have
13 their overriding royalty is a retained economic interest.
14 They would continue to get capital gains treatment on their
15 royalties. They get capital gains treatment no matter how
16 the Court decides.

17 QUESTION: But, if a lessee has an uncancellable
18 lease for 20 years, the depletion allowance is shared, isn't
19 it?

20 MR. SMITH: If the lessee has an uncancellable --
21 if the lessee has a noncancellable lease for 20 years, then the
22 lessee gets percentage depletion.

23 QUESTION: Percentage depletion.

24 MR. SMITH: Right.

25 QUESTION: And what does the owner get?

1 MR. SMITH: The owner gets capital gains on his
2 royalties and also, as I understand it, he can claim cost
3 depletion. In other words, on each dollar that he gets
4 back --

5 QUESTION: On that, I'm going to ask you again, what
6 if we held in this case that the lessee had an economic
7 interest in the --

8 MR. SMITH: I don't think it would affect.

9 QUESTION: Wouldn't it affect the amount of deple-
10 tion the owner --

11 MR. SMITH: No.

12 QUESTION: In effect -- ?

13 MR. SMITH: No, because I think the owner here would
14 continue to get, only because -- Mr. Justice White, let me say
15 this. Your general --

16 QUESTION: Your answers sound inconsistent, I'm not
17 sure.

18 MR. SMITH: Your general statement about sharing
19 depletion deductions is correct, but it's not true for purposes
20 of coal, because it's a peculiar rule of Section 631(c) which
21 says that, you know, in such a situation the owner of the coal
22 deposit is not eligible for percentage depletion. So he can't
23 get it. And in fact, the Court of Claims in Bakertown, in
24 the Bakertown Coal Company, I think at Footnote 2 --

25 QUESTION: Well, so I'll ask you again, what about

1 in a coal mining case where the lessee has a lease that's good
2 for 20 years? Now he has an economic interest in the minerals
3 in place.

4 MR. SMITH: He has an economic interest in the
5 minerals in place.

6 QUESTION: And he gets -- what kind of depletion
7 does he get?

8 MR. SMITH: He gets percentage depletion.

9 QUESTION: He gets percentage depletion. What does
10 the landowner get?

11 MR. SMITH: What does the landowner get? The land-
12 owner gets on his retained royalty, under Section 631(c), be-
13 cause he has made a transfer that fits that section, he gets
14 capital gains treatment on his royalties, the basis of which --

15 QUESTION: Under what section?

16 MR. SMITH: Under Section 631(c). It says that you
17 get capital gains treatment --

18 QUESTION: All right. What if we ruled in this
19 case, having decided the very case we just described, we said,
20 well this case that we now have before us, this Swank case,
21 is exactly like that one. We looked at all the facts here,
22 and it's just like having a lease for 20 years.

23 MR. SMITH: Right.

24 QUESTION: Well, then, what have we said now? What
25 about the effect on the landowner then?

1 MR. SMITH: It would have, in my view, no effect on
2 the landlord, because this still would be a Section 631(c)
3 case. The other thing really involved in this case is whether
4 the lessee is eligible for percentage depletion. The lessor,
5 because of the peculiar -- Section 631(c) is not elective
6 and if you make a transfer like that in the coal area, you are
7 not eligible for percentage depletion. The statute is clear
8 on that. It's a special benefit for transfers of coal deposit
9 -- you know, interests in coal deposits and more or less, as
10 I understand it, is a tradeoff that says, you don't get per-
11 centage depletion on your overriding royalties the way you
12 would if you were in oil or a variety of other minerals but
13 you'll get capital gains treatment and, you know, correspond-
14 ingly, cost depletion.

15 QUESTION: Mr. Smith, can I summarize it just to be
16 sure I have it right? If you had the 20-year lease situation, the
17 lessor would get both capital gains treatment and cost deple-
18 tion?

19 MR. SMITH: Right.

20 QUESTION: And he would get that in this case
21 regardless of how we decide it?

22 MR. SMITH: Right; that's right.

23 Well, getting back to what I think is sort of germane
24 here, and that is, on the question of the importance of the
25 terminability provision, in Parsons, like this case, there were

1 clear and explicit termination clauses in the contracts.

2 But in Paragon, the importance of terminability to the Court
3 was so significant that the Court implied a termination right
4 on the behalf of the lessors, on the fact that the contractors
5 could have walked off at any time.

