17 T.C. 1208 (1952)

Intangible drilling and development costs for natural resources are not deductible under Section 124 of the Internal Revenue Code, which provides for special amortization of emergency facilities; instead, such costs are recoverable through depletion under Section 23(m) of the Code.

Summary

Arkansas-Oklahoma Gas Company sought to deduct the intangible drilling and development costs of three gas wells under Section 124 of the Internal Revenue Code, arguing they qualified as emergency facilities due to a Necessity Certificate issued in 1941. The Commissioner denied the deduction, asserting these costs were subject to depletion under Section 23(m). The Tax Court upheld the Commissioner's decision, finding that Section 124 was intended for depreciable assets, not those subject to depletion. The court emphasized the legislative history and existing regulations, which treated depletion as the proper method for recovering such costs. This case clarifies that intangible drilling costs cannot be amortized as emergency facilities.

Facts

Arkansas-Oklahoma Gas Company (petitioner) drilled six natural gas wells in the Spiro Field in LeFlore County, Oklahoma. A Necessity Certificate was issued to Western Oklahoma Gas Company, then a subsidiary of the petitioner, on May 28, 1941, under Section 124 of the Internal Revenue Code. The certificate covered the drilling of the wells. The facilities covered by the Necessity Certificate were acquired and completed in 1941. The petitioner elected to take the amortization deduction beginning January 1, 1942. On August 31, 1943, the assets of Western Oklahoma Gas Company, including the Necessity Certificate, were transferred to the petitioner. For the tax years 1944 and 1945, the petitioner sought to deduct amortization of the intangible drilling and development costs for three of the six wells.

Procedural History

The Commissioner of Internal Revenue denied the amortization deductions claimed by Arkansas-Oklahoma Gas Company, allowing depletion deductions instead. The Gas Company then petitioned the Tax Court for review of the Commissioner's determination.

Issue(s)

Whether the petitioner is entitled to amortize intangible drilling and development costs of three gas wells under Section 124 of the Internal Revenue Code, or whether such costs are recoverable as depletion under Section 23(m) of the Code.

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Holding

No, because Section 124 was not intended to cover items that are subject to depletion under Section 23(m) of the Code; rather, Section 124 was designed to provide accelerated depreciation for assets that would otherwise be subject to normal depreciation under Section 23(l).

Court's Reasoning

The court reasoned that Section 124 was added to the Code to aid in national defense development by allowing industries to recover capital at a faster rate than allowed under Section 23(l) for depreciation. It cited the legislative history of Section 124, noting that it was intended to cover deductions normally covered under Section 23(l), not Section 23(m). Section 124(a) states that the amortization deduction is "in lieu of the deduction with respect to such facility for such month provided by section 23 (l), relating to exhaustion, wear and tear, and obsolescence." The court pointed to Treasury Regulations that did not define intangible drilling and development costs as an emergency facility. Because the petitioner had elected to capitalize intangible drilling and development costs, and the existing regulations under Section 23(m) did not permit amortization in instances where a Necessity Certificate was obtained, allowing amortization would create a third option for taxpayers. The court concluded that depletion, which is based on the productivity of the natural resource, is the appropriate method for recovering these costs, referencing *Choate v. Commissioner, 324 U.S. 1 (1945)*.

Practical Implications

This decision clarifies the tax treatment of intangible drilling and development costs, reinforcing that they are subject to depletion rather than amortization under Section 124, even when a Necessity Certificate has been issued. Legal practitioners should understand that this case prevents taxpayers from claiming amortization deductions for costs associated with natural resource development if those costs are eligible for depletion. Future cases should analyze whether specific costs are more appropriately treated as depreciable assets under Section 23(l) or depletable assets under Section 23(m). This case also highlights the importance of legislative history and regulatory interpretation in determining the scope of tax code provisions and the binding nature of elections made under tax regulations.

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