

INTANGIBLE DRILLING COSTS

INTRODUCTION:

In order to recognize the high risks involved in drilling exploratory and developmental wells, taxpayers are allowed to make a binding one-time election to expense intangible drilling and development costs (IDC). This election generally permits an immediate write-off of expenditures that would otherwise be capitalized and amortized. However, integrated oil companies are required to capitalize 30% of their intangible drilling costs over a 5 year period. Foreign intangible drilling costs cannot be expensed.

HISTORY:

For all practical purposes, the option to expense or capitalize the intangible drilling and development expenditures has existed since the first income tax statute. Judicial recognition of the existence of the option for the year 1916 appears in *Shaffer v. Comm.*¹

Although there was no specific provision in the Code, prior to the 1954 Code, for the expensing of intangible drilling and development costs, the Treasury Regulations granting an election were held valid by the courts.² In *Ramsey v. Comm.*,³ the Tenth Circuit explained the reason for their validity as follows:

This conclusion is strongly fortified by the fact that this regulation has been in existence for many years; Congress has repeatedly amended the revenue laws while this regulation was in full force and effect, and no effort has been made to do away with it. This is almost conclusive proof that Congress was satisfied with the construction put upon its language in the earlier acts. By repeated reenactments, Congress has ratified and approved this interpretation.

However, the validity of the regulations was questioned in *F.H.E. Oil Co. v. Comm.*⁴ where the court commented to the effect that it was unnecessary to determine the validity of the regulations to properly dispose of the case at hand. As a result of the uncertainty created by this case, Congress, in House Concurrent Resolution 50,⁵ recognized and approved the existing regulations. Later, the statutory language which provides for the intangible drilling cost election was adopted.⁶

DEFINITION:

In connection with the drilling of oil and gas wells, a taxpayer has the option either to expense or to capitalize intangible drilling and development expenditures.⁷ The option is available only to the owner of a working or operating interest and is limited to wells drilled in the United States.⁸

The election to expense intangible drilling and development costs applies to all expenditures made by the 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.”⁹ Examples would be costs incurred to:

(1) drill, shoot, or clean a well; (2) prepare the site for drilling, including ground clearing, drainage, road construction, and surveying and geological work; and (3) construct the physical facilities necessary to drill and prepare the well for production.¹⁰

The option applies only to those drilling and development expenditures that have no salvage value.¹¹ Equipment of a character that is ordinarily considered as having a salvage value, whether it consists of production facilities or equipment necessary for the completion of a well, is depreciable. Its cost may be recovered only through the depreciation allowance. This includes the cost of casing, even though such casing is cemented in the well to such an extent that it has no net salvage value.¹²

The costs of installing salvageable items required to complete the well are also treated as intangible drilling and development costs subject to the election. The IRS has ruled that a producing well is completed when the casing, including the “Christmas tree,” has been installed.¹³

Expenses that relate to the installation of production and treatment facilities, such as storage tanks and pumping equipment, are not considered to be intangible drilling costs.¹⁴ The expenses of operating wells or other facilities for the production of oil or gas are deductible as ordinary and necessary business expenses.¹⁵

THE ISSUE IS NOT THE DEDUCTIBILITY OF IDC; IT IS THE TIMING OF THE DEDUCTION. THE EXPENSING OF IDC'S IS A DEFERRAL OF TAXES NOT AN ELIMINATION. THE TREASURY DOES NOT LOSE REVENUE BY THE EXPENSING OF IDC'S, ONLY THE TIME VALUE OF THE DIFFERENCE BETWEEN EXPENSING THE IDC IN THE YEAR INCURRED VERSUS AMORTIZING THE IDC OVER THE LIFE OF THE WELL.

How does the country benefit from the expensing of IDC?

1. More wells are drilled. Historically Independents drill 105% to 110% of available cash flow. Without expensing, 25% fewer wells will be drilled. 70% of the typical well is IDC x 36% tax rate = 25%.
2. Increased production reduces the cost of oil and gas to the economy. An example is the fact that the price of natural gas has dropped significantly.
3. The oil industry directly employs blue collar workers at average wages from \$50,000 to \$100,000.
4. The oil industry consumes significant amounts of domestic steel.
5. North American energy independence is achievable in 10 years.
6. There is a renaissance in the domestic chemical industry due to the low price of natural gas.
7. Unemployment in states that produce oil and gas is significantly less than the national average.

BIBLIOGRAPHY:

¹ *Shaffer v Comm.* 29BTA 1315, CCH Dec. 8451 (1934).

² *Dakota-Montana Oil Co. v. US*, 288 US 459 (1933).

³ *Ramsey v. Comm.* 290 US 673 (1933).

