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Repository Citation

George S. Wolbert Jr. and A. Kelly Williams, *Risk Analysis: The Evolving IDC Offshore Formula*, 48 La. L. Rev. (1988)

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RISK ANALYSIS: THE EVOLVING IDC OFFSHORE FORMULA

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INTRODUCTION

It is a matter of common knowledge in the "oil patch" that the costs of offshore drilling platforms are escalating rapidly.¹ Of these costs, more than 60 percent are represented by intangibles incurred in the drilling and development phase.² Although courts are admonished to give no weight to the revenue impact of a congressionally-approved tax incentive such as the option to expense intangible drilling and development costs³ ("IDC"),⁴ the Internal Revenue Service ("I.R.S." or

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1. For example, the cost of the rigs involved in *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325, 328 (1977), offshore Trinidad was in the 40 to 50 million dollar range. According to a press release of June 24, 1986, by Shell Offshore Inc., a subsidiary of Shell Oil Company, its Boxer platform, located 120 miles south of Morgan City, Louisiana, in Green Canyon Block 19, cost about 100 million dollars. These figures are for the platforms alone. When the costs of installation and the actual drilling costs are added in, the costs range from 10 million dollars to \$1 billion dollars per platform. *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456, 1461 (1980), *aff'd*, 694 F.2d 648 (10th Cir. 1982).

2. *Exxon Corp. v. United States*, 547 F.2d 548, 555 n.10 (Ct. Cl. 1976) (citing Jackson, *Tax Planning Before Drilling: The Operator's Problem*, 27 Tul. L. Rev. 21 (1952)). See also, Fielder, *The Option to Deduct Intangible Drilling and Development Costs*, 33 Tex. L. Rev. 825 (1955); Note, *Qualifying Deductible Intangible Drilling Costs in Offshore Drilling Operations*, 8 U. Tol. L. Rev. 555 n.3 (1977). Baum, *Intangible Drilling and Development Costs: Some Recurring Problems*, 21 Inst. on Oil & Gas L. & Tax'n 337 (1970), says the IDC option has been described as "the most valuable right accorded the oil operator under the tax laws"; cf. Galvin, *The "Ought" and "Is" of Oil-And-Gas Taxation*, 73 Harv. L. Rev. 1441, 1465 (1960) ("more significant than depletion as an attractor of venture capital").

3. *Exxon Corp. v. United States*, 547 F.2d 548, 555 (Ct. Cl. 1976).

4. T.D. 4333, 11-1 C.B. 31 (1932) ("such expenditures [wages, fuel, repairs, hauling, supplies, etc. incident to the drilling of wells] have for convenience been termed intangible drilling and development costs").

"Service"), as the administrative agency charged with the responsibility of collecting the revenue, necessarily must concern itself with any potential loss of revenue which evinces signs of rapid growth. Accordingly, in 1970, the Service issued Revenue Ruling ("Rev. Rul.") 70-596,⁵ which sets forth the Government's interpretation of section 263(c) of the Internal Revenue Code of 1986,⁶ as amended, and section 1.612-4 of the Treasury Regulations ("Reg."),⁷ as applied to offshore platforms. The ruling conceded⁸ that the offshore platform was "incident to and necessary for the drilling of wells"⁹ even though it was useful in connection with subsequent production activities.¹⁰ However, as will be discussed later, this concession did not prevent the question from being raised (quite unsuccessfully) in *Exxon Corp. v. United States*¹¹ as a subpoint in the Government's "salvage" argument, in what the court termed was

5. 1970-2 C.B. 68.

6. Hereinafter cited as "I.R.C. §" or "section." All references are to the I.R.C. (or the "Code") unless otherwise stated.

7. Hereinafter cited as "Reg. §" or "Prop. Reg. §."

8. Rev. Rul. 70-596, 1970-2 C.B. 68, 69. Linden, Review of Offshore Drilling - What are Intangibles, 26 Inst. on Oil & Gas L. & Tax'n 441, 472 (1975), cited this concession and the examples in Reg. § 1.612-4 for the proposition that dual purpose (well drilling and production) facilities would be deemed "well-drilling facilities," thus qualifying for the IDC election.

9. Reg. § 1.612-4(a). As Linden observed in a 1975 address delivered at the Southwestern Legal Foundation Institute on Oil and Gas and Taxation, the words of the regulation could be read either to qualify *all* well-drilling costs for the IDC option or only those where the wells were drilled for the production of oil or gas. Linden, *supra* note 8, at 448-449. As might be expected, the I.R.S. originally took the position that wells drilled by mobile rigs to (1) establish the existence of recoverable oil and gas in place; (2) delineate the approximate structural boundaries thereof; (3) estimate the recoverable reserves; and (4) determine the optimum geographical location for a permanent drilling and production platform did not come within the option to expense intangibles under I.R.C. § 263(c) and Reg. § 1.612-4 but were "mere extensions of exploratory operations," similar to geological and geophysical surveys which had to be capitalized under *Louisiana Land & Exploration Co. v. Commissioner*, 7 T.C. 507 (1946), *aff'd* on other issues, 161 F.2d 842 (5th Cir. 1947). However, after being rejected consistently by the courts, *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325 (1977), *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456 (1980), *aff'd*, 694 F.2d 648 (10th Cir. 1982), and *Sun Co., Inc. v. Commissioner*, 677 F.2d 294 (3rd Cir. 1982), the Service acquiesced in the three cases, I.R.S. Announcement 1983-1 C.B. 1, and will not continue to litigate the issue. Gen. Couns. Mem. 38976 (Apr. 11, 1983).

10. Mim. 6754, 1952-1 C.B. 30, sets forth the Service's conclusion that drilling and development operations have ended and production operations have commenced when the "Christmas tree" has been installed. See Baum, *supra* note 2, at 339. Mim. 6754 was superseded by its restatement in Rev. Rul. 70-414, 1970-2 C.B. 132. Costs incurred after this point that do not have a salvage value are generally considered to be currently deductible as operating expenses and not IDC. Reg. § 1.612-4(c)(2). See Allbright, An Overview of Intangible Drilling and Development Costs, 28 Oil & Gas Tax Q. 283, 286 (March 1980).

11. 547 F.2d 548 (Ct. Cl. 1976).

a "monstrous step" from the requirement that IDC's be incurred during "drilling" and "preparation" to a disqualification *eo instante* at the moment of an oil or gas strike.¹² The main thrust of Rev. Rul. 70-596 was the Service's assertion that, while the costs of transporting manufactured drilling rigs and other depreciable materials and equipment to the well site after delivery to the operator, and the costs of positioning and erecting the platform and permanently anchoring it to the ocean bed (together with the costs of engineering and design specifications attributable to them) were *within* the option provided by Reg. § 1.612-4, the intangible costs (including the operator's engineering and design specification costs) incurred by the operator or his building contractor at the onshore site, where the component parts of the platform were fabricated and assembled, were *denied* optionable status.¹³ The rationale given for this distinction was a terse unsupported assertion: "Offshore platforms are tangible property ordinarily considered as having a salvage value, similar in nature to the nonoptional items mentioned as examples in section 1.612-4(c) of the regulations."¹⁴

Over an eight year period, the I.R.S. was forced to litigate its position in three different courts: *Exxon Corp. v. United States*,¹⁵ *Standard Oil Co. (Ind.) v. Commissioner*¹⁶ and *Texaco Inc. v. United States*.¹⁷ Although each of the courts decided in favor of the taxpayer, their interpretations of the regulations differed. The Service has neither appealed any of these decisions nor announced any change in its position enunciated in Rev. Rul. 70-596. Instead, it apparently decided to forum shop by going after Gulf Oil Corporation,¹⁸ presumably with the intention of testing the waters in the Third Circuit and perhaps to secure a conflict of opinion. In view of the extreme importance of this issue to the industry and to the future of offshore drilling, this article will examine the "rather unusual" history¹⁹ of the option and analyze the cases in an effort to provide interpretive assistance and to develop guidelines for future activity with respect to the option.

12. *Id.* at 557.

13. Rev. Rul. 70-596, 1970-2 C.B. 68, 69-70.

14. *Id.* at 69.

15. 547 F.2d 548 (Ct. Cl. 1976).

16. 77 T.C. 349 (1981).

17. 598 F. Supp. 1165 (S.D. Tex. 1984).

18. *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324 (1986).

19. *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C., 325, 345 (1977); see also *Harper Oil Co. v. United States*, 425 F.2d 1335, 1338 (10th Cir. 1970) ("curious"); *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324, 340 (1986) ("complex"); *Sun Co. Inc. v. Commissioner*, 677 F.2d 294, 296 (3rd Cir. 1982) ("peculiar").

THE HISTORY OF THE IDC OPTION

Until 1954, Congress refrained from enacting any *express* statutory authority²⁰ for the option to deduct or to capitalize IDC's in its various revenue acts and in the Internal Revenue Code of 1939 ("1939 Code"). Instead, it was left to the I.R.S., then the Bureau of Internal Revenue, to deal with the matter administratively. The IDC option made its first appearance on February 8, 1917, in Treasury Decision 2447²¹ (Treasury Decisions hereinafter referred to as "T.D.") relating to the Revenue Act of September 8, 1916,²² as follows: "The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense."²³ One commentator has remarked about the cautious nature of the Treasury's venture into the matter, that is, the ease with which the language could be expanded or contracted by the interpretative process of case law.²⁴ One notes that the decision, while taking a tentative wait-and-see approach, conceptualized the option in terms of current expense versus capital recovery through depreciation.²⁵ The option was expressed similarly, although in somewhat more detail, on January 2, 1918, in Article 170 of Regulations 33²⁶ issued in con-

20. Fielder, *supra* note 2, at 827, suggests that the Revenue Act of 1918, 40 Stat. 1067, and the Revenue Act of 1921, 42 Stat. 241 (1921), in Section 214(a)(10) of each gave "a nod in the direction of the optional deduction" when they provided: "in case of . . . oil and gas wells . . . a reasonable allowance of depletion and for depreciation of improvements, according to the peculiar conditions in each case, *based upon cost including cost of development not otherwise deducted . . .*" (emphasis and certain omitted words added). Moreover, the Excess Profits Tax of 1940, 54 Stat. 979 (1940), had a provision which was codified as section 711(b)(1)(H) of the 1939 Code until repealed by the Revenue Act of 1945, section 122a, 59 Stat. 568 (1945), and which reappeared in substantially the same form in the Excess Profits Tax Act of 1950, 64 Stat. 1146 (1951), recodified in the 1939 Code as section 433(b)(9)(B). Section 711(b)(1)(H) read as follows: "All expenditures for intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, . . . which the taxpayer has deducted from gross income as an expense, shall not be allowed to the extent that in the light of the taxpayer's business it was abnormal [for the base year]"

21. T.D. 2447, 19 Treas. Dec. Int. Rev. 31 (1917).

22. 39 Stat. 756 (1916).

23. T.D. 2447, 19 Treas. Dec. Int. Rev. 31, 35 (1917).

24. Fielder, *supra* note 2, at 827.

25. *Id.*; Mahin, Deduction for Intangibles, 2 Inst. on Oil & Gas L. & Tax'n 367, 370 (1951).

26. T.D. 2960, 20 Treas. Dec. Int. Rev. 126, 205 (1918). The language read: ". . . such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection

nection with the Revenue Acts of 1916 and 1917.²⁷ In neither T.D. 2447 nor in Article 170 was any mention made of the election being binding on future years.

In Article 223 of Regulations 45,²⁸ promulgated under the 1918 Revenue Act,²⁹ the language of the option was expanded to read: "Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account *returnable through depletion*."³⁰ The italicized language represented the first substantive change in the regulations, making it clear that items which had been capitalized under the election were, unlike the previous treatment, to be recovered through depletion rather than through depreciation.³¹ Article 223 continued: "If in exercising this option, the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property, it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital accounts returnable through depletion and depreciation as in the case of productive wells." The regulation then stated

with the drilling of wells and further development of the property, may, at the option of the operator, be deducted as an operating expense or charged to capital account." Id. at 206. Note that the incidental expenses "which do not necessarily enter into and form a part of the capital invested or property account . . ." language of T.D. 2447 was dropped by T.D. 2690. The most logical explanation for excluding this language is that even if the "incidental expenditure" became part of the capital invested, it still could be deducted if it otherwise qualified as an IDC under the regulation. Another interesting change was the expansion of the right to the option, which had been initially limited to fee owner-operators, to include lessee operators. As Marvin Collie has noted, the language used may have been the seminal expression of the "payout period" concept. Collie, *The Intangible Drilling Costs Election - Is There A New Look?*, 16 *Oil & Gas Tax Q.* 109, 116 (April, 1967).

27. 39 Stat. 756 (1917) (see sections 5(a)(8) and 12(b)(21)); 39 Stat. 1000 (1917).

28. T.D. 2831, 21 *Treas. Dec. Int. Rev.* 170 (1919). One notes the further broadening of the class of optionees to include "taxpayer," and the dropping of the payout language.

29. 40 Stat. 1057 (1919) (see sections 214(a)(10) (individuals) and 234(a)(9) (corporations)).

30. T.D. 2831, 21 *Treas. Dec. Int. Rev.* 170, 232 (1919) (emphasis added).

31. French, *Intangible Drilling Cost Practices - Nine Years Later*, 13 *Tul. Tax Inst.* 501, 502 (1965); Mahin, *supra* note 25, at 370; Fielder, *supra* note 2, at 827. In *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459, 462 (1933), the Court held that cost recovery of capitalized IDC's was through depletion because Art. 225 of the 1926 Act limited depreciation to physical property such as machinery, tanks, equipment, etc. See Galvin, *supra* note 2, at 1466. See also *Petroleum Exploration v. Burnet*, 288 U.S. 467 (1933), and *Twin Bell Oil Syndicate v. Helvering*, 70 F.2d 402, 412-13 (9th Cir.), *aff'd* on other issues, 293 U.S. 312 (1934).

that "[a]n election once made under this option will control the taxpayer's returns for all subsequent years" ³² Hence, for the first time, taxpayers' elections, once made, became binding on all future years unless granted dispensation by Congress or the Service.

The wording employed by Article 223 of Regulations 45 in 1919 was restated substantially verbatim in Article 223 of Regulations 62, promulgated on February 15, 1922, ³³ and likewise in Article 225 of Regulations 65, ³⁴ issued under the Revenue Act of 1924, ³⁵ despite the fact that sections 214(a)(9) ³⁶ and 234(a)(8) ³⁷ of such Act had dropped the "based upon cost including cost of development not otherwise deducted" language, which had been noted previously ³⁸ as providing some support for the regulation. ³⁹ Nor was there any change in language when Article 223 of Treasury Regulations 69 was promulgated on August 28, 1926. ⁴⁰ However, the Revenue Act of 1926, upon which such regulations were based, added a 27½% depletion allowance by virtue of section 204(c)(2) of the Act. ⁴¹ This was a substantial change because it now permitted the deduction for depletion to be based upon a percentage of *income from the property* rather than on cost or discovery value, and the basis in the depletable property became irrelevant insofar as a limit on the amount of depletion was concerned. By the same token, intangible costs, which were elected to be capitalized as part of the leasehold cost, would no longer necessarily bring any additional recovery by way of depletion. As a consequence, T.D. 4025 ⁴² was promulgated on June 18, 1927, granting all taxpayers a new election under Article 223 of Regulations 69 with respect to the IDC election, effective for tax years ending on or after January 1, 1925, the effective date of the

32. T.D. 2831, 21 Treas. Dec. Int. Rev. 170, 232 (1919).

33. T.D. 3295, 24 Treas. Dec. 207, 290 (1922) pursuant to the Revenue Act of 1921, section 214(a)(10), 42 Stat. 227, 241 (1921).

34. T.D. 3640, 26 Treas. Dec. Int. Rev. 745, 822 (1924).

35. 43 Stat. 253 (1924).

36. *Id.* at 270.

37. *Id.* at 284-85.

38. See Fielder, *supra* note 20.

39. *Harper Oil Co. v. United States*, 425 F.2d 1335, 1338-39 (10th Cir. 1970).

40. T.D. 3922, 28 Treas. Dec. Int. Rev. 558, 635 (1926).

41. 44 Stat. 16 (1926).

42. T.D. 4025, 6-1 C.B. 75 (1927) ("In view of the change in the basis for depletion provided by the Revenue Act of 1926, in the case of oil and gas wells, taxpayers may make a new election as to the treatment of [IDC's] for taxable periods ending on or after January 1, 1925, but not later than six months after the date of this decision [June 18, 1927]."). See also I.T. 2338, 6-1 C.B. 74 (1927). I.T. 2393, 6-2 C.B. 68 (1927) made it clear that such new election to expense IDC for, and after, 1925 would not affect the electing taxpayer's deductions for depreciation and depletion on items previously capitalized in accordance with a pre-1925 year election.

