

# Taxation: Determination of Gross Income for Percentage Depletion Purposes

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possible to apply conventional rules of indemnity, contribution, assumption of risk, or contributory negligence, without extensive redefinition, to cases founded on strict liability. The underlying theories of the two are incompatible.

THOMAS E. OBENBERGER

**Taxation: Determination of Gross Income for Percentage Depletion Purposes**—In *Dravo Corporation v. United States*,<sup>1</sup> the United States Court of Claims added another link to the chain of cases questioning Section 613 of the Internal Revenue Code of 1954. The Court, *inter alia*, held that Dravo Corporation (hereafter referred to as Dravo) for the tax year 1955 must compute its gross income for depletion purposes<sup>2</sup> by using per ton prices at the dredges rather than the per ton prices at the shore installations. The latter prices included various transportation and stockpiling costs.

The depletion issue concerns deposits dredged from an island in the Ohio River, transported to shore installations, and sold during 1955. The deposits were extracted by two dredges which performed the washing and sizing operations. Since stockpiling on the dredges was a practical impossibility, the sand and gravel was then moved to barges adjacent to the dredges. The first general category of Dravo's customers included those who utilized their own barges to pick up the sand and gravel at Dravo's dredges or made special arrangements with Dravo to deliver direct from the barges to the customer's location. The proceeds from the sand and gravel sales to customers in this first classification were not involved in the contest since these proceeds were derived from sale of products which never reached Dravo's shore installations. The controversy applied to the sand and gravel, about fifty per cent of Dravo's tonnage for 1955, which was sold to the second category of customers—those who purchased at the shore installations. Dravo owned

<sup>1</sup> 348 F. 2d 542 (1965).

<sup>2</sup> INT. REV. CODE OF 1954, ch. 736, §613(c), 68A Stat. 209:

(c) DEFINITION OF GROSS INCOME FROM PROPERTY—For purposes of this section—

- (1) GROSS INCOME FROM THE PROPERTY—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.
- (2) MINING—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

Subsection (4) of section 613(c) contained the original list of "ordinary treatment processes" then considered in computing gross income from property.

special barges, equipped with decks higher in the middle than on the sides and with "weep holes," to provide maximum drainage of water, and utilized these barges to transport the remaining sand and gravel to the shore installations. It was noted that the water content of the sand and gravel was appreciably reduced during this transportation.

The specific issue arose when Dravo contended that, although its gross income for depletion purposes was derived by using per ton prices at the dredge as a basis, and reported on the 1955 return as such, the gross income should have been computed by using the per ton prices at its installations on shore, which included transportation costs from dredge to shore, stockpiling and loading costs.

The theory of the depletion allowance is that a taxpayer is compensated for the capital assets consumed in the production of income. The depletion allowance is an act of legislative grace and is likened to depreciation of machinery or utilization of raw materials in manufacturing.<sup>3</sup> Percentage depletion, as first enacted in the Revenue Act of 1926,<sup>4</sup> was introduced as a legislative attempt to avoid the inherent difficulties encountered in calculating a depletion allowance by the then-existing statutory methods.<sup>5</sup> The percentage depletion allowance is a deduction derived by applying a specified statutory percentage to the gross income realized during the particular taxable year.<sup>6</sup> Since early depletion allowances were concerned primarily with the petroleum industry, "gross income from property," the base to which the statutory percentage is applied, was originally described as the gross receipts from the sale of gas and oil extracted from the property.<sup>7</sup> Congress, however, did not actually define "gross income from property" until 1943, at which time this new definition was applied retroactively to all taxable years beginning after December 31, 1932.<sup>8</sup> This definition became Section 114(b)(4)(B)<sup>9</sup> of the Internal Revenue Code of 1939 and also included an extended list of various other minerals eligible for the percentage depletion deduction.<sup>10</sup> It was not until 1951 that Congress recognized sand and gravel to be eligible for the five per cent depletion allowance.<sup>11</sup>

<sup>3</sup> *Anderson v. Helvering*, 310 U.S. 404, 408 (1940).

<sup>4</sup> Revenue Act of 1926, ch. 27, §204(c)(2), 44 Stat. 16.

<sup>5</sup> For a summary of cost and discovery depletion, see 4 MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* §§24.29-31, §§24.36-40. (1960 Revision).

<sup>6</sup> *Id.* §24.03(c).

<sup>7</sup> *U.S. v. Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81 (1960).

<sup>8</sup> Revenue Act of 1943, ch. 63, §124(c), 58 Stat. 45, amending INT. REV. CODE OF 1939 §114(b)(4).

