Use of Tax Partnerships in the Oil Patch

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Agenda

- Basic Oil & Gas Tax Benefits
- Why have a Tax Partnership?
- How Do You Form a Tax Partnership?
- The Tax Partnership Agreement
- Downsides of a Tax Partnership
- Electing Out of Tax Partnership Treatment
- Working with Other ("Real") Oil & Gas Partnerships

Basic Oil & Gas Tax Benefits

Basic Oil & Gas Tax Benefits

- Intangible Drilling Costs
- Depletion Deductions

Intangible Drilling Costs

Intangible Drilling Costs (“IDC”)

- General Principles
  - An operator is one who holds a working or operating interest in any tract or parcel of land either as fee owner or under a mineral lease. An operator’s costs in developing an oil and gas property consist of (i) intangible drilling and development costs (“IDC”) for those items that do not have a salvage value, and (ii) tangible asset costs for items such as drilling and well site equipment.
  - The operator has an option to expense or capitalize IDC. Capitalized IDC and tangible asset costs (including capitalized IDC related to equipment installation) are recoverable through the depletion and depreciation allowances, respectively.

Intangible Drilling Costs

- IDC includes all expenses incurred by an operator that are incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Treas. Reg. § 1.612-4(a).
- Examples of costs included in this definition include expenditures made by an operator for wages, fuel, repairs, hauling, and supplies. Treas. Reg. § 1.612-4(a). Also included are expenses related to (1) the drilling, shooting, and cleaning of wells; (2) the clearing, draining, road-making, surveying, and geological work needed to prepare for the drilling of wells; and (3) the construction of derricks, pipelines, and other physical structures needed for the drilling or preparation of wells. Treas. Reg. § 1.612-4(a)(1-3).
- A primary factor that distinguishes IDC from depreciable asset cost is salvage value. IDC includes expenditures that do not have a salvage value. Equipment and other tangible property having a salvage value are generally considered depreciable assets and are not eligible to be treated as IDC. Costs such as those described above are not considered as having a salvage value even though they are connected to the installation of physical property that itself has a salvage value. Treas. Reg. § 1.612-4(a).

Intangible Drilling Costs

- A general rule of thumb is that IDC is incurred until the well is deemed completed, which is generally considered the time the casing and Christmas tree are installed. The intangible expenses incurred during the installation of production equipment that were not previously necessary for the drilling of the well (such as pumping equipment, flow lines, etc.) do not qualify as IDC. *See* Rev. Rul. 70-414, 1970-2 C.B. 132.
- Difficult analytical issues typically arise in offshore oil and gas operations involving what activities are required to be completed before the treatment of costs as IDC is no longer available, such as dual purpose platform costs, ocean floor well completions that are required to be connected to above-water facilities, etc.

Title search: Use of Partnerships in the Oil Patch

Also available as part of the eCourse
Use of Partnerships in the Oil Patch

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