⁴ *F.H.E. Oil Co. v. Comm.* 147 F2d 1002; rehearing denied. 149f2d 238 (1945).

⁵ 1945 C B 45.

⁶ Section 263 (C) I.R.C. (1986).

⁷ Section 263 (C) I.R.C. (1986).

⁸ *Heberer v. Comm.* 32TCM 626 (1974).

⁹ Reg §1.612-4 (a).

¹⁰ Reg. §1.612-4 (a).

¹¹ *Ibid.*

¹² Rev. Rul. 70-44, 1970-2CB132.

¹³ *Ibid.*

¹⁴ *Ibid.*

¹⁵ Code Sec. 162; Reg. §1.612-4 (c)(2).

ORIGIN AND EVOLUTION OF THE DEPLETION ALLOWANCE

While two temporary federal income tax acts were passed prior to 1900, the Corporate Franchise Act of 1909 marks the beginning of continuous corporate income taxation in this country. This act levied a corporation franchise tax of 1% on net income. Definitions of gross income, net income, allowable deductions and other critical items were not clear, however, which resulted in considerable confusion.

A group of metal miners were among the first to challenge the Act, contending that they were entitled, on constitutional grounds, to a tax deduction to recover their investments in mining properties (i.e., a depletion allowance). The Corporate Franchise Act of 1909 carried no such provision. The miners argued that if they were unable to recover their investments solely due to federal taxation, this would amount to unconstitutional confiscation. Although the Supreme Court ruled against the miners at that time, the first general Revenue Act of 1913, and each of the over 25 federal income tax acts since then, have contained provisions for depletion of wasting assets.

The Revenue Act of 1913 limited annual depletion deductions to 5% of the gross value of the minerals produced at the mine site. This was modified by the Revenue Act of 1916 to permit depletion charges up to the larger of (1) the capital invested in the property or (2) its fair market value on March 1, 1913, the date of the first income tax act.

A major change was included in the Revenue Act of 1918 by permitting discovery *value*, rather than discovery *cost*, as the limit to depletion deductions. This act established the fair market price of new discoveries as the upper limit on total depletion deductions. While many arguments were offered in support of this change, the most defensible is that past discovery costs are frequently poor indicators of what future discovery costs will be when the original deposit is exhausted and a replacement is needed. This cost escalation is due to the disappearance of high grade and/or easily located deposits, and is entirely separate from the inflationary cost increases that prevent any industry from recovering replacement costs through depreciation. In the 1918 act, the right of and justification for permitting depletion recoveries in excess of capital costs first appears.

To eliminate alleged tax loopholes, subsequent acts limited discovery value depletion to the net income from the property, and further restricted deductions to 50% of net income from the property.

The concept of percentage depletion was born out of the fact that the Bureau was overwhelmed by the volume of work in the enforcement of discovery depletion and eventually initiated a search to accomplish the task. The search for a better plan was initiated in 1922 and was temporarily shelved. Basically the plan entailed a depletion allowance to be based upon a kind of percentage, thus doing away with valuation. That was as far as the Bureau went. ¹

The Senate Committee on Finance, realizing the seriousness of the problem exposed to it by the Select Committee Report, held a public hearing on the report. Hence, the Select Committee Report played an important role in the enactment of percentage depletion. Mr. Manson, the Counsel for the Select Committee, was the primary witness to present the report. The presentation centered on the results of the administration and application of discovery depletion. It did not at all criticize or reevaluate the liberal interpretation of the law by the Bureau, nor its administration, nor the functions performed by each sector. Instead, it took a broader point of view, that of the inequalities resulting from the application of the law, leaving the decision to the Senate Committee on Finance regarding a remedy should the Committee feel it necessary.

Manson pointed out the wide divergence of discovery valuations that resulted in a wide inequity. He cited one case where four partners with an undivided interest and actually operating the property together as a partnership, and additionally with the same property as a base, had a different valuation. The result was widely divergent units, depletion of 28.5, 33.7, 60.0 and 71.74 cents per barrel to be allowed to the respective partners. Other cases were cited and discussed. Manson concluded that the way it stood, there was a lack of consistency and uniformity which resulted in varying tax assessments. There was no system or method whereby two valuations of the same property were alike. Manson further noted that this problem was inherent in the system of valuation and that it was entirely futile to search for a method that would arrive at a just and uniform appraisal. ²

The hearings before the Senate Committee on Finance reveal that the idea of substituting a percentage depletion was in the air prior to the hearings. At one point during these hearings, Manson pointed out the liberality of the application of discovery depletion in which every foot of a producing property qualified. As a result, every producer was already getting it on his production. Accordingly, he suggested that an allowance of a flat percentage on operating earnings would not be any more liberal than discovery depletion. The section on percentage depletion was laid before the Senate for its consideration on February 11, 1926. It passed the same day but only after extensive debate.³