1926 Act. Article 243 of Regulations 74⁴³ contained the same language previously employed despite the availability of percentage depletion.

On March 30, 1932, the Treasury Department promulgated T.D. 4333.⁴⁴ In the preamble of the decision, the Treasury took great pains to stress that no change in administrative policy or *in the practice under the regulations* was made or was intended to have been made by this restatement; nor was any new option or election as to the treatment of the expenditures involved granted or intended to have been granted. The new matter appearing in the restatement represented the practice of the Bureau of Internal Revenue under the regulations since prior to the promulgation of Regulations 45, on April 16, 1919.⁴⁵

The restatement, which was subsequently embodied in Article 236 of Regulations 77,⁴⁶ is as follows:

Charges to capital and to expense in the case of oil and gas wells.

(a) Items chargeable to capital or to expense at taxpayer's option.

(1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road-making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling

43. Reg. 74, Art. 243 (1929), reprinted in 138 U.S. Rev. Acts, 1909-1950: The Law, Legislative Histories & Administrative Documents (Bernard D. Reims ed., Hein & Co., Inc. 1979) (hereinafter cited as "U.S. Rev. Acts").

44. 11-1 C.B. 31 (1932).

45. *Id.* (emphasis added).

46. Reg. 77, Art. 236 (1933), reprinted in 139 U.S. Rev. Acts 1909-1950. The italicized emphasis of "actual materials" in (c)(1) was preserved intact. In fact, the only change was the deletion in Reg. 77 of the heading in T.D. 4333(a)(3): "Elections once made under these options will control the taxpayer's returns for all subsequent years."

and development items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option, the cost of drilling nonproductive wells, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital accounts returnable through depletion and depreciation as in the case of productive wells.

(3) Elections once made under these options will control the taxpayer's returns from all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(b) Recovery of optional items, if capitalized.

(1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this article, the expenditures for clearing ground, draining, road-making, surveying, geological work, excavation, grading, and the drilling, shooting and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If in exercising these options, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are represented by physical property, are returnable through depreciation. Such expenditures are amounts paid for wages, fuel, repairs, hauling supplies, etc., used in the installation

of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be subject to the foregoing segregation for the purposes of determining the depletion and depreciation allowances.

(c) Nonoptional items distinguished.

(1) Capital items: The option with respect to intangible drilling and development costs in general does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the *actual materials* in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The options do not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense regardless of the options provided by this article, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas. General overhead expense, taxes, and depreciation of drilling equipment, are not considered as capital items even when incurred during the development of the property.

Of interest to our examination of the proper interpretation of the IDC option as applied to offshore drilling platforms was T.D. 4333's rearrangement of the subsection (a)(1) language from "such incidental expenses . . . in connection with . . . drilling of wells," to "incident to and necessary for the drilling of wells";⁴⁷ its avoidance of the *characterization* of the expense (T.D. 2447 through Reg. 77, Art. 236 had characterized such expenses as "operating," while T.D. 4333 simply called it "an expense"); and its deletion of the "returnable through depletion" language which had caused commentators to say that the method of cost recovery as depletion had been changed in 1919 because of its addition by Article 223 of Regulations 45. More important, how-

47. See *supra* text accompanying note 13 and *infra* text accompanying notes 221-25.

ever, were the addition of the (A), (B), and (C) examples of optional items; the statement that, in general, the option applied only to expenditures for those drilling and developing items which *in themselves* do not have a salvage value; and the seemingly unequivocal provision that "[f]or the purposes of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value." The negation of nonoptionability of drilling and development costs merely because they were incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot, or other unit of measurement, was added because of the judge-made exception which had developed⁴⁸ in the case of turnkey⁴⁹ drilling contracts.⁵⁰

T.D. 4333 performed a bit of "housekeeping" by stating separately the option as to nonproductive wells and describing more clearly the manner of making the election in the first year in which the IDC's were incurred. It stated separately how optionable items, if capitalized, were to be recovered through depreciation or through depletion, depending on whether or not such items were "represented by physical property."

Perhaps the most significant change was the addition of the negative definition of the option (i.e., what items were nonoptional) in paragraph (c), entitled, "Nonoptional items distinguished." These were classified into: (1) "Capital items," and (2) "Expense items." Capital items were described generally as expenditures by which the taxpayer acquires *tangible property ordinarily considered as having a salvage value*. Examples given were the costs of *actual materials* and the cost of specifically enumerated items such as drilling tools, pipe, casing, tubing, and the like. Moreover, the exclusionary language was extended to IDC-type items which were "not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas." The cost recovery

48. *Ramsey v. Commissioner*, 26 B.T.A. 277, 280 (1932), *aff'd*, 66 F.2d 316 (10th Cir.), *cert. denied*, 290 U.S. 673 (1933); *Old Farmers Oil Co. v. Commissioner*, 12 B.T.A. 203, 208, 218 (1928), *acq.* 702 C.B. 30 (1928); *cf. Hughes Oil Co. v. Bass*, 62 F.2d 176 (5th Cir. 1932).

49. Under a turnkey drilling contract, the drilling contractor obligates himself to furnish all supplies and equipment and perform every act required in the completion of the well; nothing is required of the lease operator except the payment of the agreed price. *Commissioner v. Ambrose*, 127 F.2d 47, 48 (5th Cir. 1942).

50. *Mahin*, *supra* note 25, at 371; *Fielder*, *supra* note 2, at 828. The rationale behind the disqualification of the operator from using the option of expense IDC's incurred by a drilling contractor under a turnkey contract was that the contractor did all the work, incurred the expenses, and took the risk of cost overruns. All the operator did was to pay a determined amount for a complete well in place. Hence, as to the operator, it was an acquisition cost which should be capitalized. *Commissioner v. Ambrose*, 127 F.2d 47, 48 (5th Cir. 1942).

method assigned to these items was depreciation. The second category of nonoptional items, expense items, dealt with intangible items of the same nature as IDC's (i.e., labor, fuel, repairs, etc.), but which were incurred during the production stage⁵¹ and which therefore had to be charged off as production expense.

Except for minor grammatical changes, there were no changes in the language of T.D. 4333 embodied in Reg. 77, Art. 236 (1933)⁵² and echoed by Reg. 86, Art. 23(m)-16 (1935),⁵³ Reg. 94, Art. 23(m)-16 (1936),⁵⁴ Reg. 101, Art. 23(m)-16 (1939),⁵⁵ and Reg. 103, Sec. 19-23(m)-16 (1940).⁵⁶

On June 25, 1943, T.D. 5276⁵⁷ was promulgated. Essentially, this decision froze Reg. 103, Sec. 19.23(m)-16 for years prior to 1943, but for taxable years beginning after December 31, 1942, it made substantial changes in section 19.23(m)-16. As changed, the regulation clearly made the option available only to an "operator," who was defined as "one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease, or any form of contract granting working or operating rights."⁵⁸ This language narrowed eligibility by imposing a dual test of "economic interest" in the classic *Palmer v. Bender* sense⁵⁹ and a requirement that such interest must bear all the obligations of the lease and the expenses of development,⁶⁰ but it is not as restricted a definition as is popularly used in the field to mean one who is responsible for the day-to-day operation of the property

51. As has been shown, the I.R.S. takes the position that the dividing line is the "Christmas tree"; see *supra* note 10.

52. Reprinted in 139 U.S. Rev. Acts.

53. Reprinted in 140 U.S. Rev. Acts.

54. Reprinted in 140 U.S. Rev. Acts.

55. 4 Fed. Reg. 653 (1939), reprinted in 141 U.S. Rev. Acts.

56. 5 Fed. Reg. 390 (1940), reprinted in 143 U.S. Rev. Acts.

57. 1943 C.B. 151 (1943).

58. *Id.*

59. 287 U.S. 551, 557 (1933) (an interest, acquired by investment, in oil or gas in place which secures income derived from the extraction of such oil or gas, to which the interest holder must look solely for a return of his capital).

60. Miller, *The Intangible Drilling Deduction*, 100 J. Acct. 40 (Sept. 1945). This second test disqualifies the "free-riding," nonoperating interests such as oil payments, royalty, and net profits interests. See *Brooks v. Commissioner*, 424 F.2d 116, 122 (5th Cir. 1970); *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325, 327 n.2 (1977). The current regulations, § 1.614-2(b), define an operating mineral interest to be a separate mineral interest, as described in [I.R.C.] section 614(a), "... in respect of which the costs of production are required to be taken into account by the taxpayer for purposes of computing the limitation of 50 percent of the taxable income from the property in determining [percentage depletion]."

under a joint operating agreement.⁶¹ However, once one qualified as an "operator," the IDC option was available to him whether the costs were incurred by such operator or by a drilling contractor who was doing the drilling or development work under any form of contract, including turnkey contracts, except where the drilling contractor was earning an economic interest under the contract or where the drilling contractor's costs were properly allocable to the cost of depreciable property.⁶² The other side of the coin, that is, where drilling and development was undertaken (directly or through a contract) for the grant or assignment of a fraction of the operating rights, was that only the costs which were attributable to the earned fractional interest were optional.⁶³ Other than that, the operator's directly or indirectly incurred intangible drilling and development costs were made optional, whether incurred by him prior or subsequent to the formal grant or assignment to him of his operating rights.⁶⁴ The option with respect to deducting IDC's on nonproductive wells was limited to those operators who previously had elected to capitalize such costs.

Through an amendment by T.D. 5276, Reg. 103, Sec. 19.23(m)-16, became Reg. 111, Sec. 29.23(m)-16.⁶⁵ While the availability of the option during this time remained constant from an administrative viewpoint,⁶⁶ there was some sniping at the legal validity of the regulation by taxpayers who sought to obtain untoward benefits by switching its legitimacy on and off to meet their economic advantage. The Board of Tax Appeals in the 1928 *Old Farmers Oil* case⁶⁷ was able to avoid facing up to the validity of Reg. 45, Art. 223 because, although the taxpayer had deducted

61. Klayman, *The New Intangible Drilling and Development Regulations and Their Implications*, 25 *Inst. on Fed. Tax'n* 99, 102 (1967); Baum, *supra* note 2, at 327 n.32; Bennion, *Intangible Drilling and Development Costs*, P-H Oil & Gas/Natural Resources ¶ 2002, at 2023 (1972).

62. T.D. 5276, 1943 C.B. 151, 152. This concept was expressed in Paragraph 6, amending Regulations 103, by adding a new (b)(1)(i) to the regulation with a parenthetical clause: "excluding amounts payable only out of production or the gross proceeds of production and amounts properly allocable to cost of depreciable property."

63. *Id.*; see French, *supra* note 31, at 505.

64. This grant "overruled" such cases as *Berkshire Oil Co. v. Commissioner*, 9 T.C. 903 (1941), and *Hardesty v. Commissioner*, 127 F.2d 843 (5th Cir. 1942).

65. 8 Fed. Reg. 14931-33 (1943), reprinted in 144 U.S. Rev. Acts.

66. The Treasury Department was not the instigator of litigation challenging the validity of the IDC regulations; indeed, it was more than willing to defend them in the courts. Mahin, *supra* note 25, at 374. This was true especially of taxpayers who attempted to "double dip" into the revenue by electing the option to expense and take the deduction, and then, when the statute of limitations had run, sought to reduce their capital gains on subsequent sales by increasing their adjusted basis in the property through an assertion that the regulations were invalid, hence the expenses were capital additions under the predecessors of I.R.C. § 1016.

67. *Old Farmers Oil Co. v. Commissioner*, 12 B.T.A. 203 (1928).

intangible expenses incurred in drilling a well in 1918, the court found that such expenses were incurred not by the taxpayer, but by the "turnkey" drilling contractor. The court said that, under such circumstances, Old Farmers had made no IDC expenditures in 1918; instead, it had incurred a capital acquisition cost under the turnkey drilling contract doctrine.⁶⁸ Therefore, such capitalized acquisition cost was a proper part of Old Farmer's adjusted basis in 1919 when it sold the property.⁶⁹

In the 1931 *Sterling Oil* decision,⁷⁰ which also involved Article 223 of Regulations 45, the plaintiff incurred intangible drilling expenses approximating \$150,000 in 1919 and \$163,000 in 1920. When it filed its income tax return for taxable year 1919, plaintiff treated these expenses as capital expenditures, which created an adjusted basis which sufficiently offset receipts from certain sales of the leases concerned so that net taxable income was less than the plaintiff's statutory exemption. In February, 1921, after plaintiff had sold all its Kentucky leases and had an opportunity to massage the figures, but before it filed in respect of taxable year 1920, it filed an amended return for 1919, reporting a small profit on the sales and claiming the \$150,000 of IDC's as ordinary and necessary business expenses. When the Commissioner challenged this treatment, claiming that a binding election⁷¹ to capitalize the expenses had been made, the battle was on. But the argument really was whether the taxpayer had made a *binding decision* to capitalize the IDC's by so treating such expenditures in the original 1919 return. In essence, both parties were relying on the regulation's validity.

The court, however, apparently *sua sponte*, considered whether the Commissioner had the authority to issue a regulation which granted taxpayers an election to treat IDC's as either a deductible operating expense or as a capital expenditure. The court answered its self-raised question in the affirmative, concluding that the regulation represented a reasonable disposition of a difficult problem which fell within the Commissioner's rule-making powers.⁷² The court placed substantial weight

68. See *supra* text accompanying note 49; A.R.R. 1234, 1-2 C.B. 140 (1922), *obs.*, Rev. Rul. 67-123, 1967-1 C.B. 383; French, *supra* note 31, at 504-05.

69. *Old Farmers Oil Co. v. Commissioner*, 12 B.T.A. 203, 217-18 (1928), *acq.* 7-2 C.B. 30 (1928).

70. *Sterling Oil & Gas Co. v. Lucas*, 51 F.2d 413 (W.D. Ky., 1931), *aff'd*, 62 F.2d 951 (6th Cir. 1933).

71. Reg. 45, Art. 223 provided: "An election once made under this option will control the taxpayer's returns for all subsequent years." Except for certain transition rules, this concept is still extant in the current regulations. Reg. § 1.612-4(e).

72. *Sterling Oil & Gas Co. v. Lucas*, 51 F.2d 413, 416 (W.D. Ky. 1931), *aff'd*, 62 F.2d 951 (6th Cir. 1933). The court expressed the view that it was "sounder accounting practice" to classify IDC's as "invested capital," but it yielded to the Commissioner's judgment in this "debatable" matter.

on the "continued administrative acceptance and congressional sanction" of the option, which it felt gave the regulation the force and effect of law.⁷³

The Sixth Circuit's affirming opinion did not deal with the validity of the regulation but simply approved the trial court's determination that the "election" (in the sense of a final and deliberate choice) had *not* been made in the initial return, but was made in the amended return which followed.⁷⁴ In its affirmance, the court stressed the following circumstances: (1) an original return (which showed no tax due) made on the basis of an unclosed book of accounts; (2) an inexperienced accountant's treatment of the expenses; and (3) an amended return, which was filed prior to the filing of a return for the subsequent year and which for the first time disclosed material facts relating to the extent of the lease sales.

In the *Dakota-Montana Oil* case,⁷⁵ which involved Reg. 69, Arts. 223 and 225, the controversy raged over the characterization of IDC recovery as depreciation or depletion.⁷⁶ The taxpayer, who had taken 27 $\frac{1}{2}$ % depletion allowance on the gross income from the property, sought also to deduct its IDC's on the ground that 26 U.S.C.A. § 986(a)(8) permitted the deduction of a reasonable allowance "for depreciation of improvements" *in addition to* the deduction for depletion. In support of this treatment, the taxpayer argued that the drill hole was an "improvement" of his oil property and that no logical distinction in accounting practice could be drawn between the cost of such improvement and the cost of buildings and machinery placed on the property for the operation of the well for which depreciation admittedly was allowable under Article 225. The Government's position was that the well itself was *not* tangible physical property which wears out with use so as to be depreciable property. Thus, the taxpayer's seeming attack on the validity of the regulation was really one on the Service's application of it. Because of this posture of the case (the United States Supreme Court's determination upholding the Government simply subsumed the legality of the regulation), the decision cannot be said to be a precedential determination of validity.

Within four months, specifically on July 25, 1933, the Court of Appeals for the Tenth Circuit in *Ramsey v. Commissioner*⁷⁷ did address squarely the question whether Reg. 69, Art. 223, was a valid exercise

73. *Id.*

74. *Lucas v. Sterling Oil & Gas Co.*, 62 F.2d 951, 952 (6th Cir. 1933).

