

OFFICIAL TRANSCRIPT  
PROCEEDINGS BEFORE

THE SUPREME COURT OF THE UNITED STATES

DKT/CASE NO. 82-599 & 82-774

TITLE COMMISSIONER OF INTERNAL REVENUE, Petitioner  
v.  
FRED L. ENGLE, ET UX.; and  
PHILIP D. FARMAR, ET AL., Petitioners v.  
UNITED STATES

PLACE Washington, D. C.

DATE October 11, 1983

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ALDERSON REPORTING

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P R O C E E D I N G S

CHIEF JUSTICE BURGER: Mr. Phillips, I think you may proceed whenever you are ready.

CRAL ARGUMENT OF CARTER G. PHILLIPS, ESQ.,  
ON BEHALF OF THE PETITIONER, COMMISSIONER OF  
INTERNAL REVENUE AND THE RESPONDENT, UNITED STATES

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

The issue in these consolidated cases is whether Section 613A of the Internal Revenue Code permits a lessor of oil and gas property who receives an advance payment upon the execution of a lease, the advance payment either in the form of a lease bonus or an advance royalty, is entitled to a percentage depletion deduction against those royalties even though no oil or gas allocated to that income is produced during the taxable year.

The facts in both of these cases are not disputed. In the Farmar case in 1976 taxpayers leased the mineral estate of lands they owned in Texas to two companies interested in oil and gas exploration.

Part of the compensation for that agreement was a substantial lease bonus to be paid in installments, and that was in no way dependent upon the actual production of oil or gas. Instead, it was based



1 on the acreage of the lease.

2 Taxpayers also included in that agreement a  
3 provision allowing them to receive royalties for any oil  
4 or gas actually produced. During the 1976 tax year oil  
5 and gas was extracted from those properties, and a  
6 royalty was paid.

7 Taxpayers in their 1976 federal income tax  
8 returns claimed a 22 percent depletion deduction for  
9 both the lease bonus payment and the royalty. In the  
10 Engle case in 1975 the taxpayers assigned a lease to  
11 properties they had in Wyoming to producers in return  
12 for an overriding royalty.

13 As part of the compensation scheme there the  
14 taxpayers in this case received an advance royalty of  
15 \$7600. During the 1975 tax year there was, however, no  
16 production.

17 Nevertheless, the taxpayers on their federal  
18 income tax returns for 1975 claimed a 22 percent  
19 depletion deduction for the advanced royalties that they  
20 had received. In both of these cases the Commissioner  
21 assessed a deficiency by disallowing the percentage  
22 depletion deductions for payments that were received  
23 that had no relationship to any actual production during  
24 the taxable year.

25 The Farmers paid the deficiency and filed suit

1 for return of the monies in the Court of Claims. The  
2 Engles, on the other hand, brought a proceeding in the  
3 Tax Court.

4           The Court of Claims unanimously and the Tax  
5 Court by a vote of 14 to 1 upheld the Commissioner's  
6 decision and determined that Section 613A did not allow  
7 deductions in the absence of production during the  
8 taxable year. The Engles appealed the judgment of the  
9 Tax Court to the Seventh Circuit which reversed.

10           Both the Commissioner and the Farmar's filed  
11 separate petitions to this Court. They were granted and  
12 the case consolidated.

13           Prior to 1975 it was clear that the lease  
14 bonuses and advance royalties at issue in this case  
15 would have been subject to the percentage depletion  
16 deduction. Prior to 1975 under Section 611 of the  
17 Internal Revenue Code which allows a deduction for a  
18 reasonable allowance for depreciation and Section 613  
19 which allows a deduction for gross income from the oil  
20 or gas producing property this Court had concluded the  
21 only statutory condition for allowance of the depletion  
22 deduction was the existence of gross income, and since  
23 this Court had also concluded that advance payments  
24 either in the form of lease bonuses of advance royalties  
25 were gross income from the property the deduction was

1 permitted.

2 QUESTION: Mr. Phillips, even after 1975 are  
3 bonuses and advance royalties income from the property?

4 MR. PHILLIPS: Yes, ma'am. I believe they  
5 would still remain as income from the property.

6 QUESTION: That would be consistent with our  
7 decision in Herring, the old decision.

8 MR. PHILLIPS: Yes, Your Honor. We do not  
9 dispute that decision in this case.

10 QUESTION: Well, is there anything in the  
11 statute we are talking about here or the amendments that  
12 specifically changes the definition of gross income to  
13 exclude bonuses and advance royalties or that overrules  
14 Herring?

15 MR. PHILLIPS: Nothing that expressly does  
16 that. Congress did add Subsection D to Section 613 in  
17 1975. Subsection D says you do not start with Section  
18 613 which is the provision that forces you to look at  
19 gross income. Instead it says that you look first at  
20 Section 613A and only for so much of the production as  
21 you can demonstrate satisfies the requirements of  
22 Section 613A do you then come back into Section 613 and  
23 apply the gross income tests under Herring and for that  
24 matter all of the Commissioner's rulings regarding gross  
25 income.

1           QUESTION: Well, Congress did not change the  
2 definition of gross income is what you are saying, but  
3 it did state that the deduction for percentage depletion  
4 had to be with respect to production.

5           MR. PHILLIPS: That is right, Your Honor.

6           QUESTION: Now is the statutory language not  
7 given better effect by allowing the deduction but just  
8 postponing it to the year of actual production?

9           MR. PHILLIPS: Well, of course, that is not  
10 the issue in this case. They are seeking to assert the  
11 deduction in this taxable year.

12          QUESTION: Well, I am asking you if that is  
13 not a better application of this statutory language?

14          MR. PHILLIPS: Well, I will concede that that  
15 is a reasonable interpretation of the statutory  
16 language. The Commissioner's view is that the focus in  
17 Section 613A on production in the taxable year seems to  
18 expect that that is the taxable year that they focus  
19 on. When the income is acquired prior to actual  
20 production the Commissioner has concluded that Congress  
21 simply did not intend for that to be subject to the  
22 depletion allowance.

23          As I said, Justice, I think in this case where  
24 the Seventh Circuit held that both interpretations are  
25 reasonable I submit that you could probably make a



1 reasonable argument with regard to the hypothetical you  
2 set, but I think it important to make clear that  
3 regardless of how you decide your hypothetical you would  
4 still deny the deduction for the taxpayers in these  
5 cases.

6 QUESTION: How about the converse? What if  
7 you have a deduction in one year and no income until the  
8 next?

9 MR. PHILLIPS: The Commissioner has taken the  
10 position at least with respect to the hypothetical he  
11 presented in his proposed regulations that if you have  
12 say \$100,000 of production in one year and \$85,000 of  
13 income in that year and \$15,000 of income in the next  
14 year he will permit you the \$15,000 deduction in --

15 QUESTION: In the next year even if there is  
16 not any production. So he does not apply the statute  
17 literally either.

