Tulsa Law Review

Volume 18
Issue 3 *Natural Resources Symposium*

Article 7

Spring 1983

Exploratory Intangible Drilling and Development Costs: A Tax Incentive Reinforced in Sun Co. v. Commissioner

Matthew E. Lipinski

EXPLORATORY INTANGIBLE DRILLING AND DEVELOPMENT COSTS: A TAX INCENTIVE REINFORCED IN *SUN CO. v. COMMISSIONER*

I. Introduction

Anyone connected with the oil and gas industry would agree that hydrocarbon production costs are staggering. Developers continually face increasing overhead in their search for new deposits of petroleum reserves. One source of relief in this high cost business is the availability of numerous tax deductions.[1] In addition to the usual business deductions generally available,[2] oil and gas developers are granted further tax relief through provisions designed specifically for the energy industry.[3] One such provision is the option to deduct intangible drilling and development costs (IDC).[4] The IDC option allows an operator[5] to deduct these costs as expenses in the current year rather than depreciate them over several years.[6] Costs included are amounts paid for labor, fuel, repairs, hauling, supplies, as well as other intangible expenditures outlined in the applicable Treasury Regulation.[7] "Expensing" IDCs in this manner provides the operator a substantial deduction in the year the costs are incurred and thus serves as an incentive for the development of oil and gas properties. Section 263(c)[8] of the Internal Revenue Code empowers the Treasury Secretary to prescribe regulations pertaining to the IDC option; in 1965, the Depart-

1. For an extensive discussion of tax laws associated with the oil and gas industry, see F. Burke & R. Bowhay, 1982—Income Taxation of Natural Resources.
2. *See* I.R.C. § 162 (1976 & Supp. V 1981).
3. *See* F. Burke & R. Bowhay, *supra* note 1, ¶¶ 12.01-17.14.
4. I.R.C. § 263(c) (Supp. V 1981).
5. The Treasury Regulations define an operator as "one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights." Treas. Reg. § 1.612-4(a) (1965).
6. *Id.* Many factors must be considered in making this decision. Among them are the operator's long-range plans for the property in question as well as its potential to produce hydrocarbons.

> If a taxpayer elects to capitalize intangibles and further elects to deduct the cost of dry holes, the deduction for dry-hole costs is allowed as a loss in the year the dry hole is completed and abandoned. If the taxpayer elects to expense intangibles [as IDC], such costs may not also be included in the basis of the property.

F. Burke & R. Bowhay, *supra* note 1, ¶ 14.04, at 1406-07 (footnotes omitted). For a thorough discussion of relevant factors, see *id.* ¶¶ 14.04-.11, at 1406-18.

7. Treas. Reg. § 1.612-4(a) (1965).
8. I.R.C. § 263(c) (Supp. V 1981).

ment specified when and how the option is available through its promulgation of Treasury Regulation section 1.612-4.[9] Since then there have been several disputes regarding the option's applicability in given situations. This Recent Development will analyze the widening application of Treasury Regulation section 1.612-4 and discuss its relevance to offshore exploration by examining two recent decisions: *Sun Co. v. Commissioner*[10] and *Gates Rubber Co. v. Commissioner*.[11]

II. IDCs Applied Prior to *Sun*—A Background Analysis

An oil and gas operator must decide whether to capitalize certain development costs or treat them as expenses under the IDC option.[12] Costs which are eligible for the IDC option include:

> [A]mounts paid for labor, fuel, repairs, hauling and supplies, or any of them, which are used
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> (1) In the drilling, shooting, and cleaning of wells,
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> (2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and
>
> (3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.[13]

> (c) Intangible drilling and development costs in the case of oil and gas wells and geothermal wells.
>
> Notwithstanding subsection (a), regulations shall be prescribed by the Secretary under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress.

Id.

9. Although historically the validity of the IDC option was suspect, the 1954 Internal Revenue Code firmly established IDC as legislative authority. *See id.* For the history of IDC evolution, see Exxon Corp. v. United States, 547 F.2d 548, 553-55 (Ct. Cl. 1976); F. Burke & R. Bowhay, *supra* note 1, ¶¶ 14.02-.03; Posey & Reeves, *Intangible Drilling Costs: Offshore Drilling Dilemma*, 31 Oil & Gas Tax Q. 320, 322-25 (1982).