75. *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459 (1933).

76. See *supra* text accompanying note 31.

77. *Ramsey v. Commissioner*, 66 F.2d 316 (10th Cir.), cert. denied, 290 U.S. 673 (1933).

of the Commissioner's power to resolve by regulation a doubt as to the proper classification of drilling costs. Once again, the controversy arose when a taxpayer who, during the years in question, had claimed and received current deductions for intangible drilling and development costs incurred in his development of oil and gas leases and then in a subsequent sale added back to his adjusted basis the previously deducted IDC's. When challenged by the Commissioner, the taxpayer sought to justify his position by arguing that the items concerned were *inherently capital in nature* and if the regulation was construed to permit a current deduction of such costs (as he had done in 1922-1926, prior to the sale, and as the Service presently was doing), the regulation was invalid as a contravention of the provisions of the 1921,⁷⁸ 1924,⁷⁹ and 1926 Revenue Acts,⁸⁰ which denied a deduction for any amount paid out for permanent improvements or betterments made to increase the value of any property or estate.⁸¹ The court briskly rejected Ramsey's contentions, concluding: (1) the regulation, while using the word "incidental," followed by the explanatory words "wages, fuel, repairs, hauling, etc., in connection with the drilling of wells . . . and development of the property," clearly covered the very items that Ramsey sought now to capitalize; (2) an oil well was not so conclusively a permanent improvement or betterment as to preclude a regulation permitting the deduction of irrecoverable expenses of drilling such wells as ordinary and necessary expenses incurred in carrying on a trade or business; (3) the regulation had been in existence for many years during which time Congress had repeatedly amended the revenue laws while the regulation was in full force and effect; and (4) for many years, the regulation had been utilized by the oil industry, acted under by the Commissioner, and recognized or accepted by the Board of Tax Appeals and the courts.

Although the validity of the option had gained nationwide acceptance, and by the late 1930's and early 1940's its validity appeared no longer subject to question,⁸² nagging doubts began to surface in the Fifth Circuit. In 1943, in *Hunt v. Commissioner*,⁸³ in a special concurring

78. Sec. 215 of Revenue Act of 1921, 42 Stat. 227, 242 (1921).

79. Sec. 215 of Revenue Act of 1924, 43 Stat. 253, 271 (1924).

80. Sec. 215 of Revenue Act of 1926, 44 Stat. 9, 28 (1926).

81. *Ramsey v. Commissioner*, 66 F.2d 316, 317 (10th Cir.), cert. denied, 290 U.S. 673 (1933).

82. *Grison Oil Corp. v. Commissioner*, 96 F.2d 125, 126 (10th Cir.), cert. denied, 305 U.S. 613 (1938); cf. *Estate of Goodall v. Commissioner*, 391 F.2d, 775, 805 (8th Cir.), cert. denied, 393 U.S. 829 (1968) (quite content to accept the validity of the regulation). In fact, T.D. 4885, 1938-1 C.B. (Part I) 396, issued February 11, 1939, made the IDC option (along with other outstanding regulations under "prior revenue acts") applicable to the 1939 I.R.C. in so far as it was not inconsistent with that code.

83. 135 F.2d 697 (5th Cir. 1943).

opinion, Circuit Judge Sibley expressed doubt concerning the validity of Reg. 103, Sec. 19.23(m)-16. The majority had determined that Hunt, who had drilled a well on certain pooled acreage, thereby acquiring from Ohio Oil Company a one-half interest in one of the two parcels in the pool (he had previously acquired a one-half interest in the other parcel by assignment from the Hunt Oil Company), was entitled to elect current expense treatment for one-half of the IDC's incurred in drilling the well (which one-half related to his prior interest acquired from Hunt Oil Company), but had to capitalize the other one-half of the expenses as an acquisition cost. Judge Sibley concurred with the opinion because that was clearly the proper result under the regulation and court decisions,⁸⁴ but he was troubled by the seemingly schizophrenic result, and he laid the blame on the regulation.

Two years later, in what Dean Charles O. Galvin has termed "a gratuitous assay of the whole sweep of the regulations,"⁸⁵ the same Judge Sibley, writing for a three-judge panel⁸⁶ of the Fifth Circuit in *F.H.E. Oil Co. v. Commissioner*,⁸⁷ considered the regulation as it existed prior to the 1943 amendment⁸⁸ and concluded that the IDC expense option contained therein was contrary to the revenue statute and hence was invalid.⁸⁹ The gratuitous nature of this decision is apparent from the fact that the validity of the option was not at issue; neither the taxpayer nor the Service had raised it. The real controversy was one of interpretation of the regulation, that is, whether the Commissioner's obligation well doctrine⁹⁰ should be extended to a situation where the

84. *United States v. Sentinel Oil Co.*, 109 F. 2d 854 (9th Cir.), cert. denied, 310 U.S. 645 (1940); *Commissioner v. Rowan Drilling Co.*, 130 F.2d 62 (5th Cir. 1942); *Hardesty v. Commissioner*, 127 F.2d 843 (5th Cir. 1942); cf. Gen. Couns. Mem. 22224 (July 23, 1940) 1940-2 C.B. 216, modifying Gen. Couns. Mem. 10686, 11-2 C.B. 257 (1932).

85. Galvin, The "Ought" and "Is" of Oil-And-Gas Taxation, 73 Harv. L. Rev. 1441, 1467 (1960).

86. Judges Sibley and Waller were on the panel in both the *Hunt* and *F.H.E.* cases; Judge McCord was replaced by Judge Holmes in *F.H.E.*

87. 147 F.2d 1002 (5th Cir. 1945).

88. Art. 23(m)-16 of Regs. 101 and 103; see *supra* text accompanying note 57.

89. *F.H.E. Oil Co. v. Commissioner*, 147 F.2d 1002, 1005 (5th Cir. 1945).

90. The obligation well doctrine at this point of time was that whenever drilling of a well was undertaken in consideration for the assignment of operating or royalty rights in a property, the cost of drilling the well must be capitalized as a cost of acquiring title to such economic interests. See Fielder, The Option To Deduct Intangible Drilling and Development Costs, 33 Tex. L. Rev. 825, 835-37 (1955), for the historical development of the doctrine from its humble beginning in a 1927 General Counsel Memorandum, GCM 932, 6-1 C.B. 241 (1927), obs., Rev. Rul. 67-123, 1967-1 C.B. 383, to the time of the *F.H.E.* decision. As Fielder pointed out, extension of the obligation well to its logical extreme would have eliminated the option because virtually all oil and gas leases cease unless drilling is commenced within the primary term and even thereafter because of the implied covenant for reasonable development.

leasehold interest was not assigned expressly in consideration of drilling and did not obligate F.H.E. to drill; however, unless F.H.E. did drill within a limited number of days, its rights would expire. The court could have simply affirmed the Tax Court's extension of the obligation well doctrine from denial of the IDC option to one who drills to obtain an interest to a denial to one who drills to keep his interest.⁹¹

Judge Sibley apparently was unable to confine himself to the issue at hand. He just had to vindicate the "one judge [in *Hunt v. Commissioner*, who] then for the first time argued that the true reason for disallowing expense deductions in the *Hardesty* and *Hunt* cases was that the part of the regulation giving the option was void, since the making of a producing well by one who owned the oil reserve, or became entitled thereby to an interest in it, was a capital investment returnable through depletion under the statute."⁹² The absence of a challenge to the option's validity in *F.H.E.* was breezily excused by Judge Sibley who reasoned that taxpayers were not disposed to bite the hand that fed them, and the Commissioner, like Shakespeare's Touchstone,⁹³ could not disown his own child, as poor and ill-favored as it was.⁹⁴ Having led himself that far down the primrose path, it was easy for the judge to conclude that "if the option be in truth contrary to the revenue statutes, it is void, and it is the duty of the judges to declare and uphold the law, and disregard the regulation."⁹⁵

In order to reach a position that the regulation was contrary to the statute, Judge Sibley had to discredit the Tenth Circuit's decision in *Ramsey*. He sought to do this by stating flatly that a producing well was a permanent improvement;⁹⁶ hence, because *Ramsey* had predicated its conclusion of the option's validity partially on a doubt whether an oil well was a permanent improvement, he was half of the way home. The other basis for *Ramsey*'s holding of validity was the long existence of the regulation and the many reenactments of the statute with their relevant parts unchanged. Judge Sibley rejected this argument as being applicable only where a regulation resolved ambiguities or uncertainties, but "of no force at all when a regulation is contrary to the terms of

91. *F.H.E. Oil Co. v. Commissioner*, 3 T.C. 13, 24-25 (1944). Such an extension also was made by *Tripplehorn v. Commissioner*, 2 T.C.M. (CCH) 8, 10-12 (1943).

92. *F.H.E. Oil Co. v. Commissioner*, 147 F.2d 1002, 1004 (5th Cir. 1945).

93. Shakespeare, *As You Like It*, Act V, Scene IV. (The characterization of the option essentially was that of Judge Sibley; the analogy was our own).

94. *F.H.E. Oil Co. v. Commissioner*, 147 F.2d 1002, 1003 (5th Cir. 1945).

95. *Id.*

96. *Id.* at 1005.

the statute."⁹⁷ Reaction from Treasury and taxpayer alike was immediate and urgent,⁹⁸ and the court was inundated with amicus curiae briefs.⁹⁹

Judge Sibley, who denied the first motion for rehearing, was quite evidently taken aback by the Pandora's box which his first opinion had opened. While disclaiming any "fault in [his] previous reasoning" and characterizing his former opinion as "a right one to have been rendered twenty years ago,"¹⁰⁰ he found it "unnecessary to consider so broadly the validity of the option" and confined the court's decision to agreeing with the Tax Court's holding that wells drilled to get an oil property or an increased interest in one already owned were "so clearly capital investments in that property that no part of their cost can be called an expense of business."¹⁰¹ Judge Sibley "laid to one side" the question whether a successful oil well on property which the driller fully owns is a "permanent improvement" and therefore a part of the capital investment which could not be expensed. He identified the sole issue before the court to be whether one who does not own an oil property and who agrees to "make" a well to *obtain* an interest (the *Hardesty* and *Hunt* "obligation well" doctrine), or who has an interest in the property which will last only for a few days unless he drills a well (the Tax Court's extension of the "obligation well" doctrine in the trial below), and drills to *retain* such interest, thereby makes a capital investment "which cannot be a mere business expense under the statute."¹⁰²

While gratified by Judge Sibley's reluctant retreat from the broad sweep of the first opinion, the industry pressed for relief both in the Congress and before the Fifth Circuit, moving for a second rehearing. On July 21, 1945, Congress adopted House Concurrent Resolution 50,¹⁰³ which memorialized its recognition and approval of the provisions of

97. *Id.* The Judge stated "[t]he Congress in every Revenue Act has defined expenses and stated plainly what could not be treated as expense; and has provided for oil and gas wells modes of depletion for returning the capital invested in them. If these provisions contravene prior regulations, instead of approving the regulations, they annul them." *Id.*

98. Mahin, *supra* note 25, at 378; cf. *F.H.E. Oil Co. v. Commissioner*, 149 F.2d 238 (5th Cir. 1945) ("probably a billion dollars of corrections might result in expense deductions in tax returns made within the statutes of limitation, if the option is invalid").

99. See *Harper Oil Co. v. United States*, 425 F.2d 1335, 1340 (10th Cir. 1940); Mahin, *supra* note 25, at 378.

100. *F.H.E. Oil Co. v. Commissioner*, 149 F.2d 238, 239 (5th Cir. 1945).

101. *Id.*; cf. *Harper Oil Co. v. United States*, 425 F.2d 1335, 1340 (10th Cir. 1940).

102. While the particular facts in *F.H.E.* involved a lease on property which apparently had only a few days to go, the principle espoused was sufficiently broad to cover all "unless" leases from the day the lease was granted.

103. H.R. Con. Res. 50, 79th Cong., 1st Sess., 1945 C.B. 545. The House of Representatives adopted the Resolution on June 19, 1945, and the Senate concurred on July 21, 1945 (legislative day, July 9, 1945).

Reg. 111, Sec. 29.23(m)-16.¹⁰⁴ However, notwithstanding the fact that Resolution 50 was fully in place when the Fifth Circuit heard the second motion for rehearing in *F.H.E. Oil Co.*,¹⁰⁵ the court, in a per curiam opinion, not only denied the motion for rehearing on the ground that its rules did not provide for a second rehearing, but also took the occasion to deprecate the Resolution, stating that it was not an Act of Congress approved by the President or passed over his veto and hence it neither made law nor changed it.¹⁰⁶ Under the circumstances, the status of the option's validity lay in uneasy decision.¹⁰⁷ Nonetheless, taxpayers and the Treasury continued to follow the regulations relating to the option,¹⁰⁸ and no other court ever joined the Fifth Circuit in its (with-drawn) view as to the invalidity of the regulations grant of the option.¹⁰⁹ As mentioned previously by footnote, the IDC election option regulations had been made applicable to the 1939 Internal Revenue Code,¹¹⁰ and Reg. 118, Sec. 39.23(m)-16, which was in effect at the time that the

104. "Resolved by the House of Representatives (the Senate concurring), That in the public interest the Congress hereby declares that by the reenactment, in the various revenue Acts beginning with the Revenue Act of 1918, of the provisions of section 23 of the Internal Revenue Code and of the corresponding sections of prior revenue Acts allowing a deduction for ordinary and necessary business expenses, and by the enactment of the provisions of section 711(b)(1) of the Internal Revenue Code relating to the deduction for intangible drilling and development costs in the case of oil and gas wells, the Congress has recognized and approved the provisions of section 29.23(m)-16 of Treasury Regulations 111 and the corresponding provisions of prior Treasury Regulations granting the option to deduct as expenses such intangible drilling and development costs." H.R. Con. Res. 50, 79th Cong., 1st Sess., 1945 C.B. 545.

105. *F.H.E. Oil Co. v. Commissioner*, 150 F.2d 857 (5th Cir. 1945).

106. *Id.* at 858. Murray, *Intangible Drilling and Development Costs of Oil and Gas Wells*, 26 *Taxes* 312, 315 (1948), viewed the court's comments as abandoning its constitutional objections to the option as an administrative usurpation of the judicial power to define "income" as that term was employed by the 16th Amendment. However, H.R. Rep. No. 761, 79th Cong., 1st Sess. 1 (1945), reprinted in 111 U.S. Rev. Acts, which accompanied Resolution 50, clearly expressed Congressional intent underlying the option: "The purpose of the resolution is to remove any doubt as to the *validity* of Treasury regulations giving to the taxpayer the option to either capitalize or charge to expense intangible drilling and development costs in the case of oil and gas wells." (emphasis added). The report referred to Judge Sibley's original opinion in *F.H.E.* and described his position on the option's validity as "untenable." Moreover, it stated, on page 2 of the H.R. Rep., that "Congress has approved the administrative construction adopted in such regulations [Reg. 111, Sec. 29-23(m)-16] and has thereby given them the full force and effect of law." It concluded by saying that "... your committee deems it necessary to have Congress reaffirm that such regulations are in accordance with and have the full force and effect of law."

107. Galvin, *supra* note 85, at 1467; French, *Intangible Drilling Cost Practices - Nine Years Later*, 13 *Tul. Tax. Inst.* 501, 506 (1964) ("open question").

108. Fielder, *supra* note 90, at 830.

109. Mertens *Law of Fed Income Tax* § 24.48b; cf. Fielder, *supra* note 90, at 830.

110. See *supra* note 82.

1954 Internal Revenue Code was enacted, merely echoed the language of the earlier option provisions under Regulations 103 and 111.¹¹¹

When the 1954 Code was adopted, congressional supporters of the IDC option thought it best to provide express authority for it in the new Code.¹¹² This was done by placing, in section 263(c), an exception to 263(a)'s general rule of no deduction for capital expenditures, reading: "Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress."¹¹³

One immediate effect of 263(c)'s enactment was to smother Judge Sibley's retreating blast in *F.H.E.*'s third edition to the effect that Resolution 50 did not make law or change a law made by a previous Congress;¹¹⁴ the IDC option now had firm statutory authority.¹¹⁵ Moreover, the Senate Finance Committee's Report bespoke firmly the congressional intent that "[§ 263(c) of the new 1954 I.R.C. did] not affect the treatment now allowed by regulations relating to the deduction of capitalization of intangible drilling and development costs in the case of oil and gas."¹¹⁶ Hence, it would be a bold court that would challenge the validity of the regulations, even with respect to years before 1954.¹¹⁷

The second effect of the enactment of section 263(c) was to render cases dealing with the question of whether certain expenditures were capital in nature patently useless in determining whether IDC expenditures were optional because the very purpose of section 263(c) was to provide for the IDC option where the expenses obviously were capital expenditures described in section 263(a).¹¹⁸

111. A reading of Reg. 118, § 39.23(m)-16 against Reg. 111, § 29.23(m)-16 reveals that the wording is identical.

112. Fielder, *supra* note 90, at 830.

113. I.R.C. § 263(c) (1954).

114. *F.H.E. Oil Co. v. Commissioner*, 150 F.2d 857, 858 (5th Cir. 1945).

