

BURNET, COMMISSIONER OF INTERNAL REVENUE, *v.* A. T. JERGINs TRUST.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

No. 541. Argued February 15, 16, 1933.—Decided March 13, 1933.

1. A city made an oil and gas lease to a private party, covering part of a tract owned by the city and used by it for water supply and other purposes. Under the lease the oil and gas recovered were sold by the parties jointly and the proceeds were divided in stated proportions between them. *Held* that a federal tax on the receipts of the lessee was not invalid, since the subject taxed was so remote from any governmental function that the effect of the exaction on the city's activities was inconsiderable, and its collection was consistent with, and did not trench upon, the immunity of the State as a sovereign. P. 514.
 2. In determining net income under the Revenue Act of 1921, capitalized expenses for drilling and developing oil wells may not be deducted from gross income as depreciation allowance. *United States v. Dakota-Montana Oil Co.*, *ante*, p. 459; *Petroleum Exploration v. Burnet*, *ante*, p. 467. P. 516.
- 61 F. (2d) 92, reversed.

CERTIORARI * to review a judgment reversing a decision of the Board of Tax Appeals, 22 B. T. A. 551.

Assistant Attorney General Youngquist, with whom *Solicitor General Thacher*, and *Messrs. Whitney North Seymour, Sewall Key, and Francis H. Horan* were on the brief, for petitioner.

A tax offends against the implied limitation only if it is imposed directly upon the governmental instrumentality of the State, or if, though not so imposed, its effect is to place a substantial burden upon the exercise of a governmental function. *Willcuts v. Bunn*, 282 U. S. 216; *Metcalf & Eddy v. Mitchell*, 269 U. S. 514, 525; *Indian Motorcycle Co. v. United States*, 283 U. S. 570, 576.

* See Table of Cases Reported in this Volume.

Much of the land acquired was not presently required in connection with the business of water-supply that the city took over from public service corporations. It was therefore available, as property owned by the city but not presently needed, for such nongovernmental uses as might be most profitable; and leases to various tenants were made for various strictly private uses. The situation is the reverse of that presented in *Trinidad v. Sagrada Orden*, 263 U. S. 578, 582, in that the city instead of adhering to and advancing the purpose for which the lands were originally acquired, stepped aside from that purpose and devoted them to general business pursuits. The mere fact that the lessor was a municipality does not render the tenant immune from taxation, for it is a matter of common knowledge that municipalities exercise functions which are purely proprietary as well as those which are strictly governmental. See *Vilas v. Manila*, 220 U. S. 345, 356. The lessee must show that imposition of the tax upon its income will result in substantial interference with the performance by the city of some strictly governmental function. The record does not disclose the use to which the royalties paid the city were put; but assuming that they were devoted to governmental purposes, such use would not be sufficient basis for exemption of such receipts. *South Carolina v. United States*, 199 U. S. 437; *Olson v. North Dakota*, 33 F. (2d) 848, appeal dismissed for lack of jurisdiction, 280 U. S. 528.

The situation at bar is not different from a case where a city leases vacant land to one who erects an office building thereon, or to a farmer for agricultural purposes. Certainly the income of the lessee would not be exempt from tax. In such cases the city is a mere proprietor engaged in business for profit.

The fact that the city originally acquired the lands in connection with other lands acquired for water purposes

does not require a different conclusion. The oil lease to the respondent had nothing to do with the supply of water. The land was, in effect, segregated from the rest of the tract and devoted to other and wholly different purposes.

The tax has no economic effect upon the performance of any governmental function of the city. The supplying of water, while undoubtedly a "public" or "municipal" purpose, is not a strictly governmental function. *Davoust v. Alameda*, 149 Cal. 69, 72-73; *South Pasadena v. Pasadena Land Co.*, 152 Cal. 579, 593; *Morrison v. Smith Bros.*, 211 Cal. 36, 45; *Chafor v. Long Beach*, 174 Cal. 478, 483; *Marin Water Co. v. Sausalito*, 168 Cal. 587, 594-595; *Sincerney v. Los Angeles*, 53 Cal. App. 440, 447. This view of the California courts is supported by the weight of authority elsewhere. Cf. *Flint v. Stone Tracy Co.*, 220 U. S. 107, 172; *South Carolina v. United States*, 199 U. S. 437, 462.

In the *Coronado* case, 285 U. S. 393, there was the combination of circumstances that the land leased had been dedicated by the grant from the United States and the organic law of Oklahoma to the furtherance of a governmental function, and that the proceeds of the leases were required to be paid into the school fund. The lands in the *Gillespie* case, 257 U. S. 501, were held in trust for the Indians by the United States. The Court therefore concluded that the leases were governmental instrumentalities. In the case at bar, the city was free to devote its profits from the lease to any purpose, whether proprietary or governmental. So far as appears from the record, the functions of the city were not in any way affected by the tax on respondent's income.

