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SETTLEMENT GUIDELINES

INDUSTRY: Petroleum

ISSUE: Capitalization of Delay Rentals

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APPEALS SETTLEMENT GUIDELINES
PETROLEUM INDUSTRY

CAPITALIZATION OF DELAY RENTALS

ISSUE

Are delay rentals paid or incurred under an oil and gas lease subject to capitalization under I.R.C. section 263A as costs of producing property?

EXAMINATION DIVISION'S POSITION

Taxpayers have argued that the general uniform capitalization rules of section 263A do not override the specific rule of Treas. Reg. § 1.612-3(c)(2), which allows a current deduction for delay rentals. Commissioner v. Idaho Power, 418 U.S. 1 (1974), makes clear, however, that the Internal Revenue Code contains a “priority-ordering directive,” which dictates that the capitalization provisions may take precedence over a specific provision and require that an expenditure be capitalized even when it otherwise might be deemed deductible. Consistent with Idaho Power, the proposed regulations do not represent a change in the law. Rather, they reiterate the existing law.

CONCLUSION

For tax years beginning after December 31, 1993, delay rentals incurred under an oil and gas lease are required to be capitalized to the depletable basis of the property to which they relate pursuant to section 263A if the lease is held for development or if development of the lease is reasonably likely at some future date. A taxpayer who performs geological and geophysical surveys (G&G) on acquired leaseholds or files a plan of development with an appropriate governmental agency has demonstrated an unequivocal intention to develop the leasehold in the future. Even in the absence of such unequivocal steps, it can be presumed that taxpayers in the business of producing oil and gas acquire leasehold interests with the intent to develop them. Thus, it is assumed that development of an acquired leasehold will ordinarily occur. Therefore, unless the taxpayer can establish by credible evidence that the leasehold was acquired for some reason other than development, the taxpayer must capitalize the delay rentals incurred with respect to that leasehold.

For tax years beginning before January 1, 1994, a taxpayer must take a "reasonable position" on its federal income tax return when applying section 263A to delay rentals.

Some examples of reasonable positions are to capitalize delay rentals on leaseholds that the taxpayer had a plan to produce, (*i.e.*, to develop), to capitalize delay rentals on all leaseholds that the taxpayer acquired and thereafter gathered G&G data on, to capitalize delay rentals on leaseholds in amounts equal to the taxpayer's historical percentage of actual leasehold development, or to capitalize all of the delay rentals that were incurred by the taxpayer. In any event, capitalization of zero delay rentals is not a reasonable position.

CHANGE IN METHOD OF ACCOUNTING

A change from deducting delay rentals in the year paid or incurred to capitalizing the delay rentals to the depletable basis of the property to which they relate, pursuant to section 263A, is a change in method of accounting to which the provisions of I.R.C. sections 446 and 481 apply. The adjustment required under section 481(a) to take into account amounts that would be duplicated or omitted solely by reason of the change in method of accounting is computed as of the beginning of the year of the change in method of accounting. See section 2.10 of Rev. Proc. 97-27, 1997-1 C. B. 680, for the terms and conditions ordinarily applicable for a change in method of accounting made by a Compliance Director.

INDUSTRY/TAXPAYER POSITION

1. Treas. Reg. § 1.612-3(c) specifically gives the taxpayer the option to either currently deduct delay rentals or capitalize such delay rentals to the cost of the leasehold. With no specific mention of delay rentals in the final (August 1993) section 263A regulations, this option remains open to the taxpayer.

2. Factually, a limited number of leases ever produce. Examination Division's interpretation of "pre-production costs" would require that the intent to produce be inferred for every lease for which a delay rental is paid; see Treas. Reg. § 1.263A-2(a)(3)(ii) and compare the first & second sentences.

3. If it is concluded that section 263A overrides Treas. Reg. § 1.612-3(c) and requires capitalization of delay rentals, such delay rentals would nonetheless be deductible as intangible drilling & development costs (IDC). Section 263A(c)(3) specifically excludes IDC from the capitalization regime of section 263A.

