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subject: Section 199 treatment of proceeds from the sale of leasehold rights in natural gas properties

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

ISSUE

Whether Taxpayer's gross receipts derived from the sale of Leasehold Rights are domestic production gross receipts (DPGR) under § 199(c)(4)(A)(ii)?

CONCLUSION

Taxpayer's gross receipts derived from the sale of Leasehold Rights are not DPGR under § 199(c)(4)(A)(ii).

FACTS

Corporation X (Taxpayer) is an independent natural gas exploration and production company. During 2006, Taxpayer entered into an Oil, Gas, and Mineral Lease (Lease) with Individual Y. The terms of the Lease give Taxpayer certain rights. Taxpayer can enter Individual Y's land for a period of time to investigate, explore, prospect, drill for

unsevered oil, natural gas, and/or minerals. If Taxpayer finds oil, natural gas, and/or minerals on the land, then Taxpayer is entitled to the oil, natural gas, and/or mineral production (subject to an in-kind or cash equivalent royalty based on the amount of oil, natural gas, and/or mineral produced). Taxpayer may exercise an option to continue the Lease beyond the initial term. Additionally, Taxpayer may assign the Lease to another party. The above rights are considered Taxpayer's interest in the Lease and are collectively referred to as "Leasehold Rights."

Taxpayer bears all expenses associated with producing the oil, natural gas, and/or minerals, such as for oil and natural gas constructing a well (or wells), pipeline, and processing plant. In 2006, Taxpayer drilled a natural gas well on Individual Y's property. The well consisted of a borehole, the steel casing, and the well head (collectively the "Well"). There are various pipes to transfer the natural gas from the Well to measuring and separating equipment that Corporation X placed near the well head. Taxpayer expensed all of its intangible drilling and development costs (IDC) related to drilling the Well. The Well produced natural gas into 2009. For purposes of § 199, Taxpayer treated its share of the gross receipts derived from the sale of the produced natural gas as DPGR.

During 2009, Taxpayer sold its Leasehold Rights and the Well to Corporation Z (an unrelated corporation) for a lump sum. Taxpayer sold other property in this sale, but this advice does not address whether gross receipts from the sale of such other property are DPGR.

LAW AND ANALYSIS

Section 199

Under § 199(a), the domestic production activities deduction is determined by applying a percentage to the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income (determined without regard to the § 199 deduction). The applicable percentage is 3% for taxable years beginning in 2005 and 2006, 6% for taxable years beginning in 2007 through 2009, and 9% for taxable years beginning after 2009.

Under § 199(c)(1), QPAI is determined by taking DPGR for the taxable year less cost of goods sold (CGS) allocable to such DPGR, less other expenses, losses, or deductions, which are properly allocable to such DPGR.

Section 199(c)(4)(A)(ii) provides DPGR means the gross receipts of the taxpayer which are derived from, in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property performed in the United States by the taxpayer in the ordinary course of such trade or business.

Section 1.199-3(m)(1)(i) provides the term construction means activities and services

relating to the construction or erection of real property (as defined in § 1.199-3(m)(3)) in the United States by a taxpayer that, at the time the taxpayer constructs the real property, is engaged in a trade or business (but not necessarily its primary, or only, trade or business) that is considered construction for purposes of the North American Industry Classification System (NAICS) on a regular and ongoing basis. A trade or business that is considered construction under the NAICS means a construction activity under the two-digit NAICS code of 23 and any other construction activity in any other NAICS code provided the construction activity relates to the construction of real property such as NAICS code 213111 (drilling oil and gas wells) and 213112 (support activities for oil and gas operations). For purposes of § 1.199-3(m), the term construction project means the construction activities and services treated as the item under § 1.199-3(d)(2)(iii). Tangible personal property (for example, appliances, furniture, and fixtures) that is sold as part of a construction project is not considered real property for purposes of § 1.199-3(m)(1)(i). In determining whether property is real property, the fact that property is real property under local law is not controlling. Conversely, property may be real property for purposes of this § 1.199-3(m)(1)(i) even though under local law the property is considered tangible personal property.

