1 T.C. 624 (1943)

A taxpayer using the accrual method of accounting must deduct intangible drilling costs in the year those costs are incurred, regardless of when the well is completed.

Summary

Great Western Petroleum Corporation, an oil producer using the accrual method, sought to deduct intangible drilling costs in 1938 for a well (Dobler No. 5) that was started in 1937 but completed as a producing well in January 1938. The Commissioner of Internal Revenue disallowed the deduction, arguing the costs should have been deducted in 1937. The Tax Court agreed with the Commissioner, holding that under the accrual method, expenses are deductible in the year they are incurred, regardless of when the project is completed. The court rejected the taxpayer's argument that it could wait until the well's completion to determine deductibility.

Facts

Great Western Petroleum Corporation was in the business of oil and gas production. It used the accrual method of accounting for its books and filed its income tax returns accordingly. The company had consistently elected to deduct intangible drilling costs as expenses rather than capitalizing them. In October 1937, Great Western began drilling Dobler No. 5 well. Intangible drilling costs of $8,175.11 were incurred in 1937 and carried on the books as "Work in Progress." The well was completed as a producing well on January 8, 1938. Great Western expensed the 1937 drilling costs on its 1938 income tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Great Western's 1938 income tax, disallowing the deduction of the 1937 intangible drilling costs. Great Western petitioned the Tax Court for review of the Commissioner's determination. The Tax Court upheld the Commissioner's determination, finding the deduction was improper for the 1938 tax year.

Issue(s)

Whether a taxpayer using the accrual method of accounting can deduct intangible drilling costs in the year the well is completed, or whether the costs must be deducted in the year they are incurred.

Holding

No, because a taxpayer using the accrual method must deduct expenses in the year they are incurred, regardless of when the project is completed and income is generated.

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Court’s Reasoning

The court reasoned that under the accrual method of accounting, expenses are deductible in the year they are incurred, not necessarily when the related project is completed. The court referenced Treasury Regulations that allow taxpayers to elect to either capitalize or expense intangible drilling costs. Having elected to expense these costs, Great Western was required to deduct them in the year incurred. The court noted, “[T]axpayer is given an option, exercisable in the first year in which he makes such expenditures, either to charge them off as expenses against gross income in the year in which incurred, or to capitalize them and recover them by depreciation and depletion.” The court rejected Great Western’s argument that it could wait until the well’s completion to determine whether it was a producer or a dry hole, stating that the option to deduct costs for nonproductive wells (dry holes) in the year the well is completed did not apply since Dobler No. 5 was a producing well. The court also dismissed the stipulation regarding industry practice of carrying such expenses in a “Work in Progress” account, noting that this practice does not override the fundamental principles of accrual accounting.

Practical Implications

This case clarifies the timing of deductions for intangible drilling costs under the accrual method of accounting. It emphasizes that electing to expense these costs requires deducting them in the year they are incurred, not when the well is completed. This decision affects how oil and gas producers using the accrual method manage their deductions and tax liabilities. It also highlights the importance of understanding and adhering to the specific requirements of the chosen accounting method and the applicable Treasury Regulations. Later cases have cited this ruling when discussing the proper timing of deductions under various accounting methods and the binding nature of elections made regarding the treatment of intangible drilling costs.

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