

OFFICIAL TRANSCRIPT
PROCEEDINGS BEFORE
THE SUPREME COURT
OF THE
UNITED STATES

CAPTION: UNITED STATES, Petitioner v.

WILLIAM F. HILL, ET UX.

CASE NO: 91-1421

PLACE: Washington, D.C.

DATE: November 2, 1992

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IN THE SUPREME COURT OF THE UNITED STATES

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UNITED STATES, :
Petitioner :
v. : No. 91-1421
WILLIAM F. HILL, ET UX. :
- - - - - X

Washington, D.C.
Monday, November 2, 1992

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:02 a.m.

APPEARANCES:

KENT L. JONES, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Petitioner.
RICHARD B. ROBINSON, ESQ., Denver, Colorado; on behalf of the Respondents.

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1 P R O C E E D I N G S

2 (10:02 a.m.)

3 CHIEF JUSTICE REHNQUIST: We'll hear argument
4 now in No. 91-1421, United States against William F. Hill.
5 Mr. Jones.

6 ORAL ARGUMENT OF KENT L. JONES

7 ON BEHALF OF THE PETITIONER

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

10 The question in this case which affects billions
11 of dollars of revenues under the minimum tax is ultimately
12 a quite narrow one: what costs are properly included in
13 the adjusted basis of a depletable mineral deposit?

14 While the question is a narrow one, its
15 background is somewhat complex. Since 1926 the tax
16 treatment of mineral deposits has created a sizable
17 incentive or tax preference for mining activities. The
18 mineral depletion allowance for mineral deposits differs
19 dramatically from the ordinary depreciation of other types
20 of wasting assets. Percentage depletion exempts from tax
21 a portion of the total income derived from the mineral
22 deposit. The allowance continues so long as production
23 continues, even long after the total costs of the mineral
24 deposit have been fully recovered.

25 By 1969 the percentage depletion allowance and

1 other tax preferences had been abused to such an extent
2 that many wealthy taxpayers were able to shield their
3 entire incomes from Federal tax. Congress enacted the
4 minimum tax to avoid this inequity and to improve the
5 fairness of the tax system as a whole.

6 QUESTION: When did Congress enact the minimum
7 tax?

8 MR. JONES: The first version of the minimum tax
9 was enacted in 1969.

10 QUESTION: Thank you.

11 QUESTION: Mr. Jones, Congress has recently
12 enacted another change?

13 MR. JONES: Yes.

14 QUESTION: And by virtue of the most recent
15 change, I guess no minimum tax will be applied to this.

16 MR. JONES: Under section 1915 of the Energy
17 Policy Act of 1992, which was enacted 2 weeks ago,
18 Congress has exempted the restricted minimum -- I'm
19 sorry -- percentage depletion allowance for independent
20 oil producers from the coverage of the minimum tax.
21 Congress left in place the application of the minimum tax
22 to all other types of percentage depletion allowances.

23 QUESTION: Well, that certainly indicates that
24 at least the present Congress isn't viewing the situation
25 quite like you do.

1 MR. JONES: Actually what we think and what I
2 believe the statute reflects is that there are two ways to
3 attack abusive tax preferences. One is to tax them, which
4 is the way the minimum tax works. The other is to
5 restrict the availability of the preference. What
6 Congress has done since 1969 for oil and gas depletion
7 alone is to create a statute, 613(a), which very narrowly
8 restricts the availability of the depletion allowance for
9 that one industry. Since 1969 Congress has cut the
10 depletion rate applicable to oil production in half, from
11 27 to 15 percent. They have removed the availability of
12 oil and gas depletion for all integrated refining and
13 marketing companies, which are the major producers of oil
14 in this country.

15 They have also restricted, even for independent
16 producers, the amount of depletion from an unlimited
17 quantity, first to 2,000 barrels a day and now to 1,000
18 barrels a day.

19 And perhaps most importantly, in section
20 613(a)(D), Congress has provided that the oil and gas
21 depletion allowance cannot be used to exempt more than 65
22 percent of the total income of the taxpayer, and so in
23 that manner, Congress has avoided the spectacle of the
24 depletion allowance being used to exempt all of the
25 taxpayer's income, which is the function of the minimum

1 tax.

2 QUESTION: Well, Mr. Jones, since I have you
3 interrupted, may I ask one other question? I thought that
4 the regulation, 1.571(h), was particularly relevant in
5 this case, and yet your brief doesn't really address it or
6 discuss it.

7 MR. JONES: Well, we address it in the sense
8 that all that regulation does is refer the reader to
9 section 1016 of the code for adjustments to basis. Every
10 one of the depletion regulations has the same
11 cross-reference, and the significance of that --

12 QUESTION: Well, but this regulation 1.57 at
13 least can be read to mean that the special rule referred
14 to in the regulation 1.612 doesn't apply.

15 MR. JONES: Well, there's --

16 QUESTION: And so, I just wondered why you
17 didn't even talk about it.

18 MR. JONES: There's at least two reasons why
19 that regulation has no relevance to the Court's decision
20 in this case. The first is that the reference to
21 1016 -- if you look at 1016(a)(2), it says you shall make
22 downward adjustments to basis for depletion allowances.
23 That is the reason that 57 and the regs under 61, 612
24 itself, all refer to 1016. These -- under 1016(a)(2), the
25 adjusted basis of a mineral deposit is adjusted downward

1 each year.

2 The other and perhaps more important reason why
3 1016 has no ultimate relevance to this case is because the
4 court simply misunderstood what the -- how that statute
5 works, and if you like, I can address it now or I can come
6 to it in the course of the discussion.

