Standard Oil Company (Indiana) v. Commissioner of Internal Revenue, 68 T. C. 325 (1977); 1977 U. S. Tax Ct. LEXIS 99; 57 Oil & Gas Rep. 441

Intangible drilling and development costs incurred by an operator in the development of offshore oil and gas properties are deductible, even for wells drilled from mobile rigs prior to the decision to install a permanent platform.

Summary

Standard Oil sought to deduct intangible drilling costs for offshore wells drilled from mobile rigs in the Gulf of Mexico, the North Sea, and off Trinidad. The IRS disallowed these deductions, arguing the costs were exploratory and should be capitalized. The Tax Court held that these costs were deductible under the intangible drilling and development costs (IDC) option, as they were incurred in the development of oil and gas properties. The court emphasized the congressional intent to encourage oil and gas exploration by allowing such deductions, even for exploratory wells drilled before the decision to install a permanent platform.

Facts

Standard Oil Company (Indiana) and its subsidiaries, Amoco Production, Amoco U. K. , and Amoco Trinidad, drilled wells from mobile rigs in the Gulf of Mexico, the North Sea, and offshore Trinidad waters between 1967 and 1969. These wells were drilled to ascertain the existence of hydrocarbons and to determine the feasibility of installing permanent platforms. The wells were left in a condition for reentry to hydrocarbon-bearing zones. Standard Oil claimed deductions for intangible drilling costs on its tax returns, which the IRS disallowed, asserting that the wells were exploratory and the costs should be capitalized.

Procedural History

Standard Oil filed a petition with the U. S. Tax Court challenging the IRS's disallowance of deductions for intangible drilling costs. The Tax Court, after considering the evidence and arguments, issued its opinion on June 7, 1977, ruling in favor of Standard Oil.

Issue(s)

1. Whether the intangible expenses incurred by Standard Oil's subsidiaries in drilling offshore wells from mobile rigs constitute intangible drilling and development costs within the meaning of section 263(c) of the Internal Revenue Code and section 1. 612-4 of the Income Tax Regulations.

Holding

1. Yes, because the intangible costs incurred in drilling each of the wells were incident to and necessary for the drilling of wells for the production of oil or gas,

thus qualifying as intangible drilling and development costs deductible under the regulations.

Court's Reasoning

The court applied section 1. 612-4 of the Income Tax Regulations, which allows operators to deduct intangible drilling and development costs. The court rejected the IRS's argument that these costs were merely exploratory and should be capitalized until a decision to install a permanent platform was made. The court found that the regulations did not require an intent to produce from a particular well and that the costs were incurred in the development of oil and gas properties. The court also noted the congressional intent to encourage oil and gas exploration through the IDC option, citing historical legislative actions and statements. The court emphasized that the drilling of exploratory wells, even from mobile rigs, is within the scope of the IDC option, as it aligns with the legislative purpose of incentivizing exploration.

Practical Implications

This decision allows oil and gas operators to deduct intangible drilling costs for offshore wells drilled from mobile rigs, even before deciding to install permanent platforms. This ruling encourages exploration in unproven offshore areas by reducing the financial burden on operators. It also clarifies that the IDC option applies broadly to all wells drilled to a postulated oil or gas deposit, not just those drilled after a production decision. This has significant implications for tax planning and financial management in the oil and gas industry, potentially affecting investment decisions in offshore exploration. Subsequent cases and IRS rulings have followed this precedent, reinforcing the deductibility of IDC in offshore drilling operations.

