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istrative action. Judicially, this may be accomplished by engrafting an exception on the *Silverman* doctrine by including short term straddles (i.e., matched puts and calls for options issued for less than six months) within the scope of section 16(b). This would be difficult, however, in view of the technical rationale set forth by both the District and Circuit Courts in *Silverman.*

The better remedy rests with the Securities Exchange Commission. Administratively, the Commission has the power to bar insiders from issuing or acquiring put and call options singly as well as in combination. This power exists pursuant to sections 9(b), (c) of the act.[35] It is submitted that the Commission should exercise this power and avoid the problem of the insider realizing short-swing profits which now can be obtained with immunity under the doctrine of *Silverman.*

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ECONOMIC INTEREST AND DEPLETION ALLOWANCE FOR MINING CONTRACTORS

In recognition that minerals, oil, gas and other natural deposits are wasting assets and that capital is consumed in the process of extracting these deposits from the earth, a reasonable depletion allowance deduction[1] is accorded to a taxpayer who has an economic

[35]"Sections 9(b) and 9(c) of the act give the Commission rule-making power with respect to the acquisition, endorsement and guarantee of any put, call, straddle or other option." The Commission has been reluctant to utilize this power in the past, presumably because the anti-manipulative weapons have worked so well. The Commission has sought to avoid the needless hampering of the legitimate use of options. Loss, Securities Regulation 1544 (2d ed. 1961).

There are principally two ways in which the Commission may assert its views as to the proper interpretation of the statute and avoid utilizing its rule-making powers. One is by issuing an opinion as to its views in the form of a press release, letter, or informal statement. This method is not feasible here since the Commission does not have any function in the enforcement of private litigation under § 16(b), and does not undertake to predict how the courts might resolve the enforcement of private actions under § 16(b). Administrative interpretations relating to § 16(b) are rendered by the second method, i.e., when an issue of sufficient importance is raised concerning the administration of the act, the Commission may request permission to file a brief as amicus curiae (as in Silverman). Cook and Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 387-88 (1953).

[1]This allowance is deductible from gross income in determining adjusted gross income for federal tax purposes. Int. Rev. Code of 1954, § 62(5), (6).

interest in such deposits.[2] The depletion allowance deduction is intended to compensate the taxpayer for the exhaustion of assets consumed in the production of income.[3]

A mineral owner, a royalty owner,[4] a long-term lessee and an overriding royalty owner[5] clearly have an economic interest in the mineral deposit. Without question, they are entitled to the benefit of the depletion allowance.[6]

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[2]"In the case of mines, oil and gas wells, [and] other natural deposits..., there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate." Int. Rev. Code of 1954, § 611(a).

Pursuant to the authority delegated, the regulations provide: "Annual depletion deductions are allowed only to the owner of an economic interest in the mineral deposit. ... An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in the mineral in place..., and secures, by any form of legal relationship, income derived from the extraction of the mineral. ..., to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit...does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction...does not convey a depletable economic interest." Tres. Reg. § 1.611-1(b) 1 (1963).

[3]Helvering v. Bankline Oil Co., 303 U.S. 362, 366 (1938). There are presently two kinds of depletion allowances in connection with natural deposits. They are cost depletion (Int. Rev. Code of 1954, § 612) and percentage depletion (Int. Rev. Code of 1954, § 613). Whichever method will produce the greater deduction is the method taxpayer, in any particular year, is presently required to use. Int. Rev. Code of 1954, § 613(d). See 4 Mertens, Federal Income Taxation § 24.35, following n.13 (1960). Only the percentage depletion method is dealt with in this comment.

The percentage allowance "is subject to both of two limitations, namely, to a prescribed fraction of the 'gross income from the property' and also to 50% of the 'taxable income from the property.' In the case of oil and gas wells, the fraction in the first limitation is 27½%; in the case of other various types of mineral properties, that fraction varies from 5% to 23%. Inasmuch as neither of the two limitations bears any relationship to cost, it is readily apparent that through percentage depletion a taxpayer may recover more than his cost over the life of the property." 4 Mertens, Federal Income Taxation § 24.31(a) (1960). See Commissioner v. Southwest Exploration Co., 350 U.S. 308, 312 (1956).