18 MR. PHILLIPS: Not precisely. I think the  
19 exception made for that -- It is not clear that he would  
20 allow that if all of the income were derived in a  
21 separate year, only if a small portion is.

22 In addition, it is clear that that distinction  
23 that the Commissioner has drawn is fully consistent with  
24 the intention and purpose of Section 613A. That is,  
25 Congress' dominant concern was to assure the production

1 of oil and gas, the extraction of oil in hand and  
2 certainly under the hypothetical that the Commissioner  
3 has proposed you have production in hand so, therefore,  
4 he has decided to go ahead and allow that. Certainly no  
5 taxpayers are likely to complain about the proposed  
6 regulation.

7 QUESTION: Is it clear that he would not if  
8 you have advance royalties in one year and the next year  
9 you have production he would not allow the depletion of  
10 the royalties received in a prior year?

11 MR. PHILLIPS: That seems clear, yes, Your  
12 Honor.

13 QUESTION: He will not do that?

14 MR. PHILLIPS: He will not do that. He will  
15 be allowed cost depletion for the income that you have  
16 received in the prior year. They will not allow the  
17 special advantage frankly that is afforded through  
18 percentage depletion.

19 QUESTION: Mr. Phillips, let me just be sure I  
20 understood you correctly. You said the dominant purpose  
21 of Congress in granting this exemption was to be sure  
22 there was some production of oil and gas unrelated to  
23 any particular time period.

24 MR. PHILLIPS: During the taxable year. I  
25 failed to say that, but I believe that Congress' dominant

1 concern was some production prior to the income. I  
2 think -- I'm sorry. Go ahead.

3 QUESTION: I am just wondering about whether  
4 there was this refinement of the general objective that  
5 there must be some production during the lease term  
6 which would be consistent with the old law and it really  
7 would not make much difference whether you had a year  
8 beginning or the end of the year lease where there was  
9 no production whereas there is a difference under the  
10 proposed regulations.

11 MR. PHILLIPS: Well, of course, the proper  
12 result in this case does not really hang on whether or  
13 not the proposed regulations are consistent. It seems  
14 to me we are still dealing with this particular case  
15 which is a situation where we have income and no  
16 production.

17 QUESTION: If there is no production during  
18 the entire life of the lease even the taxpayer would  
19 agree he would have to give back the --

20 MR. PHILLIPS: That is correct, but it seems  
21 perfectly consistent with the statute to expect that  
22 Congress may have preferred to have production as  
23 quickly as possible and not postpone it five to ten  
24 years.

25 QUESTION: One of the purposes of Congress was

1 to discourage the practice of leasing with an advance  
2 royalty payment scheme?

3 MR. PHILLIPS: Well, I think not to discourage  
4 it particularly but simply not to provide the  
5 extraordinary encouragement that percentage depletion  
6 would otherwise grant.

7 QUESTION: It is correct, is it not, that the  
8 Commissioner's position will discourage this particular  
9 form of lease?

10 MR. PHILLIPS: From the prior practice, yes,  
11 it will not be as readily adopted but of course --

12 QUESTION: Which may in turn cause --

13 MR. PHILLIPS: Anybody other than a small  
14 producer would not be --

15 QUESTION: That is right. We are only talking  
16 about small producers, but this may in turn make it more  
17 difficult for small producers to enter into advantageous  
18 leases.

19 MR. PHILLIPS: I do not think so, Your Honor.  
20 The small producer retains the very substantial  
21 advantage that comes when there is production on the  
22 property.

23 QUESTION: Right, but he loses the advantage  
24 if the lessee cannot assure him that there will be  
25 production in the year in which he is first receiving



1 royalties.

2           MR. PHILLIPS: That is correct. But most  
3 royalty owners I would imagine would still realize that  
4 a small producer if there is reasonable likelihood of  
5 production will offer the advantages of percentage  
6 depletion that were not available if he used a large  
7 producer so that all this does is make the large  
8 producer small producer equal with regard to advance  
9 payments from which no oil is produced and for which  
10 Congress presumably had no real concern or interest in.

11           CHIEF JUSTICE BURGER: We will resume at one  
12 o'clock.

13           (Whereupon, at 12:00 p.m., the hearing in the  
14 above-entitled matter recessed to reconvene at 1:00 p.m.  
15 this same day.)

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1 AFTERNOON SESSION

2 (1:00 p.m.)

3 CHIEF JUSTICE BURGER: Mr. Phillips, you may  
4 resume.

5 ORAL ARGUMENT OF CARTER G. PHILLIPS, ESQ.,  
6 ON BEHALF OF THE PETITIONER, COMMISSIONER OF INTERNAL  
7 REVENUE AND THE RESPONDENT, UNITED STATES -- CONTINUED

8 MR. PHILLIPS: Mr. Chief Justice, and may it  
9 please the Court:

10 In 1975 Congress in the Tax Reduction Act  
11 eliminated for the most part percentage depletion  
12 allowance for oil and gas. After 1975 the existence of  
13 the percentage depletion allowance was no longer  
14 contingent exclusively on the existence of gross  
15 income.

16 Instead Congress added Subsection D to Section  
17 613 which expressly requires the taxpayer to determine  
18 availability of any deduction, percentage deduction that  
19 is, under Section 613A first and then determine on the  
20 basis of whether you comply with the requirements of  
21 Section 613A how much of the deduction generally  
22 specified in Section 611 will be computed specifically  
23 under Section 613.

24 Congress in Section 613A permitted percentage  
25 depletion for a royalty owner such as the taxpayers in

1 these cases who leased to an independent producer "with  
2 respect to so much of the taxpayer's average daily  
3 production of domestic crude oil as does not exceed the  
4 taxpayer's depletable oil and natural gas quantity."  
5 Average daily production is determined by dividing the  
6 aggregate production for the year by the number of days  
7 in the taxable years.

8           The depletable quantity is an arbitrary number  
9 that the Congress had set in order to limit the maximum  
10 amount of production and the guarantee that the  
11 producers were in effect small producers. As the  
12 majority of the Tax Court held, Section 613A places  
13 repeated emphasis on the concept of production, and  
14 production itself commonly means extraction from the  
15 ground and, therefore, it is fair to read the statutory  
16 language itself as requiring actual production during  
17 the taxable year, and accordingly the taxpayers in this  
18 case who cannot attribute any of their income to actual  
19 production during the taxable year are not entitled  
20 under the plain meaning of the language of Section 613A  
21 to a percentage depletion deduction.

22           QUESTION: Mr. Phillips, what do you make of  
23 the language immediately preceding the critical section  
24 where it says "with respect to". Are you familiar with  
25 that?

