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CASE NOTES

FEDERAL TAXATION—Percentage Depletion—Applicability of Depletion Allowance to Geothermal Resources. Arthur E. Reich P—H Tax Ct. Rep. ¶ 52.74, at 497 (July 31, 1969).

Of late tremors have been felt within the halls of Congress concerning the value and policy for the continuation of the depletion allowance currently allowed to various concerns in the production and mining of specific natural resources. With the court's decision in the case to be discussed, the blood pressure of a few Congressmen is certain to register on the Richter Scale.

In 1954, Congress, in its revisions of the Internal Revenue Code (I.R.C.) allowed for percentage depletion of certain types and classes of natural resources (Sec. 613). Within this provision, petitioners (hereinafter called Thermal) sought to have the benefits of the depletion allowance applied to the production and exploitation of geothermal wells. Thermal was engaged in the business venture of drilling into geyser formations in order to tap the steam trapped below, and then piping the steam to be used as a source of power to operate generators. In 1957, Thermal began drilling the commercially productive steam wells.

The facts of this case are extremely important and must be considered carefully, as the final decision of the court was determined by its ultimate findings of the facts. At the outset, the court decided the commercial value and product of the wells was the steam with its characteristic pressure and not the heat produced by the steam. The reasoning behind their decision was the fact that heat alone will not produce sufficient power to turn a generator.

Thermal's expert witnesses provided the court with the important scientific evidence upon which it based its decision. By geological evidence, Thermal proved that the steam being tapped for commercial use, was, in effect, an isolated, irregular-shaped underground reservoir of steam with uniform internal pressures. The reservoir contained water trapped by fractured layers of rock and was heated by the heat conducted from the molten center of the earth, thereby producing steam. Further evidence, based upon well-head gas pressures of the various wells over a ten year period, indicated a decline in the

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static internal pressure from 180 pounds per square inch to 130 pounds per square inch. On the basis of this evidence, Thermal sought to show that the volume of the trapped steam was not inexhaustible. To use the court's words: "Evidence indicates there can be neither significant water present in the steam reservoir, nor liquid recharge, and that the reservoir is essentially a closed volume of steam."[1]

Therefore, Thermal, on its Federal income tax return. deducted a depletion allowance at the rate of 27½ percent against the gross income received from the geothermal wells.

On the basis of this information, the court, in its ultimate findings of fact determined:

(a) The commercial product of the geothermal wells is steam;

(b) Steam is a gas. "Steam is a gaseous form of H_2O."[2]

(c) The geothermal steam is contained within a closed reservoir in a finite amount, with no significant liquid influx. The geothermal steam is an exhaustible natural resource which has depleted and is continuing to deplete.

Whether Thermal was entitled to deduct a depletion allowance at the rate of 27½ percent against gross income received from the well (pursuant to section 613 of the Internal Revenue Code) became the major issue of the case.

The problem which faced the court at the outset was the seeming inconsistancy of its final holding, and section 613(6)(7)(A) of the I.R.C. ,which provides a 15 percent depletion allowance for "all other minerals' 'except soil, sod, dirt, turf, *water* or mosses, or 613(6)(7)(B) minerals from sea water, the air, or similar *inexhaustible* sources.[3] The key words, in

1. Arthur E. Reich, P—H Tax Ct. Rep. ¶ 52.74, at 502 (July 31, 1969).
2. *Id.* at 503.
3. INT. REV. CODE of 1954, § 613(b)(7) "15% [depletion allowance for]—all other minerals. . . . For the purpose of this section 'all other minerals' does not include—
   (A) soil, sod, dirt, turf, water, or mosses;
   (B) minerals from sea water, the air, or similar inexhaustible sources."
   The court said in United States v. Shurbet, 347 F.2d 103 (5th Cir. 1965), that the specific exemptions in 7(A) and (B) extended to all of § 613. In effect these specific exemptions apply not only to the 15% depletion clause, but to any percentage depletion to be allowed under 613. *See also* Treas. Reg. § 1.613-2(3)(b)(4) (1954).

