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DEDUCTIBILITY OF PREPAID INTANGIBLE DRILLING AND DEVELOPMENT COSTS IN THE YEAR OF PAYMENT—A CURRENT REVIEW

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I. INTRODUCTION

To create a “deferral tax” shelter, taxpayers often elect to currently deduct intangible drilling and development costs (IDCs).¹ IDCs generally include all expenditures for “wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling . . . and the preparation of wells for the production of oil or gas.”² Typically, a higher bracket taxpayer will pay IDCs and elect to deduct this payment in the current year, thereby offsetting income from other sources. To accelerate this deduction, taxpayers often pay IDCs prior to commencement of drilling and development work. These advance payments constitute prepaid IDCs.

Internal Revenue Code section 263(c)³ permits a taxpayer/operator (the holder of a working or operating interest) who incurs IDCs in the development of oil and gas properties to either capitalize such costs or currently deduct them as an expense.⁴ A tax-

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1. For a discussion of IDCs, see Allbright, *An Overview of Intangible Drilling and Development Costs*, 28 OIL & GAS TAX Q. 283 (1980); Burke & Maultsby, *Establishing Deductions for Prepaid Intangible Drilling and Development Costs*, 28 OIL & GAS TAX Q. 127 (1979).

2. Treas. Reg. § 1.612-4(a) (1982).

3. I.R.C. § 263(c) (Supp. II 1979).

4. *Id.* “[R]egulations shall . . . [grant] the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells”

payer elects to treat IDCs as a current expense by claiming the IDCs as a deduction on the tax return for the first taxable year in which the taxpayer incurs the IDCs.⁵ Failure to currently deduct the IDCs as an expense constitutes an election to recover the IDCs through depletion and depreciation deductions.⁶

The first part of this Article reviews and discusses the case law and the Internal Revenue Service's (Service) positions⁷ concerning the current deductibility of prepaid IDCs. A review of these sources suggests that seven requirements must be satisfied to successfully deduct prepaid IDCs in the year of payment. The second part of the Article presents and discusses these seven requirements.

II. CASE LAW AND INTERNAL REVENUE SERVICE POSITIONS

*Pauley v. United States*⁸ is a fountainhead for any discussion of the proper year to deduct prepaid IDCs. Since the United States District Court for the Southern District of California rendered this decision in 1963, taxpayers have relied on *Pauley* as the basis for currently deducting prepaid IDCs.

Pauley involved two California taxpayers engaged in the oil production business. The taxpayers, husband and wife, filed separate individual tax returns for 1947. Each reported income on the calendar year basis and employed the cash receipts and disbursements method of accounting.⁹ During 1947, the taxpayers developed a certain oil and gas lease in California. On November 10, 1947, they entered into an oral contract with an independent drilling contractor to perform the drilling and development work on the lease. In this contract, the taxpayers agreed to make an initial payment of \$95,000 prior to the contractor's actual drilling of the well. In preparing the lease for drilling, the taxpayers made water and gas available on the lease, designated the exact drill site on the lease, and obtained the proper drilling permits from the government. On December 31, 1947, the taxpayers and the contractor reduced their drilling agreement to writing and the taxpayers remitted

5. Treas. Reg. § 1.612-4(d) (1982).

6. *Id.*

7. Private Letter Rulings (P.L.R.) and Technical Advice Memoranda (T.A.M.) have been used in this article. However, I.R.C. § 6110(j)(3) (1976) provides that only those taxpayers who requested the P.L.R. or T.A.M. may rely on it.

8. 63-1 U.S. Tax Cas. (CCH) ¶ 9280, 11 A.F.T.R.2d (P-H) ¶ 63-490 (S.D. Cal. 1963).

9. *Id.* The court consolidated the taxpayers' (spouses') separate refund suits since the cases involved the same transaction.

the initial payment of \$95,000. The contractor began to drill the well during January 1948, and completed it within two and one-half months of the prepayment, on March 12, 1948.¹⁰ The taxpayers deducted their prepaid IDCs in 1947, but the Service disallowed this deduction, arguing that the taxpayers could only deduct the payment in the year of performance.¹¹

The court held for the taxpayers and allowed them to deduct the prepaid IDCs in the year of payment. The court found that the drilling contractor required the prepayment and that the prepayment was a natural and reasonable business practice designed to provide the drilling contractor with adequate working capital and assurance that the taxpayers would pay for the drilling.¹²

Revenue Ruling 71-252¹³ brought the Service's position into line with *Pauley*.¹⁴ This ruling closely resembled *Pauley*, in that the taxpayer deducted in the year of payment IDCs made to an independent drilling contractor for work to be performed the following year. The Service approved the taxpayer's current deduction of this prepayment, pointing out that the obligation to prepay the IDCs arose from a binding contract created in a bona fide transaction to provide the driller with operating funds.¹⁵ During the year of prepayment, the taxpayer also arranged for fuel and water to be available at the drill site and obtained all governmental permits needed to prepare the lease for drilling.

Within months of publishing Revenue Ruling 71-252, however, the Service issued Revenue Ruling 71-579¹⁶ which narrowed its broad

10. *Id.*

11. *Id.*

12. *Id.*

13. Rev. Rul. 71-252, 1971-1 C.B. 146.

14. Rev. Rul. 71-252 revoked Rev. Rul. 53-170, 1953-2 C.B. 141, which had expressed the Service's view that a taxpayer may deduct prepaid IDCs only in the year of performance. In Rev. Rul. 53-170 which was based on the facts of *Pauley*, the Service stated that the prepayment of IDCs is analogous to advance rental payments or prepaid insurance premiums—it is not an ordinary and necessary business expense in the year paid.