1           MR. PHILLIPS: Yes. Our view is that the  
2 "with respect to" is the way to describe how much  
3 production you get to use for the percentage depletion,  
4 that is, you get with respect to so much production  
5 depletion under 611 to be computed under Section 613.  
6 The "with respect to" language is actually the pivotal  
7 language in our mind in determining that production is  
8 crucial because it is only with respect to so much  
9 production that you are allowed any kind of a  
10 depletion.

11           QUESTION: I do not quite read it that way.  
12 It says "except as provided in Subsection D the  
13 allowance for depletion under Section 611 shall be  
14 computed in accordance with Section 613 with respect to  
15 so much of the taxpayers average daily production of  
16 domestic crude oil as does not exceed the taxpayers  
17 depletable oil quantity."

18           That suggests to me that there may be other  
19 instances of depletion allowance that are not embraced  
20 within that language. Do you disagree with that?

21           MR. PHILLIPS: No, I agree with that. It is  
22 clear that it is with respect to both that you have to  
23 have some production and with respect to so much as does  
24 not exceed the depletable quantity.

25           So anything over 2000 barrels in 1975 will not



1 be with respect to which you can deduct under the  
2 percentage depletion. Just as if you do not have any  
3 production it is with respect to zero production that  
4 you are allowed the depletion. So I would read that  
5 language as saying with respect to whatever number  
6 between 1 and 2000 barrels are produced by primary means  
7 of extraction.

8           Of course, the taxpayers are still entitled to  
9 cost depletion under Section 612, but in our reading of  
10 the plain meaning of the statute they are no longer  
11 entitled to percentage depletion simply as a simple  
12 arithmetic means. That is, the numerator of aggregate  
13 production is zero divided by any number obviously  
14 equals zero, and so with respect to how much production  
15 is there a deduction the answer is zero.

16           QUESTION: Mr. Phillips, does the Commissioner  
17 require the lessees to capitalize lease bonus and  
18 advance royalty payments that they make and to take a  
19 percentage depletion allowance against them in the year  
20 of actual production?

21           MR. PHILLIPS: Well, he does not permit them  
22 -- They have historically not been permitted to take the  
23 lease bonus and advance royalty and deplete that, use  
24 percentage depletion on that. He does require them to  
25 capitalize it as a straight deduction.

1           He continues to take the view that the lease  
2 bonus and advance royalties are not subject to the  
3 percentage depletion allowance to the lessee. That, by  
4 the way, is compelled I think in the House committee  
5 report in 1974.

6           We submit that the result compelled by the  
7 statutory language is equally supported by the only  
8 relevant legislative history in this case. When the Tax  
9 Reduction Act was passed out of the House committee in  
10 1975 it contained no provision with regard to oil and  
11 gas depletion, and an amendment on the House floor  
12 completely abolished oil and gas depletion which passed.

13           The bill then went to the Senate. Again, the  
14 Senate Finance Committee reported out a bill that again  
15 contained no provision for oil and gas depletion, and on  
16 the floor of the Senate was the amendment added that  
17 conforms basically to Section 613A.

18           All of the courts that have considered this  
19 issue below have concluded that reading the legislative  
20 history in 1975 provides no useful insights into the  
21 solution of the problem presented by these cases. That  
22 is, there is nothing in there that tells you how to  
23 treat lease bonus and advance royalties.

24           However, in 1974 during the prior Congress,  
25 indeed the last session of the prior Congress and merely

1 four months prior to the date that the conference  
2 committee announced the final Section 613A compromise,  
3 the House considered legislation that had been proposed  
4 by Wilbur Mills then the Chairman of the Ways and Means  
5 Committee that is strikingly similar to Section 613A.

6 That legislation provided a percentage  
7 depletion deduction that was permissible again with  
8 respect to so much of the taxpayers average daily  
9 production of domestic crude oil as in that bill did not  
10 exceed 3000 barrels. Average daily production in that  
11 legislation was defined precisely as it is defined in  
12 Section 613A.

13 When that bill was reported out of committee  
14 the House Ways and Means Committee made the only  
15 statement that is directly relevant to the appropriate  
16 disposition of this case, and the House committee's  
17 report states thus the deducton applies to gross income  
18 attributable to oil which is sold or removed from the  
19 premises and not to other types of depletable income.

20 QUESTION: Mr. Phillips, does any of the  
21 history address covering the Commission?

22 MR. PHILLIPS: Directly?

23 QUESTION: Yes.

24 MR. PHILLIPS: No, Your Honor, it does not.

25 QUESTION: Your answer to the argument based

1 on Herring is?

2 MR. PHILLIPS: Is that it obviously did not  
3 require Congress to have considered the prior law in  
4 order to change that law. If it adopts language in the  
5 statute that is just completely inconsistent with the  
6 basic ground rules that gave rise to the Herring  
7 decision which we submit it did, then Herring is just no  
8 longer appropriate as a basis for decision.

9 The House committee report says expressly, for  
10 example, a lease bonus paid to the lessor of mineral  
11 lands in a lump sum or in installments is independent of  
12 any actual production from the lease and thus would not  
13 be within any of the exemptions. That is directly  
14 inconsistent with Herring, and it is clear that Congress  
15 meant to change the rules that income alone was no  
16 longer the basis for percentage depletion. What was  
17 necessary now is actual production and that in the  
18 taxable year.

19 I take it as self-evident frankly that if that  
20 legislative statement had been included by the Senators  
21 who proposed the amendment in 1975 on the floor of the  
22 Senate that these cases would not be here today. There  
23 is simply no way to mask the clear intent of the House  
24 Ways and Means Committee four months before this actual  
25 legislation was passed with regard to exactly what this



1 language means, and it is the with respect to the  
2 taxpayers average daily production that is the pivotal  
3 language in the 1975 legislation, and under our theory  
4 that is precisely the same language that the House Ways  
5 and Means Committee was interpreting in 1974.

6           We submit there is simply no justification for  
7 doing as the Seventh Circuit did to disregard the only  
8 clearly relevant legislative history we have to tell us  
9 what that statute meant and intended in the cases we  
10 have before us today, nor indeed do we believe that such  
11 an extraordinary result as the Seventh Circuit reached  
12 can be justified simply on the basis that Congress  
13 failed to make reference to the prior law with regard to  
14 lease bonuses and advance royalties in 1975.

15           QUESTION: Mr. Phillips, can I interrupt you  
16 one second. In looking at the language from the 1974  
17 legislative history you are relying on, say you had a  
18 five-year lease with a five-year lease bonus paid in  
19 five installments, equal installments, and there was  
20 production in the first four years of the lease but not  
21 in the fifth. Would there be any depletion allowance on  
22 the fifth installment of the lease bonus under your  
23 view?