10. 677 F.2d 294 (3d Cir. 1982).

11. 74 T.C. 1456 (1980), *aff'd per curiam*, 694 F.2d 648 (10th Cir. 1982).

12. The procedure utilized for making this decision and the ramifications thereof are beyond the scope of this Recent Development. For an analysis of the criteria for successfully deducting prepaid IDCs, see Behnke & Gentzler, *Deductibility of Prepaid Intangible Drilling and Development Costs in the Year of Payment—A Current Review*, 17 Tulsa L.J. 428 (1982); Burke & Maultsby, *Establishing Deductions for Prepaid Intangible Drilling and Development Costs*, 28 Oil & Gas Tax Q. 127 (1979).

For a discussion of the nature of the IDC option, and a flow-chart of the IDC election procedure, see Allbright, *An Overview of Intangible Drilling and Development Costs*, 28 Oil & Gas Tax Q. 283 (1980).

13. Treas. Reg. § 1.612-4(a) (1965).

Generally, the option only applies to expenditures for drilling and developing items that "in themselves do not have a salvage value."[14]

This salvageability restriction was the subject of litigation in *Exxon Corp. v. United States*.[15] The *Exxon* controversy focused upon whether the expenditures incurred in the construction of offshore platforms were eligible for the IDC option pursuant to section 263(c).[16] In *Exxon*, the offshore platforms were partially assembled on land before being transported to the drilling site. Final preparations were made on a barge while at sea.[17] The costs in question were those for labor, fuel, repairs, supplies, and hauling, all of which were incurred before removal of the platform from the transport barge.[18] Interpretation and application of the term "salvage value" became important in determining the applicability of the IDC option. The government contended that the oil company deducted costs as IDC which, in reality, fell into three categories, one of which was not deductible as IDC.[19] Conceding that (1) expenditures for the construction of structures which in themselves had no salvage value; and (2) expenditures for intangibles " 'used in connection with the installation of physical property which has a salvage value' "[20] both qualified as IDC, the government argued that acquisition expenditures—intangible costs " 'by which the taxpayer *acquires* tangible property ordinarily considered as having a salvage value' "[21]—do not qualify as IDC and must therefore be capitalized.[22] The court flatly rejected that position as untenable.[23]

Following a brief history of the evolution of the IDC option,[24] the *Exxon* court stated that because Congress had consistently viewed the IDC election as an incentive to oil and gas exploration,[25] it followed that Congress would favor a liberal interpretation of the applicable

14. *Id.* The regulation goes on to indicate that for IDC option purposes, labor, fuel, repairs, hauling, and supplies are not considered to have a salvage value even though used in connection with the installation of tangible property which has a salvage value. *Id.*
15. 547 F.2d 548 (Ct. Cl. 1976).
16. *Id.* at 553.
17. *Id.* at 550.
18. *Id.* at 551.
19. *Id.* at 553.
20. *Id.* (quoting the Service).
21. *Id.* (quoting the Service) (emphasis added by the court).
22. *Id.* The government contended that all expenditures made by the taxpayer while the platform was on land, as well as a portion of those made while the platform was in transit, fell into this category. *Id.*
23. *Id.*
24. *See supra* note 9.
25. The IDC deduction is an incentive to producers through the substantial tax savings it provides. Developers are motivated to undertake exploratory ventures because tax costs are

Treasury Regulations.[26] Further, the specific terms of the regulation at issue[27] allowed the IDC election for all costs deducted by Exxon.[28] Because the only costs at issue in *Exxon* were intangible expenses which were incident to and necessary for drilling and because these costs in and of themselves did not have a salvage value, the court asserted that "the 'bottom line' has been reached and the matter is at an end."[29] Although the government advocated numerous limitations on section 263(c),[30] the court concluded that restrictive interpretation of IDC regulatory language should be disapproved.[31] The opinion firmly sets forth the basic rule that "optional intangible drilling and development costs are those expenditures by an oil and gas operator for items which are incident to and necessary for the drilling of wells *and* which, when each is considered individually as a unit in and of itself, have no salvage value."[32] Finding that all of Exxon's expenditures were "incident to and necessary for" oil and gas production, and none were for items which in and of themselves had any salvage value, the court held the IDC option available.[33]

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greatly reduced after deducting IDCs. Without the IDC option, exploratory costs would often be prohibitive, particularly those involved with speculative ventures.

