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Memorandum

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subject: Treatment under § 167(h) of the Internal Revenue Code of Seismic Data acquired in an Asset Acquisition

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Seller =
Parent =
Natural Resources =

a =
b =
c =
Date =
Year 1 =
Year 2 =
City =
Location 1 =
Location 2 =

Assets =
Formation =
State =
x =

ISSUES

1) If a taxpayer acquires seismic data as part of an asset acquisition, has the taxpayer paid or incurred geological and geophysical (G&G) expenditures within the meaning of § 167(h)?

2) Can more than one taxpayer amortize G&G expenditures related to the same seismic data under § 167(h)?

3) Does the extent to which a seller used seismic data acquired by a taxpayer affect whether the taxpayer can later amortize G&G expenditures related to the same seismic data under § 167(h)?

CONCLUSIONS

1) A taxpayer that acquires seismic data as part of an asset acquisition has not paid or incurred G&G expenditures within the meaning of § 167(h).

2) Because we conclude that Taxpayer did not pay or incur G&G expenditures within the meaning of § 167(h) when it acquired seismic data as part of an asset acquisition, we do not reach the issue of whether more than one taxpayer can amortize G&G expenditures related to the same seismic data under § 167(h).

3) Because we conclude that Taxpayer did not pay or incur G&G expenditures within the meaning of § 167(h) when it acquired seismic data as part of an asset acquisition, we do not reach the issue of whether the extent to which a seller used seismic data acquired by a taxpayer affects whether the taxpayer can later amortize G&G expenditures related to the same seismic data under § 167(h).

FACTS

Taxpayer is a wholly-owned subsidiary of Parent, a diversified global natural resources company that produces natural resources in many areas around the world. Taxpayer is headquartered in City and owns oil and gas producing operations located primarily in Location 1 and Location 2.

In an asset acquisition on Date, Taxpayer, an independent oil and gas company, acquired a percent of Assets from Seller. Assets included all of Seller's upstream operations in the Formation in State, including producing and non-producing leases and reserves, and the associated wells and field production equipment. Taxpayer also acquired Seller's midstream pipeline business in the Formation area as well as seismic

data acquired by Seller between Year 1 and Year 2 related to the Formation area. The total purchase price for the acquisition as provided in the Purchase and Sale Agreement ("PSA") is $b. The parties to the PSA allocated $c of the purchase price to the seismic data related to the Formation area.

The seismic data, which is the subject of this Chief Counsel Advice, is subsurface data that Seller had previously acquired and used to locate and drill wells within its Formation area leases. Seller had acquired non-producing leases and used the seismic data to drill wells, many of which were successful and producing at the time of the acquisition by Taxpayer. Because of its successful exploration and development, Seller marketed many of the properties within the Formation area to Taxpayer as proved and developed.

At the time of the acquisition, there were still undeveloped properties within the Formation area but many were offset locations directly adjacent to existing productive wells that were considered proved or probable reserves. After the acquisition, Taxpayer amortized the allocated value of the seismic data ($c) over 24 months as G&G expenditures under § 167(h).

LAW AND ANALYSIS

Section 167(h)(1) provides for any G&G expenses paid or incurred in connection with the exploration for, or development of, oil or gas within the United States (as defined in § 638) to be allowed as a deduction ratably over the 24-month period beginning on the date that such expense was paid or incurred.

Section 167(h)(2) requires that any payment paid or incurred during a taxable year be treated as having been paid or incurred on the mid-point of that tax year.

Section 167(h)(3) states that no other depreciation or amortization deduction is allowable with respect to qualified G&G expenditures.

Section 167(h)(4) provides that if any property with respect to which G&G expenditures are paid or incurred is retired or abandoned during the 24-month period, no deduction is allowed on account of such retirement or abandonment and the amortization deduction continues with respect to such payment.

Section 167(h)(5(B) provides that in the case of major integrated oil companies, § 167(h)(1) is to be applied by substituting "7-year" for "24-month."

Section 167(h) was enacted in the Energy Policy Act of 2005[1], and was subsequently amended by the Tax Increase Prevention and Reconciliation Act of 2005[2]

[1] P.L. 109-58, § 1329(a), 119 Stat. 594 (August 8, 2005).
[2] P.L. 109-222, § 503(a), 120 Stat. 345 (May 17, 2006).

to add §167(h)(5)(B), which extended the 24-month amortization period to five years for G&G expenditures paid or incurred by major integrated oil companies after May 17, 2006. The Energy Independence and Security Act of 2007[3] further extended the five year amortization period to seven years for G&G expenditures paid or incurred by major integrated oil companies after December 19, 2007.

