

# Court Decision Could Cost Oil Industry Billion Dollars

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One billion dollars may be the cost to the oil industry of a recent decision by the United States Fifth Circuit Court of Appeals, New Orleans, which has ruled that intangible drilling costs were capital investments when incurred by a firm or operator in developing its or his own leases and for which producing wells resulted.

The ruling by the three-judge appellate court, with one judge dissenting, was made on appeals by the F. H. E. Oil Company of Fort Worth and the Fleming-Kimbell Corporation, also of Fort Worth, from adverse decisions by the tax court which upheld previous rulings by the Commissioner of Internal Revenue. Motion for rehearing now is before the appellate court and if refused, the cases will be taken to the United States Supreme Court.

The appellate court's ruling dealt with a Department of Internal Revenue regulation which gave the oil operator the option of deducting intangible drilling costs as an expense item or to charge them as a capital investment and capture their return through the depletion and depreciation allowance.

In making its decision, the court said:

"The question of validity seldom has been raised, the taxpayers not wishing to attack it because it favors them and the commissioner not being in position to repudiate the regulation of his own department . . . but if the option be in truth contrary to the revenue statutes, it is void and it is the duty of the judges (of the tax court) to declare and uphold the law and disregard the regulation."

The court ruled that the option which resulted clearly in a double

deduction for the driller of a successful oil or gas well, was not the intent of Congress, and therefore should not be allowed.

The court based its decision on the fact that it considered a producing oil or gas well a "permanent improvement or betterment" to the oil or gas lease. In arriving at its decision that a producing oil or gas well was a permanent improvement or betterment to the property, the court said:

"It seems clear to us that a producing well is a permanent improvement. It costs more in many cases than the land in which it is constructed, and multiplies many times the value of the oil it reaches. It is permanent, because not intended to be removed, and indeed incapable of removal as a whole. It is not temporary, though its useful life is limited. Many buildings put up for special purposes have a useful life less than their physical life."

There was one dry hole drilled on the lease in question in the tax litigation. With regard to the dry hole, the court said:

"Whether the cost of any unproductive well, after abandoning it and salvaging what is salvable, can be treated as a realized loss is not here in question."

If the appellate court should be upheld by the United States Supreme Court, tax attorneys are of the opinion remedial action lies only with Congress.

In the meantime, the oil industry's tax returns for 1942, 1943 and 1944 are affected by the court's ruling.

If Congress refuses to make the regulation a part of the income tax law, one company already has estimated it will cost it an additional \$23,000,000 in taxes.