115. *Harper Oil Co. v. United States*, 425 F.2d 1335, 1342 (10th Cir. 1970); *Exxon Corp. v. United States*, 547 F.2d 548, 555 (Ct. Cl. 1976).

116. S. Rep. No. 1622, 83d Cong., 2d Sess. 81, reprinted in 1954 U.S. Code Cong. & Admin. News 4629, 4714; cf. H.R. Rep. No. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. Code Cong. & Admin. News, 4025, 4202; see also *Sun Co. v. Commissioner*, 677 F.2d 294, 299 (3d Cir. 1982).

117. Fielder, *supra* note 90, at 830.

118. *Sun Co. v. Commissioner*, 677 F.2d 294, 296 (3d Cir. 1982); *Sun Co. v. Commissioner*, 74 T.C. 1481, 1507 (1980); *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325, 344 (1977); *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1168 n.7 (S.D. Tex. 1984); *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456, 1474 (1980), *aff'd*, 694 F.2d

The third impact of the inclusion of section 263(c) in the 1954 Code was the clear signal that the IDC option had been codified as a result of a continuing congressional objective to encourage risk-taking with respect to,¹¹⁹ and to provide an incentive for, exploration for oil and gas.¹²⁰ Moreover, it is fair to conclude from the foregoing history of the IDC option that Congress consistently has favored a liberal interpretation of the regulation¹²¹ in order to permit the option to fulfill its role as an incentive to oil and gas prospecting, clearly a continuing objective of national importance.¹²² In light of this obvious concern by Congress, it is somewhat surprising that the manner in which the option was to perform was not addressed either in the hearings or by the committee reports on the Internal Revenue Code of 1954.¹²³ This absence of operative guidelines probably was the result of the enormity of the project confronting Congress in recodifying the Code and the feeling that the option had been sufficiently developed under the prior regulations¹²⁴ and was best left to the administrative agency (the I.R.S.) charged with the enforcement of the law to continue further development¹²⁵ in a flexible manner consistent with the prior regulations.¹²⁶

648 (10th Cir. 1982). One wonders if this conclusion was not presaged by the change in language from T.D. 2447 to T.D. 2690. See *supra* note 26. By the same token, any idea that IDC's were ordinary and necessary business expenses, as was suggested in *Ramsey v. Commissioner*, 66 F.2d 316, 318 (10th Cir.), cert. denied, 290 U.S. 673 (1933), was laid to rest by the Fifth Circuit's *F.H.E. [III]* opinion. *Linden, Review of Offshore Drilling - What are Intangibles?*, 26 *Inst. on Oil & Gas L. & Tax'n* 441, 447 (1975).

119. *Sun Co. v. Commissioner*, 677 F.2d 294, 300 (3d Cir. 1982); *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325, 350 (1977); cf. *United States v. Cocke*, 399 F.2d 433, 453 (5th Cir. 1969); *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456, 1477 (1980) (encouragement of risk-taking is the *raison d'être* of the IDC option); Jackson, *Tax Planning Before Drilling: The Operator's Problem*, 27 *Tul. L. Rev.* 21 (1952).

120. *Sun Co. v. Commissioner*, 677 F.2d 294, 300 (3d Cir. 1982); *Exxon Corp. v. United States* 547 F.2d 548, 555 (Ct. Cl. 1976); Murray, *Intangible Drilling and Development Costs of Oil and Gas Wells*, 26 *Taxes* 312, 316 (1948); cf. H.R. Rep. No. 761, 79th Cong., 1st Sess. 2 (1945).

121. *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456, 1475 (1980), *aff'd*, 694 F.2d 648 (10th Cir. 1982); *Sun Co. v. Commissioner*, 74 T.C. 1481, 1508 (1980); *Standard Oil Co. (Ind.) v. United States*, 68 T.C. 325, 345 (1977).

122. *Exxon Corp. v. United States*, 547 F.2d 548, 555 (Ct. Cl. 1976); *Sun Co. v. Commissioner*, 677 F.2d 294, 299-300 (3d Cir. 1982) (this incentive has assumed even greater relevance in light of current energy problems).

123. Note, *Qualifying Deductible Intangible Drilling Costs in Offshore Drilling Operations*, 8 *U. Tol. L. Rev.* 555, 560 (1977).

124. Those which a prior Congress, the 79th, had recognized and approved in H. Con. Res. 50, i.e., Reg. 111, Sec. 29.23(m)-16 (and corresponding provisions of prior regulations).

125. I.R.C. § 263(c).

126. The authors base their conjecture of flexibility on the use, in section 263(c), of the words "corresponding to," but see Fielder, *supra* note 90, at 830 (expressing concern that enactment of section 263(c) would tie the Service to provisions and, impliedly, to interpretations thereof as they were in 1945 when H. Con. Res. 50 was adopted).

Despite the congressional mandate in I.R.C. § 263(c) to prescribe regulations "corresponding to" the IDC regulations under the 1939 Code approved by House Concurrent Resolution 50, the Service got itself bogged down¹²⁷ by the thorny "carried interest" problem.¹²⁸ The Service published two sets of Proposed Regulations,¹²⁹ interspaced by the adoption of a Final Regulation under I.R.C. § 263(c),¹³⁰ to deal with this problem. Each of the Proposed Regulations was met by a veritable barrage of criticism ranging from a general charge of invalidity because they went beyond the scope of the regulations which had been two-step

127. Baum, *Intangible Drilling and Development Costs: Some Recurring Problems*, 21 *Inst. on Oil & Gas L. & Tax'n* 337, 355-56 (1970); Klayman, *The New Intangible Drilling and Development Regulations and Their Implications*, 25 *Inst. on Fed. Tax'n* 99, 103 (1967); Klayman, *The Final Intangibles Regulations: Where Do We Stand Now?*, 17 *Inst. on Oil & Gas Law & Tax'n* 371, 376-82 (1966).

128. A carried interest is an arrangement between two or more co-owners of a working interest, whereby one agrees to advance all or some part of the development costs on behalf of the others and to recover such advances from future production, if any, accruing to the other owners' share of the working interest. Russell & Bowhay, *Income Taxation of Natural Resources* § 2.08 (1986). Most commentators categorize these deals into three types, bearing the names of the taxpayers in the three leading cases: (1) *Manahan*, (2) *Herndon*, and (3) *Abercrombie*. *Manahan Oil Co. v. Commissioner*, 8 T.C. 1159 (1947); *Herndon Drilling Co. v. Commissioner*, 6 T.C. 628 (1946); *Commissioner v. J.S. Abercrombie Co.*, 162 F.2d 338 (5th Cir. 1947). In the *Manahan* type, approved by the Service in Gen. Couns. Mem. 22730, 1941-1 C.B. 214, the owner of a working interest, the carried party, assigns all or part of his working interest to the carrying party, subject to a right of reversion in favor of the carried party. If, and after, the carrying party has recouped his development and operating costs from production, he then reassigns the specified fraction of his working interest to the carried party. If the production is insufficient to enable the carrying party to recoup his cost, the carried party's reversion never comes into possession. In the *Herndon* type, the carried party assigns to the carrying party a fraction of the working interest, together with an oil payment, carved out of his retained fraction of the working interest, equal to the amount of the development cost incurred by the carrying party which is attributed to the carried party's retained interest, plus operating costs during the "pay-out" period. In the *Abercrombie* type, the carried party assigns a fraction of the working interest and also gives the carrying party a mortgage or lien on the fractional interest retained by the carried party. *Wienert's Estate v. Commissioner*, 294 F.2d 750 n.1 (5th Cir. 1961). Although the economics of the three types of arrangements were virtually the same, each method gave rise to a different tax treatment of IDC's. Klayman, *The New IDC Regulations*, supra note 127, at 106-08; Baum, supra note 127, at 356-58; see also Bean, *Taxation of Carried Interests in Oil and Gas Transactions - In Retrospect and Prospect*, 10 *U. Kan. L. Rev.* 391 (1962).

129. Prop. Reg. § 1.612-4, 21 *Fed. Reg.* 8446 (Nov. 3, 1956); Prop. Reg. § 1.612-4, 25 *Fed. Reg.* 3761 (Apr. 29, 1960).

130. T.D. 6313, 1958-2 C.B. 114, filed on September 16, 1958, which read laconically: "§ 1.263(c)-1. *Intangible Drilling and Development Costs in the case of Oil and Gas Wells* - For rules relating to the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells, see § 1.612-4." This remains unchanged today.

incorporated by I.R.C. § 263 (c) via House Concurrent Resolution 50,¹³¹ to specific attacks on the Treasury's attempts to address formally the carried interest problem. The first (1956) set of proposed regulations expressly permitted the full deduction of IDC's incurred by the carrying party in *Manahan* situations (where the entire operating interest had been assigned to the carrying party until full recoupment, solely out of production, of his drilling and operating costs).¹³² However, for the first time, the regulation attempted to define the recoupment period, which was given the name "complete payout period."¹³³ Thus was opened the can of worms: once the complete payout period was defined, one immediately asked what tax treatment of the carrying party's IDC's results where the carried party's operating interest reverted *before* the complete payout period terminated?¹³⁴

The 1956 proposed regulations set forth the rule that the carrying party could deduct that part of his IDC's incurred which represented the ratio which his share of the operating net income¹³⁵ bore to the total operating net income during the complete payout period.¹³⁶ While the rule was sound from a logical standpoint, it was useless as a practical matter¹³⁷ because it was not always possible to compute the carrying party's share of the operating net income on the basis of ascertainable facts when he filed his return.¹³⁸ Moreover, the definition of the "complete payout period" did not take into account the fact that part of the development costs could have been financed by holders of non-operating interests.¹³⁹

131. See, e.g., Bean, *supra* note 128, at 409 (went beyond); Driscoll, *The Tax Relationship of Oilman and Investor: The Carried Interest Problem*, 15 *Inst. on Fed. Tax'n* 314, 332 (1957) (proposed regulations establish an entirely new pattern for treatment of carried interests and, therefore, are invalid as not "corresponding"); but see, e.g., French, *supra* note 107, at 508 (since Resolution 50 referred to prior Treasury Regulations as well as Reg. 111, sec. 29-23(m)-16, which in itself contained one set of provisions applicable to taxable years beginning prior to January 1, 1943 and another (different) set after December 31, 1942, one could argue that the Treasury could adopt regulations that were not necessarily identical, but merely which "corresponded" to those existing in 1945 when Resolution 50 was adopted).

132. Prop. Reg. § 1.612-4(a)(4), Example (1) (1956), 21 *Fed. Reg.* 8446, 8447 (November 3, 1956).

133. Prop. Reg. § 1.612-4(a)(2) (1956), 21 *Fed. Reg.* 8446 (November 3, 1956).

134. See Klayman, *The New IDC Regulations*, *supra* note 127, at 107; Klayman, *The Final Intangible Regulations*, *supra* note 127, at 377. This is known as a "partial carry."

135. Gross income attributable to the operating interest less operating costs, Prop. Reg. § 1.612-4(a)(2) (1956).

136. Klayman, *The New IDC Regulations*, *supra* note 127, at 107.

137. Klayman, *The Final Intangibles Regulations*, *supra* note 127, at 378.

138. See Driscoll, *supra* note 131, at 326-32.

139. As Klayman, *The New IDC Regulations*, *supra* note 127, at 109, pointed out,

As a result of the objections, the 1956 proposed regulations were withdrawn and the 1960 proposed regulations took their place. The new proposals maintained the official position: full deductions for *Manahan* scenarios, partial deductions for *Herndon* types, and a "no comment" on *Abercrombie* situations.¹⁴⁰ However, there was an attempt to meet the objections to the 1956 proposal. There were a number of changes for that purpose, including a new "partial carry" rule that treated the carrying party's interest as equating to his residual operating interest "immediately after the complete payout period," and a new definition of "complete payout period" which took into account the fact that part of the development costs may have been incurred by nonoperating interest holders.¹⁴¹ In addition, the 1960 proposed regulations carried the "complete payout period" concept to the extreme of its logic, for its "terminable working interest" rule would have given a carrying party an option to deduct 100% of his IDC's if he had the entire working interest up to the moment of complete payout even though his entire interest terminated immediately thereafter.¹⁴²

The 1960 proposed regulations were not received with any more enthusiasm than were the earlier proposed regulations. After a substantial period during which the Treasury gave the matter further study and considered a number of alternatives,¹⁴³ it determined that discretion was the better part of valor and retreated to the 1939 Code regulations¹⁴⁴ by publishing, on July 14, 1965,¹⁴⁵ final regulations under I.R.C. § 612,¹⁴⁶ which not only "corresponded" to the earlier regulations but were, in effect, identical to them,¹⁴⁷ at least insofar as the definitional paragraphs with which this article primarily is concerned, i.e., "(a)"

the complete payout period could be shortened whenever the operating interests recouped their development costs at a faster rate than did the non-operating interests—thereby "tilting" the wheel in favor of the carrying party—and, conversely, would be lengthened if the nonoperating interests recouped their costs more rapidly than the operating interests, thereby making it harder for the carrying party to obtain the full intangible deduction.

140. Klayman, *The Final Intangibles Regulations*, supra note 127, at 379.

141. The new definition of "complete pay-out [sic] period" was "the period ending when the gross income attributable to all of the operating mineral interests in the well (or wells) equals all expenditures for drilling and development (tangible and intangible) of such well (or wells) plus the costs of operating such well (or wells) to produce such an amount." Prop. Reg. § 1.612-4(a)(2) (1960), 25 Fed. Reg. 3761 (Apr. 29, 1960).

142. Klayman, *The New IDC Regulations*, supra note 127, at 111.

143. Klayman, *The New IDC Regulations*, supra note 127, at 112; Klayman, *The Final Intangibles Regulations*, supra note 127, at 383.

144. Klayman, *The Final Intangibles Regulations*, supra note 127, at 372.

145. T.D. 6836, 1965-2 C.B. 182.

146. Reg. § 1.612-4.

147. Bennion, *Intangible Drilling and Development Costs: The Final Regulations*, 15 Tul. Tax Inst. 665 (1965); cf. Klayman, *The Final Intangibles Regulations*, supra note 127, at 383.

the inclusionary paragraph, and “(c)” the exclusionary paragraph. The problem of carried interests was relegated to rulings made on a situation-by-situation basis.¹⁴⁸

THE LANGUAGE OF THE IDC OPTION

Despite the controversies that raged over the validity of the pre-1954 Code regulations, the legislative history is bereft of guidance on how the option was intended to perform in the future. The Ways and Means Committee Report¹⁴⁹ accompanying House Concurrent Resolution 50 proclaimed vigorously the legal force of the regulations and bespoke Congress’ strong support of them, but it did not go into the matter of *how* the option should be interpreted. Neither the Hearings nor the Committee Reports¹⁵⁰ on the adoption of the 1954 Code shed any light on the intended interpretation.¹⁵¹ Thus, we are left with only the bare words of the regulation¹⁵² and a judicial recognition that Congress favors a liberal interpretation of the regulation.¹⁵³

The Code, specifically subsection 263(c), is the appropriate starting point. As previously noted, this subsection does not, in itself, prescribe any rule, but instead delegates to Treasury the authority to prescribe regulations “corresponding to” the regulations which were recognized and approved by House Concurrent Resolution 50.¹⁵⁴ The only regulation promulgated under subsection 263(c) is Treasury Regulation section 1.263(c)-1, which adroitly shifts the responsibility to section 1.612-4,¹⁵⁵ itself a mere republication of the earlier regulations under the 1939 Code. As in the Old Testament, the hand may be the Code’s, but the voice is that of Treasury Regulation section 1.612-4.¹⁵⁶

The regulation is divided into five subsections. Subsection (a) explains the general characteristics of intangible drilling and development costs

148. T.I.R. 749 (July 15, 1965), republished as Ann. 65-63, 1965-34 I.R.B. 53. For examples of such rulings, see, e.g., Rev. Rul. 69-332, 1969-1.C.B. 87; Rev. Rul. 70-336, 1970-1 C.B. 145, modified, Rev. Rul. 80-104, 1980-1 C.B. 129; Rev. Rul. 71-206, 1971-1 C.B. 105, Rev. Rul. 71-207, 1971-1 C.B. 160.

