Caltex Decision Provides Guidance on Structuring Prepaid Drilling Contracts to Satisfy the Economic Performance Requirement

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In January 2012 the Tax Court issued the Caltex Oil Venture v. Commissioner decision. The decision is a mixed bag for taxpayers. On the one hand, the Court determined that to receive a current year deduction for intangible drilling costs (IDCs) under the special 90-day economic performance rule of 461(i)(2)(A), the commencement of drilling requires actual penetration of the ground by a drill bit. However, the Court also created a viable second path to current year deduction which may allow taxpayers current year IDC deductions even if drilling cannot be commenced within 90 days after the end of a year.

Caltex Oil Venture (Caltex) was organized in 1999, as an accrual method partnership. On December 31, 1999, Caltex entered into a turnkey drilling contract with Red River Exploration Inc. (Red River), under which Caltex paid approximately $5.2 million in cash and a note for the drilling of two wells. The contract required Red River to commence drilling the two wells no later than March 31, 2000. However, no drilling occurred prior to March 31. Caltex subsequently deducted the entire payment made to Red River on its 1999 return as intangible drilling costs (IDCs). In 2007, the IRS issued a final partnership administrative adjustment to Caltex that denied the entire IDC deduction, asserting that Caltex had not satisfied the economic performance requirement under section 461(h).

The Tax Court started its analysis by agreeing with the IRS's determination that under section 461(h), the IDCs at issue did not satisfy the economic performance requirement. The Tax Court then analyzed two exceptions to the general economic performance requirement to see if Caltex qualified.

First, the Court held that Caltex did not satisfy the 90-day rule under section 461(i)(2)(A). The 90-day rule requires drilling of a well to commence within 90 days after the tax year during which the taxpayer prepaid the IDCs and claimed the deduction. The Court held that drilling a well commences when a drill penetrates the ground, and here, no drill penetrated the ground during 1999 or 2000.

Second, the Court analyzed whether Caltex was entitled to a partial deduction for IDCs prepaid in 1999 under regulation section 1.461-4(d)(6)(ii), the 3 ½ month rule. The 3 ½ month rule allows a taxpayer to treat services as provided, if the taxpayer reasonably expects the services will be provided within 3 ½ months following payment. The IRS argued that the turnkey, non-severable contact at issue did not qualify because Caltex could not reasonably expect all the services called for in the contract to be completed within 3 ½ months of payment. Caltex argued that it should have been allowed a deduction for the services it reasonably expected would be completed within 3 ½ months of payment. Caltex argued further that if the 3 ½ month rule required all the contracted services within a turnkey contract to be completed within 3 ½ months of payment, then the 3 ½ month rule could never be applied to the oil and gas industry.

The Tax Court concluded that the 3 ½ month rule contemplates that all of the services called for under an undifferentiated, non-severable contract must be performed within 3 ½ months of payment. Caltex entered into a turnkey, non-severable contract, and it could not reasonably expect all of the services paid for would be completed within 3 ½ months of payment; therefore the Court held that Caltex could not treat any of the services due under the contact as being performed in 1999.

In analyzing the 3 ½ month rule, the Tax Court drew a significant distinction between undifferentiated, non-severable contracts and differentiated, severable contracts. A differentiated contract allocates specific payment amounts to specific services. While an undifferentiated contract allocates the entire payment amount to all the services. The Tax Court held the former qualifies under the 3 ½ month rule, while the latter does not. As a result, if each prepayment correlates to a portion of the services that the taxpayer can reasonably expect to be performed within 3 ½ months of payment, then the taxpayer would be entitled to deduct the amount in the year paid.

After Caltex, taxpayers entering into turnkey drilling contracts wanting to protect themselves from a loss of IDC deduction in the current year as a result of unforeseen difficulties in commencement of drilling must consider differentiated, severable drilling contracts, which may reduce the risk. Proper contract drafting and tax planning to meet the requirements set forth in Caltex is essential for future oil and gas drilling ventures.