



1983

# Deductibility of Prepaid IDC after Keller

Michael R. Donaldson

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## Recommended Citation

Note, Deductibility of Prepaid IDC after Keller, 32 Clev. St. L. Rev. 295 (1983-1984)

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## I. INTRODUCTION

In recent years,<sup>1</sup> the Internal Revenue Service (IRS) has succeeded in eliminating a number of tax-sheltering mechanisms by employing both changes in the tax laws<sup>2</sup> and zealous—some would say overzealous—enforcement of tax law interpretations. While some of these mechanisms may have been abusive,<sup>3</sup> others which were harmless and productive have also fallen victim to the wholesale assault.<sup>4</sup> In July of 1982, with the Tax Court's decision in *Keller v. Commissioner*,<sup>5</sup> one of the most

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<sup>1</sup> In 1973, the National Office of the I.R.S. began its Coordinated Program for Examination of the Oil and Gas Drilling Industry. This program was later expanded to include tax shelters in the areas of farm operations, real estate, and motion pictures. Carter & Parrott, *IRS Targets "Abusive" Oil and Gas and Other Tax Shelter Investments as "Litigating Vehicles,"* 29 OIL & GAS TAX Q. 319, 320 (1980).

<sup>2</sup> The most notable change in the tax laws came with the enactment of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified at scattered sections of titles 5, 7, 15, 19, 26, 29, 42 & 46 U.S.C. (1982)).

<sup>3</sup> The IRS Tax Shelters Examination Handbook defines an abusive tax shelter as "one in which the present value of all future income is less than the present value of all the investments and associated costs in the shelter." [1982 Index] STAND. FED. TAX REP. (CCH) ¶ 351(7), at 8567. "The Handbook covers motion pictures, real estate, farming, oil and gas, coal, equipment leasing, and commodity options and futures, and outlines the principal issues raised in such transactions and an exposition of the applicable law." R. HAFT & P. FASS, 1982 TAX SHELTERED INVESTMENTS HANDBOOK 475.

<sup>4</sup> "Tax shelter cases now dominate the time of the Tax Court. [These cases] involve \$5 billion in possible disallowances, 25,000 tax shelters under attack and 200,000 taxpayers who will be affected." Jacobowitz, *Tax Shelters—Current Issues, Practice and Trends*, 39 INST. ON FED. TAX'N intro. chs. 22-25 (1980).

<sup>5</sup> 79 T.C. 7 (1982) (holding, under standards not previously applied to the IDC area, that

widespread and traditionally favored tax-shelter vehicles,<sup>6</sup> the oil and gas exploratory<sup>7</sup> drilling fund, was placed on the endangered species list, its ultimate fate as yet undeterminable. The *Keller* court held that a cash-basis taxpayer could not currently deduct expenditures made at year-end as payments for intangible drilling and development costs (IDC) to be incurred in the following year, because the allowance of such a deduction would, in the opinion of the Commissioner of Internal Revenue (the Commissioner) and the *Keller* court, result in a material distortion of income.<sup>8</sup>

## II. GENERAL BACKGROUND

The typical tax shelter is comprised of three elements: 1) conversion of ordinary income into capital gain; 2) leverage; and 3) deferral.<sup>9</sup> Conversion occurs "when [a] capital gain is realized on the sale or other disposition of an asset, which gain was created by accelerated deductions taken against ordinary income."<sup>10</sup> Leveraging is the principle whereby an "investor uses borrowed funds to pay expenses for which current deductions are received."<sup>11</sup> Deferral, which is of primary importance for the purposes of this Note, occurs when deductions are accelerated, thereby reducing the tax liability of investors in the initial year or two of the program and "resulting in an interest-free loan from the government until the shelter reverses."<sup>12</sup>

During its heyday, the oil and gas drilling limited partnership provided investors with the opportunity to take advantage of each of these elements. First, the gain or loss on the sale of a limited partner's interest in a drilling program was treated as a long-term capital gain or loss, provided, of course, the partner had held his interest for more than twelve months. This successfully converted his initial investment, which might

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the IDC prepaid by a limited partnership could not be deducted in the year of payment, but would have to await the year the services were actually rendered).

<sup>6</sup> The real estate tax shelter is the most abundant, but "the second most common source of tax-oriented investments is oil and gas drilling operations." Pineo, *Tax-oriented Investments: The Current Trend*, 39 INST. ON FED. TAX'N § 22.00, at 22-7 (1980).

<sup>7</sup> An "exploratory" drilling program is composed of a relatively high percentage of properties which are unproven, in comparison with "development" or "income" drilling programs, which involve less of a gamble for investors. "Exploratory" programs provide investors "with greater tax benefits and greater opportunity for growth, at greater risk, than a 'development' or 'income' fund." Klueger, *Deductibility of "Prepaid" Intangible Drilling and Development Costs*, 30 OIL & GAS TAX Q. 431 (1982). See R. HAFT & P. FASS, *supra* note 3, at 251.

<sup>8</sup> 79 T.C. at 41.

<sup>9</sup> Harrell & Stricof, *Overview of an Oil and Gas Tax Shelter*, 28 OIL & GAS TAX Q. 496, 496 (1980).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

have been taxable as ordinary income,<sup>13</sup> into an investment amenable to capital gains treatment. Second, one of the principal means of taking advantage of leveraging prior to 1972 was through the use of nonrecourse loans by the general partner or by an outside lender to the limited partners for investment in the drilling program. These "leveraged" drilling programs frequently offered five dollars or more of deductions for each dollar of investment.<sup>14</sup> Third, deductions could be accelerated by the use of the special treatment afforded IDC by congressional mandate. The Internal Revenue Code (I.R.C. or Code) directs the Secretary to prescribe regulations granting "the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells."<sup>15</sup> The Secretary has complied with this directive and has promulgated a treasury regulation which provides that "intangible drilling and development costs incurred by an operator . . . in the development of oil and gas properties may at his option be chargeable to capital or expense. This option applies to all expenditures . . . for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling . . . and the preparation"<sup>16</sup> of oil and gas wells.

By the proper exercise of this option, IDC, which are the major expenses incurred in any oil and gas drilling program,<sup>17</sup> can be written off against current income ("expensed"), as opposed to being capitalized and depreciated. This results in substantially lower after-tax costs in drilling oil and gas wells.<sup>18</sup> Treasury regulations provide that the option to expense IDC "may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's return for the first taxable year in which the taxpayer *pays or incurs* such costs."<sup>19</sup> The Secretary's use of the phrase "pays or incurs" creates one of the more controversial tax shelter features of oil and gas drilling programs, because for "the investor seeking to shelter income . . . the key feature is the ability of the

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<sup>13</sup> Provided the investment is made at the end of the taxable year using money which would be includable as ordinary income on the taxpayer's federal income tax return and provided the taxpayer has invested in a program in which his distributive share of partnership losses is equal to or greater than the amount of his initial investment, the net effect of the transaction will be to shelter the initial investment from federal income taxation during the life of the shelter. When it is finally taxed at the time the taxpayer's interest is liquidated, the investment will, at least in part, be taxed at the capital gains rate, which is presently a maximum of twenty percent. See *infra* text accompanying note 21 for further clarification.

<sup>14</sup> See Pennell, *Alleviating the At-Risk Rules*, 29 TUL. TAX INST. 1 (1979).

<sup>15</sup> I.R.C. § 263(c) (1982).

<sup>16</sup> Treas. Reg. § 1.612-4(a) (1966).

<sup>17</sup> It has been estimated that, on the average, "these costs represent upwards of 70% of the total cost of a well." Webb, *Petroleum Tax Policy, Controls and the Energy Crisis*, 22 OIL & GAS TAX Q. 203, 229 (1974).

<sup>18</sup> *Id.*

<sup>19</sup> Treas. Reg. § 1.612-4(d) (1965) (emphasis added).

program to incur and expense IDC in the earliest possible year. [So.] for the investor who must shelter income in a given tax year . . . the ability to deduct IDC in the year of investment . . . , through 'prepaid' IDC"<sup>20</sup> is the key investment criterion, for it is the use of prepaid IDC which permits an investor to write off most, if not all, of his investment in the year of investment.

Subsequent to the idyllic days of its inception, the oil and gas drilling fund tax shelter endured a series of assaults. First, due to changes in the tax laws, "the portion of any gain which is attributable to the partner's share of recapture of IDC, to depreciation recapture on equipment, or to any other unrealized receivables and any other substantially appreciated property held by the partnership as a dealer will generally be treated as ordinary income"<sup>21</sup> upon the disposition of partnership interests.

Second, in 1972, the IRS ruled that nonrecourse loans by the general partner to the limited partners, while constituting an addition to the interest of the general partner, did not increase the basis of the limited partners.<sup>22</sup> Then, in 1976, the use of nonrecourse loans was totally foreclosed as a leveraging mechanism for oil and gas exploration activities.<sup>23</sup> As part of the Tax Reform Act of 1976, Congress enacted the "at risk" rules under I.R.C. section 465. These rules limited allowable losses to the total amount the investor has "at risk" in the venture at the end of the taxable year.<sup>24</sup> The amount of allowable deductions for any particular limited partner in an oil and gas limited partnership is presently limited to "the amount of money or property invested in the activity, funds borrowed with personal recourse and invested in the partnership or activity, or loans for which the investor has pledged property other than that of the activity involved."<sup>25</sup> In the event that a limited partner's distributive share of loss exceeds his adjusted basis, any "[d]isallowed losses are deductible in the next succeeding year in which the amount 'at risk' in the

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<sup>20</sup> Klueger, *supra* note 7, at 431. An expense will generally be considered prepaid when "paid in a taxable year prior to the taxable year prior to the taxable year in which the benefits therefrom are received; nondeductibility of a prepaid expense is based on the assumption that expense in a fixed amount can be directly associated with the benefit to be received in a future year." *Texas Instruments, Inc. v. United States*, 551 F.2d 599 (5th Cir. 1977).

<sup>21</sup> R. HAFT & P. FASS, *supra* note 3, at 251. For the specific provisions dealing with the share of recapture attributable to an individual partner, see I.R.C. § 1254 (1982).

<sup>22</sup> Rev. Rul. 135, 1972-1 C.B. 200.

<sup>23</sup> I.R.C. § 465(c)(1) (1982). In addition to "exploring for, or exploiting, oil and gas resources," I.R.C. § 465 also applies to "(A) holding, producing or distributing motion picture films or video tapes, (B) farming . . . , (C) leasing any section 1245 property . . . , [and] . . . (E) exploring for, exploiting, geothermal deposits." I.R.C. § 465(c)(1) (1982). See also note 1 *supra*.

<sup>24</sup> Any loss disallowed because it exceeds this amount can be deducted in the next taxable year, subject to the same limitation. See I.R.C. § 465(a)(2) (1982).

<sup>25</sup> Harrell & Stricof, *supra* note 9, at 508.

activity is increased above zero, and may be carried forward indefinitely."<sup>26</sup>

Third, the deferral aspect of the oil and gas drilling tax shelter, though previously the least assaulted, likewise did not go unassailed, even prior to *Keller*. The Tax Reform Act of 1976, while not directly attacking the IDC option, "diminish[ed] the value of the resulting tax deferral by adding 'excess' IDC to the list of tax preference items upon which the minimum tax is imposed."<sup>27</sup>

Despite its embattled past, the typical oil and gas drilling fund is much the same in structure now as it has always been. Generally, in a proposed drilling fund, subscriptions are offered by the corporation which will serve as the managing general partner through various investment-oriented companies.<sup>28</sup> The program is usually structured as a single-tier or a two-tier limited partnership<sup>29</sup> and is targeted at investors in the higher tax brackets.

