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Exploration for Oil and the Federal Income Tax

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EXPLORATION FOR OIL AND THE FEDERAL INCOME TAX

Introduction

The unprecedented demand for petroleum products during World War II has continued to plague the post-war period. This is due to a tremendous increase in civilian oil-consuming units, such as heating plants and diesel engines, accompanied by abnormally large peace-time military requirements stemming from the current national defense program. While the shortage of tank cars, tankers, and steel pipe lines has presented the most immediately pressing problem,[1] our petroleum industry is most acutely sensitive to the marginal nature of underground oil reserves in North America. Consequently exploration activities have reached an all-time high, with millions of dollars being spent annually in the relentless, competitive search, both in this country and abroad, for new oil fields to replace those that are fast becoming exhausted.

There is little doubt that costs of exploration activities are ordinary and necessary, in the non-technical sense of those words. They are ordinary in the sense that certain oil producers (those known as "operators") commonly incur them;[2] they are necessary in the sense that without them such producers could not meet competition and would go out of business. However, since the decision in the *Schermerhorn* case[3] in 1942, followed by the prompt issuance of

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1 See generally H. R. Report of Investigation of Petroleum in Relation to National Defense, 80th Cong., 2d Sess. (1948).

2 *See* Texas Conservative Oil Company v. Jolly, 149 S. W. 2d 265, 268 (1941), where the court said that it thought employment of a geologist to survey an area was in the "ordinary course" of an oil producing business. An "operator" is one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights. Treas. Reg. 111, §29.23(m)-16(b)(1)(i) (1943).

3 Schermerhorn Oil Corporation, 46 B.T.A. 151 (1942), discussed *infra*.

somewhat ambiguous instructions[4] by the Bureau of Internal Revenue to its field offices with respect to geological and geophysical expenditures, there has been serious doubt that exploration costs are "ordinary and necessary" expenses of the type made currently deductible by Section 23 of the Internal Revenue Code.[5] At the same time the realization has sprung up that the option granted by the Treasury Regulations covering intangible drilling and development costs[6] does not extend to exploration costs—a realization expressly confirmed by the Tax Court's decision in the case of *The Louisiana Land And Exploration Company* in 1946.[7]

Unfortunately the Bureau has not seen fit to publish a ruling for the guidance of taxpayers[8] on the subject of exploration costs, apparently preferring to compromise differences with oil producers in the division engineers' offices instead of insisting on strict conformity with the rules laid down in the *Schermerhorn* and *Louisiana Land And Exploration Company* cases. This is almost certain to result in differences in treatment of taxpayers according to the differing interpretations of the Bureau's instructions by the various division engineers and their engineer revenue agents. The extent to which such differences in treatment may be resisted by the taxpayers, on the one hand, or enforced by the Bureau, on the other, may be indicated by the analysis that follows.

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4 Unpublished, However, see note 25 *infra.*

5 INT. REV. CODE §23(a)(1)(A) provides: "In computing net income there shall be allowed as deductions: . . . All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ."

6 Treas. Reg. 111, §29.23(m)-16(b)(1) (1943), discussed *infra.*

7 7 T. C. 507 (1946), *aff'd,* 161 F. 2d 842 (C.C.A. 5th 1947).

8 One of the arguments in the taxpayer's brief in *The Louisiana Land And Exploration Company, supra* note 7, was that the Bureau's instructions covering geological and geophysical expenditures were not incorporated in the Regulations, or a General Counsel's Memorandum, or even an I. T. Mimeograph. In H. R. REP. No. 761, 79th Cong., 1st Sess. 2 (1945), it was declared that uncertainty of the Regulations granting an option to capitalize or deduct intangible drilling costs was materially interfering with exploration for and production of oil.

NATURE OF EXPLORATION

Before attempting to evaluate the tax atmosphere surrounding exploration costs, it is essential that a precise understanding be had of the nature and function of exploration. A distinction should first be made between exploration—a preliminary step—and development—the final step in oil production.[9] Next, it should be realized that exploration, as such, is ordinarily not aimed at finding oil, but merely the geological conditions that are commonly associated with the accumulation of oil,[10] sometimes collectively referred to as a "prospect".[11] Once a prospect has been located, oil and gas leases are acquired, whenever practicable, in all properties in the vicinity.[12] Then, at a specific location on the block of leased properties selected on the basis of competent geological advice, "one will drill a wild cat or test well to a depth great enough to test all probable oil-bearing formation or to the greatest depth possible and practical."[13] If a flowing well is the happy result, the public may be "surprised," but the geologist or geophysicist and the oil producer he works for consider it as merely the confirmation of expectations based on carefully assembled, and expensive, scientific data. Indeed, the technique of exploration has improved to the point where, as long ago as 1939, the statement was made by the Chief Geologist of the Sun Oil Company, F. H. Lahee, that "In prospecting by the best modern

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9 The following steps in the technique of production of oil are described in AMERICAN PETROLEUM INSTITUTE, PETROLEUM INDUSTRY HEARINGS BEFORE THE TEMPORARY NATIONAL ECONOMIC COMMITTEE 14 (1943):

a. *Exploration*—selecting a proper site for an exploratory well.

b. *Leasing*—obtaining the right to drill.

c. *Testing*—drilling a wild cat or test well to a depth great enough to test all probable oil-bearing formations (or "sands").

d. *Development*—drilling of a test well does not disclose the true elements and potentialities of a field. They must be determined by further drilling.

10 NETTLETON, GEOPHYSICAL PROSPECTING FOR OIL 3 (1940).

11 RICE, DICTIONARY OF GEOLOGICAL TERMS (1940).

12 Provided, of course, such leases were not acquired prior to exploration.

13 AMERICAN PETROLEUM INSTITUTE, *op. cit. supra* note 9, at 289 (statement by E. De Golyer, Consulting Geologist).

practice, the odds against success are probably as low as 6 to 7 against 1." [14]

At the risk of oversimplification, it might be helpful to visualize the geological conditions commonly associated with the accumulation of oil as taking the form of a hill (known as an "anomaly") rising above the surface of a relatively flat rock bed, both of which are under the surface of the earth.[15] The object of exploration ordinarily is to locate the anomaly and to determine its size and shape. Two general methods of exploration may be used: direct (geological), and indirect (geophysical). Geological surveying for oil today is usually conducted by means of "core drilling"—drilling a hole for the purpose of obtaining samples ("cores") of sand and rock [16] at various levels of the subsurface.[17] There are several ways of conducting geophysical surveys, but the ones most widely followed require the use of a magnetometer, gravitymeter, or seismograph, or often a combination thereof. The basic procedure in the use of these instruments consists in measuring force fields at the surface of the earth and, on the basis of variations in these force fields that result from subsurface configurations, locating and mapping anomalies.[18]

The magnetometer, for example, records degrees of magnetic intensity, which fluctuate according to subsurface structural formations. By plotting the recordings as the survey team moves along the surface of the earth, a contour map is prepared which will give general indications of the possible

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14 *Id.* at 288.

15 For a complete list of types of anomalies, with accompanying sketches, see NETTLETON, *op. cit. supra* note 10, at 45. Some anomalies appear above the earth's surface, but for the most part these have long since been exploited.

16 An oil sand is that part of subsurface rock in which free oil is present within the rock pores in recoverable quantities.

17 Also known as "slim-hole" drilling, this method is used by the mining industry as well as the petroleum industry. See AMERICAN PETROLEUM INSTITUTE, *op. cit. supra* note 9, at 293; also JAKOSKY, EXPLORATION GEOPHYSICS 12 (1940).

18 JAKOSKY, *op. cit. supra* note 17, at 18, who also lists the following additional geophysical methods: electrical, radioactive, geothermal, and geochemical.

existence of anomalies.[19] This information can be used as the basis of a more detailed survey over such part of the subsurface as appears interesting (the "area of interest"). Here is where the seismograph comes in, for under favorable conditions it will enable the mapping of a geologic bed many thousands of feet under the surface.[20] The seismograph operates on the principle that "hard rocks reflect waves just as hard glass reflects light." By setting off dynamite charges, waves are set in motion which bounce back from the subsurface rocks. The seismograph measures the time of travel of the wave from the surface down to the rock and back, thus enabling one to determine the depth of the rock with reasonable accuracy; in fact, errors of tolerance of only twenty-five feet are allowable. The difference in time intervals will indicate and measure the differences in depth as the seismograph is moved along over the surface of the earth, so that the reflecting surface can be plotted on a contour map.[21] Thus, a preliminary magnetic or gravimetric survey over a large area (commonly referred to as a "reconnaissance survey") is ordinarily followed by the more expensive, but much more accurate, seismic survey (commonly referred to as a "detail survey") over any area of interest revealed by the reconnaissance survey.[22]

From the foregoing, it should be understood that "exploration" refers to various geological and geophysical surveys, whose function is that of "localizing areas to lease and prospects to drill",[23] or, more precisely, whose function is

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19 The latest development in the magnetic method is the airborne magnetometer, used by the government and by some mining companies. Jensen, *Airborne Magnetometer*, The Oil and Gas Journal, March 11, 1948, p. 89.