Most industry arguments involve one or more of these points, plus some factual disagreements in specific situations.

DISCUSSION

FACTS

Oil & Gas Producers acquire leasehold mineral interests in the ordinary course of their business. Lease agreements (contracts) between mineral interest owners and Oil & Gas Producers can vary widely in their terms in regard to development rights and obligations. Generally, a domestic oil and gas lease grants to the lessee/producer certain exploration and development rights in the property for a specified period. At the time of the acquisition, the lessee (or sublessee, if that's the situation) pays a lease bonus and capitalizes that lease bonus cost to the property.

The leasehold interest grants the lessee the right to explore for and develop oil and gas deposits within the lease area, but also obligates the lessee to do so in a timely manner. Typically, the lease term (also called *primary term*) is for a period of five years but the lease bonus will hold the property for one year or less (depending on how "hot" the area is). Again typically, oil and gas leases currently in use provide that the lessee can retain the lease during the primary term by: 1) continuous drilling activity, 2) commercial production, or, 3) payment of periodic delay rentals. For any period (period usually means one year, but that can be changed by contract) that the lessee fails to drill on the leasehold, the lessee must pay this delay rental to the lessor. There is, to be sure, the possibility of variations on these delay rentals; the focus herein will be on the typical delay rental clause in the typical oil and gas lease.

LAW AND ANALYSIS

I.R.C. section 263A was enacted as part of the Tax Reform Act of 1986, and was intended to provide the statutory framework for a uniform set of rules (the uniform capitalization rules) which could be applied to determine which costs should be included in inventory costs or capitalized to a produced asset.

I.R.C. Section 263A. CAPITALIZATION AND INCLUSION IN INVENTORY COSTS OF CERTAIN EXPENSES.

(a) NONDEDUCTIBILITY OF CERTAIN DIRECT AND INDIRECT COSTS. -

(1) IN GENERAL - In the case of any property to which this section applies, any costs described in paragraph (2) -
(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and
(B) in the case of any other property, shall be capitalized.

(2) ALLOCABLE COSTS - The costs described in this paragraph with respect to any property are -
(A) the direct costs of such property, and
(B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.

Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

[Tax Reform Act of 1986 (P.L. 99-514)]

The rationale for section 263A is contained in the Senate & Conference Committee Reports for P.L. 99-514 and paraphrased in T.D. 8482, 1993-2 C.B. at p. 78:

> Prior to the enactment of section 263A, the rules regarding the capitalization of costs incurred in producing property were deficient in two respects. First, no uniform system regarding the capitalization of costs incurred in producing property existed. Rather, costs were capitalized under a variety of Internal Revenue Code provisions depending on the nature of the underlying property and its intended use. Second, costs incurred in producing, acquiring, or carrying property were permitted, in some instances, to be deducted currently, rather than accounted for in the year when the property was used or sold.

With a number of exceptions, these rules require the capitalization of allocable costs, direct and indirect, to property produced by a taxpayer.

Treas. Reg. § 1.612-3(c) predates the enactment of section 263A and provides that delay rentals are in the nature of rent and that the payor may elect to deduct delay rentals as an expense. Treas. Reg. § 1.612-3(c):

> (1) A delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production.
>
> (2) Since a delay rental is in the nature of rent it is ordinary income to the payee and not subject to depletion. The payor may at his election deduct such amount as an expense, or under section 266 and the regulations thereunder, charge it to depletable capital account.

[T.D. 6446, 1960-1 C.B. 208, 1-20-60; originally published in precisely its present form &

wording.]

By notice of proposed rulemaking dated February 8, 2000 [Internal Revenue Bulletin 2000-8, February 22, 2000, page 706], the Internal Revenue Service has released proposed regulations (REG-103882-99) that would conform the regulations on delay rentals to the requirements of section 263A. The proposed change would remove the second sentence of § 1.612-3(c)(2) and insert in its place the following two sentences:

> (2) * * * To the extent the delay rental is not required to be capitalized under section 263A and the regulations thereunder, the payor may at his election deduct such amount or under section 266 and the regulations thereunder, charge it to depletable capital account. The second sentence of this paragraph (c)(2) applies to delay rentals paid with respect to leasing transactions entered into on or after the date these regulations are published as final regulations in the Federal Register.