26. 547 F.2d at 555. "Congress has consistently viewed the optional treatment of IDC as an incentive to oil and gas prospecting and exploration . . . ." *Id.*

27. Treas. Reg. 118, § 39.23(m)-16 (1951) is the predecessor to Treas. Reg. § 1.612-4 (1965) and was in force in 1954, the pertinent taxable year in *Exxon*. The language in § 1.612-4 is essentially the same today. *See* Stanton v. Commissioner, 26 T.C.M. (CCH) 191, 195 n.5 (1967). The validity of the *Exxon* decision remains, therefore, unquestioned.

28. Section 39.23(m)-16(a)(1) states in part:

> 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, may, at the option of the operator, be deducted from gross income as an expense or charged to capital account.

Treas. Reg. 118, § 39.23(m)-16(a)(1) (1951).

The only conditions placed on IDC election are that the costs must have been incurred in the construction of structures necessary for the drilling and preparation of wells for production, and that the cost items in and of themselves must not have a salvage value. *See* Treas. Reg. § 1.612-4(a) (1965). Further, the regulation clearly states that "labor, fuel, repairs, hauling, supplies, etc., *are not considered as having a salvage value*, even though used in connection with the installation of physical property which has a salvage value." *Id.* (emphasis added).

29. 547 F.2d at 556.

30. Governmental assertions included a limited interpretation of the word "installation" to allow IDC deductions only for expenditures incurred at the well site. To this argument, the court stated that the defendant "has grossly misread its own language." *Id.* The Service also asserted that at the moment of an oil or gas "strike," the drilling platform becomes completely salvaged and therefore "*no* costs relating to a platform are deductible because they *all* have salvage value." *Id.* at 557 (emphasis in original). The court rejected this conclusion. *Id.*

31. *Id.* at 558.

32. *Id.* (emphasis in original).

33. *Id.* at 559. The Court was also unconvinced by the Service's "fragmentation" argument. The Service argued that each operational phase in *Exxon* should be "fragmented," so that expenditures could be evaluated for IDC purposes at the time they were made. Thus, only those

Five years later, the Tax Court in *Standard Oil Co. (Indiana) v. Commissioner*[34] interpreted *Exxon* as holding that all onshore costs of fabricating offshore platforms qualify as IDC.[35] In *Standard Oil*, the taxpayer was engaged in constructing "jacket-type" drilling platforms[36] in the North Sea, and deducted as IDC what it termed "other" costs.[37] Using arguments similar to the ones it made in *Exxon*, the Service urged the court to abandon its former position and narrowly construe Treasury Regulation section 1.612-4.[38] The court refused to do so and capsulized the issues as:

> (1) Whether the platforms as a whole are ordinarily considered as having a salvage value; and (2) if the answer to (1) is no, whether the intangible-type costs in issue were expended to integrate materials which were, prior to such integration, usable in such a fashion that they would be ordinarily considered as having a salvage value, into components which are, after such integration, not ordinarily considered as having a salvage value.[39]

The *Standard Oil* opinion concluded that the jacket-type platforms in question are not ordinarily considered to have a salvage value and that the "other" costs in issue were indeed expended to integrate materials into finished products which ordinarily do not have a salvage value.[40] These "other" costs were therefore properly deducted as IDC in accordance with Treasury Regulation section 1.612-4.

A review of the *Exxon* and *Standard Oil* decisions demonstrates that the determination of the IDC option's availability hinges on the salvage value of the items for which expenditures were made. Thus, it appears that by liberally interpreting Treasury Regulation section

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costs incurred at the well site would qualify as IDC. *Id.* at 556. Justifying its rejection of the argument, the court stated that the Treasury Regulation was intended to set forth a simple and basic rule, rather than one which could lead to "ambiguities, overlaps, and problems of categorization." *Id.* at 558.

34. 77 T.C. 349 (1981).