6 QUESTION: But wouldn't you agree, Mr. Smith, that
7 in both of those cases, even if they'd been 20-year deals,
8 there wouldn't have been an economic interest on the part of
9 the --

10 MR. SMITH: Well, that is true, that is true, because
11 -- exactly. But in our view, and I think that, really, this
12 is the important thing, that I couldn't agree with you more,
13 that if you can't sell the coal to anyone you please but you
14 have to sell it to the lessor, you really are a kind of glori-
15 fied coal miner. But it seems to me that the right of termina-
16 tion on 30 days' notice without cause is an equally important
17 right that subordinates the whole thing, because it basically
18 says, the whole deal, I can nullify the whole deal anytime I
19 want. And it seems to me that if you are operating under
20 those kinds of restraints you don't really have much of a deal
21 anymore than you would if you had to sell the coal to the
22 lessor. It seems to me that both those factors are of equal
23 weight.

24 QUESTION: Mr. Smith, do you see any tension or
25 inconsistency between Parsons and Paragon?

1 MR. SMITH: Do I see any?

2 QUESTION: Yes.

3 MR. SMITH: No. No. It seems to me that Paragon
4 follows the rule of Parsons. And indeed, that was one of the
5 points I wanted to make. It seems to me that one of the other
6 points that the respondents make and the Court of Claims made
7 is that, well, it's very nice to talk about termination and
8 the terminability, but that's really a wholly theoretical thing
9 and here nobody terminated. What does that matter? It's kind
10 of instructive -- I was reading the dissent in Parsons, in
11 Paragon this morning, and the dissent made much the same com-
12 plaint that the respondents do here in which the Court of
13 Claims -- It's incredible that no one has sort of made the
14 analogy that the same complaint -- the Court tries to assimi-
15 late this case to Parsons by stating that Paragon could have
16 terminated the interest of the operators. But the actual
17 facts are really that Paragon never gave the slightest intima-
18 tion that it might terminate anyone's contract, and in our view
19 it's the right to terminate that's important, because deple-
20 tion and the allowances that flow from these mining contracts
21 necessarily have to turn on the rights. The statute has to
22 be administered in accordance with the rights that the parties
23 set forth in their contracts. And, indeed --

24 QUESTION: I take it, Mr. Smith, that a mining con-
25 tract, in Paragon and Parsons, equates in your view with a

1 mining lease, such as we have here.

2 MR. SMITH: Yes, in our view it does equate. They
3 are equivalents for these purposes. I'm not suggesting that
4 there aren't property law distinctions but I think the
5 Court has said often in this area that property law really has
6 to take a back seat to the governing principles in this area.

7 So, essentially, in our view, these respondent-les-
8 sees are much like tenants at sufferance. They can be ejected
9 at any time, and if they are ejected at any time -- they can be
10 ejected at any time. Whether in fact they are or they aren't
11 is irrelevant. The essential point is that they don't have an
12 economic interest in coal in place, and if they don't have that
13 they don't get the depletion allowance.

14 I'd like to save the rest of my time for rebuttal.

15 MR. CHIEF JUSTICE BURGER: Mr. Katz.

16 ORAL ARGUMENT OF LeROY KATZ, ESQ.,

17 ON BEHALF OF THE RESPONDENTS

18 MR. KATZ: Mr. Chief Justice, Members of the Court:

19 We are exactly at odds with the statements which have
20 been made by the Government in this case. He is wrong in
21 stating that the lessor gets, besides capital gains, gets cost
22 depletion. It's just not true, Your Honors. Section 631 spe-
23 cifically says that the lessor shall no longer get any deple-
24 tion and in its place the lessor will get capital gains on the
25 royalties which he receives.

1 QUESTION: Well, isn't that designed to let him
2 recover his capital in a -- ?

3 MR. KATZ: Yes, Your Honor --

4 QUESTION: Isn't it?

5 MR. KATZ: Yes.

6 QUESTION: And that was the conventional purpose, to
7 take the place of depletion?

8 MR. KATZ: To take the place of depletion; that's
9 right. They --

10 QUESTION: And so, to the extent that someone else
11 gets depletion, well, at least I wouldn't suppose that people
12 ought to get depletion on the same assets?