Within the announcement of the proposed regulation, it is stated that the change to § 1.612-3(c)(2) "clarifies that subsequent to the enactment of section 263A, the payor of a delay rental may elect to expense currently the delay rental or charge it to depletable capital account under section 266 to the extent that the delay rental is not required to be capitalized under section 263A and the regulations thereunder."

Application.

Question 1: Does I.R.C. section 263A have any application to delay rentals?

The short answer is, "Yes."

Section 261 provides that in computing taxable income no deductions shall, in any case, be allowed in respect of the items specified in sections 261 through 280H. Within the rationale of Exam's Coordinated Issue Paper (and the recently proposed revision to Treas. Reg. § 1.612-3(c)(2)), delay rentals may not be deducted under § 1.612-3(c)(2) if they are required to be capitalized under another Internal Revenue Code section, namely section 263A. Exam's Paper concludes that delay rentals, unquestionably deductible prior to section 263A, are costs allocable to the production of an oil or gas well, squarely within the parameters of T.D. 8482, *supra*. The cost of such delay rental would, as a result, be capitalized to the lease involved, at the time it is paid or incurred. Such cost would be recovered through depletion, if the property ultimately produces oil or gas; or as an abandonment loss when the lease is terminated, if it is terminated.

Section 263A requires the capitalization of all direct costs and an allocable portion of indirect costs to property produced by a taxpayer, including inventory. Certain costs are excluded from the general application of Section 263A by Subsection 263A(c). Section 263A(c)(3) specifically excepts from the provisions of section 263A "Certain develop- ment and other costs of oil and gas wells or other mineral property" allowable as a deduction pursuant to some other Code or Regulatory provision, to include those deductible under sections 263(c), 263(i), 291(b), 616, and 617. Delay rentals are not excluded from the application of section 263A in any of the above-enumerated exceptions. Thus, it is logical to conclude that delay rentals must be capitalized if they relate to property produced by the taxpayer.

The contrary argument is that there was also nothing that specifically included delay rentals in section 263A or the related Regulations; and Treas. Reg. § 1.612-3(c) was not amended nor revoked (until the change proposed by Notice in IRB 2000-8). The position taken in Examination's Coordinated Issue Paper did not *de facto* revoke Treas. Reg. § 1.612-3(c), but use of §1.612-3(c) is severely limited by application of section 263A as proposed in Exam's paper. It is unclear, this contrary argument goes, that this result was intended when the final Section 263A Regulations were issued.

If there is a conflict within the statutory and regulatory design, how should it be resolved? In Walt Disney Inc., 97 T.C. 221 (1991), there appeared to be a conflict between I.R.C. section 47(a)(1) or (2) and Treas. Reg. § 1.1502-3(f)(2) & (3). At page 228 of Walt Disney Inc., the Tax Court states: "When the authority to prescribe legislative regulations exists, this Court is not inclined to interfere if the regulations as written support the taxpayer's position." [citations omitted]. Treas. Reg. §1.612-3 is not legislative but would nonetheless be given "great weight" as interpretation of the Service position. In Bulova Watch Company, Inc. v. U.S., 365 U.S. 753, 758 (1961) the Supreme Court states: " . . . it is familiar law that a specific statute controls over a general one 'without regard to priority of enactment'." [citations omitted]. The conflicting conclusions of §1.612-3(c) and section 263A currently results in uncertainty and litigating hazards.

Pre-1994 Application of I.R.C. section 263A:

Since the final regulations pursuant to section 263A generally became effective for tax years beginning after December 31, 1993, it is reasonable to ask:

Question 2: How does section 263A apply to the tax years beginning before 1994?

Treas. Reg. § 1.263A-l(a)(2): *Effective Dates*. --

> (ii) For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A. For purposes of

> this paragraph (a)(2)[(ii)], a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. See § 601.601(d)(2)(ii)(b) of this chapter.