7 QUESTION: As you wish.

8 MR. JONES: Well, I think it might be helpful if
9 I put it into the context of the overall discussion in
10 this case.

11 Section 57 recognizes that the percentage
12 depletion allowance is a tax preference only to the extent
13 that the allowance exceeds the adjusted basis of the
14 mineral deposit. The question presented in this case is
15 the apparently elementary one of how the adjusted basis of
16 a mineral deposit is determined. Does it, as we contend,
17 include only the intangible costs of acquiring and
18 developing the deposit, or as the courts below concluded,
19 does it also include the costs of depreciable physical
20 property used in connection with production?

21 In our view, which all of the commentators have
22 agreed with, the answer is clearly set forth in the
23 statute and the regulations and in the decisions of this
24 Court, as well as in the history of the minimum tax.

25 Under section 611 of the code, the costs of the

1 mineral deposit are to be recovered by depletion, and the
2 costs of physical improvements are to be recovered by
3 depreciation. Since separate methods are employed to
4 recover these different types of costs, the regulations
5 specifically require that the basis of the depletable
6 minerals be maintained separately from the basis of the
7 depreciable improvements. The regulations state that the
8 basis of the mineral deposit does not include amounts
9 recoverable through depreciation deductions. This is what
10 Justice O'Connor was referring to as perhaps the special
11 rule.

12 But if you look at section 1.611-2(b)(2) of the
13 regulations, you'll see that it is not a special rule that
14 applies only to cost depletion because the regulation says
15 in no event shall percentage depletion in excess of the
16 basis of the mineral deposit be credited to the
17 depreciable improvements account. Congress did not -- I'm
18 sorry. The Service -- and these, by the way, are
19 substantive rules authorized by section 611.

20 The Service quite clearly did not intend to
21 allow these bases to be commingled. In 1937, they issued
22 a ruling which states -- and I quote -- the basis of
23 depletable property must be set up as an item separate
24 from the basis of depreciable property. So, the question
25 in this case is ultimately and directly answered by the

1 regulations.

2 The agency's longstanding requirement that a
3 separate basis be maintained reflects a fundamental
4 principle of tax accounting. As Judge Friendly said in
5 Commissioner v. Ferrar, the bases of even closely related
6 assets must be maintained separately when one is subject
7 to one kind of tax treatment and the other is subject to a
8 different kind.

9 It was for this very reason that in the United
10 States v. Dakota-Montana case in 1933 this Court rejected
11 the taxpayer's claim that depletable property could be
12 recovered through depreciation. The Court said that those
13 different types of costs must be recovered through the
14 separate mechanisms that Congress provided, and the basis
15 of the two types of property, therefore, can't be
16 commingled.

17 The Court said essentially the same thing in
18 Parsons v. Smith when they said -- and I quote --
19 depreciable equipment is not an investment in the minerals
20 in place.

21 The legislative history of the '86 amendments to
22 the minimum tax confirms this same distinction, for the
23 conference report to the bill stated that the depletion
24 preference under section 57 is -- and I quote again -- the
25 excess of the depletion allowance over the adjusted basis

1 of the depletable property. It is, after all, excess
2 depletion, not excess depreciation that the depletion tax
3 preference in section 57 addresses.

4 Well, what the court below concluded,
5 notwithstanding all of this evidence, was that the costs
6 of depreciable equipment should be included in the
7 adjusted basis of the depletable property because the
8 court concluded that this kind of physical property
9 represents an improvement to the mineral deposit, and the
10 court thought that under section 1016 of the code all
11 improvements are necessarily to be merged into the basis
12 of the assets that they improve. That in turn --

13 QUESTION: In that event, I suppose the
14 improvements or the tangible assets that you think are
15 depreciable wouldn't be -- there wouldn't be a
16 depreciation allowance.

17 MR. JONES: Well, that's right. If -- they
18 either are depreciable or they're not. If they are
19 depreciable, they have to be maintained separately.

20 QUESTION: Yes.

21 MR. JONES: And if they're merged --

22 QUESTION: But under the court of appeals' view,
23 the depreciable assets would be included in the depletion
24 base.

25 MR. JONES: That's correct.

1 QUESTION: But then they wouldn't be depreciated
2 also, would they?

3 MR. JONES: Well, that's -- that doesn't follow.
4 I mean, that follows logically, but that's not what the
5 court seemed to think. The courts --

6 QUESTION: Well, is that what -- the company is
7 both depleting -- both including the basis of the -- these
8 tangible assets in their depletion base and also
9 depreciating them?

10 MR. JONES: Yes. They are including -- they are
11 depreciating them, and they're saying that they should be
12 included in the basis for purposes of the -- in
13 determining the basis of the depletable property.

14 QUESTION: So, you're recovering the cost of
15 them twice.

16 MR. JONES: That's -- that would be their
17 ultimate position. I don't think they've been pressed to
18 describe it that way.

19 QUESTION: But you wouldn't care even if they
20 weren't depleting them. Even if they weren't depreciating
21 them, you would say that they still -- I mean, that's how
22 they have to be treated.

23 MR. JONES: Yes.

24 QUESTION: Depreciated rather than depleted.

25 MR. JONES: The regulations require that they be

1 depreciated. The taxpayer doesn't have an election here.
2 They have to be set up as a depreciable asset.