Although the IRS published Rev. Rul. 53-170 prior to the *Pauley* decision, the court refused to follow the Service's interpretation. "*Revenue Ruling 170*, . . . the facts of which have been taken from the case at bar, is not binding on the Court and will not be followed. Administrative rulings cannot preempt the functions of the Court." 63-1 U.S. Tax Cas. (CCH) ¶ 9280, at 87,657, 11 A.F.T.R.2d (P-H) ¶ 63-490, at 960 (S.D. Cal. 1963). The IRS subsequently published Rev. Rul. 71-252, revoking Rev. Rul. 53-170 and embracing *Pauley*.

15. "[T]he taxpayer as a result of a bonafide transaction was obligated to pay the amounts of intangible drilling and development costs at the times specified in the drilling contract." Rev. Rul. 71-252, 1971-1 C.B. 146, 147.

16. Rev. Rul. 71-579, 1971-2 C.B. 225.

acceptance in Revenue Ruling 71-252 of the current deductibility of prepaid IDCs. Revenue Ruling 71-579 involved a cash basis, calendar year taxpayer engaged in the business of developing oil and gas leases. During 1970, the taxpayer entered into a written drilling contract with an independent driller. The terms of this agreement required the taxpayer to pay the driller when the well reached a specified depth. No preliminary work of any kind was performed in 1970 and the contractor performed the actual drilling and development work in 1971. The taxpayer, however, voluntarily prepaid a portion of the driller's fee in 1970 and attempted to deduct this prepayment in the same year. The Service ruled that the prepayment did not create a current deduction in 1970 because the legal obligation to pay the driller did not arise under the contract until the year of performance.¹⁷

The Service has continued to develop its position regarding the deductibility of prepaid IDCs in a series of Technical Advice Memoranda, Private Letter Rulings, and Revenue Rulings. In Technical Advice Memorandum 7510310050A,¹⁸ the Service addressed the issue of whether an accrual basis limited partnership may currently deduct its prepaid IDC expense. This Memorandum involved a limited partnership which entered into a drilling agreement with a related general contractor. The terms of the drilling agreement required the limited partnership to prepay the drilling costs even though the general contractor would not perform until the following year. Under the partnership agreement, the corporate general partner had sole authority to select the general drilling contractor and to negotiate the drilling agreement. The general partner selected its parent corporation as general contractor for the IDC work. As general contractor, the parent corporation hired subcontractors to perform the actual drilling.¹⁹

The Service ruled that this factual situation substantially varied from the facts in Revenue Ruling 71-252 and *Pauley*. The Service held that the prepayment did not serve a valid business purpose because the related drilling contractor did not actually drill the wells, and the prepayments were not necessary to provide working capital, create cash discounts, or assure commencement of drilling by a specific date.²⁰ The Service also found the drilling contractor did not need a prepayment

17. *Id.*

18. T.A.M. 7510310050A (Oct. 31, 1975).

19. *Id.*

20. *Id.*

since it had access to funds in the limited partnership through its control of the general partner.²¹ For these reasons the Service ruled that the limited partnership could deduct the prepaid IDCs only in the year of performance.

In Technical Advice Memorandum 7609309653A,²² the Service discussed a two-tier partnership arrangement engaged in the development of oil and gas properties. Investors purchased participation units in an "investment" partnership which invested as a limited partner in a lower tier "drilling" partnership.²³ The general partner of the drilling partnership served as drilling contractor for the development of the partnership's wells. As contractor, the general partner hired subcontractors to perform most of the actual drilling and development work. The drilling partnership and the general partner also entered into a separate turnkey contract²⁴ for the drilling of the wells. This contract contained a provision requiring the partnership to prepay the contract price prior to the actual drilling of the wells. However, in addition to the IDCs, the turnkey price included non-IDC items such as leasehold acquisition costs and tangible costs.

In holding that the drilling partnership could deduct the prepaid IDCs only in the year the general partner paid its subcontractors, the Service distinguished this Memorandum from *Pauley* and Revenue Ruling 71-252. First, this partnership agreement prohibited solicitation of competitive bids from other contractors for the drilling contract. The Service pointed out that the prepayment provision and the price term in the parties' turnkey contract resulted from the parties' relationship and not from arm's-length bargaining.²⁵ Second, the prepayment amount covered the entire cost of developing the well to casing point.²⁶ In *Pauley* and Revenue Ruling 71-252 the prepayment was merely a portion of the estimated drilling fee. Moreover, in the present case, a portion of the prepayment could be refunded to the partnership if the

21. *Id.*

22. T.A.M. 769309653A (Sept. 30, 1976). The factual situation and holding of this T.A.M. is similar to the factual situations presented in the following memoranda, all of which were issued September 30, 1976: T.A.M. 7609300010A, 7609309650A, 760930951A, 769309652A, and 7609309654A.

23. T.A.M. 7609309653A (Sept. 30, 1976). (The T.A.M. does not indicate the accounting method used by the partnership).

24. In the oil drilling industry, a turnkey contract requires the driller of the oil well to do all work required to complete the well and place it on production for a set price. BLACK'S LAW DICTIONARY 1359 (rev. 5th ed. 1979).