[Treasury Decision 8482, 1993-2 C.B. at p. 90, 8-6-93]

Regarding such pre-1994 delay rentals, Examination's Coordinated Issue Paper states that:

> Section 263A, its legislative history and the temporary regulations all indicate that carrying charges, such as delay rentals, are subject to capitalization under section 263A. Accordingly, it is not reasonable for taxpayers/ lessees to rely on Treas. Reg. § 1.612-3(c)(2) as authority to deduct all delay rentals in the year paid or incurred.

Technical Advice Memorandum 9602002, issued January 1996, reaches the same conclusion for pre-1994 tax years, using approximately the same words in that conclusion.

In Von-Lusk, 104 TC 207 (1995), and in John J. Reichel, 112 TC 14 (1999), the Tax Court considered costs incurred by real estate developers when such costs were incurred prior to the commencement of any physical activity on the property at issue. In Reichel, the Court elaborates on the decision in Von-Lusk:

> The question in Von-Lusk was whether a partnership had to capitalize costs incurred before it undertook any activities that would physically alter certain land it was developing. The taxpayer had begun activities, such as performing engineering and feasibility studies, similar to those normally conducted by petitioner. . . . We held that activities such as these were development activities even though they had no immediate physical impact on the property and that a taxpayer who undertakes them has begun producing the property.

Reichel, p.17.

In Reichel, the taxpayer argued that none of these activities had begun; that the land had simply been purchased and nothing further done because development "was deferred by adverse economic conditions." The Tax Court concluded that, nonetheless, property taxes must be capitalized to the cost of the land: as pre-production costs. The critical determination in the decision seems to be the following:

> In sum, petitioner has conceded that although development of the San Bernardino parcels was deferred by adverse economic conditions, he acquired and held those parcels intending to develop (*i.e.*, produce) them. . . .

Reichel, p. 18.

That is, once the intent to develop is established, costs related to holding the property must be capitalized unless specifically excluded, such as the interest costs in Von-Lusk.

Post-1993 Application of I.R.C. section 263A:

Question 3: How does section 263A apply to the tax years beginning after 1993?

The final section 263A regulations clarify that "pre-production" costs (in addition to production costs) must be capitalized. Treas. Reg. § 1.263A-2(a)(3):

> (3) Costs required to be capitalized by producers --
>
> (i) In general. Except as specifically provided in section 263A(f) with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in section 263A(f)(4)(B).
>
> (ii) Pre-production costs. If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.
>
> (iii) Post-production costs. . . .

[Treasury Decision 8482, 1993-2 C.B. at p.101, 8-6-93; effective 1/1/94 for costs incurred in taxable years beginning after 12/31/93.]

Answering one set of questions raises another set of questions. How are "Production" and "Pre-Production" defined? How is "property held for future production" distinguished from property for which "it is reasonably likely that production will occur at some future date"? How should "reasonably likely" be defined?

Production and Pre-Production.

For purposes of section 263A, subsection 263A(g)(1) defines the term "produce" as including "construct, build, install, manufacture, develop, or improve." *See also* Treas. Reg. § 1.263A-2(a)(1)(i). The production under discussion herein is the production of an oil or gas well on a leasehold. Commercially feasible oil or gas production is not required for capitalization to be required. Section 263A(f)(4)(B) defines the "production period." It states that the term "production period" means the period beginning on the date on which production of the property begins and ending on the date on which the property is ready to be placed in service or is ready to be held for sale. Costs incurred before, during and after the production period must be capitalized under section 263A. Treas. Reg. § 1.263A-2(a)(3)(i). These costs include both direct and indirect costs. Treas. Reg. § 1.263A-2(a)(3)(ii). Developing a leasehold qualifies as a production activity within the meaning of section 263A. *See* Treas. Reg. § 1.263A-8(d)(3)(ii) which states that the drilling of an oil well constitutes an improvement to real property and, therefore, "production." *See* Treas. Reg. § 1.263A-13(b)(1) [Adopted 12/28/94 by T.D. 8584, 1995-1 C.B. 20] for the rules in determining the beginning of the production period for oil & gas activities. Appropriate costs (both direct and indirect) relating to this activity must be capitalized under section 263A. These costs include costs incurred prior to production, for example: delay rentals. Within the ambit of section 263A, production on an oil and gas lease can occur long before, and regardless of whether, the lease actually produces a flow of hydrocarbons.