13 MR. KATZ: Absolutely -- on the same asset, but not
14 on the same -- not get the same depletion --

15 QUESTION: On the same interest?

16 MR. KATZ: Yes, sir, on the same interest. And
17 that is not the case in this situation, Your Honor. You see,
18 in a lease he gets a royalty. That's what --

19 QUESTION: He gets his capital gain on a negotiated
20 royalty?

21 MR. KATZ: That's correct.

22 QUESTION: Which is negotiated, I suppose, on some
23 assumptions about depletion?

24 MR. KATZ: No, sir. Well --

25 QUESTION: Well, I would suppose they would be.

1 MR. KATZ: The intricacies of the market determine
2 whether or not a lessor is going to lease his property to a
3 lessee and what the royalty rate will be. Now, when he has
4 to figure what his capital gain is, he has to figure his cost
5 in exactly the same way that if you bought a piece of machi-
6 nery and later sold it; to see whether you had a capital gain
7 you have to figure his cost. That is what the Government in
8 its 631(c) statute say, that they must figure their cost and
9 then take capital gains on it. But the important thing is --

10 QUESTION: You're talking about the cost of the
11 mineral to him, in place?

12 MR. KATZ: Yes, if, for example, if you had paid for
13 your property \$100,000, for example, and then you had a million
14 tons of coal in that property, and then you leased it to a les-
15 see, your unit cost in that is a million divided by a hundred
16 thousand, ten cents; ten cents a ton. And then, if you go
17 from there and see what the lessee, how many tons he mines
18 and the royalty that he gets from that, you can figure what
19 your cost is, and based upon that cost then you determine what
20 your capital gain is. But the important thing is, Your Honor,
21 is that leaves nothing -- we do not describe what the lessee
22 is to get.

23 You see, the percentage depletion allowance is based
24 upon gross income from mining. So that means, what is the
25 coal sold for on the market and what did the lessee, who had

1 the absolute right, as soon as he cut that coal out of the
2 mountain and as soon as he brought it in and had it cleaned,
3 he had to sell it; he was responsible for it. He had to take
4 the risk of the loss, he had all of the obligations of an
5 owner. And he had to sell that coal.

6 Now, for example, you give the lessor 25 cents.
7 According to his theory, that's all there is in the way of
8 depletion. Not so. If the lessee sells that coal for, say,
9 \$30 a ton, his depletion is based upon that \$30 a ton less
10 the 25 cents that he gave to the lessor. Now, that is the
11 depletion that we're talking about. And the Government would
12 say that, no, that's not right. We say it can't be any other
13 way, Your Honors. It cannot be any other way. We have lost
14 the depletion allowance, and we say that nobody -- and I
15 repeat, what we're talking about here, and what we have been
16 denied by their appeal -- we were granted in the Court of
17 Claims -- what we have been denied is the percentage depletion
18 which is based upon the gross income from the mining of that
19 coal, which we did in every taxable year in this case.

20 That includes Swank, that includes Bull Run, and it
21 includes Black Hawk. Now you tell me why we are not entitled
22 to that depletion allowance which the Federal Government, by
23 virtue of this Congress, has given us, and said we are
24 entitled to it?

25 No one else, and I repeat it again, no one else can

1 claim that depletion, and no one else will get it if we don't.
2 And that's true of Swank, of course, because the governmental
3 agency in Northumberland County doesn't have to worry about
4 it. But it is also true in Bull Run and it is true in Black
5 Hawk.

6 QUESTION: Then you say that the regulation issued
7 under 631 is not valid? If it says that you have to have a
8 one-year period?

9 MR. KATZ: No, there's no such regulation as that,
10 Your Honor. What he is talking about was a General Counsel's
11 Memorandum which came out in 1950 and which they have now aban-
12 doned. General Counsel's Memorandums do not have the force of
13 regulations; they don't have the force of a Revenue Ruling;
14 they are just an opinion from the General Counsel's Office
15 and they are not the law.

16 QUESTION: Well, I mentioned in my comment to
17 Mr. Smith that I had never heard of GCM. There are lots of
18 parts of the Tax Court I've never heard of too, but you say
19 they don't have the force of a regulation?

20 MR. KATZ: Absolutely not, no, sir. And I might add
21 this, that I was in the Bakertown case in the Court of Claims,
22 which we won, and which the Government did not appeal. That
23 was in 1973. From 1973 on to this date, to this very date,
24 the Government has made no attempt to put a regulation in ex-
25 plaining what they think of. They have withdrawn the GCM

1 that the Government contends is their rule of thumb. Why
2 they withdrew it I don't know, but it's gone.

