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Alternative Minimum Tax: The Percentage Depletion Tax Preference For Investments In Natural Resources After *Hill v. United States*

INTRODUCTION

The Alternative Minimum Tax (AMT) was enacted by Congress in 1969 for both individuals and corporations.[1] The tax was enacted because some of these taxpayers had effectively avoided tax on a substantial portion of their economic income through various extraordinary deductions.[2] The AMT was an attempt by Congress to curtail this tax avoidance by applying a smaller tax rate against a larger tax base (i.e. a base without these special deductions). By enhancing the larger tax base, the AMT would theoretically cause more taxpayers to pay income tax.

Congress enacted the AMT after the Treasury Department reported that some individuals with large incomes were paying little or no tax.[3] The report found that these individuals were escaping tax liability by effectively using various income exclusions allowed in the income tax scheme.[4] As a result, the middle

[1] *See* Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, § 301 (codified as amended in scattered sections of 26 U.S.C.). Although the minimum tax originally enacted in 1969 was an add-on tax for both corporations and individuals instead of an alternative tax, the distinction is not important for purposes of this note.

[2] S. REP. No. 552, 91st Cong., 1st. Sess., 1969-3 C. B. 423, 495 (some examples include a percentage reduction of long term capital gains, accelerated depreciation deductions, and depletion deductions greater than cost depletion).

[3] TAX REFORM STUDIES AND PROPOSALS, U.S. TREASURY DEPT., 91st Cong., 1st Sess., Part 2, p. 132 (Comm. Print 1969) (concluding that a larger percentage of taxpayers in the $50,000 to $100,000 income bracket pay an effective tax exceeding 30 percent compared to taxpayers with annual incomes greater than $500,000). *See also* H.R. REP. No. 413, 91st Cong., 1st Sess., 1969-3 C.B. 200 (finding that there were 154 individuals in 1966 with adjusted gross incomes in excess of $200,000 who paid no income tax). Although the Treasury focused on the tax disparity among individuals, Congress found this inequality prevalent for both corporations and individuals when enacting the AMT. *See supra* note 1 and accompanying text.

[4] TAX REFORM STUDIES, U.S. TREASURY DEPT., at 132.

and low income classes were bearing a significant portion of the tax burden.[5] The Treasury Department believed this result was contrary to a fundamental principle on which the income tax system had been based—an individual's tax liability should be equated with his economic ability to pay.[6] Therefore, to help remedy this problem, the Department proposed a minimum tax system that would assure that all individuals, even those with large incomes, would pay their share of income taxes.[7]

The proposed minimum tax would be computed by applying a minimum tax rate against an expanded income base including both taxable income and exempt income.[8] The preference items added back into income were items which the Treasury Department believed contributed most to the tax disparity among individuals. Only four preferences were specifically mentioned in the original proposal.[9] One such preference was the exclusion from taxable income of all income resulting from allowable deductions for percentage depletion in excess of the capital invested in property, for example, mineral operations.[10] To develop an understanding of why the Treasury Department believed the percentage depletion preference item enabled certain individuals to avoid their proportionate tax burden, an analysis of the depletion allowance is presented below.

THE DEPLETION ALLOWANCE

Minerals such as oil, gas, metallic ores, valuable nonmetallic rock and coal are wasting assets. As the minerals are produced or sold, the mineral deposit from which they are taken is gradually exhausted. Similar to the depreciation allowance for the use of physical properties, depletion is an allowance which enables an investor in natural resources to recover his capital outlay in the mineral.[11] Depletion and depreciation are also similar in that the costs are generally recovered over the life of the prop-

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[5] *See* TAX REFORM STUDIES, U.S. TREASURY DEPT., at 132.

[6] TAX REFORM STUDIES, U.S. TREASURY DEPT., at 132.

[7] *See* TAX REFORM STUDIES, U.S. TREASURY DEPT., at 132-133.

[8] TAX REFORM STUDIES, U.S. TREASURY DEPT., at 133.

[9] *Id.*

[10] *Id.* The other three preferences mentioned were; interest on state and local government bonds, the exclusion from net long term capital gains, and the appreciation of property contributed to charities.