If delay rentals are to be included within the ambit of section 263A, then it is as pre-production costs, by the very nature of the cost. Delay rental payments need not be made if production (drilling activity) has begun. Clarification of the treatment of such pre-production costs in Treas. Reg. §1.263A-2(a)(3)(ii) eliminates the argument that delay rentals should not be subject to section 263A capitalization since such payments are actually made to defer production. This also answers the argument that, if delay rentals are subject to section 263A treatment, then they are excluded pursuant to section 263A(c)(3) as Intangible Development Costs. IDC begins only when production (development) begins, clearly excluding pre-production costs from IDC.

If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (*e.g*., purchasing, storage, handling, and other costs), even though production has not begun; § 1.263A-2(a)(3)(ii), 1st sentence. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date, § 1.263A-2(a)(3)(ii), 2nd sentence.

Contrasting Pre-1994 with Post-1993 Production Costs

When the final section 263A regulations were issued, generally effective January 1, 1994, it was made clear that pre-production costs are to be capitalized to property or inventory produced, absent some specific exception (see above). In Reichel, *supra*, the Tax Court has indicated that this should also be true for costs incurred before 1/1/94:

> A close analysis of the language and structure of section 263A supports the conclusion that Congress intended that the capitalization rules cover costs incurred before as well as during the production period. . . .
>
> The legislative history of section 263A also supports this reading. In describing the reasons for enacting section 263A, the relevant section of the House report is headed, "Pre-production costs" and states the concern that then-existing rules "may allow costs that are, in fact, costs of producing property to be deducted currently." H. Rept. 99-426 at 625 (1985), 1986-3 C.B. (Vol.2) 1, 625.

Reichel, at p. 16.

So, while pre-production costs became more clearly defined by issuance of the final section 263A regulations, the Tax Court, at least has determined that the same general rules of pre-production also applied before 1/1/94. The critical factors are whether the taxpayer "holds the property for future production" or, if not held for production, whether "it is reasonably likely that production will occur at some future date."

Factual Considerations

In the case of an acquired oil and gas leasehold, the lessee might seem to demonstrate intent to produce such leasehold by its acquisition. Why else would such a lease be acquired? The answer is neither so simple nor intuitive as it might seem. Leasing petroleum prospects may involve speculation, protection of better prospects and a number of other motives unrelated to any intention to ever develop the particular lease involved. The circumstances of each situation will indicate whether there was intent to develop the lease: for example, whether there was a plan to develop an area, which included the lease, in question or if geological and geophysical (G & G) analyses which are conducted over an area which included the lease.

Finally, given that delay rentals should be treated as any other type of carrying cost, subject to capitalization under section 263A; and that some portion of the delay rentals actually incurred should be capitalized, the obvious next question is, "What portion?" Should all delay rentals be required to be capitalized? Are there other approaches that would be more "reasonable" in appropriate circumstances? A number of possible approaches are suggested as tools for the Appeals Officer:

1. Capitalize those delay rentals paid for leases that are part of an area for which there was a comprehensive plan to explore and produce wells.

2. Capitalize those delay rentals paid for leases that are part of an area in which there has been G&G activity since acquisition, or for which there has been a purchase of G&G information.

3. Use taxpayer information to develop an historical production and pre-production rate for leases.

4. Take a "look-back" at what actually occurred. That is, deduction of delay rentals would be allowable in the year in which there was no further pursuit of production or pre-production activities for the particular lease area. This would be feasible since Appeals consideration would be well after the fact.

5. Historical lease abandonment rates of the taxpayer involved could be used to determine an appropriate write-off period for delay rentals, without regard to the particular lease involved.

6. Use of any other facts or factors, perhaps unique to the situation, which might indicate intent to develop or a lack thereof.

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