this provision, are water and inexhaustible.[4] The government seized upon the exemption of water from any depletion allowance, and argued that because steam is gaseous H_2O and water is liquid H_2O, steam is water. Therefore, Thermal should not be entitled to any depletion allowance. In reply to this argument, the court stated that the term "water," as used in section 613(6)(7)(A) does not refer to water in its chemical sense as two parts hydrogen combined with one part oxygen (H_2O); rather, the term refers to water in its ordinary sense or liquid H_2O. Courts interpret the terms used in the depletion statute in light of their ordinary usage. On this point, the court cited as its only precedent *Blue Ridge Stone Corp. v. United States.*[5] The court's major premise relies upon the determination that water, as used in this section, must be construed in its ordinary sense as a liquid. It becomes important to determine if this interpretation is correct in view of the legislative history of the section, judicial precedents construing the section, and analogies used by courts applicable to the issue of whether steam is water.

The legislative history of section 613 gives no clue for any possible interpretation of the word "water," or the context in which it is to be used. The provision in the 1939 Internal Revenue Code relating to depletion mentions the 27½ percent allowance for oil and gas wells, but it is silent as to the water exception.[6] Not until the drafting of the 1954 I.R.C. was the water exception included. Not much is garnered from the Congressional discussion as to the legislative intent concerning the meaning of the terms used. All that was mentioned in the discussion in the House was that the term "all other minerals" does not include soil, sod, dirt, water, turf, or mosses, or minerals from sea water, the air or from sources by which commonly

4. For the evolution of § 613(b)(7)(A) from prior Internal Revenue enactments *see:*
   INT. REV. CODE of 1926, § 204(c)(2), 44 Stat. 14
   INT. REV. CODE of 1928, § 114(b)(3), 45 Stat. 821
   INT. REV. CODE of 1932, § 114(b)(3), 47 Stat. 202
   INT. REV. CODE of 1934, § 114(b)(3), 48 Stat. 710
   INT. REV. CODE of 1936, § 114(b)(3), 49 Stat. 1686
   INT. REV. CODE of 1938, § 114(b)(3), 52 Stat. 494
   INT. REV. CODE of 1939, 26 U.S.C.A. § 114(b)(3), 1940 ed.
   INT. REV. CODE of 1954, 26 U.S.C.A. § 613(b)(6)(A), 1954 ed.
5. Blue Ridge Stone Corp. v. United States, 170 F. Supp. 569 (W.D. Va. 1959).
6. INT. REV. CODE of 1939, 26 U.S.C.A. § 114(b)(3), 1940 ed.

accepted economic standards are regarded as *inexhaustible.*[7] The Senate Report merely stated "all other minerals" does not include soil, sod, dirt, turf, water, mosses, or minerals from sea water, the air, or from similar *inexhaustible* sources.[8] The Conference Report adopted the Senate's interpretation.[9] All that can be said concerning this information is the intent of Congress appears to be the exempting from depletion allowances those minerals which are inexhaustible and hence do not require a depletion allowance. The reports indicate that water, dirt, etc., are specific examples of what Congress thought were commonly inexhaustible resources. The second clause is added to further show specific examples of inexhaustible resources and to provide a catch-all phrase for any inexhaustible resources not mentioned specifically.

It is now necessary to shift the emphasis to judicial interpretation of the various terms of steam and water to determine if the court had something to hang its hat on when it stated steam is not water. "While water is to be defined as a mineral, the rules of law as to its use must logically vary from those applicable to coal, ore, and the like. Water is a fluid, and mobile, 'a fugitive.' Water analogy to natural gas and oil is more apt."[10]

Treasury Regulations section 1-611-1(d) (5) states minerals include ores of metals, coal, gas, oil, and all other natural deposits, metallic and non-metallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It may then be said, for purposes of the Internal Revenue, that water is a mineral. Most courts, when speaking about water, refer to it in its fluid form or as a liquid. It is more important to consider how the courts interpret steam. "Steam means only one thing, water in gas form. Man uses steam for heat or energy."[11] There are two definitions of steam: "Technical definition—steam is the vapor of water. Commonly accepted definition—steam is vapor of water confined in space. Steam is the elastic aeriform fluid into which

