

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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to: David U. Zamora, Petroleum Engineer, Houston Team 1832

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subject: Geological and Geophysical Expenditures

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

LEGEND

X =

Y =

A =

B =

C =

D =

ISSUE

Whether X may include in the calculation of gain or loss on the sale of mineral properties the remaining amortizable amount of geological and geophysical ("G&G")

expenses that X incurred in tax years after August 8, 2005, and that were subject to section 167(h) of the Internal Revenue Code.

### CONCLUSION

X may not include the remaining amount of the section 167(h) amortizable G&G expenses in the calculation of gain or loss on the disposition of the properties.

### FACTS

X is the common parent of a U.S. consolidated group, and is an indirect wholly owned subsidiary of Y, a foreign entity. X is a major integrated oil company within the meaning of section 167(h)(5)(B).

In Year D, X and its subsidiaries sold numerous domestic properties to unrelated third parties. X recognized gain on each of these sales. X calculated its gain amounts for the leasehold portion of the properties by subtracting the adjusted basis of the properties from the gross sales price. X derived the adjusted basis amounts in part from the remaining amount of depletable and amortizable costs for each property.

The amortizable costs consisted in part of intangible drilling and development costs that X had paid or incurred, and that were subject to the capitalization rules under sections 291(b) and 59(e). The amortizable costs also included G&G expenses, which had been paid or incurred in connection with the exploration and development of the properties. X capitalized these G&G expenses pursuant to section 167(h)(5). For G&G expenses incurred in Years A and B, X applied a five-year amortization period to recover the costs. For G&G expenses incurred in Years C through D, X applied a seven-year amortization period.

### LAW AND ANALYSIS

Section 167(h)(1) states that any geological and geophysical expenses that are paid or incurred in connection with the exploration for, or development of, oil or gas within the United States shall 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)(5) provides an extended amortization period for major integrated oil companies. In the case of a major integrated oil company, the deduction period is seven years instead of 24 months. For tax years after August 8, 2005, and prior to December 19, 2007, the amortization period was five years for major integrated oil companies.

Section 167(h)(4) discusses the treatment of remaining G&G expenses in the case of retirement or abandonment of the property. If property with respect to which G&G expenses are paid or incurred is retired or abandoned during the amortization period described in section 167(h)(1), no deduction shall be allowed on account of such

retirement or abandonment, and the amortization deduction shall continue with respect to such payment.

Treas. Reg. §1.167(a)-8(a) provides the rules for retirements of assets under section 167. Treas. Reg. §1.167(a)-8(a) defines the term "retirement" as the "permanent withdrawal of depreciable property from use in the trade or business or in the production of income," and offers several examples of how a withdrawal may be made. A withdrawal may occur by a taxpayer selling, exchanging, or actually abandoning the property. It also may occur by a taxpayer otherwise removing the property from productive use. The sales here are retirements within the meaning of Treas. Reg. §1.167-8(a) without disposing of the property.

X sold properties for which G&G expenses had been paid or incurred in connection with exploration or development of the properties. The sales constitute retirements. X may not immediately deduct the remaining amortizable G&G expenses that it paid or incurred in connection with the exploration or development of those properties. X also may not include the remaining amount as additional basis in its calculation of gain or loss on the sale of the properties. Sections 167(h)(1) and (4) make clear that the taxpayer must deduct the remaining amortizable G&G expenses in accordance with the original amortization schedule provided by sections 167(h)(1) and (5).

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