<sup>9</sup> Essentially identical to INT. REV. CODE OF 1954, §613(c), *supra* note 2.

<sup>10</sup> Int. Rev. Code of 1939, §114(b)(4) as amended by Revenue Act of 1943, ch. 63, §§124(a), (c), 58 Stat. 44. The 1943 amendment also specified which processes were included as "ordinary treatment processes" for certain minerals not relevant to this discussion.

<sup>11</sup> Revenue Act of 1951, ch. 521, §319(a), 65 Stat. 497 amending INT. REV. CODE OF 1939, §114(b)(4). This amendment did not specify which processes were included as "ordinary treatment processes" for sand or gravel.

Thus, the problem in the *Dravo* case is interpretation of the phrase "gross income from property" as defined in Section 613(c) of the Internal Revenue Code of 1954. This definition states that "gross income from property" means "gross income from mining." "Mining," for the 1955 tax year, included "the ordinary treatment processes normally applied . . . to obtain the commercially marketable mineral product. . . ." <sup>12</sup> It was then necessary to determine whether Dravo's specific transportation, stockpiling and loading expenses were includible in this definition of "gross income" as "ordinary treatment processes."

In judicial analysis of the generalized phrase "gross income from property," the courts have adhered to the definition as appearing in Section 114(b)(4)(B) of the Internal Revenue Code of 1939 and Section 613(c)(1) of the Internal Revenue Code of 1954 which essentially equate "gross income from property" with "gross income from mining." An early case has indicated that "gross income from property" is to be strictly construed.<sup>13</sup> The controversy arises as to what is included in "gross income from mining" and specifically what constitutes "ordinary treatment processes normally applied . . . to obtain a commercially marketable mineral product. . . ." The Revenue Act of 1950 amended the definition of "mining" contained in the Internal Revenue Code of 1939<sup>14</sup> so as to include within its scope the phrase: "and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto. . . ." <sup>15</sup> The United States District Court in the 1954 case of *United States vs. Cherokee Brick & Tile Co.*<sup>16</sup> held that, within the statutory definition of "mining" for purposes of computing a depletion allowance, all processes ordinarily employed in the industry in mining raw clay and processing it into burnt brick and tile were "ordinary treatment processes normally applied . . . to obtain a commercially marketable mineral product." This decision resulted from the fact that there was no market for brick and tile clay except in the form of finished burnt brick and tile. *Cherokee*, a landmark case,<sup>17</sup> hinged

<sup>12</sup> INT. REV. CODE OF 1954, §613(c)(2), later amended by Pub. L. No. 86-564, §302(b)(1), 74 Stat. 292.

<sup>13</sup> *Monroe Coal Mining Co.*, 7 T. C. 1334 (1946).

<sup>14</sup> Int. Rev. Code of 1939, §114(b)(4)(B), as amended by Revenue Act of 1943, ch. 63, §124(c), 58 Stat. 44.

<sup>15</sup> Revenue Act of 1950, ch. 994, §207(a), 64 Stat. 931, later amended by Pub. L. No. 86-564, §302(b)(1), 74 Stat. 292.

<sup>16</sup> 122 F. Supp. 59, *aff'd* 218 F. 2d 424 (5th Cir. 1954).

<sup>17</sup> *Cherokee* was the leading case in the area until *U.S. v. Cannelton*, *supra* note 7, was decided in 1960. *Cherokee* was followed in *U.S. v. Merry Brothers Brick & Tile Co.*, 242 F. 2d 708 (5th Cir. 1957), *cert. denied* 355 U.S. 824 (1957). Only *Dragon Cement Co. v. U.S.*, 144 F. Supp. 188 (1956) criticized the *Cherokee* decision, but *Dragon* was reversed on appeal and the *Cherokee* position was adopted. 244 F. 2d 513 (1957).

largely upon the district court's decision that the term "commercially marketable mineral product" must be assigned an ordinary meaning, that is, "a mineral product marketable in commerce."<sup>18</sup> Thus, the court reasoned that before a product can be considered "commercially marketable," there must exist an actual market for such mineral product.

Another variation of the theory of marketability arose in *International Talc Co. Inc.*<sup>19</sup> which held that since there was no recognized market for crude talc and since it was not customarily purchased in the form of a crude mineral product, the *first* commercially marketable form of talc was in the powdered form as it came from petitioner's mills. This theory was reaffirmed in *Black Mountain Corporation*,<sup>20</sup> holding that an oil treatment applied to coal to make it more salable for domestic home heating purposes was *not* the "first commercially marketable mineral product" since a portion of Black Mountain's annual coal production was sold to the industrial market without the oil treatment. The Court in the latter case noted<sup>21</sup> that the regulations interpret the phrase "commercially marketable mineral product" as meaning the "*first* commercially marketable mineral product." (Emphasis added.) Thus when combining the decisions in *International Talc* and *Cherokee*, the formula appeared to be "the first mineral product which actually possesses a market in commerce."