3 QUESTION: Where are all these sections set
4 forth? I've been looking through your briefs.

5 MR. JONES: Which sections because there's --

6 QUESTION: The ones you're relying on.

7 QUESTION: 1016.

8 MR. JONES: Well --

9 QUESTION: They're in the United States Code.
10 Right?

11 MR. JONES: Yes, 26 U.S.C. Was that your
12 question?

13 QUESTION: It would have been nice if they were
14 in the briefs somewhere.

15 QUESTION: Your statute involved -- you don't
16 even set out 1016.

17 MR. JONES: Oh, you mean if I had set them out
18 in the -- I noticed that myself, Justice Scalia, after we
19 filed the brief. I think it would have been helpful if we
20 had had additional materials, and I apologize for that.

21 QUESTION: Can you tell me why it is that the
22 regulations under section 57 direct you to go to IRSC 1016
23 and its regulations to determine the adjusted basis? I
24 would have thought they would have told you to go to IRSC
25 612 and the special rule.

1 MR. JONES: Well, they -- if you will notice,
2 under the regs under 612 and 611, they also refer the
3 reader to the regs under section 1016. And as I was
4 trying to say earlier, that is because 1016(a)(2) requires
5 that the basis be adjusted downward each year as depletion
6 is taken.

7 But there's a -- there's a larger philosophical
8 and practical point here that I haven't had a chance to
9 explain. Under section 1016, the costs of
10 improvements -- under 1016(a)(1), the costs of
11 improvements are not always added to the basis of the
12 asset they improve. They are to be merged only with that
13 asset when, as the statute says, it is proper to do so.

14 If we take the simple example of a commercial
15 structure built on a tract of land, the land is not a
16 depreciable asset. The costs of the land are, therefore,
17 to be maintained in a basis separate from the costs of the
18 commercial structure which is depreciable. The
19 regulations under section 167(a)(5) require that result.
20 So, even though the commercial structure can be said to be
21 an improvement to the land, the costs of that improvement
22 have to be maintained in a separate basis.

23 This Court recognized in the Dakota-Montana case
24 that that simple example applies directly to mineral
25 enterprises. A mineral deposit, like other types of

1 interests in land, is not depreciable. It can sit there
2 for a billion years and never be depreciated. Its costs
3 are to be recovered by depletion only as production
4 occurs. By contrast, the depreciable property that is
5 installed on the location can be depreciated from the day
6 of its installation without regard to whether production
7 occurs, without regard to the quantity of production, and
8 without regard to whether production ceases.

9 QUESTION: Mr. Jones, can I ask you a question
10 about the statutory text? 57(a) refers to the adjusted
11 basis of the property.

12 MR. JONES: Yes, sir.

13 QUESTION: And when you stated the case, you
14 described it as adjusted basis of the mineral deposit.
15 You were very careful to focus on mineral deposit.

16 What is it that makes the word property mean
17 mineral deposit within the statute?

18 MR. JONES: The reference in 57(a)(8), as it
19 existed at the time this case arose, is to the property as
20 defined in section 614. Under 614, the word property is
21 defined as mineral deposit.

22 QUESTION: I see.

23 MR. JONES: The regulations under 614 make that
24 express.

25 And at page 8 of the briefs of the amicus and

1 the respondent, they concede that the question in this
2 case is what is the adjusted basis of the mineral deposit.
3 That's why I compressed that issue since it wasn't --

4 QUESTION: It's -- section 614 is the one
5 that --

6 MR. JONES: Yes, sir. That's the short answer.

7 QUESTION: Thank you.

8 QUESTION: Of course, your reply brief refers to
9 them as improvements to a mineral enterprise.

10 MR. JONES: That's correct.

11 QUESTION: Why did you shift terminology?

12 MR. JONES: I don't think I shifted. Mineral
13 enterprise is a different regulatory term. Mineral
14 enterprise is defined in the regulations under 611 as the
15 mineral deposit and improvements.

16 Now, we point out in our brief that that term,
17 mineral enterprise, has been known to Congress a long
18 time, and so if Congress wanted to reach the result that
19 the courts reached in this case, the wording in the
20 statute would have referred not to the adjusted basis of
21 the mineral deposit, but to the unrecovered costs of the
22 mineral enterprise. That is the result that the courts
23 reached here, which went well beyond what Congress wrote.

24 QUESTION: Well, how do the definitions of
25 mineral enterprise and mineral deposit differ?

1 MR. JONES: The term mineral deposit is defined
2 by the regulations as minerals in place. The term mineral
3 enterprise is defined by the regulations as mineral
4 deposit plus improvements. Section 611 has in its text a
5 separate provision for depletion and for depreciation of
6 improvements. And so on occasion it is relevant to group
7 the entire property at issue, the deposit plus the
8 improvements, and when the regulations group those
9 separate constructs, they group it under the term mineral
10 enterprise. And that is one of the points we made in our
11 brief, that if Congress had meant to group these two
12 separate concepts, they would have used the term mineral
13 enterprise in doing so.

14 QUESTION: Mr. Jones, you did make that point in
15 your reply brief, but the reason I said it seemed to me
16 you shifted is, as you framed the question presented,
17 whether the unrecovered costs of depreciable tangible
18 improvements to a mineral deposit may properly be included
19 in the adjustable basis. That's not what you're saying
20 now. These are not improvements to the mineral deposit.

21 MR. JONES: These are what section 611 refers to
22 as improvements. They are improvements to the mineral
23 enterprise.