24           MR. PHILLIPS: No, Your Honor. There would  
25 not be any depletion allowance on any of the lease bonus

1 under the interpretation of the House Ways and Means  
2 Committee in 1974 because they say that lease bonus is  
3 clearly not attributable to income from production. It  
4 has nothing to do with production. It is based on  
5 acreage and, therefore, it is not subject to the  
6 depletion allowance, percentage depletion allowance. It  
7 is still subject to cost depletion but not percentage  
8 any longer.

9           QUESTION: So that when we are looking at  
10 lease bonuses we do not care whether there is production  
11 or not.

12           MR. PHILLIPS: That is correct, Your Honor. I  
13 believe that is a fair interpretation of the House  
14 committee's report.

15           The Seventh Circuit believed that it could  
16 reach a contrary result. The Seventh Circuit in  
17 reaching its decision first stated that under the  
18 statutory language the Commissioner's interpretation was  
19 perfectly reasonable.

20           Under the legislative history in 1975 the  
21 Commissioner's interpretation was perfectly reasonable.  
22 That recognized that the 1974 legislative history if  
23 considered provided substantial support for the  
24 Commissioner's interpretation, and it blinded itself to  
25 all of that and decided the case on the basis of the

1 failure of Congress in 1975 to expressly state that it  
2 was going to overturn prior law.

3           In the context of what Congress was doing in  
4 1975 that simply ignores the reality of that  
5 congressional session. Congress acted within six days  
6 between the time that the Senate proposed the amendment  
7 and the House committee -- Excuse me, the House-Senate  
8 conference committee adopted the compromise solution to  
9 this proposal that that legislation came out.

10           In the context of eliminating almost all  
11 percentage depletion allowance it is just simply not  
12 reasonable to assume that anyone would have worried  
13 about this very small portion of the problem of  
14 percentage depletion. The future of percentage  
15 depletion simply was in no way contingent on the  
16 treatment of the royalty owner's advance royalties and  
17 lease bonuses.

18           Therefore, it is not appropriate to rely on  
19 the failure to make comment in 1975 as the basis for  
20 deciding this case. In 1975 Congress was reacting to a  
21 severe oil shortage which caused the price of  
22 deregulated oil to skyrocket.

23           It responded by eliminating the extraordinary  
24 tax advantages that percentage depletion had previously  
25 granted in most situations. Congress decided to

1 continue to give some depletion protection to  
2 independent producers, but it quite reasonably withheld  
3 the percentage depletion advantage to situations where  
4 oil was actually extracted during that taxable year and  
5 even then only so long as the amounts reflected a small  
6 producer.

7           In all other situations Congress simply  
8 relegated the taxpayer to the cost depletion that most  
9 other taxpayers are able to use in most of their  
10 industries. Taxpayers here were entitled to the  
11 latter. They were not entitled to the former.

12           The federal circuit correctly so held, and its  
13 judgment in *Farmar* should be affirmed. The Seventh  
14 Circuit's holding should be reversed.

15           QUESTION: May I ask another question? I am  
16 just wondering how important the words "lease bonus" are  
17 and I guess we have expressly a lease bonus in one case  
18 and an advance royalty in the other case.

19           Is it conceivable that the two cases could be  
20 decided differently, the government win in one and lose  
21 in the other?

22           MR. PHILLIPS: It is conceivable that we  
23 could. I do not think the Congress intended to draw a  
24 distinction. I think if --

25           QUESTION: Well, to the extent that you rely



1 on the lease bonus language in the '74 report, does that  
2 language apply with the same force to the advance  
3 royalty situation?

4 MR. PHILLIPS: Well, since the advance  
5 royalties and lease bonuses had historically been  
6 treated essentially the same I would say that there is  
7 no reason to draw a distinction between them simply  
8 because Congress in its example referred to lease  
9 bonus. If you take the more general statement that  
10 proceeds the --

11 QUESTION: So in effect in your argument the  
12 history really has changed, that the old law was  
13 changed, not just limited to a certain category of  
14 persons. I do not remember the name of the case.

15 MR. PHILLIPS: The Herring?

16 QUESTION: The Herring case.

17 MR. PHILLIPS: Well, no. I do not believe so  
18 because it seems to me that there is still the question  
19 of what is gross income and if you have gross income  
20 whether you are entitled to a depletion. I do not think  
21 that has been modified at all. It simply tells you that  
22 it has to have some production that goes with it.

23 That is just simply adding a precondition.  
24 Once you satisfy the precondition Herring applies just  
25 as it always had.

1 I do not think Congress had intended to change  
2 that, nor would I expect them to have made reference to  
3 that portion of it. The reason I think it inappropriate  
4 to distinguish between lease bonus and advance royalties  
5 is because the sentence that precedes this specific  
6 example talks generally about attributing income to  
7 production, and that is just as true in an advanced  
8 royalty as a lease bonus. That is, an advance royalty  
9 with no production the income is just not attributable  
10 to any production.

11 QUESTION: Well, not until there is production  
12 at least.

13 MR. PHILLIPS: Right.

14 QUESTION: Under their view once there is  
15 production it could be attributable.

16 MR. PHILLIPS: Sure, but if that is not done  
17 in the taxable year then the statutory language itself  
18 makes clear that you ought not to be entitled to the  
19 percentage deduction in that year.

20 QUESTION: The thing that troubles me about  
21 your emphasis on years are if I understand the papers  
22 correctly there are situations in which you would agree  
23 that in a fifth year of a lease there could be a  
24 depletion allowance based on production during earlier  
25 years in the lease, a fifth year in which there was no

1 production in the fifth year.

2 MR. PHILLIPS: If there were income.

3 QUESTION: Yes..

4 MR. PHILLIPS: And production. The  
5 Commissioner's proposed regulation does suggest that  
6 that is true that he will accept at least some portion  
7 of income in a subsequent year although the production  
8 precedes it. The facial inconsistency with the  
9 statutory language as we read it in this case is  
10 conceded, but it does seem to me that the notion of  
11 allowing the deduction in that situation is fully  
12 consistent with the purpose here.

13 That is, the purpose is to have oil and that  
14 purpose is fully served. As I say, I doubt that any  
15 taxpayers will complain about the Commissioner's  
16 interpretation on that side.

17 They seem only to be complaining about the  
18 Commissioner's interpretation on this side. Moreover,  
19 it does not seem to me that the tail of how you deal  
20 with that problem should wag the dog of how you deal  
21 with this essential problem here. That is, we still  
22 have to decided this case first.

23 QUESTION: Except that it will have an effect  
24 on the way in which people will negotiate their leases.  
25 That is what I am trying to think through.

1           MR. PHILLIPS: I think it will have some  
2 effect on the way they negotiate their leases, but I do  
3 not think it undermines the basic purpose which was to  
4 encourage independent producers to continue producing,  
5 that is, because they still have the basic advantage  
6 when you get to income when you have actual production  
7 and actual income you still get a significant advantage  
8 with percentage depletion that you simply do not get  
9 otherwise.