The exemption of an instrumentality of one government from taxation by the other must be given a practical application, without an undue impairment either of the taxing power of the one or of the appropriate exer-

cise of its functions by the other. *Susquehanna Co. v. Tax Comm'n*, 283 U. S. 291, 294; *Metcalf & Eddy v. Mitchell*, 269 U. S. 514, 523, 524.

One who seeks to escape the burden of a tax must show the facts which entitle him to relief. See *Willcuts v. Bunn*, 282 U. S. 216, 230, 231. See also *Phillips v. Dime Trust & Savings Bank*, 284 U. S. 160, 167; *Burnet v. Houston*, 283 U. S. 223, 227; *Niles Bement Pond Co. v. United States*, 281 U. S. 357, 361; *Reinecke v. Spalding*, 280 U. S. 227, 232.

The decision of the Board of Tax Appeals as to depletion was erroneous.

Messrs. Marc F. Mitchell and A. Calder Mackay, with whom Mr. Thomas R. Dempsey was on the brief, for respondent.

It is well settled that under the Federal Constitution, the Federal Government and the States may not tax each other's property. *Lee v. Osceola Improvement Dist.*, 268 U. S. 643, 645.

If the land can not be taxed, revenue derived therefrom can not be taxed. Neither government may tax the instrumentalities of the other. *Pollock v. Farmers Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601; *Indian Territory Illuminating Oil Co. v. Oklahoma*, 240 U. S. 522; *Union Pacific R. Co. v. Peniston*, 18 Wall. 5; *United States v. Baltimore & Ohio R. Co.*, 17 Wall. 322; *Collector v. Day*, 11 Wall. 113; *McCulloch v. Maryland*, 4 Wheat. 316; *Gillespie v. Oklahoma* 257 U. S. 501; *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393.

The principle applies whether the land is held by the sovereign in a proprietary or in a so-called governmental capacity. *Woodruff v. North Bloomfield Gravel Co.*, 18 Fed. 754-772; *Irwin v. Wright*, 258 U. S. 219; *Van Brocklin v. Tennessee*, 117 U. S. 151; *Wisconsin Central R. Co. v. Price County*, 133 U. S. 496; *Lee v. Osceola Improvement Dist.*, 268 U. S. 643.

The land was part of a tract acquired and used by the city in its governmental capacity in order to: (1) improve its streets; (2) eliminate unsanitary conditions; (3) protect the health of the community; (4) provide adequate water and pressure for fighting fires, and (5) to assure a clean and wholesome supply of water for its inhabitants.

The same considerations that invalidate a tax on the city's lease invalidate a tax upon the profits derived by the lessee. That the city's profit from the lease will be diminished to some extent by the requirement that the lessee pay a tax upon its income derived from the city's property is as clear in the case at bar as in those cases wherein the right of the federal or state government to tax proceeds from publicly owned lands has been denied.

No higher police duty can rest upon municipal authority than that of furnishing an ample supply of pure and wholesome water for public and domestic uses. *Columbus v. Mercantile Trust & Deposit Co.*, 218 U. S. 645.

Protection against fire and the maintenance of public streets and roads are governmental functions. *Denning v. State*, 123 Cal. 316; *Davoust v. Alameda*, 149 Cal. 69. See also *Chicago, B. & Q. R. Co. v. Illinois ex rel. Greenwood*, 200 U. S. 561. Cf. *McCulloch v. Maryland*, 4 Wheat. 316, 330, 409, 410, 411.

Messrs. Charles D. Hamel and John Enrietto, by leave of Court, filed a brief on behalf of the Public Ownership League of America, as *amicus curiae*, to maintain that a city's function in supplying water to its inhabitants is governmental.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

Prior to 1911 the city of Long Beach, California, procured water from companies owning and operating

artesian wells on lands lying outside the city. The service proving inadequate and unsatisfactory, the municipality in 1911 acquired these lands, comprising about 600 acres, and the appurtenant systems, and has since used the tract for water supply and other purposes. In 1922 oil was discovered in the vicinity, and the respondent was organized under the law of California with the intention of obtaining an oil and gas lease on the lands in question. The city leased to the respondent 140 acres, the agreement stipulating that the lessee should receive sixty per cent. of the proceeds of oil and gas recovered and the city forty per cent. As permitted by the lease the oil and gas produced have been sold under a contract made by the city and the respondent as joint vendors. The trust has derived substantial income from the lease.

Upon audit of the taxpayer's returns for the years 1922, 1923 and 1924, the Commissioner, by formal written notification, proposed a deficiency in income taxes for those years. The respondent appealed to the United States Board of Tax Appeals raising two issues, (1) Whether its income derived from the lease was immune from taxation, and, if not, (2) Whether capitalized expenses for drilling and developing its oil wells were to be returned through depletion allowance, as ruled by the Commissioner, or by way of depreciation. The Board held the income taxable and the intangible development costs recoverable through depreciation charges. The Circuit Court of Appeals upon cross-petitions for review decided that the income from the lease was immune from federal income tax, and therefore found it unnecessary to pass upon the matter of depreciation allowance presented by the Commissioner's petition. 61 F. (2d) 92. Both questions are raised by the petition for certiorari.