35. *Id.* at 387.

36. "Jacket-type" drilling platforms include a deck, the jacket, and pilings. The jacket consists of tubular steel legs which act as support for the deck. *Id.* at 358.

37. The "other" costs included fuel, labor, repairs, hauling, supplies, and an allocable portion of overhead. In essence, "other" costs refers to all costs, except those incurred for materials, realized in the construction of offshore drilling equipment. *Id.* at 361.

38. *Id.* at 386.

39. *Id.* at 400-01. It is possible to conclude that IDC election in an onshore operation may be subject to narrower interpretation than in an offshore context since it is likely that onshore components are far more salvageable than their offshore counterparts. The court, however, did not specifically address this distinction.

40. *Id.* at 401.

1.612-4,[41] the courts are moving toward allowance of the IDC deduction for all development expenses other than costs for materials which later have a salvage value. Under *Standard Oil*, even costs incurred to integrate materials which ordinarily have a salvage value into a final product which is ordinarily not considered to have a salvage value, such as a drilling platform, are deductible as IDC.[42]

III. *Sun Co.* and *Gates Rubber Co.*—Exploratory IDCs

The most recent challenges to the liberalization of the IDC option have occurred in the context of exploratory operations. The language of the Internal Revenue Code permits a deduction for "drilling and development costs" related to oil and gas wells.[43] By equating the Treasury Regulation language "development of oil and gas properties" with "production," the Service disallowed IDC deductions in those ventures where there was no intent to produce.[44] Taxpayers have successfully challenged the Service's position in *Sun Co. v. Commissioner*[45] and *Gates Rubber Co. v. Commissioner*.[46]

Sun Company and its affiliates had participated in two separate ventures: one off the shores of Louisiana; the other in the North Sea.[47] Both were initially exploratory operations. Sun Company drilled a to-

41. The Tax Court and the IRS have continually been at odds over the proper interpretation of Treas. Reg. § 1.612-4(a). While the court favors allowing the IDC election following the commencement of drilling operations, *see* Standard Oil Co. (Ind.) v. Commissioner, 68 T.C. 325, 353 (1977), the Service seeks to further require demonstration of production intent, *see* Technical Advice Memorandum No. 7834002, 1978 IRS Let. Rul. (CCH) book 6, fiche 2 (microfiche) (May 3, 1978) (*Standard Oil* (1977) criticized as misreading § 1.612-4(a) by not requiring production intent as prerequisite for IDC election); Technical Advice Memorandum No. 7837004, 1978 IRS Let. Rul. (CCH) book 6, fiche 4 (microfiche) (June 9, 1978); Rev. Rul. 80-342, 1980-2 C.B. 99 (IDC deductions disallowed where wells were drilled solely to obtain geological information).

Thus, despite the Service's desire to restrict the option's availability, it has become clear that the IDC deduction will be allowed regardless of whether the operator intends to produce. *See* Gates Rubber Co. v. Commissioner, 74 T.C. 1456, 1477 (1980), *aff'd per curiam*, 694 F.2d 648 (10th Cir. 1982); Sun Co. v. Commissioner, 74 T.C. 1481, 1508-09 (1980), *aff'd*, 677 F.2d 294 (3d Cir. 1982).

42. Drilling platforms are, of course, salvageable. However, the costs involved in salvaging offshore platforms often prohibit the practice. Because the jacket-type drilling platforms at issue in *Standard Oil* (1981), as well as most other offshore platforms, are disposed of following their useful lives, they are not ordinarily considered as having a salvage value. 77 T.C. at 401.

43. I.R.C. § 263(c) (Supp. V 1981).

44. *See* Treas. Reg. § 1.612-4(a) (1965). The Service has long asserted that the IDC option is not available until an operator decides to produce oil or gas. *See supra* note 41. Therefore, an operation at the exploratory stage cannot qualify for the IDC deduction because without a discovery of oil or gas, no intent to produce can be exhibited by a developer. *See, e.g.*, *Standard Oil* (1977), 68 T.C. at 343.

45. 677 F.2d 294 (3d Cir. 1982).

46. 74 T.C. 1456 (1980), *aff'd per curiam*, 694 F.2d 648 (10th Cir. 1982).