There are several advantages in utilizing the limited partnership structure which help to account for its popularity among drilling funds. First, it allows for the pooling of capital by many smaller investors. With their capital pooled, the group can enter into a more diversified program which no one alone could have undertaken, thereby spreading the risk inherent in wildcat drilling ventures.<sup>30</sup>

Second, a limited partnership has the advantage of permitting tax benefits to be passed on directly to the individual investor<sup>31</sup> on a "functional

<sup>26</sup> R. HAFT & P. FASS, *supra* note 3, at 438.

<sup>27</sup> Glickman & DeBerry, *Post-1976 Oil and Gas Operations Will Require Careful Planning to Overcome Adverse Effects*, 46 J. TAX'N 230, 230 (1977); see I.R.C. § 57(a)(11) (1982). For a good discussion of the minimum tax and the alternative minimum tax, see R. HAFT & P. FASS, *supra* note 3, at 278-81.

<sup>28</sup> Generally, brokerage firms and those engaged in tax advisory functions account for the majority of subscription sales.

<sup>29</sup> In multi-state operations, two-tier partnerships are being used with great success to alleviate the problems of burdensome registration and filing requirements." Record, *Financing Oil and Gas Exploration*, 24 INST. ON OIL & GAS L. & TAX'N, 111, 121-22 (1973).

<sup>30</sup> "According to data reported by the American Association of Petroleum Geologists, only one out of every sixty new field wildcats discovers a significant field . . . Furthermore, even a significant discovery can be a financial loss, or only marginally profitable, because of high exploration and development costs." Webb, *supra* note 17, at 211.

<sup>31</sup> In a limited partnership which is treated as such for federal income tax purposes, each limited partner reports his distributive share of partnership income, loss, credit, etc., on his personal tax return. On the other hand, if the IRS were to classify the partnership as an association, the entity would be taxed as a corporation and the partners would be treated as its shareholders. Under these circumstances, any distributions from the partnership would be taxable to the limited partners as dividends, and partnership income, loss, etc. could not be passed through to the limited partners. For a full discussion, see Treas. Reg. §§ 301.7701.2, 301.7701.3. For cases dealing with challenging partnership status, see *Larson v. Commissioner*, 65 T.C. 159 (1975), later withdrawn and reissued against the Commissioner on Apr. 27, 1976 in 66 T.C. 159; *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

allocation" basis. In this system, "the general partner usually contributes the leases and possibly tangible equipment costs, and the limited partners make cash contributions to the partnership. The limited partners are allocated the intangible drilling costs, while capitalized costs are allocated to the general partner."<sup>32</sup> The IRS first stated its position regarding allocations of IDC in Revenue Ruling 68-139,<sup>33</sup> which provides that the allocation should be allowed "unless examination discloses that the principal purpose of the allocation is the avoidance or evasion of Federal income tax."<sup>34</sup>

Third, while the use of a limited partnership has the sometimes undesirable characteristic of limiting the amount of allowable deductions,<sup>35</sup> it also, by definition, has the desirable characteristic of limiting the liability of the individual investors to the amount each has actually invested in the venture—or to some other specified amount if financing mechanisms are utilized.

### III. HISTORY OF IDC DEDUCTIBILITY

Primarily because oil and gas exploration activities involve an extremely high risk of loss,<sup>36</sup> "[s]ince 1917—or virtually since the inception of the federal income tax laws—the operator of an oil and gas property has been afforded an election either to deduct or to capitalize the intangible costs associated with drilling and developing the property."<sup>37</sup> Due to the high risk involved in oil and gas drilling ventures "one of the important motivating factors in inducing investors to contribute capital to funds is the 'up-front' deduction through the use of IDC."<sup>38</sup>

The enactment of provisions granting the option to expense IDC,<sup>39</sup> as opposed to capitalizing it and recovering it over a number of years, did not at first necessarily mean that a taxpayer using the cash receipts and

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<sup>32</sup> Harrell & Stricof, *supra* note 9, at 501.

<sup>33</sup> 1968-1 C.B. 311 (ruling that the provisions of the partnership agreement relating to the allocation of IDC will govern if a proper election is made under Treas. Reg. §§ 1.703-1(b)(1), 1.612-4).

<sup>34</sup> *Id.* at 312. See also *Orrisch v. Commissioner*, 55 T.C. 395 (1970), *aff'd per curiam*, 9th Cir., unpublished (special allocation of depreciation of two apartment houses by amendment to the partnership agreement held to have been undertaken principally for tax avoidance purposes); I.R.C. § 704, as amended by the Tax Reform Act of 1976 (providing that allocations will be recognized for income tax purposes unless they do not have "substantial economic effect"); Attermeier, *The Crude Oil Windfall Profits Tax of 1980: How It Will Affect Oil Companies*, 52 J. TAX'N 264 (1980) (dealing in part with the IRS repudiation of the liberal stance it had adopted in Rev. Rul. 68-139).

<sup>35</sup> See *supra* note 24 and accompanying text.

<sup>36</sup> See *supra* note 30.

<sup>37</sup> Baum, *Intangible Drilling and Development Costs: Some Recurring Problems*, 21 INST. ON OIL & GAS L. & TAX'N 337 (1970).

<sup>38</sup> Klein, *Tax Shelter from Tax Reform*, 25 OIL & GAS TAX Q. 163, 179 (1976).

<sup>39</sup> See *supra* notes 15-16 and accompanying text.

disbursements method of accounting could deduct IDC in the year in which they were paid. Because I.R.C. section 263(c) did not speak directly to the timing of the deduction, the early position of the IRS was that "IDC prepaid by a taxpayer, who keeps his accounts and files his returns on the cash basis and elects to treat such costs as expenses, constitute an allowable deduction only for the taxable year in which the drilling and developing services are actually rendered."<sup>40</sup> So, while I.R.C. section 162 permits expenses to be deducted in the year payment is made by a cash-basis taxpayer,<sup>41</sup> the position of the IRS was that in order to be currently deductible, IDC must have been both incurred and paid and, in addition, the taxpayer must already have received the benefits of the transaction.<sup>42</sup>

The initial treatment accorded IDC prepayments was identical to treatment of prepaid insurance by the IRS. In *Commissioner v. Boylston Market Association*,<sup>43</sup> it was held that a cash-basis taxpayer which bought insurance policies covering periods of three and more years could deduct only the pro rata portion of the prepaid premiums attributable to each year.<sup>44</sup> In other words, the taxpayer should deduct the expense only in the year that it paid for and received its bargained-for benefit.

Though current deductibility of prepaid IDC was ostensibly precluded by Revenue Ruling 53-170,<sup>45</sup> that issue was not presented to the Tax Court until 1963. *Pauley v. United States*<sup>46</sup> involved a taxpayer who had executed a written contract with a drilling company on December 31, 1947 and had paid the driller \$95,000 as "payment for work to be performed and materials to be furnished"<sup>47</sup> as IDC under the agreement. Drilling commenced in January, 1948, and the taxpayer took a deduction for the full amount paid on his 1947 federal income tax return. The IRS ruled that the taxpayer was required to deduct the prepaid IDC in the year the work was actually performed, rather than in the year of payment.<sup>48</sup> The district court disagreed with the IRS, however, and held that the "prepayment of the intangible drilling expenses was both an 'ordinary' and a 'necessary' expense under Section 23(a)(1)(A) of the Internal Revenue Code of 1939, [and] fully deductible in the year of payment. . . ."<sup>49</sup> The taxpayer was allowed to deduct the prepaid IDC despite the fact that in the view of the Commissioner a distortion of income

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<sup>40</sup> Rev. Rul. 170, 1953-2 C.B. 141, 141.

<sup>41</sup> I.R.C. § 162(a) (1982).

<sup>42</sup> 1953-2 C.B. at 142.

<sup>43</sup> 131 F.2d 966 (1st Cir. 1942).

<sup>44</sup> *Id.* at 966.

<sup>45</sup> 1953-2 C.B. 141.

<sup>46</sup> 63-1 U.S. Tax Cas. (CCH) ¶ 9280 (S.D. Cal. 1963).

<sup>47</sup> *Id.* at 87,652.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* at 87, 656.



resulted.<sup>50</sup> The two diametrically opposed positions, the *Pauley* court's position and the position taken by the Commissioner in Revenue Ruling 53-170, could never be reconciled, so the *Pauley* court dismissed Revenue Ruling 53-170 as being of no more binding force than "the opinion of any other lawyer."<sup>51</sup>

It was not until eight years after the *Pauley* decision that the IRS formally acquiesced in the court's position regarding current-year deductibility. In 1971, the Commissioner issued two rulings<sup>52</sup> which seemed to settle the issue that IDC "*paid under a contract* by a cash-basis taxpayer who elected in a prior year to treat such costs as expenses, are deductible in the year paid even though work is performed in the following year."<sup>53</sup> Revenue Ruling 71-252<sup>54</sup> involved a taxpayer who, on December 31, 1969, paid for work which was performed in 1970. The taxpayer deducted the entire payment as an expense on his 1969 federal income tax return pursuant to the I.R.C. section 263(c) option.<sup>55</sup> The full amount of the prepayment was allowed as a deduction for 1969 because "the circumstances . . . show[ed] that the taxpayer, as a result of a bonafide transaction, was *obligated to pay* the amount of IDC at the times specified in the drilling contract."<sup>56</sup> In contrast, Revenue Ruling 71-579<sup>57</sup> provided that IDC "*paid by a cash-basis taxpayer in a taxable year prior to the year in which payment is required* under a drilling contract are not deductible in that year."<sup>58</sup> This latter Revenue Ruling involved a taxpayer who, although obligated to pay only upon completion of the well in 1971, voluntarily prepaid \$50,000 during 1970 and deducted this amount on his federal income tax return for that year.<sup>59</sup>

Viewed together, these two rulings appeared to necessitate a binding contractual obligation to prepay the IDC at the time payment is in fact made as the prerequisite to current-year deductibility. Even as late as 1982, the Commissioner advised that prepaid IDC was deductible in the year in which the taxpayer was legally obligated to make the

<sup>50</sup> See I.R.C. § 446(b) (1982); see *infra* text accompanying notes 131-39.

<sup>51</sup> 63-1 U.S. Tax Cas. (CCH) ¶ 9280, at 87,657. While it is true that revenue rulings are not binding on the Commissioner, they are in many instances the best guidance available to tax attorneys and taxpayers. Section 601.201(a)(5) of the Statement of Procedural Rules "describes a revenue ruling as the official interpretation by the Internal Revenue Service, published for the information and guidance of taxpayers and *Internal Revenue Service officials*." *Keller v. Commissioner*, 79 T.C. 7 (1982) (emphasis added).

<sup>52</sup> See Rev. Rul. 252, 1971-1 C.B. 146; Rev. Rul. 579, 1971-2 C.B. 225.

<sup>53</sup> Rev. Rul. 252, 1971-1 C.B. 146, 146 (emphasis added).

<sup>54</sup> 1971-1 C.B. 146.