10           QUESTION: Other people do not get that.

11           MR. PHILLIPS: That is right. Large producers  
12 do not get that so if you go to Amoco or Exxon or  
13 someone and ask them to drill your hole if you get a lot  
14 if income you are not going to --

15           QUESTION: Could I ask did the Seventh Circuit  
16 believe that your suggestive interpretation and the  
17 interpretation submitted by your opponents both were  
18 reasonable?

19           MR. PHILLIPS: Yes, Your Honor. That is  
20 precisely what they said. The statutory language  
21 supports either interpretation.

22           QUESTION: Yet they turned down your  
23 interpretation.

24           MR. PHILLIPS: That is correct, Your Honor.  
25 That is an extraordinary result in our view.



1           QUESTION: Did they give an explanation for  
2 rejecting yours or for saying that they need not give  
3 you any deference at all?

4           MR. PHILLIPS: They gave no explanation for  
5 why the Commissioner ought not to receive some deference  
6 in interpreting his statute or why the Tax Court should  
7 receive no deference in interpreting the statute. They  
8 simply said that failure of Congress in 1975 to make  
9 express reference to prior law was the basis for  
10 deciding against the Commissioner.

11           We submit the Commissioner's interpretation  
12 should be upheld.

13           QUESTION: Mr. Phillips, if you look at the  
14 conference committee report because this language was  
15 added in a floor amendment so we do not have a lot of  
16 history to go by and if you just look at the conference  
17 committee report for the language that was actually  
18 adopted, there is no indication that Congress intended  
19 to amend the definition of gross income from property.

20           MR. PHILLIPS: I do not believe --

21           QUESTION: Or to change the prior result. It  
22 just is not there. You cannot find it.

23           MR. PHILLIPS: It seems to me there are two  
24 answers to that. First, we are not arguing that the  
25 definition of gross income from property has been

1 changed or need be changed in order to support our  
2 interpretation.

3           Second of all it seems perfectly unreasonable  
4 to assume that the conference committee six days after  
5 the Senate amendment would be sitting down trying to  
6 sort out these problems. The problems that the  
7 conference committee addressed itself to were twofold.

8           First, the conference said we are going to  
9 keep percentage depletion at 22 percent. That is how we  
10 resolved the difference between the House and the Senate  
11 version.

12           Second of all, we are going to keep the  
13 depletable quantity at 2000 barrels. That is the  
14 difference between the 3000 and the 1000 barrel  
15 proposals that were in the Senate.

16           You would expect that in the conference they  
17 are going to explain just what the differences were and  
18 how they were resolved, and that is all the conference  
19 report discusses. That makes sense in context, but that  
20 is not basis for saying that our interpretation should  
21 not be adopted simply because Congress did not go  
22 further and explain every other problem that might  
23 exist.

24           QUESTION: Well, it also indicated that it  
25 intended to retain the percentage depletion privilege

1 for the independent producer. That is what it intended  
2 to do.

3 MR. PHILLIPS: Well, no it said it intended to  
4 retain the percentage depletion at 22 percent for 2000  
5 barrels. What it retained was the Senate's version of  
6 22 percent and retained the Senate's version of 2000  
7 barrels.

8 It does not say anything about intending to  
9 retain any more than that and even the Seventh Circuit  
10 in its decision in this case declined to read into  
11 retains in the context of that conference committee  
12 report anything other than it is out there and that it  
13 explained what the compromise in conference was about.

14 Thank you.

15 CHIEF JUSTICE BURGER: Very well.

16 Mr. Donnelly.

17 ORAL ARGUMENT OF THOMAS J. DONNELLY, ESQ.,

18 ON BEHALF OF THE RESPONDENT, ENGLE

19 MR. DONNELLY: Thank you, Mr. Chief Justice,  
20 and may it please the Court:

21 I represent the Engles who are the Respondents  
22 in No. 82-599. The Engles received \$7600 in advance  
23 royalties in 1975, a year in which there was no  
24 production in the sense of physical extraction from the  
25 oil and gas properties that were involved.

1           The Engles nevertheless claimed under the  
2 independent producer exemption Section 613A(c) of the  
3 Revenue Code which was added under the Tax Reduction Act  
4 of 1975 the percentage depletion allowance. The Tax  
5 Court decided against the Engles' position finding that  
6 the statute had overruled the decision of the Herring  
7 case and required production, that is, that the payment  
8 must be directly related to production.

9           The Seventh Circuit reversed finding that  
10 there was no production requirement imposed by the  
11 statute but rather that the statute imposed a limitation  
12 only on the amount that would be eligible for the  
13 deduction in effect defining who is the small  
14 independent producer that was to have available to him a  
15 continuing percentage depletion allowance though  
16 Congress had intended to eliminate the depletion  
17 allowance for the large oil company.

18           It is the Engles' position that the language  
19 in Section 613A which requires the deduction to be  
20 computed in accordance with Section 613 requires that  
21 the deduction be based only on gross income from the  
22 property. The advance royalties are gross income from  
23 the property.

24           There is nothing in Section 613A that says  
25 that the deduction is to be calculated on the value of



1 production, and Mr. Phillips' position would suggest  
2 that the calculation is to be based on the value of  
3 production. Since we contend that prior law was to be  
4 retained for the small independent producer, a brief  
5 summary of prior law would be in order.

6 Under the Herring case there was no production  
7 requirement. Lease bonus and advance royalties were  
8 eligible for percentage depletion in the same manner as  
9 the proceeds of actual extraction.

10 There was a recapture rule I think that has  
11 been referred to before. If by the termination of the  
12 lease there had not been production sufficient to  
13 justify the advance royalty or lease bonus, then under  
14 the tax benefit rule the amount of depletion previously  
15 claimed would be recaptured.

16 QUESTION: Mr. Donnelly, would it not be a  
17 reasonable position for the Commissioner to require that  
18 the deduction -- Even if you are right about the fact  
19 that bonuses and advance royalties are part of gross  
20 income, would it not be reasonable for the Commissioner  
21 to require that the deduction be taken in the year of  
22 actual production?

23 MR. DONNELLY: Well, I think that would be  
24 reasonable, but under the statute cannot be done. The  
25 percentage depletion allowance can only be taken in the

1 year in which the proceeds or the money is received.

2           It has to be based on the gross income from  
3 the property. There is a limitation contained in  
4 Section 613 that it may not exceed 50 percent of the net  
5 income from the property so that the deduction, its  
6 calculation requires that it be taken in the year in  
7 which the money is received for cash basis taxpayers.

8           It would have been reasonable I think for  
9 Congress to have drafted the statute so that at the time  
10 there is production the depletion allowance be taken.

11           QUESTION: Well then maybe that is what  
12 Congress did do.

13           MR. DONNELLY: Well, Congress -- You see under  
14 the 1974 bill that Mr. Phillips referred to there was no  
15 requirement that the calculation be made in accordance  
16 with Section 613. That, however, is in the 1975 bill.

