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(1976), Does Not Include Depreciable Drilling
and Development Costs Recognized in Treas. Reg.
§ 1/612-4(c) (1) (1976)

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United States v. Hill

**“ADJUSTED BASIS,”
AS USED IN
26 U.S.C. § 57 (a)(8) (1976),
DOES NOT INCLUDE
DEPRECIABLE DRILLING
AND DEVELOPMENT COSTS
RECOGNIZED IN
TREAS. REG.
§ 1/612-4(c)(1) (1976).**

Justice Souter, writing for a unanimous court, authored *United States v. Hill*, 113 S. Ct. 941 (1993), which resolved the conflict surrounding the term “mineral deposit” in the definition of “property” in 26 U.S.C. § 614(a) (1976). The Court held that depreciable drilling and development costs identified in Treas. Reg. § 1.612-4(c)(1) (1976) may not be included in the “adjusted basis,” as used in 26 U.S.C. § 57(a)(8) (1976), of a depletable mineral deposit.

In 1981 and 1982, William F. and Lola E. Hill were in the oil and gas exploration and production business, and deducted \$439,884 and \$371,636 on their federal income tax returns for depletion of oil and gas deposits for those respective years. Included in the deductions were unrecovered costs of depreciable tangible items such as machinery, tools, and pipes. Under § 57(a)(8), the excess of the allowable depletion deduction for each deposit interest over the adjusted basis for each interest is an “item of tax preference” and is assessed a “minimum tax.” The Hills paid taxes of \$29,812 for 1981 and \$26,736 for 1982 on those items.

The Commissioner of Internal Revenue assessed deficiencies based on the improper inclusion of tangible costs in the adjusted bases. The taxpayers paid the respective deficiencies of \$30,963 and \$18,733, and filed a refund claim which the Commissioner denied. The Hills sued the United States for a refund in the claims court and were granted summary judgment. The decision was affirmed by the Court of Appeals for the Federal Circuit, and the United States Supreme Court granted certiorari.

The Supreme Court began its analysis of the facts of the present case by noting that under 26 U.S.C. § 263(c) (1976), taxpayers may deduct “certain ‘intangible drilling and development costs.’” *Id.* at 947. The Court pointed out, however, that the Treasury Regulations limit the costs

recoverable by distinguishing “intangible costs” from “capital items,” also referred to as “tangible costs.” *Id.* (citing 26 U.S.C. § 263(c) (1976)). The Court recognized that the Hills wanted to include these capital items in the adjusted bases of their deposit interests to the extent that they had not been depreciated, in an attempt to reduce their minimum tax liabilities. *Id.*

The Supreme Court next explained that in defining “property,” § 57(a)(8) refers to § 614, “which speaks in terms of the adjusted basis of ‘each separate interest owned by the taxpayer in each mineral deposit.’” *Id.* (quoting 26 U.S.C. § 614(2) (1976)). In turn, the Court explained further, Treas. Reg. § 1.611-1(d)(4) (1976) defines “mineral deposit” as “minerals in place.” *Id.* However, Treas. Reg. § 1.611-1(d)(3) (1976) defines the term “mineral enterprise” to include “the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas.” *Id.* (emphasis omitted). The Court indicated that because these regulatory definitions were well-established at the time Congress passed § 57(a)(8), it is reasonable to assume that Congress was aware of the distinction when it made reference to “mineral deposit” in § 614. The Court stated that “property” as used in § 57(a)(8) excludes the tangible costs the Hills wanted to include in the adjusted basis. *Id.* at 947-48.

The taxpayers asserted that the term “mineral enterprise” has a limited function and occurs in only one operative provision in the regulations, Treas. Reg. § 1.611-1(d)(4). They pointed out that Treas. Reg. § 1.57-1(h)(3) (1976), in implementing § 57(a)(8), references 26 U.S.C. § 1016 (1976) for the determination of adjusted basis. *Id.* at 948. The calculation of adjusted basis under § 1016, the taxpayers argued, is independent of the definition and function of “mineral enterprise” in § 611 regulations.

Id.

The Supreme Court agreed that § 1016 provides for the proper calculation of adjusted basis, but rejected the calculation under § 1016 as independent of an understanding of the distinction between “mineral deposit” and “improvements” within the meaning of the § 611 regulations. *Id.*

The Hills directed the Court’s attention to the last phrase of Treas. Reg. § 1.1016-2(a) (1976): “The cost or other basis shall be properly adjusted for any expenditure . . . or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property.” *Id.* They asserted that “improvements” and “betterments” include all valuable additions beyond mere repair. In addition, the taxpayers stated that the tangible costs incurred in developing the deposits have increased their value, and “are specifically referred to in the regulations implementing § 611 as ‘improvements.’” *Id.* Therefore, the Hills argued, the tangible costs were properly included in adjusted basis for the purposes of § 1016.

The Court negated the taxpayers’ argument by noting that the phrase “including the cost of improvements and betterments made to the property” in Treas. Reg. § 1.1016-2(a) is not a guide to inclusions or exclusions from adjusted basis, but rather ensures the coordination of § 1016 with 26 U.S.C. § 263 (1976). *Id.* at 948. Section 263 provides that capital expenditures may not be deducted from current income. *Id.* at 948-49. The Court pointed out that expenditures prohibited from being deducted because they are deemed “improvements and betterments” may be recovered later through various recovery methods such as depreciation or depletion. *Id.* at 949.

The Court stated that the question of whether drilling and development costs are included in adjusted basis is answered by following the

directives set forth in § 1016. Section 1016(a)(2) “requires a taxpayer to subtract from his original basis in the property sold or exchanged ‘not less than the amount allowable’ [for exhaustion, wear and tear, obsolescence, amortization, and depletion] ‘under this subtitle or prior income tax laws.’” *Id.* The Court indicated that a taxpayer must determine whether parts of an item sold have different tax treatments, and must categorize such parts as different properties for the purposes of § 1016. *Id.* The Court explained that if a mineral deposit and associated equipment are sold together, then § 1016 requires that these properties be separated for the purpose of determining gain or loss on the sale. The Court concluded that since Treas. Reg. § 1.57-1(h)(3) incorporates § 1016 into § 57(a)(8), the taxpayers’ tangible costs may not be included in adjusted basis for the purpose of calculating the amount of depletion subject to the minimum tax. *Id.* at 951.

In *United States v. Hill*, the United States Supreme Court ruled that ad-

justed basis, as used in § 57(a)(8), excludes depreciable drilling and development costs identified in Treas. Reg. § 1.612-4(c)(1). Justice Souter noted that a taxpayer would like to include as much as possible in adjusted basis because the amount subject to the minimum tax is reduced dollar-for-dollar. Due to the Court’s choice of a narrow definition of “mineral deposit,” and the requirement of separating the deposit from its associated equipment under § 1016, a taxpayer may not recover the cost of depreciable tangible items in this manner. The difference in minimum tax liabilities may be significant. For instance, in the present case, the Hills were able to approximately halve their minimum tax liabilities by including the tangible items in adjusted basis. Although the cost of the tangible items is recoverable under the depreciation method, given time value of money considerations, this method is less beneficial to the taxpayer.

- Paul J. Mantell