<sup>55</sup> *Id.* at 146.

<sup>56</sup> *Id.* at 147 (emphasis added).

<sup>57</sup> 1971-2 C.B. 225.

<sup>58</sup> *Id.* at 225 (emphasis added).

<sup>59</sup> *Id.*

prepayments.<sup>60</sup>

A binding obligation to prepay the IDC did not stand as the sole requirement for current-year deductibility, however. Both prior and subsequent IRS rulings and court decisions established what, at least before *Keller*, seemed to be relatively firm structural guidelines for allowing the prepayment of IDC to be deducted in the year of payment. These requirements for allowance of the deduction for prepaid IDC in the year of payment are: 1) the taxpayer seeking to exercise the I.R.C. section 263(c) option must have held a working or operating interest;<sup>61</sup> 2) the taxpayer must have possessed the operating interest at the time the expense was incurred;<sup>62</sup> 3) the amount of the prepaid IDC must have been determined in an arm's-length transaction;<sup>63</sup> 4) the payment for IDC required under a contract must have been made to the drilling contractor who would actually perform the work;<sup>64</sup> 5) any contractual obligation to prepay the IDC must have been binding on all owners of the operating interest;<sup>65</sup> 6) there must have been a legitimate business purpose for the prepayment requirement;<sup>66</sup> 7) the prepayment of IDC must have satisfied the limitations of Treasury Regulation section 1.461-1(a)(1)<sup>67</sup> meeting the

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<sup>60</sup> Letter Ruling 8226135, [Private Letter Rulings] Fed. Taxes (P-H) § 4145 (1982).

<sup>61</sup> See Treas. Reg. § 1.612-4 (1965); see also Rev. Rul. 176, 1977-1 C.B. 77 (driller receives an assignment of the entire working interest in the drill site and an undivided fraction in the remainder of the tract from lessee of the land); Rev. Rul. 207, 1971-1 C.B. 160 (carrying party owns entire interest until it recoups one-half of drilling and completion costs; thereafter it owns an undivided one-fourth interest); Rev. Rul. 657, 1970-2 C.B. 70 (taxpayer who owns one-half interest has option to charge one-half of the IDC); Rev. Rul. 336, 1970-1 C.B. 145 (taxpayer whose operating interest is subject to a retained overriding royalty that may be converted to a 50% operating interest); Rev. Rul. 332, 1969-1 C.B. 87 (taxpayer who owns less than a full operating interest but who is entitled to receive the entire interest income until recoupment of his expenditures); Rev. Rul. 34, 1967-1 C.B. 72 (taxpayer who holds the working or operating interest in oil and gas properties has the option to capitalize or expense the IDC).

<sup>62</sup> See Rev. Rul. 304, 1975-2 C.B. 94; Rev. Rul. 71, 1980-1 C.B. 210; Letter Ruling 8226135, [Private Letter Rulings] Fed. Taxes (P-H) ¶ 4145 (1982); Letter Ruling 8111055, [Private Letter Rulings] Fed. Taxes (P-H) ¶ 3792 (1981); see also *Phillips v. United States*, 233 F. Supp. 59 (E.D. Tex. 1964), *aff'd* 66-1 U.S. Tax Cas. (CCH) ¶ 9157 (5th Cir. 1965) (payments not deductible as IDC since taxpayer was not operator of well); *Platt v. Commissioner*, 207 F.2d 697 (7th Cir. 1953) (payments not deductible as IDC).

<sup>63</sup> Rev. Rul. 211, 1973-1 C.B. 303.

<sup>64</sup> See Rev. Rul. 71, 1980-1 C.B. 210; Letter Ruling 8012060, [Private Letter Rulings] Fed. Taxes (P-H) ¶ 3524 (1980).

<sup>65</sup> Letter Ruling 8012060, [Private Letter Rulings] Fed. Taxes (P-H) ¶ 3524 (1980).

<sup>66</sup> *Compare Pauley v. United States*, 63-1 U.S. Tax Cas. (CCH) ¶ 9280 (S.D. Cal. 1963) (prepayment of IDC allowed as a deduction) and *Stradlings Building Materials, Inc. v. Commissioner*, 76 T.C. 84 (1981) (prepayment of IDC allowed despite failure of contractor to perform services in subsequent year) with Rev. Rul. 71, 1980-1 C.B. 210 (IDC prepayments by a partnership to a partner are not deductible until paid to the independent contractors).

<sup>67</sup> Rev. Rul. 71, 1980-1 C.B. 106. This section proscribes the full deduction of an expenditure which results in the creation of an asset having a useful life which extends substan-

"clear reflection of income" standard of I.R.C. section 446(b);<sup>68</sup> 8) the contracts should have specified the locations of the wells to be drilled;<sup>69</sup> and 9) the contracts should have provided that the drilling be accomplished within a reasonable time.<sup>70</sup>

Thus, IRS rulings and judicial interpretation of prepaid IDC deductibility had combined to develop a sizable body of authority prior to the dramatic reassessment of existing law by the court in *Keller*.

#### IV. THE FACTS OF KELLER

In 1973, the Kellers acquired a \$50,000 interest in an oil and gas drilling program which involved a group of related entities. The sponsor, Amarex, Inc. (Amarex), was a publicly held company which had been involved in oil and gas exploration and development since 1968.<sup>71</sup> Amarex Funds of Delaware, Inc. (Amarex Funds), was incorporated in 1970 as a wholly owned subsidiary of Amarex. Amarex Drilling Program, Ltd.-72/73 (the Program Partnership) was formed in October of 1972 as a limited partnership, and it invested as a limited partner in four drilling partnerships engaged in the exploration for and production of oil and gas. Amarex and Amarex Funds were the general partners in both tiers of limited partnerships, with Amarex Funds serving as the Program Partnership's manager and the drilling partnership's operator.<sup>72</sup>

Investors, like the Kellers, who purchased five or more \$1,000 units of participation became limited partners in the Program Partnership. The Program Partnership did not acquire oil and gas properties or actively engage in any drilling-related activities, but instead reinvested the investors' money in the four drilling partnerships which conducted the oil and gas operations.<sup>73</sup>

The rights and obligations of the parties were governed by two agree-

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tially beyond the close of the taxable year. See *infra* text accompanying notes 183-87 for a detailed discussion of this issue.

<sup>68</sup> Rev. Rul. 71, 1980-1 C.B. 106. This limitation and its interplay with the Commissioner's power under Treas. Reg. § 1.461-1 is probably the single most important aspect of IDC current-year deductibility. See *infra* text accompanying notes 119-74, for a detailed discussion.

<sup>69</sup> Letter Ruling 8111055, [Private Letter Rulings] Fed. Taxes (P-H) ¶ 3792 (1981).

<sup>70</sup> *Id.* The issue of what constitutes a reasonable time for accomplishment of the drilling is closely related to the issue outlined *supra* note 68 and is explored in the same general discussion cited therein.

<sup>71</sup> According to a recent unsubstantiated report, Amarex entered bankruptcy proceedings during 1983. Brecher & Lampert, *Bill Simon's New Treasury*, NEWSWEEK, Aug. 8, 1983, at 62.

<sup>72</sup> *Keller v. Commissioner*, 79 T.C. 7, 9-10 (1982).

<sup>73</sup> The investors' subscriptions were allocated to the drilling partnership, which was accepting subscriptions at the time of the investment. Of Amarex Drilling Partnerships No. 72-73A, No. 72/73B, No. 72/73C and No. 72/73D, the Kellers' investment was allocated to the last one. *Id.* at 10-11.

ments. Each Program Partnership investor entered into a limited partnership agreement (Program Partnership Agreement) with the general partners, Amarex and Amarex Funds, and as each drilling partnership was commenced, the Program Partnership entered into a limited partnership agreement (Drilling Agreement) with the same general partners.<sup>74</sup>

The Drilling Agreement required Amarex to contribute oil and gas leases, equipment, and cash to the drilling partnership's capital, and it gave Amarex Funds full and exclusive control over all necessary and/or desirable business activities of the drilling partnership. The Program Partnership was expressly precluded from exercising any power over management of the operations of the drilling partnership and was, therefore, merely a "passive conduit"<sup>75</sup> which transferred the investors' subscriptions to the drilling partnership and transferred the drilling partnership's losses or gains to the investors.<sup>76</sup>

Amarex Drilling Partnership No. 72/73D<sup>77</sup> (Drilling Partnership) began its drilling program in August of 1973 and a total of 182 wells were drilled under the program: 63 wells were completed in 1973; 94 wells were completed in 1974; and 25 wells were completed after December 31, 1974. Both the Drilling Partnership and the Program Partnership used the cash-basis method of accounting, and on its 1973 partnership tax return the Drilling Partnership elected to expense IDC in accordance with I.R.C. section 263(c)<sup>78</sup> and Treasury Regulation section 1.612-4.<sup>79</sup>

In December, 1973, the Drilling Partnership transferred \$487,869 to various drilling contractors and service companies pursuant to more than 330 contracts relating to 87 proposed oil and gas wells. It deducted this amount on its 1973 income tax return as prepaid IDC pursuant to three types of contracts: footage and daywork contracts;<sup>80</sup> turnkey drilling contracts;<sup>81</sup> and third-party well-servicing contracts.<sup>82</sup> No work was done

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at 23.

<sup>76</sup> *Id.* at 11.

<sup>77</sup> See *supra* note 73.

<sup>78</sup> See *supra* text accompanying notes 15-19.

<sup>79</sup> See *supra* text accompanying notes 16-19.

<sup>80</sup> Under these standard-form agreements, the total cost of the completed well is not known at the inception of the contract. The drilling costs are based on a certain price per foot of drilling and/or a certain price per day. See MILLER'S OIL & GAS FEDERAL INCOME TAXATION §§ 20-22 (J. Houghton ed. 1982).

<sup>81</sup> Under this type of contract, it is agreed that the well will be drilled to a specified depth for a specified total price, irrespective of the actual amount of time, labor, and materials ultimately necessary to accomplish the task. When the drilling contractor has fulfilled his obligations under the contract, the well will be ready for production and the owner need only "turn the key" in order to start oil flowing. See W. DROLLINGER, TAX SHELTERS AND TAX-FREE INCOME FOR EVERYONE (1977).

<sup>82</sup> Under this type of contract, certain specified materials, services and equipment are agreed to be furnished for specifically enumerated wells at fixed prices. The prices are, however, generally subject to adjustment if delivery occurs after a certain date specified in the

during 1973 on 71 of the 87 wells for which prepayments were made.<sup>83</sup>

Also in December of 1973, the Drilling Partnership transferred \$147,691 to the operator, Amarex Funds, as a fixed price for the supervision of the drilling of certain specified wells in lieu of the monthly rate chargeable under the Drilling Agreement. Amarex Funds performed the supervisory services, for which the prepaid well charges were transferred, after the end of 1973.<sup>84</sup>

Finally, in the same month, the Drilling Partnership transferred an additional \$137,200 to Amarex Funds as a management fee, payable pursuant to the Drilling Agreement.<sup>85</sup> The management services rendered in exchange for this sum were limited to collecting subscriptions from the individual investors, allocating the investments to the Drilling Partnership, keeping the books, and issuing annual reports and tax returns.<sup>86</sup>

In 1973, the Drilling Partnership reported an ordinary loss of \$1,373,257. The Program Partnership reported a \$1,327,000 ordinary loss on its partnership tax return as its distributive share of the Drilling Partnership's loss.<sup>87</sup> The Kellers, who also maintained their books and filed their federal income tax returns using the cash-basis method of accounting, deducted \$50,000 as their distributive share<sup>88</sup> of the Drilling Partnership's loss on their 1973 return.<sup>89</sup>

Upon review of the Drilling Partnership's 1973 return, the Commissioner disallowed \$772,760 in deductions claimed for 1973.<sup>90</sup> As a result, the Kellers' distributive share of the partnership loss was determined to be \$21,595 instead of the claimed \$50,000. The Commissioner determined a deficiency in the Kellers' income tax of \$14,202 for 1973 and, faced with having to pay this amount, the Kellers sought review by the United States Tax Court.<sup>91</sup>

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contract.