25. Note 23 *supra*.

26. *Id.*

wells were not completed.²⁷ Third, the purpose of the prepayments was not to insure the driller adequate funds to commence drilling, because the general partner later subcontracted the actual drilling work, paying the subcontractors only upon performance.²⁸ The Service concluded that the general partner did not have reason to require a prepayment since the partner had complete control over the disbursement of partnership funds.²⁹

Private Letter Ruling 8012060³⁰ also presented factors not present in *Pauley* or in Revenue Ruling 71-252. In this Ruling, a drilling program partnership entered into footage and daywork, as well as turnkey drilling contracts with independent contractors.³¹ These contracts required the partnership to prepay a certain amount of the drilling costs, but did not include a refund provision. The partnership owned less than 100% of the operating interest in a part of the leases covered by the drilling contracts; however, the remaining owners joined in the drilling contracts so that the terms of the contracts bound all the owners of the working interest.³²

The Service ruled that the partnership could deduct the prepaid IDCs currently if:

1. The prepayments were made to independent contractors who were to actually perform the drilling;
2. The drilling agreement created a binding contract which required the partnership to prepay the IDCs regardless of when the driller performed; and
3. The drilling contract bound the owners of 100% of the operating interest of the tract.³³

This Ruling marked the first time the Service presented a list of requirements for taxpayers to satisfy to currently deduct prepaid IDCs.

27. *Id.*

28. *Id.*

29. *Id.*

30. 1980 IRS LETTER RUL. REP. (CCH) 8012060 (Dec. 27, 1979).

31. "Footage and daywork" contracts are widely used in the industry. Under these standard form agreements, the price for drilling is based on a certain compensation per foot of drilling and/or a certain compensation per day. Under "turnkey" contracts, contractors will earn a certain monetary amount for the basic drilling of the well. The driller may receive additional compensation if daywork rates are applied. *Id.*

32. *Id.*

33. *See id.* Neither *Pauley* nor Rev. Rul. 71-252 involved a partnership which prepaid IDCs; neither discussed the type of drilling contract involved—footage and daywork, or turnkey; and neither involved a situation in which the taxpayer owned less than the entire working interest of the well to be drilled.

Revenue Ruling 80-71,³⁴ which represents the Service's most recent position regarding the current deductibility of prepaid IDCs, introduced a new requirement that taxpayers must satisfy to currently deduct prepaid IDCs. This Revenue Ruling involved a limited partnership engaged in exploring and developing oil and gas properties. Unlike Private Letter Ruling 8012060, however, this limited partnership entered into a drilling contract with a related drilling contractor—the corporate parent of the general partner.³⁵ The general contractor's duties under the agreement were to arrange the drilling, completion, and equipping of the wells. The general contractor did not perform the actual drilling but subcontracted with independent third parties who were paid upon performance of the drilling work.³⁶ The general contractor's drilling contract with the limited partnership, however, required the limited partnership to prepay the IDCs. The contract also bound the owners of 100% of the lease's operating interest, and provided a set price for drilling and completing each well, including a fixed price for drilling a well that proved to be unproductive. In lieu of a refund provision, the contract provided that the contractor would credit excess payments toward the cost of drilling other partnership wells at locations to be designated in the future.³⁷

This Ruling differs materially from *Pauley*, Revenue Ruling 71-252, and Private Letter Ruling 8012060. Here, the parties intended the prepayment to cover the entire cost of the wells. Moreover, the payments were made to a related general contractor, which did not actually drill the wells. The Service ruled that the limited partnership could not deduct the IDCs in the year of payment. Its conclusion was based on two separate theories. The first rationale was similar to the Service's earlier position on IDCs. The relationship of the drilling contractor to the general partner and the contractor's subcontracting of the actual drilling work to third parties, with payment due only upon performance, were factors which convinced the Service that the prepayments were not in accordance with customary business practice.³⁸

The second rationale for disallowing a current deduction of the prepaid IDCs heralded a new factor the Service will consider in these cases. For the first time, the Service stated that prepaid IDCs must

34. Rev. Rul. 80-71, 1980-1 C.B. 106.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

satisfy the specific limitations of Treasury Regulation section 1.461-1(a)³⁹ in order to pass the clear reflection of income test of Internal Revenue Code section 446(b).⁴⁰ The Service found that the prepayments were assets that possessed a useful life extending substantially beyond the close of the current taxable year, and therefore ruled that the current deduction of 100% of these prepayments would substantially distort the limited partnership's income.⁴¹

Private Letter Ruling 8111055⁴² is the most recently published Ruling to address the deductibility of prepaid IDCs. Investors purchased interests in a general partnership, which invested, as a limited partner, in a drilling partnership, which utilized the cash method of accounting and elected to deduct IDCs in the year of payment.⁴³ The drilling partnership entered into drilling contracts with independent contractors for the development of the wells. Each drilling contract specified the well's location and depth, and the specific commencement date for drilling the well. The drilling would commence as early as possible but no later than an undisclosed date. Each contract included a prepayment provision: For turnkey contracts, the full contract price would be prepaid; for footage and day work contracts the prepayment would be a reasonable estimate of the total cost due under the contract, with adjustment upon completion of the well.⁴⁴ The contracts also provided that even if the drilling partnership owned less than 100% of the operating interests in the lease, the prepayment requirement would bind the owners of 100% of the operating interest.⁴⁵

In addition to incorporating the requirements of Revenue Ruling 80-71, Private Letter Ruling 8111055⁴⁶ presented a set of requirements a partnership must satisfy in order to deduct IDCs in the year of payment:

1. The binding obligation to prepay IDCs must exist regard-

39. Treas. Reg. § 1.461-1(a) (1982).

40. I.R.C. § 446(b) (1976).

41. Rev. Rul. 80-71, 1980-1 C.B. 106. The new emphasis on the clear reflection of income test of I.R.C. § 446(b) as it applies to the deductibility of prepaid IDCs appears to be part of an effort by the Service to apply this test to prepaid deductions in general. For example, in Rev. Rul. 80-70, 1980-1 C.B. 104, the Service applied the identical rationale to the current deductibility of advance coal royalties.