20 NETTLETON, *op. cit. supra* note 10, at 6.

21 HAGER, PRACTICAL OIL GEOLOGY 387 (5th ed. 1938).

22 It should not be inferred that the seismograph cannot be used in a reconnaissance survey. If the dynamite charges should be set off more than a mile apart, the detail of subsurface formation would be lacking, and the survey would then be appropriately termed "reconnaissance." HAGER, *op. cit. supra* note 21, at 394.

23 24 BULLETIN OF THE AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS 1380 (1940) (statement by E. A. Eckhardt, past president of the Society of Exploration Geophysicists).

that of furnishing oil producers with *data, such as a contour map, that will be used as a basis for acquiring, or retaining, oil and gas leases.*[24]

BUREAU POSITION ON EXPLORATION COSTS

Prior to the decision of the Board of Tax Appeals in the *Schermerhorn* case, it seems that the policy of the Bureau of Internal Revenue was to permit costs of exploration to be deducted as ordinary and necessary business expenses if the work was carried out by the taxpayer's own staff of geologists; but if the work was done under contract by a professional exploration company, the costs were required to be capitalized. Following the *Schermerhorn* case, however, the Commissioner's headquarters issued instructions to the field directing that the costs of all geological and geophysical surveys resulting in the acquisition or retention of properties be capitalized.[25] Unfortunately these instructions

24 NETTLETON, *op. cit. supra* note 10, at 419, after observing that the final result of a geophysical survey is nearly always a map, states: "The values, contours, or perhaps only the nebulous outlines of one or more 'areas of interest' on such a map are *the basis of decisions affecting leasing*, drilling, or perhaps more geophysical work. In any case these decisions will usually involve at least a few thousand and not infrequently many thousand or even hundreds of thousands of dollars. The geophysical map is generally accompanied by a written report. The text of the report may give technical details of the geophysical field operations, the interpretation methods and calculations or the geology of the area; but *when the decisions are made, it is probably the map that receives the final study and closest attention.* In many cases the loss of a geophysical report would not be serious *if the loss did not include the map.*" (Emphasis supplied.)

25 The instructions are described by F. J. Blaise, certified public accountant, in his article, *The Deductibility of Exploration Costs,* 23 TAXES 221, 222 (1945). They place survey costs in four categories and prescribe their treatment as follows:

(A) Geological and geophysical expense, incurred for the purpose of determining whether properties should be acquired or rejected, which resulted in the acquisition of properties. (This expense should be capitalized as part of the cost of the properties acquired.)

(B) Geological and geophysical expense, incurred on properties already owned for the purpose of determining whether they should be retained under lease or surrendered, which resulted in their retention. (This expense should be capitalized as part of the cost of the properties retained.)

(C) Geological and geophysical exploration expense which did not result in the acquisition of properties, or resulted in the surrender of properties owned, or *of a general nature not applicable to any specific* appear to have been somewhat ambiguously worded. Consider, for example, the following problems posed by one writer:[26]

> " . . . the Commissioner contends that the cost of the survey should be capitalized on the acreage retained. Does that mean that, if 10,000 acres are held before the survey and as a result of the survey 9,000 acres are surrendered, the cost of the survey should be capitalized on the 1,000 acres retained? That would conflict with the Commissioner's third point [classification (C), footnote 25] which permits a deduction for exploration expense which resulted in the surrender of properties. It frequently happens that a survey is made in a locality where some acreage is held and as a result of the survey part of the acreage is surrendered and also some new acreage is acquired. What happens to the cost of that survey?" [27]

Another problem arises from a reference in the instructions to exploration expense "of a general nature not applicable to any specific properties." While it is difficult to conceive of a geological or geophysical survey that would not be applicable to the specific area (and the properties therein)—large or small—over which the survey was being conducted, this indiscriminate phrasing has occasioned the belief, in some quarters, that costs of reconnaissance surveys (as dis-

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properties. (This expense is allowable as a current deduction.) (Emphasis supplied.)

(D) Geological and geophysical expense incurred for the purpose of determining the location of wells to be drilled, supervising the drilling of wells, and facilitating the production of wells. (This expense is allowable as a current deduction, provided a proper election has been made under the option provided by Treas. Reg. 103, § 19.23(m)-16 (1940), carried over to Treas. Reg. 111 (1943).)

26 *Id.* at 223.

27 The answer is that the entire cost of the survey probably should be capitalized. This would be so whether there was but one lease covering the 10,000 acres held before the survey, or several leases ("properties"), as will be seen from the discussion *infra.* Such a problem arises from a failure to set forth in the instructions that the word "properties" is used in the sense of "interest" (e.g. an oil and gas lease) as defined by the Regulations, rather than in the sense of "acres" or "land." Treas. Reg. 111, § 29.23(m)-1(i) (1943) states: "The taxpayer's interest in each separate mineral property is a separate 'property'; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single 'property,' provided such treatment is consistently followed." For an elaborate discussion of the Bureau's concept of a "property," see G.C.M. 22106, 1941-1 Cum. Bull. 245, modified by G.C.M. 24094, 1944 Cum. Bull. 250.

tinguished from costs of detail surveys) are currently deductible, regardless of the part they play in acquisition of properties.

The next statement disclosing the Bureau's position on exploration costs appeared in a letter from the Commissioner, dated May 4, 1945,[28] in which it was held that a "bottom hole contribution"[29] to the drilling of a producing well is a capital expenditure to be charged to the cost of "the properties benefited by the exploration." However, it was also stated that a contribution to the drilling of a dry well[30] would be *presumed* to be of no benefit to the contributor, who would be allowed to deduct it as an ordinary loss. Just why such a presumption would be indulged was not indicated; but, where geological information obtained from drilling a dry hole is used as a basis for the acquisition or retention of properties, it would seem that the cost of that information should be capitalized to the same extent that the cost of information obtained from drilling a producing well is required to be capitalized. In referring to "properties benefited by the exploration", the Bureau showed for the first time that it was resting its rule of capitalization of exploration costs on Section 24(a) (2) of the Internal Revenue Code,[31] an extremely questionable basis.

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28 5 P-H 1945 FED. TAX SERV. ¶ 76,209.

29 "Money or property given to an operator for his use in the drilling of a well on property in which the payor has no interest. The contribution is payable whether the well is productive or non-productive." ARTHUR ANDERSEN & CO., OIL AND GAS FEDERAL INCOME TAX MANUAL 161 (1948). The example is given (pp. 15-16) of operator A, who prepares to drill a well. If the well is productive, information thereby obtained by A regarding the geologic and producing possibilities will be beneficial to B, who owns an adjoining lease. Accordingly, B agrees to contribute $5,000 to the cost of drilling A's well.

30 This could be either a "bottom hold contribution" or a "dry hole contribution", which is payable *only* in the event the well is found to be non-productive. *Ibid.*

31 INT. REV. CODE § 24(a)(2) provides that in computing net income no deduction shall in any case be allowed in respect of "Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

The latest expression of Bureau policy on this subject was contained in a Mimeograph, dated November 5, 1946.[32] Although this instruction was principally concerned with one of the separate classes of income used in determining "abnormal income" for purposes of the excess profits tax, the following noteworthy statement was made:

> Geological and geophysical survey costs have been the subject of intensive study by the Bureau and repeated representations by the industry. The Bureau's position is that the cost of all such surveys which have for their purpose the accumulation of knowledge on which to base action in the acquisition or retention of property is capital in nature. Only that small portion of such surveys which have [sic] for their [sic] object the location of the exact spot on which to drill a well has been recognized as part of the development cost of the lease and, as such, forming a part of the intangible development cost subject to the option provided by Section 29.23(m)-16 of Regulations 111 . . .

This is clear evidence that the Bureau has abandoned Section 24(a)(2) of the Internal Revenue Code as the basis for its rule of capitalization of exploration costs and has returned to the "acquisition or retention" theory, originally adopted from the *Schermerhorn* opinion when the Bureau's first instructions to the field were issued.