47. 677 F.2d at 294.

tal of seventeen exploratory wells, fifteen in the Gulf of Mexico and two in the North Sea. In the Gulf of Mexico operation, seven of the fifteen wells drilled encountered hydrocarbons, but all were permanently plugged and abandoned. Some of the remaining eight wells were dry holes, while others were not drilled to the intended depth due to mechanical difficulties. After the drilling of these fifteen wells was completed, Sun established and installed three fixed production platforms from which forty-five production wells were eventually drilled.[48] The two wells drilled in the North Sea were both plugged and abandoned, one permanently, the other temporarily; yet no production facility was ever ordered or built in that area.[49]

In its 1971 tax return, Sun deducted from its gross income its allocable share of the costs incurred from the drilling of the seventeen wells, claiming the deductions qualified as IDC. The Internal Revenue Service disallowed the IDC deduction, finding that because the drilling took place at an exploratory stage and before a decision had been made to develop the properties, the exploratory costs could not be deducted as IDC.[50] Upon Sun's petition, the Tax Court reversed the IRS ruling, stating that all drilling costs here involved were deductible as IDC.[51] The Third Circuit Court of Appeals affirmed the decision of the Tax Court.[52]

The Third Circuit indicated that the issue was "whether the costs of drilling offshore *exploratory* oil and gas wells from mobile rigs are deductible . . . as [IDC] under 26 U.S.C. § 263(c) and Treas.Reg. § 1.612-4(a)."[53] Beginning its analysis, the court noted that section 263(a) allows no deductions for costs of " 'permanent improvements or betterments made to increase the value of any property or estate.' "[54] Although this provision would appear to preclude the IDC deduction for offshore rigs,[55] the court stated that subsection (c) dealt specifically with such costs and exempts them from the general prohibition of section 263(a).[56]

Sun recognized that the statutory ancestry of section 263(c) had

48. *Id.* at 295-96.
49. *Id.* at 296.
50. *Id.*
51. 74 T.C. 1481.
52. 677 F.2d at 294.
53. *Id.* (emphasis added).
54. *Id.* at 296 (quoting I.R.C. § 263(a)(1) (Supp. V 1981)).
55. *Id.*
56. *Id.*; *see supra* note 8.

been questioned, but found that it is today sound authority, fully approved by Congress.[57] There remained, however, a difference of opinion between the Service and the *Sun* court regarding the IDC option's applicability to exploratory wells. While section 263(c) appears to allow the IDC deduction without distinguishing between exploratory and production operations, the Treasury Regulation which gave effect to section 263(c)[58] used more limited language. Treasury Regulation section 1.612-4(a) provides that IDCs incurred by an operator

> in the *development* of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to 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.[59]

The Service asserted that this language allows the IDC deduction only for costs of production, thereby characterizing section 263(c) as equally narrow. The IRS argued that section 1.612-4(a) makes the IDC option available only to developmental activities as distinct from exploratory activities.[60] A two-pronged test was developed by the Service for determining the availability of the IDC option to operators of offshore, wildcat wells, making the option available when:

> (1) the cost of the drilling was incurred *after* a taxpayer has discovered an oil or gas reservoir and *decided* to commence production; or
>
> (2) when the taxpayer was drilling "wells" which the Commissioner defines restrictively as a shaft *drilled with the intention* of producing from that shaft any hydrocarbons en-

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57. 677 F.2d at 296-97. The court indicated that the IDC deduction was first promulgated in Treasury Department regulations in 1918, without reference to any specific enactment by Congress. *See* Harper Oil Co. v. United States, 425 F.2d 1335, 1338 (10th Cir. 1970). Although doubts regarding the IDC option's validity later surfaced, *see, e.g.*, F.H.E. Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir. 1945), Congress responded quickly by enacting a resolution which led to the adoption of § 263(c). *See* 677 F.2d at 296. That 1945 Concurrent Resolution states in part: "[T]he Congress has recognized and approved the provisions of section 29.23(m)-16 of Treasury Regulations 111 and the corresponding provisions of prior Treasury Regulations *granting the option to deduct as expenses such intangible drilling and development costs*." H.R. Con. Res. 50, 79th Cong., 1st Sess., 59 Stat. 844 (1945) (emphasis added).