[4]An example of a royalty interest is as follows: Mineral owner A sells his mineral rights to B, reserving to himself, his heirs and assigns, a percentage of any mineral extracted. A owns a royalty interest.

[5]An example of an over-riding royalty is as follows: B leases mineral rights from owner A. Then B assigns the lease to C, reserving to himself, his heirs and assigns, a percentage of the mineral extracted by C, his agents or assigns. An overriding royalty interest is owned by B. See 4 Mertens, Federal Income Taxation § 24.23(a) n.58 (1960).

[6]Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946) (holding that an

As is sometimes the case, especially in the coal mining industry, a mineral owner or a long-term lessee may enter into a contract with an independent contractor for the extraction of the mineral, oil, gas or other natural deposit, which is then to be sold by one or the other of the parties to the contract.[7] A difficult problem exists as to such arrangements: whether or not the depletion allowance deduction is available to the independent contractor.[8] Agreements of this nature are often so complex and intricate that the problem is difficult to resolve.[9] However, the underlying problem, as in the other mentioned types of legal relationships, is whether or not the contractor has acquired an "economic interest" in the natural deposit.[10]

In a recent case, *McCall v. Commissioner*,[11] the Court of Appeals for the Fourth Circuit was called upon to decide whether, under the facts involved, independent contractors had a sufficient economic

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over-riding royalty owner has an economic interest in the mineral deposit and is entitled to the depletion allowance).

But, where there are several with economic interests in the same mineral deposit, the depletion allowance must be apportioned equitably among them. Equitable apportionment is provided for by § 613 of the Int. Rev. Code of 1954 which requires that the percentage depletion be applied against "gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect to the property."

Example. A leases coal-bearing lands to B on condition that B will annually pay a royalty of 25 cents a ton on coal mined and sold by B. During the year 1956, B mines and sells f.o.b. mine 100,000 tons of coal for $600,000. In computing "gross income from the property" for the year 1956, B will exclude $25,000 (100,000 tons x $0.25) in computing his allowable percentage depletion deduction. B's allowable percentage depletion deduction (without reference to the limitation based on taxable income from the property) for the year 1956 will be $57,500 (($600,000-$25,000) x 10 percent). Treas. Reg. § 1.613-2(c)5(i) (1963). A's "gross income from the property" is $25,000 and to determine his percentage depletion allowance deduction the applicable percentage (10% in this example) will be multiplied times the $25,000 he received. See Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934).

[7]See 4 Mertens, Federal Income Taxation § 24.28 (1960). Usually such contracts do not mention whether or not the transfer of an interest in the mineral deposit to the contractor was intended. The contract may not, however, effectively provide that the contract-miner has an economic interest if in fact he does not. See William M. Legg, 39 T.C. 21, 28 (1962).

[8]Also to be considered is the problem of whether or not the other party to the contract (mineral owner or long-term lessee) must suffer a reduction of his percentage depletion allowance by having to reduce his "gross income from the property," to which the percentage depletion fraction is applied, by the amount of his payment (in kind or in money) to the independent contractor. See Commissioner v. Gregory Run Coal Co., 212 F.2d 52, 55 (4th Cir. 1954), where, through the consolidation of two cases, both facets of the problem were involved.

[9]Commissioner v. Southwest Exploration Co., 350 U.S. 308, 313 (1956).

[10]Supra note 2.

[11]312 F.2d 699 (4th Cir. 1963).

interest in the mineral in place to be entitled to a percentage depletion allowance deduction.

In the *McCall* case, taxpayer-contractors had obligated themselves to extract by deep mining[12] and to deliver coal from a certain leasehold interest to Norman Mining Company, which had a twenty-year lease right to mine the property. The term of the contract with taxpayer-contractors was made coextensive with the term of the mining company's lease. Under the provisions of the contract, taxpayer-contractors were to furnish all the machinery and labor, maintain all roads, lay all track, etc., for the deep-mining operation. Taxpayers were given the exclusive right to do the mining. They were to be paid a fixed price per ton delivered with a provision for adjustment due to market fluctuation. The mining company reserved the right, if by reason of economic conditions it was unable to sell at a reasonable profit the coal mined and delivered to it by taxpayers, to require taxpayers to suspend mining upon twenty-four hours notice. The contract further provided, however, that *"either party may terminate this Contract, without cause, after thirty (30) days notice, in writing, to the other party, of his or its intention so to do."*[13] The Court of Appeals, in affirming the Tax Court, held that taxpayers did not have such an "economic interest" in the coal in place as to entitle them to a depletion allowance deduction.