STATUS OF THE LAW ON EXPLORATION COSTS

Costs of Acquisition or Retention as Capital Expenditures

There is no provision in either the Internal Revenue Code or in the Treasury Regulations which specifically mentions exploration costs, much less provides for their treatment. However, Section 41 of the Internal Revenue Code[33] requires

32 *Development Period of Oil Properties in Connection with the Application of Section 721(a)(2)(C) of the Internal Revenue Code,* 1946-2 CUM. BULL. 95.

33 INT. REV. CODE § 41 provides: "The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . . "

that the taxpayer's accounting method *clearly reflect income.* Except for a few cases involving special circumstances clearly not related to exploration for oil,[34] this requirement has consistently been held to necessitate capitalization of costs of acquiring or retaining assets having a useful life extending substantially beyond the year in which such costs were incurred.[35] This rests on the principle that such costs should be recovered (for example, by depreciation or depletion) over a period of years rather than a period of one year if distortion of annual income is to be avoided. Over forty years ago the Supreme Court of the United States recognized such a principle in a rate case,[36] where a carrier sought to base its rates on operating expenses that included expenditures for real estate, right of way, tunnels, bridges, and other permanent-type improvements. The Court upheld a decision of the Interstate Commerce Commission that the rates were excessive, saying:

> It would seem as if expenditures for additions to construction and equipment, as expenditures for original construction and equipment, should be reimbursed by all of the traffic they accommodate during the period of their duration, and that improvements that will last many years should not be charged wholly against the revenue of a single year.

Since that time, this principle has been readily and uniformly applied to require capitalization in numerous federal

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34 Marsh Fork Coal Co. v. Lucas, 42 F. 2d 83 (C.C.A. 4th 1930) (expenditures for electric locomotives, mine cars and steel rails held deductible as operating expenses where they did not increase production, decrease costs of production, or add to value of a mine, but were necessary to merely maintain normal output of the mine); Commissioner v. Brier Hill Collieries, 50 F. 2d 777 (C.C.A. 6th 1931). *Cf.* Libby & Blouin, Ltd., 4 B.T.A. 910 (1926) (expenditures for small parts of large machine to maintain efficient working condition held deductible as ordinary and necessary business expense).

35 Treas. Reg. 111, § 29.41-3(2) (1943) reads: "Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have *a useful life extending substantially beyond the year* should be charged to a capital account and not to an expense account." (Emphasis supplied.)

36 Illinois Central R.R. Co. v. Interstate Commerce Commission, 206 U.S. 441, 462, 27 S. Ct. 700, 707, 51 L. Ed. 1128, 1137 (1907).

income tax cases,[37] not the least significant of which are those concerned with research and development costs.[38] The mere fact that an expenditure was not part of the *purchase price* of an asset has never prevented it from being capitalized as part of the *cost* of that asset. Indeed, most of the decisions requiring capitalization have been concerned with costs other than the purchase price, and a considerable number of them have concerned costs of acquiring or retaining interests in real property.[39]

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37 Clark Thread Co. v. Commissioner, 100 F. 2d 257 (C.C.A. 3d 1938) (sum paid competitor to discontinue use of trade name held capital expenditure); Beneficial Industrial Loan Corporation v. Handy, 16 F. Supp. 110 (D.C. Del. 1936) (deduction of accountant's fee for examining accounts of companies being taken over by taxpayer disallowed, because such expense was "linked with the acquisition of capital assets"); Manistique Lumber and Supply Co., 29 B.T.A. 26 (1933) (cost of road on taxpayer's lumberyard held capital expenditure); Stires Corporation, 28 B.T.A. 1 (1933) (deduction of $362,434.60 paid to several influential people who had been instrumental in securing an option to purchase oil company stocks disallowed, because such amount "was as much a cost of the stocks as was the $100,000 paid for the option").

38 Claude Neon Lights, Inc., 35 B.T.A. 424 (1937) (costs of maintaining laboratory and employing engineers to do research in electricity, rare gases, and tubular lighting); Forest Products Chemical Co., 27 B.T.A. 638 (1933), *aff'd without written op.*, (C.C.A. 6th Dec. 18, 1934), *cert. denied*, 294 U.S. 726, 55 S. Ct. 636, 79 L. Ed. 1257 (1935) (costs of sending president of corporation and a chemical engineer to Europe to investigate a process for producing acetic acid); Acme Products Co., Inc., 24 B.T.A. 194 (1931) (costs amounting to $79,835.51 incurred in attempt to discover a commercially practical means of manufacturing ester-gum); Goodell-Pratt Co., 3 B.T.A. 30 (1925) (costs of maintaining department for purpose of working out new ideas and developing new tools, patents, secret processes, methods of manufacture, and special machinery); Gilliam Manufacturing Co., 1 B.T.A. 967 (1925) (salaries, materials, and overhead in connection with experimentation and development of automobile tops). See also Stream, *Pioneering Activities*, 26 TAXES 64 (1948), and the author's article, *Research and Development Costs*, PROCEEDINGS OF THE NEW YORK UNIVERSITY SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION (1948). The *modus operandi* in exploration for oil is basically the same as that in development of inventions, the procedure of locating a prospect in exploration having its counterpart in the procedure of "isolating the problem" in invention. See BERLE & DECAMP, INVENTIONS AND THEIR MANAGEMENT 18 (1937).

39 Acer Realty Co. v. Commissioner, 132 F. 2d 512 (C.C.A. 8th 1942) (portion of officers' salaries allocable to supervising construction of buildings); Jones' Estate v. Commissioner, 127 F. 2d 231 (C.C.A. 5th 1942) (attorneys' fees in suit to cancel cloud on title to real property); Moynier v. Welch, 97 F. 2d 471 (C.C.A. 9th 1938) (attorney fees and litigation costs over oil royalties); Home Trust Co. et al. v. Commissioner, 65 F. 2d 532 (C.C.A. 8th 1933) ($75,000 paid to secure immediate possession of 99-year leasehold); Jordan Creek Placers, 43 B.T.A. 131 (1940) (cost of option under which taxpayer had acquired mining properties); M. & F. Holding Company, 26 B.T.A. 504 (1932) (fee of $25,000 paid in connection with negotiating and closing a long term lease); D. N. & E.

Exploration Costs as Costs of Acquisition or Retention of Oil and Gas Properties[40]

The first case directly concerned with exploration costs was *Seletha O. Thompson,*[41] decided by the Board of Tax Appeals in 1928. There the taxpayer, who was engaged in buying and selling oil and gas leases, prospecting for oil and gas, and drilling oil and gas wells, sought to deduct as ordinary and necessary business expenses the cost of maps, abstracts of title, legal opinions on titles, and recording fees; also $5,241 paid for *geological surveys and opinions.* The Commissioner disallowed the deductions and treated the payments as part of the cost of oil and gas properties. The Board affirmed, saying:

> The evidence establishes that during 1919 the petitioner expended $1,036.40 for maps, abstracts, legal opinions on titles and recording fees, and $3,333.33 in settlement of a suit involving title to leased lands. Such items have been held by the Board to be capital expenditures *to be added to the cost of acquiring the property* in connection with which they are paid and considered in computing gain or loss on sale or in fixing the basis for depreciation or depletion. . . . *The same is true of the amounts paid for geological surveys and opinions,*

Walter & Co., Inc., 4 B.T.A. 142 (1926) (payment of $5,000 to real estate agents for services in procuring lease). See also the cases directly concerned with exploration costs, discussed *infra.*

40 It is arguable that exploration costs represent the cost of acquisition of geological and geophysical maps and should be capitalized as the cost thereof. *Cf.* Pitzman's Co. of Surveyors, 21 B.T.A. 1368 (1931) (deduction allowed for depreciation of plat books, city district maps, city topographical maps, blueprints of subdivisions, and numerous field sketches, owned by firm engaged in engineering and surveying business); Crooks v. Kansas City Title & Trust Co., 46 F. 2d 928 (C.C.A. 8th 1931) (deduction allowed for obsolescence of abstract plants comprising abstract books, maps, plats, indices, and transcripts of judgments); Isbell Porter Co. v. Commissioner, 40 F. 2d 432 (C.C.A. 2d 1930) (restoration to invested capital allowed in amount of previous deductions for costs of model and design drawings). *All of these decisions presupposed that the maps or drawings concerned were assets.* While it is well known that oil companies treat their geological and geophysical maps as property of a highly confidential nature and often use them for trading purposes, it is believed that treating them as assets would be myopic, for their principal function is to serve as the basis for decisions regarding the acquisition or retention of properties. Any value that they might have for trading purposes would be purely accidental and an extremely secondary objective of any oil producer's exploration program.