7. 3 U.S. CODE CONG. & AD. NEWS 4324 (83d Cong., 2d Sess., 1954).
8. *Id.* at 4972.
9. *Id.* at 5312.
10. Erickson v. Crookston Waterworks, Power & Light Co., 100 Minn. 481, 111 N.W. 391, 393 (1907).
11. Opelousas Compress Co. v. American Ins. Co., 88 F. Supp. 828, 830 (D.C. La. 1950).

water is converted when heated to the boiling point. Steam is an elastic fluid generated by heat to the boiling point of water."[12]

These definitions do not allow an individual to readily determine if steam is water. Both are fluids, but in different forms. Therefore, the important consideration is the distinguishing factor: form. Although a substance may have identical chemical compositions, the form (solid, liquid, gas) determines the use of that substance. In this case, water would not have driven the generators. The operation of the generators demanded a pressure much higher than liquid water can achieve. Similarly, ice can be used to build an igloo, but certainly liquid water or steam cannot. As the court in the present case noted, Congress did not qualify its use of the "water" by saying gaseous water or solid water, which it easily could have done. Therefore, the court's conclusion that water means only a liquid has merit.

A recent decision illustrates Arizona's approach to the problem of construing the meaning of the terms water and steam as used in its Constitution. The provisions in the Constitution provided that water was to be used for irrigation and steam was to be used for heating purposes. The court said "it is difficult to believe that the Framers of the [Arizona] Constitution intended to convey any greater significance to the word water than as it was used in its ordinary and natural sense. Nor does the context in which the word water was used indicate that it was to have a meaning other than a fluid."[13] To emphasize this point, Cardozo stated that the point of view in fixing a meaning of a term must not be that of the scientist. It must be that of the average man. This test, the common speech of men, is also the test to be applied by the courts.[14] From this line of argument, it is clear the words "water" and "steam" must be used in their ordinary sense as understood by common men. To the common man, steam and water are not the same thing. When Congress said water, it meant liquid and not gas.

12. Reynolds v. Washington Real Estate Co., 23 R.I. 197, 49 A. 707, 710 (1901).
13. Williams v. Pipe Trades Industry Program of Arizona, 100 Ariz. 14, 409 P.2d 720, 724 (1966).
14. Lewis v. Ocean Acc. & Guar. Corp., 224 N.Y. 18, 120 N.E. 56, 57 (1922).

Another inference to be drawn from a reading of the whole of section 613 is that Congress was specific concerning many of the minerals mentioned, i.e., Scoria—only scoria produced from natural deposits. Clay, refractory and fire. Only clay which has a pyrometric cone equivalent of 19 or higher.[15] From the exactness Congress used in describing these minerals, especially if the intent was to exclude all forms of water, it is difficult to imagine why, in their choice of the word water, Congress did not become specific, unless it is conceded that water was to be construed only as liquid.

Another line of argument the court could have used to justify its decision in the present case is reasoning by analogy from other cases which construe the other elements of 613(b)(7)(A). In a leading case, the court did allow cost depletion for underground water. The facts in that case were very similar to the facts in the present case.[16]

The evidence presented in *United States v. Shurbet*[17] was based upon testimony by geologists showing that the pressure of the Ogallala formation which held the trapped underground water was stable before pumping. The average annual natural recharge [water seeping in from above] was approximately equal to the average annual natural discharge. The water was in dynamic equilibrium.[18] The steam wells involved in the present case are also in dynamic equilibrium. The Internal Revenue Service in the *Shurbet* case attempted to argue that section 613(b)(7)(A), concerning water, applied to section 611 regarding cost depletion.[19] The court dismissed this contention on the grounds that some minerals which are not subject to percentage depletion may be subject to cost depletion.