Section 1.199-3(m)(2)(i) provides that activities constituting construction are activities performed in connection with a project to erect or substantially renovate real property, including activities performed by a general contractor or that constitute activities typically performed by a general contractor, for example, activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, and required job modifications.

Section 1.199-3(m)(2)(iii) provides that construction activities also include activities relating to drilling an oil or gas well and mining and include any activities the cost of which are IDC within the meaning of § 1.612-4 or development expenditures for a mine or natural deposit under § 616.

Section 1.199-3(m)(3) defines real property to mean buildings (items that are structural components of buildings), inherently permanent structures (as defined in § 1.263A-8(c)(3)) other than machinery (as defined in § 1.263A-8(c)(4)) (including items that are structural components of inherently permanent structures), inherently permanent land improvements, oil and gas wells, and infrastructure.

Section 1.199-3(m)(6)(i) provides assuming all requirements of § 1.199-3(m) are met, DPGR derived from the construction of real property performed in the United States includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the United States (whether or not the property is sold immediately after construction is completed and whether or not the construction project is completed). DPGR derived from the construction of real property includes compensation for the performance of construction services by the taxpayer in the United States. DPGR derived from the construction of real property includes gross receipts derived from materials and supplies consumed in the construction project or that

become part of the constructed real property, assuming all requirements of § 1.199-3(m) are met.

Section 1.199-3(m)(6)(iii) provides that DPGR from the construction of real property does not include, except as provided in § 1.199-3(m)(2)(iii), gross receipts derived from the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized to the land).

Section 1.199-8(i)(1) provides that § 1.199-3 is applicable for taxable years beginning on or after June 1, 2006.

IDC under § 1.612-4

Section 263(a) provides that no deduction is allowed for capital expenditures. However, notwithstanding the provisions of § 263(a), § 263(c) allows a taxpayer an election, under regulations prescribed by the Secretary, to deduct IDC. Those regulations are set forth in § 1.612-4.

Section 1.612-4(a) provides that IDC incurred by an operator in the development of oil and gas properties may at his option be chargeable to capital or to expense. If the taxpayer chooses to expense IDC, the taxpayer also has an option to elect to amortize the IDC over 60 months. Section 59(e).

Under § 1.612-4(a), IDC are expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of IDC are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used: (1) In the drilling, shooting, and cleaning of wells, (2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and (3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

Section 1.612-4(b)(1) provides that the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion. However, amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the premises of derricks and other physical structures are considered to be represented by physical property.

Under § 1.612-4(d), a taxpayer may exercise the election to expense IDC by claiming IDC as a deduction on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs such costs. No formal statement is necessary, but if the taxpayer fails to deduct the IDC, the taxpayer is deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property and through depreciation to the extent that they are represented by physical property. Once an election is made, the taxpayer is bound by such election in future years.

In your request, you asked our Office whether Taxpayer's gross receipts derived from the sale of the Leasehold Rights are DPGR. Your request agrees that Taxpayer's gross receipts attributable to the sale of the Well qualify as DPGR. Section 199(c)(4)(A)(ii) provides DPGR means the gross receipts of the taxpayer which are derived from, in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property performed in the United States by the taxpayer in the ordinary course of such trade or business. Taxpayer constructed the Well in the ordinary course of its business, the Well is considered real property under § 1.199-3(m)(3), and Taxpayer meets the other requirements of § 199.¹ Thus, Taxpayer's gross receipts from the sale of the Well are DPGR.²

However, you question whether the gross receipts derived from Taxpayer's sale of the Leasehold Rights qualify as DPGR. Our Office concludes that the gross receipts from the sale of the Leasehold Rights do not qualify as DPGR.

The Leasehold Rights are not part of the real property that Taxpayer constructed (i.e. the Well). Among the requirements of § 199(c)(4)(A)(ii), for gross receipts to qualify as derived from the construction of real property, a taxpayer must construct property, and that property must be real property. Taxpayer did not construct the Leasehold Rights. The Leasehold Rights that Taxpayer sold to Corporation Z are the same Leasehold Rights that Taxpayer acquired by entering into the Lease with Individual Y. The costs of acquiring the Leasehold Rights are not IDC under § 1.612-4, and thus are not part of Taxpayer's construction activities with respect to the Well under § 1.199-3(m)(2)(iii). Taxpayer's construction of the Well does not transform the Leasehold Rights into real property constructed by the Taxpayer.