41 9 B.T.A. 1342 (1928).

> unless, perhaps, it is shown that such payments were made for surveys and opinions upon tracts never purchased.[42] (Emphasis supplied.)

One month later, the *Nusbaum* case[43] was decided. Here the taxpayer had become interested in the oil possibilities of a forty acre tract. Prior to acquiring a lease of the property, services of an oil geologist were secured. After "an extended investigation and study", the geologist advised acquisition. In payment for these services, it was agreed that the geologist should receive one-third of any profits that resulted from operations under the lease. Subsequently a disagreement arose over the method of determining the share of profits, as a result of which the geologist surrendered his rights to receive any profits in exchange for $23,000 (of which the taxpayer paid $7,640). When the taxpayer sought to deduct the payment as a business expense, the Commissioner disallowed the deduction and held that such payment should be regarded as part of the capital cost of the lease. The Board affirmed "upon the authority of many cases".[44]

With the exception of a few mining cases[45] upholding the principle expressed in the *Thompson* and *Nusbaum* opinions, the next case of major interest was *Schermerhorn Oil Corporation*,[46] decided in 1942. Here the factual situation was similar to that in the *Nusbaum* case. The services of one Tomlinson, an oil geologist, were retained prior to acquisi-

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42 *Id.* at 1345.

43 C. M. Nusbaum, 10 B.T.A. 664 (1928).

44 Citing, among others, D. N. & E. Walter & Co., Inc., *supra* note 39.

45 Parker Gravel Company, 21 B.T.A. 51 (1930) ($122 paid an engineer to map and estimate the extent of gravel deposits, *after* taxpayer had secured a gravel mining lease, held to be a capital expenditure); G. E. Cotton, 25 B.T.A. 866 (1932) (costs incurred during *exploration stage* of mining operations held to be capital expenditures); Rialto Mining Corporation, 25 B.T.A. 986 (1932) (costs in connection with survey and *exploration* of mining property which taxpayer owned or expected to own held to be capital expenditures). *Cf.* O.D. 314, 1 CUM. BULL. 143 (1919) ("All expenditures by a mining company for prospecting and development for the purpose of enlarging the business or continuing it beyond its present limits must be charged to capital account.").

46 46 B.T.A. 151 (1942), consolidated with the *Schermerhorn-Winton Company* and the *Charles Weldon Tomlinson* cases.

tion of any leases. On the basis of Tomlinson's advice, certain oil and gas leases were acquired, it having been agreed that he would receive ten percent of the net profits therefrom in addition to his regular salary. The principal issue was whether the Commissioner erred in treating such additional payments as capital expenditures. The Board of Tax Appeals pointed out that in the case of *North American Oil Consolidated* [47] it had treated comparable costs as capital expenditures and said:

> The obligation to make the additional payments to Tomlinson was just as much a part of the cost of acquiring the leases as the consideration which the companies agreed to pay the lessors. It arose when the properties were acquired, the time of payment being postponed until net profits should be realized. If the companies had covenanted to pay Tomlinson certain lump sums at the time of acquisition of each property, it would perhaps be more obvious that such payments were made in connection with the acquisition of a capital asset; but there is no substantial distinction between such payments and those which the corporations covenanted to make. As we view them they are *somewhat analogous* to commissions paid in connection with the purchase of property, expenditures made for surveys, abstracts of title, or geological opinions, and amounts paid in defending or perfecting title to real estate, all of which have been held to be capital expenditures [citing, among others, the *Thompson* case] . . . *The test is whether the expenditures are made in connection with the acquisition or preservation of a capital asset.* If so, they are capital expenditures.[48] (Emphasis supplied.)

[47] 12 B.T.A. 68 (1928) (four percent of oil produced was paid to attorneys for services in defending title to certain oil lands and securing land patents thereon).

[48] 46 B.T.A. 151, 161-162 (1942). It is true that the Board was then under the impression that the interests of Tomlinson in *net* profits from the oil and gas leases were not economic interests in the leases themselves. It is also true that this impression subsequently was proved to be erroneous by the Supreme Court's holding in Kirby Petroleum Company v. Commissioner, 326 U.S. 599, 66 S. Ct. 409, 90 L. Ed. 343 (1946), that "Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." However, this does not affect the validity of the *Schermerhorn* decision that additional payments to the geologist were capital expenditures. Whether he received an outright economic interest in an oil lease at the time of its acquisition or some other kind of interest, the decisive point is that the additional payments to him by the oil companies were made "in connection with the acquisition . . . of a capital asset."

In view of the "acquisition or preservation" test thus prescribed, the Board's decision was clearly indicated by the facts of the case set forth at page twenty-four of the taxpayer's own brief:

> . . . both parties contributed capital at the outset *with which* the properties were acquired, Tomlinson furnishing the necessary geographical maps, geological data, and other information relating to structures, formations and other scientific matters, including a recommendation as to the advisability of acquiring specific properties . . . and the Schermerhorn companies contributed the funds with which to purchase and develop the properties recommended by Tomlinson, or such of the same as it deemed advisable . . . (Emphasis supplied.)

The last case directly in point was decided in 1946 by the Tax Court.[49] One of the issues was whether the sum of $11,361.56, paid out in 1941 for geophysical surveys covering two tracts held by the taxpayer under a mineral lease, was deductible as an ordinary and necessary business expense. Following the survey, the taxpayer had acquired leases on some additional land adjacent to one of the tracts surveyed. The Commissioner argued that the entire sum was "in the nature of an addition to lease cost" and, under Section 24(a)(2) of the Internal Revenue Code must be capitalized.[50] The taxpayer replied that Section 24(a)(2) did not prohibit the deduction claimed. However, the court declared that it was unnecessary to discuss either the scope

49 The Louisiana Land And Exploration Company, 7 TC 507 (1946), *aff'd on other issues*, 161 F. 2d 842 (C.C.A. 5th 1947). The decision on exploration costs was not appealed.

50 It appears that the Commissioner misconceived his argument when he cited § 24(a)(2), since this relates generally to betterments and improvements of assets rather than to the acquisition of assets. A citation to § 41 and to Treas. Reg. 103, § 19.41-3(2) (1940) would have been more in point. (The latter currently appears as Treas. Reg. 111, § 29.41-3(2) (1943), quoted in note 35, *supra.*) Geological and geophysical surveys do not "better" the property in the area surveyed. Indeed the property is no different after such a survey than it was before. There have been no improvements added, such as the boundary stakes and markers which characterize a land survey. *Cf.* Hannibal Missouri Land Co., 9 B.T.A. 1072 (1928) (allocating to each parcel of real estate within a subdivided tract a part of the cost of the land survey whereby the tract was subdivided).

of that section or the "ordinary and necessary" character of the disputed deduction, because

> . . . in our view the geophysical expense here involved is capital in nature and is for that reason not deductible under Section 23(a)(1)(A). The distinction between capital expenditures and business expenses is generally made by looking to the extent and permanence of the benefit derived from the outlay. The benefit from business expenses is generally realized and exhausted within a year . . . On the other hand, an item of expense is of a capital nature where it results in the taxpayer's *acquisition or retention of a capital asset,* or in the improvement or development of a capital asset in such a way that the benefit of the expenditure is enjoyed over a comparatively lengthy period of business operation.[51] (Emphasis supplied.)