24 QUESTION: To the enterprise. So, the question
25 presented, were we to follow that, would mislead us.

1 MR. JONES: Well, I wouldn't say mislead you. I
2 think that this is to a large degree a semantical question
3 about what is being improved.

4 QUESTION: You raised it. I didn't. I mean,
5 it's --

6 MR. JONES: Well, I didn't mean to raise it.

7 QUESTION: You make a big point of it in your
8 reply brief. All I'm saying is I wish you had made the
9 same point in your question presented.

10 MR. JONES: Well, again, I have no recourse but
11 to apologize if we should have done it differently, but it
12 appears to me that this -- the purely semantical question
13 is what does this improve. It doesn't matter what it
14 improves because the regulations say that improve -- the
15 basis of improvements are to be kept separately from the
16 basis of the mineral deposit.

17 I think that it is more logical to apply the
18 terminology that the regulations apply, that what is
19 improved is the mineral enterprise; in the same way, as we
20 point out in our brief, a manufacturing enterprise may be
21 improved by adding a machine to a plant, but you would
22 keep the basis of those assets separately and account for
23 them separately.

24 I want to stress just for a moment the
25 import -- that this issue remains vitally important even

1 for years after this recent amendment to the minimum tax.
2 Of course, as we've told you, it involves a good deal of
3 money before and after the enactment, but there's another
4 important way in which the application of this tax to
5 other types of minerals production is of extreme
6 importance.

7 These other types of minerals production are not
8 subject to the restrictions that are applicable to oil and
9 gas depletion allowance, and so they are -- they have more
10 opportunity to obtain this depletion allowance, more --

11 QUESTION: I take it that with hard minerals,
12 the tangible costs for replacing equipment are very, very
13 high.

14 MR. JONES: Yes, and would be recovered over a
15 long time. And that perhaps focuses the greatest
16 illogical feature of this Court's -- of the lower court's
17 decision because it allows the unrecovered depreciable
18 cost to be set off against the depletion allowance each
19 year even if prior depletion allowances have fully
20 recovered all of the costs of the mineral enterprise.

21 As several of the commentators have pointed out,
22 this utterly eviscerates the minimum tax as applied to
23 these types of minerals producers with large amounts of
24 depreciable equipment, and as the amicus brief for the
25 coal and hard minerals industry in this case has pointed

1 out -- and we agree with it -- their coverage under the
2 minimum tax will be decided by this Court's decision in
3 this case.

4 QUESTION: Could -- is it your position that the
5 provision of the regulations, 612-1(b)(1)(i), which says
6 that the basis for cost depletion of mineral property does
7 not include amounts recoverable through depreciation
8 deductions -- that's superfluous really.

9 MR. JONES: No. That's -- that is --

10 QUESTION: What does that achieve?

11 MR. JONES: That -- that notes the marked
12 distinction that the regulations require between the basis
13 for depreciable and depletable property. They're to be
14 kept separately.

15 QUESTION: But that would be the case even if
16 that regulation didn't exist. You mean that regulation is
17 simply observing what the -- what the effect of the law
18 is.

19 MR. JONES: I agree with that. The regulation
20 states what -- what proper tax accounting requires.

21 QUESTION: What it would have -- would have
22 produced anyway.

23 MR. JONES: Yes, sir.

24 QUESTION: Why didn't the percentage -- a
25 percentage depletion reg say the same thing then? Why the

1 lack of parallelism?

2 MR. JONES: Well, these regs are rather
3 complicated. The percent -- in 611-2(b)(2), the regs say
4 that the percentage depletion allowance shall in excess
5 of -- maybe I had better quote it. I don't want to --

6 QUESTION: You have the advantage over us. You
7 have the text right there.

8 MR. JONES: Well, Justice Scalia, in somewhat
9 self-defense, there's an awful lot of text here, but I
10 suppose we could have put it all in a -- in an appendix.

11 The 611-2(b)(2) reg says in no event shall
12 percentage depletion in excess of the basis of the mineral
13 deposit be credited to the depreciable improvements
14 account. So that observes for percentage depletion the
15 same distinction between depletion account and
16 improvements account. It runs throughout the regs and it
17 appears in many places.

18 That is the clearest expression that the
19 Service, who is the authoritative interpreter of this
20 substantive regulation and whose interpretation is
21 entitled to deference -- but it is the clearest expression
22 of the Service's views that percentage depletion should be
23 kept -- that the account of the mineral deposit for
24 percentage depletion purposes must be kept separately from
25 the account of depreciable property.

1 QUESTION: Mr. Jones, it may not be your fault,
2 but I think it's a reflection on the Government in this
3 case that all the statutory and regulatory material that
4 you wish to have us consider was not included in your
5 brief.

6 MR. JONES: Well, I note that and I -- as I
7 mentioned to Justice Scalia, in reviewing the materials in
8 preparation for argument, I felt the same deficiency.

9 I'd reserve the balance of my time for rebuttal.

10 QUESTION: Very well.

11 We'll hear now from you, Mr. Robinson.

12 ORAL ARGUMENT OF RICHARD B. ROBINSON

13 ON BEHALF OF THE RESPONDENTS

14 MR. ROBINSON: Mr. Chief Justice, and may it
15 please the Court:

16 This case involves the operation of a formula
17 that was created by Congress for determining how much of a
18 taxpayer's depletion deduction would be subject to the
19 minimum tax. In section 57(a)(8), Congress stated that
20 taxpayers would be subject to a minimum tax for their
21 depletion only to the extent that their depletion
22 deduction for each mineral deposit exceeds the adjusted
23 basis they have in that property.