17           The statute does not say compute the deduction  
18 with respect to the barrelage amount allowed under  
19 Section 613A(c)(1)(a). It says the calculation is to be  
20 made in accordance with Section 613, that is, with  
21 respect to the gross income from the property on so much  
22 of the production as does not exceed the barrel  
23 limitation.

24           Our position, of course, all along has been  
25 zero production does not exceed 2000 barrels. If we had

1 zero production and we had gross income from the  
2 property, the calculation is simply to be based on the  
3 gross income from the property.

4           Only in the event that our production should  
5 exceed 2000 barrels a day would the limitation come into  
6 play. We believe that we are indeed then what Congress  
7 intended to define as a small independent producer.

8           The statutory history, I think, has been  
9 given, and we believe that since the independent  
10 producers exemption was inserted into the law as a  
11 result of the Senate amendment that the Senate committee  
12 report is of particular relevance. That report  
13 indicates that it was the intention to retain percentage  
14 depletion for the small independent producer.

15           We believe that this meant that prior law was  
16 to be retained as to the calculation of the exemption  
17 for the small independent producer, that the words "in  
18 accordance with Section 613" fully reflect the intention  
19 of Congress to make the calculation in accordance with  
20 prior law.

21           QUESTION: Mr. Donnelly, can I ask you a  
22 question?

23           MR. DONNELLY: Yes.

24           QUESTION: It will reveal my ignorance, but is  
25 there another definition of the term "small independent

1 producer" in the statute other than the --

2 MR. DONNELLY: No.

3 QUESTION: This is what defines it.

4 MR. DONNELLY: This is the definition. The  
5 statute prevents large retailers and large refiners and  
6 large producers if you fall into any one of those  
7 categories from being eligible for the small independent  
8 producer exemption.

9 The intent was to eliminate percentage  
10 depletion for the large oil company.

11 QUESTION: Explain this to me then. Why would  
12 this language not permit one of the giant oil companies  
13 to take this deduction to the extent that their  
14 production did not exceed this limit?

15 MR. DONNELLY: Well, most of the giant oil  
16 companies are retailers and refiners or one of the two.  
17 If you are a retailer or a refiner you cannot use the  
18 small independent producer exemption.

19 If you are a producer only the oil company  
20 would be eligible for the exemption within the  
21 limitations of the small independent producer  
22 exemption.

23 QUESTION: So the only meaning of the word  
24 "small" is that if you are otherwise an independent  
25 producer then you may take depletion up to the maximum



1 limits that year.

2 MR. DONNELLY: That is correct.

3 QUESTION: I see.

4 MR. DONNELLY: If production limits do not  
5 exceed that total, you are considered a small producer  
6 and you are entitled to the full depletion --

7 QUESTION: It seems to me that tends to  
8 support your view that this is a limit rather than a  
9 basic condition for eligibility.

10 MR. DONNELLY: We believe that it does support  
11 that.

12 QUESTION: I see.

13 MR. DONNELLY: In the case of our client, our  
14 client received \$7600 in advance royalties based on the  
15 price of oil as it existed in 1975. That would have  
16 been the equivalent of less than one barrel of oil per  
17 day as compared to the 2000 which the statute allows.

18 QUESTION: But you do not say, do you, that if  
19 there is never any production that you can have  
20 percentage depletion on advance royalties or bonus  
21 payments?

22 MR. DONNELLY: Justice White, we recapture.  
23 If by the termination of the lease the production had  
24 not --

25 QUESTION: So there is a precondition to

1 claiming percentage depletion on this income other than  
2 being a small producer?

3 MR. DONNELLY: The precondition --

4 QUESTION: There has to be some production.

5 MR. DONNELLY: The precondition claiming  
6 percentage depletion on advance royalties has always  
7 been that ultimately --

8 QUESTION: That may be be, but the answer is  
9 yes.

10 MR. DONNELLY: So as to avoid recapture.

11 QUESTION: Okay.

12 MR. DONNELLY: Right.

13 QUESTION: Your answer is yes. It is the same  
14 precondition that existed before 1975?

15 MR. DONNELLY: That is correct.

16 The effect of the government's position on us  
17 I think can be expressed by an example. Let us assume  
18 that there were \$7600 in advance royalties received in  
19 1975, a 5 percent royalty rate and no physical  
20 extraction.

21 In 1976 \$200,000 in value of oil is extracted  
22 from the property. \$10,000 then in royalty would have  
23 been earned, 5 percent of \$200,000.

24 The \$7600 advance would be offset against the  
25 \$10,000 earned and the balance of \$2400 would be owing.

1 Further assume the \$2400 is paid in 1977.

2           The government's position would give us no  
3 percentage depletion deduction in 1975 because there was  
4 no physical extraction. We would get no percentage  
5 depletion deduction in 1976 because there was no gross  
6 income from the property, and in 1977 I thought that  
7 under the government's position in this case we would  
8 get no percentage depletion during that year either;  
9 however, Mr. Phillips has said that the government would  
10 condescend in that year because there had been prior  
11 production to grant depletion on a reasonable quantity  
12 whatever that is, whatever he may mean by that, the  
13 gross income from the property which is paid during that  
14 year.

15           We think the statute does not work as to  
16 that. The statute also does not work as to an extractor  
17 who, for example, receives \$100,000 in advance in 1975  
18 in anticipation of production in 1976.

19           He gets no percentage depletion deduction in  
20 1975. In 1976 let's assume there is \$200,000 in  
21 production.

22           The \$100,000 advance is offset. It is  
23 previously paid. The gross income from the property is  
24 only \$100,000. This is all he can take percentage  
25 depletion with respect to.

1           We think that the difficulty with the  
2 government's position is found in the first paragraph of  
3 the question presented in its original brief where the  
4 question presented is stated, "Section 613A(2)(a) --  
5 Actually that is a misprint. It should be A(1)(a) --  
6 "of the Internal Revenue Code of 1954 allows a  
7 percentage depletion deduction to be computed" --  
8 eliminating the words "in accordance with Section 613",  
9 the significance of those words being that the deduction  
10 has to be calculated on the gross income from the  
11 property. The government, however, eliminates those  
12 words when it paraphrases this section of the Code.

13           They then go on, "with respect to" --  
14 eliminating the words "so much of the" -- "the average  
15 daily production of oil or gas" -- eliminating the words  
16 "as does not exceed" -- "defined in terms of production  
17 for any taxable year."

18           The government attempts to convert the  
19 statutory language which imposes merely a limitation  
20 into a production requirement. This is the same thing  
21 the government attempted to do at the time of Herring  
22 some 50 years ago to impose a production requirement,  
23 but a production requirement does not work with a  
24 statute that bases the calculation on gross income from  
25 the property.