[11] JOHN S. DZIENKOWSKI AND ROBERT J. PERONI, NATURAL RESOURCE TAXATION 279 (1988).

erty—depreciation over the estimated useful life of the asset and depletion over the life of the resource (i.e. until the resource is exhausted).[12] Although there is some similarity in the mechanics and objectives of depreciation and depletion,[13] these recovery methods are two entirely different schemes under the present income tax system.[14]

To determine the depletion allowance, the taxpayer computes depletion under both the cost[15] and the percentage[16] methods, and then claims the greater of the two amounts on his tax return.[17] Basically, cost depletion allows taxpayers to recover a portion of those costs which are allocable to mineral property sold or otherwise used in producing the income for that year.[18] Under this method, once depletion has been claimed for the year, the taxpayer reduces his adjusted basis in the mineral property by the allowable depletion.[19] The cost depletion allowance continues pro-rata until the mineral resource is completely exhausted.[20] Once a taxpayer's capitalized costs have been recouped, he can no longer recover cost depletion.[21]

Percentage depletion, on the other hand, is computed by multiplying a statutory percentage by the annual gross income from the property.[22] Since percentage depletion is based on income, there is a possibility of recovering deductions during the property's lifetime totalling more than the actual investment in the property.[23] Thus, owners or lessees of interests in mineral

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[12] Elton Lasseigne, *Oil and Gas Transactions*, 110 Tax Mgmt. (BNA) A-1 (1991). (This is not true for the percentage depletion method.) *See infra* notes 22-23 and accompanying text.

[13] Depreciation and depletion contain similarities, however, cost depletion is actually more akin to cost of goods sold. Martin J. McMahon, *Fundamentals of Federal Income Taxation of Natural Resources*, 3 J. MIN. L. &POL'Y 225, 233-234 (1987-1988) (citing an analogy in U.S. v. Ludey, 274 U.S. 295, 302 (1927)).

[14] *Compare* I.R.C. §§ 167-68 *with* I.R.C. §§ 611-14 (West 1986).

[15] I.R.C. §§ 611-12 (West 1986).

[16] I.R.C. § 613 (West 1986).

[17] Treas. Reg. § 1.611-1(a)(1) (as amended in 1973). *Compare* I.R.C. § 613A (West 1986) (Investors in hard minerals are allowed to take percentage depletion; however, only certain oil and gas producers are allowed to use this method.).

[18] Treas. Reg. § 1.611-2(a)(1) (as amended in 1972).

[19] I.R.C. § 612 (West 1986) (citing § 1011 for the purpose of computing adjusted basis).

[20] Treas. Reg. § 1.611-2(b)(2) (as amended in 1972).

[21] Javed A. Khokhar, *Alternative Minimum Tax*, 288-4th Tax Mgmt. (BNA) A-73 (1989). (Note that the investor has already recovered his investment tax-free.)

[22] Treas. Reg. § 1.613-1(a). The applicable percentages for various minerals are set out in I.R.C. § 613(b) (West 1986).

[23] Khokhar, *supra* note 21.

deposits are able to receive tax-free income through this depletion method.[24]

Since depletion and depreciation are separate concepts under the income tax scheme, taxpayers must properly allocate capitalized costs between the property's depletable basis and its depreciable basis.[25] In the case of coal mines and other hard mineral operations, any "[e]xpenditures for improvements [or] replacements" on the mine are normally capitalized and recovered through depreciation deductions.[26] That is, they are allocated to the property's depreciable basis rather than to the property's adjusted depletable basis.

In the case of oil and natural gas wells, the drilling and development costs incurred during the operation of the wells are categorized as intangible or tangible costs.[27] Intangible costs include "all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas."[28] Tangible costs include physical improvements to the property for the operation of the wells such as the addition of machinery, tools, equipment, pipes, and similar items.[29]

For intangible costs, a taxpayer has the option either to deduct in full (as expenses) the costs incurred in that year or to capitalize them.[30] If the taxpayer capitalizes the costs, he then recovers those costs either through depreciation or depletion, depending on their nature.[31] Intangible costs incurred through installation of physical structures and equipment are recovered through depreciation.[32] Intangible costs of clearing ground, draining, road making, surveying, and drilling wells are recoverable through depletion.[33]

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[24] *Id.* (Owners/lessees are still allowed to recover a statutory percentage of gross income from the mineral property even though the property's depletable basis has been reduced to zero.).

[25] Martin J. McMahon, *Fundamentals of Federal Income Taxation of Natural Resources*, 3 J. MIN. L. & POL'Y 225, 272 (1987-1988).

[26] Treas. Reg. § 1.612-2(a) (1960). (However, if these expenditures meet certain requirements under this section, they are expensed when paid.)