The *Sun* court highlighted Judge (now Justice) Blackmun's declaration in *Harper Oil* that " '[t]he option, although long possessed of dubious statutory ancestry, now has firm congressional authority in § 263(c) of the 1954 Code.' " 677 F.2d at 297 (quoting *Harper Oil*, 425 F.2d at 1335).

58. Treas. Reg. § 1.612-4(a) (1965).

59. *Id.* (emphasis added).

60. *See* 677 F.2d at 297. "The dividing line between development and exploration, according to the Commissioner, is that point at which an operator decides to produce the hydrocarbons that drilling has discovered or that drilling might encounter." *Id.*

countered in commercial quantities.[61]

The court discounted the Service's interpretation, noting that the Tax Court has rejected the exploratory/developmental distinction and the two-pronged test on four separate occasions.[62] Moreover, the *Sun* court found that the Service's analysis misread the language of Treasury Regulation section 1.612-4(a), and disregarded the legislative history and congressional intent of section 263(c).[63]

Section 1.612-4(a) makes no distinction between exploratory and developmental operations, yet the Service relied on *Louisiana Land & Exploration Co. v. Commissioner*[64] as authority for the existence of such a distinction.[65] In that case, geophysical survey costs were not deductible as expense and were capitalized.[66] Because the Service associated geophysical surveys with exploration, it asserted in *Sun* that *Louisiana Land* precluded the allowance of a deduction for anything but production or later development costs.[67] However, the Third Circuit found that *Louisiana Land* identified geophysical work as an initial stage in property development and distinguished it from both exploratory and developmental drilling.[68] Therefore, *Louisiana Land* simply did not apply to the facts in *Sun*. The court then turned to the Service's argu-

61. *Id.* (emphasis in original).

62. *Id.*; *see* Sun Co. v. Commissioner, 74 T.C. 1481 (1980).

> [The Service] would deny the IDC option with regard to the intangible costs of drilling the so-called "exploratory" wells. We could not be more convinced that this chain of reasoning and its resulting effect are erroneous.
>
> The weak link in [the Service's] theory is the conclusion that "development" occurs only after a decision to produce . . . has been made.

Id. at 1509. The Tax Court used identical language to reject the Service's theory in *Gates*, 74 T.C. at 1476.

In Standard Oil Co. (Ind.) v. Commissioner, 68 T.C. 325 (1977), the court said:

> [The Service] maintains that "development" . . . does not begin until an operator . . . makes the decision to commence production drilling. . . . Until that point is reached, [it] argues, all costs of exploratory wells must be capitalized.
>
> [The Service's] position finds no support in the language of the regulations or the relevant authorities and is indeed contrary to both.

Id. at 348.

The fourth rejection of the exploratory/developmental distinction has, according to the *Sun* opinion, occurred in *Monsanto Company*, No. 1417-79 (U.S.T.C. filed Jan. 6, 1982). *See* 677 F.2d at 297-98.

63. 677 F.2d at 298.

64. 7 T.C. 507 (1946), *aff'd*, 161 F.2d 842 (5th Cir. 1947).

65. 677 F.2d at 298.

66. *Louisiana Land* is, for present purposes, outdated. It was decided long before legislative recognition of the IDC option and certainly before any judicial liberalization of IDC. The court did not even use the term "IDC." The issue in *Louisiana Land* concerned the deductibility of the costs of geophysical surveys as an ordinary business expense. The opinion defined "geophysical survey," 7 T.C. at 510, and held that the survey costs were not deductible. *Id.* at 516.

67. 677 F.2d at 298.

68. *Id.*

ment which cited *Miller v. United States*[69] as authority for limiting the IDC option to wells drilled with an intent to produce hydrocarbons.[70] *Miller*, however, was summarily discounted since it dealt with a taxpayer who attempted to deduct as IDCs expenditures incurred while seeking hot water energy sources.[71] The *Sun* court held that since the operations in *Miller* did not relate to oil and gas, as required by both Treasury Regulation section 1.612-4(a) and Internal Revenue Code section 263(c),[72] its holding was not controlling.