149. H.R. Rep. No. 761, 79th Cong., 1st Sess. 1, 2 (1945).

150. H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954).

151. Driscoll, *supra* note 131, at 326; Note, *supra* note 123, at 560.

152. Driscoll, *supra* note 131, at 326; cf. *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1169 (S.D. Tex. 1984).

153. *Exxon Corp. v. United States*, 547 F.2d 548, 555 (Ct. Cl. 1976); *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 386-387 (1981); *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456, 1475 (1980); *Sun Co. v. Commissioner*, 74 T.C. 1481, 1508 (1980); *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325, 345 (1977).

154. See *supra* text accompanying notes 112-26.

155. See *supra* text accompanying notes 127-47.

156. Cf. *Genesis* 27:22.

and serves generally as a definition of expenses included in the option to expense or to capitalize.¹⁵⁷ Subsection (b) is a classification section and operates only after an operator has elected to charge such expenditures as fall within the option ("optional" items) to capital account. As such, it seems more dependent upon, than determinative of, the correct interpretation which we are seeking. Subsection (c) is negatively definitional, as it purports to describe which expenses do *not* qualify for the option (termed in the regulation "nonoptional" items). Subsections (d) and (e), respectively, treat the manner of making the election, and the effect of the option and of the election. Thus, the interpretive issue narrows to the proper construction of subsections (a)¹⁵⁸ and (c).¹⁵⁹

157. As previously noted, all of the items involved are capital in nature, and, under I.R.C. § 263(a), would be denied a current deduction but for the exception contained in § 263(c), the parameters of which are being explored in this article.

158. Reg. § 1.612-4(a), which provides, in pertinent part:

(a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are use—

(1) In the drilling, shooting, and cleaning of wells.

(2) In such clearing of ground, draining, roadmaking, surveying, and geological works as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc. are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value

159. Reg. § 1.612-4(c), which provides: (c) *Nonoptional items distinguished.*

(1) *Capital items:* The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which

The provisions of subsection (a), the inclusionary definition, provide answers for the traditional "who," "what," "when," "how," and "where" questions. In order to qualify for the option, the expenditures must be made by (or on behalf of) an operator.¹⁶⁰ This represented a change wrought by T.D. 5276, effective for taxable years beginning after December 31, 1942.¹⁶¹ Requiring that the optionee be an operator brings together the risk-taker and the incentive to take the risk. The "what" question is addressed three times in subsection (a): first in the second sentence of the lead paragraph, which broadly enunciates the general characteristics of those expenditures which have, for convenience, been termed "intangible drilling and development costs"; the second time in the examples of items to which the option applies; and the third time in the second sentence of the foot paragraph of subsection (a) which states that, for purposes of the option, such items are not considered as having a salvage value *even if used in connection with the installation of physical property which does have a salvage value*. Clearly, "what" is optionable are expenditures for items such as wages (labor), fuel, repairs, hauling, supplies, etc.¹⁶²

The answer to the question of "when" emerges from subsection (a) as qualifying those costs of the type just discussed that are "incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas."¹⁶³ The fourth sentence of subsection (a) eliminates any "how" question that the operator *personally* must perform the drilling or development work which gave rise to the IDC's;

are constructed in the wells and on the property, and the costs of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

160. See supra note 158, first sentence, second clause of subsection (a).

161. See supra text accompanying notes 57-61. Prior to that time, the optionees needed only to be a "taxpayer." See e.g., Reg. 77, Article 236, set forth at length in text following supra note 46.

162. Even the negative, exclusionary subsection (c) agrees that these are the items in question; it would exclude such items only for other reasons such as lack of connection with the drilling activity, e.g., incurred in connection with capital items used for storage or treating or for time of incurrence, namely in the production phase of the operation.

163. It should no longer be subject to question that offshore drilling platforms are "incident to and necessary for the drilling of wells" despite the fact that they subsequently serve as production platforms where the drilling is successful. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 391 (1981), Rev. Rul. 70-596, 1970-2 C.B. 68, 69; *Linden, Review of Offshore Drilling - What are Intangibles?* 26 Inst. on Oil & Gas L. & Tax'n 441, 472 (1975); Note, *Qualifying Deductible Intangible Drilling Costs in Offshore Drilling Operations*, 8 U. Tol. L. Rev. 555, 571 (1977); See also supra notes 8-10 and accompanying text.

such costs will qualify if done for the operator by contractors under any form of contract, including turnkey contracts.¹⁶⁴ The "where" question is addressed in the next sentence, which lists examples of items included in the option: "(1) In the drilling, shooting, and cleaning of wells, (2) In such clearing of ground, draining, roadmaking, surveying, and geological works as are necessary in preparation for the drilling wells, and (3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas."¹⁶⁵ Obviously, the operator must be engaged in the performance of at least one of those activities while incurring the costs which he seeks to expense under the IDC option. However, it is clear that offshore drilling platforms *are* physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.¹⁶⁶

The seeds of dissension were sown in the next two sentences: "In general, this option applies only to expenditures for those drilling and developing items *which in themselves do not have a salvage value*. For the purposes of this option, labor, fuel, repairs, hauling, supplies, etc., *are not considered as having a salvage value*, even though used in connection with the installation of physical property which has a salvage value."¹⁶⁷ Prior to these two sentences, the requirements for costs to be optional were simply that they be: (1) of an intangible type such as wages, fuel, etc.—for convenience termed IDC's; (2) incurred by an "operator" (or on his behalf by a contractor); and (3) which were incident to or necessary for the drilling of wells. Moreover, in determining what activities might be taken as included within the activities contemplated by the third requirement, the regulation listed three types that most certainly were within the pale: i.e., drilling, shooting and cleaning of wells; a second type not as yet contested offshore; and "the construction of such derricks, tanks, pipelines, and other physical struc-

164. The development of this answer to the "how" question goes back to T.D. 4333, 11-1C.B. 31 (1932), when the Commissioner tacked onto the end of subsection (a)'s predecessor the following sentence: "Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement." Although the Service pushed hard to deny an operator the benefit of the option where the well was drilled on a "turnkey" basis, see *supra* text accompanying notes 48-50 and 67-69, it repudiated the "turnkey doctrine" in 1943 by promulgating T.D. 5276, 1943 C.B. 151. See *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1170 (S.D. Tex. 1984).

165. Reg. § 1.612-4(a).

166. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 394 (1981); *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1170 (S.D. Tex. 1980); cf. Rev. Rul. 70-596, 1970-2 C.B. 68, 69.

167. Reg. § 1.612-4(a) (emphasis added).

tures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.”¹⁶⁸ At this point in the regulation, intangible costs associated with the constructing of offshore drilling platforms, hauling to the offshore drilling site, erecting and anchoring the platform to the ocean floor, and drilling for oil or gas would appear patently to be optional IDC’s.

What additional light is shed by the two sentences just mentioned? The conclusion seems inescapable that the first sentence introduces an *additional determinant* — salvage value — expressed thusly: “In general [ordinarily], this option applies only to expenditures for those [IDC’s] which in themselves do not have a salvage value.” The second sentence is somewhat equivocal. It can be read to mean that intangible expenditures such as labor, fuel, repairs, etc. (IDC’s), for the purpose of the option, do not have a salvage value *as a matter of regulation*, and that this is so notwithstanding the fact that such costs may have been incurred in connection with the installation of physical property which does have a salvage value.¹⁶⁹ However, it may also be construed simply to be a statement that intangible-type costs do not have salvage value “in themselves,” and that merely because such costs may be used in connection with, and are represented by, physical property does not necessarily disqualify them.¹⁷⁰ Section 1.612-4(b) is consistent with this negative inference, because it states that IDC-type items which have been capitalized under the option are to be recovered through depreciation “insofar as they are represented by physical property.”¹⁷¹ If being represented by physical property constituted a disqualification of optionability, there would be no need for this provision.

Looking at the second definitional provision of section 1.612-4, namely subsection (c), the issue of whether an item is optional may be approached from the opposite end of the spectrum, that is, what is not an optional item. The structure of this exclusionary subsection roughly mirrors that of inclusionary subsection (a) in that subsection (c) first makes a general statement: “The option . . . does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value,”¹⁷² and then proceeds to give examples of such excluded items.¹⁷³

168. *Id.* at the fifth, or “Examples,” sentence.

169. *Exxon Corp. v. United States*, 547 F.2d 548, 556, 559 (Ct. Cl. 1976); cf. *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1170 (S.D. Tex. 1984).

170. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 395 (1981).

171. Reg. § 1.612-4(b)(2).

172. Reg. § 1.612-4(c)(1). Note that this paragraph deals with capital items. Paragraph (c)(2) treats intangible items of expense which are incurred at the operation stage of

On April 9, 1970, in a case which arose in Oklahoma, there was some judicial gloss placed upon the expression used in section 1.612-4(c)(1) of "tangible property ordinarily considered as having a salvage value." In this case, *Harper Oil Co. v. United States*,¹⁷⁴ Harper Oil Company challenged a disallowance by the I.R.S. of deductions claimed under section 263(c) for intangible costs incurred in installing surface casing in producing wells drilled by the company in Oklahoma. Quite naturally, the Service pointed to the language in subsection (c)(1) of its regulation section 1.612-4, which provided then, as it does now, that "[t]he option [to expense or to capitalize IDC's] does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value." Moreover, argued the Service, the quoted subsection of the regulation gave examples of such items, among which was casing.

Harper Oil Company's counter, which was successful in the United States District Court for the Western District of Oklahoma, was that surface casing, unlike the production string, is designed to prevent contamination of fresh surface water strata and to prevent caving at the surface (and blow-outs); hence, it was always cemented in place. This made the cost of recovering the surface casing uneconomical, a fact which was the subject of a stipulation at pretrial. In addition to this usual circumstance, the regulations of the Oklahoma Corporation Commission, the state regulatory body with cognate jurisdiction, had required surface casing used in the presence of fresh water strata to be cemented and forbade its removal. Thus, there could not possibly be any salvage of Harper's surface casing. This fact led the District Court to reason that because surface casing in Oklahoma rarely, if ever, could be removed, it "ordinarily" could have no salvage value. On appeal, the Tenth Circuit reversed, holding: (1) the absence of salvage value did not qualify a cost for the option;¹⁷⁵ (2) the District Court had too narrowly construed the term "ordinarily" in subsection (c); and (3) "ordinarily" should be related to casing in *general* and not to Oklahoma

production, and excludes them as being beyond the scope of option, time-wise. See Rev. Rul. 70-413, 1970-2 C.B. 132 (replacing Mim. 6754, 1952-1 C.B. 30).

173. "Examples of such items are the costs of the *actual materials* in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc." (emphasis supplied, although T.D. 4333, 11-1 C.B. 31, which first adopted the forerunner of subsection (c)(1), in March 1932, italicized "actual materials" and all subsequent regulations continued the emphasis through Reg. 111, Sec. 29.23(m)-16 (1943)).

174. 425 F.2d 1335 (10th Cir. 1970).

175. *Id.* at 1343. Earlier in its opinion, the court put this proposition in a slightly different way: "The salvage value reference strikes us only as the usual, but not the necessary characteristic of the non-option item." *Id.* at 1342.

surface casing in particular. The court concluded: "Casing is casing. And casing ordinarily has salvage value."¹⁷⁶

One commentator has read *Harper Oil* to stand for the proposition that the test to be used in determining whether tangible property ordinarily has a salvage value is objective in nature.¹⁷⁷ But even if one embraced the concept that "casing is casing" and casing "ordinarily" has salvage value, does it necessarily follow that the intangible costs expended in connection with tangible property (casing) which ordinarily has salvage value are made nonoptional? To say that it does would appear to read out of the regulation the language of subsection (a): "For the purposes of this option, labor, fuel, [and other IDC types of expenditure] are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value."¹⁷⁸ One way of attempting to give the language of each subsection a meaning would be to limit the "ordinarily considered to have salvage value" concept to the determination of the optionability of tangible property such as the "actual materials" mentioned nondefinitively, and the physical property items such as drilling tools, pipe, casing, tubing, etc., which were specifically enumerated in subsection (c), and not to utilize it in connection with the expensable intangible items which subsection (a) designated as IDC's (labor, fuel, repairs, hauling, supplies, etc.).¹⁷⁹ However, this appears to be educing from subsection (a) the concept that IDC's are IDC's, and are nonsalvageable per se.¹⁸⁰ One wonders whether this approach does not treat subsection (c) as roughly as the "casing is casing" line of reasoning treated subsection (a).

In attempting to resolve this dilemma as it impacts offshore drilling IDC's, we must remember that the development of the IDC option from its seminal appearance in a 1917 Treasury Decision¹⁸¹ through its expansions in Article 170 of Regulations 33, Article 223 of Regulations 45, Treasury Decisions 4333, in 1933, 5276, in 1943,¹⁸² and contractions at the behest of the Service¹⁸³ in the case of obligation wells, acquisition

176. Id. at 1343.

177. Note, *supra* note 163, at 561.

178. Reg. 1.612-4(a).

179. This appears to be the approach taken by Judge Davis, concurring in *Exxon Corp. v. United States*, 547 F.2d 548, 559-60 (Ct. Cl. 1976).

180. The Tax Court in *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 387-88 (1981), so reads the *Exxon* case, especially Judge Davis' concurring opinion.

181. T.D. 2447, 19 Treas. Dec. Int. Rev. 31 (1917).

182. This development is traced in the text accompanying *supra* notes 20-64.

183. The practice of the Treasury to ignore or to erode its own regulations and rulings when it can collect more revenue by doing so has been described by an ex-Treasury officer

wells, turnkey drilling contracts and the like, all took place within the framework of the onshore drilling industry. It was not until the impact of the swiftly expanding offshore drilling industry with its rapidly escalating costs that the Service apparently concluded that the regulation was too all-embracing for current conditions. It sought to cope with the perceived revenue loss by issuing Revenue Ruling 70-596.¹⁸⁴ Thus was the issue first addressed in the context of offshore drilling.¹⁸⁵

THE NATURE OF OFFSHORE DRILLING

Although offshore drilling resembles onshore drilling in certain respects, there are several important differences which pose significant problems not found in the onshore environment. Generally, the lessor will be either the federal government or a littoral state government. The acreage per lease is substantially greater than that of its onshore counterpart, and the cost of securing the lease, for the most part via a competitive sealed bidding process, is astronomically greater.

Onshore, the operator merely moves a drilling rig to the drill site, drills the well, and if oil or gas is discovered in commercial quantities, he uses the same rig to run the casing and tubing strings and otherwise to complete the well for production. The cellar, well-head, flow or lead lines, auxiliary separating and treating facilities, and lease storage tankage are located right on the lease. However, offshore wells drilled to determine the presence, quantity, and areal extent of the producing formations generally will be drilled from mobile rigs.¹⁸⁶ In the fortuitous event that this drillstem exploration¹⁸⁷ proves up a commercially recoverable accumulation of oil or gas, a permanent drilling and production

as "bizarre administrative behavior." Eisenstein, *A Critical View of the Treasury*, 15 *Inst. on Fed. Tax'n* 21, 30 (1957). This comment may be a bit unjust as applied to the Service's attempt to contain its own authorization of the IDC option "within bounds" prior to the congressional codification of the regulation in section 263(c) of the 1954 internal Revenue Code. After the legislative imprimatur, further erosive attempts by the I.R.S. can properly be viewed as "bizarre."

184. 1970-2 C.B. 68. Judge Davis has characterized the ruling as an attempt "to read [the IDC] regulation in a drastic new way." *Exxon Corp. v. United States*, 547 F.2d 548, 560 (Ct. Cl. 1976) (Davis, J. concurring).

185. Note, *supra* note 163, at 561.

186. E.g., *Sun Co. v. Commissioner*, 677 F.2d 294, 295 (3d Cir. 1982); *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456, 1459-1460 (1980), *aff'd*, 694 F.2d 648 (10th Cir. 1982); *Standard Oil Co. (Ind.) v. Commissioner*, 68 T.C. 325, 328-29 (1977).

187. Geological and geophysical surveys may have located the presence of a promising structure; "bright spot" technology might give an indication of the presence of a gas or liquid; but the drillstem is the final arbiter of whether "paying quantities" of petroleum are at hand. Linden, *supra* note 163, at 442.

platform will be installed near the geographical center¹⁸⁸ of the reservoir in order to develop and produce the zone.