42. 1981 IRS LETTER RUL. REP. (CCH) 8111055 (Dec. 16, 1980).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

less of whether the drilling contractor has performed any work under the agreement;

2. The commencement date for drilling the wells must be on or before an undisclosed date and the IDC payments must be restricted to contracts specifying the location and depth of the well;

3. The partnership must properly elect to currently deduct IDCs;

4. Such payment must constitute true IDCs under the Regulations;⁴⁷ and

5. The owners of the entire operating interest in the lease must be individually and severally bound by all provisions of the same drilling contract.⁴⁸

Since no date for commencement of drilling was disclosed in this ruling, one cannot determine the Service's position as to when a prepayment will create an asset with a useful life which extends substantially beyond the close of the taxpayer's current taxable year which, when deducted, will substantially distort the taxpayer's income. However, in an unpublished Private Letter Ruling,⁴⁹ issued prior to Revenue Ruling 80-71, the Service allowed the taxpayer to currently deduct a prepaid IDC when the driller would commence drilling within nine months.

47. Under Treas. Reg. § 1.612-4(a) (1982), true IDCs are defined as including the costs to operators of any drilling or development work. Examples of these costs are those expenditures for labor, fuel, repairs, hauling, and supplies in such operations as preparing the site for drilling, building necessary structures, and drilling, shooting, and cleaning of the well.

48. Note 42 *supra*. The IRS indicated the ruling was void unless the entire operating interest in the lease was subject to the drilling contract when IDCs were prepaid to the contractor. *Id.*

49. Unpublished Private Letter Rul. (August 6, 1979) (on file with the authors).

In this private letter ruling the taxpayer invested in a general partnership which in turn invested in a limited partnership engaged in developing oil and gas prospects. The partnerships elected the cash receipts and disbursements method of accounting and elected to deduct rather than capitalize IDCs.

The limited partnership entered into contracts with independent contractors to drill the wells. These contracts included daywork and footage, and turnkey agreements. The drilling contract bound 100% of the owners of the operating interest in the wells and specified the location and depth of the wells. Drilling was to commence as soon as possible, but in no event later than September 30 of the following year. The contract required prepayment of the drilling fee in the current year.

The Service ruled the taxpayer could deduct its allocable share of partnership IDCs actually paid in the current year, provided:

- (a) The partnership prepaid the IDCs, regardless of whether the driller performed any work;
- (b) The partnership elected to deduct IDCs rather than capitalize;
- (c) Such payments constituted IDCs; and
- (d) All operating interest owners were bound by the provisions of the same drilling contract.

The courts have examined the current deductibility of prepaid IDCs in three recent cases: *Cheroff v. Commissioner*,⁵⁰ *Stradlings Building Materials, Inc. v. Commissioner*,⁵¹ and *Dillingham v. United States*.⁵² *Cheroff* and *Stradlings* were decided by the Tax Court, while *Dillingham* was decided by the U.S. District Court for the Western District of Oklahoma. In *Cheroff*, an accrual basis limited partnership entered into a drilling contract with a related general contractor. Although the drilling agreement required the limited partnership to prepay IDCs, the contractor hired third-party subcontractors to perform the actual drilling, paying them upon performance.⁵³ The court upheld the taxpayer's current deduction of the prepaid IDCs. It refused to consider whether the drilling contract's prepayment provision lacked economic substance or a valid business purpose, because the Service failed to raise these arguments until it had filed its trial brief.⁵⁴ The court also did not consider whether the drilling contract created an asset with a useful life extending substantially beyond the close of the current taxable year, or whether the drilling contract distorted the limited partnership's income.⁵⁵

The significance of *Cheroff* lies in the court's apparent willingness to apply the Service's new analysis of the deductibility of IDCs as contained in Revenue Ruling 80-71.⁵⁶ The Tax Court, however, did not have to rule on this issue.

In *Stradlings*,⁵⁷ the taxpayer invested in a limited partnership engaged in developing oil and gas properties. The partnership hired an independent contractor to drill six oil and gas wells on specific well sites, and prepaid the drilling fees. The partnership elected to deduct these prepaid fees and the taxpayer reported its allocable share of these partnership IDCs on its own return. Following the year of prepayment, the drilling contractor breached the agreement by failing to perform on five of the six wells, and the partnership obtained a judgment against the defaulting contractor.⁵⁸

The Service disallowed the taxpayer's allocable share of partner-

50. 1980 T.C.M. (P-H) ¶ 80,125 (April 21, 1980).

51. 76 T.C. 84 (1981).

52. 81-2 U.S. Tax Cas. (CCH) ¶ 9,601 (W.D. Okla. May 29, 1981).

53. 1980 T.C.M. (P-H) ¶ 80,125, at 80-647.

54. *Id.*

55. *Id.*

56. Note 35 *supra*; see also *supra* text accompanying notes 35-42.

57. 76 T.C. 84 (1981).

58. *Id.* The facts do not indicate whether the partnership was able to satisfy its judgment.

ship IDCs relating to the drilling fees for the five wells which the contractor failed to drill. The Service argued that, as to these five wells, the partnership had not incurred IDCs because the prepayments were not expenditures for actual drilling and development work.⁵⁹ The court rejected the Service's position and allowed the taxpayer to deduct its entire allocable share of prepaid IDCs. The court found that neither case law nor Treasury Regulations conditioned deductibility of IDCs on commencement or completion of actual drilling services. The court found deductibility of prepaid expenses to be generally a question of tax accounting, governed by the rules of Internal Revenue Code section 461 and regulations thereunder.⁶⁰ Because the partnership must determine its income based on its annual accounting period, the deductibility of items incurred in any one year must be based upon the facts as they existed with respect to the particular year involved.