Finally, the court examined the congressional intent behind section 263(c) and found further justification for rejecting any distinction between exploratory and developmental costs, as well as the IRS' two-pronged test.[73] The court noted that the entire legislative history of section 263(c) indicated that the IDC option was created "as a result of a continuing Congressional objective to encourage risk-taking with respect to the exploration for, and production of, oil and gas."[74] The court cited discussion on the floor of the Senate, when that body was considering liberalizing the IDC option, which emphasized the high risk associated with drilling: " 'Only one *exploratory well* in nine produces anything. Eight . . . are dry holes. . . . Any delay in enacting this amendment will result in reductions in *desperately needed exploratory drilling*.' "[75] Because of this legislative history and the consistent conclusions of other courts and commentators[76] that the IDC option was established as an incentive to oil and gas exploration, the court was not persuaded by the Service's interpretation that the IDC deduction should be available only after the discovery of recoverable hydrocarbon deposits.[77] The court stated that to follow such analysis would be to allow the IDC option when investment risks are at a minimum, in

69. 78-1 U.S. Tax Cas. (CCH) ¶ 9127, 41 A.F.T.R.2d (P-H) ¶ 78-324 (C.D. Cal. 1977).

70. 677 F.2d at 299.

71. *Id.*

72. 78-1 U.S. Tax Cas. (CCH) ¶ 9127, at 83,097, 41 A.F.T.R.2d (P-H) ¶ 78-324, at 78-380; *see supra* notes 8, 59, and accompanying text.

73. 677 F.2d at 299-300.

74. *Id.* at 300.

75. *Id.* (quoting 123 CONG. REC. 12,816-17 (1977) (remarks of Sen. Bentsen)) (emphasis added by the court).

76. *See* Exxon Corp. v. United States, 547 F.2d 548, 555 (Ct. Cl. 1976); United States v. Cocke, 399 F.2d 433 (5th Cir. 1968); Jackson, *Tax Planning Before Drilling: The Operator's Problem*, 27 TUL. L. REV. 21 (1952); Murray, *Intangible Drilling and Development Costs of Oil and Gas Wells*, 26 TAXES 312, 316 (1948). For more recent commentary on IDCs, see articles cited *supra* note 12.

77. 677 F.2d at 300.

contradiction to congressional intent surrounding the deduction.[78] The Third Circuit was convinced that the relevant authority and accompanying rationale favored allowance of the IDC option in exploratory energy development. Thus, the Tax Court decision was affirmed.[79]

The issue of allowing the IDC option for exploratory drilling was one of first impression to the Third Circuit,[80] and remained so in the other circuits until December of 1982, when the Tenth Circuit addressed the question in *Gates Rubber Co. v. Commissioner*.[81] In a brief opinion, that court noted that the *Gates* issues were "identical" to those in *Sun*.[82] *Gates* involved offshore operations in the Gulf of Mexico.[83] After extensive geological and geophysical work was completed and evaluated, a number of exploratory wells were drilled, five of which were at issue in *Gates*.[84] The IRS argued before the Tax Court that development does not occur until a decision to produce has been made,[85] and again the court rejected that assertion.[86] The Service stated that "wells," as defined in Treasury Regulation section 1.612-4(a), includes "only those shafts drilled with the intent to produce hydrocarbons."[87] The Tax Court consistently held that " 'wells' requires no finding with regard to any person's intent,"[88] and that therefore the

78. *Id.*
79. *Id.*
80. *Id.* at 298.
81. 694 F.2d 648 (10th Cir. 1982), *aff'g* 74 T.C. 1456 (1980).
82. The *Gates* opinion reported by the Tenth Circuit follows in its entirety.

Per Curiam.

In this appeal we are asked to decide whether the costs of drilling offshore exploratory oil and gas wells from mobile rigs are deductible in the year in which they are incurred as "intangible drilling and development costs" under 26 U.S.C. § 263(c) and Treas. Reg. § 1.612-4(a) ("the IDC option"). The Tax Court ruled in favor of the taxpayer and against the Commissioner.

All parties agree that the issue in this case is identical with the prior consideration of this issue by the Third Circuit in Sun Co. v. Commissioner, 677 F.2d 294 (3rd Cir. 1982). The Third Circuit held for the taxpayer. We agree with the Third Circuit.