<sup>83</sup> *Keller*, 79 T.C. at 17.

<sup>84</sup> *Id.* at 21.

<sup>85</sup> The agreement provided that the "[o]perator shall, at the time of activating this Drilling Partnership, charge the Joint Account for the account of the Program Partnership Manager as a fee for its managing the activities of the Program Partnership an amount equal to 10% of Drilling Subscriptions for this Drilling Partnership." *Id.*

<sup>86</sup> *Id.* at 50.

<sup>87</sup> See I.R.C. § 704(d) (1982). This section applies to the Program Partnership in its capacity as a limited partner in the Drilling Partnership.

<sup>88</sup> *Id.* This section applies to the Kellers as limited partners in the Program Partnership.

<sup>89</sup> *Keller*, 79 T.C. at 12.

<sup>90</sup> The Commissioner disallowed as current-year deductions the \$487,869 prepaid as IDC to the drillers and the \$147,691 paid to Amarex Funds as prepaid IDC for well supervision. The \$137,200 paid to Amarex Funds as a management fee was disallowed entirely because in the Commissioner's opinion it represented a capital expenditure. The \$487,869 prepayment and the \$147,691 prepayment could be deducted in subsequent years when the services were actually rendered, but the \$137,200 payment would have to be capitalized and amortized. *Id.* at 26.

<sup>91</sup> *Id.* at 8.

## V. KELLER ANALYZED UNDER THE ESTABLISHED GUIDELINES

Employing new standards, the Tax Court disallowed prepayments under the footage and daywork contracts, the well-supervision contracts, and the management-fee contract. It allowed the prepayments under the turnkey contracts. Had the *Keller* court chosen to resolve the issues presented by the factual situation under the previously established guidelines,<sup>92</sup> it would have had little difficulty in reaching these same results.

In *Keller* 1) the prepayments were the result of binding contractual obligations;<sup>93</sup> 2) the partnership held the operating interest in the properties and had held it at the time the expenses were incurred;<sup>94</sup> 3) the prepayment amount was the best estimate of the ultimate costs calculated "by the combined efforts of technical personnel on staffs of Amarex and contractors,"<sup>95</sup> hence the result of an arm's-length transaction;<sup>96</sup> 4) the payments were made to the parties who were to perform the actual work;<sup>97</sup> and 5) the contracts required payment from all the working interest owners.<sup>98</sup> The court's resolution of the funds transfers to the drillers and the funds transfers to Amarex Funds for well supervision could have been achieved by using the legitimate business purpose requirement.<sup>99</sup>

Despite proffered explanations such as ensuring rig availability,<sup>100</sup> ensuring commencement of drilling before the expiration of leases,<sup>101</sup> locking in prices,<sup>102</sup> and ensuring preferential treatment,<sup>103</sup> the *Keller* court specifically found that "petitioners [had] not shown a convincing business purpose for any prepayments [by the Drilling Partnership] under any footage and daywork and servicing contracts."<sup>104</sup> Under the guidelines as they existed in 1973,<sup>105</sup> the deductions for the prepayments for the foot-

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<sup>92</sup> See *supra* text accompanying notes 60-70. All of these guidelines had not been articulated in 1973, however.

<sup>93</sup> 79 T.C. at 13. This limitation was articulated prior to 1973, when the Kellers made their investment.

<sup>94</sup> *Id.* These two limitations were also articulated before 1973.

<sup>95</sup> *Id.* at 14. This was also one of the guidelines established prior to the time of the Kellers' investment.

<sup>96</sup> *Id.* This limitation was articulated before 1973. By analyzing the payment of a management fee to Amarex as a disproportionate consideration for the services rendered, the IRS, using only the guidelines established at the time of the Kellers' investment, could have found the payment not to have been the result of an arm's length transaction.

<sup>97</sup> *Id.* This requirement was also on record in 1973.

<sup>98</sup> *Id.* This guideline was, likewise, already enunciated at the time of the Kellers' investment.

<sup>99</sup> See *Pauley v. United States*, 63-1 U.S. Tax Cas. (CCH) ¶ 9280 (S.D. Cal. 1963).

<sup>100</sup> 79 T.C. at 32.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 33.

<sup>103</sup> *Id.* at 35.

<sup>104</sup> *Id.* at 36.

<sup>105</sup> This qualification of the articulated guidelines is meant to include only those require-

age and daywork contracts and for the well-servicing contracts would have been disallowed, just as they were by the court in *Keller*. The prepayments to drillers under the turnkey contracts, supported by the legitimate business purposes of locking in prices<sup>106</sup> and shifting "the drilling risk from the owner to the driller"<sup>107</sup> would have created allowable deductions under the established guidelines, just as they were allowed by the *Keller* court.

The court also found that the \$147,691 transferred to Amarex Funds for well-supervision charges lacked a sufficient business purpose.<sup>108</sup> This finding was made despite a showing that by paying the lump sum, the Drilling Partnership paid less than it would have paid under the monthly-charges structure contained in the Drilling Agreement. The *Keller* court dismissed this contention, stating "petitioner's post hoc argument concerning a lock in of price is irrelevant in our determination of the partnership's motive for prepaying on December 31, 1973, because the record clearly indicated that the lump sum was calculated to maintain a price which had already been locked in."<sup>109</sup> The prepayment for well supervision would have been disallowed as a current-year deduction under the established guidelines, as it was by the court in *Keller*.

Finally, the issue arising out of the transfer of \$137,200 to Amarex Funds, ostensibly as a management fee, could also have been resolved by simply resorting to established authority. As the *Keller* court stated, the "Drilling Partnership's designation of the payment as a fee for management services [did] not determine . . . this issue."<sup>110</sup> The payment, representing ten percent of the total subscriptions, was paid to Amarex Funds as the Program Partnership manager. In exchange for this amount, Amarex Funds did nothing, because it had already been reimbursed for all expenses incurred in performing this function.<sup>111</sup> The payment was, therefore, most probably made as compensation for Amarex Funds' role in the organization of the drilling venture. "It is a settled principle that expenditures for corporate organization are capital expenses, . . . [as] are merger expenses . . . . Included under this classification have also been expenditures incurred in the organization of a partnership."<sup>112</sup> Since it was a capital expenditure, the type of fee characterized by the Drilling

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ments of which the Kellers could and/or should have been aware at the time of their investment.

<sup>106</sup> 79 T.C. at 47.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 44.

<sup>109</sup> *Id.* at 45.

<sup>110</sup> *Id.* at 48.

<sup>111</sup> *Id.* at 50.

<sup>112</sup> *Cagle v. Commissioner*, 539 F.2d 409, 415 (5th Cir. 1976) (citations omitted) (\$90,000 guaranteed payment made by a partnership to its managing partner not automatically deductible as an ordinary and necessary business expense by the partnership, but instead must be treated the same as if made to a nonpartner).

Partnership as a management fee could not be deducted as an expense.

The Kellers and thousands of other investors presumably relied either directly or indirectly on the standards articulated by the IRS and the courts at the time of their investment in the venture.<sup>113</sup> It would, therefore, only have been equitable to resolve the issues presented in accordance with those standards, without resort to any ex post facto additions to or repudiations of them. It would have been reasonable to charge the Kellers with notice of those requirements expressly enunciated prior to the time of their investment, whether or not they in fact had possessed actual knowledge thereof. Charging them with notice of requirements pronounced at a later date, however, cannot be reconciled with any accepted theory of imputing knowledge.<sup>114</sup> In no conceivable way can it be argued that the Kellers did or could know, or even should have known, of the nature or extent of later-established standards.

## VI. THE NEW STANDARD

Although the *Keller* court could have resolved the issues using the established guidelines without resort to any new tests concerning deductibility and could have reached the identical conclusions ultimately attained, it refused to do so. It chose instead to launch the latest salvo in the assault on the oil and gas drilling tax shelter by adopting a new two-part test (the *Keller* test) for current-year deductibility of IDC. The new, potentially-precedential standard espoused by the Commissioner, adopted by the *Keller* court, and boding ill for the future resolution of numerous taxpayers' cases, requires that: 1) the expenditure be a payment rather than a deposit;<sup>115</sup> and 2) the deduction of the prepayment in the payment year not result in a material distortion of income.<sup>116</sup>

The first part of the *Keller* test, that the expenditure must be a payment and not a deposit, while not previously systematically applied in the IDC context, seems to have been an implied assumption supporting each of the previously-established guidelines. The revenue rulings and court decisions all spoke in terms of "payment," and no payment occurs unless the taxpayer's money is "irretrievably out of pocket."<sup>117</sup> As the *Keller*

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<sup>113</sup> If the Kellers had had actual knowledge of the articulated guidelines and had acted in reliance on them when making their investment, they would have relied directly on the IRS standards. If they had not had actual personal knowledge of the articulated guidelines, but instead had acted in reliance on the advice of a tax attorney or the program promoter from whom they purchased their subscriptions, they would have relied indirectly on such standards.

<sup>114</sup> In binding the Kellers to standards promulgated after the time of their investment, the Tax Court is employing something akin to a strict liability standard for noncompliance.

<sup>115</sup> 79 T.C. at 28.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* at 29. The court reiterated, "[t]he term 'payment' has a special meaning for tax purposes. It does not mean a simple transfer of money by a taxpayer. A transfer of money



court explains, "if by express, implied or customary terms, a taxpayer retains a unilateral power to get the money back, then the money transfer is a 'deposit' rather than a payment,"<sup>118</sup> and as such, it cannot be deducted as an expense when tendered. This distinction is based on sound policy considerations. If, on December 31, a taxpayer could transfer funds to another party under the guise of an expense and take a deduction for that year, and then on January 1 of the succeeding year unilaterally compel a full refund, the potential and incentive for abuse would be enormous. The taxpayer could effectively shelter as much as his income as he desired by tying it up for only one day at year-end and bear no risk of loss whatsoever.