The *Stradlings* case is important for two reasons. First, the Service did not challenge the deduction based on the fact that the taxpayer was an accrual basis taxpayer.⁶¹ Second, the court cited Revenue Ruling 80-71 and Internal Revenue Code section 461 for the proposition that deductibility of prepaid IDCs is generally a question of tax accounting, and that the deduction must be consistent with the taxpayer's accounting method.⁶² The references to these two sources suggest that the court agreed with the Service's material distortion of income analysis announced in Revenue Ruling 80-71.⁶³

The most recent case to consider the deductibility of prepaid IDCs is *Dillingham v. United States*.⁶⁴ In this case, the taxpayer invested in a lower tier "program" partnership, which invested in a "drilling" partnership engaged in oil and gas development. The terms of the drilling partnership required the general partner to serve as contractor to drill and develop the oil and gas wells. The drilling partnership and the general partner entered into a turnkey contract for the drilling of the wells at a reasonable prepaid fee. This fee was deducted in the year it was paid, and the taxpayer reported its allocable share of the partner-

59. *Id.*

60. See Treas. Reg. § 1.461-1(a) (1982); Rev. Rul. 71-252, 1971-1 C.B. 146; Rev. Rul. 71-579, 1971-2 C.B. 225; Rev. Rul. 80-71 1980-1 C.B. 106. The *Stradlings* court cites the above rules as governing deductibility of prepaid expenses. 76 T.C. at 89.

61. 76 T.C. 84 (1981).

62. *Id.*

63. See Rev. Rul. 80-71, 1980-1 C.B. at 107-08.

64. 81-2 U.S. Tax Cas. (CCH) ¶ 9,601 (W.D. Okla. May 29, 1981).

ship IDCs on its return.⁶⁵ In the following year, the general contractor drilled a portion of the wells and hired subcontractors to drill the remaining wells. However, the general partner's contract with the drilling subcontractors did not call for payment until they completed their drilling.⁶⁶

The Service disallowed that part of the partnership's prepaid IDCs that the general partner paid to the subcontractor in the following year. The Service argued that these fees were only deductible in the year the general partner paid the subcontractor.⁶⁷ The court, however, held for the taxpayer and allowed the entire prepayment as a current deduction in the year of payment. The court found that prepayment to a related general contractor which paid its subcontractors only on performance did not prohibit a current deduction of prepaid IDCs where the taxpayer could show that the prepayment was required for a legitimate business purpose, and the transaction was not entered into merely to permit the taxpayer to control the timing of the deduction.⁶⁸ Specifically, the court found the principal reason for the prepayment was to provide the general partner with working capital for the drilling of wells and other operations.⁶⁹

Dillingham is the second case to reject the Service's position that advance payments made to a related drilling contractor, who subsequently subcontracts the actual drilling work and pays the subcontractors upon performance, are only deductible in the year the subcontractor is paid. The *Dillingham* court does not state whether the partnerships or the taxpayer were on the accrual or cash accounting method, but in dicta the court does cite the *Stradling* case as authority for the proposition that taxpayers on the accrual accounting method may deduct such payments in the year of payment.⁷⁰

III. REQUIREMENTS TAXPAYERS MUST SATISFY TO SUCCESSFULLY DEDUCT IDCs IN THE YEAR OF PAYMENT

Based on a review of the case law and the Service's position discussed above, the authors have determined seven requirements which taxpayers must satisfy to properly deduct IDCs in the year of

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

payment.⁷¹

First, *the terms of the drilling contract must require the taxpayer to prepay IDCs in the current year*. For a taxpayer to currently deduct its prepaid IDCs, the payment must satisfy a legal obligation created by the drilling contract. In *Pauley v. United States*,⁷² where an IDC deduction in the year of payment was allowed, the court found that the drilling agreement obligated the taxpayer to make an initial payment upon the execution of the written agreement.⁷³ Revenue Ruling 71-252,⁷⁴ Private Letter Ruling 8012060,⁷⁵ and *Dillingham v. United States*⁷⁶ were similar to *Pauley* in this respect. The contract requirement alone does not determine whether the taxpayer's current deduction of prepaid IDCs will be allowed.⁷⁷ Its importance, however, is illustrated in Revenue Ruling 71-579,⁷⁸ where the terms of the drilling contract did not require payment until the driller reached a predetermined depth. The Service ruled that a prepayment was not deductible until the taxpayer's legal obligation arose under the terms of the contract.⁷⁹

Since many IDC prepayments occur at or near the end of the year, the taxpayer must also insure that it has actually made a "payment" in the current year. Delivery of a check is generally considered to be a conditional payment which becomes absolute upon delivery to and acceptance by the drawee bank.⁸⁰ At least one court⁸¹ and the Service⁸²

71. The IRS Audit Manual includes a checklist of Useful Auditing Techniques for evaluating the deductibility of IDCs. This checklist suggests that the Agent inspect the drilling contracts and determine (1) whether the contract terms required the prepayment, (2) whether the prepayment is a deposit and, (3) whether the prepayment was made directly to the drilling contractor. The Agent is also advised to determine (4) when the well was staked and (5) when work commenced. Finally, the Agent is advised to (6) compare the facts surrounding the prepayment in question with the facts of Rev. Rul. 71-579, 1971-2 C.B. 225 and Rev. Rul. 71-252, 1971-1 C.B. 146. I INT. REV. MAN.-AUDIT (CCH) MT 4232.8-4, at 7271-45 (1981).

72. 63-1 U.S. Tax Cas. (CCH) ¶ 9,280, 11 A.F.T.R. 2d (P-H) ¶ 63-490 (S.D. Cal. 1963).

73. *Id.*; see *supra* text accompanying notes 8-11.

74. Rev. Rul. 71-252, 1971-1 C.B. 146; see *supra* text accompanying notes 12-14.

75. 1980 IRS LETTER RUL. REP. (CCH) 8012060 (Dec. 27, 1979); see *supra* text accompanying notes 30-34.