The respondent, in support of its claim of immunity, relies upon the principle that a tax upon instrumentalities of the states is forbidden by the Federal Constitution;

that by clear implication the means employed by the general government to carry into operation the powers granted to it are exempt from taxation by the states, as are those employed by the states exempt from taxation by the general government. The principle is settled by a wealth of authority and has been applied in varying circumstances; has been recently fully discussed and the authorities collected and commented upon in decisions of this court (*Metcalf & Eddy v. Mitchell*, 269 U. S. 514; *Willcuts v. Bunn*, 282 U. S. 216; *Indian Territory Illuminating Oil Co. v. Board of Equalization*, and *Indian Territory Illuminating Oil Co. v. Board of County Commissioners*, ante, p. 325); and no purpose would be served by a repetition of what was there said.

The Revenue Acts do not discriminate between the respondent and others similarly situated, in the imposition of the income tax. If the respondent is exempt from the exaction the conclusion must follow because the tax directly burdens the functions of the state acting through the city of Long Beach. Considerations which have led to the condemnation of taxes in other circumstances are here absent. The levy is not upon the property of the municipality, nor upon the income it derives from its property, is not upon the city's share of the oil recovered, the lease, or the gross income therefrom. The law measures the assessment by the net income of the respondent, whose operations are carried on in a private and not in a public capacity for the personal gain of its *cestuis que trustent*. The government asserts that the incidence of the tax is so remote from the activities of the municipality as to have no substantial adverse effect upon them. The respondent insists that as lessee of the lands in question it is a governmental agency and any tax laid upon its income directly burdens governmental functions.

In *Metcalf & Eddy v. Mitchell*, supra, this court said [p. 522]:

"Just what instrumentalities of either a state or the federal government are exempt from taxation by the other cannot be stated in terms of universal application."

And further [p. 523]:

"As cases arise, lying between the two extremes, it becomes necessary to draw the line which separates those activities having some relation to government, which are nevertheless subject to taxation, from those which are immune. Experience has shown that there is no formula by which that line may be plotted with precision in advance. But recourse may be had to the reason upon which the rule rests, and which must be the guiding principle to control its operation. Its origin was due to the essential requirement of our constitutional system that the federal government must exercise its authority within the territorial limits of the states; and it rests on the conviction that each government, in order that it may administer its affairs within its own sphere, must be left free from undue interference by the other. . . ."

It was there pointed out that while in one aspect the extent of the exemption must finally depend upon the effect of the tax upon the functions of the government alleged to be affected, still the nature of the governmental agencies and the mode of their constitution may not be disregarded in passing upon the question of tax exemption. An agency may be so intimately connected with the exercise of a power or the performance of a duty by the government that any taxation of it would be a direct interference with the functions of government itself. In *Baltimore Shipbuilding Co. v. Baltimore*, 195 U. S. 375, it was said [p. 382]:

". . . it seems to us extravagant to say that an independent private corporation for gain, created by a State, is exempt from state taxation, either in its corporate person, or its property, because it is employed by the United States, even if the work for which it is employed is important and takes much of its time."

The statement holds true as well when the positions of the sovereigns are reversed.

The application of the doctrine of implied immunity must be practical (*Railroad Co. v. Peniston*, 18 Wall. 5, 31, 36) and should have regard to the circumstances disclosed. We think that in the present instance the subject of the tax is so remote from any governmental function as to render the effect of the exaction inconsiderable as respects the activities of the city. Compare *Alward v. Johnson*, 282 U. S. 509, 514. Its collection is not inconsistent with and does not trench upon the immunity of the state as a sovereign. The income of the respondent from the lease is not immune from federal income tax.

The respondent relies upon *Gillespie v. Oklahoma*, 257 U. S. 501, and *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, as authorities binding upon us and requiring a decision in its favor. In both of those cases the sovereign was acting as the trustee of an express trust with regard to the lands leased. In both the burden upon the public use was more definite and direct than in the present case. As said in the *Coronado* case, the doctrine of *Gillespie v. Oklahoma* is to be applied strictly and only in circumstances closely analogous to those which it disclosed. The decisions relied on cannot be held to be authority upon the facts presented by this record.

The petitioner also asserts that the Board of Tax Appeals was in error in holding that the cost of drilling should be amortized by way of depreciation charges, and not through the statutory allowance for depletion. The identical issue is involved and settled in favor of petitioner by *United States v. Dakota-Montana Oil Co.*, ante, p. 459, and *Petroleum Exploration v. Burnet*, ante, p. 467, decided this day.

The judgment is reversed and the cause remanded for further proceedings in conformity with this opinion.

Reversed.