Under the new analysis, a failure to conform to the tax-related definition of "payment" was the major problem with the bulk of the year-end money transfers in *Keller*. The footage and daywork contracts were executed utilizing standard-form contracts prepared and printed by the American Association of Oilwell Drilling Contractors and by the International Association of Drilling Contractors. Each of the contracts contained a provision whereby the Drilling Partnership could stop work under the contract and receive a substantial refund.<sup>119</sup> The provision also provided for reimbursement of all reasonable expenses incurred by the Drilling Contractor in connection with the contract and for a small sum (ten percent) as liquidated damages. Because of this provision, at year-end, the only portion of the prepayments "irretrievably out of pocket"<sup>120</sup> would be any amounts already expended by the Drilling Contractor and the ten percent damages amount. Similarly, with the well-servicing contracts, "although no work stoppage or refund provisions were explicitly included . . . , it was understood and agreed that the Drilling Partnership could stop work at any time for any reason and . . . would receive, as a refund, that portion of the prepaid amount which had not been earned by the contractor."<sup>121</sup>

The "payment v. deposit" analysis used by the *Keller* court, while unusual in the IDC context, is certainly not a recent innovation. As the court states, "that the expenditure must be payment rather than a refundable deposit is a sine qua non for deductibility in any context."<sup>122</sup>

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pursuant to a binding contract is also not enough. . . . A payment occurs only when the taxpayer's money is 'irretrievably out of pocket.'" *Id.* (citations omitted).

<sup>118</sup> *Id.*

<sup>119</sup> The provision read in pertinent part that the Owner [the Drilling Partnership] shall have the right to direct the stoppage of the work to be performed by Contractor hereunder at any time prior to reaching the specified depth, and even though Contractor has made no default hereunder, and in such event Owner shall be under no obligation to Contractor.

*Id.* at 15.

<sup>120</sup> See *supra* note 117.

<sup>121</sup> 79 T.C. at 16.

<sup>122</sup> *Id.* at 28.

The future systematic application of this analysis in the IDC area should cause little inconvenience to future investors, as only a simple change in the standard contract work-stoppage provision would be necessary to make the sum transferred a payment rather than a deposit. Since the "payment v. deposit inquiry properly focuses only on the unilateral power of a taxpayer to compel a return of the prepaid amounts,"<sup>123</sup> if the provision were changed to require the sum paid under a subsequently-cancelled contract to be applied toward the completion of a different well instead of being refunded by the drilling contractor, the sum, since "irretrievably out of pocket," would necessarily be construed as a payment.<sup>124</sup>

The more onerous implications of this "payment v. deposit" analysis are obvious when viewed in light of those who invested under the previously-enunciated guidelines.<sup>125</sup> The contracts utilized by the Drilling Partnership in *Keller* were standard contracts, prepared and printed by two of the major trade organizations in the oil and gas drilling industry. One can reasonably assume that these, or contracts with similar provisions, have been in use by a large portion of the industry for a number of years, and each one of the deductions created by prepayments under this type of contract is now open to challenge and to disallowance by the Commissioner.

The second part of the *Keller* test, the material distortion of income aspect, is also a principle new only to the IDC area. It results from blending the second and third parts of the test postulated by the Commissioner in the prepaid-feed context.<sup>126</sup> The *Keller* court refused to consider a legitimate business purpose as an independent requirement because "the two concepts are so inextricably interwoven that the material distortion analysis mandated by [I.R.C.] section 446(b) must include a substantial consideration of the business purpose aspects of the transaction."<sup>127</sup> Instead of accepting the Commissioner's framing of the test, the *Keller* court decided that the existence of "a substantial legitimate business purpose satisfies the distortion of income test."<sup>128</sup> Its absence, however, is not

<sup>123</sup> *Id.* at 46.

<sup>124</sup> See *Owens v. Commissioner*, 64 T.C. 1 (1975), *aff'd in part and rev'd in part*, 568 F.2d 1233 (6th Cir. 1977) (holding in part that refundability only in case of death, bankruptcy, or insolvency of the recipient, does not make money transfers refundable deposits rather than payments); *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973) (taxpayer's transfer of money to seller for feed to be delivered in 1967 deductible as an ordinary and necessary expense for 1966).

<sup>125</sup> See *supra* text accompanying notes 113-14.

<sup>126</sup> See *supra* note 124. In Rev. Rul. 152, 1975-1 C.B. 144, the test was stated as: First, the expenditure must be a payment . . . rather than a mere deposit; second, the prepayment must be made for a business purpose and not merely for tax avoidance; and third; the deduction of such costs in the taxable year of prepayment must not result in a material distortion of income.

<sup>127</sup> *Keller*, 79 T.C. 7, 28.

<sup>128</sup> *Id.* (quoting *Van Raden v. Commissioner*, 71 T.C. 1083, 1106 (1979)).

by itself conclusive proof of a material distortion of income.

In future endeavors, assuming *Keller* is upheld on appeal, it would be wise for partnerships wishing to avoid scrutiny for material distortion of income to include in the drilling contracts an explicit reference to a business purpose<sup>129</sup> motivating all prepayments and to provide for prepayment on all wells.<sup>130</sup> Just as the court in *Keller* was unpersuaded by post hoc justifications,<sup>131</sup> however, it is quite likely that a similarly disposed court would be equally unpersuaded by self-serving pronouncements of a business purpose. If some recited purpose is not sufficient to satisfy the second part of the *Keller* test, then the transactions themselves will be subjected to the material-distortion-of-income analysis utilized by the Commissioner in other contexts.

The I.R.C. provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books,"<sup>132</sup> and that, as a general rule, "[t]he amount of any deduction . . . allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."<sup>133</sup> This means that "[u]nder the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid."<sup>134</sup> As with most general rules, however, and especially with those in the tax area, an automatic assumption of applicability can be disastrous, because most are subject to qualifications. Section 446(a) of the Code notwithstanding, I.R.C. section 446(b) grants the Commissioner wide discretion when "no method of accounting has been regularly used by the taxpayer, or if the

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<sup>129</sup> Some recitation similar to the following might suffice: "As is widely known throughout the industry, the acquisition, exploration and development of interests in attractive oil and gas properties are highly competitive. Moreover, from time to time, drilling rigs, steel products and other drilling or field equipment may not be readily available, and competition for such items may, therefore, become intense. Since failure to secure such items can under certain circumstances result in loss of revenues and/or properties, the partnership will prepay the contract price in order to ensure rig availability and to gain any competitive advantage which could potentially arise therefrom."

It must be kept in mind, however, that such self-serving recitations have generally not been very persuasive to the IRS. In the absence of other corroborative evidence regarding the legitimacy and substantiality of the business purpose underlying any IDC prepayments, it is highly improbable that any recitation in a contract will be sufficient.

<sup>130</sup> The Drilling Partnership in *Keller* prepaid only for the drilling of some wells at year-end. The remainder were drilled during 1973 on a pay-as-you-go basis. This inconsistent action by the Drilling Partnership severely undermined the post hoc justifications offered at trial regarding the legitimacy and substantiality of the underlying business purpose.

<sup>131</sup> 79 T.C. at 45.

<sup>132</sup> I.R.C. § 446(a) (1982).

<sup>133</sup> I.R.C. § 461(a) (1982).

<sup>134</sup> Treas. Reg. § 1.461-1(a)(1) (1957).

method used does not clearly reflect income,"<sup>135</sup> by providing that in those circumstances "the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."<sup>136</sup> This broad discretion applies not only to the overall accounting method employed by a taxpayer, but also includes the power to change the accounting treatment of any item which in particular distorts income from the point of view of the Commissioner.<sup>137</sup> Most often this discretion is authorized through the qualification contained in the treasury regulations: "[i]f an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made."<sup>138</sup>

By way of example, I.R.C. section 163 provides that interest is deductible when paid,<sup>139</sup> but "prepaid interest has been a major factor in the development of the 'material distortion' doctrine."<sup>140</sup> In *Sandor v. Commissioner*,<sup>141</sup> a cash-basis taxpayer borrowed \$100,000 at a 7.5% annual rate for a term of five years. On December 27, 1968, he paid \$38,041, the interest that would accrue over the next five years. On his 1968 federal income tax return, the taxpayer deducted the whole amount pursuant to I.R.C. section 163, but the Commissioner, concluding that the taxpayer's method of accounting materially distorted his income, disallowed the deduction.<sup>142</sup> In effect, the taxpayer was forced to adopt the accrual method of accounting for one item, the prepaid interest, because it created an asset the life of which extended substantially beyond the end of the taxable year in which it was paid. Similarly, in *Burck v. Commissioner*,<sup>143</sup> the Second Circuit affirmed the Tax Court's determination that the Commissioner had properly exercised his I.R.C. section 446(b) discretion in applying the accrual method of accounting to interest prepaid for a term of 51 months.<sup>144</sup> In *Resnick v. Commissioner*,<sup>145</sup> the Seventh Circuit was in agreement with the position "that there was no abuse of discretion by the

<sup>135</sup> I.R.C. § 446(b) (1982) (emphasis added).

<sup>136</sup> *Id.*

<sup>137</sup> See *Commissioner v. Hansen*, 360 U.S. 446 (1959) (accrual-basis taxpayers must include as income amounts credited to them in reserve accounts maintained in the books of finance companies); *Stephens Marine, Inc. v. Commissioner*, 430 F.2d 679 (9th Cir. 1970) (theoretical possibility of being forced to refund part of a payment under a contract with the United States Navy is not sufficient cause to defer including the whole amount as income for the year of receipt).

<sup>138</sup> Treas. Reg. § 1.461-1(a)(1) T.D. 6520, 1961-1 C.B. 52, 62.

<sup>139</sup> I.R.C. § 163 (1982).

<sup>140</sup> Dixon, *Timing of Deductions*, 26 TUL. TAX INST. 1, 5 (1976).

<sup>141</sup> 62 T.C. 469 (1974), *aff'd*, 536 F.2d 874 (1976).

<sup>142</sup> 62 T.C. at 473.

<sup>143</sup> 63 T.C. 556 (1975), *aff'd*, 533 F.2d 768 (2d Cir. 1976).

<sup>144</sup> 533 F.2d at 774.

<sup>145</sup> 555 F.2d 634 (7th Cir. 1977).

Commissioner in disallowing the deduction"<sup>146</sup> and in dealing with the interest prepayment under the accrual method of accounting.<sup>147</sup>

Substantially similar treatment has been accorded the prepayment of insurance premiums<sup>148</sup> and the prepayment of rent.<sup>149</sup> In each instance, the Commissioner determined that the prepayment created an asset fitting the description contained in Treasury Regulation section 1.461-1(a)(1);<sup>150</sup> that, therefore, the cash-basis method of accounting materially distorted the taxpayer's income; and that the accrual method of accounting would more clearly reflect income if it were applied to the item in question.

Each of these items—prepaid interest, prepaid insurance, and prepaid rent—involve "period" costs,<sup>151</sup> and are, therefore, easily distinguishable from the concept of IDC, which bear no relation to the passage of time. As the *Keller* court acknowledged, "we cannot simply prorate prepaid IDC as we have prorated period cost items [because] the prepaid [IDC] do not entail 'period' costs . . . . Instead, the prepaid IDC is more akin to . . . the concept of 'product' costs delineated in [the prepaid cattle-feed context]."<sup>152</sup>

The IRS position regarding prepaid feed was solidified by Revenue Ruling 75-152,<sup>153</sup> wherein the Commissioner outlined the three-part test<sup>154</sup> subsequently repostulated in *Keller*. The test has been widely accepted by the courts, and the Commissioner has attempted to invoke the third part of this test<sup>155</sup> to disallow current-year deductions in the prepaid-feed context on several occasions, but to little avail.<sup>156</sup> The majority

<sup>146</sup> *Id.* at 636.

<sup>147</sup> *Id.* at 636-37. This treatment of expenditures for prepaid interest was finally codified in 1976 as I.R.C. § 461(g).