76. 81-2 U.S. Tax Cas. (CCH) ¶ 9,601 (W.D. Okla. May 29, 1981); see *supra* text accompanying notes 64-70.

77. See, e.g., Rev. Rul. 80-71, 1980-1 C.B. 106; T.A.M. 7510310050A (Oct. 31, 1975); T.A.M. 7609309653A (Sept. 30, 1976).

78. Rev. Rul. 71-579, 1971-1 C.B. 225.

79. *Id.*

80. See *Estate of Spiegel v. Comm'r*, 12 T.C. 524, 529 (1949).

81. *Estate of Witt v. Fahs*, 160 F. Supp. 521, 523 (S.D. Fla. 1956) (check mailed on Dec. 31, 1946, and received on Jan. 4, 1947, was deductible as a gift in 1946 tax year).

82. Treas. Reg. § 1.170-1(b), T.D. 6900, 1966-2 C.B. 72, 73, provides that the mailing of a check which subsequently clears in due course constitutes an effective contribution when mailed.

consider mailing a check to be effective delivery for purposes of receiving a charitable deduction. This same analysis of delivery may apply in the case of deductions of IDCs.

Second, *the payment must not resemble a deposit or escrow account.* In Revenue Ruling 80-71,⁸³ the parties to the drilling agreements intended the prepayment to satisfy the entire cost of the drilling work. In the event of an overpayment, the contracts provided for a refund. The Service found this arrangement resembled a deposit rather than a payment and as such was not deductible in the year made.⁸⁴

IDC prepayments should be a reasonable estimate of the amount of IDCs the taxpayer will incur. The prudent taxpayer will prepare and retain a list of the estimated amounts that will be payable under the drilling contract. The contract must not permit the driller to refund any unused funds to the taxpayer or credit such funds to the taxpayers for payment toward drilling future wells not covered under the prepayment agreement.

Third, *the prepayment provision in the drilling contract must flow from a bona fide business transaction.* The prepayment provision in the drilling contract must have a valid business purpose. The court in *Pauley v. United States*,⁸⁵ found that the prepayment requirement was a natural and reasonable business practice designed to provide the driller with adequate working capital to commence drilling, and to assure the driller that the taxpayer would pay for the drilling work. Similarly, in Revenue Ruling 71-252, the Service stated that the prepayment provision was part of a bona fide transaction.⁸⁶ In Technical Advice Memorandum 7609300010A,⁸⁷ the Service explained that the bona fide transaction test does not go to whether the contract itself is valid, but whether the prepayment provision flows from a "valid business purpose and not merely for tax avoidance."⁸⁸ In *Dillingham*,⁸⁹ the court found the prepayment term was motivated by the bona fide business

83. Rev. Rul. 80-71, 1980-1 C.B. 106; see also T.A.M. 7609309653A (Sept. 30, 1976).

84. *Id.*

85. 63-1 U.S. Tax Cas. (CCH) ¶ 9,280, 11 A.F.T.R.2d (P-H) ¶ 63-490 (S.D. Cal. 1963).

86. "The oral contract provided that the taxpayer would pay the contractor an initial 100x dollars upon execution of a written drilling contract to assure the contractor would have operating funds to begin the taxpayer's well." Rev. Rul. 71-252, 1971-1 C.B. 146, 147.

87. T.A.M. 7609300010A (Sept. 30, 1976).

88. *Id.* In this case, the drilling prepayment was found to have no valid business purpose because, *inter alia*, it was not bargained for with an independent contractor and the prepayment was found to have a primary purpose of tax avoidance.

89. 81-2 U.S. Tax Cas. (CCH) ¶ 9,601 (W.D. Okla. May 29, 1981). The court rejected the Internal Revenue Service's position, stating that "although the contract which requires prepay-

purpose of providing the general contractor with working capital for drilling the wells and other operations. However, in situations where the Service found the relationship between the taxpayer and the drilling contractor to be contrary to customary business practice, it disallowed a current deduction of prepaid IDCs because the prepayment provisions were not part of a bona fide transaction.⁹⁰ Typically, the prepayments did not serve the parties' stated business purpose, of providing the driller with working capital.

Fourth, *general contractors that subcontract the actual drilling work must prepay their subcontractors in the same year the general contractor receives the taxpayer's prepayment*. It is the Service's view that a taxpayer cannot currently deduct prepaid IDCs made to a related general contractor if the contractor subcontracts the actual drilling work and pays the subcontractors in the year they complete their work.⁹¹ This prohibition is a specific application of the general rule that a taxpayer cannot deduct prepaid IDCs if the "expenditures . . . were prompted by the Federal income tax advantages that resulted from the deduction,"⁹² rather than from a bona fide transaction.

Private Letter Ruling 8012060⁹³ illustrates the importance of avoiding a prepayment to a related general contractor that subcontracts the actual drilling work to third parties who will not be paid until the year of performance. In this ruling, the Service conditioned its favorable ruling allowing the taxpayer to currently deduct prepaid IDCs on the understanding that the payments were made to independent drilling contractors that would actually perform the drilling services.⁹⁴

If the taxpayer enters into a drilling agreement with a contractor that will not perform the actual drilling, the taxpayer should require

ment is between related parties, the court finds that the contract is an enforceable contract of economic substance which Basin had a fiduciary as well as a contractual duty to perform." *Id.*

90. *See, e.g.*, Rev. Rul. 80-71, 1980-1 C.B. 106, 107 (where, after reviewing factors, the IRS found the prepayments were "not made in accordance with the customary business practice."); T.A.M. 7510310050A (Oct. 31, 1975) (drilling prepayment not for a valid business purpose where not bargained for with an independent contractor); T.A.M. 7609300010A (Sept. 30, 1976) (no valid business purpose found where drilling prepayments were not necessary to provide operating funds and the party receiving the prepayments did not actually perform the drilling services).