Our Office also notes that any gross receipts attributable to unsevered oil, natural gas, and minerals relate to the Leasehold Rights, and not to the Well. The Leasehold Rights

1. Although it was not a fact provided in the advice request, our Office assumes that Taxpayer's activities with respect to the Well are considered construction for purposes of NAICS as required by § 1.199-3(m)(1)(i).

2. Taxpayer's gross receipts derived from the sale of the Well should include any gross receipts that are derived from activities constituting construction activities for purposes of § 199. These activities include activities relating to drilling an oil or gas well and include any activities the cost of which are IDC within the meaning of § 1.612-4 or development expenditures for a mine or natural deposit under § 616 as provided in § 1.199-3(m)(2)(iii).

give Taxpayer (and now Corporation Z) permission to produce, and ownership rights in, the oil, natural gas, and/or minerals. The Well only provides the means to produce the unsevered natural gas, not any production or ownership rights in the natural gas. Under § 199(c)(4)(A)(i)(III), a qualifying disposition of natural gas only occurs after a taxpayer produces natural gas.

Our Office notes that if Taxpayer did not expense its IDC, then some of Taxpayer's basis in the Lease (and therefore the Leasehold Rights) may be attributable to IDC of the constructed Well. For example, if a taxpayer does not elect to expense IDC, then that taxpayer may charge the costs (that are not represented by physical property) to its lease, and recover the costs through depletion upon production of oil or gas. Therefore, a taxpayer's adjusted basis in its lease, for purposes of calculating gain or loss upon disposition, may include IDC that were capitalized by the taxpayer and not yet recovered through depletion. If Taxpayer capitalized IDC to the basis in its Lease, then those amounts should be considered costs related to the construction of the Well, and an amount of the gross receipts derived from the sale allocable to the capitalized IDC qualifies as DPGR. However, the DPGR amount should not exceed the amount of capitalized IDC.

Your advice also seeks clarification on whether § 1.263A-8(c)(2) is relevant for determining what real property Taxpayer constructed under § 199(c)(4)(A)(ii). Section 1.263A-8(c)(1) defines real property in general to include land, unsevered natural products of land, buildings, and inherently permanent structures. Section 1.263A-8(c)(2) provides that unsevered natural products of land include mines, wells, and other natural deposits. Taxpayer's sale occurred in 2009 so § 1.199-3(m) is applicable. Section 1.199-3(m)(3) defines real property and includes buildings, oil and gas wells, and references § 1.263A-8(c)(3) (inherently permanent structures) and § 1.263A-8(c)(4) (machinery for exclusion purposes), but does not cross reference § 1.263A-8(c)(1) or (2). This is because § 1.199-3(m) describes "construction of real property," and so § 1.199-3(m)(3) describes real property that can be constructed, and includes oil and gas wells without reference to § 1.263A-8(c)(2). Our Office concludes that Taxpayer's Well is separate from the unsevered oil, natural gas, and minerals under § 199(c)(4)(A)(ii). The construction of a Well does not transform the unsevered oil, natural gas, and minerals into real property constructed by the Taxpayer. Therefore, § 1.263A-8(c)(2) is not relevant in determining the real property Taxpayer constructed under § 199(c)(4)(A)(ii).

Based on this analysis our Office concludes that Taxpayer's gross receipts derived from the sale of the Leasehold Rights are not DPGR under § 199(c)(4)(A)(ii).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Our Office does not believe that there are significant hazards with respect to the conclusion that the Leasehold Rights are not part of the real property that Taxpayer constructed in the ordinary course of its business. While Leasehold Rights may be

considered real property, which some taxpayers have argued means that gross receipts from the sale should qualify as DPGR, it is clear under the facts provided that the Leasehold Rights were not constructed by Taxpayer.

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 James Holmes at (202) 622-3040 if you have any further questions.