[27] *See* Treas. Reg. § 1.612-4(a), (c) (1965).

[28] Treas. Reg. § 1.612-4(a) (1965).

[29] Treas. Reg. § 1.612-4(c) (1965).

[30] Treas. Reg. § 1.612-4(a) (1965).

[31] *See supra* notes 25-26 and accompanying text (illustrating a similar allocation of costs for mineral operations).

[32] Treas. Reg. § 1.612-4(b)(2) (1965) (including amounts paid for wages, fuel, repairs, hauling, supplies, etc.).

[33] Treas. Reg. § 1.612-4(b)(1) (1965).

The AMT preference item for percentage depletion proposed by the Treasury Department was adopted by Congress as part of the Tax Reform Act of 1969.[34] The preference item was defined as "the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year)."[35] By including this preference in the minimum tax calculation, the federal government was attempting to prevent producers and investors in mineral interests from reducing their income tax liability through the percentage depletion allowance while maintaining substantial economic income. This was part of an effort to strengthen progressivity and assure that all economically profitable taxpayers paid at least some income tax.

However, the recent court of appeals decision, *Hill v. United States*,[36] contravenes this purpose by permitting mineral operators to continue enjoying a significant tax preference by effectively claiming percentage depletion in computing their alternative minimum taxable income.[37] In *Hill*, the husband and wife plaintiffs were in the oil and gas exploration business.[38] On their 1981 and 1982 income tax returns, they included unrecovered tangible costs (i.e. the remaining depreciable basis) of machinery and equipment that had been installed on the mineral property in the calculation of the property's adjusted basis in order to compute the amount of depletion as a tax preference subject to the minimum tax.[39] The United States Claims Court initially approved this computation,[40] and its decision was affirmed by the United States Court of Appeals for the Federal Circuit.[41] A writ of certiorari has recently been granted by the Supreme Court, but no decision has been released as of this publication.[42]

In deciding for the taxpayers, the court misapplied the statutory and regulatory language concerning the tax preference

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[34] Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, § 301 (codified as amended in scattered sections of 26 U.S.C.).

[35] I.R.C. § 57(a)(8) (West 1986).

[36] Hill v. United States, 945 F.2d 1529 (Fed. Cir. 1991), *cert. granted*, 60 U.S.L.W. 3735 (U.S. April 27, 1992) (No. 91-1421).

[37] *Id.* at 1537-38.

[38] *Id.* at 1530.

[39] *Id.* at 1531-32.

[40] Hill v. United States, 21 Cl. Ct. 713 (1990).

[41] *Hill*, 945 F.2d at 1529.

[42] Hill v. United States, 60 U.S.L.W. 3735 (U.S. April 27, 1992) (No. 91-1421).

item. The court reached its determination after analyzing section 57(a)(8) of the 1982 Code.[43] The regulations under this section refer to section 1016 for computing the adjusted basis of the property[44] and to section 614 for defining the property.[45] Section 1016 requires an adjustment to basis for all "expenditures, receipts, losses, or other items properly chargeable to capital account."[46] The regulations promulgated under this section of the Code include the "cost of improvements or betterments made to the property" as an item properly chargeable to capital.[47] They also specifically disallow any adjustment to basis for any item expensed and deducted during the tax year.[48] Since those costs of tangible improvements to the property in the *Hill* case which had not been expensed (i.e. the depreciable basis) met the above requirement, the court determined they should be included in the property's adjusted basis for computation of the depletion preference.[49]

The court also concluded that section 614 did not aid in defining a mineral property's adjusted basis, even though the regulations under section 57(a)(8) refer to that section for purposes of defining "property."[50] The court held that although section 614 "speaks expansively about what interests in mineral deposits can be aggregated into a single property, it says nothing about what adjustments to the cost basis of *that property* are appropriate when calculating the 'adjusted basis.'"[51] Thus, the court determined that section 1016 alone controlled the determination of what constituted a property's adjusted basis for minimum tax purposes.

To support its analysis that the adjusted basis for minimum tax purposes included unrecovered tangible costs, the court concluded its decision was in line with the Internal Revenue Code policy of providing tax incentives for investors in the oil and

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[43] I.R.C. § 57(a)(8) (1982) (the excess of the depletion deduction allowable over the adjusted basis of the property at the end of the year disregarding the current year's depletion deduction).

[44] Treas. Reg. § 1.57-1(h)(3) (1987).