The question of profitability in such commercial marketability was presented to the Supreme Court in *United States vs. Cannelton Sewer Pipe Co.*<sup>22</sup> Cannelton, the respondent, was an integrated miner-manufacturer of fire clay and shale for which there was a definite market but which market was not profitable until respondent processed them into finished products of sewer pipe and other vitrified articles. The Supreme Court in reversing the United States Court of Appeals held that the depletion allowance was to be based upon the *first* commercial mineral product marketable in commerce despite its nonprofitability. Respondent contended that the nonprofitability of the fire clay and shale, the first commercial mineral product, restricted and limited its actual marketability in commerce. The Supreme Court noted that depletion is an allowance for the exhaustion of capital assets and not a subsidy to manufacturers or high-cost mine operators,<sup>23</sup> thus implying an industry-wide rather than an individual standard for initial marketability. If the respondent's formula had been adopted, a discriminatory situation would have been created whereby the integrated miner-manufacturer would have been granted a distinct competitive advantage over the

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<sup>18</sup> 122 F. Supp. at 63.

<sup>19</sup> 15 T.C. 981 (1950).

<sup>20</sup> 21 T.C. 746 (1954).

<sup>21</sup> *Id.* at 756.

<sup>22</sup> *Supra* note 7.

<sup>23</sup> 364 U.S. at 86.

nonintegrated miner and nonintegrated manufacturer.<sup>24</sup> The Court therefore rejected Cannelton's profitability argument and interpreted congressional intent to be that the integrated miner-manufacturer is to be treated as if the miner sold the mineral to himself for fabrication. *Cannelton* has been cited as the controlling case in this area since its inception in 1960.<sup>25</sup> Thus the *Cannelton* formula appeared to be: (1) determine the statutory percentage to be applied to the mineral product, (2) determine what is the proper "cut-off point" at which the mining and ordinary treatment processes end and the manufacturing process begins, (3) determine what other costs may be added to the cost of mining to effect the first commercially marketable mineral product.

Just three days after the Supreme Court decided *Cannelton* in 1960, a House-Senate Conference Committee recommendation significantly altering section 613(c) became law. The amendment, prompted by the flood of litigation based upon interpretation of this Code section, altered the definition of "mining" by: (1) deleting the phrase "commercially marketable mineral product,"<sup>26</sup> (2) deleting the phrase "ordinary treatment processes" and inserting additions to the list of treatment processes which would thereafter be considered "mining,"<sup>27</sup> (3) inserting a list of treatment processes which would *not* be considered "mining."<sup>28</sup> These amendments, however, applied only to taxable years beginning after December 31, 1960.<sup>29</sup> This legislation enabled the Internal Revenue Service to determine more easily the second and third factors in the previously noted Cannelton formula.

Thus in *Dravo*, a 1965 case contesting a 1955 tax return, the 1954 Code and the *Cannelton* decision apply, but the 1960 Amendment to the 1954 Code does not. *Dravo* contended that its transportation costs in conveying the sand and gravel from the dredge to its shore installations and its stockpiling and loading costs were includible in "ordinary treatment processes" as defined in Section 613(c) (4) of the 1954 Code. The Court stated that whether the cost of any or all of these three operations was to be considered in computing gross income is dependent

<sup>24</sup> *Id.* at 87.

<sup>25</sup> *Virginia Greenstone Co. v. U.S.*, 308 F. 2d 669 (4th Cir. 1962); *Morton Salt Co. v. U.S.*, 316 F. 2d 931 (Ct. Cl. 1963), *cert denied* 375 U.S. 951 (1963); *C.I.R. v. Hallquist*, 291 F. 2d 49 (7th Cir. 1961), *cert denied* 368 U.S. 930 (1961); *Standard Realization Co. v. U.S.*, 289 F. 2d 247 (7th Cir. 1961); *U.S. v. Portland Cement Co. of Utah*, 338 F. 2d 798 (10th Cir. 1964); *Riddell v. California Portland Cement Co.*, 297 F. 2d 345 (9th Cir. 1962).

<sup>26</sup> Pub. L. No. 86-564, §302(b), 74 Stat. 292.

