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SC TECHNICAL ADVICE MEMORANDUM #88-12

TO: Mr. Marvin Davant, Director
Field Services Division

FROM: John Swearingen, Manager
Tax Policy and Procedures Department

DATE: May 11, 1988

SUBJECT: Apportionment Ratio/Intangible Drilling Costs

REFERENCE: S.C. Code Ann. Section 12-7-1150(2) (1976)
SC Revenue Procedure #87-3

AUTHORITY: S.C. Code Section 12-3-170
SC Revenue Procedure #87-3

SCOPE: A Technical Advice Memorandum is a temporary document issued to an individual within the Commission, upon request, and it applies only to the specific facts or circumstances related in the request. Technical Advice Memoranda have no precedential value and are not intended for general distribution.

Question:

Are intangible drilling costs included in the property factor of the apportionment ratio?

Facts:

Prior to calendar year 1985, intangible drilling costs (IDC's) were included in the property factor for South Carolina income tax purposes. At that time South Carolina required the IDC's to be capitalized and depreciated over a ten year life, while Internal Revenue Code Section 263(c) allowed IDC's to be expensed. South Carolina has adopted IRC Section 263 (c) for calendar year 1985 and after.

Discussion:

South Carolina Code Section 12-7-1150 which provides for the property factor of the three factor apportionment ratio provides that:

- (1) The ratio of average value of real estate and tangible personal property...used by such taxpayer in this State....to the average value of the entire real estate and tangible personal property...used by the taxpayer every where...

Any property the net income from which is allocated directly shall be excluded in the computation of the property ratio.

- (2)(e) "Value" as applied to property other than inventories, shall mean the original cost plus any additions and improvements, without regard to deduction for depreciation, amortization, write down or similar charges;...

Code Section 12-7-700(8) provided that the basis in property for depreciation purposes was:

...the basis upon acquisition for determining gain or loss plus the cost of any additions and improvements since acquisition, including, in the case of mines and other natural deposits, the cost of development not otherwise deducted....

Code Section 12-7-910 provided that the basis for determining gain or loss "shall be the cost of such property...." Additionally this section includes "such basis shall be increased by the cost of any improvements not otherwise deducted from income and decreased by any depreciation..."

When read together, the above Sections indicate that the "value" as applied to property other than inventories is the cost of such property increased by the cost of any improvements not otherwise deducted from income that is the capitalized costs for tax purposes. This is consistent with the past interpretation by the Commission. Additionally, the term "original cost" is defined in Section 12-37-930 to mean gross capitalized cost as shown on the taxpayer's records for income tax purposes. Prior to conformity the Commission required the IDC's to be capitalized and depreciated over a ten year life. As a result of this treatment, the capitalized costs of the IDC's were included in the property factor of the apportionment ratio.

This position is evidenced by the Commission's position in the Allied court case. The South Carolina Supreme Court in Allied Corporation v. S.C. Tax Commission 341 S.E. 2d 139 (S.C. 1986) ruled that intangible drilling costs were capital expenditures made to produce a separate asset and were therefore required to be capitalized in determining South Carolina taxable income. The Court stated that Allied was required to capitalize the drilling costs as expenditures for making betterments to real property, i.e., oil and gas wells. During the years in question, the Commission had included the intangible drilling costs in the property factor of Allied Corporation as the costs were capitalized.

The Allied ruling involved tax years prior to the adoption of IRC Section 263(c) providing for the expensing of IDC's. Therefore, as South Carolina now allows the expensing of IDC's, IDC's are included in the property factor only to the extent that these costs are capitalized for income tax purposes.

Conclusion:

Intangible drilling costs are included in the property factor of the apportionment ratio to the extent capitalized for income tax purposes.