[45] Treas. Reg. § 1.57-1(h)(1) (1987).

[46] I.R.C. § 1016(a)(1) (1986).

[47] Treas. Reg. § 1.1016-2(a) (1983).

[48] *Id.*

[49] *Hill*, 945 F.2d at 1538.

[50] *Id.* at 1535.

[51] *Id.* (emphasis in original).

gas industry.[52] The court believed that including unrecovered costs for tangible improvements to the property in determining the adjusted basis was consistent with the policy of encouraging oil and gas development.[53] Finally, the court reached its conclusion without support from the legislative history of the AMT tax preference item because it concluded that this history was not helpful.[54]

ANALYSIS OF THE *HILL* DECISION

The court reached the wrong conclusion in *Hill* and the following analysis will critically examine its decision.[55] The specific language of the Treasury Regulations demonstrates that the mineral property's adjusted basis should not include depreciable basis for purposes of the depletion tax preference. In computing the adjusted basis of the property for purposes of the depletion preference, Treasury Regulation 1.57-1(h)(3) refers to section 1016 of the Internal Revenue Code.[56] The regulations under section 57(a)(8) refer to section 614 for purposes of defining the property on which the preference is calculated.[57] This section defines property as "each separate interest owned by the taxpayer in each mineral deposit . . . ."[58] Thus, according to section

[52] *Id.* at 1533.

[53] *Id.*

[54] *Hill*, 945 F.2d at 1535, n.10. (The court was correct in this assessment. Although the depletion preference proposed by the Treasury Department required percentage depletion in excess of *depletable* basis, the subsequent amendments and revisions by Congress never specifically defined what constituted the property's adjusted basis.) *See* TAX REFORM STUDIES AND PROPOSALS, U.S. TREASURY DEPT. 91st Cong., 1st Sess. 139 (Comm. Print 1969). *See generally* H. R. REP. No. 91-413, 91st Cong., 1st Sess. 1645, *reprinted in* 1969-3 C.B. 200, 249-50; S. REP. No. 91-552, 91st Cong., 1st. Sess. 2027, *reprinted in* 1969-3 C.B. 423, 497; CONF. REP. No. 91-782, 91st Cong., 1st. Sess. 2392, *reprinted in* 1969-3 C.B. 644, 659. For a general analysis of the legislative history surrounding the depletion preference, see Marvin K. Collie and William M. Linden, *The Tax Reform Act of 1969 and Domestic Oil and Gas Producers*, 21 INST. ON OIL & GAS L. & TAX'N 419, 432-37 (1970).

[55] For other commentaries critical of the *Hill* decision, see Martin J. McMahon, *Significant Current Developments in Oil and Gas Taxation*, 42 INST. ON OIL & GAS L. & TAX'N §§ 15.10(2), 15-1, 15-51 (1991); John S. Dzienkowski and Robert J. Peroni, *A Critical Review of the Hill Decisions: Calculating Excess Depletion Under the Alternative Minimum Tax*, THE NAT. RESOURCES TAX REV. 243 (Sept.-Oct. 1991).

[56] Treas. Reg. § 1.57-1(h)(3) (1987).

[57] Treas. Reg. § 1.57-1(h)(1) (1987).

[58] I.R.C. § 614(a) (1982).

1016(a)(1), the "property" on which adjustments to basis should be made is the "mineral deposit."[59]

A mineral deposit is defined as "minerals in place."[60] This mineral deposit makes up part of the mineral enterprise. A mineral enterprise, in contrast to a mineral deposit, is defined as "the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction."[61]

The distinction between a mineral enterprise and a mineral deposit is important because only the mineral deposit is subject to depletion.[62] In order to receive a depletion deduction, it is necessary to maintain a separate capital account for the mineral deposit.[63] As the dissent in *Hill* correctly noted, "the capital account of the mineral deposit on which depletion is calculated includes the cost of the deposit itself and certain exploration costs . . . . It does not include the costs of improvements used in production, such as machinery and pipes. The latter are adjustments only to the enterprise."[64] Thus, these unrecovered tangible costs are not "properly chargeable to the capital account" of the mineral deposit as required by section 57(a)(8) for purposes of computing the adjusted basis of the property.[65] This is the plain language of the statutes and the regulations, yet the court in *Hill* misconstrued this language. The court did not specifically define "property" in section 1016 as the mineral deposit, but defined it as the mineral enterprise. Thus, it determined that the adjusted basis of the mineral property should

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[59] Treas. Reg. § 1.614-1(a)(1) (1977) (defining property for purposes of the Internal Revenue Code as each separate interest owned in the mineral deposit). *Cf.* Treas. Reg. § 1.614-2(a) (1974) (as amended by § 226(b)(3) of the Revenue Act of 1964) which prior to the enactment of Revenue Act of 1964 allowed a taxpayer to aggregate separate operating mineral interests and treat them as one property, even if the interests were from different tracts of land.