There was nothing said with respect to whether the court thought that the amount paid for the surveys should have been added to the cost of the original lease, to the cost of the leases subsequently acquired, or to the cost of all of them.[52]

THE OPTION COVERING INTANGIBLE DRILLING AND DEVELOPMENT COSTS

The option to deduct or capitalize intangible drilling and development costs, presently contained in Treasury Regula-

[51] 7 TC 507, 514-515 (1946). Although at the time of the *Schermerhorn* case real property used in the trade or business (such as an oil and gas lease) came within the scope of the definition of "capital assets", as set forth in § 117 of the Code, this was not so when the opinion was issued in the case of *The Louisiana Land And Exploration Company*. During the interim real property used in the trade or business had been shifted to the category. of "non-capital assets" under § 117(j). The reason for this was that Congress considered it "more appropriate to treat all property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business." SEN. REP. No. 1631, 77th Cong., 2d Sess. 119 (1942). There was no intention to provide a basis for distinguishing between expenditures made in the acquisition of capital assets and expenditures made in the acquisition of non-capital assets. Such expenditures, in either case, are clearly "capital expenditures" because they are made in the acquisition of *assets that will last substantially beyond the taxable year.*

[52] If, as a result of a geophysical survey, both the original lease was retained and additional leases were acquired, it would seem that the cost of the survey should be allocated to *all* of the leases. See the discussion on how to treat exploration costs for federal income tax purposes, *infra.*

tions 111, Section 29.23(m)-16(b)(1) (1943),[53] was first granted by Treasury Regulations 33, Article 170 (1918). The original option, which divided operators into two classes (owners and lessees) for the purpose of determining the amount of capital to be returned through annual deductions for depletion, provided:

> In the case of the operating fee owner, the amount returnable through depletion deductions is the . . . cost of the property . . . plus . . . the cost of development (other than the cost of physical property incident to such development) up to the point at which the income from the developed territory equals or exceeds the deductible expenses.
>
> In the case of a lessee, the capital thus to be returned is the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease, plus also all expenses incurred in developing the property (exclusive of physical property) prior to the receipt of income therefrom sufficient to meet all deductible expenses, *after which time* as to both owner and lessee, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the drilling of wells and further development of the property, may, at the option of the operator, be deducted as an operating expense or charged to capital account. (Emphasis supplied.)

It is thus seen that, in its inception, the option covered only those expenses arising *after the time* that receipt of income from the property was sufficient to meet all deductible expenses—expenses clearly arising subsequent to those incurred for the purpose of locating and acquiring the property or, if already acquired, for the purpose of determining whether or not to retain it.

The option was recast in Treasury Regulations 45, Article 223 (1921), to read as follows:

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53 ". . . Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying, and *geological work* as are *necessary in preparation for the drilling of wells;* and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparations of wells for the production of oil or gas. . . ." (Emphasis supplied.)

> Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the *exploration* of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion. (Emphasis supplied.)

This was upheld in the *Ramsey* case,[54] where the taxpayer sought to include such costs in the basis of leases that had been sold, although these costs had been previously deducted under the option. The court recognized that the question was squarely presented whether the regulation could permit the irrecoverable cost of drilling oil wells to be classed as an expense of operation rather than as a permanent improvement or betterment. It remarked that whether an oil well was a permanent improvement was "at least a debatable question", and said:

> The incidental costs here involved are irretrievably gone when the well is finished, whether it be a dry hole or a producer. . . . The truth is that the hole upon which the money is expended is simply a means of reaching the oil sands, and it is the oil which increases the value of the property; the hole is of value only if oil is found, and then only as long as the sands will produce. . . . we are of the opinion that the holes through which the oil is recovered are not so conclusively "permanent improvements or betterments" as to preclude a regulation permitting the deduction of irrecoverable expenses of drilling them as ordinary expenses . . . [55]

The option was again recast in 1932 by Treasury Decision 4333 [56] and has been continued in substantially the same form ever since. This Treasury Decision provided an option to deduct ". . . all expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas . . ." No mention was made this time of expenses "in connection with the exploration of the property," al-

54 W. R. Ramsey v. Commissioner, 66 F. 2d 316 (C.C.A. 10th 1933), *cert. denied* 290 U.S. 673, 54 S. Ct. 91, 78 L. Ed. 581 (1933).

55 *Id.* at 318.

56 XI-1 Cum. Bull. 31 (1932) (amending Treas. Regs. 45 and 62, Art. 223· Treas. Reg. 65, Art. 225; Treas. Reg. 69, Art. 223; and Treas. Reg. 74, Art. 243)

though examples of items to which the option applied included expense of surveying and geological work necessary in *preparing for the drilling of wells.* It was specifically announced in Treasury Decision 4333 that the restatement of the option resulted in no change in administrative policy or practice under the regulations. This implied that expense "in connection with the exploration of the property", as described in the Regulations beginning with Regulations 45 in 1921, referred to expense of surveying and geological work necessary in *preparing for the drilling of wells,* rather than to costs of exploration necessary in determining what properties should be acquired or retained for the drilling of wells.[57] Possible disapproval of such a restrictive application of the option was indicated by the Court of Appeals for the Fourth Circuit in a dictum in *Burnet v. Petroleum Exploration Company.*[58] In the course of holding that the capitalized cost[59] of drilling wells should be recovered through allowances for percentage depletion rather than depreciation, the court said:

> The outlay for geological study and survey is directly connected with the location or discovery of the oil deposit, and would seem to be not subject in any way to depreciation but should be allowed under depletion *when capitalized.* So with the hole in the ground. It cannot be withdrawn or inventoried as having any independent value or resold as may be done with casing, tools, or machinery. As the wages for labor and other expenses in connection with the transportation and work of a geologist in prospecting an oil field are a part of the cost of discovery or development, so the wages for labor

[57] Note Judge Hill's positive position on this point in the case of The Louisiana Land And Exploration Company, 7 TC 507, 516 (1946): "Petitioner does not contend that the expenditure here involved is deductible under the option accorded by the regulations, and if such contention were made we should decline to adopt it The option is directed to the costs of preparations for the drilling of particular wells after the drilling has been at least tentatively decided upon, which preparations are far removed from over-all geophysical exploration such as we are here considering."

[58] 61 F. 2d 273, 277 (C.C.A. 4th 1932), *aff'd.* 288 U.S. 467, 53 S. Ct. 439, 77 L. Ed. 898 (1933).

[59] Cost included amounts paid to drilling contractors for drilling wells, amounts paid for freight and haulage of equipment put into the wells, and amounts paid for labor in installing the equipment in the wells.

in drilling a well are such a part of the cost of discovery or development as are not susceptible of depreciation." (Emphasis supplied.)

Article 223 of Treasury Regulations 69, which contained the phrase "in connection with the exploration of the property," was before the court, whose use of the words "when capitalized" might imply that the outlay for geological study and survey could have been deducted as an expense under the option *as then worded.* Accordingly, it is reasonable to believe that regardless of the caution in Treasury Decision 4333 that no change in administrative policy or practice resulted from the restatement of the option, the Fourth Circuit might have thought that the option had actually been tightened up.

Even if it be seriously contended that the option now extends to costs of acquisition [60] legality of the option would still be in doubt. In the *F.H.E. Oil Company* case,[61] the taxpayer sought to deduct (under the option) the intangible drilling and development costs of wells which it had drilled to prevent forfeiture of its properties. The Tax Court, in a split decision, held that the wells were capital investments, no part of the cost of which could be deducted as an expense. The minority opinion merely pointed out that the option expressly covered the costs in question. The Fifth Circuit said (p. 1005):

> The minority is right as to what the Regulation says. The majority is right in holding that the Regulation in giving an optional expense deduction cannot prevail against the fact that a capital investment, an "improvement or betterment of the estate or property" has been made, for by statute the cost of such cannot be deducted as expense, but can be recouped only by annual allowances for depletion or depreciation.

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60 With respect to the scope of the option, the Court of Appeals for the Fifth Circuit held that it does not extend to intangible drilling costs incurred as consideration for the assignment of oil properties. Hardesty v. Commissioner, 127 F. 2d 1002 (C.C.A. 5th 1945).

61 F. H. E. Oil Company v. Commissioner, 147 F. 2d 1002, *motion for rehearing denied,* 149 F. 2d 238, *2d motion for rehearing denied,* 150 F. 2d 857 (C.C.A. 5th 1945).

The court also remarked (p. 1003) that "if the option be in truth contrary to the revenue statutes it is void, and it is the duty of the judges to uphold the law, and disregard the regulation." It specifically disagreed with the statement of the Tenth Circuit in the *Ramsey case* [61a] to the effect that there is a debatable question as to whether an oil well is a permanent improvement, saying that a producing well *is* clearly a permanent improvement.[62]

The point might be pressed that in 1945 Congress passed a joint resolution stating its approval of the option covering intangible drilling and development costs.[63] However, it appears that Congress was well aware that *exploration* costs were not covered by the option. Five years before, in connection with what was to become Section 711(b)(1)(I) of the Internal Revenue Code, a conference report [64] called attention to a Senate amendment requiring corporations computing their excess profits credit under the income plan to exclude any "deductions in connection with exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing." It then stated that, upon conference, the Senate amendment had been "*limited* to deductions allowed in respect of expenditures for intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, or for development costs in the case of mines." (Emphasis

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61a W. R. Ramsey v. Commissioner, 66 F. 2d 316, 318 (1933).