In so holding, it indicated that the water involved in this case could not be classified as a mineral coming from an in-

15. Treas Reg. § 1.613-2(3)(b)(1) (1954).
16. United States v. Shurbet, *supra* note 3, at 105. For discussion of the *Shurbet* case and cost of depletion for water generally, *see:* Mitchell, *Impact of Shurbet-Cost Depletion*, 20 OKLA. L. REV. 225 (1967). *Cost Depletion for Water*, 15 OIL & GAS TAX Q. 7 (Oct. 1965). Sun Oil Co. v. Whitaker, 412 S.W.2d 680, 683 (Tex. Civ. App. 1967).
17. United States v. Shurbet, *supra* note 3, at 105.
18. *Id.*
19. INT. REV. CODE of 1954, § 611(a)—"In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion."

exhaustible source. Here the water, as in the present case, came from an inexhaustible source. If, then, exhaustibility is the key, exhaustible water is not included within the exception against water in section 613(b)(7)(A). Thus, it should be emphasized that the court apparently recognized a distinction between exhaustible water and non-exhaustible water.

In another leading case construing section 613(b)(7)(A), the court held that a taxpayer is entitled to a deduction for depletion of top soil (sod) under section 611 and granted the cost depletion for the sod sold to homeowners.[20] The decision was based on the fact that there was an actual loss of soil, and consequently, a loss of the length of production, which cannot be restored except at costs which are totally prohibitory. Again, the court was more concerned with the exhaustibility of a resource rather than with the mere categorizing of the resource as soil. Sod is also included with water as being exempt from percentage depletion under section 613(b)(7)-(A). If cost depletion is allowed for water and sod on the basis of exhaustibility, is there any reason from disallowing percentage depletion when the same resources are again exhaustible? The answer to this is beyond the scope of this article, but it appears that this could be an argument a court could use to justify a holding, such as the one in the present case.

Another example along the same lines is provided by the Internal Revenue, when it stated "soil in place is a natural deposit. If such soil is severed and sold by the landowner, the proceeds are ordinary income subject to a depletion allowance."[21]

The Internal Revenue has also provided an analogy relating to the previous discussion concerning the importance of the form that a resource assumes. This is relevant as it concerns mosses, which are also excluded from depletion under section 613(b)(7)(A). The Service has ruled that peat moss is a natural deposit for which percentage depletion is allowed. The origin of peat is from the disintegration of moss. Likewise the origin of steam is from a change of water. Therefore peat moss is entitled to this depletion, but moss is not while it

20. Fiona Corp. v. United States, 218 F. Supp. 354 (S.D. Fla. 1963).
21. REV. RUL. 78, 1953-1 CUM. BULL. 18.

is still in the form of moss and before it becomes peat, since moss is specifically excluded.[22] Cannot the same be said of water? Water is excluded until it undergoes the requisite change of form and becomes steam. The molecular structure of moss and peat moss are the same; likewise the molecular origin of water and steam is the same.

The foregoing analysis is presented to show the various methods courts could have used, if it so chose, to arrive at its holding. The "pegs" may appear to be inconsistent, but there is an underlying key which will be discussed after the determination of the next issue, namely, "Is steam a gas?"

Agreeing with the court that steam is not water, and therefore, is not excluded from a percentage depletion, the next question facing the court was deciding if steam was a gas and thereby entitled to fall within section 613(b) which allows a "27½ percent depletion allowance for oil and gas."[23]

The discussion again must turn to judicial precedents established by the courts in determining the definitions of steam and gas, for the meaning of the term "gas," as used in the Internal Revenue Code, has not been defined within the Code. Also, specific and illuminating legislative history on the point does not appear to exist.

> The term "gas" is, in a sense a generic term and is broad and sweeping in its meaning . . . it is an aeriform fluid, a term at first used by chemists as synonymous with air, but since restricted to fluids supposed to be permanently elastic, as oxygen, hydrogen, etc., in distinction from vapors, as steam, which became liquid on a reduction of temperature. In present usage, since all of the supposed permanent gases have been liquified by cold and pressure, the term has resumed nearly its original significance and is *applied to any substance in* elastic or aeriform state.[24] [Emphasis added.]