<sup>148</sup> See Rev. Rul. 413, 1970-2 C.B. 103; *Peters v. Commissioner*, 4 T.C. 1236 (1945).

<sup>149</sup> See *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3rd Cir.), *cert. denied*, 284 U.S. 674 (1931); *Galatore Bros. v. Lines*, 23 F.2d 676 (5th Cir. 1928).

<sup>150</sup> See *supra* text accompanying note 138.

<sup>151</sup> Period costs occur when both the benefits and the liabilities arise with the passage of time.

<sup>152</sup> 79 T.C. at 7.

<sup>153</sup> 1975-1 C.B. 144.

<sup>154</sup> See *supra* note 126.

<sup>155</sup> The third element of the Commissioner's test requires that the deduction "not result in a material distortion of income." Rev. Rul. 152, 1975-1 C.B. 144, 144.

<sup>156</sup> *Commissioner v. Van Raden*, 650 F.2d 1046 (9th Cir. 1981) (where substantially all of the prepaid cattle feed purchased by the taxpayer was consumed within a one-year period, taxpayer could deduct the feed expenditures in the year of purchase without creating a material distortion of income as argued by the Commissioner); *Frysiner v. Commissioner*, 645 F.2d 523 (5th Cir. 1981) (cash-basis taxpayer entitled to deduct in 1975 the cost of cattle feed purchased in December, 1975 for use in a 1976 cattle-feeding program, where the prepayment was for the legitimate business purpose of obtaining the lowest possible price and not merely for tax avoidance); *Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977) (holding, in part, that the cash-basis taxpayer was allowed a deduction for expenditures made in 1964 for feed to be delivered in 1965 and that it would be an abuse of his

of courts deciding the issue have ruled against the Commissioner because Treasury Regulation section 1.471-6(a) provides that a farmer has the option of using cash-basis or inventory<sup>157</sup> accounting in making his federal income tax return. The Commissioner's invocation of Treasury Regulation section 1.461-1(a)(1) in order to disallow the deduction of prepaid-feed expenses and force the deduction of the feed expense only in the year of consumption "would require the farmer either to inventory the feed . . . or to maintain consumption records."<sup>158</sup> The courts have, therefore, almost uniformly<sup>159</sup> rejected these attempts because "consumption records are nothing more than a backhanded inventory method . . . contrary to the historical concession to farmers . . ."<sup>160</sup> of allowing "the purchase of feed connected with raising livestock [to] be treated as expense deductions insofar as such costs represent actual outlays."<sup>161</sup>

As questionable as the applicability of Treasury Regulation section 1.461-1(a)(1) is to the prepaid-feed context, it is even more inappropriate in the area of IDC. Keeping in mind the general rules of cash-basis accounting,<sup>162</sup> it is obvious that the granting of an option to expense what would under ordinary circumstances be a capital asset inherently involves the sanctioning of a distortion of income, but neither the IRS nor the *Keller* court accepts this. Instead, the court would allow the Commissioner to exercise his discretion under I.R.C. section 446(b) to disallow the current-year deduction.<sup>163</sup> "The problem with the Commissioner's argument is that under Regulations section 1.446(a)(1) [the counterpart to Code section 446(b)] the Commissioner is required to choose some other method of accounting that would more accurately reflect income"<sup>164</sup> and no other method would do so.

Under the accrual method of accounting, expenses can be deducted in "the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with

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§ 446(b) discretion for the Commissioner to order that this one item be dealt with under the accrual method of accounting). *But see* *Clement v. Commissioner*, 580 F.2d 422 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979) (Commissioner could use Treas. Reg. § 1.461-1(a)(1) to require the proration of feed expenditures made in one year for feed to be consumed during the next year, in order to avoid what would otherwise be a material distortion of income).

<sup>157</sup> "Under inventory accounting, the taxpayer may deduct the cost of materials used to produce the product only when the product is sold." *Commissioner v. Van Raden*, 650 F.2d 1046, 1048 (9th Cir. 1981).

<sup>158</sup> *Fryinger v. Commissioner*, 645 F.2d 523, 528 (5th Cir. 1981).

<sup>159</sup> *But see* *Clement v. Commissioner*, 580 F.2d 422 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979).

<sup>160</sup> *Commissioner v. Van Raden*, 650 F.2d at 1108.

<sup>161</sup> *Dixon, supra* note 140, at 11. *See* Treas. Reg. § 1.162-12(a), T.C. 7198, 1972-2 C.B. 166, 167.

<sup>162</sup> *See supra* note 134 and accompanying text.

<sup>163</sup> *Keller*, 79 T.C. at 38-39.

<sup>164</sup> *Owens v. Commissioner*, 568 F.2d 1233, 1246 (6th Cir. 1977).

reasonable accuracy.”<sup>165</sup> In *Cheroff v. Commissioner*,<sup>166</sup> where the only issue before the court was the current deductibility of IDC incurred by an accrual-basis taxpayer in 1972 and deducted on its 1972 federal income tax return, the Tax Court held that the contracts entered into were “sufficient to establish the fact of liability and the amount thereof in 1972,”<sup>167</sup> despite the fact that the taxpayer did not sustain the losses in 1972. Similarly, in *Keller*, liability and the amount of liability were both established; the losses were also sustained in the year in question. In the absence of a refund provision, it should be obvious that a change from cash-basis to accrual accounting would not result in a clearer reflection of income, since the prepayments would be deductible under either method. Such an order would, therefore, not be within the Commissioner’s discretion.

The only remaining option for the Commissioner would therefore be to exercise his I.R.C. section 446(b) discretion through Treasury Regulation section 1.461-1(a) and to order that the IDC prepayment be prorated as a capital asset with a useful life extending substantially beyond the end of the taxable year. This option, however, is rife with conceptual difficulties. Ordinarily IDC would fall within the ambit of I.R.C. section 263(a), which provides that such expenditures must be capitalized and depreciated over their useful lives as capital assets.<sup>168</sup> Regardless of the accounting method utilized by the taxpayer, only a certain portion of the total expenditure would be deductible in any one year if it were not for the option Congress formally granted through the enactment of I.R.C. section 263(c) in 1954. This option to expense can be exercised “by claiming [IDC] as a deduction on the taxpayer’s return for the first taxable year in which the taxpayer *pays or incurs* such costs.”<sup>169</sup>

At the time this option was granted by Congress there were no hybrid accounting methods authorized by the Internal Revenue Code.<sup>170</sup> It is beyond question that a cash-basis taxpayer who has incurred but has not yet paid an expense at year-end must wait until the year of payment

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<sup>165</sup> Treas. Reg. § 1.461-1(a)(2) (1957).

<sup>166</sup> 40 T.C.M. (CCH) 183 (1980).

<sup>167</sup> *Id.* at 186. Prior to this appeal the Commissioner had failed to raise any other issues such as whether the deduction in that year created a material distortion of income; therefore, the court refused to consider them.

<sup>168</sup> I.R.C. § 263(a) (1982).

<sup>169</sup> Treas. Reg. § 1.612-4(d) (1965).

<sup>170</sup> “A hybrid method of accounting exists where a single taxpayer computes income for a particular accounting period by applying different methods of accounting to different items of income or deduction within the particular accounting period.” Weary, *IRS Creation of Hybrid Prepayment Methods: Prepayments and the Cash Method; Prepayments and the Accrual Method*, 35th INST. ON FED. TAX’N 59, 61 (1977). Such methods are now permitted, although the “Code and Regulations do not use the term ‘hybrid,’ but instead speak of ‘combination of methods.’” *Id.* n.1.

before deducting it.<sup>171</sup> Likewise, an accrual-basis taxpayer who has paid but not yet incurred an expense at year-end must similarly wait another year before deducting it.<sup>172</sup> It is, therefore, a reasonable assumption that Congress intended the phrase "paid or incurred" to mean that a taxpayer who elected to use the cash method could deduct IDC in the year paid, and that an accrual-basis taxpayer could deduct IDC in the year incurred. This interpretation is strengthened by the very language chosen for Treasury Regulation sections 1.461-1(a)(1) and 1.461-1(a)(2), by which the Commissioner would seek to mandate capitalization of IDC. Under the heading of "Taxpayer using cash receipts and disbursements method," treasury regulations state that "if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, *for the taxable year in which made*,"<sup>173</sup> while, under the heading of "Taxpayer using an accrual method," treasury regulations provide that such an expenditure "may not be deductible . . . *for the taxable year in which incurred*."<sup>174</sup>

The Commissioner's argument is, however, that by allowing what Congress apparently intended, a material distortion of income results, and that IDC should really be deductible only when paid and incurred and when the services have been rendered. The same "substantially beyond" limitation sought by the Commissioner, however, would seem to require the implementation of I.R.C. section 263(a), which deals with the treatment of capital expenditures in general, disallowing their deduction and requiring amortization over their useful lives instead. This is true because Treasury Regulation section 1.263(a)-2(a) defines the expenditures falling within I.R.C. section 263(a) as assets having a "useful life substantially beyond the taxable year."<sup>175</sup> For such items as prepaid interest, prepaid insurance, and prepaid rent, this causes no conceptual problems, because normally they would not fall within I.R.C. section 263(a), but would simply be period costs expensable when paid. Even for expenditures in the prepaid-feed area, although it has been successfully argued that capitalizing and then prorating the deduction is merely backhanded

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<sup>171</sup> Treas. Reg. § 1.461-1(a)(1), T.D. 6520, 1961-1 C.B. 52, 62.

<sup>172</sup> Treas. Reg. § 1.461-1(a)(2) (1960). See also *Lukens Steel Co. v. Commissioner*, 442 F.2d 1131 (3rd Cir. 1971) (credits to a contingent liability account were properly deducted by the accrual-basis taxpayer); *Natco Corp. v. United States*, 240 F.2d 398 (3rd Cir. 1956) (accrual-basis taxpayer's definite and absolute obligation to pay an expense is sufficient to allow deduction of it regardless of whether the item is presently paid or payable); *Pierce Estates v. Commissioner*, 195 F.2d 475 (3rd Cir. 1952) (reversing the Tax Court's decision that interest paid in 1946 had actually accrued earlier and was, therefore, not deductible by the accrual-basis taxpayer for 1946).

<sup>173</sup> Treas. Reg. § 1.461-1(a)(1) T.D. 6520, 1961-1 C.B. 52, 62 (emphasis added).

<sup>174</sup> Treas. Reg. § 1.461-1(a)(2) (1960) (emphasis added).

<sup>175</sup> Treas. Reg. § 1.263(a)-(2)(a) (1960).



inventorying,<sup>176</sup> treatment as a capital expenditure would not be the ordinary course. The ordinary treatment would be through inventory accounting, to which I.R.C. section 263(a) has no relevance.