Although the activity in the mid-1960's frequently involved tender platforms which anchored a barge or tender alongside the platform during drilling to accommodate and store part of the drill pipe and other materials used in the drilling, by far the predominate type now used, as the work has moved further offshore, is the self-contained platform. These were developed to decrease the number of work stoppages that were brought about by rough weather which required the disconnection of the tender.¹⁸⁹

As many as thirty-six producing wells can be drilled directionally from the platform so as to achieve the optimum drainage from the reservoir.¹⁹⁰ The number of wells per platform, as well as the number of platforms per reservoir, depends upon the size, depth, and configuration of the reservoir.¹⁹¹ The design of the platform itself is a function of water depth, tide, storm incidence,¹⁹² wave force, soil conditions, and number and depth of wells desired.¹⁹³ As a result, no two platforms have the same design criteria, although the basic structural design is similar for all self-contained drilling and production platforms¹⁹⁴ After the design criteria are accumulated, detailed plans and specifications are prepared. In the case of most large companies, the design work is performed by its own engineers, aided by consultants in such specialties as soil stability and bearing capacity, meteorology, and oceanography.¹⁹⁵ All these factors are fed into a computer, and the output therefrom is used to develop plans and specifications for each platform.

188. As noted by Linden, frequently the platform will be set when only three sides of the reservoir have been delineated (assuming that the exploratory wells drilled to that point of time have established the economic viability of the project). Linden, *supra* note 163, at 443. This is a function of the time value of money and the time constraints of the lease terms.

189. See *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324, 328 (1986).

190. Linden, *supra* note 163, at 443.

191. *Id.* Needless to say, the expected gas/oil ratio ("GOR") is a very important factor. *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324, 329 (1986).

192. Every recorded storm since the early 1900's, at least since the maintenance of reliable records, is plotted. Recurring patterns can be detected and probability or "survivor" curves for each location can be constructed.

193. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 359 (1981); *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1167-68 (S.D. Tex. 1984).

194. *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324, 328 (1986). Therefore, in practice, each platform is custom-designed for one particular location and is seldom used in a different location. Linden, *supra* note 163, at 471.

195. Because of the cost, and importance, of the platforms, designers usually build in an expected "100-year storm" and its partner, the 100-year storm wave. There is an additional lateral stress problem arising from the soil conditions in the Mississippi Delta. *Id.*

Once the plans and specifications have been developed, the project is put out for competitive bids or selective negotiation for the onshore construction of as much as can be accomplished onshore. Because of the magnitude of the work and the degree of specialization involved, the majority of the successful contractors are shipyards or large contractors with marine divisions. It is customary for the operator to have a "live-in" project manager, together with a sufficient number of engineers and welding inspectors from the operator's staff to oversee the work of the onshore fabrication contractor and to ensure that the platform is built in conformity with the plans, drawings, and specifications of the operator. While it is customary for large operators to supply or arrange for the furnishing of large items of materials to the contractor in order to minimize the costs of these items, called "actual materials" in the cases,¹⁹⁶ the optionability of such items has not been an issue because the operators uniformly have followed the specific language of the regulation and capitalized them. However, during the design and onshore fabrication phases, usually consolidated in the cases into one phase,¹⁹⁷ a substantial amount of costs for items such as labor, fuel, repairs, hauling, supplies, etc., and an allocable portion of overhead and profit is incurred.¹⁹⁸ These costs, referred to for convenience in the regulations¹⁹⁹ and the cases²⁰⁰ as "other costs," incurred in connection with the onshore design and fabrication of offshore platforms, have been the main bone of contention between the industry and the Service.²⁰¹

After construction, the major components²⁰² of a platform usually are loaded on a ship or barge for transportation to the platform location. The jacket is then skidded or lifted off the ship or barge by means of a floating crane and placed in the water. The legs are carefully flooded while the upper portion is held in position by the crane hook. Once the proper positioning on the ocean floor has been accomplished and

196. The origin of this term comes from Reg. § 1.612-4(c)(1), the "examples" sentence.

197. The adverb "usually" was necessitated by *Exxon Corp. v. United States*, 547 F.2d 548, 550 (Ct. Cl. 1976).

198. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 361 (1981); cf. *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1167 (S.D. Tex. 1984).

199. Reg. § 1.612-4(a).

200. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 361 (1981); *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1167 (S.D. Tex. 1984).

201. In Rev. Rul. 70-596, 1970-2 C.B. 68, 69-70, the Service conceded the optionability of intangible costs incurred in transporting platforms to the drill site after the onshore construction phase was completed, and those associated with the positioning, erecting, and permanently anchoring the platform to the ocean bed. It continued this concession throughout the *Exxon*, *Standard Oil Co. (Ind.)*, *Texaco*, and *Gulf* cases.

202. The jacket, the piling, and the deck. *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324, 330 (1986); *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1168 (S.D. Tex. 1984); *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 358 (1981).

the unit is leveled, the pilings are driven through the jacket legs until the designed circumferential-friction refusal level has been met. Grouting is poured in the annular space between the outer circumference of the piling and the inner surface of the jacket legs. The pilings are welded to the top of the jacket legs in order to complete the anchoring and support of the jacket. After this is done, the deck section is lifted and positioned on the stabilized jacket. The deck column is positioned with the aid of stabbing guides that fit into the top of the piling, and then welded in place.²⁰³

THE LITIGATED CASES ON OFFSHORE IDC

The first major decision focusing directly on the offshore IDC issue, *Exxon Corp. v. United States*,²⁰⁴ was decided by the United States Court of Claims. Exxon's predecessor, Humble Oil and Refining Company, had obtained shallow water offshore leases from the State of Louisiana. In order to drill and develop these leases in 1954, Humble built six templet-type offshore drilling and production platforms.²⁰⁵ The judges on the court agreed that a basic component, the templet, was standard for all platforms.²⁰⁶ The issue was not drawn in the Court of Claims whether the templet design was simply a cost of production saving device or had been adopted to facilitate salvage. However, the Tax Court, perhaps influenced by the fact that Humble (Exxon) had salvaged components of one of the platforms by the time its case went to trial,²⁰⁷ stated in a subsequent decision: "The templets were clearly designed to be salvaged as a unit and were reusable."²⁰⁸

The construction and fabrication of the platforms followed the normal four stages described above. Humble's engineers designed the

203. This description is a composite of those found in *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324, 328-36 (1986); *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1168 (S.D. Tex. 1984), and *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 360-61 (1981). See also *Linden*, supra note 163, at 470-72.

204. 547 F.2d 548 (Ct. Cl. 1976).

205. A templet-type platform was described by the Court of Claims as follows: [It is a] a large deck area, on which are mounted derricks and various other drilling paraphernalia, all supported above sea level by 'templets,' which are compound, trussed structures, analogous in function to table legs but composed of several large vertical steel beams and pipes (usually an even number) arranged in a rectangular fashion with bars running between the pipes for support and spacing. Several templets are ordinarily used to support one deck, the number depending on the size, weight, and other features of the deck and equipment to be installed thereon.

Id. at 549-50 n.4.

206. Id. at 551, 562.

207. Id. at 551.

208. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 387 (1981).

platforms and drew up the plans and specifications. Its employees also determined the drill site locations, aided by consultation with outside soil engineers. During the land phase, when the initial prefabrications were made, various costs were incurred, including some for labor, materials, fuel, hauling, insurance, allocated overhead, and the profit of the marine construction contractor, who was selected on the basis of competitive bids, under a typical fixed-price contract which included those items. Humble also incurred directly some costs of transporting materials which it had agreed to supply to the contractor's yard, in addition to the costs of its own engineers who were assigned to oversee the progress of the work at the contractor's fabrication yard and to assure compliance by the contractor with Humble's specifications. It also incurred the cost of its welding inspector assigned to oversee the contractor's welders and to test the finished welds.

Once the land-phase construction contract was completed, the partially constructed components of the platform were loaded on barges for movement to the drill site. At this point, a different contractor, acting under a cost-plus-fixed fee contract, took control and transported the components to the location, while performing further cutting, welding, and other fabrication work en route. The skidding and lifting off the barge, positioning, erection, and assembly of the platform on its site then took place.

In accordance with his position in Revenue Ruling 70-596, the Commissioner conceded the application of the IDC option to the costs of transporting the components to the wellsite and to those incurred in the erection and on-site assembly of the platform. However, the Service contested the deduction of the costs incurred for labor, fuel, repairs, supplies, and hauling, etc., during the onshore construction of the platforms, together with similar costs incurred during offshore construction en route to the site, claiming that such costs were not subject to the option because they were "pre-installation expenditures by which Humble acquired what the regulation calls 'tangible property ordinarily considered as having a salvage value.'"²⁰⁹

Both Exxon²¹⁰ and the Government agreed that the language of Treasury Regulations § 1.612-4's immediate, and virtually identical, predecessor,²¹¹ was determinative of the controlling issue, and both parties relied solely on such language in the regulation and argued that all construction expenditures (except for "actual materials" such as steel pipes, beams, etc.) both onshore and offshore qualified for the option.

209. *Exxon Corp. v. United States*, 547 F.2d 548, 551 (Ct. Cl. 1976).

210. Exxon became the owner of Humble's claim for refund as a result of the merger of Humble into Exxon.

211. Reg. § 118, § 39.23(m)-16.

Exxon founded its position upon the language in subsection (a)(1) which provided that the option applied to “. . . items which in themselves do not have a salvage value” and the following sentence: “For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value. . . .”²¹² Exxon downplayed the impact of subsection (c)(1) by citing it for the proposition that the expenditures made nonoptional by subsection (c)(1) because they were the means “by which the taxpayer acquires tangible property ordinarily considered as having a salvage value” were epitomized by “actual materials in [the] structures,” which had *always* been capitalized by Exxon.

The Government, also basing its argument solely on the language of the regulation, took issue with Exxon’s intangible versus tangible distinction. It relied upon subsection (c)(1) as the basis for its proposed “salvage value” test which related the costs of the tangibles to the process by which they were incurred. Implicitly, this test embraced the concept that certain intangibles, “in themselves” *can* acquire a salvage value on the basis of the incremental value their expenditure added to the fabricated component.²¹³ The Government first distinguished between intangible costs incurred in the construction of physical structures which in themselves do not have a salvage value (which would fall outside subsection (c)(1)’s exclusion from, as well as being included in (a)(1)’s inclusion in, the option) and those intangible expenditures by which the taxpayer *acquired* tangible property ordinarily considered as having a salvage value. Then, it sought to reconcile its allowance of the greater part of the water-phase costs by creating a category of expenditures which did not have a salvage value because they did not create an added value to the raw materials.²¹⁴ However, as the case was argued, the disallowance of all land expenditures and a portion of the water-phase expenditures was predicated on their being “acquisition” costs, as distinguished from “installation” costs.²¹⁵ Exxon replied that since the

212. *Id.* at subsection (a)(1), designated simply subsection (a) in Reg. § 1.612-4. This is, of course, the literal “IDC are IDC, and are nonsalvable per se” argument set forth *supra* in the text accompanying note 180.

213. Note, *Qualifying Deductible Intangible Drilling Costs in Offshore Drilling Operations*, 8 U. Tol. L. Rev. 555, 565 (1977). Thus, it would seem that the Government did *not* agree that the listed expenditures “in themselves” had no salvage value, although it could hardly deny, in the light of its own regulation, that “in and of themselves” so called “other costs” had no salvage value. Judge Kashiwa, dissenting in the *Exxon Corp.* case, objected to the majority’s “substitution” of “in and of themselves” for the regulation’s “in themselves” language. *Exxon Corp. v. United States*, 547 F.2d 548, 565 (Ct. Cl. 1976) (referring to pages 556 and 558).

214. This argument is inconsistent economically. Even hauling alone would produce a place differential value.

215. *Exxon Corp. v. United States*, 547 F.2d 548, 553 (Ct. Cl. 1976). The “installation” or “on-site” costs versus “pre-installation” or “acquisition” cost is a carryover from

challenged costs had no salvage value (per the language of subsection (a)(1)) and thus qualified as IDC, the Government's salvage argument was a false and irrelevant issue.²¹⁶

The majority of the *Exxon* court, after examining the administrative and legislative history of the regulation and concluding that Congress favored a liberal interpretation of it, categorized Exxon's construction expenditures into: (1) costs of actual materials used in the structure; (2) labor necessary to construct the same; (3) transportation of the structure; and (4) miscellaneous "other" costs such as repair work, fuel, supplies and the like. The first category clearly had to be capitalized under the regulation, but Exxon consistently had done so. The majority opinion continued: "With equal clarity, however, the regulation grants an option to the operator with respect to all other of the categories listed above."²¹⁷ It considered the only qualifications placed on the optionability of such cost items to be that they must have been incurred in the construction of derricks, tanks, pipelines and other physical structures necessary for the drilling of wells and the preparation of wells for the production of oil or gas, and they must not "in and of themselves" have a value.²¹⁸ The majority concluded that the fact that Exxon had recovered some materials from salvaged platforms in the past was immaterial because the regulation made it clear that the intangible-type costs enumerated in the regulation ("other costs") were "*not considered as having a salvage value*, even though used in connection with the installation of physical property which has a salvage value."²¹⁹

The majority then rejected as an "emasculat[i]on of a long-standing regulation" the I.R.S.'s position that the word "installation," as used in the quoted sentence, limited the availability of the IDC option to those expenditures incurred while installing the platform at the well site no matter how necessary the pre-installation construction may have been to the drilling and preparation of the well. Stating that the Government had "grossly misread its own language" by seizing upon the isolated word "installation" to support its argument, the majority construed the

Rev. Rul. 70-596's geographic distinction. One commentator has suggested that while Reg. § 1.612-4(c)(1) provides that if construction is done in the wells and on the property, only the actual materials are tangible property items which the taxpayer has acquired and which therefore must be capitalized. The converse is not necessarily true, i.e., merely because construction is conducted off the property does not mean that the entire cost, including the cost of assembly is an acquisition cost. Linden, *Review of Offshore Drilling - What Are Intangibles?*, 26 *Inst. on Oil & Gas L. & Tax'n* 441, 473 (1975).

216. *Exxon Corp. v. United States*, 547 F.2d 548, 551 (Ct. Cl. 1976).

217. *Id.* at 555-56, citing the first sentence of Reg. 118, § 39.23(m)-16(a)(1).

218. *Id.* at 556.

219. *Id.* This was a quotation from the predecessor of Reg. § 1.612-4(a), footparagaph, second sentence, and presupposes that the expenditures otherwise qualify for the option.

sentence in question as being an attempt to forestall any possible contention that the "other costs" in question would acquire a salvage value simply because they were connected with the installation of admittedly salvable property. Further, the majority rejected as "impoverished" the Government's attempt to bolster its salvage value argument through the use of the section 263(a) cases on capitalization, pointing out that the real issue was the proper interpretation of section 263(c), a clear exception to 263(a).²²⁰ Finally, the majority sharply rejected the Government's "functional" argument that an offshore drilling platform becomes completely salvaged at the instant of an oil and gas strike due to its use as a production facility afterwards.²²¹

The majority's adoption of Exxon's interpretation caused it to reach the correct result, but its failure to deal with the impact of subsection (c) and to struggle with the definition of terms such as "actual materials" created an aura of unfinished business. Judge Bennett, in his concurring opinion, appreciated this fact, but he noted that, since each platform in the case had been designed to accommodate ocean depth and current conditions at the proposed drilling site, one was led to suspect that platform component subassemblies were not uniformly salvable. Ascertainment of the fact of salvability and the amount thereof in the year of construction would, in Judge Bennett's opinion, depend upon fact problems not at all readily resolved or resolvable. In order to avoid the difficulties which would ensue for taxpayers attempting to apply the regulation, and the I.R.S. and the courts striving to enforce it under such circumstances, Judge Bennett chose to go along with the majority's approach.²²²

Judge Kashiwa, concurring in part and dissenting in part, attempted to meet the problem head-on. Among other things, he sought to include the templets (and other component parts such as the cap and portal sections) with in the meaning of "actual materials."²²³ Proceeding on this premise, Judge Kashiwa expressed the view that the expenditures for wages, fuel, supplies, etc. (intangible-type costs) incurred during the fabrication process were "[subsection (c)(1)] expenditures by which the taxpayer . . . [acquired] tangible property ordinarily considered as having

220. Id. at 556. See also supra note 118 and accompanying text.

221. Note, supra note 213, at 570, characterized the Government's argument as "fallacious." It points out, correctly, the fact that the issue in *Exxon* was not the size of the deduction but the propriety thereof. Id. at 571.

222. *Exxon Corp. v. United States*, 547 F.2d 548, 561 (Ct. Cl. 1976).