1 Thank you.

2 CHIEF JUSTICE BURGER: Mr. Collie.

3 ORAL ARGUMENT OF MARVIN K. COLLIE, ESQ.,

4 ON BEHALF OF THE PETITIONERS, FARMAR, ET AL

5 MR. COLLIE: Mr. Chief Justice, and may it  
6 please the Court:

7 We represent two taxpayer ranchholders in west  
8 Texas by the name of the Farmars and the Suggs. They  
9 executed oil and gas leases in 1975 providing for  
10 installment bonuses.

11 They received a part of their installment in  
12 1976. In that same year they also received a royalty  
13 paid as a part of the actual production from their  
14 leases.

15 Not only is that a differentiation that one  
16 should note as a fact but also there is actual proof in  
17 this case that as the amount of the bonus goes up the  
18 amount of the percentage royalty goes down and vica  
19 versa. As a matter of economic logic that must be.

20 May I digress from what I would otherwise say  
21 to perhaps address what Justice Stevens was asking  
22 about. There is a very pertinent point to be realized  
23 that a person that does not have substantial economic  
24 means is going to take the bonus because of the  
25 certainty of income regardless of the depletion

1 allowance because he must have those dollars in hand and  
2 he cannot afford to gamble on the royalty that might  
3 ultimately be greater if he said forget the bonus and I  
4 will take the greater royalty in the future.

5           Now with respect to the reply brief of the  
6 government which was filed just a week ago, we believe  
7 it would be profitable to spend a few moments on that  
8 reply brief, and in that connection we respectfully ask  
9 the Court if it should choose to do so to look at the  
10 copies of Section 613A and the bill in 1974. We thought  
11 it might be more convenient for the Court if it could  
12 lay those two down side by side because what that shows  
13 one when it is done it -- Section 613A, and it is  
14 unfortunate they put a cap "A" there because of a  
15 section reference. It is not a small "a" in parentheses  
16 but a 613 cap A.

17           QUESTION: Mr. Collie, are you referring to a  
18 particular point in the briefs here that you would like  
19 to have us look at?

20           MR. COLLIE: Sir, Justice Rehnquist, what I am  
21 referring to is where the brief says there is remarkable  
22 similarity between the 1974 bill and the Act that came  
23 out as 613A. If we could look at the Act for a moment  
24 then I would like to compare it to the other bill and  
25 show the difference.

1 QUESTION: Where should we turn to look at the  
2 Act?

3 MR. COLLIE: Sir, in the application for  
4 certiorari the last page, page 93, has that. It  
5 actually starts at page 92.

6 QUESTION: That is 93 in your case.

7 MR. COLLIE: In application for certiorari in  
8 my case, yes, sir.

9 The point that we desire to make is that  
10 Section 613A says that without regard to Section 613,  
11 the old Act granting depletion, we will have two  
12 exceptions. One is an exception for certain domestic  
13 gas wells and then it starts off with respect to the  
14 exception for certain gas wells with this very important  
15 language, this clinching language. "The allowance for  
16 depletion under Section 611 shall be computed in  
17 accordance with Section 613 with respect to" and then it  
18 mentioned two types of natural gas that will still get  
19 percentage depletion.

20 Then it drops down in Subsection C to the  
21 exemption for independent producers and royalty owners,  
22 and it starts off the same way. It says "except as  
23 provided in Subsection D" -- which is irrelevant for our  
24 question -- "the allowance for depletion under Section  
25 611 shall be computed under and in accordance with

1 Section 613."

2           Now why did Congress choose that  
3 cross-reference, this web of cross-references that it  
4 has woven into the fabric of the Internal Revenue Code?  
5 It is because Congress wanted to tell us that we wanted  
6 to go back to 613.

7           We want all of the law, the regulations, the  
8 baggage, the decisions of this Court including Herring  
9 in order that we can see when we go to the limitation  
10 that Congress meant for this Court to look and meant for  
11 the administration of the Internal Revenue Service to  
12 look at what it has said before over a period of 50  
13 years with respect to Section 611 through Section 613.

14           That is the important thing. When the  
15 legislative history of the prior bill in 1974 is  
16 referred to by the government and saying that there it  
17 said you cannot have the bonus, the depletion on the  
18 bonus, look what that bill says. It does not have  
19 anything, not a word, about a cross-reference to Section  
20 611, not a word about a cross-reference to Section 613.

21           There is the all-important difference between  
22 the bill that the IRS would have us look at and the  
23 actual enactment in 1975. The legislative history may  
24 be different, but it is for a very good reason the  
25 statutory language is entirely different and without the



1 vital, the all-important cross-references.

2           Now a moment more about legislative history if  
3 legislative history should be relevant here. In the  
4 original briefs of the government they cited us three  
5 cases saying that we should look back from one Congress,  
6 the Congress in 1975 to a prior Congress in 1974.

7           They cited two cases. In our briefs we showed  
8 that neither of those cases were applicable. Now they  
9 come along with the Dahlaheight case, the famous Texas  
10 City disaster case involving the Federal Tort Claims  
11 Act.

12           In that case this Court considered a prior  
13 legislative report to the Congress that enacted the Tort  
14 Claims Act. But why? It was because the statute, the  
15 bill in the prior Congress was exactly the same and the  
16 legislative report was exactly the same word for word.  
17 The only reason they leaped forward back a year is  
18 because they wanted to pick up some testimony with  
19 respect to the prior bill because the bill that was  
20 actually enacted never had any legislative hearings.

21           Therefore, we respectfully submit that it had  
22 absolutely no support for going back into a prior  
23 Congress as to a bill that was never enacted.

24           Your Honors, in the situation the government  
25 would have us look at here we had a bill that came out

1 of a committee. Nothing further ever happened to it.

2 It was never referred to again in any place.

3 The danger as the Congressional Record shows

4 is of doing such a thing as that aside from the vacuum

5 that we are looking at the Ways and Means Committee

6 changed 51 percent in those two years and changed in

7 chairmanship from Chairman Mills to Chairman Ullman.

8 Next we would respectfully suggest --

9 QUESTION: May I ask you one question?

10 MR. COLLIE: Yes, sir.

11 QUESTION: Did the 1974 bill -- What did that

12 do with respect to regulated natural gas and natural gas

13 sold under fixed contract?

14 MR. COLLIE: They had a provision for it, yes,

15 sir.

16 QUESTION: For preserving or eliminating?

17 MR. COLLIE: For preserving it.

18 QUESTION: I see.

19 MR. COLLIE: But -- Excuse me, sir.

20 QUESTION: So it was parallel in that regard?

21 MR. COLLIE: In that regard, but again without

22 the transitional or shall we say cross-referencing

23 language that picks up 611 and picks up 613 in that

24 manner. Your Honor, it is to show that it is before

25 this Court.