<sup>27</sup> *Ibid.*

<sup>28</sup> Pub. L. No. 86-564, §302(b) (2), 74 Stat. 293, becoming §613(c) (5) of INT. REV. CODE OF 1954.

<sup>29</sup> Pub. L. No. 86-564, §302(c), 74 Stat. 293. There were two significant concessions for certain minerals for tax years beginning before January 1, 1961. Pub. L. No. 87-312, 75 Stat. 674, changed retroactively the application of *Cannelton* in cases of shale, brick, tile clay and fire clay. Pub. L. No. 87-321, 75 Stat. 683, concerns percentage depletion of quartzite and clay.

upon whether the mined product, after processes on the dredge were completed, was ready for industrial use or consumption. The Court, in analyzing Dravo's dredge-to-shore transportation expense, compared the instant case with *Matagorda Shell Co.*,<sup>30</sup> a pre-*Cannelton* case which presented a situation similar to that in *Dravo*. The petitioner dredged oyster shell from Matagorda Bay. The shells were washed and screened on the dredge, loaded onto barges which hauled them to shore where they were stockpiled and later loaded for shipment. The Tax Court held that Matagorda's first commercially marketable mineral product was the oyster shell loaded for shipment on shore. The expenses encountered in hauling the shell fifty miles, the statutory limit,<sup>31</sup> were held to be includible in computing its total "gross income from mining" for purposes of the percentage depletion allowance. The Court in *Dravo* seems to distinguish the *Matagorda* case upon the fact that Dravo's first customers purchased at the dredge while Matagorda's initial customer contact occurred at the shore installations. Thus the transportation of their respective products from dredge to shore was includible within the statutory definition of "mining" for Matagorda, while not so for Dravo.

In dismissing Dravo's contention that stockpiling was an "ordinary treatment process," the Court cites the traditional theory that stockpiling "is not designated to effect a physical or chemical change in the sand and gravel."<sup>32</sup> The Court in noting that the physical separation of the light from heavy gravel was performed at the dredge, held that in this situation stockpiling was not a requisite to marketability and hence not an "ordinary treatment process."

Dravo's loading and transportation expenses were also disallowed for purposes of gross income computation since under section 613(c)(2) transportation is includible in mining only if transportation took the mineral product to a location at which an ordinary treatment process was applied.<sup>33</sup>

In conclusion, *Dravo Corporation v. United States* seems to represent another phase of continuing judicial and legislative recognition that uncertainty and general terminology within section 613 results in litigational havoc, such as that which arose in attempting to interpret "ordinary treatment processes." The situation becomes more apparent by illustration of the timing in a depletion controversy. Presuming the litigation is to commence in the current year and the tax year in dispute began prior to December 31, 1960, the 1954 Code applies, fraught with its varying judicial interpretations of "ordinary treatment processes"

<sup>30</sup> 29 T.C. 1060 (1958).

<sup>31</sup> INT. REV. CODE OF 1954, §613(c)(2).

<sup>32</sup> 348 F. 2d at 549.

<sup>33</sup> *Zonolite Co. v. U.S.*, 211 F. 2d 508 (7th Cir. 1954); *Winsboro Granite Corp.*, 32 T.C. 974 (1959), *aff'd per curiam* 283 F. 2d 307 (4th Cir. 1960).

and "commercially marketable mineral product." Cannelton still controls in this area and, *a fortiori*, in cases involving tax years commencing before the aforementioned date. The taxpayer must prove that the processes or transportation items he desires to include in gross income are within the judicial interpretation of these sections of the Code as reflected by previous cases. However, for disputed tax years beginning after December 31, 1960, the 1954 Code, modified by the post-*Cannelton* legislation,<sup>34</sup> is relevant. The taxpayer must establish that the processes he performs are within the statutory scope of treatment processes considered to be "mining."<sup>35</sup> These specific classifications drastically limit the area of judicial interpretation extant before such legislation was enacted. The apparent intent of the specificity of the post-*Cannelton* was to decrease substantially the amount of litigation in this area, thereby reducing the need for judicial interpretation. Perhaps this legislative awareness has been prematurely translated into decisions such as *Dravo Corporation v. United States* which today distinguishes *Matagorda Shell Co.* but might not have done so five years ago—before the 1960 amendment which had no direct bearing on *Dravo*. Speculation as to the future indicates that prior as well as possible future legislative specificity will considerably narrow the channels of legislative grace.

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<sup>34</sup> See note 26 to 29 *supra*.

<sup>35</sup> INT. REV. CODE OF 1954, §613(c)(4) as amended by Pub. L. No. 86-564, §302(b), 74 Stat. 292.