223. Judge Kashiwa took pains to note that since each platform was of templet-type basic design, his opinion was limited to such platforms and did not consider with respect to the IDC option the other types of offshore structures used by oil companies such as caissons and jacket-type platforms. Id. at 561 n.23.

a salvage value," and hence, were not optional, recoverable only through depreciation.²²⁴ He sought to bolster this interpretation by a review of the history of the IDC option. In making this review, Judge Kashiwa stressed the language of T.D. 2447, which sounded in terms of "incidental expenses" which "do not [necessarily] enter into and form a part of the capital invested or property account,"²²⁵ and "costs which in themselves do not have a salvage value."²²⁶ He then orchestrated these phrases into a "recurring theme to determine qualification of expenditures for the IDC option" as limiting optionability to those "expenditures by which the taxpayer does not acquire 'tangible property ordinarily considered as having a salvage value.'"²²⁷

Judge Kashiwa took issue with the majority's interpretation that the salvage value phrase, as used in subsection (c)(1), related only to the tangible raw materials from which the templets and other basic components were fabricated. In his opinion, the "actual materials" term used in the examples set forth in the second sentence of subsection (c)(1) was sufficiently broad to encompass the fabricated templet basic unit component.²²⁸ Based upon this conclusion, Judge Kashiwa subscribed to the Government's "installation versus acquisition" argument, which he summarized as follows:

The labor, fuel, etc., used in erecting the platform structure, or in transporting the structure to the drilling site, add no value to the structure which can be salvaged when the drilling operation is completed and, hence, do not "in themselves" have salvage value. On the other hand, labor, fuel, etc., used in fabricating the salvageable components of such a structure do add value to and become integrated with the tangible basic materials comprising the component part. Therefore, the items, both intangible and tangible materials, have salvage value "in themselves." Having a salvage value "in themselves," the items do not qualify for the IDC option: the cost of the items must be capitalized and recovered only through depreciation.²²⁹

224. *Id.* at 562. Thus, Judge Kashiwa accepted the "value added" concept implicit in the Government's argument. See *supra* text accompanying note 213.

225. *Id.* at 563. As was set forth *supra* note 26, this language was deleted in 1981 by T.D. 2690.

226. This concept was introduced in 1933 by T.D. 4333, although as Judge Kashiwa correctly observes, the restated regulation was said, by the Treasury, not to make any "change in administrative policy or in the practice under the regulations." See *supra* notes 44-46 and accompanying text.

227. *Exxon Corp. v. United States*, 547 F.2d 548, 564 (Ct. Cl. 1976) (thus consciously, or unconsciously, prioritizing subsection (c)(1) over subsection (a)(1) of the 1.612-4 regulation).

228. *Id.*

229. *Id.* at 565-66.

The second decision involving offshore IDC was handed down by the Tax Court in 1981 in the case of *Standard Oil Co. (Ind.) v. Commissioner*.²³⁰ During the years 1970 and 1971, the taxpayer ("Indiana"), through its wholly-owned subsidiaries, constructed and installed offshore drilling platforms in various locations throughout the world.²³¹ Unlike the *Exxon* case, none of the nine offshore platforms involved in the controversy were of templet design but were of the 4-pile tender (3 platforms) and the 8-pile self-contained (6 platforms) basic design.²³² The design, fabrication, and erection of the platforms were completed utilizing the normal four-stage construction process.²³³ Each of the nine platforms consisted of three major units, which were constructed separately onshore: (1) the deck, (2) the jacket, and (3) the pilings.²³⁴

During the construction and fabrication phase, Indiana incurred costs for materials acquired from outside sources (conceded to be nonoptional) and for "other costs" such as labor, fuel, repairs, hauling, supplies, etc., and an allocable portion of overhead and profit.²³⁵ Prior to this case, Indiana had expensed the "other costs" in the load-out, transportation, and installation phases but had capitalized such costs incurred in the first (construction and fabrication) phase. Probably as a result of the *Exxon* case, Indiana, in addition to the instant petition, filed 3 petitions in the Tax Court, alleging error in the capitalization of such "other costs" in the first phase and claiming them as IDC deductible expense. It compromised with the Service for taxable years 1960-1969, agreeing not to change its treatment of such "other costs." Hence no question was raised over depreciation deductions taken in 1970 and 1971 with respect to such capitalized "other costs" incurred in prior years. However, Indiana was litigating its contention that the "other costs" incurred in the first (onshore construction) phase also represented deductible IDC.

After disposing of the Service's preliminary argument that I.R.C. § 446(e) precluded Indiana from changing its "method of accounting"

230. 77 T.C. 349 (1981).

231. *Id.* at 352-58. The locations of the platforms in questions were the Gulf of Mexico, the Leman Field in the United Kingdom sector of the North Sea, and fields off the coast of Trinidad. "Constructed" carries the usual offshore connotation which includes construction by contractors on Indiana's behalf.

232. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 357-58 (1981).

233. *Id.* at 358; see *supra* text accompanying notes 196-203.

234. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 358 (1981).

235. *Id.* at 361-63. Included also in the court's "other costs" were the cost of the rolling and the welding of steel sheet into tubing or "cans" which were used to form jacket legs, jacket bracing, or pilings. These costs, which represented 15% of the "other costs," were found to be optional even under subsection (c)(1) because the "cans" were found by the court to be tangible property usable only within a structure which itself was not ordinarily considered as having a salvage value. *Id.* at 403.

without the consent of the Service on the ground that the treatment of the IDC's was "otherwise provided [for] in [section 263(c)]," thus making 446(e) inapplicable by its own terms,²³⁶ the Tax Court squarely addressed the opposing theories propounded by the majority and dissenting opinions in *Exxon*. The court reviewed the *Exxon* majority's opinion, as crystallized in Judge Davis' concurring opinion, and embellished by Judge Bennett's concurring opinion, in which the savings in judicial effort inherent in the per se IDC approach were stressed, and Judge Kashiwa's dissenting opinion, as epitomized by the statement quoted above, and remarked that the authors of those various opinions had set forth the major arguments for and against the deduction of Indiana's "other costs."²³⁷

The Tax Court, however, refused to adopt an either/or approach; instead it perceived the necessity for a synthesis of a broad rationale from which a proper, detailed holding could be obtained.²³⁸ First the court made an analysis along the lines of that contained above in "The Language of the IDC Option." It then noted that Indiana's (the *Exxon* majority's) "purchase versus construction" test of optionality was "flawed conceptually" because it did not take into account the fact that even "purchased" materials contain intangible costs. Thus, some limitation had to be provided, because each level of production is the result of the expenditure of intangible-type costs which, ultimately, are expended for drilling and development. It was precisely for this purpose of limitation that the salvage value concept was adopted, according to the Tax Court, which stated:

In excluding from the option expenditures for ordinarily salvageable tangible property, the Treasury, and now Congress, appears to have drawn the line such that expenditures that *ordinarily are economically unrecoverable should the well be dry*, whether or not such expenditures are "represented by physical property," are to be included within the option, whereas expenditures for items *which ordinarily are recoverable*, even if the well is dry, are excluded from such option.²³⁹

236. *Id.* at 382-84, putting aside the "prepaid intangibles" issues involved in *Keller v. Commissioner*, 725 F.2d 1173 (8th Cir. 1984) and *Levy v. Commissioner*, 732 F.2d 1435 (9th Cir. 1984).

237. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 387-90 (1981).

238. *Id.* at 393.

239. *Id.* at 396-97 (emphasis added). The court may have treated Indiana's "purchase versus construction" argument a bit roughly here. The mere fact that intangibles may have been involved in the production of a purchased "actual material" does not mean that the purchase - vs. construction test does not act as a limitation; quite the converse, it would disqualify such intangible from optionality. See *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1171 n.10 (S.D. Tex. 1984).

The Tax Court then characterized this economic recovery rule in terms of a "risk analysis." It cited a number of prior decisions that had linked the allowance of the IDC deduction to the bearing of risk.²⁴⁰ From this "inextricable relationship" between IDC and risk, the court deduced the relevance of the phrase "ordinarily considered as having a salvage value" as used in subsection (c)(1); namely, if an item "ordinarily" has salvage value, expenditures for (and connected with) that item are not subject to the risk of the drilling activity — but if it does not have such salvage value, then expenditures represented by that item are very much at risk.

That analysis brought the court face-to-face with the Tenth Circuit's *Harper Oil*²⁴¹ language. Conceding that portions of Justice Blackmun's opinion could be taken to imply that salvage value was not an inevitable companion of nonoption status, the Tax Court seized upon (and slightly manhandled) Justice Blackmun's reference to Williams and Meyers, Oil and Gas Terms,²⁴² as saying that usually surface casing is cemented (thus rendering it non-salvageable) only in the completion of a producing well.²⁴³ Having thus remolded the language, the Tax Court reconciled *Harper Oil* with its risk analysis concept by saying that Justice Blackmun, relying upon this (recast) statement, could easily conclude that casing is not cemented until and unless oil was discovered in paying quantities, and therefore its cost was not at such risk as should qualify for the IDC option.²⁴⁴

The Court then articulated its risk analysis formula for determination of the salvage value limitations on IDC optionality in the offshore platform context:

[W]hen the ultimate tangible property resulting from a chain of drilling, development, construction, etc., activities (such activities

240. Standard Oil Co. (Ind.) v. Commissioner, 77 T.C. 349, 397 (1981).

241. 425 F.2d 1335 (10th Cir. 1970).

242. 425 F.2d at 1342.

Casing appears to be a generic term in the industry. One authority says, 'Most oil wells are completed with two strings of cemented casing, the surface pipe and the production string,' but also speaks of a possible additional casing [ed: the so-called intermediate or salt string]. H. Williams and C. Meyers, Oil and Gas Terms (2d ed.) p. 46. The same work observes, p. 364, 'It is customary to set [cement] casing in the completion at a producing well.' The record here is to like effect.

Id.

243. Standard Oil Co. (Ind.) v. Commissioner, 77 T.C. 349, 399 (1981). This version may surprise the inhabitants of the oil patch.

244. Id. A proponent of the "IDC's are non-salvable per se" theory might properly suggest that *Harper Oil* rested on the specific enumeration of casing as a component of tangible property in subsection (c)(1), to which the "ordinarily-considered-as-having-a-salvage-value" test clearly was applicable.

being of the type covered by the IDC option) is ordinarily considered as having a salvage value, none of the costs of acquiring or constructing such property are IDC. If such ultimate tangible property is not ordinarily considered as having a salvage value, then the intangible-type costs expended to integrate materials which were, prior to such integration, usable in such a fashion that they would be ordinarily considered as having a salvage value, into a component which is, after such integration, not ordinarily considered as having a salvage value, are IDC. Any further intangible-type costs expended to integrate this "first unsalvageable component" into the ultimate tangible property, which is not ordinarily considered as having a salvage value, are IDC.²⁴⁵

The Court illustrated the application of its formula by a hypothetical example: the costs of converting iron ore into salvageable angle iron are not IDC's, and the costs of turning angle iron into a salvageable templet would not be IDC's.²⁴⁶ However, the costs of turning sheet metal, which up to that point was usable in such a fashion as to be "ordinarily considered as having a salvage value" into an unsalvageable piling (assuming it is not ordinarily considered as having a salvage value) would, assuming that the platform itself was unsalvageable, qualify as IDC's.

Addressing the issue before it, the Tax Court applied its newly articulated risk analysis test by deciding first whether the offshore platforms involved were, as a whole, ordinarily considered as having a salvage value. Its answer to this question was that the jacket-type platforms in issue clearly were not so considered. Since the answer was negative, a second question had to be answered, namely, were the intangible-type costs in issue incurred to integrate materials that, prior to such integrations, would ordinarily be considered as having a salvage value, into components which, after such integration, were not ordinarily considered as having a salvage value? The court found that they were so incurred. The costs involved were of the intangible type of costs mentioned in the second and fifth sentences of subsection (a); they were incurred to fabricate "materials," which were tangible property ordinarily considered as having a salvage value, into discrete components, such as "cans," jacket, pilings and deck, none of which was found by the court, after detailed examination, to be ordinarily considered to have a salvage value, hence qualifying the intangible costs for the IDC option.²⁴⁷

245. *Id.* at 399-400.

246. *Id.* at 400. The reader will observe that this conflicts squarely with the Court of Claim's majority opinion in *Exxon*.

247. *Id.* at 401-03.

*Texaco, Inc. v. United States*²⁴⁸ was decided by the United States District Court for the Southern District of Texas on September 28, 1984. Texaco had installed platforms in the Gulf of Mexico off of the Louisiana and Texas coast, Copake Inlet, Alaska, and the Santa Barbara Channel, California. Each platform was constructed, transported, and installed by independent contractors under the operator's supervision following the normal four-stage process.²⁴⁹ Texaco incurred costs, as had Exxon and Indiana, during the design and construction phase of platform development, for materials and "other costs" (the usual labor, fuel, hauling, supplies, etc., and an allocable portion of overhead and profit of the contractors). Texaco followed the standard industry practice of capitalizing the costs of the actual materials; hence, the sole issue in the case was the appropriate treatment of the "other costs" incurred in the design and construction phase of platform development. As was the case in *Indiana*, no templet-type platforms were involved;²⁵⁰ each platform was designed and constructed for use at a specific site and the evidence revealed that, as a practical matter, neither any platform nor any major component was salvageable.²⁵¹

Texaco relied upon the majority opinion in *Exxon*,²⁵² while the Government argued that the *Indiana* risk analysis test was the proper criterion. Moreover, the Government attempted to "leverage" its position by arguing that, under risk analysis approach, salvageability should be determined at the end of the drilling phase. The District Court rejected the *Exxon* majority's IDC per se argument on the same ground adopted by the Tax Court in *Indiana*, saying: "the tangible costs of converting raw materials, which in themselves do not have an intrinsic salvage value, into salvageable components would preserve the integrity and value of the intangible cost."²⁵³ But the Government's attempt to take a "second bite" by urging application of the salvage value test at the time the tangible property (with which the intangible "other costs" are associated) was no longer useful to the taxpayer, was found by the court to be unsound.

248. 598 F. Supp. 1165 (S.D. Tex. 1984).

249. *Texaco, Inc. v. United States*, 598 F. Supp. 1165, 1167-68 (S.D. Tex. 1984).

250. *Id.* at 1173 n.13. There were 14 self-contained platforms, 12 tender platforms, 5 three-pile well protector platforms, and 1 caisson jacket platform. *Id.* at 1167-68.

251. *Id.* at 1176-77.

252. *Id.* at 1172. Of course, Texaco argued, in the alternative, that in the event that the risk-analysis formula was held to be applicable, its "other costs" would still be optional because neither the platforms nor their components were salvageable. *Id.* at 1976-77.

253. *Id.* at 1172. Translated, this means that because their value will be recovered when the salvageable component is salvaged, if the drilling is unsuccessful, there is no need to allow the IDC treatment.

After reviewing the *Harper Oil* case and its integration into the risk analysis of the Tax Court in *Indiana*, the *Texaco* court held that although the usual test of salvage value should be applied at the time the property was no longer useful to the taxpayer in his own particular trade or business, such test's modification wrought by subsection (c)(1) of the IDC regulation through the phrase "ordinarily considered as" having a salvage value, requires that the test be applied at the time the property is acquired by the taxpayer.²⁵⁴ Applying the risk-analysis test, viewed as of the time of acquisition, the court found that neither *Texaco's* platforms nor their major components were "ordinarily considered as having a salvage value."

The most recent case is *Gulf Oil Corp. v. Commissioner*,²⁵⁵ involving a number of offshore platforms installed in the Gulf of Mexico during 1975 and in the North Sea during the years between 1977 and 1984. Again, no templet-type platforms were involved; all of the Gulf of Mexico platforms were self-contained with their major components being the deck, jacket, and piling.²⁵⁶ The platforms in the North Sea likewise were all self-contained, but because there were different working interest owners and different lessor governments involved, no two platforms were designed alike.²⁵⁷ The usual four-phase process of onshore design and construction, load-out, transportation to site, and on-site installation was followed.²⁵⁸ The sole issue was the eligibility of "other costs," incurred in the first phase, for optional expense treatment as IDC's under I.R.C. § 263(c) and Reg. § 1.612-4.

The distance between the contending parties' positions had narrowed since the *Texaco* case; the battleground was confined to the question whether the platforms at issue or their major components would "ordinarily be considered as having a salvage value," and the main line of resistance was the point in time at which the platforms or their major components should be examined to determine whether they are "ordi-

254. *Id.* at 1175. The Government was overreaching on this argument. At best, if the court had required *Texaco* to wait until the platforms (and/or its components) no longer were useful to it before a determination was made, the suspense account status of the costs would produce the same results economically as if *Texaco* had been forced to capitalize them—a sub-rosa "repeal" of the IDC option. Realistically, to adopt the Government's position would mean that no platform from which any production was obtained could qualify for the option.

255. 87 T.C. 324 (1986).

256. *Id.* at 330.

257. *Id.* at 333-34.