24 The specific question at issue here is whether
25 certain depreciable improvements to the taxpayer's mineral

1 deposit can be included in the calculation of adjusted
2 basis.

3 Now, the tax law recognizes two kinds of
4 improvements to an oil and gas property, and that is the
5 specific issue that is involved in this case, whether or
6 not the improvements to an oil and gas property can be
7 included in adjusted basis. These are intangible
8 improvements and tangible improvements. Both kind of
9 improvements improve the mineral deposit itself, the oil
10 and gas, because they allow it to be produced.

11 Intangible improvements are the costs incurred
12 in drilling the well and preparing the well for
13 production. A taxpayer has the election for these
14 improvements to either capitalize them or to expense them.
15 If they elect to capitalize them, then those intangible
16 costs that are associated with physical property are
17 recoverable through the depreciation deduction, but those
18 intangible costs that are not represented by physical
19 property are recovered through the depletion deduction.

20 The Government would agree that those intangible
21 improvements which are recoverable through depreciation
22 would be included in the adjusted basis for this
23 calculation.

24 The second kind of improvements are tangible
25 improvements, and those are the improvements that are at

1 issue in our case. The tangible improvements are those
2 physical improvements that are connected to the oil and
3 gas deposit in order to produce it. Those are the
4 improvements that are used to lift the oil and gas out of
5 the ground and bring it to the surface.

6 QUESTION: As distinguished from the cost of
7 drilling the well in the first place?

8 MR. ROBINSON: Your Honor, I think they both
9 help in terms of producing them, but yes, they are
10 distinguished from drilling the well in the first place.

11 QUESTION: And drilling the well is in your view
12 an intangible.

13 MR. ROBINSON: Drilling the well is an
14 intangible cost. That's exactly right.

15 Without the cost of these tangible improvements,
16 there could be no production, and if there is no
17 production from the well, there can be no depletion
18 deduction. So these tangibles are a cost associated with
19 obtaining the depletion deduction itself.

20 Now, the Government contends in this case that
21 the code draws a clear barrier between the depreciation
22 deduction and the depletion deduction.

23 And I might add in response to an earlier
24 question that the taxpayer is not claiming both depletion
25 and depreciation with respect to these costs. The

1 tangible improvements are only being recovered through
2 depreciation.

3 QUESTION: Well, are you depreciating any
4 tangible property in connection with this mineral
5 enterprise?

6 MR. ROBINSON: Your Honor, we are depreciating
7 the tangible improvements to the mineral deposit. I might
8 add --

9 QUESTION: You're taking a depreciation
10 deduction.

11 MR. ROBINSON: A depreciation deduction for the
12 tangible improvements.

13 QUESTION: And not including that for purposes
14 of figuring your depletion.

15 MR. ROBINSON: We are not including it for
16 purposes of figuring our depletion.

17 QUESTION: So what kind of -- what kind of
18 property are you depreciating?

19 MR. ROBINSON: We're depreciating the casing
20 that goes down into the well, the pump that brings the oil
21 and gas to the surface.

22 QUESTION: And you're not including that in
23 your -- figuring your depletion.

24 MR. ROBINSON: No, we're not.

25 QUESTION: Well, without those properties, you

1 wouldn't have much of an oil well either.

2 MR. ROBINSON: We couldn't. That was my point,
3 Your Honor, is that those are -- we couldn't be able to
4 pull the oil up from the ground. And if you recall, there
5 is no depletion deduction that can be obtained unless
6 there is production from the property. So these are a
7 cost you must incur in order to obtain the depletion
8 deduction.

9 QUESTION: Well, I thought you said that you
10 were -- the casing -- are you including that in
11 your -- your basis for the depletion?

12 MR. ROBINSON: Not for depletion, Your Honor.

13 QUESTION: Even though it's absolutely essential
14 for -- to get the oil out of the ground.

15 MR. ROBINSON: Any costs that are represented by
16 physical property have to be recovered through
17 depreciation. You can't recover those costs of physical
18 property through depletion.

19 QUESTION: Well, now, tell me again. What
20 properties then are at issue in this case?

21 MR. ROBINSON: It is the casing, the pipes, and
22 the pumps that are lifting the oil and gas out of the
23 ground. We were including those costs in the calculation
24 of our adjusted basis.

25 QUESTION: May I just --

1 MR. ROBINSON: Yes.

2 QUESTION: It's those costs to the extent they
3 have not been depreciated.

4 MR. ROBINSON: That's exactly right.

5 QUESTION: So the amount changes every year.

6 MR. ROBINSON: The amount goes down each year as
7 we claim a depreciation deduction on those items.

8 QUESTION: Which means that the minimum tax, or
9 whatever they call the tax, goes up every year.

10 MR. ROBINSON: Once we've -- yes.

11 QUESTION: Until you go down to zero on your
12 basis.

13 MR. ROBINSON: Once we've recovered all the
14 costs of these depreciable improvements, then each year,
15 as we're claiming depreciation, the amount of the minimum
16 tax -- subject to the minimum tax goes up. That's
17 correct.

18 QUESTION: So, what are the expenses that you're
19 claiming the depletion on? That is just the cost of
20 drilling the well?

21 MR. ROBINSON: No, not the cost of drilling the
22 well, Your Honor. In the record, if you look in the
23 record at -- that was filed with the Federal Circuit at
24 page 850 and 868, we listed through a stipulation with the
25 Government what those expenses were, and they are the

1 pipes, the pumps, and the equipment that is used to lift
2 it. When you're drilling an oil and gas well, the costs
3 of drilling, the wages, the fuel, those are intangible
4 costs. That's the costs of actually putting the hole in
5 the ground that are not represented by physical property.