Affirmed.

Id.

83. 74 T.C. at 1471.
84. *Id.* at 1471-72.
85. *Id.* at 1475. The Service contended that, "as a general rule, only the intangible costs of drilling those shafts drilled after a taxpayer has decided to commence preparing to produce a reservoir fall within the definition of IDC." *Id.*
86. *Id.* at 1476. "The weak link in respondent's theory is the conclusion that 'development' occurs only after a decision to produce from a particular reservoir has been made." *Id.* The court further discounted the Service's position, stating that it "would deny . . . the IDC deduction to the very entrepreneurs for whom it was enacted—those investors who take the enormous risks entailed in drilling the wildcat wells—and would allow the IDC deduction only for those low-risk wells drilled after the wildcatters had found the oil or gas." *Id.* at 1477.
87. *Id.* at 1478.
88. *Id.* at 1479.

IDC deduction was available to the taxpayer.[89]

IV. Analysis

The IDC option has been the subject of litigation more frequently due to improper timing than to improper election.[90] The Service's recent challenges to the election have been prompted by its conservative interpretation of section 1.612-4. The courts have rejected such an approach and clearly favor liberal availability of the IDC deduction. Two conclusions may be drawn from this review of current law regarding the IDC deduction. First, the term "salvage value" will be given a broad interpretation, thereby allowing IDC election for virtually all drilling and development expenditures other than materials and equipment.[91] Courts may allow expenditures for materials integrated into a finished product which has no salvage value to be expensed as IDCs.[92]

Second, the IDC election is available to taxpayers involved in either exploratory or producing operations which pertain to oil and gas development. Purely "wildcat" ventures are apparently included in this category based on the rationale in *Sun*. Since both of the circuit courts that have reviewed this issue consistently extended IDC availability to offshore, exploratory operations, it is likely that other circuits will follow suit under similar facts.

The *Sun* and *Gates* holdings are sound decisions. Embodying the intent behind section 263(c), they reaffirm necessary incentives for oil and gas developers. Due to the high risk nature of exploratory operations, as well as the staggering costs associated with such wildcat ventures, it is only proper that substantial tax relief be granted in the form of the IDC option. *Sun* and *Gates* are significant steps in that direction.

V. Conclusion

The option to expense intangible drilling and development costs

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89. *Id.* at 1480.

90. *See, e.g.*, Pauley v. United States, 63-1 U.S. Tax Cas. (CCH) ¶ 9280, 11 A.F.T.R.2d (P-H) ¶ 63-490 (S.D. Cal. 1963); Keller v. Commissioner, 79 T.C. 7 (1982) (appeal filed 8th Cir.); *see also* Behnke & Gentzler, *supra* note 12 (guidelines for deducting prepaid IDCs in the year of payment).

91. For a non-inclusive list of expenditures within the IDC election, see F. Burke & R. Bowhay, *supra* note 1, ¶ 14.12, at 1420-21.

92. *See* Standard Oil Co. (Ind.) v. Commissioner, 77 T.C. 349, 400 (1981). *But cf.* Harper Oil Co. v. United States, 425 F.2d 1335 (10th Cir. 1970). There, the cost of surface casing for producing wells could not be expensed as IDC, but had to be capitalized even though Oklahoma Corporation Commission regulations prohibited casing removal, thus rendering it unsalvageable. *Id.* at 1341-42.

can only be deemed a necessity for oil and gas developers. Although suspect as a valid deduction in the early part of this century, the IDC option has evolved into a firmly established tax incentive for the energy industry. The consistency with which the Tax Court has liberally applied section 1.612-4(a) indicates its concurrence with the congressional intent behind the IDC deduction. The Internal Revenue Service has, with equal consistency, sought to narrowly construe the IDC option and to preclude its application to exploratory ventures. The *Sun* and *Gates* appeals represent an affirmation of the Tax Court's liberal view. If the IDC option is to be a true tax incentive, its election must be available to developers engaged in exploratory as well as producing operations. The opinions issued by the circuit courts in *Sun* and *Gates* not only support this premise, but also decisively overrule the Service's narrow perspective.

Matthew E. Lipinski