



Deducting Intangible Drilling Costs

Who can elect?

A taxpayer who owns the working or operating rights in an (1) oil or gas, or (2) geothermal well and incurs intangible drilling and development costs (IDC) must elect to expense these costs, or the IDC must be recovered through depletion (or depreciation for physical property). This ownership can be either as a fee owner or under a lease, or any other form of contract granting working or operating rights that is an entity-level election.

IDCs are excluded from the capitalization rules implemented by the Tax Reform Act of 1986. This act provides uniform rules for the capitalization of costs incurred regarding property used in production. It is important to note that this election is unavailable for productive wells located outside of the United States.

The rules are different for a corporate taxpayer that is an integrated oil company.

When do I make the election?

It is first of all very important that you make a clear election. Otherwise, you will be deemed to have made an election based on how you treated IDCs on the first return that is filed with IDCs. Exercise care in this regard as it is not always obvious that IDC has been paid or incurred. It is common for a taxpayer to pay or incur IDC even when no actual well drilling has occurred. The mobilization of a drilling rig or drilling a rat hole at the drill site would be IDC. If you fail to deduct these costs, you are deemed to have elected to capitalize the costs and to recover through depletion.

For oil and gas wells, this election is due by the due date of the tax return for the tax year in which IDC is first paid or incurred. Presumably, this is the due date including extensions. In several Letter Rulings, the IRS has allowed elections made on delinquent returns since these were the first returns filed by the respective taxpayers that included IDC. However, courts have denied the election when made on an amended return (see *Burford Oil Co. and Titus Oil & Investment Co.*).

How do I make the election?

You can make the election simply by claiming the deduction on the return. Although an election statement is not required, we STRONGLY recommend attaching a statement to the return due to the importance of making the election in the year IDC is first paid or incurred.

Sample Election – Oil and Gas Well

ELECTION TO DEDUCT INTANGIBLE DRILLING COSTS ON OIL AND GAS WELLS

Taxpayer hereby elects, pursuant to IRC Sec. 263(c) and Reg. 1.612-4 to deduct all intangible drilling costs paid or incurred in the drilling and preparation of wells.

Sample Election – Geothermal Well

ELECTION TO DEDUCT INTANGIBLE DRILLING COSTS ON GEOTHERMAL WELLS

Taxpayer hereby elects, pursuant to IRC Sec. 263(c) and Reg. 1.612-5 to deduct all intangible drilling costs paid or incurred in the drilling and preparation of wells.

More Resources

For further guidance on tax considerations related to oil and gas investments, visit www.mrzllp.com to schedule a consultation with an oil and gas tax professional or call us at 713-955-1123.