Reich v. Commissioner, 52 T. C. 700 (1969)

Geothermal steam is considered a depletable gas for tax purposes, qualifying for percentage depletion at the rate of 27. 5%.

Summary

The petitioners, involved in geothermal steam ventures, sought tax deductions for percentage depletion and intangible drilling costs. The Tax Court held that geothermal steam, produced from wells at The Geysers in California, is a depletable gas under the tax code, entitling Thermal Power Co. to a 27. 5% depletion rate against gross income from steam production. Additionally, all petitioners were allowed to expense intangible drilling and development costs. The court's decision hinged on the interpretation of 'gas' to include steam, the depletability of the steam resource, and the applicability of existing tax regulations to geothermal ventures.

Facts

The petitioners were involved in partnerships that drilled for and exploited geothermal steam, primarily at The Geysers in California. Magma Power Co. obtained a lease in 1955 and later formed a partnership with Thermal Power Co. Drilling began in 1957, and by 1960, steam production was used to generate electricity. Thermal Power Co. claimed a 27. 5% percentage depletion deduction against its gross income from steam production, and all petitioners sought to deduct intangible drilling and development costs. The Commissioner of Internal Revenue challenged these deductions.

Procedural History

The case was initially filed in the U. S. Tax Court. The court consolidated multiple petitions related to the same geothermal ventures. The parties narrowed the issues before trial, focusing on the depletion rate and the deductibility of intangible drilling costs. The Tax Court heard extensive testimony from geological and engineering experts regarding the nature of geothermal steam and its production.

Issue(s)

1. Whether Thermal Power Co. is entitled to an allowance for percentage depletion at the rate of 27. 5% against gross income received from geothermal steam wells?
2. Whether all petitioners are entitled to deduct the intangible costs of drilling and developing geothermal steam wells under section 263(c)?

Holding

1. Yes, because geothermal steam is considered a depletable gas under section 613(b)(1), and the steam at The Geysers is an exhaustible resource.
2. Yes, because the court interpreted the term 'gas' in section 263(c) to include

© 2025 SCOTUSreports.com. All rights reserved.

steam, allowing the deduction of intangible drilling and development costs.

Court’s Reasoning

The court determined that the commercial product of the wells at The Geysers was steam, not heat, as argued by the Commissioner. It found that steam is considered a ‘gas’ in the common commercial usage relevant to the tax code, thus qualifying for the 27. 5% depletion rate under section 613(b)(1). The court also established that the geothermal steam at The Geysers is an exhaustible resource, supported by extensive geological and engineering evidence. The court rejected the Commissioner’s arguments that the steam was inexhaustible and that Congress did not intend to include steam under the depletion provisions. For the second issue, the court extended the interpretation of ‘gas’ to section 263(c), allowing all petitioners to deduct intangible drilling costs. The decision was supported by a concurring opinion that emphasized the common usage of ‘gas’ to include steam, while a dissenting opinion argued that the depletion rate was excessively generous and not intended by Congress for non-hydrocarbon gases.

Practical Implications

This decision established that geothermal steam is subject to percentage depletion at the same rate as oil and gas, significantly impacting the tax treatment of geothermal energy ventures. It provided a precedent for similar cases, encouraging investment in geothermal resources by offering tax benefits comparable to those in the oil and gas industry. The ruling also affected how geothermal energy companies could account for drilling costs, potentially influencing their operational and financial strategies. Subsequent cases and tax regulations have cited Reich v. Commissioner to clarify the treatment of non-traditional energy resources under the tax code. The decision underscored the importance of interpreting tax statutes in light of common commercial usage and highlighted the court’s role in resolving complex scientific and legal issues in tax disputes.

© 2025 SCOTUSreports.com. All rights reserved.