91. *See, e.g.*, Rev. Rul. 80-71, 1980-1 C.B. 106: "[I]t does not follow that all amounts paid are deductible in the year of payment when such payment is made in advance of the rendering of services by the drilling contractor." *Id.* at 108.

92. *Id.*; *see also* T.A.M. 7609300010A (Sept. 30, 1976); T.A.M. 7510310050A (Oct. 31, 1975).

93. 1979 IRS LETTER RUL. REP. (CCH) 8012060 (Dec. 27, 1979).

94. *Id.*

the drilling contractor to prepay the subcontractors in the same year the taxpayer makes its prepayment. This action by the general contractor should help qualify the taxpayer's prepayment for a current deduction, although no authority has addressed this issue. Furthermore, since a taxpayer who is a member of a drilling arrangement organized as a joint operating agreement can only deduct its prepayment to the operator in the year the operator actually pays the driller, not in the year the taxpayer pays the operator,⁹⁵ the operator should furnish the taxpayer with a copy of its transmittal of payment to the driller.

Fifth, *all of the operating interests under the lease must be subject to the same IDC prepayment contract*. This requirement, an outgrowth of the business purpose requirement, first appeared in Private Letter Ruling 8012060⁹⁶ in which the Service stated its favorable ruling on the current deductibility of prepaid IDCs would only apply if 100% of the owners of the operating interest in the lease were subject to the provisions of the drilling agreement. The Service also included this requirement in Private Letter Ruling 8111055⁹⁷ and Revenue Ruling 80-71.⁹⁸ The Service disallowed the current deduction of IDCs in Revenue Ruling 80-71 for other reasons.⁹⁹

Sixth, *the drilling agreement should specify the well to be drilled and identify its location*. A drilling contract with these two provisions will most closely resemble the factual situations in which the Service and courts have allowed the taxpayer to currently deduct prepaid IDCs. In *Pauley* and Revenue Ruling 71-252, the drilling agreement addressed a specific well at a designated location;¹⁰⁰ in Technical Advice Memorandum 7510310050A, the drilling contract described the wells to be drilled;¹⁰¹ and in Private Letter Rulings 8012060 and 8111055 the tax-

95. *McAdams v. Comm'r*, 15 T.C. 231 (1950), *aff'd*, 198 F.2d 54 (5th Cir. 1952); MILLER'S OIL AND GAS FEDERAL INCOME TAXATION 331 (J. Houghton ed. 1979). *But see* BURKE, INCOME TAXATION OF NATURAL RESOURCES 1416 n.67 (1981) which states that the Service has limited *McAdams* to its facts in an unpublished T.A.M.; *Rife v. Comm'r*, 356 F.2d 883, 888 (5th Cir. 1966), which limited *McAdams* to its facts insofar as the presumption that the payment by one co-owner of another's share of an outstanding debt of their joint venture was intended as a loan.

96. 1980 IRS LETTER RUL. REP. (CCH) 8012060 (Dec. 27, 1979).

97. 1981 IRS LETTER RUL. REP. (CCH) 8111055 (Dec. 16, 1980).

98. Rev. Rul. 80-71, 1980-1 C.B. 106.

99. *Id.* The prepayments were not made in accordance with customary business practice. They could be applied to wells for which no contract had been made. In existing contracts, no date had been specified for commencement or completion of drilling and the controlling general partner of the limited partnership was a wholly-owned subsidiary of the general contractor.

100. 63-1 U.S. Tax Cas. (CCH) ¶ 9,280, 11 A.F.T.R.2d (P-H) ¶ 63-490 (S.D. Cal. 1963); Rev. Rul. 71-252, 1971-1 C.B. 146.

101. T.A.M. 7510310050A (Oct. 31, 1975).

payers entered into drilling agreements with independent contractors for the drilling of oil and gas wells on certain leases.¹⁰² Similarly, in *Cheroff v. Commissioner*,¹⁰³ the taxpayer had entered into multiple well or blanket drilling agreements in which the driller agreed to drill a specified number of designated wells. The cases of *Stradlings Building Materials, Inc. v. Commissioner*¹⁰⁴ and *Dillingham v. United States*,¹⁰⁵ also involved prepayment contracts which specifically described the wells to be drilled.

Although the cases and rulings have not emphasized this specification requirement like they have the previously discussed requirements, in each situation where the taxpayer successfully deducted prepaid IDCs, the drilling agreement satisfied this requirement. For instance in Revenue Ruling 80-71,¹⁰⁶ where the drilling agreement provided that a portion of prepaid IDCs could be used to offset the drilling cost of future wells at undesignated locations, the Service ruled that the taxpayer could not deduct this prepayment because this provision, along with others in the drilling agreement, indicated that the contract was not in accordance with customary business practice and the prepayments created an asset with a useful life which extended substantially beyond the close of the current taxable year.¹⁰⁷ The Service might apply the same analysis to a drilling contract that required the taxpayer to prepay IDCs but did not identify the location or specify the well to be drilled.

Seventh, *the taxpayer's deduction of the prepaid IDCs must not substantially distort his income*. The Service announced in Revenue Ruling 80-71¹⁰⁸ that in order to satisfy the clear reflection of income test of Internal Revenue Code section 446,¹⁰⁹ the current deduction of prepaid IDCs must satisfy the specific limitation of Treasury Regulation § 1.461-1(a).¹¹⁰ This regulation provides that a cash basis taxpayer may not currently deduct an expenditure that creates an asset with a useful life that extends substantially beyond the close of the taxable year.¹¹¹

102. 1980 IRS LETTER RUL. REP. (CCH) 8012060 (Dec. 27, 1979).

103. 1980 T.C.M. (P-H) ¶ 80,125 (Apr. 21, 1980).