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22. REV. RUL. 57-336, 1957-2 CUM. BULL. 325.
23. INT. REV. CODE of 1954, § 613(b), "The mines, minerals, and other natural deposits, and the percentages are as follows . . .: (1) 27½% for oil and gas." This is the only category allowed to receive the full 27½% allowance.
24. Birss v. Order of United Commercial Travelers of America, 109 Neb. 226, 190 N.W. 486 (1922). *See also:* Lamar v. Iowa State Traveling Men's Ass'n., 216 Ia. 317, 249 N.W. 149 (1933).

Another court defined gas as an *aeriform fluid,* having neither independent shape nor volume, but tending to expand indefinately.[25]

From the beforementioned definition of "steam"—"steam is the elastic aeriform fluid"[26]—it can be said that steam clearly falls within other courts' definitions of gas. Therefore, the court was correct in concluding steam is a gas. The question then arises as to whether Congress intended gas to have a common meaning when it used the term in the depletion statute or whether it sought to give it a specific meaning, relating only to petroleum gas, particularly since the term "gas" follows the term "oil." Again the court based its decision of this question on the *Blue Ridge* case, and stated that the court must construe the terms in the depletion statutes in light of their ordinary commercial usage. Again he argument can be raised that if Congress intended gas to mean only hydrocarbon petroleum gas, it could have easily imposed its will to that effect by merely adding the requisite adjectives. Instead, Congress chose only o use the word gas, therefore, all of the ramifications of that word must be considered, as the court did in the present case. The court states that it would indeed be perilous to cast the burden of taxation on the basis of speculation about specific cases actually envisioned by Congress, when it enacted a statute using general terms to enact legislation the benefit of which the taxpayer seeks.[27]

The reader at this point has probably gathered that the court in the present case pulled a shot in the dark. As mentioned previously, there is a void of cited material for precedent in the opinions. The reader might also feel that the inferences and analogies may be dubious. With this contention the writer cannot agree. The precedents and analogies were presented in light of providing the proverbial pegs on which the court could have hung its decision. The court in the present case expanded the depletion allowance to steam with an eye on the policy for percentage depletion. As mentioned before, there is a key which runs through the inferences,

25. Roy v. Arkansas-Louisiana Gas Co., 200 La. 233, 7 So.2d 895, 896 (1942). *See also:* Undercofler v. Colonial Pipeline Co., 114 Ga. App. 739, 152, S.E.2d 769 (1966).
26. Reynolds v. Washington Real Estate Co., *supra* note 12.
27. Arthur E. Reich, P—H Tax Ct. Rep. ¶ 52.74, at 506 (July 31, 1969).

precedents, and the opinion of the court. This key is the exhaustibility versus the inexhaustibility of a natural resource. Depletion allowances, as a matter of legislative grace, are predicated on congressional recognition of the fact that extraction of *exhaustible* natural resources results in a reduction of the taxpayers' reserve of the commodity being depleted. It enables the taxpayers to achieve a tax free return of the capital exhausted during that period.[28] An example of an inexhaustible resource for which a depletion allowance is not given is saline minerals extracted from the water of the Great Salt Lake. These minerals continually replenish themselves.[29]

In the present case, the court, in the last analysis, decided that if the natural resource is exhaustible, the percentage depletion allowance must be given. It is submitted that this decision can only apply in a fact situation such as is found in the present case. In a given fact situation, wherein it is demonstrated the resource is inexhaustible, most cetrainly, the holding of this case could not be used as precedent.

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28. Mitchell, *Impact of Shurbet, supra* note 16. For a discussion of the history and justification of percentage depletion generally *see:* Mielke, *Petroleum Depletion Allowance: A Justification,* 55 KY. L. J. 158 (1966). Peloubet, *Depletion for United States Income Tax Purposes,* 15 OIL & GAS TAX Q. 137 (April 1966).
29. REV. RUL. 65-7, 1965-1 CUM. BULL. 254.