The extraction of minerals reduces the capital investment of those having an interest in such resources. As compensation for this reduction, a reasonable deduction for depletion is allowed in computing taxable income.⁴

Since 1954, all minerals are entitled to percentage depletion under the Internal Revenue Code.⁵ It is important to note that oil and gas is excluded from the basic statute and the provisions concerning oil and gas are in a subsequent statute due to the fact that the depletion of oil and gas has been greatly restricted relative to other minerals.⁶ Code Section 613A imposes substantial limitations on the allowance for percentage depletion. Among these are the fact that depletion is limited to a maximum of 1,000 barrels of average daily production of domestic crude oil equivalent per day;⁷ further limited to the net income computed on a property by property basis,⁸ and ultimately limited to 65 percent of the taxpayer's taxable income for the year.⁹

Cost depletion and the statutory percentage depletion are basically the same, according to the Supreme Court. In *Herring v. Commissioner*¹⁰, that court in discussing percentage and cost depletion, stated:

But the nature and the purpose of the allowance is the same in both cases, and we find neither statutory authority nor logical justification for withholding it in the one and granting it in the other.

In *O'Shaughnessy, Inc. v. Commissioner*, ¹¹ the Tenth Circuit expressed its belief that Congress granted the depletion deduction to avoid the taxation of capital:

It is clear that it was the Congressional purpose to allow return of capital through statutory depletion from the date of the acquisition of the depletable interest, so long as gross income is realized dependent upon the production of oil or gas.***

The formula prescribed by Sections 23(m)-114(b)(3), [I.R.C. (1939)], having direct relationship to gross income from sources within its scope (oil and gas wells), is exclusive in its application and to that extent it is an arbitrary substitute for the fundamental rule against the taxing of gross income before recovery of capital cost.

In conclusion, it is our opinion that the repeal of percentage depletion will result in the recurrence of the same valuation and enforcement problems that confronted the government in the 1920's.

BIBLIOGRAPHY

1. S. Simon, *Economic Legislation of Taxation: A Case Study of Depletion in Oil and Gas* 169-170 (1969).
2. *Ibid* 170-171.
3. 67 Congressional Record 3762-3778 (1926).
4. Internal Revenue Code of 1986, § 611, 613, and 613A.
5. *Ibid* § 613.
6. *Ibid* § 613A.
7. *Ibid* § 613A(c)3.
8. *Ibid* § 613(a).
9. *Ibid* § 613A(d).
10. *Herring v. Comm'r*, 293 US 322 (1934).
11. *O'Shaughnessy, Inc. v. Comm'r*, 124 F. 2d 33 (10th Cir. 1941).

EXHIBIT A

PERCENTAGE DEPLETION RATES

The mines, wells, and other natural deposits, and the percentages are set forth in the numbered paragraphs below:

(1) 22 percent

(A) sulphur and uranium; and

(B) if from deposits in the United States-anorthosite, clay, laterite, and nephelite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc.

(2) 15 percent

If from deposits in the United States-

(A) gold, silver, copper, and iron ore, and

(B) oil shale (except shale described in paragraph (5)).

(3) 14 percent

Metal mines, rock asphalt, vermiculite, ball clay, bentonite, china clay, sagger clay, and clay used or sold for use for purposes dependent on its refractory properties.

(4) 10 percent

Asbestos, brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(5) 7½ percent

Clay and shale used or sold for use in the manufacture of sewer pipe or brick, and clay, shale, and slate used or sold for use as sintered or burned lightweight aggregates.

(6) 5 percent

(A) gravel, peat, pumice, sand, scoria, shale (except shale described in paragraph (2)(B) or (5)), and stone (except stone described in paragraph (7));

(B) clay used, or sold for use, in the manufacture of drainage and roofing tile, flower pots, and kindred products; and

(C) if from brine wells-bromine, calcium chloride, and magnesium chloride.

(7) 14 percent

All other minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "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; or

(C) oil and gas wells.

Minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake within the United States shall not be considered minerals from an inexhaustible source.

(6) 5 percent

(A) gravel, peat, pumice, sand, scoria, shale (except shale described in paragraph (2)(B) or (5)), and stone (except stone described in paragraph (7));

(B) clay used, or sold for use, in the manufacture of drainage and roofing tile, flower pots, and kindred products; and

(C) if from brine wells-bromine, calcium chloride, and magnesium chloride.

(7) 14 percent

All other minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include-

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