[60] Treas. Reg. § 1611-1(d)(4) (1974).

[61] Treas. Reg. § 1.611-1(d)(3) (1974).

[62] Treas. Reg. § 1.611-1(b)(1) (1987).

[63] Treas. Reg. § 1.611-2(b)(1) (1974).

[64] *Hill*, 945 F.2d at 1539 (dissenting opinion); *see* Treas. Reg. § 1.612-4(b). But even the dissent was in error by stating the adjustments should be made to the enterprise because an enterprise cannot have a basis. *See* I.R.C. § 1060 (holding that the costs should be allocated among all of the assets within the "enterprise."). *See also* Williams v. McGowan, 58 F. Supp. 692 (W.D. N.Y. 1944) (holding the costs of a business should be allocated among the individual assets).

[65] I.R.C. § 1016(a)(1) (1986).

include unrecovered depreciable costs.[66] But, as mentioned above, the property on which the adjusted basis is computed is defined by section 614 as the mineral deposit, not the mineral enterprise.[67]

The court's interpretation of section 57(a)(8) also conflicts with a previous Claims Court decision. In 1985, this court addressed whether a minimum tax on the percentage depletion preference was unconstitutional in *Mobley v United States*.[68] The issue was whether the minimum tax on the above preference constituted a tax on income or a direct tax on the recovery of capital.[69] In determining that the minimum tax was constitutional, the court construed section 57(a)(8) of the 1954 Internal Revenue Code.[70] The court interpreted this statutory section as follows:

> According to [the] clear language of the statute, the minimum tax, as applied to percentage depletion, does not operate as a direct tax on the return of capital. Rather, it operates to tax income otherwise sheltered by plaintiffs' depletion deductions which are in excess of their *basis in the depletable property*.[71]

By allowing the Hill's to include unrecovered depreciable costs in the adjusted basis of the mineral property, the court is allowing a result inconsistent with the reasoning in *Mobley*. The *Mobley* court properly recognized that the depletion preference was an amount in excess of only the depletable property's basis.[72] By recognizing that the computation focused on depletable property, the court eliminated the addition of unrecovered depreciable property to the adjusted basis. Although the Claims Court correctly construed section 57(a)(8) in *Mobley*, the reasoning used in that decision was not followed in *Hill*.

Not only did the *Hill* court misconstrue the express statutory and regulatory provisions concerning the depletion preference, but its decision also conflicts with basic tax fundamentals underlying the concepts of depletion and depreciation. Depletion and depreciation are two entirely separate concepts. The Su-

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[66] *Hill*, 945 F.2d at 1533.

[67] I.R.C. § 614(a) (1982).

[68] Mobley, Jr. v. United States, 8 Cl. Ct. 767 (1985).

[69] *Id.* at 769.

[70] This is the same 1976 statute under analysis in the *Hill* case.

[71] *Mobley*, 8 Cl. Ct. at 771.

[72] *Id.*

preme Court recognized this distinction in *Choate v. Commissioner.*[73] In this case the Court properly recognized that depreciation was an allowance for the exhaustion of an asset used in a trade or business and that depletion was an allowance for the exhaustion of natural resources.[74] More importantly, the Court held that "only intangible drilling and development costs, not costs represented by physical property, are returnable by way of depletion."[75] Thus, this opinion requires that the taxpayer correctly allocate capitalized costs when they are incurred between the depletable natural resource property and non-depletable assets.