6 QUESTION: And how do you treat those for tax
7 purposes?

8 MR. ROBINSON: Those are treated as intangible
9 costs as compared to tangible, and you have the option of
10 either --

11 QUESTION: Of capitalizing.

12 MR. ROBINSON: -- of capitalizing or expensing
13 them.

14 QUESTION: But now, are you suggesting that you
15 treat your pipes and so forth different from the casing to
16 your well?

17 MR. ROBINSON: No. I'm treating that the same.
18 Anything represented by physical property falls within the
19 category of tangibles.

20 QUESTION: Now, what is the basis for the
21 distinction between tangibles and intangibles?

22 MR. ROBINSON: There's two bases, Your Honor.
23 Number one is the intangibles have to do with drilling the
24 well.

25 QUESTION: No. I understand what they have to

1 do with -- what text justifies depreciating only tangibles
2 and not depreciating, as you say --

3 MR. ROBINSON: In the regulations under section
4 612, which in our brief, Your Honor, they're described for
5 you over on page 18, and they were cited in the discussion
6 of the opinion of the lower courts over on the appendix to
7 the Government's petition for their writ of certiorari on
8 the appendix on page 5a.

9 QUESTION: What's the regulation number? I have
10 my own --

11 MR. ROBINSON: It's section 612-4(a), (b), and
12 (c), which goes through the discussion of what is tangible
13 and what is a non -- intangible expense.

14 QUESTION: Well, I'm not worried about
15 identifying them. I'm worried about what entitles them to
16 disparate treatment.

17 MR. ROBINSON: The regulations describe the
18 disparate treatment for them, and it's based -- it is
19 based on --

20 QUESTION: What regulation in particular?

21 MR. ROBINSON: Section 612-4.

22 QUESTION: Dash 4.

23 MR. ROBINSON: Yes, and that is derived, Your
24 Honor, from code section 263(c) which authorizes the
25 Secretary of the Treasury to issue regulations describing

1 the election to expense or capitalize intangible costs.

2 QUESTION: Where in your brief will we find the
3 text of 612.4?

4 MR. ROBINSON: In our brief, Your Honor --

5 QUESTION: Well, where in the briefs if you
6 haven't a better way --

7 MR. ROBINSON: Yes. In the petition for the
8 writ of certiorari, appendix 5a, the opinion discusses
9 section 612 and --

10 QUESTION: And does it set it out?

11 MR. ROBINSON: No, it doesn't, Your Honor.

12 QUESTION: Then where in your brief is it if
13 you're relying on it?

14 MR. ROBINSON: I have set out portions, but I
15 did not set out the text, Your Honor.

16 QUESTION: Well, that reflects on you, Mr.
17 Robinson --

18 MR. ROBINSON: Yes.

19 QUESTION: -- the same way the Government's
20 failure -- if you want us to consider something, it ought
21 to be fully set out in the text of your brief.

22 MR. ROBINSON: I apologize, Your Honor.

23 The Government's principal objection to the
24 lower court's opinion -- or criticism of the lower court's
25 opinion is that the code draws separate treatment -- draws

1 a line between the treatment of the depletion deduction
2 and the treatment of the depreciation deduction, and that
3 the lower court's opinion improperly crosses that line.

4 And I would suggest that the Government is not
5 accurately reflecting the lower court's opinion. The
6 lower courts recognized the difference between the
7 depletion deduction and the depreciation deduction, but
8 the lower courts said that the issue in this case does not
9 involve the calculation of the depletion deduction. This
10 case involves the calculation under a formula of how much
11 depletion is subject to the minimum tax, and code section
12 57(a)(8) tells us that we make that determination by
13 reference to the adjusted basis of the property.

14 QUESTION: If the regulations under section 57
15 had directed you to 612 instead of to 1016, would you have
16 been able to make the same argument that you're making
17 here?

18 MR. ROBINSON: Your Honor, I think that there is
19 a difference in the statutory language between section
20 57(a)(8) and section 612 in that section 57(a)(8) does not
21 contain any possibility of an exception or a special
22 meaning for the rule of adjusted basis, whereas section
23 612 talks about except as otherwise provided.

24 In the section 612 regs, Your Honor -- and they
25 are reprinted on page 14 of our brief -- those regulations

1 make it clear that there are two separate rules at issue
2 here and that the Government is focusing on the rules for
3 calculating the depletion deduction; whereas section 57
4 and the regulations focus on the rules for calculating
5 adjusted basis.

6 The title of these regulations is Basis for Cost
7 Depletion, and if you look at section 612-1(a) of those
8 regulations, they tell you that the basis upon which the
9 cost depletion deduction is to be calculated is the
10 adjusted basis of the property as provided in section 1011
11 for purposes of determining gain or loss except as
12 otherwise provided. So they tell you that there is a rule
13 for calculating the adjusted basis of the property for
14 determining gain or loss.

15 And then there is this special rule provided in
16 calculating the adjusted basis for calculating cost
17 depletion, and that special rule is set forth under
18 paragraph (b). Paragraph (b) says that the basis for cost
19 depletion excludes the cost of depreciable improvements to
20 the property, amounts recoverable through the depreciation
21 deduction.