The IDC area is, at least in part, unique among this group, however. In *Woodward v. Commissioner*,<sup>177</sup> the Supreme Court observed that “[i]t has long been recognized, as a general matter, that costs incurred in the acquisition . . . of a capital asset are to be treated as capital expenditures.”<sup>178</sup> This principle, clearly applicable to the purchase of capital assets, “has been applied, as well, to the costs incurred in a taxpayer’s construction of capital facilities.”<sup>179</sup> An oil well is incontrovertibly a capital asset; therefore, IDC incurred in the construction of capital facilities would be treated as capital expenditures under the general rules. However, mindful of the earlier warning regarding general rules,<sup>180</sup> the court in *Ransburg v. United States*,<sup>181</sup> noted that “[w]hile . . . the basic fundamental of the Internal Revenue Codes of past and present is not to allow the deduction of capital expenses from ordinary income but to offset such against capital gains, nevertheless the Congress can and does digress from the fundamental when granting tax relief.”<sup>182</sup> When Congress authorized the enactment of the option to expense IDC it was such a digression. Without the overriding provision of I.R.C. section 263(c), IDC would be capitalized and amortized under I.R.C. section 263(a). The Commissioner now strives for the mandatory capitalization of prepaid IDC through Treasury Regulation section 1.461-1(a), which again places IDC squarely within the scope of I.R.C. section 263(a) as capital expenditures, despite the express intent of Congress to exempt IDC from the provisions of that section. The extreme conceptual defect in the Commis-

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<sup>176</sup> *Commissioner v. Van Raden*, 71 T.C. 1083, 1108 (1979), *aff’d*, 650 F.2d 1046, 1048 (9th Cir. 1981).

<sup>177</sup> 397 U.S. 572 (1970).

<sup>178</sup> *Id.* at 575. See also *Georator Corp. v. United States*, 485 F.2d 283 (4th Cir. 1973), *cert. denied*, 417 U.S. 945 (1975) (legal fees incurred while resisting the cancellation of a trademark registration constituted a capital expenditure); *Helgeson v. United States*, 426 F.2d 1293 (8th Cir. 1970) (litigation expenses incurred by the corporate majority stockholders in a corporation in intervention in mandamus proceedings constituted a nondeductible capital expenditure); *Brooks v. Commissioner*, 424 F.2d 116 (5th Cir. 1970) (the foreseeable excess of costs over income in connection with oil and gas wells was deductible and did not have to be capitalized by the working-interest owners); *Great Lakes Pipeline Co. v. United States*, 352 F. Supp. 1159 (W.D. Mo. 1972) (funds expended under salary assurance agreements in order to induce key personnel to remain with the corporation during a change of ownership had to be capitalized).

<sup>179</sup> *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 12 (1973) (equipment depreciation allocable to the taxpayer’s construction of capital facilities had to be capitalized under I.R.C. § 263(a)(1)).

<sup>180</sup> See *supra* text accompanying notes 134-35.

<sup>181</sup> 281 F. Supp. 324 (S.D. Ind. 1967) (expense of pruning trees grown for Christmas sale could be deducted from ordinary income).

<sup>182</sup> *Id.* at 328.

sioner's reasoning is thus laid bare when followed to its own natural conclusion.

An area analogous to the IDC context and the I.R.C. section 263(c) option is I.R.C. section 174, which deals with research and experimental expenditures.<sup>183</sup> Such expenditures are explicitly recognized as being capital in nature in I.R.C. section 263(a)(1)(B), which provides that section 263 shall not apply to such expenditures which are deductible under section 174.<sup>184</sup> As Professor Boris Bittker has stated in considering this particular congressional digression from the general rule regarding capital expenditures:

An accounting method that is explicitly authorized . . . by Congress cannot be rejected even if the IRS, on sober evaluation of its impact, concludes that it does not clearly reflect income. The preemptive character of such statutory provisions as IRC [section] 174, permitting taxpayers to deduct research and experimental expenditures even if income would be more clearly reflected by capitalizing these outlays and depreciating them over their useful lives is obvious.<sup>185</sup>

Judge Goffe followed this same logic in his well-reasoned dissent to *Keller*. He stated that I.R.C. section 263(c) must be viewed as preempting the Commissioner's power under I.R.C. section 446(b) because:

[T]he only way that an accounting treatment for IDC can clearly reflect income is to treat such capital items in the traditional manner . . . . This treatment is, however, contrary to section 263(c) . . . . Admittedly, exercise of the option to deduct IDC results in a distortion of income but that distortion has been authorized by Congress.<sup>186</sup>

If *Keller* is allowed to stand on appeal, given its determination that the Commissioner's power under I.R.C. section 446(b) can override the option granted to expense IDC,<sup>187</sup> it is likely that a similar assault will be forthcoming against the research and development tax shelter. The same reliance on what was presumed to be preemptive authority granted by Congress is found in both tax shelters.

<sup>183</sup> I.R.C. § 174 (1982).

<sup>184</sup> I.R.C. § 263(a)(1)(B) (1982).

<sup>185</sup> B. BITTKER, 4 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, 105-18 (1981).

<sup>186</sup> 79 T.C. at 58 (Goffe, J., dissenting).

<sup>187</sup> The majority in *Keller* maintained that neither provision overrides the other because I.R.C. § 263(c) does not deal with the timing of the deduction. 79 T.C. at 39. This is disingenuous, however, because I.R.C. § 263 deals explicitly with capitalization and the option granted thereunder is to expense or capitalize. The option is not merely to capitalize and amortize for two or three years, as the Commissioner would require via Treas. Reg. § 1.461-1(a), or to capitalize and amortize over the useful life of the oil or gas well.

## VII. THE ONE-YEAR RULE

The applicability of the Commissioner's position in the prepaid-feed context to IDC prepayments will undoubtedly be appealed. As Judge Goffe stated in dissent:

[T]he issues here should not be examined in the context of [Revenue Ruling] 75-152. This Ruling does not constitute authority. It may well be that the Commissioner would prefer scrutiny under Revenue Ruling 75-152 rather than focus upon the case law and published and private rulings which he has issued on the precise question involved here because his position in this case is inconsistent with those rulings.<sup>188</sup>

If the *Keller* test is upheld as the appropriate standard for examining prepaid IDC transactions, a definitive ruling as to what constitutes an asset having a useful life extending "substantially beyond" the close of the tax year for the purposes of Treasury Regulation section 1.461-1(a) should be rendered by the Supreme Court, as the circuits are not in accord on this issue.

In *Zaninovich v. Commissioner*,<sup>189</sup> the cash-basis taxpayer made a rental payment on December 20, 1973 for a lease year that extended eleven months beyond the end of the taxable year of payment. The Commissioner maintained that, since the payment covered a term from December 1 to November 30 of the subsequent year, a full deduction in the year of payment would materially distort the taxpayer's income.<sup>190</sup> Through the use of Treasury Regulation section 1.461-1(a)(1), the Commissioner ordered that the payment be prorated; i.e., capitalized and amortized, thereby delaying the deduction of eleven-twelfths of the payment until the year in which the taxpayer received the benefits of the payment.<sup>191</sup> The Tax Court agreed with the Commissioner,<sup>192</sup> but the Ninth Circuit Court of Appeals rejected this approach and, instead, adopted the "one-year rule"<sup>193</sup> to distinguish between currently-deductible expenses and capital expenditures having useful lives which extend "substantially beyond" the end of the current taxable year within the meaning of Treasury Regulation section 1.461(a).<sup>194</sup> The court of appeals held that prepaying one year's rent was deductible in the year of payment because the prepayment did not create an asset with a useful life which extended

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<sup>188</sup> 79 T.C. at 53 (Goffe, J., dissenting).

<sup>189</sup> 616 F.2d 429 (9th Cir. 1980).

<sup>190</sup> *Id.* at 430.

<sup>191</sup> *Id.* at 431.

<sup>192</sup> 69 T.C. 605 (1978).

<sup>193</sup> The majority of circuits addressing the issue have framed the rule as requiring that the expenditure not create an asset with a useful life extending more than one year beyond the end of the taxable year in which the deduction was taken.

<sup>194</sup> 616 F.2d at 432.

“substantially beyond” the end of the tax year.<sup>195</sup>

The Ninth Circuit’s approach, although new to that circuit, has been utilized in an increasing number of circuits for many years because “[t]he overriding advantage of the ‘one-year rule’ is ease of application. [Also it] eliminates pointless complexity in the calculation of the timing of deductions.”<sup>196</sup> The Fourth Circuit, in disallowing a taxpayer’s deduction for a portion of rental payments paid into a reserve fund, stated that “[t]he issue to be resolved is not an unfamiliar one for on prior occasions we have been called upon to determine into which category various expenditures should appropriately be placed. [And] in *Richmond Television Corp. v. United States* . . . we embraced the ‘one-year rule’ then followed by the Tenth Circuit.”<sup>197</sup> Similar acknowledgements of the one-year rule’s value as guidance for courts in determining what “substantially beyond” the end of the tax year should mean can be found in the First Circuit,<sup>198</sup> the Second Circuit,<sup>199</sup> the Sixth Circuit,<sup>200</sup> the Seventh Circuit,<sup>201</sup> the Eighth Circuit,<sup>202</sup> and the Tenth Circuit.<sup>203</sup>

The position of the Third Circuit, as illustrated by *Schultz v. Commissioner*,<sup>204</sup> is that the “distinction between an ordinary expense and a capital expenditure . . . is based on a factual analysis of the relationship of

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<sup>195</sup> *Id.* at 433.

<sup>196</sup> *Id.* at 432.

<sup>197</sup> *Jack’s Cookie Co. v. United States*, 597 F.2d 395 (4th Cir. 1979) (rental payments are deductible only in the year in which they are actually applied for the benefit of the lessee).

<sup>198</sup> *Appliance Co. v. Commissioner*, 349 F.2d 515 (1st Cir. 1965) (no deduction allowed for the installation costs of leased gas appliances with useful lives of twelve years).

<sup>199</sup> *American Dispenser Co. v. Commissioner*, 396 F.2d 137 (2d Cir. 1968) (no deduction allowed for payments to a competitor in exchange for a covenant not to manufacture, since the taxpayer could expect many years of benefit therefrom).

<sup>200</sup> *Bilar Tool & Die Corp. v. Commissioner*, 530 F.2d 708 (6th Cir. 1976) (upholding the disallowance of a current deduction for attorney fees incurred in the reorganization of a business).

<sup>201</sup> *Clark Coil & Refining Corp. v. United States*, 473 F.2d 1217 (7th Cir. 1973) (affirming the disallowance of a deduction representing the settlement of a nuisance action).

<sup>202</sup> In a slight variation from the position of the other circuits, the Eighth Circuit stated the rule as requiring the taxpayer to show that the payment did not result in the acquisition of an asset with a life in excess of one year. *Wells-Lee v. Commissioner*, 360 F.2d 665 (8th Cir. 1966) (money paid by osteopathic doctors as a “staff fee” in order to secure the use of a hospital not deductible).

<sup>203</sup> The Tenth is the circuit which has most frequently applied the one-year rule, calling on it consistently since 1950, when the circuit decided *KingKade v. Commissioner*, 180 F.2d 310 (10th Cir. 1950), which concerned expenditures by a lessee for repairs and maintenance of a hotel that were held to be capital in nature and, therefore, not deductible. See *Snyder v. United States*, 674 F.2d 1359 (10th Cir. 1982); *Cincinnati, N.O. and T.P. Ry. Co., Inc. v. Commissioner*, 523 F.2d 137 (10th Cir. 1975); *United States v. Wehrli*, 400 F.2d 686 (10th Cir. 1968); *Connecticut Light & Power Co. v. United States*, 368 F.2d 233 (10th Cir. 1966); *United States v. Akin*, 248 F.2d 742 (10th Cir. 1957).