3 QUESTION: Well, in the old days, a GCM was pretty
4 high up in the hierarchy.

5 MR. KATZ: Well, all I can say, Your Honor, it does
6 not have the power of a regulation or revenue ruling.
7 And of course the regulation is the next thing to law, but --
8 and of course that can be objected to too, but that has the --
9 powerful act. But we don't have it. It's been withdrawn, so
10 that shows you what you can do with the General Counsel's
11 Memorandum. But after one year --

12 QUESTION: You say that's just another lawyer's opin-
13 ion then?

14 MR. KATZ: Well, it's an important opinion because
15 it comes from the General Counsel, but it does not have the
16 force of law and doesn't have the --

17 QUESTION: It doesn't come from the Secretary,
18 though.

19 MR. KATZ: I beg your pardon?

20 QUESTION: It doesn't come from the Secretary or the
21 Commissioner.

22 MR. KATZ: No, sir, it does not. And assuredly,
23 Your Honor, that under those circumstances we've also got to
24 remember, as far as -- the Government in its brief has been
25 arguing that this depletion allowance is what the lessor

1 is entitled to and what he gets. No such thing. He gets no
2 depletion allowance. Now, I also want to call the Court'
3 attention to the fact, to strengthen it, that under the
4 depletion deduction -- under Section 611, it says this:

5 "No depletion deduction" -- no depletion deduction
6 -- "shall be allowed the owner with respect to any coal" --
7 I'm leaving out the other minerals -- "that such owner has
8 disposed of under any form of contract by virtue of which he
9 retains an economic interest in such coal, if such disposal
10 is considered a sale of the coal under Section 631(c)."

11 Now, how he can say that they are going to get some
12 depletion, the owner, under 631 is beyond me, because I'm just
13 reading it right out of the book.

14 QUESTION: Mr. Katz, I understood Mr. Smith to be
15 saying that he was referring, not to percentage depletion,
16 but rather to what he called a "cost depletion," which as I
17 understand it is really nothing more than the cost in any
18 capital gains transaction, and you're --

19 MR. KATZ: That's right.

20 QUESTION: Well, you agree that they do get the ten
21 cents in your hypothetical example?

22 MR. KATZ: Oh, yes, I agree.

23 QUESTION: It's just a question of whether we call
24 it cost depletion or not.

25 MR. KATZ: Well, but -- that's just the method of

1 figuring the -- he gets a better deal, Your Honor --

2 QUESTION: I mean, Mr. Smith did not suggest that
3 the lessor got percentage depletion. At least I certainly
4 didn't understand him to suggest that.

5 MR. KATZ: Well -- no, he did not. But in his brief
6 he used those terms that the owner was entitled to the deple-
7 tion in this case, and this case involves percentage depletion,
8 does not involve cost depletion.

9 QUESTION: Well, I thought he referred to cost de-
10 pletion there too. So I may have --

11 MR. KATZ: No, sir, he does not.

12 QUESTION: It doesn't matter. We -- All right,
13 I understand.

14 MR. KATZ: Now, he says there's no difference be-
15 tween a lease and a contract. Let me say this. We think there
16 is a great deal of distinction between what we have here and
17 what we have in Paragon Jewel, which was also my case.

18 Your Honor, in Paragon Jewel we had a contractor
19 who was mining coal for the lessee. And I might say this,
20 in the -- I'm not accusing him of trying to confuse the Court,
21 but he kept saying in his brief --

22 QUESTION: We've heard him before.

23 MR. KATZ: Oh, all right. Anyhow, the contractor
24 in that case was mining the coal for the lessee. He was -- he
25 did not depend upon what the lessee got for the coal on the

1 open market. He was paid a certain amount per ton. He was
2 required to bring the coal to the lessee's tipple. He was
3 required to give it to the lessee who then in turn sold it,
4 and who was responsible for what happened on the market, whe-
5 ther he made money or whether he lost money. And as a result
6 of that, the contractor, this Court said, was not entitled to
7 any depletion allowance. They didn't base it on the termina-
8 bility. He had no economic interest in the coal in place,
9 because all he was doing was getting paid for work which he
10 performed and before he walked into that mine he knew exactly
11 how much he was going to get for every ton of coal he pulled
12 out, irrespective of what the lessee, Paragon, got in that
13 case.