22 As the lower courts recognized, the difference
23 in the language between the section 57 regulations and the
24 section 612 regulations is very significant. The fact
25 that the section 612 regulations had to have what is

1 labeled a special rule to exclude the cost of depreciable
2 improvements from the calculation evidences that absent
3 that special rule, the normal rules of calculating
4 adjusted basis would apply. And the lower courts felt
5 that if Congress or the Treasury had wanted that special
6 rule to apply, because that special rule under the
7 regulations had been outstanding for at least 10 years at
8 the time that section 57(a)(8) was adopted and the 57
9 regulations drafted, then there was a way for them to
10 achieve that result, but that they didn't adopt that
11 special rule. And what the Government is asking this
12 Court to do is to, in effect, redraft the section 57
13 regulations so that they would read the same as under the
14 section 612 regulations.

15 QUESTION: Mr. Robinson, you say -- to be sure
16 it is entitled special rule, special rule, but I think
17 what the issue comes down to is whether it is a
18 disposition that would not occur but for the fact that
19 it's recited in the regulation, or whether it is, as Mr.
20 Jones suggests, simply an acknowledgement of what the law
21 would otherwise provide.

22 And that -- the regulation you're
23 referring -- you're referring to, 612-1(b), in addition to
24 saying that, what you have just discussed, also says, for
25 example, in the case of any mineral property, the basis

1 for cost depletion does not include amounts representing
2 the cost or value of land for purposes other than mineral
3 production. I tend to think that would have been the case
4 even if it weren't set forth there, don't you?

5 MR. ROBINSON: In terms of calculating the
6 depletion deduction, you're right, Your Honor, and that is
7 the point that I'm trying to make.

8 QUESTION: Well, the point that I'm trying to
9 make is that -- is that (b) -- is that 612-1(b) includes
10 some dispositions that are just a recitation of what the
11 law would be even without any specification. If you
12 acknowledge that that sentence is simply reciting what is
13 obvious from other provisions of the code, why can't I say
14 that (b)(i) is meant to do the same thing?

15 MR. ROBINSON: Because, Your Honor, I believe
16 there's a difference between the rules for calculating
17 adjusted basis for property on the sale of the property
18 and the rules for calculating the depletion deduction.

19 Adjusted basis is an aggregate concept. If you
20 would turn back to our discussion on page 2 of the
21 regulations under section 1016, section 1016-2(a) of the
22 regulations, which discuss the rules for calculating the
23 adjusted basis of property, it makes it clear that this is
24 an aggregate concept.

25 What we're trying to identify in the calculation

1 of adjusted basis is all the capital outlays that are
2 associated with the property that are taken into account
3 in connection with computing the gain or loss on the sale
4 of that property. And these regulations very specifically
5 tell us that adjusted basis includes the cost of
6 improvements or betterments made to the property. There's
7 no qualification on the kind of improvements or
8 betterments that are added to adjusted basis. They use
9 the word including without any qualification. So, for
10 example --

11 QUESTION: But it depends on what you mean by
12 the property. I mean, that's the essential dispute
13 between you and the Government.

14 MR. ROBINSON: No, I don't believe that's true,
15 Your Honor. We agree that the property is the taxpayer's
16 interest in the mineral deposit that's identified in
17 section 614, but the issue is not what the cost of that
18 property is, because section 57(a)(8) tells us that we
19 have to compute the adjusted basis of that property in
20 order to determine the tax preference item for depletion.

21 And in computing adjusted basis, we have to take
22 into account a variety of costs associated with the
23 property. For example, if we had a building and we
24 installed a new furnace into that building, that new
25 furnace would be an improvement to the building. And when

1 we went to sell the building, we would include the
2 unrecovered cost of that furnace in our calculation of
3 adjusted basis in computing the gain or loss. Now, that
4 furnace might be subject to -- we may have already
5 depreciated down the building. It might be subject to
6 another cost recovery method.

7 Or, for example, if we had a parcel of land and
8 we installed a fence on that land, that fence would be an
9 improvement to the land. And we went to sell it, we would
10 include the cost of that fence even though in that case
11 the land would not be subject to depreciation, but the
12 fence would be.

13 So, by focusing under the section 57 regulations
14 on the adjusted basis of the property, I believe that this
15 is a fundamentally different concept, and that explains
16 why there has to be a special rule under the section 612
17 regulations because a variety of items that may not be
18 subject to the depletion deduction, such as tangibles
19 whose costs are recovered through depreciation, have to be
20 withdrawn from the calculation in order to compute the
21 amount of cost depletion since those amounts aren't --
22 those costs are not recoverable through the depreciation
23 -- the depletion deduction.

24 Now, as was pointed out earlier in the
25 discussion, the section 57 regulations are very

1 significant on this point because these regulations do not
2 contain any reference to a special rule. Their
3 cross-reference is directly to the general rule for
4 calculating adjusted basis under this regulation at
5 1016-2(a), and as a consequence, we should be entitled to
6 take those improvements into the calculation in computing
7 adjusted basis.

8 I have nothing else, Your Honor, unless you have
9 any further questions.

10 QUESTION: Very well. Thank you, Mr. Robinson.
11 Mr. Jones, you have 6 minutes remaining.

12 REBUTTAL ARGUMENT OF KENT L. JONES
13 ON BEHALF OF THE PETITIONER

14 MR. JONES: Thank you. I did want to clear up
15 what seemed to me to have been a confusion in the
16 discussion that I just heard.