<sup>204</sup> 420 F.2d 490 (3rd Cir. 1970).

the expenses to the entire transaction."<sup>205</sup> This case-by-case approach gives no guidance whatsoever to either lower courts or taxpayers.

The approach of the Fifth Circuit, as stated in *Cagle v. Commissioner*,<sup>206</sup> is that "[w]hen . . . an expenditure is made for the acquisition of an asset the useful life of which will extend beyond the year in which the cost is incurred, such expenditure is considered as a capital item, and is not generally deductible as a business expense."<sup>207</sup> While this position is preferable to the ambiguous standard of the Third Circuit in that it gives clearer guidance to lower courts and to taxpayers, it is still somewhat ambiguous because, as the Supreme Court has stated, "many expenses concededly deductible have prospective effect beyond the taxable year."<sup>208</sup>

The elimination of arbitrariness in the interpretation of ambiguous provisions of the Code should be an earnestly sought-after goal, just as it is in the interpretation of criminal statutes. Justice Douglas, in his dissent in *Commissioner v. Idaho Power Co.*,<sup>209</sup> pointed out the inherent evil arising from the possibility of conflicting interpretations of such Code provisions.<sup>210</sup> He made it clear that he had no desire "to impugn the integrity of the IRS,"<sup>211</sup> but offered an example only to illustrate "the capricious character of how law is construed to get from the taxpayer the greatest possible return."<sup>212</sup>

While it is true that the IRS has a legitimate interest in trying to maximize revenue, it is also true that this should be accomplished on some principled basis, and not by the individual agent according to his own caprice. Uniform adoption of the "one-year rule" would help to eliminate arbitrary disallowance of deductions and would give firm prospective guidance both to IRS agents and to investors regarding the extent of allowable deductions during the critical first year of a legitimate tax-sheltering mechanism.<sup>213</sup>

The adoption of the "one-year rule" would also create an equitable bal-

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<sup>205</sup> *Id.* at 491.

<sup>206</sup> 539 F.2d 409 (5th Cir. 1976) (holding that the payment by a partnership to its managing partner was a capital expenditure and, therefore, not deductible).

<sup>207</sup> *Id.* at 415.

<sup>208</sup> *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (1971).

<sup>209</sup> 418 U.S. 1, 12 (1973) (Douglas, J., dissenting).

<sup>210</sup> In *Idaho Power*, the Commissioner successfully argued that a vehicle with a useful life of ten years, which had been used for construction of a building with a useful life of forty years, should be depreciated over a forty-year period. Justice Douglas stated that he "suspect[ed] that if the life of the vehicle were 40 years [instead of 10 years] and the life of the building were 10 years [instead of 40 years] the Internal Revenue Service would [still] be here arguing persuasively that depreciation of the vehicle should be taken over a 40-year period." *Id.* at 12 (Douglas, J., dissenting).

<sup>211</sup> *Id.*

<sup>212</sup> *Id.*

<sup>213</sup> See *supra* text accompanying notes 17-20.

ance. Since cash-basis taxpayers are not entitled to take deductions in a period other than when obligations for expenses are paid, even though the benefits received are almost entirely attributable to an earlier tax period, the one-year rule would serve "as a corollary to this imprecision in the cash method."<sup>214</sup> The "one-year rule" would be easy to apply and would allow taxpayers to enjoy the simplicity of cash-basis accounting while also enjoying the intentional benefits of options granted by Congress through the enactment of provisions such as I.R.C. section 263(c).

The arbitrariness of setting a one-year rule cannot be denied. Any such line-drawing is inherently arbitrary, but what the Commissioner terms an "impermissible distortion in net income . . . must be distinguished from the distortions in matching inherent in the cash disbursements method of accounting itself."<sup>215</sup> In the vast majority of prepayment cases "if there is any distortion, it arises from permitting taxpayers to use an accounting method other than the accrual basis."<sup>216</sup> To allow the Commissioner to exercise virtually unbridled discretion in favor of some arbitrary notion of what more clearly reflects income<sup>217</sup> is unjustifiable, especially when the method chosen by the Commissioner comes no closer to matching the expense item with the income it will ultimately produce.<sup>218</sup> "[I]f there was a distortion of income in every situation in which an accounting method did not precisely match items of expense and income, the cash basis method would not be a permissible method of accounting, as a certain degree of imprecision is built into [it]."<sup>219</sup> The cash method is, however, and has always been an officially sanctioned method of accounting.<sup>220</sup>

The *Keller* court did not address the issue of whether to follow the "one-year rule" in the IDC context because "the parties did not present

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<sup>214</sup> *Bonaire Dev. Co. v. Commissioner*, 679 F.2d 159, 162 (9th Cir. 1982) (upholding the disallowance of a voluntary payment for management services to be rendered in the subsequent year).

<sup>215</sup> *Id.* at 162.

<sup>216</sup> *Id.*

<sup>217</sup> In assessing the standards governing IRS determinations concerning what does or does not clearly reflect income, Professor Bittker stated that "[t]he statutory phrase is not only hopelessly vague but circular to boot, since the 'income' that must be clearly reflected by the taxpayer's accounting method is *taxable* income, not financial, economic, or any other variety of income." B. BITTKER, 4 *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS*, 105-19 (1981).

<sup>218</sup> Only capitalization of the expenditure and the prorated deduction of it over the useful life of the asset would accurately match income and expense items.

<sup>219</sup> *Zaninovich v. United States*, 616 F.2d 429, 433 (9th Cir. 1980). *See also Osterloh v. Lucas*, 37 F.2d 277, 278 (9th Cir. 1930) (cash-basis taxpayer not entitled to deduct the difference between the value of shares of stock borrowed for collateral and the amount realized on the sale thereof by the banks on the taxpayer's default after it declined in value, where the loss was not actually paid during the tax year in question).

<sup>220</sup> The cash receipts and disbursements method of accounting was officially sanctioned in I.R.C. § 41 (1939) and it is still specifically enumerated as an acceptable method in I.R.C. § 446 (1982).

this issue for . . . determination or provide a factual basis for . . . consideration of it."<sup>221</sup> Even if the court had been presented with the issue, it is highly improbable that it would have resolved the various aspects of the case differently, due to its initial determination, under the first part of the *Keller* text,<sup>222</sup> that the majority of the money transfers were deposits, not payments, for tax purposes. Any definitive statement regarding the Commissioner's power under Treasury Regulation section 1.461-1(a) and the applicability of the "one-year rule" to the IDC context will have to await a proper test case,<sup>223</sup> but with the *Keller* test as a new weapon in the Commissioner's arsenal and with the IRS's long history of attacking the oil and gas drilling tax shelter, the wait will no doubt be brief.

When that proper test case comes before the courts, there are several underlying policy considerations which strongly support the recognition of the "one-year rule." First, an immediate benefit would be a drastic reduction in the number of cases presently in litigation.<sup>224</sup> By having a firm guide, many of the pending cases could either be dismissed, if they satisfied the standard, or settled, if the payment clearly violated the rule.<sup>225</sup> In addition, the prospective guidance afforded by such a rule to individual taxpayers, tax attorneys, IRS agents, and the lower courts would go far toward preventing the necessity for litigation in many cases which under the Third Circuit system<sup>226</sup> would proceed to trial.

Second, as Congress recognized when it chose to grant the I.R.C. section 263(c) option, the highly speculative nature of oil and gas exploration necessitates compensatory provisions in order to stimulate investor interest.<sup>227</sup> Although under present conditions<sup>228</sup> it may be true that the larger oil companies no longer require the added incentive to explore, "[m]any independent operators . . . do not have the cash resources or borrowing ability to absorb the additional cash requirements . . . caused by deferring the deduction for [IDC]."<sup>229</sup> Many of the independent drillers require funds from outside investors, especially from one-time investors seeking to shelter income in a given year. "[W]ithout the current deductibility of [IDC], it would substantially close the door to outside sources of funds for joint participation in exploratory ventures by others

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<sup>221</sup> 79 T.C. at 40 n.24.

<sup>222</sup> See *supra* text accompanying note 115 (payment rather than deposit).

<sup>223</sup> The proper case would have to satisfy the first part of the *Keller* test; i.e., any money transfers would have to be payments within the tax-related definition. In addition, the prepayments would have to have been under contracts which either did not contain any recitation of an underlying business purpose or contained one which, in the opinion of the Commissioner, was insufficient to justify the prepayments.

<sup>224</sup> See Pineo, *supra* note 6.

<sup>225</sup> 616 F.2d at 432.

<sup>226</sup> See *supra* text accompanying notes 198-99.

<sup>227</sup> See H.R. Con. Res. 50, 59 Stat. 844 (1945).

<sup>228</sup> The change has primarily been the result of the decontrol of oil prices.

<sup>229</sup> Webb, *supra* note 17, at 229.

outside the industry.<sup>230</sup> As individuals are increasingly foreclosed from entering the market, the market structure moves further away from the freely-competitive economic theory which American society has embraced. Instead it approaches an artificially- controlled oligopolistic and potentially monopolistic<sup>231</sup> form.<sup>232</sup>

Finally, while the world market is currently experiencing an oil glut, this is merely a transitory condition. Congress should not be misled into abandoning its long-standing policy of encouraging oil and gas exploration. Our dependence as a nation on foreign sources of oil places us in the unenviable position of being at the mercy of powers potentially hostile to our best interests.

### VIII. CONCLUSION

In conclusion, it is not the ends achieved by the court in *Keller* which create a new controversy, but rather the court's method of obtaining them. Congress has for many decades encouraged oil and gas exploration activities and has implicitly sanctioned the income distortion attendant to the means employed as an incentive to encourage such activities. Any drastic change in treatment should, therefore, be accomplished by congressional action specifically addressed to prepaid IDC deductibility, as was the case with prepaid interest,<sup>233</sup> and not by the Tax Court.

The Tax Court's departure from established case law and its discarding of nearly two decades of published and private IRS rulings regarding IDC deductibility in favor of the Commissioner's nebulous "distortion of income" concept has the potential of working a great injustice on thousands of taxpayers who acted in justifiable reliance on these unceremoniously-abandoned guidelines. In order to mitigate this harsh impact, any implementation of the *Keller* test should be accomplished by a nationwide acknowledgement of the "one-year rule" as the proper standard for differentiating between acceptable mismatches of income and expense and unacceptable material distortions of income. Such a uniform recognition would aid in the equitable resolution of thousands of pending cases and, in addition, would serve as a stable guideline for future investors, so that

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<sup>230</sup> *Id.* See also Klein, *supra* note 38; Dougherty, *Operation of Section 1254: Questionable Recapture of IDC*, 26 OIL & GAS TAX Q. 300 (1977); Burke, Jr. & Maultsby, Jr., *Establishing Deductions for Prepaid Intangible Drilling and Development Costs*, 28 OIL & GAS TAX Q. 127 (1979).

<sup>231</sup> OPEC is a classic example of an oligopoly functioning for all intents and purposes as a monopoly, at least until the latest round of oil price reduction talks, at which no agreement could be reached.

<sup>232</sup> The DeBeers diamond cartel is a near-perfect example of the ability of a functioning monopoly to control the supply of a product artificially and, thereby, to control the wholesale market. See generally R. DORFMAN, *PRICES AND MARKETS* (1967).

<sup>233</sup> See *supra* note 147 and accompanying text.



more than the mere caprice of the Commissioner would control current-year deductibility.

MICHAEL R. DONALDSON