Keller v. Commissioner, 79 T. C. 7 (1982)

A cash basis taxpayer may deduct prepaid intangible drilling costs (IDC) in the year of payment if the payment is not a refundable deposit and does not materially distort income.

Summary

In Keller v. Commissioner, the U. S. Tax Court addressed the deductibility of prepaid intangible drilling costs (IDC) by a cash basis taxpayer. Stephen A. Keller invested in an oil and gas drilling program and sought to deduct his share of the partnership's losses, which included significant prepaid IDC. The court held that such costs are deductible in the year of payment if they are considered payments rather than refundable deposits and do not materially distort income. The decision hinged on a two-part test evaluating whether the expenditure was a payment and whether it resulted in material income distortion. The court allowed deductions for IDC under turnkey contracts and for wells spudded in the year of payment but disallowed deductions for other prepaid IDC due to the lack of a business purpose and potential income distortion.

Facts

Stephen A. Keller invested $50,000 in Amarex Drilling Program, Ltd. -72/73, which invested in a drilling partnership that drilled 182 wells. The drilling partnership elected to expense IDC under Section 263(c) of the Internal Revenue Code. In December 1973, the partnership prepaid $635,560. 71 for IDC related to 87 wells, with 65 wells actually drilled. The prepayments were made under three types of contracts: footage and daywork drilling contracts, turnkey drilling contracts, and third-party well-servicing contracts. Additionally, the partnership paid $147,691. 38 to Amarex Funds for well supervision and $137,200 as a management fee. The IRS allowed deductions for pay-as-you-go IDC but disallowed the prepaid IDC and the management fee.

Procedural History

Keller filed a joint tax return with his wife and claimed a $50,000 deduction for their share of the partnership's losses. The IRS issued a deficiency notice disallowing $28,405 of the claimed deduction, primarily related to the prepaid IDC and the management fee. Keller petitioned the U. S. Tax Court for a redetermination of the deficiency. The court heard the case and issued its opinion on July 8, 1982, allowing some deductions for prepaid IDC while disallowing others.

Issue(s)

1. Whether the drilling partnership's prepaid intangible drilling costs (IDC) under footage and daywork drilling contracts, turnkey drilling contracts, and third-party well-servicing contracts are deductible in the year of payment under Section 263(c)

of the Internal Revenue Code?

2. Whether the drilling partnership's payment of $147,691. 38 to Amarex Funds for well supervision constitutes deductible IDC in the year of payment?

3. Whether the drilling partnership's payment of $137,200 to Amarex Funds as a management fee constitutes an ordinary and necessary business expense deductible under Section 162(a) of the Internal Revenue Code?

Holding

1. Yes, because the IDC under turnkey contracts were payments and not refundable deposits, and deducting them in the year of payment did not materially distort income. No, because the IDC under footage and daywork drilling contracts and third-party well-servicing contracts for wells not spudded in 1973 were refundable deposits, and deducting them would have materially distorted income.

2. No, because the payment to Amarex Funds for well supervision was a payment for services to be performed after 1973, and deducting it in 1973 would have materially distorted income.

3. No, because the petitioners failed to prove that the payment of the management fee was for ordinary and necessary business expenses.

Court's Reasoning

The court applied a two-part test to determine the deductibility of prepaid IDC: (1) whether the expenditure was a payment or a deposit, and (2) whether the prepayment resulted in a material distortion of income. The court found that IDC under turnkey contracts were payments because they were not refundable and the price was locked in, thus satisfying the first part of the test. The court also held that deducting these payments in the year of payment did not materially distort income, as the taxpayer received the bargained-for benefit in that year. For footage and daywork drilling contracts and third-party well-servicing contracts, the court determined that amounts prepaid for wells not spudded in 1973 were refundable deposits and thus not deductible. The court also found no business purpose for prepaying these costs, which reinforced the conclusion that deducting them would distort income. The payment to Amarex Funds for well supervision was disallowed because it was for services to be performed after 1973, and deducting it in 1973 would distort income. The management fee was disallowed because the petitioners failed to prove it was for ordinary and necessary business expenses.

Practical Implications

This decision clarifies that cash basis taxpayers can deduct prepaid IDC in the year of payment if the payments are not refundable deposits and do not materially distort income. Practitioners should carefully review the terms of drilling contracts to determine whether prepayments are deductible, particularly under turnkey contracts. The decision also highlights the importance of establishing a business purpose for prepayments to support the timing of deductions. For similar cases, taxpayers and their advisors should consider the nature of the prepayment and whether it is a payment or a deposit, as well as the potential for income distortion. This ruling may impact the structuring of oil and gas partnerships and the timing of investments, as investors may need to adjust their expectations regarding the immediate deductibility of their investments. Subsequent cases, such as Dillingham v. United States, have followed the Keller approach, emphasizing the need for a business necessity for prepayments to be deductible.