Prior to the enactment of § 167(h), several courts held that exploration expenditures are capital in nature and not ordinary and necessary business expenses.[4] Following the rationale of those cases, in 1950, the Service issued I.T. 4006[5], which held that if a property is acquired or retained on the basis of G&G data obtained from an exploration project, the cost of the exploration project should be capitalized as a part of the cost of the property acquired or retained under § 24(a)(2) of the Internal Revenue Code of 1939.[6] Conversely, if no property is acquired or retained on the basis of such G&G data, the cost of the exploration project is deductible as a loss under § 23(e) or (f) of the Internal Revenue Code of 1939.[7]

In 1977, the Service issued Rev. Rul. 77-188[8], which restated and updated under the then current statute and regulations, the provisions set forth in I.T. 4006. Rev. Rul. 77-188 provides guidance regarding the treatment of G&G expenditures. Rev. Rul. 78-188 states that G&G exploration expenditures are incurred by the taxpayer "for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition or retention of property by a taxpayer who is engaged in exploring for minerals…"[9] The revenue ruling further states that the expenditures attributable to such exploration are allocable under § 263(a) to the cost of the property or properties, as defined in § 614,

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[3] P.L. 110-140, § 1502(a), 121 Stat. 1492 (December 19, 2007).

[4] *Thompson v. C.I.R.*, 9 B.T.A 1342 (1928) (expenditures for surveys and geological opinions, among other costs, are not deductible as ordinary and necessary expenses but are capital expenditures to be added to cost of the property and considered in computing gain or loss on the sale thereof); *G.E. Cotton v. C.I.R.*, 25 B.T.A. 866 (1932) (deductions for expenditures made in prospecting a mineral lease were held to be capital expenditures and added to the cost of the mine to be recovered through depletion deductions if the development resulted in the discovery of commercial ores or claimed as an abandonment loss if the prospect is abandoned); *Schermerhorn Oil Corp. v. C.I.R.*, 46 B.T.A. 151 (1942) (net profits payments to a geologist for exploration advice and other services were part of the cost of acquiring the related properties); and *Louisiana Land & Exploration Co. v. C.I.R.*, 7 T.C. 507 (1946), *acq.* 1946-2 C.B. 3, *aff'd.* 161 F.2d 842 (5th Cir.) (expenditures paid for a geological survey of property (owned for 10 years before the survey) to determine whether subsurface structures in the properties appeared sufficiently favorable to justify drilling for oil and gas required to be capitalized because the expenditure resulted in the acquisition or retention of a capital asset).

[5] I.T. 4006, 1950-1 C.B. 48, *superseded by* Rev. Rul. 77-188, 1977-1 C.B. 76.

[6] Rev. Rul. 77-188, 1977-1 C.B. 76, *superseding* I.T. 4006, 1950-1 C.B. 48.

[7] *Id*. citing *Louisiana Land & Exploration Co.* , 7 T. C. 507 (1946); *Schermerhorn Oil Corp.*, 46 B.T.A. 151 (1942); *Rialto Mining Corporation v. C.I.R.*, 25 B.T.A. 980 (1932); *G. E. Cotton*, 25 B.T.A. 866 (1932); *Parker Gravel Co., Inc., v. C.I.R.*, 21 B.T.A. 51 (1930); *C. M. Nusbaum v. C.I.R.*, 10 B.T.A. 664 (1928); and *Seletha O. Thompson v. C.I.R.,* 9 B.T.A. 1342 (1928).

[8] *Id*.

[9] *Id*. citing *Louisiana Land & Exploration Co.*, 7 T. C. 507 (1946); *Schermerhorn Oil Corp.*, 46 B. T. A. 151 (1942); *G. E. Cotton*, 25 B.T.A. 866 (1932); *C. M. Nusbaum v. C.I.R.*, 10 B.T.A. 664 (1928); and *Seletha O. Thompson v. C.I.R.,* 9 B.T.A. 1342 (1928).

acquired or retained, and discusses the allocation of G&G expenditures among areas of interest located and identified as the result of such expenditures. The revenue ruling also states that if no property is acquired or retained within or adjacent to an area of interest, the entire G&G expenditure allocable to the area of interest is deductible as a loss under § 165 for the taxable year in which that particular project area is abandoned as a potential source of mineral production.