Development of the "economic interest" concept began in *Palmer v. Bender*,[14] decided by the United States Supreme Court in 1933. In that case the Court held that two lessees had acquired an "economic interest" in oil in place even though legal title was in their lessor, in retaining an overriding royalty by transferring their operating rights to two oil companies, they had retained an "economic interest" in the oil in place. In holding that their retained "economic interest" entitled them to a depletion allowance deduction,[15] the Supreme Court said:

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[12]"Deep mining involves the sinking of shafts or the driving of slopes or drifts from the surface into the mineral deposit and the underground development of entries or galleries from which the mineral is removed for transportation to the surface." 19 Wash. & Lee L. Rev. 276 n.1 (1962).

[13]312 F.2d at 701. (Emphasis added by the court.)

[14]287 U.S. 551 (1933).

[15]Previous to the Palmer v. Bender decision, many of the judicial decisions and administrative rulings generally took the position that the right to the depletion allowance deduction rested upon considerations of title, necessitating highly technical differentiations between an assignment and a sublease. The struggle revolved around the right of a lessee to the allowance after he had transferred his operating rights, while retaining an overriding royalty. See 4 Mertens, Federal Income Taxation § 24.20 (1960).

The United States Supreme Court, in Lynch v. Alworth-Stephens Co., 267

"The language of the statute [providing for depletion allowance] is broad enough to provide, at least, for every case in which the taxpayer [claimant] has acquired, by investment, any interest in the oil [or other natural deposit] in place, and secures, by any form of legal relationship, income derived from the extraction of the oil [or other natural deposit], to which he must look for a return of his capital."[16]

Following the decision in the *Palmer* case, the "economic interest" test was incorporated in the regulations, in its present wording, as follows:

"Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits.... An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place. ..and secures, by any form of legal relationship, income derived from the extraction of the mineral. .., to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit. ..does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter... to compensation for extraction...does not convey a depletable economic interest."[17]

It was in this setting, before the Supreme Court decided *Parsons v. Smith*[18] in 1959, that the Tax Court and the lower federal courts dealt with the problem of what factors would result in a contract-

U.S. 364 (1925) settled this question by holding that "property interest," and "not legal title," was the test and that a royalty owner had a property interest in the natural deposit in place, although he did not have legal title.

The differences between Palmer v. Bender and Lynch v. Alworth-Stephens Co. are two: (1) the Palmer case involved an over-riding royalty owner, whereas the Lynch case involved a royalty owner, and (2) in the Palmer case, the Court spoke in terms of "economic interest," whereas in the earlier Lynch case, it spoke in terms of "property interest."

[16]287 U.S. at 557.

[17]Treas. Reg. § 1.611-1(b)1 (1963). The next to the last sentence in the regulation is the product of a refinement on Palmer made in Helvering v. Bankline Oil Co., 303 U.S. 362 (1938).

It should be noted that the regulation is not comprehensive in its definition. The regulation undertakes only to state extremes. Cf. 4 Mertens, Federal Income Taxation § 24.19(a) n.99 (1960).

[18]359 U.S. 215 (1959).

producer having such an "economic interest"[19] as to entitle him to share the depletion allowance.[20]

In the decided cases, the contracts generally contained provisions dealing with (1) the party required to furnish machinery and equipment to carry out the mining operation, (2) the method and amount of compensation to the contractor, (3) the rights of the parties regarding cancellation, and sometimes, (4) the rights of the parties regarding suspension of operations.[21]

A conflict arose between the Third and Fourth Circuits as to the weight to be given to a contractor's investment in mining equipment, required to be furnished by him pursuant to the contract. The Fourth Circuit held in *Commissioner v. Hamill Coal Corp.*[22] that such an investment resulted in the contractor having an economic interest in the natural deposit.[23] However, the Third Circuit in *Parsons v. Smith*[24] took a different view of such a capital investment in mining equipment. The court said:

> "[I]t is very doubtful whether investment in equipment of general utility in a contractor's business is the type of capital expenditure which can properly be found to constitute an investment in a particular mineral deposit which the contractor has undertaken to work."[25]

The factor given the most prominence by the Circuit Courts, in deciding whether or not a contractor has acquired an economic interest, has been the existence or absence of a provision in the contract

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[19]"At first blush the phrase 'economic interest' appears to be simple in meaning. Like so many other simple expressions in the tax law, however, that phrase has given rise to considerable litigation and presumably will continue to do so for sometime." 4 Mertens, Federal Income Taxation § 24.19 n.97 (1960).

[20]Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934). See supra note 6.

[21]See Commissioner v. Mammoth Coal Co., infra note 33.

[22]239 F.2d 347 (4th Cir. 1956). The Tax court in Walter Bernard McCall, 27 T.C. 133 (1956), made a similar holding on substantially the same operative facts. This case was not appealed.

[23]The court in Hamill points out in its opinion, as an additional consideration, that the contractor had the sole right to carry out the mining operation. No mention is made in the opinion, however, of a provision in the contract, disclosed in the court's statement of the facts, which gave to either party, after one year, the right to cancel the contract without cause.

In Commissioner v. Gregory Run Coal Co., 212 F.2d 52 (4th Cir. 1954), the court held that the contractor had an economic interest in the deposit even though the necessary mining equipment was furnished to the contractor by the other party, a long-term lessee, pursuant to the contract. In this case, the contract was not terminable without cause.

[24]255 F.2d 595 (3d Cir. 1958).

[25]Id. at 599.

giving the other party, a mineral owner or a long-term lessee, the right to short-term cancellation without cause. In cases involving contracts providing for such cancellation, the courts usually held that the contractor had not acquired an economic interest in the deposit.[26] On the other hand, in two cases decided by the Fourth Circuit, involving contracts cancellable only for cause, the court held that the contractor had acquired an economic interest in the mineral deposit.[27]

The United States Supreme Court in *Parsons v. Smith*,[28] decided in 1959, interpreted the economic interest requirement, established by it in the *Palmer* case, and held that a contract-miner whose contract was terminable by the mineral owner without cause on short notice had not acquired an economic interest in the mineral deposit. In the *Parsons* case, the Court listed seven factors in support of its conclusion:

> "(1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered... and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts."[29]

In the *McCall* case, the Fourth Circuit said "the Parsons decision... constituted a marked shift in emphasis if not in basic law... of the circumstances where a depletion deduction could lawfully be claimed."[30] The court then proceeded to say that the determining

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[26]Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959); Parsons v. Smith, 255 F.2d 595 (3d Cir. 1958); Emil Usibelli, 23 P-H Tax Ct. Mem. 585 (1954), aff'd, 229 F.2d 539 (9th Cir. 1955). But cf. Commissioner v. Hamill Coal Corp., supra. notes 22 & 23.

[27]Stillwell v. United States, 250 F.2d 736 (4th Cir. 1957); Commissioner v. Gregory Run Coal Co., 212 F.2d 52 (4th Cir. 1954), cert. denied, 348 U.S. 828 (1954). See supra notes 22 & 23. Also see James Ruston, 19 T.C. 284 (1952).

[28]359 U.S. 215 (1959).

[29]Id. at 225.

[30]312 F.2d at 706. The court of necessity had to conclude that the Parsons case constituted a "marked shift in emphasis if not in basic law" in order to

factor is whether or not the contract is subject to termination by the owner or long-term lessee and not the extent of the taxpayer's capital expenditure.[31] Applying that test, the court concluded that the contractor was not entitled to share in the depletion allowance, since the contractor's rights under the contract were subject to short-term cancellation without cause and he, therefore, had no economic interest in the mineral deposit.[32] It is submitted that the court is wrong, both in asserting that *Parsons* brought about a shift in the law and in holding that capital investment is no longer important. First, the *Parsons* decision did not shift emphasis or change the law; it merely emphasized the factors to be considered in determining whether or not an economic interest has been acquired by a contract-miner. The Court in *Parsons* makes it clear that the interest "acquired by investment" statement made by it in *Palmer* had reference to investment in the mineral in place and not investment in equipment used to extract the mineral. When the Court shifted from "property interest" to "economic interest" in *Palmer,* it was recognizing, perhaps, that "economic interest" is a broader concept than "property interest" and that, although all "property interests" are "economic interests," the reverse is not necessarily true. And, in speaking of interests acquired by investment, the Court was probably recognizing that those "economic interests" which are "property interests" are many times acquired by purchase. Second, capital investment may still be an important consideration in other than contract-mining cases.