14 Now, that's the difference. But, now, here the
15 Government has conceded that we have a valid lease. The
16 Government concedes that absent this termination clause, that
17 we had all the rights, all the privileges, all of the duties
18 of any lessee. In the case of Black Hawk, we had to even have
19 a minimum royalty. We had to pay \$5,000 a year whether we
20 mined a ton of coal or not.

21 QUESTION: How long, in fact where each of these
22 leases mined by the claimants?

23 MR. KATZ: All right, sir, in the case of Black
24 Hawk, we mined it for 13 years, to exhaustion. We mined every
25 drop of coal out. In the case of Bull Run, they mined it for

1 11 years, and mined every drop of coal out, to exhaustion.
2 It just happened that way. In Swank, there were two leases.
3 One, they had to abandon after a year because they had a slide;
4 and the other, they mined for the two years when it was trans-
5 ferred to someone else.

6 But in each of the instances that I have named, we
7 have mined that coal through every tax year. We think this
8 is an important item. The question that we have mined that
9 coal in the tax years in issue, and that's what this case is
10 about, were we entitled to the depletion allowance during the
11 tax years in issue? Well, we mined it. Why shouldn't we get
12 it? It is not like Paragon where in that case two people
13 were claiming the same depletion, the same percentage
14 depletion. The miner, the contract miner said, I am entitled
15 to it on what I got paid, which is \$10. We contend that the
16 lessee was entitled to it because he ran the risk of the mar-
17 ket, and that he had the economic interest in the coal in
18 place. So, that was the difference between the two, and be-
19 tween what we have here and what we had in Paragon.

20 QUESTION: And in this case your argument, as I un-
21 derstand it, would go so far as to say that if the lease were
22 just a day-to-day lease terminable at will, so long as in
23 fact the lessee stays there and mined it through a taxable
24 year, then he's entitled to the percentage depletion?

25 MR. KATZ: Absolutely; yes. Because, let me explain

1 why, though, Your Honor.

2 QUESTION: Well, I think you told us why. You
3 think --

4 MR. KATZ: Well, I mean, you've got to remember some-
5 thing about percentage depletion. It's not a right that you
6 get just by signing the lease, and all of a sudden you can go
7 and take a deduction. First of all, you've got to mine the
8 coal.

9 QUESTION: That's right.

10 MR. KATZ: Secondly, you've got to sell it. And,
11 most importantly, you've got to sell it at a profit. And if
12 you don't combine all of those three factors, you don't get
13 a dime's worth of percentage depletion.

14 QUESTION: But all your mining and sales costs are
15 deductible.

16 MR. KATZ: Yes. Well, the calculation for percent-
17 age depletion tell you how to calculate it.

18 QUESTION: No, no, all the costs are deductible.

19 MR. KATZ: Shown costs are deducted, yes.

20 QUESTION: What's the justification for depleting
21 that mineral in place?

22 MR. KATZ: Because the statutes say that we are
23 entitled to it. We get a ten percent --

24 QUESTION: Where did percentage depletion come from?
25 That just didn't come off some tree somewhere. Congress had

1 some purpose in --

2 MR. KATZ: It came this way. At first, way back
3 there, in the early years, in 1918 and before, we had what
4 was called discovery depletion.

5 QUESTION: Then you had cost completion.

6 MR. KATZ: And then came the cost depletion.

7 QUESTION: And that was very complicated.

8 MR. KATZ: Yes. And now we're -- then we came to
9 percentage depletion, and the Congress just said that for coal
10 we're going to give you ten percent.

11 QUESTION: And the theory is -- and perhaps it is
12 just a theory, because I think the ten percent is probably a
13 politically negotiated figure --

14 MR. KATZ: Yes.

15 QUESTION: But the theory must be then that the
16 ordinary mine run coal mine, the asset is wasted and depleted
17 at the end of ten years.

18 MR. KATZ: Well, they don't say that.

19 QUESTION: Well, that must be the theory, isn't it?

20 MR. KATZ: Well, I can't say that that is the theory
21 that it would be ten years because I don't believe it has any
22 relation.

23 QUESTION: What other theory could possibly support
24 any depletion at all, or particularly a ten percent depletion?

25 MR. KATZ: I don't believe that the Congress --

1 QUESTION: It's a wasting asset that's completely
2 exhausted in ten years. That must be the underlying proposi-
3 tion.