104. 76 T.C. 84, 76 TAX CT. REP. DEC. (P-H) ¶ 76.4 (1981).

105. 81-2 U.S. Tax Cas. (CCH) ¶ 9,601 (W.D. Okla. May 29, 1981).

106. Rev. Rul. 80-71, 1980-1 C.B. 106.

107. *Id.*

108. *Id.*

109. I.R.C. § 446(b) (Supp. II 1979).

110. Treas. Reg. § 1.461-1(a) (1982).

111. *Id.*

Revenue Ruling 80-71 does not define that point in time where an IDC prepayment will create an asset having a useful life extending "substantially beyond" the close of the taxable year and no case law or Service positions speak directly to this issue. The Service does, however, point to the two and one-half month period between the prepayment and the drilling of the well in *Pauley* as acceptable.¹¹² In an unpublished Private Letter Ruling,¹¹³ issued prior to Revenue Ruling 80-71, the Service permitted a taxpayer to deduct IDC prepayments relating to wells to be drilled as late as nine months after the close of the taxable year of the prepayment, and in analogous situations (prepaid cattle feed and prepaid interest) the Ninth Circuit Court of Appeals adopted a one year rule.¹¹⁴

The Service's approach in Revenue Ruling 80-71 seems to be inconsistent with the election granted by Internal Revenue Code section 263(c)¹¹⁵ to currently deduct IDCs. Internal Revenue Code section 263(c), by permitting a current deduction for an inherently capital expenditure, appears to create a statutory exception to the clear reflection of income rule of Internal Revenue Code section 446(b).¹¹⁶ Without the election authorized by Internal Revenue Code section 263(c), the taxpayer would have to capitalize IDCs and recover them through depletion and depreciation deductions.¹¹⁷ However, to insure a current deduction, the prudent taxpayer should strive to satisfy Revenue Ruling 80-71¹¹⁸ even though the Service's rationale may be questionable.

To comply with Internal Revenue Code section 446, taxpayers must also insure that their current deduction of prepaid IDCs is consistent with their established method of accounting. Taxpayers using the cash receipts and disbursement method of accounting generally take into account allowable deductions in the taxable year in which such deductions are paid, unless the payment distorts income.¹¹⁹ Taxpayers using the accrual method of accounting deduct an expense in the taxable year in which the amount of liability can be determined with rea-

112. Rev. Rul. 80-71, 1980-1 C.B. 106.

113. Note 49 *supra*.

114. *See* Commissioner v. Von Raden, 650 F.2d 1046 (9th Cir. 1981); Zaninovich v. United States, 616 F.2d 429 (9th Cir. 1980).

115. I.R.C. § 263(c) (Supp. II 1979).

116. Note 109 *supra*.

117. I.R.C. § 263(a) (Supp. II 1979).

118. Rev. Rul. 80-71, 1980-1 C.B. 106. Revenue Ruling 80-71, however, does not present any guidance as to whether the clear reflection of income test should be applied at the partner level as well as the partnership level.

119. *See* Treas. Reg. § 1.461.1(a) (1982).

sonable accuracy, and in which all events which determine liability have occurred (the "all events test").¹²⁰

Accrual basis taxpayers have appeared in five situations. Technical Advice Memoranda 7510310050A and 7609300010A¹²¹ involved accrual basis partnerships. However, in these cases the Service did not address the question of the deductibility of prepaid IDCs and the accrual basis taxpayer. The Service disallowed the IDCs deduction in both because the prepayment provision in the contract lacked a valid business purpose.¹²² Similarly, in *Cheroff*,¹²³ the Service argued that an accrual basis partnership's deduction for prepaid IDCs lacked a valid business purpose. The Service did concede, however, that the drilling contracts were sufficient to establish the fact and amount of liability (the "all events test" of accrual accounting method). The court rejected the Service's argument, and the accrual basis partnership was able to take the deduction for prepaid IDCs in the year of payment.¹²⁴ In *Stradlings*,¹²⁵ the Service conceded that an accrual basis partner could deduct its allocable share of prepaid partnership IDCs in the year of payment, and in *Dillingham*¹²⁶ the court held that prepaid IDCs required by the terms of the drilling agreement and motivated by a valid business purpose were deductible in the year of payment under either the cash or the accrual method of accounting.

IV. CONCLUSION

The law governing the deductibility of prepaid intangible drilling and development costs in the year of payment continues to evolve. From the time the Tax Court announced its holding in *Pauley v. United States*,¹²⁷ and the Service embraced this holding in Revenue Ruling 71-252,¹²⁸ taxpayers have tried to expand the factual situations in which they can currently deduct prepaid IDCs. The courts and the Service have responded by setting out additional requirements taxpayers must satisfy in order to enjoy a current deduction. The seven criteria set out in this Article, based on a review of the case law and the

120. *Id.* § 1.461-1(a)(2) (1982).

121. T.A.M. 7510310050A (Oct. 31, 1975); T.A.M. 7609300010A (Sept. 30, 1976).

122. *Id.*

123. 1980 T.C.M. (P-H) ¶ 80,125 (April 21, 1980).

124. *Id.*

125. 76 T.C. 84, 76 TAX CT. REP. DEC. (P-H) ¶ 76.4 (1981).

126. 81-2 U.S. Tax Cas. (CCH) ¶ 9,601 (W.D. Okla. May 29, 1981).

127. 63-1 U.S. Tax Cas. (CCH) ¶ 9,280, 11 A.F.T.R.2d (P-H) ¶ 63-490 (S.D. Cal. 1963).

128. Rev. Rul. 71-252, 1971-1 C.B. 146.

Service's current position, embody the current requirements a taxpayer must satisfy to successfully deduct prepaid IDCs in the year of payment.