1                   Now much has been made about the mechanical  
2 difficulties. Principally this mechanical difficulties  
3 is found in the concurring opinions in the Tax Court and  
4 the dissenting opinions in the application of the  
5 statute.

6                   We respectfully submit those mechanical  
7 difficulties are wholly illusory. They are simply not  
8 there.

9                   We would simply apply and why the IRS did it I  
10 cannot understand except they started it off wrong.  
11 They would simply apply the same technique that the  
12 lessor does today with respect to cost depletion.

13                   In other words, the lessor would have to do  
14 nothing more than he does today with respect to cost  
15 depletion in order to allocate this percentage depletion  
16 that he takes on his bonus over the actual production  
17 that he may receive in the future, and of course as  
18 Justice White pointed out if there is no production in  
19 the future the percentage depletion evaporates. So the  
20 mechanical difficulties as all of the commentators have  
21 pointed out are simply not there.

22                   May I add with respect to the some 11 or more  
23 commentators that have commented on the cases now before  
24 this Court I am pleased to report they all have come  
25 down in favor of the taxpayers' position.

1 QUESTION: Do you feel that weighs heavily in  
2 your favor?

3 MR. COLLIE: Sir?

4 QUESTION: Do you feel that weighs heavily in  
5 your favor?

6 (Laughter)

7 MR. COLLIE: Justice Rehnquist, I would rather  
8 it be on our side than on the other side.

9 (Laughter)

10 QUESTION: Are you happy to report that none  
11 of them is a student?

12 MR. COLLIE: Sir?

13 QUESTION: Are you happy to report that none  
14 of them is a student?

15 MR. COLLIE: No, sir. I cannot say that.

16 (Laughter)

17 MR. COLLIE: I can say though to Your Honor  
18 that about half of them are practitioners and half of  
19 them are students. But I would say the students' notes  
20 are very lucid and well done, and any practicing  
21 attorney would be delighted to have been associated with  
22 them.

23 QUESTION: Unless he is on the other side of  
24 the case.

25 (Laughter)



1 MR. COLLIE: Lastly --

2 QUESTION: Mr. Collie, before you go on do I  
3 understand that you think that it would be appropriate  
4 to require the deduction then to be taken in the year of  
5 the actual production?

6 MR. COLLIE: No, ma'am. I think, Justice  
7 O'Connor, it would be appropriate to take the percentage  
8 depletion deduction in the time of the receipt of the  
9 dollar. It is possible to devise a method to take the  
10 deduction at a later period of time, but I do not  
11 believe that is in accordance with the teaching of the  
12 Herring case which we believe is still vital and was not  
13 destroyed.

14 QUESTION: Well would it not be consistent  
15 with it and be a reasonable interpretation that the  
16 Commissioner could make?

17 MR. COLLIE: Yes, ma'am.

18 QUESTION: So perhaps even if we agreed with  
19 you on the gross income issue it should be remanded to  
20 the court below to consider deference to the  
21 Commissioner on that?

22 MR. COLLIE: With all deference, Justice  
23 O'Connor, to the Commissioner when the Commissioner has  
24 adopted a totally erroneous position he is not entitled  
25 to prevail.

1                   QUESTION: Well, maybe we could disabuse him  
2 of that position in the process.

3                   MR. COLLIE: I would hope, of course, the  
4 Court would, yes, Your Honor.

5                   Lastly, we would respectfully call the  
6 attention of the Court to the fact that the Farmers and  
7 the Suggs had actual production during the year of the  
8 receipt of their bonus and so there is absolutely  
9 nothing in the statute that says that they cannot  
10 combine these two types of gross incomes from the  
11 property.

12                   The gross income that is truly gross income  
13 from the property in the form of a bonus and the dollars  
14 they receive from the percentage royalty, I put the two  
15 together and take their percentage depletion upon that.  
16 You can easily combine them and see whether or not the  
17 limitation had been violated.

18                   So, therefore, we have an even, simplistic  
19 method of applying the statute. What the taxpayers here  
20 are suggesting conform with all of the decisions, the  
21 mosaic, almost Grecian mosaic that this Court worked out  
22 with respect to percentage depletion on bonuses over a  
23 very long period of time.

24                   It conforms with what Congress intended for  
25 the small producer. It is simple. It is logical, and

1 the taxpayers should prevail.

2 QUESTION: May I ask you a question about your  
3 position? Supposing you had a lease with a very large  
4 producer.

5 MR. COLLIE: A very large what, sir?

6 QUESTION: A very large producer. It is an  
7 independent producer so it is not a retailer and all that  
8 stuff, which produced ten barrels on December 31, or the  
9 last day of the taxable year and in the taxable year it  
10 got an advance royalty of \$10 million and then it got  
11 very small payments but very large production  
12 thereafter. Would it get the full deduction under your  
13 view in the first year?

14 MR. COLLIE: Yes, sir, but then it would have  
15 to be spread over the large production if I understand  
16 the question correctly in the later years and it would  
17 immediately violate the 3000 or 2000 barrel limit and  
18 you would immediately in the next year restore a part of  
19 the depletion deduction to income.

20 In other words, you estimate your recoverable  
21 reserves, Your Honor, and then you spread that -- Say  
22 you are going to get 1000 barrels -- I mean a million  
23 since we are dealing with big figures a million barrels  
24 a year for the next ten years.

25 QUESTION: Right.

1                   MR. COLLIE: So you spread your bonus over  
2 that ten years proportionately, and if you take your  
3 bonus and spread it to the next year and see how many  
4 dollars you are getting for that production you  
5 immediately are able to see that you have gone over in  
6 the second year your 2000 barrel limitation and so in  
7 the second year you immediately restore the depletion  
8 you took in the first year back to income.

9                   CHIEF JUSTICE BURGER: I think you have  
10 answered the question now.

11                   Do you have anything further?

12                   MR. PHILLIPS: No.

13                   CHIEF JUSTICE BURGER: Thank you, gentlemen.

14                   The case is submitted.

15                   (Whereupon, at 1:49 p.m., the case in the  
16 above-entitled matter was submitted.)

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**CERTIFICATION**

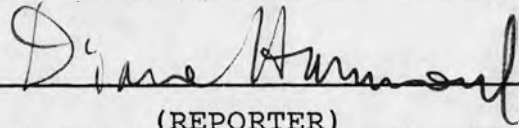
**Alderson Reporting Company, Inc., hereby certifies that the attached pages represent an accurate transcription of alectronic sound recording of the oral argument before the Supreme Court of the United States in the Matter of:**

**COMMISSIONER OF INTERNAL REVENUE, Petitioner v. FRED L. ENGLE, ET UX. : #82-599 and PHILIP D. FARMAR, ET AL, Petitioner v.**

**UNITED STATES #. 82-774**

**and that these attached pages constitute the original transcript of the proceedings for the records of the court.**

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