62 Compare the option formerly granted by Article 168 of Treas. Regs. 45, 62, and 65, whereby a taxpayer was permitted to deduct or capitalize expenditures for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of nis facilities or his product. With the publication of Treas. Reg. 69 in 1926, the option was withdrawn, apparently as a result of emphatic decisions that such expenditures were capital. Gilliam Manufacturing Co., 1 B.T.A. 967 (1925); Goodell-Pratt Co., 3 B.T.A. 30 (1925). The question that now appears to be wide open is: Will the option to capitalize or deduct intangible drilling and development costs meet the same fate as the former option covering designs, drawings, patterns, models, and the like?

63 H. CON. RES. 50, 79th Cong., 1st Sess. (1945).

64 H. R. REP. No. 3002, 76th Cong., 3d Sess. 46 (1940), which accompanied the Second Revenue Bill of 1940.

supplied.) Thus it was recognized that *exploration* costs were not the same as intangible drilling and development costs. Therefore, the joint resolution approving the option covering intangible drilling and development costs appears to be of no consequence insofar as exploration costs are concerned.

Accounting Practice and the Burden of Proof Factor

Much may be made by a taxpayer over its consistent practice, down through the years, of charging exploration costs to current expense. The answer probably is that the virtue of consistency does not justify the vice of deducting as ordinary and necessary business expenses what are in fact capital expenditures. At least that is the answer that the Tax Court has usually given.[65] However, in 1943 the Tax Court issued a memorandum opinion which might be interpreted as some indication that the court could be prevailed upon to give the virtue of consistency some reward—at least where the consistency is in line with good business accounting practice. In *Pittsburgh Screw and Bolt Corporation*,[66] the taxpayer had been issued a basic propeller patent in 1929, as a result of which it formed a propeller division in its plant. From 1929 to 1938, it charged off to expense re-

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65 Gilliam Manufacturing Co., 1 B.T.A. 967 (1925) ("The taxpayer has no option to treat expense items as capital or capital expenditures as ordinary and necessary expense of carrying on a trade or business . . . "); Goodell-Pratt Co., 3 B.T.A. 30 (1925) (". . . from the standpoint of good accounting no right ever vested in any business enterprise to treat certain expenditures according to either of two diametrically opposed theories."); R. S. Newbold & Son Co., 7 B.T.A. 471 (1927) ("We have found that the costs should have been capitalized and the fact that they were erroneously treated as expenses does not preclude the petitioner from now correcting its error."); Frishkorn Real Estate Co., 15 B.T.A. 463 (1929) (court upheld Commissioner's disallowance of a deduction of $900 expended for surveying and staking a parcel of land, saying that such an item was a capital expenditure and that "petitioner's custom of treating such a charge as an expense does not establish its character as such."); Magnetic Analysis Corporation, P-H 1943 TC Mem. Dec. Serv. ¶ 43,180 (1943) (costs incurred from 1930-1936 in development of machines, although currently charged off by taxpayer during those years, allowed to be restored in computing invested capital for excess profits tax purposes).

66 P-H 1943 TC Mem. Dec. Serv. ¶ 43,414 (1943).

search and development costs amounting to $392,000. The propeller division was sold in 1939, and, with a view to increasing the basis thereof, the taxpayer sought to capitalize the costs originally charged off—even offering to make any adjustments necessary during the earlier taxable years that were barred by the statute of limitations. The Commissioner refused to permit the basis to be so increased, and the Tax Court affirmed, because "it has not been demonstrated that the proposed deferment or capitalization of all the costs in question is a better system or would more accurately reflect income." The court also made these significant remarks (pp. 1325-1326):

> There are many border-line cases in the matter of accounting. *It may well be questioned if the best accounting practice in a business such as petitioner was conducting* [viz. propeller development, production, and sale] *is not to charge research and development costs to expense* and if true income is not better reflected thereby. . . . It was only in 1939 when it faced a large tax on the sale of the Propeller Division assets that it was suggested that the previous system was wrong. The record does not satisfy us that the petitioner's practice, followed with the approval of the respondent during the period 1929 to 1938, was erroneous and did not accurately reflect income.

If such a comment could be made with respect to research and development costs, might it not be made with respect to the exploration costs of an oil company? The answer, discernable in the following paragraph, is "probably"—but not by a *majority* of the court!

Any optimism engendered by the opinion in the *Pittsburgh Screw and Bolt* case should be leavened with a realization that the decision turned solely on burden of proof. In that case the taxpayer had made a *change* in its accounting method of treating research and development costs. Hence, for purposes of Section 41 of the Internal Revenue Code,[67] there was no "regularly employed" method of accounting for

[67] See Note 33 *supra*.

such costs.[68] Accordingly, the Commissioner was authorized to employ a method which, in his opinion, clearly reflected the taxpayer's income. The method selected (which was the one formerly used by the taxpayer) was to charge off as expense the costs of research and development. The burden of proof was then on the taxpayer to show that the Commissioner's method *did not* clearly reflect income.[69] While the new method which the taxpayer proposed to use was clearly in line with previous holdings that research and development costs must be capitalized, the taxpayer still lost the case because it failed to prove that the *Commissioner's* method *did not* clearly reflect income. Such a burden might be almost impossible to sustain, because there are many degrees of "clearness" in the reflection of income.[70] On the other hand, if the taxpayer had not changed from its method of charging off research and development costs to expense, and the Commissioner had, say in 1938, proposed a deficiency on the ground that such costs should have been capitalized, the burden of proof on the taxpayer would have been to show that *its* "regularly employed" method of accounting *did* clearly reflect income. This burden would not have been quite as difficult to uphold, because, as just pointed out, there are many degrees of "clearness" in the reflection of income. However, the doctrine of *stare decisis* makes it

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68 *Cf.* Capital Warehouse Co., Inc., 9 TC 966 (1947), where during its first two years of business the taxpayer, on the accrual basis, sought to exclude from income the amount of a reserve for removing goods ("Reserve for Handling Out") at the end of their storage period. The Commissioner's method of computing the deficiency ignored the reserve. The court held for the Commissioner, distinguishing Towers Warehouses, Inc., P-H 1947 TC MEM. DEC. SERV. ¶ 47,013 (1947), relied upon by the taxpayer, by saying that in the case before it *there was no question of deduction in conformity with a long-established practice.* (In the *Towers* case the taxpayer was upheld in its 25-year practice of deducting such a reserve in computing its income.)

69 Brown v. Helvering, 291 U.S. 193, 54 S. Ct. 356, 78 L. Ed. 725 (1934).

70 Bradstreet Co. of Maine, 23 B.T.A. 1093 (1931), *aff'd on this point,* 65 F. 2d 943 (C.C.A. 1st 1933), where the Board admitted that conservative accounting might justify the new method adopted by the taxpayer, but said that such was not a perfect method and did not "more clearly" reflect income than the Commissioner's method (which was the taxpayer's old method). The Board also remarked that sometimes good accounting dictates more conservatism than the necessities of income tax reporting permit.

doubtful that such a burden would have been sustainable *in the Tax Court* in the face of the numerous holdings by the Board of Tax Appeals and the court itself that capital expenditures are not deductible as ordinary and necessary expenses. Similarly, it would seem that the burden would be equally difficult to sustain before the Tax Court in the case of an oil producer seeking to prove that its long-established method of charging off exploration costs to expense clearly reflects income.[71] If such a case were to come before one of the courts of appeals or the Court of Claims, it is possible that evidence of accounting practices of the industry, consistently followed by the taxpayer, might carry the burden. At least, those courts do not have *quite* as foreboding a line of direct or analogous precedents to discourage a taxpayer.[72] Finally, whether the Supreme Court would

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71 Perhaps significant is the fact that the only exploration cases that the Commissioner has contested before the Board of Tax Appeals or the Tax Court appear to have involved treatment of exploration costs for the first time, rather than treatment in accordance with a long-established, "regularly employed" method of accounting. This means that the taxpayer had the burden of proving that the method adopted by the Commissioner *did not* clearly reflect income—an almost insuperable burden, as has just been pointed out.