258. *Id.* at 174. The only "new wrinkle" in *Gulf* was due to the larger structures required in the North Sea than in the Gulf of Mexico; thus resulting in a flotation element being built into the structures so that the deck or module support frame could be floated out to the site as one unit and erected by controlled flooding. *Id.* at 331.

narily considered as having a salvage value." The Government contended that the examination should be made at the time drilling was terminated, the same position that it had unsuccessfully taken in the *Texaco* court. It attempted to subvert the risk-analysis test through the use of a syllogism: (1) once the platform was no longer used for drilling, it no longer was at risk; (2) IDC's and risk are inextricable related; (3) therefore, the examination should be made when the drilling ceased.²⁵⁹

The Tax Court was not deceived by this legal legerdemain. It noted that the practical effect of adopting the Government's choice of timing would result in denial of the option in the case of any platform from which production was attained.²⁶⁰ It clarified what "risk" in its risk analysis meant, specifically, the general risk of exploration for, drilling, and producing hydrocarbons — which risk does not cease at an arbitrary point in time, such as the end of drilling a particular well, prior to the end of the use of the platform in the operator's trade or business. Finally, the court made this interesting observation with respect to the term "actual materials" used in subsection (c):

Past opinions have differentiated between the "actual materials" referred to in section 1.612-4(c), Income Tax Regs., and other costs and concluded that the physical and tangible materials that are transformed via labor, fuel, etc., into the desired assets for drilling are the "actual materials" rather than the completed platforms or their major components (deck, jacket, piles, etc.) as urged by [the Government]. The result of this conclusion is that the availability of the IDC option for the costs at issue will depend on whether these costs are expenditures by which the taxpayer has acquired tangible property ordinarily considered having salvage value. Sec. 1.612-4(c), Income Tax Regs.²⁶¹

CONCLUSION

The IDC regulation, in virtually its present form, dates back to 1943,²⁶² and, except for administrative tinkering with the question of

259. *Id.* at 345. This argument proves the old saying: Allow me to choose my premises, and I'll always win the argument.

260. *Id.*; see also *supra* note 253. The court also noted that the timing of the determination of whether a platform can ordinarily be considered as having a salvage value must be consistent with that of the depreciation regulations because if the platforms do not qualify for IDC, they do qualify for depreciation. Under Reg. § 1.167(a) and (c)(1), the amount of salvage value upon which depreciation is taken is determined at the time the asset is acquired. Therefore, such time is the appropriate moment for the determination of whether the asset is ordinarily considered as having a salvage value under Reg. § 1.612-4(c). *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324, 345-46 (1986).

261. 87 T.C. at 344.

262. T.D. 5276, 1943 C.B. 151.

who was entitled to elect the option to expense,²⁶³ the main framework of the regulation, including the affirmative and negative definitions of optionable items found in sections (a) and (c), was established in 1932.²⁶⁴ It is to be expected that the phraseology of regulations drawn in light of industry practices so long ago would prove difficult to apply to the advanced technology of modern offshore drilling.²⁶⁵ The Service's attempt in 1970²⁶⁶ to apply the regulations to the offshore drilling industry can be described best as misguided.²⁶⁷ The kindest thing that can be said for it is that it did serve to focus attention on the problem.

Unfortunately, the ensuing litigation has not been adequately illuminating. Although each case reached the same result, allowing the respective offshore operators to elect to expense the intangibles incurred during the off-site, onshore construction phase, a deep conceptual schism has arisen. The Court of Claim's²⁶⁸ approach, faced with the facts that the basic discrete component (the templet) of the platforms in *Exxon* was standardized, and that some actually had been salvaged, drew a distinction between the intangible costs enumerated in subsection (a), such as labor, fuel, repairs, hauling, supplies, etc., which are not considered as having a salvage value, and the costs of physical, tangible items ordinarily considered as having a salvage value. The only requirements for optionality that needed to be met by the first category of costs, said the *Exxon* majority, was that they must have been incurred "in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells" and that they must not "in and of themselves" have a salvage value. There was no question as to the factual fulfillment of the first requirement, and the majority felt that the regulation conclusively provided the second qualification;²⁶⁹ hence, the majority brusquely rejected the Government's salvage argument as immaterial.

263. See *supra* text accompanying notes 57-64. Among the changes was that of the optionee from "taxpayer" to "operator" and expansion of the optionee's right to contract out his drilling without disqualification even through "turnkey" contracts, but not through "obligation" wells.

264. T.D. 4333, 11-1 C.B. 31 (1931).

265. Cf. Note, Qualifying Deductible Intangible Drilling Costs in Offshore Drilling Operations, 8 U. Tol. L. Rev. 555, 577 (1977).

266. Rev. Rul. 70-596, 1970-2 C.B. 68.

267. Cf. *Exxon Corp. v. United States*, 547, F.2d 548, 560 (Ct. Cl. 1976) (Davis, J., concurring).

268. More accurately, the majority of the court's approach.

269. The majority relied upon the seventh sentence of Reg. § 1.612-4(a): "For the purposes of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even if used in connection with the installation of physical property which as a salvage value." The preceding sentence of the regulation actually refers to items which "in themselves" do not have a salvage value.

The majority's approach has the advantage of simplicity. It avoids the extended scrutiny envisioned by Judge Bennett which would otherwise be required of the operator in the first instance, the Service on examination, and ultimately the courts on a case-by-case basis, into exactly what components of the final assembly could be saved and subsequently used. In Judge Bennett's view, such an inquiry is an a priori venture into fact questions not at all readily resolved or resolvable.²⁷⁰ Moreover, although logic and taxation are not always the best of friends,²⁷¹ the majority's view is logically sound: it is more natural and less strained to read the regulation, in view of its structure, as placing primary stress on the optionality of all intangible drilling and development costs incurred in the development of the operator's offshore properties and employing the "salvage value" concept as a minor theme dealing with the other side of the question — denial of the option in the case of the physical and tangible materials which ordinarily are considered salvageable.²⁷²

The opposing view, originally expounded by Judge Kashiwa in his dissenting opinion in *Exxon*,²⁷³ and fine-tuned by the Tax Court in its *Indiana* opinion,²⁷⁴ employed a more in-depth analysis of the various subsections of the regulation and attempted to give equal time to both subsections (a) and (c). The court found fault with the operator's attempt to confine subsection (c)'s limitation role to purchased "actual materials," as opposed to the costs of work performed by or on behalf of the operator in order to utilize such materials in the construction of the platform. This proved too much, for each level of production from the time the native raw materials were extracted from the soil until the time the final platform was constructed involved the expenditure of intangible costs. In lieu of that, the Tax Court came up with its "risk analysis" as the appropriate tool for demarcation between optional and nonoptional items, and declared that its analysis gave the proper weight to the phrase "ordinarily considered as having a salvage value."²⁷⁵ It constructed its theory by correctly postulating a relationship between the grant of the option to expense IDC's and congressional desire to en-

270. *Exxon Corp. v. United States*, 547 F.2d 548, 560-61 (Ct. Cl. 1976) (Bennett, J., concurring).

271. *Sonneborn Bros. v. Cureton*, 262 U.S. 506, 552, (1923) (McReynolds, J., concurring).

272. *Exxon Corp. v. United States*, 547 F.2d 548, 559 (Ct. Cl. 1976) (Davis, J., concurring).

273. *Id.* at 564-66; see quotation from Judge Kashiwa's dissenting opinion in *supra* text accompanying note 229.

274. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 393-400 (1981).

275. *Id.* at 395-97.

courage operators to undertake the risk of drilling.²⁷⁶ The court then assumed that Congress drew the line between optional and nonoptional items on the basis that costs which ordinarily are economically unrecoverable should the well be dry, whether or not such costs were represented by physical property, were optional, whereas costs which ordinarily are recoverable even if the well is dry were nonoptional. From these two hypotheses it determined the relevance of the phrase "ordinarily considered as having a salvage value." The court adroitly manipulated Justice Blackmun's language in *Harper Oil* to the point where it stated that Justice Blackmun, by relying on the (Tax Court's misstated) "opinion of an authority" that usually surface casing is cemented (thus rendering it nonsalvageable) only in the case of a producing well, "could easily conclude [under the Tax Court's risk analysis] that casing is not cemented until and unless oil or gas was discovered in commercially producible quantities and, therefore, is not at risk such that the costs of such casing should qualify for the IDC option."²⁷⁷ Using its "risk analysis," the Tax Court expounded the view that all of the operator's IDC-type expenditures to produce a material that ordinarily was considered to be salvageable, and all such expenditures incurred to integrate materials which prior to such integration were ordinarily considered as having a salvage value into larger units which themselves were ordinarily considered to have salvage value, were nonoptional.

The *Texaco* and *Gulf Oil* cases followed the *Indiana* case rationale and added only the refinements that the "not ordinarily considered as having a salvage value" test was to be judged by total industry practice, not just the use by a particular taxpayer, and that the appropriate point in time to make this judgment was at the time the item was acquired or constructed. Significantly, all three risk analysis cases reached the same result of optionability as did the *Exxon* case, but were based on more current industry practice.

While the Tax Court's risk-analysis test represents a good faith, scholarly attempt to give both subsection (a) and subsection (c) of Reg. § 1.612-4 as much meaning as possible, the analysis contains some very serious flaws. First, the Tax Court has deliberately chosen a more complicated approach than that of the *Exxon* majority, but without the redeeming grace of reaching a more desirable result. It has added another, nonstatutory requirement for optionability. Second, it directly contradicts the regulation when, for the purpose of the IDC option, the costs of labor, fuel, repairs, hauling, supplies, etc., expended to

276. *United States v. Cocke*, 399 F.2d 433, 452 (5th Cir. 1968); *Sun Co. v. Commissioner*, 677 F.2d 294, 299 (3rd Cir. 1982); *Standard Oil Co. (Ind.) v. Commissioner* 68 T.C. 325, 350 (1977); *Haass v. Commissioner*, 55 T.C. 43, 50 (1970).

277. *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 399 (1981).

produce, or to integrate ordinarily salvageable material into, physical property which has a salvage value are nonoptional.²⁷⁸ Third, even if risk were a true proxy for optionability, the entire history of its use in this context has shown that it is too unruly a horse to ride. Early on, it was judicially encrusted upon the regulation by courts faced with the issue of who was entitled to the option in situations involving obligation wells²⁷⁹ and turnkey drilling contracts,²⁸⁰ only to have the Commissioner overturn the turnkey drilling contract doctrine and modify the obligation well doctrine in T.D. 5276.²⁸¹ Thereafter, the concept of risk was pivotal in the "carried interest" controversy, which caused the Service to delay the congressionally mandated promulgation of IDC regulations under the 1954 Code for 11 years, at which time it simply republished the old regulations in force under the 1939 Code.²⁸² Fourth, and more importantly, the *Indiana* court's foundation for its risk-analysis test is pure sand. Justice Blackmun in *Harper Oil* did not say that usually surface casing is cemented (thus rendering it nonsalvageable) *only* in the completion of a *producing well*;²⁸³ he simply quoted Williams and Meyer's for the straightforward comment that "[i]t is customary to set [cement] casing in the completion of a producing well. . . ."²⁸⁴ The court's misreading of *Harper Oil Co.* is reminiscent of that of another old Equity draftsman, the Lord Chancellor in *Iolanthe*, who deftly doctored the wording of a law to get a diametrically opposite result.²⁸⁵ Moreover, the court misperceived the reality of the risk undertaken in offshore drilling. Unlike onshore drilling, it is *not* a well-by-well situation, but, at the very least, a platform-by-platform risk. Merely because one well might be completed successfully does not make the entire offshore project

278. The court's statement is paraphrased; for the exact language see *supra* text accompanying note 244. By not giving credence to the Treasury's own language in section 1.612-4(a), the court commits an egregious error. Recognition by the Treasury that risk is the basis for the option obviously is the reason for placing the language "even though used in connection with the installation of physical property which has a salvage value" in the regulation. Denial of optionality of otherwise qualifying IDC's clearly undermines the language of the regulation and the basis for the option.

279. E.g., *Hardesty vs. Commissioner*, 127 F.2d 843 (5th Cir. 1942); *Hunt v. Commissioner*, 135 F.2d 697 (5th Cir. 1943); see *supra* text accompanying notes 100-102 for discussion of this issue in the *F.H.E. Oil Co.* case.

280. See *supra* text accompanying notes 48-50.

281. 1943 C.B. 151.

282. The history of this fiasco is set forth in *supra* text accompanying notes 128-47.

283. See *Standard Oil Co. (Ind.) v. Commissioner*, 77 T.C. 349, 399 (1981), for this incorrect characterization of Justice Blackmun's words.

284. *Harper Oil Co. v. United States*, 425 F.2d 1335, 1342 (10th Cir. 1970).

285. Gilbert & Sullivan, *Iolanthe*, Act II: "Allow me, as an old Equity draftsman, to make a suggestion. The subtleties of the legal mind are equal to the emergency. The thing is really quite simple - the insertion of a single word will do it. Let it stand that every fairy shall die who doesn't marry a mortal, and there you are, out of your difficulty at once!"

successful. The *totality* of the wells drilling *in that location* must produce oil or gas in commercial quantities, and they must do so before the platform is destroyed by fire, by water, by wind or by blowout, and before external market factors foreclose the possibility of ever recovering the tremendous sums invested. Since risk can be defined as a composite probability that the funds expended will fail to obtain an economic benefit and that other property (or money) will be lost because the original expenditure has incurred an economic detriment in excess of the loss of the expenditure itself, it is easy to see that very high risk expenditures are at issue,²⁸⁶ not the "sure thing" that the *Indiana* court apparently visualized.

RESOLUTION

The Treasury Department has overloaded the judiciary by failing to update the language of the IDC regulations to comport with current offshore drilling technology. This paper expressed dissatisfaction with the risk analysis approach that the courts appear to have adopted. A seemingly obvious conclusion would be to recommend that the Service rectify the situation by undertaking a comprehensive, procedurally proper process of amending Reg. § 1.612-4, with ample provision for input by the industry and other interested parties. Implicit in such an approach would be the prompt withdrawal of Rev. Rul. 70-596, whose sole virtue is the fact that it alerted the tax community and the industry to the difficulties inherent in applying an archaic regulation to conditions of modern sophisticated offshore technology.

Unfortunately, logic cannot be relied upon in this matter. The Service, in Gen. Couns. Mem 39564 (Oct. 27, 1986), has evinced an implacable determination to deny to operators the benefits of the I.R.C. § 263(c) option to expense IDC-type expenditures incurred "away from the property," principally aiming at onshore construction costs. In its October, 1986 memorandum, the General Counsel reached the conclusion that, for purposes of qualification for expense treatment, a distinction should be drawn between IDC's incurred "on the property" (eligible for the option) and those incurred "away from the property" (non-optional). The purported justification ignored the *Exxon*, *Indiana*, and *Gulf* decisions, and cited only the *Texaco* case, the most poorly reasoned decision of the four. It seized upon the phrases "construction on the property" (in Reg. § 1.612-4(b)(2)), "constructed in the wells and on the property" (in subsection (c)(1)) and "operation of the wells and other facilities on the property" (in subsection (c)(2)) as support for its

286. Linden, Review of Offshore Drilling - What are Intangibles? 26 Inst. on Oil & Gas L. & Tax'n 441, 454-57 (1975).

newly adopted position. This language has been in the regulation since 1943 and is *exactly* the same today as it was in 1970 when Gen. Couns. Mem. 34346 (Sept. 14, 1970) stated flatly that the on-site/off-site distinction was not supportable.

What has changed since that time? Not the language and not the determination of the Service to deny the option to on-shore construction IDC's. What has changed is the holding in *Indiana, Texaco* and *Gulf* that neither the offshore platforms nor their major components (pilings, jackets and decks) are "ordinarily considered as having salvage value." Having lost on what Gen. Couns. Memo. 34346 declared was the sole supportable ground for denial of the option, the Service now asserts that when the Service uses an expression in Reg. § 1.612-4, it means just what the Service chooses it to mean — neither more nor less. Moreover, in true Orwellian "think-speak" fashion, this meaning can change from time to time, and is to be treated as if the regulation always has meant what the Service now says it does.

The importance of the offshore drilling industry to the nation's economy and its security, not to mention the Government's proprietary interest as virtually the only lessor involved, is far too great to place the fate of the IDC option in the hands of the Service. Therefore, the only conclusion that can safely be reached is that Congress must address the problem squarely and, by legislation, make it unmistakably clear that I.R.C. § 263(c) grants to operators the option currently to deduct IDC's incurred in the construction of offshore drilling platforms and their components at onshore or other economically efficient construction sites including, but not limited to, the drill site.