In 1983, the Service issue Rev. Rul. 83-105 to amplify Rev. Rul. 77-188. Rev. Rul. 83-105 explains the tax treatment of G&G expenditures under Rev. Rul. 77-188, in seven factual situations. In addition it illustrates, by example, how the various G&G expenditures are to be allocated, and explains what constitutes an abandonment as a potential source of mineral production.

Issue 1: If a taxpayer acquires seismic data as part of an asset acquisition, has the taxpayer paid or incurred G&G expenditures within the meaning of § 167(h)?

As noted above, case law and IRS administrative decisions consistently have defined G&G expenditures as “costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.”

Although § 167(h) changes the prior tax treatment of G&G expenditures, it does not define the term “geological and geophysical expenditures.” Rather, the legislative history underlying § 167(h) makes clear Congress’ intention to adopt the long-standing income tax definitions of the terms used in § 167(h). For example, the legislative history of § 167(h) includes a House Ways and Means Committee Report (House Report) that summarizes a proposal for the amortization of G&G expenditures found in section 205 of Enhanced Energy Infrastructure and Technology Tax Policy Act of 2005.[10] Consistent with the definition of G&G expenditures contained in case law and IRS administrative decisions, the House Report states that, “[g]eological and geophysical expenditures (“G&G costs”) are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.”[11]

The function of G&G activities is to locate and identify properties with the potential to produce commercial quantities of oil and natural gas, as well as to determine the optimal location for exploratory and developmental wells. These costs are an important and integral part of exploration and production for oil and natural gas. Rev. Rul. 77-188 characterizes G&G expenses as “exploration expenses”.

The legislative history underlying § 167(h) also indicates that Congress was concerned about providing favorable treatment for costs that foster increased

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[10] H.R. 1541, 109th Cong. (1st Sess. 2005). This language is substantially similar to § 167(h) enacted in the Energy Policy of 2005.
[11] H.R. Rep. No. 109-45, at 34-36 (2005).

exploration for new sources of oil and gas. The House Report discussed above summarizes the Congress' intentions when enacting § 167(h):

> The Committee believes that substantial simplification for taxpayers, significant gains in taxpayer compliance, and reductions in administrative cost can be obtained by establishing a clear rule that all geological and geophysical costs may be amortized over two years, including the basis of abandoned property.
> The Committee recognizes that, on average, a two-year amortization period accelerates recovery of geological and geophysical expenses. *The Committee believes that more rapid recovery of such expenses will foster increased exploration for new sources of supply*.[12] (Emphasis added.)

In the present case, Taxpayer acquired seismic data from Seller in an asset acquisition after Seller used the same seismic data to locate and identify wells in the Formation area. Seller had acquired non-producing leases and used the seismic data to drill wells, many of which were successful and producing at the time of the acquisition by Taxpayer. Because of its successful exploration and development, Seller marketed many of the properties within the Formation area to Taxpayer as proved and developed. Although, at the time of the acquisition, there were still undeveloped properties within the Formation area many were offset locations directly adjacent to existing productive wells that were considered proved or probable reserves

Because Taxpayer acquired properties that were either developed or proved or probable, Taxpayer did not incur costs to locate and identify properties with the potential to produce commercial quantities of oil and natural gas. In other words, Taxpayer did not incur costs to obtain and accumulate data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. Accordingly, we conclude that Taxpayer did not pay or incur G&G expenditures within the meaning of § 167(h).

Issue 2: Can more than one taxpayer amortize G&G expenditures related to the same seismic data under § 167(h)?

Because we conclude that Taxpayer did not pay or incur G&G expenditures within the meaning of § 167(h) when it acquired seismic data as part of an asset acquisition, we do not reach the issue of whether more than one taxpayer can amortize G&G expenditures related to the same seismic data under § 167(h).

Issue 3: Does the extent to which a seller used seismic data acquired by a taxpayer affect whether the taxpayer can later amortize G&G expenditures related to the same seismic data under § 167(h)?

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[12] *Id*.

Because we conclude that Taxpayer did pay or incur G&G expenditures within the meaning of § 167(h) when it acquired seismic data as part of an asset acquisition, we do not reach the issue of whether the extent to which a seller used seismic data acquired by a taxpayer affects whether the taxpayer can later amortize G&G expenditures related to the same seismic data under § 167(h).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Jennifer Bernardini at (202) 317-6853 if you have any further questions.