None of the contract-mining cases, including *Parsons,* undertake to do more than state that the presence or absence of terminability on short notice without cause will result in the contractor not acquiring or acquiring, as the case may be, an economic interest. Such statements seem to be no more than assertions, but it is submitted that there is a rational underlying explanation for such conclusions.

A contract-miner, with the right to mine to exhaustion, is in the same position in this respect as a long-term lessee who does not necessarily have to have any investment in the mineral in place. There is one inherent distinction between the usual contractor's position

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avoid the application of res judicata. This same question on identical facts had been litigated in a previous year. In the previous litigation, the taxpayer prevailed in the Tax Court, and the decision was not appealed. See supra note 22.

[31]See Stilwell v. United States, 250 F.2d 736 (4th Cir. 1957). For two recent Tax Court holdings to the same effect as the McCall holding, See Raymond E. Cooper, 39 T.C. 188 (1962); William M. Legg, 39 T.C. 21 (1962).

[32]The Supreme Court holding in the Parsons case and the Fourth Circuit holding in the McCall case necessarily nullify the Fourth Circuit's holding in the Hamill case, supra note 22.

and the usual lessee's position. The agreement between a mineral owner or a long-term lessee and the contract-miner usually provides that the contractor will extract and make delivery to the owner, or long-term lessee, as the case may be, of a controlled volume of the mineral. In this respect the contractor is in the position of the usual royalty owner; he has no control over production.

When the contractor enters into a contract which is terminable only for cause, he, like a royalty owner, a long-term lessee, or an over-riding royalty owner, looks to the entire deposit for the "possibility of profit." On the other hand if the contract is terminable on short notice without cause, the contractor has no right to expect his profit to be measured by the entire deposit. In such a case there is no analogy which can be made to the lease situations, and the contractor is nothing more than a hireling, deriving an economic advantage from the contract, while in force.[33]

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[33]Viewed as having such an underlying rational basis, the holdings of two cases, otherwise difficult to understand, become justifiable.

In Commissioner v. Mammoth Coal Co., 229 F.2d 535 (3d Cir. 1955), cert. denied, 352 U.S. 824 (1956), an owner had entered into an agreement with a stripping contractor, giving it the exclusive right to mine certain coal veins. The contract was not cancellable without cause but did give the owner the right to suspend production indefinitely on five days notice. In the event of such suspension, the contractor had the right to cancel the contract. The court held that the contractor had acquired an economic interest entitling it to share the depletion allowance. Based on an analogy to lease situations, the decision seems to be sound. A lessee inherently has the right to give up his lease. This inherent right, however, does not impair his entitlement to the depletion allowance deduction. Also, an owner's power to suspend the contract-miner's production would not be inconconsistent with the contractor having an economic interest in the deposit. When and if production is resumed, the contractor has the exclusive right to extract the mineral; the contractor has retained his right to look to the entire deposit for "the possibility of profit."

The other case is Weirton Ice & Coal Supply Co. v. Commissioner, 231 F.2d 531 (4th Cir. 1956). In that case the contractor's right to mine the mineral was terminable by the owner on short notice without cause. The Fourth Circuit held that the contractor had an economic interest in the deposit. In so holding, the court relied on its decision in Commissioner v. Hamill Coal Corp., 239 F.2d 347 (4th Cir. 1956). The decision of the Supreme Court in the Parsons case necessarily nullified the holding of the Fourth Circuit in the Hamill case; but it did not nullify, necessarily, the holding in Weirton. There was a peculiar twist in the Weirton facts; if the owner cancelled the contract, the owner was obliged to reconvey the property to the contractor, who had conveyed it to the owner as part of the production contract arrangement. Thus, the contractor had the exclusive right to mine to exhaustion whether or not the contract was terminated.