72 *Cf.* J. I. Case Co. v. U. S., 65 F. Supp. 464 (Ct. Cl. 1946) (court evidenced a liberal concept of acceptable accounting practice by allowing taxpayer on the accrual basis to deduct taxes that had not accrued because they were attributable to the taxable period under consideration); Huntington Securities Corporation v. Busey, 112 F. 2d 368 (C.C.A. 6th 1940) (use of the word "clearly" in the requirement that a taxpayer's accounting method "clearly reflect the income" is in the sense of plainly, honestly, straightforwardly and frankly, rather than in the sense of accurately or precisely); Osterloh v. Lucas, 37 F. 2d 277 (C.C.A. 9th 1930) ("In our opinion all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law.") There are a number of unfavorable precedents in courts other than the Tax Court, however. Commissioner v. Boylston Market Assn., 131 F. 2d 966 (C.C.A. 1st 1942) (requiring three-year insurance policy to be prorated over three years); Clark Thread Co. v. Commissioner, 100 F. 2d 257 (C.C.A. 3d 1938) ("The benefits derived from this right cannot be confined to the year in which it was acquired and, therefore, the cost of acquiring it cannot be charged against income earned in that year."); Moynier v. Welch, 97 F. 2d 471 (C.C.A. 9th 1938) (attorney fees and litigation expenses held to constitute additional cost of oil properties); Home Trust Co. et al. v. Commissioner, 65 F. 2d 532 (C.C.A. 8th 1933) ($75,000 paid by bank to secure immediate possession of a 99-year lease held not deductible as an ordinary and necessary business expense); Parkersburg Iron and Steel Co. v. Burnet, 48 F. 2d 163 (C.C.A. 4th 1931) (changes in lighting conditions held not deductible as ordinary and necessary business expense, even though the purpose of the

permit capital expenditures to be consistently charged off as ordinary and necessary expense is, of course, conjectural, although that body has manifested respect for business accounting methods.[73] However, the principle that expenditures for items lasting substantially beyond the taxable year should be capitalized is so long and firmly established in the law of federal income taxation [74] that a decision to overturn it in favor of consistency is most unlikely.

HOW TO TREAT EXPLORATION COSTS FOR FEDERAL INCOME TAX PURPOSES

Single Property Acquired

From the discussion early in this article relative to the nature of exploration, it will be recalled that geological and geophysical surveys are carried out in areas of interest which have been selected after a careful study of all available data. Exploration of each area of interest is ordinarily conducted as a separate project [75]—usually under the name that has been assigned to the area of interest.[76] Although

changes—increased productivity of plant—was not achieved); Dempster Mill Mfg. Co. v. Burnet, 46 F. 2d 604 (App. D.C. 1931) (advances to subsidiary for experimental purposes held to constitute capital expenditures).

73 In Lucas v. Kansas City Structural Steel Co., 281 U.S. 264, 50 S. Ct. 263, 74 L. Ed. 848 (1930), the court disapproved the taxpayer's practice of valuing normal stock at a constant price regardless of cost or market, saying that such method ". . . does not conform with the general or best accounting methods and is apparently obsolete." *But see* Brown v. Helvering, note 69 *supra,* where it was said that "It is not the province of the court to weigh and determine the relative merits of systems of accounting."

74 This principle, now set forth in Treas. Reg. 111, § 29.41-3(2) (1943), was laid down by the Treasury Department as long ago as 1921. Treas. Reg. 45, Art. 24(3) (1921). Congress has never seen fit to change the law with respect to accounting methods (currently Section 41 of the Code) as a result of the Regulations, or to otherwise indicate its disapproval of the principle.

75 There may be exceptional instances where an area of interest is explored piecemeal. If the exploration of each "piece" is conducted *without reference to* the exploration of other "pieces", it would seem that there are several "projects".

76 For example: "Salt Creek"; "Indian Rock"; "X-50 Area". In the case of a large producer, several projects may be conducted simultaneously, each under the jurisdiction of a different geological or geophysical survey team. Often the producer's own survey teams are augmented by teams from independent exploration companies.

only a fraction of such area will probably be found desirable for testing and exploitation, the purpose of a project is, nonetheless, to obtain data upon which acquisition of an interest in that fractional part will be based. Therefore, if a property is acquired on the basis of such data, the cost of the *entire* project represents a cost connected with the acquisition of an asset having a life extending substantially beyond the taxable year. As such, *all* of the cost of the project should be capitalized as a part of the cost of the property. Such treatment is compelled by a realistic view of each exploration project as a unified whole. In other words, *all* of the shots made in surveying an area of interest by means of a seismograph, for example, are used to prepare a contour map on the basis of which a *final* decision will be made to acquire or retain a property in or near the area.[77]

Single Property Retained

Sometimes one or more properties are acquired prior to exploration. In such a case, the purpose of the exploration project is to obtain data needed to decide whether and to what extent the properties should be retained for testing and exploitation. If a property is retained on the basis of such data, *all* of the cost of the project should be capitalized as a part of the cost of that property, notwithstanding that other properties are determined to be undesirable and are abandoned, *Surrender of any properties would be merely incidental to the purpose of isolating the area in which a property should be retained and would not mean that a proportionate part of the potential oil and gas in the area explored was also surrendered.*[78] Indeed, it would hardly be expected

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[77] Compare ARTHUR ANDERSEN & Co., *op. cit. supra* note 29, at 5, recommending that *all* of the expenditures made for exploration of an area be capitalized as a part of the cost of a lease acquired on the basis of information obtained from the exploration project.

[78] Oil is of a "fugitive and wandering" nature and consequently possession of the land is not necessarily possession of the oil. Ohio Oil Co. v. Indiana, No. 1, 177 U.S. 190, 204, 20 S. Ct. 576, 582, 44 L. Ed. 729, 737 (1900).

that all of the properties in an area would be found suitable for testing, although it might be sound practice to acquire all of them prior to exploration for the purpose of insuring against the possibility that a competitor might benefit from knowing that an area of interest was being worked.[79] If a single property in a large acreage has been acquired prior to exploration and, on the basis of data obtained from exploration, the property is retained in only a fraction of the acreage, the same principles apply. Surrender of the property in the rest of the acreage would be merely incidental to the purpose of isolating the acreage in which a property should be retained and would not mean that a proportionate part of the potential oil and gas was also surrendered. Moreover, it would usually not be expected that all of the acreage would be found suitable for testing.

Reconnaissance Survey Followed by Detail Survey

A relatively inexpensive reconnaissance survey is often made over a very large area for the purpose of finding an area of interest in which to conduct a detail survey. While it is true that a reconnaissance survey is not confined to any small, restricted area and may even cover several counties in a short space of time, the decisive fact remains that data obtained therefrom constitute the basis for the detail survey that is conducted in any area of interest that is located in the large area. Accordingly, the cost of obtaining such data represents part of the cost of the detail survey; and, if a property is acquired on the basis of data from the detail survey, the combined cost of *both* surveys should be capitalized as part of the cost of the property.

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79 Compare 4 SUMMERS, OIL AND GAS 56 (1939), where it is stated that if a particular area of land shows some surface indication of containing mineral structure, "every move that an oil producer makes toward procuring leases or testing the land by geophysical methods brings a flock of speculators, lessees and royalty buyers who secure any sort of a mineral interest possible from the landowners."

More Than One Property Acquired or Retained

Where, as a result of an exploration project covering a particular area of interest, more than one property is acquired or retained, a problem of allocating the cost of the project arises. Allocation *might* be according to the respective values of the properties. Thus, if two properties are acquired, one having an estimated value of $50,000 and the other having an estimated value of $100,000, cost of the project would be allocated on the basis of one-third and two-thirds, respectively. However, since it would be almost impossible to estimate the value of untested properties,[80] such a method appears to be impractical. The *better* method would seem to be allocation according to the respective acreages covered by the properties. Thus, if the two properties acquired covered 1,000 acres and 3,000 acres, cost of the project would be allocated on a basis of one-fourth and three-fourths, respectively. This method bears some relation to the use which was made of the data obtained from the project, since the data were used as the basis for acquiring properties covering *acreage* deemed suitable for testing and exploitation.[81]

More Than One Area of Interest Located

Where, as a result of a reconnaissance survey, more than one area of interest is located, in each of which a detail survey is to be conducted, a problem of allocating the cost of the reconnaissance survey arises. Here the number of acres in an area of interest does not bear any reasonable

80 *Cf* F. A. Gillespie & Sons Co. v. Commissioner, 154 F. 2d 913 (C.C.A. 10th 1946), *cert. denied,* 329 U.S. 781, 67 S. Ct. 204, 91 L. Ed. 670 (1946), where the court indicated dissatisfaction with the evidence of value contained in the record, but affirmed the Tax Court's allocation of cost to properties sold and properties retained on the basis of their respective values. No such dissatisfaction was expressed in Columbia Oil & Gas Co. v. Commissioner, 118 F. 2d 459 (C.C.A. 5th 1941), but a reading of the opinion will convince one of the complexity of problems of valuation of oil properties.