Although the difference between depletion and depreciation was not recognized by the *Hill* court, many other authorities have understood the distinction. For example, the Tax Court held in *Clemente, Inc. v. Commissioner*[76] that a proper computation of the depletion allowance for a property should be determined only after removing the nondepletable assets from the basis. The Internal Revenue Service (IRS) held in a revenue ruling that the cost of acquiring a mineral enterprise should properly be allocated between the property's depletable and depreciable bases.[77] Also, tax commentators on natural resources have agreed that "the [property's] depletable basis does not include nondepletable, nondepreciable assets such as land, nor does it include wasting assets such as equipment and improvements that are subject to . . . depreciation."[78] These authorities uniformly agree that depreciation and depletion are entirely separate concepts for purposes of regular and minimum tax; therefore, the *Hill* court contradicted logic and reason by allowing unrecovered tangible costs to be included in the property's depletable basis.[79]

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[73] Choate v. Commissioner of Internal Revenue, 141 F.2d 641 (10th Cir. 1944), *rev'd* 324 U.S. 1 (1945).

[74] *Choate*, 324 U.S. at 2-3.

[75] *Choate*, 324 U.S. at 3.

[76] Clemente, Inc. v. Commissioner, 50 T.C.M. (CCH) 497 (1985).

[77] Rev. Rul. 69-539, 1969-2 C.B. 141.

[78] DZIENKOWSKI *supra* note 11, at 321. *See also* McMahon, *supra* note 13, at 272 (stating that only the part of a property's basis attributable to the mineral property may be included in the depletable basis); Khokar, *supra* note 21, at p. A-32, A-76 (stating that a depletion deduction is allowed only if the costs are not represented by physical property and that if such costs are represented by physical property, then a depreciation deduction may be claimed).

[79] However, the IRS misapplied the same issue in Rev. Rul. 68-231, 1968-2 C.B.

Finally, the result in *Hill* is inconsistent with the legislative intent of enacting a minimum tax, especially as it relates to producers and investors in natural resources. The minimum tax scheme was enacted to reestablish progressivity among the economic classes.[80] More specifically, the percentage depletion preference was enacted to prevent investors and producers in natural resources who use percentage depletion from realizing excessive amounts of tax-free income. Yet, the court's decision permits these taxpayers to continue realizing tax-free benefits even after the property's depletable basis has been exhausted—a result completely inconsistent with the purpose of the minimum tax.[81]

The court also tried to support its conclusion in *Hill* by arguing that the outcome was consistent with congressional encouragement in oil and gas investment.[82] However, that conclusion seems extraneous in light of the actions taken by Congress. By enacting the Tax Reform Act of 1969, not only did Congress create a percentage depletion preference item for minimum tax purposes, but it also reduced the percentage depletion rate from 27.5% to 22%.[83] In fact, when the Senate had an opportunity to leave the percentage depletion rate at 27.5%, it declined to do so by a substantial margin.[84] Furthermore, incentives to oil and gas producers were subsequently limited when Congress enacted Internal Revenue Code section 613A in 1975. This section prevented many producers from computing percentage depletion in determining the annual depletion allowance.[85]

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264 (permitting a lessor of mineral property and equipment to depreciate equipment and deduct percentage depletion on royalties attributable to the equipment).

[80] H.R. REP. No. 413, 91st Cong., 1st Sess. 1645, *reprinted in* 1969-3 C.B. 200.

[81] A double benefit is allowed for minimum tax purposes for post-1986 tax years due to the implementation of section 56(a)(1). This section requires depreciation to be computed on tangible assets for alternative minimum tax purposes using longer recovery periods than the depreciation computation for regular tax purposes. Not only does a taxpayer reduce his percentage depletion tax preference amount by the property's current year depreciable basis, he gets to subsequently reduce his minimum tax depreciation adjustment in future years when his AMT depreciation exceeds his regular depreciation.

[82] *Hill*, 945 F.2d at 1533.

[83] Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 682 (codified as amended in scattered sections of 26 U.S.C.). Today, the percentage depletion rate is 15% for those oil and gas investors who can claim percentage depletion.

[84] 115 Cong. Rec. 38228-9 (1969).

[85] *See infra* note 87 and text. Although I.R.C. section 613A was enacted by a different Congress than the one enacting section 57(a)(8), it substantially restricts the *Hill* court's reasoning that section 613 allows oil and gas taxpayers an incentive by recovering amounts far in excess of their expenditures because many of these taxpayers were no longer allowed to use section 613 depletion after 1975. The *Hill* court failed to mention this point.

The congressional actions described above clearly demonstrate that Congress was not as concerned with encouraging oil and gas investment as it was with effectively curtailing investors from reaping tax-free benefits. The *Hill* decision is inconsistent with that policy.