17 The respondents claim a right to depreciate the
18 physical property. They also claim a right to add the
19 costs of that property into the basis of the mineral
20 deposit for purposes of determining the amount of the tax
21 preference. So, in that respect, as Justice White
22 discussed at the beginning, I think it's quite clear
23 they're trying to merge these -- merge the adjustments and
24 the deductions in a way that's just logically
25 inconsistent, as well as inconsistent with the

1 regulations.

2 And as far as the question about why is it that
3 some kinds of intangible drilling costs are added to the
4 basis of the mineral deposit, but tangible improvements
5 are not, well, there's the fact that that's the way the
6 regulations require them to be treated, but this Court
7 dealt with that issue at length in 1933 in the
8 Dakota-Montana case.

9 And the Court's explanation of the different
10 treatment was that the costs of drilling a hole in the
11 ground don't depreciate over time and have a salvage
12 value, the way that a machine or a pump does. So, it's
13 not depreciable over time in the way depreciable property
14 is. What the Court said in Dakota-Montana is that the
15 hole simply adds to the value of the mineral deposit, the
16 minerals in the ground, and that that is the logical
17 reason for joining the intangible drilling costs with the
18 mineral deposit.

19 QUESTION: Of course, that case didn't deal with
20 the tax on the depletion allowance. I mean, that's just
21 distinguishing depreciation from depletion. It doesn't
22 involve the second step that we have here.

23 MR. JONES: Well, it certainly doesn't involve
24 the minimum tax.

25 QUESTION: Right.

1 MR. JONES: But it certainly does explain the
2 rather stark line that the Court has recognized for 60
3 years between the separate bases of depletable and
4 depreciable property, and that's the primary relevance of
5 it for this case.

6 QUESTION: But the taxpayer here is not
7 including the value of these depreciable properties in
8 figuring the depletion allowance.

9 MR. JONES: Not in figuring the allowance per
10 se.

11 QUESTION: Exactly. They're just -- it's just
12 for figuring the tax, the -- this extra tax.

13 MR. JONES: Yes, only for the purpose of
14 reducing their tax preference from depletion. They're
15 saying that in determining the amount of the excess
16 depletion they've recovered, they should be able to set
17 off the unrecovered depreciable costs.

18 But the only way they can reach that result is
19 by showing that these unrecovered depreciable costs form
20 part of the basis of the mineral deposit, and that's where
21 their argument breaks down because the regulations and
22 this Court's decisions and the Service's rulings
23 specifically require that those accounts be kept
24 separately.

25 And the logic of the minimum tax requires that

1 they be kept separately too because, as I mentioned
2 earlier, as commentators have pointed out, if you're
3 allowed to each year set off these unrecovered depreciable
4 costs against the depletion allowance, the result is to
5 create a gaping hole in the coverage of the act and to
6 allow large amounts of excess depletion wholly to escape
7 taxation, which is precisely contrary to the objectives of
8 the minimum tax.

9 QUESTION: I must say you describe the minimum
10 tax and the adjustments as much more rational creatures
11 than it seems to me they are. I mean, if you were going
12 to say there's a hole, you would just say, well, so
13 there's a hole. Congress left a hole.

14 MR. JONES: Well, I --

15 QUESTION: You can regard the whole depletion
16 allowance as a hole. It's a great big hole, and Congress
17 wanted the hole.

18 MR. JONES: I don't think it's really quite that
19 simple, Justice Scalia. When the minimum tax was enacted,
20 what Congress said was -- and in the legislative reports
21 -- what they said was that they were concerned that these
22 tax preferences were destroying taxpayer morale, and by
23 that what they meant was that our tax system is based upon
24 each individual's obligation to report and pay their
25 taxes. And Congress was concerned that if certain

1 taxpayers were allowed to escape utterly from Federal tax,
2 it would have a devastating impact on the long-range
3 morale of the taxpayers and the ability of the system to
4 work as a whole. And so, it does serve that very
5 important function.

6 QUESTION: They did not eliminate the depletion
7 allowance.

8 MR. JONES: No.

9 QUESTION: The only question is how much of the
10 depletion allowance they chose to leave in effect. That's
11 all we're arguing about.

12 MR. JONES: Well, I certainly agree with that,
13 but our point is that the analysis of the courts below
14 would result in a large amount each year that would be
15 exempt from the effect of the tax in --

16 QUESTION: Don't they just achieve that
17 exemption by investing more and more on their properties?
18 Isn't there sometimes an incentive to do that? Basically
19 you're talking about unrecovered investment in these
20 properties that presumably will produce more oil and gas
21 over the long run.

22 MR. JONES: Well, the amount of investment
23 required for production -- I mean, you don't necessarily
24 get more production by more investment, but those kinds of
25 economic issues are really outside the scope of the

1 statute because what the statute says, what Congress said,
2 was that in deciding the amount of the preference, it's
3 simply the amount of the depletion above the basis of the
4 deposit. That was their economic judgment.

5 QUESTION: I'm not sure that the basic reason
6 for giving it a depletion allowance in the first place is
7 inconsistent with the taxpayer's position in this case.

8 MR. JONES: Well, the basic reason is to provide
9 an incentive, and the flip side of that incentive is the
10 abuse. And to the extent there's an abuse, the tax
11 applies, but the abuse is defined by Congress as simply
12 the amount of the depletion in excess of the adjusted
13 basis.

14 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Jones.
15 The case is submitted.

16 (Whereupon, at 10:52 a.m., the case in the
17 above-entitled matter was submitted.)
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CERTIFICATION

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The United States in the Matter of:

United States v William F. Hill

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BY Ann-Marie Federico

(REPORTER)