81 The "acreage basis" of allocating the cost of a lease covering three different tracts was approved in *Berkshire Oil Company,* 9 TC 120 (1947).

relation to the use which is made of the data obtained from the reconnaissance survey, because such data are ordinarily not precise enough to be used as a basis for a *final* decision to acquire or retain properties covering acreage deemed suitable for testing and exploitation. They merely serve to isolate roughly the areas of interest to be surveyed by methods designed to furnish more precise data. Thus, if two areas of interest have been found, one of which is large and the other small, a property may eventually be acquired or retained only in the small area. However, since two distinct detail survey projects have been established on the basis of the reconnaissance data, the explorer has really developed two "chances" of locating properties deemed suitable for testing. Under such circumstances, it would appear proper to allocate one-half the cost of the reconnaissance survey to each detail survey and, in turn, to the property acquired or retained on the basis of information furnished by the latter.

No Properties Acquired or Retained

Costs of an exploration project which fails to lead to the acquisition or retention of a property would appear to constitute a loss under Sections 23(e) or 23(f) of the Internal Revenue Code [82] and would be deductible in full.[83] How-

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[82] INT. REV. CODE § 23(e) provides that in computing net income *of an individual* there shall be allowed as deductions ". . . losses sustained during the taxable year and not compensated for by insurance or otherwise — (1) if incurred in trade or business; or (2) if incurred in any transaction entered into for profit, though not connected with the trade or business . . ." INT. REV. CODE § 23(f) provides that in computing net income *of a corporation* there shall be allowed as deductions ". . . losses sustained during the taxable year and not compensated for by insurance or otherwise."

[83] The Empire District Electric Co., 4 TC 925 (1945), where the issue was the year of abandonment of a hydroelectric project. In 1923 the taxpayer was granted a preliminary permit by the Federal Power Commission for a period of three years for a project to consist of a dam across the White River at Table Rock, Missouri, and the development of a hydroelectric plant at that site. From 1925 to 1930 the taxpayer engaged in core drilling for the dam foundations, topographical surveying, preliminary engineering, and other preparations at Table Rock. The expenses of this work, plus legal fees and costs of preparing applica-

ever, the loss will not be allowed by the Commissioner unless the taxpayer can show that the project, or the property to which it relates, has actually been abandoned.[84] Thus, at the close of a taxable year, an oil company may find itself in the middle of an exploration project, the results of which may not be finally determined for some time. In such a case, it cannot be said that a loss has been sustained, and consequently no deduction in the amount of the costs of the project is allowable. Deduction must await some identifiable event, signifying abandonment.[85]

tions for the federal license, amounted to $330,000. Although most of this sum was expended prior to 1933, the Board upheld the taxpayer's deduction of the entire sum as a loss in 1936, when the project was abandoned. See also Charles T. Parker, 1 TC 709 (1943) (cost of making test runs on a mining property following favorable investigation report held to constitute a loss under INT. REV. CODE § 23(e)(2) upon abandonment of project). In Leslie N. Duryea and Ruth H. Duryea, P-H 1947 TC MEM. DEC. SERV. ¶ 47,230 (1946), the cost of investigating several mining properties preliminary to investment in their acquisition, promotion, and operation was held to be deductible (in the case of one not engaged in the mining business) upon abandonment of the investigatory projects on authority of several cases holding such expenditures to be deductible either as ordinary and necessary expenses or as losses from transactions entered into for profit (citing, among others, the *Parker* case and *The Empire District Electric Co.* case. *But cf.* Robert Lyons Hague, 24 B.T.A. 288 (1931), where attorney's fees, paid for investigations of propositions relating to the purchase of real estate, were held nondeductible even though the propositions were never accepted. The taxpayer argued that the costs of such investigations were deductible as losses incurred in transactions entered into for profit, but the Board disagreed, saying (p. 290): "The simple answer to this contention is that petitioner did not enter into these transactions but, on the contrary, stayed out of them." However, it is believed that the realistic answer is not quite that simple, and that the taxpayer entered upon a transaction for profit *from the moment that he ordered each investigation*. He did not know what the outcome would be, but he certainly had some hope that the investigations would prove favorable enough to warrant acceptance of the real estate propositions. Accordingly, he set the wheels in motion whereby he hoped to realize a profit. The fact that the wheels stopped soon thereafter is immaterial.

84 Missouri-Kansas Pipe Line Co., P-H 1944 TC MEM. DEC. SERV. ¶ 44,009 (1944) ($33,000 expended for legal and engineering fees in the investigation of a contemplated natural gas pipe line project held not deductible as a loss *because the taxpayer failed to prove abandonment* of the project during the taxable year; no question was raised over the fact that the cost of investigation would be deductible as a loss in the year the project was proved to have been abandoned.

85 Coalinga-Mohawk Oil Co. v. Commissioner, 64 F. 2d 262 (C.C.A. 9th 1933) (". . . . it is well settled that a loss is sustained within the meaning of the statute in question only when the transaction in respect of which the loss is claimed is closed and completed by some identifiable event . . ."); Portland General Electric Co., P-H 1947 TC MEM. DEC. SERV. ¶ 47,299 (1947) (mere charge-off on taxpayer's books not sufficient to prove abandonment of hydroelectric projects).

CONCLUSION

Naturally, a realization that the Bureau of Internal Revenue will be able to enforce its determinations that exploration costs must be capitalized as part of the cost of properties acquired or retained as a result of exploration projects, will not be a happy one for the taxpayers concerned. This is because such taxpayers are already enjoying the advantages of percentage depletion, so that any additional cost of *properties on which percentage depletion is being taken* will never be recovered.[86] However, the results to these taxpayers could hardly be termed disastrous. In the first place, only about one out of six properties that are acquired or retained prove successful.[87] The others are abandoned, and, of course, the cost thereof (including exploration costs that should have been capitalized) is deductible as a loss in the year of abandonment. Accordingly, *about five-sixths of the capitalized costs of exploration will be recovered, sooner or later.* Indeed, recovery may be somewhat greater when one takes into consideration the increase in cost depletion that will result from capitalizing exploration costs—in the case of those properties (few though they may be) on which cost depletion is greater than percentage depletion. A one-sixth

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86 Suppose that a taxpayer (whose practice has been to improperly charge exploration costs to current expense) has purchased an oil property for $25,000, after paying out $20,000 for an exploration project as a result of which the property was acquired. It is estimated that 500,000 barrels of crude oil will be extracted over the life of the property. Suppose further that during the taxable year 25,000 barrels of crude are extracted, resulting in gross receipts from the property of $75,000 (allowing $3 per barrel) and net income of $50,000. On the basis of *percentage* depletion of 27½ per cent of gross receipts, the taxpayer would be entitled to a depletion deduction of $20,625 (which is proper, inasmuch as it does not exceed 50 per cent of net income and is greater than $1,250—the amount of *cost* depletion computed on a basis of $25,000). INT. REV. CODE § 114(b)(3). If the exploration costs of $20,000 were properly capitalized as part of the cost of the property, the basis for *cost* depletion would be $45,000, and *cost* depletion would then be $2,250 instead of $1,250. However, allowable *percentage* depletion of $20,625 is still far greater. Thus, by capitalizing exploration costs, depletion would, in this case, not be increased at all.

87 See AMERICAN PETROLEUM INSTITUTE, *op. cit. supra* note 9, at 288.

increase in taxable income will assuredly increase the federal income taxes of oil producers. However, it may be confidently predicted that, as long as percentage depletion of 27½ per cent remains on the statute books, the search for oil will continue undiminished.[88]

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[88] "Since 1928 large oil and mining corporations have been entitled to deduct from 5 to 27½ per cent of their gross income as an allowance for the depletion of their mines and wells, and the deduction may be taken even though the cost of the property has been completely recovered. Thus, in 1936, one mining company deducted nearly $3,000,000 under this provision, although it had already completely recovered the cost of its property. The amount of the deduction was a sheer gift from the United States to this taxpayer and its stockholders, and the revenue that we lost thereby was $818,000. . . . The estimated annual loss of revenue due to this source alone is about $75,000,000." REPORT OF THE JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE, H. R. Doc. No. 337, 75th Cong., 1st Sess. 4 (1937).

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