4 MR. KATZ: Well, I don't believe that's correct. Well,
5 they'd have to say --

6 QUESTION: Well, they have the same sorts of
7 figures for all the minerals, don't they?

8 MR. KATZ: Every mineral has a different --

9 QUESTION: And it is a rough approximation of the
10 rate as which some resource is being depleted?

11 MR. KATZ: Well, let me say this, Your Honor --

12 QUESTION: When they set 27 percent for oil, they
13 didn't really think that the oil was going to be necessarily
14 played out in three years?

15 MR. KATZ: No, that's correct. And they didn't in
16 the case of coal, for example. It used to be five percent.

17 QUESTION: Well, but there's another --

18 MR. KATZ: It wasn't the theory that they later
19 said, well, it ought to be ten percent because they could mine
20 it more quickly. I don't believe that's -- I think it is
21 just political.

22 QUESTION: Well, based on that theory, it would be
23 a function of the cost invested in it. It's not related to
24 cost at all, it's related to sales price.

25 MR. KATZ: Not related to cost at all. There's no

1 relation.

2 QUESTION: There's another drive, and that is to
3 promote exploration and discovery.

4 MR. KATZ: Yes. It's to promote discovery, Your
5 Honor, and it's to reimburse the one who has to mine that
6 coal for the capital which he expends. I mean, this Court
7 has said --

8 QUESTION: In order to have any depletion allowance
9 deduction, you must have a wasting asset.

10 MR. KATZ: Yes, that's correct. That is exactly
11 correct. And in this case, it's ten percent, but it's not
12 just ten percent flat. It's ten percent of the gross income
13 not to exceed 50 percent of your net income after you've
14 figured out your net income. So that is what it is. Contrary
15 to what my opponent has stated here, Your Honor, we feel that
16 the percentage depletion allowance should be given to us.

17 The Government is not injured because the Congress
18 has told us we are entitled to that depletion. Not only that,
19 Your Honor, if I may make this point, it doesn't make any
20 difference whether we mine ten tons or a million tons, is
21 this Court going to get into this debate that we have now in
22 the Tax Court? They have said, no; 30 days is not enough; 60
23 days is not enough; they have just come out with a case in
24 which they say, well, 120 days is.

25 Now, is this Court going to say, well, we're going

1 to fix a year or five years or six months, is that the job of
2 this Court? Why isn't the Government asking for, one,
3 legislation, or two, to put down some regulations that we know
4 how to follow? And we feel that unless they do that they
5 should not bring us into court every time they decide that
6 they don't want to give out the depletion allowance.

7 We've fought it in Parsons v. Smith. We had to fight
8 in Paragon Jewel. I fought it in Bakertown, to get the deple-
9 tion to which we were entitled. They did not appeal. And I
10 believe, Your Honors, that we are entitled to that depletion
11 and that it should be granted.

12 MR. CHIEF JUSTICE BURGER: Do you have anything
13 further, Mr. Smith?

14 ORAL ARGUMENT BY STUART A. SMITH, ESQ.,
15 ON BEHALF OF THE PETITIONER -- REBUTTAL

16 MR. SMITH: I just have a couple of points.

17 As I understand why the GCM which has been bandied
18 about today has been rendered obsolete, it's simply because
19 it's been subsumed in other authorities including this
20 Court's decisions in Parsons and in Paragon, and in the rul-
21 ings which I cited today. I don't think that this case can be
22 decided on the basis of notions that Congress enacted the
23 depletion deduction. I think we can all agree on that.
24 I think that what we have to decide is whether these respon-
25 dents have an economic interest in coal in place. And in our

1 view, they don't have any more than the right to stay there;
2 and they didn't have any more than a right to stay there, more
3 than an additional 30 days. And in our view, that is not
4 significant enough to have an economic interest in coal in
5 place.

6 QUESTION: And then, in your view, the fact that
7 they did stay there and mine the coal until it was exhausted
8 in two out of these three cases has nothing to do with it?

9 MR. SMITH: Is absolutely irrelevant. You cannot
10 administer the statute, in our view, on the basis of the
11 hindsight, look-back. Thank you.

12 MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.
13 The case is submitted.

14 (Whereupon, at 2:55 o'clock p.m., the case in the
15 above-entitled matter was submitted.)

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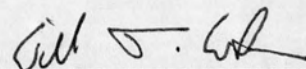
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