IMPACT OF THE DECISION ON DEPLETION PREFERENCE TODAY

Even though the *Hill* decision construed the 1954 Internal Revenue Code, which was amended with the enactment of the 1986 Tax Reform Act,[86] this decision still has a significant impact today on the percentage depletion tax preference item for the mineral industry nationwide. When Congress enacted the Tax Reform Act of 1986, the language in section 57(a)(8) was carried over verbatim from the 1954 Code and codified in section 57(a)(1).[87] Since the language for the depletion preference is the same, the regulations drafted by the Treasury Department for section 57(a)(8) of the 1954 Code are relevant in interpreting section 57(a)(1) of the 1986 Code. Because the *Hill* court construed statutory language and regulations which continue to be in force even today, its decision has continuing vitality for post-1986 tax years.

Under current law, the greatest impact of *Hill* from a monetary standpoint is on the hard minerals industry. This is because many producers in the oil and gas industry are prohibited from using percentage depletion. In the Tax Reduction Act of 1975,[88] Congress curtailed the number of oil and gas producers who could claim percentage depletion.[89] Section 613A of the Code eliminated the percentage depletion allowance for any oil and gas properties owned by integrated oil producers, proven oil and gas properties transferred after 1974, and foreign oil and gas properties.[90] Thus, percentage depletion was no longer available

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[86] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

[87] LANCE ROOK, TAX PLANNING FOR AMT, § 8.02 (1991).

[88] Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (codified as amended in scattered sections of 26 U.S.C.).

[89] *See generally* I.R.C. § 613A.

[90] DZIENKOWSKI, *supra* note 11, at 280-81. (In 1990, the Revenue Reconciliation Act repealed the provision relating to the transfer of proven properties.)

to large retailers and refiners, but only to the small independent producers or royalty owners.[91]

Unlike oil and gas producers, large corporate producers engaged in the exploration and production of hard minerals are not subject to the 1000 barrel limitation in computing percentage depletion.[92] Since the IRS has admitted that the *Hill* decision applies to this industry,[93] these corporations arguably could reduce the depletion preference using the *Hill* analysis by including unrecovered costs from their processing plants and production equipment such as tipples, draglines and other depreciable assets in the property's adjusted basis. This procedure could significantly reduce the impact of the alternative minimum tax on such producers. The IRS has already received $400 million of refund claims,[94] and "estimates that there are $5 billion of refund claims with respect to open years."[95] More importantly, these numbers do not consider future tax years.

As previously mentioned, the Supreme Court has granted a writ of certiorari to the Federal Circuit to decide the tax preference issue. This article makes no prediction as to the Court's ultimate decision. However, even if the Supreme Court affirms the Federal Circuit's decision, the IRS still might attempt to amend the regulations concerning the alternative minimum tax implemented by the 1986 Tax Reform Act. The regulations for section 57 of the Code have not been updated since passage of the 1986 Act.[96] Therefore, the IRS may issue new regulations that better define a property's adjusted basis for purposes of the depletion preference.

Congress has given the Treasury Department the authority to issue regulations in section 7805 of the Code. This section

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[91] ELTON LASSEIGNE, 110 T.M., OIL AND GAS TRANSACTIONS A-43 (1991). (In 1981, the Hills qualified for percentage depletion because they were independent producers.) *See* I.R.C. § 613A(c)(3) (allowing independent producers or royalty owners to compute percentage depletion only with reference to 1,000 barrels of average daily production). *See generally* McMahon, *supra* note 13, 3 J. MIN. L. & POL'Y 225, 240-244.

[92] I.R.C. § 613(a), (b).

[93] *Percentage Depletion and Alternative Minimum Tax*, LAW LETTER (Greenebaum Doll & McDonald), Dec. 1991, at 6.

[94] *Supreme Court to Decide Proper Computation of Alternative Minimum Tax Preference*, 2 RIA's Analysis of Federal Taxes: Income (RIA Tax Pub. Div.) No. 18, at 500 (April 30, 1992).

[95] *Percentage Depletion and Alternative Minimum Tax*, *supra* note 93, at 6.

[96] Stand. Fed. Tax Rep. (CCH) ¶ 5302 (1992) (stating that old regulations may not be good since P.L. 99-514 repealed old code (1991)).

allows the Treasury to issue new regulations as necessary if there is any alteration in the laws of the internal revenue.[97] Also, the Supreme Court recently addressed the issue of a federal agency drafting new regulations in the case of *Rust v. Sullivan*.[98] In *Rust*, the Supreme Court decided that the Secretary of Health and Human Services had the authority to issue new regulations to better define section 1008 of the Public Health Services Act. The Court stated that the regulations were proper because the statutory section and its legislative history were ambiguous and because the Secretary amply supported the regulations with a reasoned analysis.[99]

Based on section 7805 and *Rust*, the IRS could validly issue new regulations concerning the alternative minimum tax provisions of the 1986 Code. The 1986 Act provided sweeping changes to the alternative minimum tax. For example, the statutory provisions enacted by Congress greatly extended the minimum tax effect on C corporations by creating a system which requires a completely separate accounting system in computing the tax, including separate depreciation rules.[100] In fact, the changes to the tax preference items were so significant, that one writer deemed the AMT regulations predating the 1986 Act as generally irrelevant.[101] Thus, the IRS could argue new regulations are necessary in order to deal with the sweeping effects of the 1986 Act.

More specifically, the statutory section and its legislative history are ambiguous as defined in *Rust* because they do not speak directly to the specific issue;[102] namely what constitutes a property's adjusted basis. After 1986, the Tax Reform Act implemented a new depreciation system for purposes of the alternative minimum tax.[103] Therefore, tangible property subject to depreciation now has two bases—regular tax and alternative

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[97] I.R.C. § 7805(a) (1986).

[98] Rust v. Sullivan, ____ U.S. ____, 111 S. Ct. 1759 (1991).

[99] *Id.* at 1762.

[100] ROOK, *supra* note 86, § 1.01(1), at 1-3.

[101] *Id.* at 1-3, n.4.

[102] *Rust*, 111 S. Ct. at 1767.

[103] I.R.C. § 56(a)(1), (2). This section requires corporations to compute depreciation on tangible assets for alternative minimum tax using longer recovery periods in addition to the depreciation computation for regular tax purposes. Also, the corporations must keep a separate depreciable basis for each asset for both the regular and alternative minimum tax.

minimum tax. In light of this modification, the statute is ambiguous because there is a "question as to whether the regular tax or the AMT adjusted basis of tangible equipment should control the determination of the preference amount."[104] Thus, there is enough ambiguity in the minimum tax provisions of the statute to warrant the issuance of new regulations.

Once the ambiguity of the statutory sections is proven, the IRS's construction of the new regulations "must be accorded substantial deference . . . and may not be disturbed as an abuse of discretion if it reflects a plausible construction of the statute's plain language and does not otherwise conflict with Congress' expressed intent."[105] By drafting regulations which define a property's adjusted basis as not including unrecovered tangible costs, the IRS should be able to meet the *Rust* threshold. The definition would qualify as a plausible construction if for no other reason than to provide a symmetry between the regular tax and alternative minimum tax provisions. The construction should also comply because the expressed intent by Congress in enacting the alternative minimum tax under the 1986 Code was to ensure all taxpayers (both individual and corporate) pay their fair share of the income tax burden.[106] By constructing the new regulations to not include unrecovered tangible costs, the IRS would further that objective.

CONCLUSION

The alternative minimum tax was established to ensure that individuals and corporations paid a fair share of income taxes. More specifically, the depletion preference was enacted to help prevent investors in natural resources who use percentage deple-

[104] *Ruling allows AMT Refunds*, 61 PETROLEUM INDEPENDENT 9, at 9 (quoting Mike Hilger).

[105] *Rust*, 111 S. Ct. at 1762 (relying on Chevron U.S.A. v. Natural Resources Defense Council, 467 U.S. 837, 842-44).

[106] S. REP. No. 313, P.L. No. 99-514, 99th Cong., 2d Sess. 518 (1986).

> [N]o taxpayer with substantial economic income [should be able to] avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals . . . to pay little or no tax undermines respect for the entire tax system and thus, for the incentive provisions themselves. In addition, aside from public perceptions, . . . it is inherently unfair for these taxpayers to pay little or no tax due to their ability to utilize various tax preferences.

tion from recovering tax-free income. In deciding *Hill*, not only does the Federal Circuit conflict with the purpose of the alternative minimum tax, but it misinterprets the statutory language of the Internal Revenue Code and fails to separate the depletion and depreciation concepts. While these flaws currently have undermined the purpose of the depletion tax preference, the Supreme Court may remedy the issue by reversing the decision of the Federal Circuit. If the Supreme Court does not reverse the prior decision, the Treasury Department may respond by issuing new regulations. Section 7805 of the Code and *Rust v. Sullivan* appear to give it that authority.

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