APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE SETTLEMENT GUIDELINES

INDUSTRY: Petroleum

ISSUE: North Sea IDC Transition Rule

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NORTH SEA IDC TRANSITION RULE

ISSUE

Whether the taxpayer's Intangible Drilling & Development Costs (IDC) qualify for the exception provided by the Transition Rule [Section 411(c)(2) of the Tax Reform Act of 1986 (TRA 1986)] to the Internal Revenue Code Section 263(i) requirement that IDC incurred outside of the United States be entirely capitalized. Examination Division's Coordinated Issue Paper (CIP) addresses three subparts of this issue:

1. When is a minority interest in a license for development acquired for purposes of the North Sea IDC Transition Rule?
2. What is the meaning of "minority interest" as used in the North Sea IDC Transition Rule?
3. Does the transition rule override the amendments to IRC Section 291(b) of the Internal Revenue Code made by the 1986 Tax Reform Act; so that the change from mandatory capitalization of 20% of IDC, and amortization over 36 months following date incurred, to capitalization of 30% of IDC, with amortization over 60 months following date incurred, would not apply to foreign IDC described in the transition rule?

EXAMINATION DIVISION POSITION

1. The transition rule requires that a United States company "acquire" a minority interest in a North Sea development license on or before December 31, 1985. A minority interest in a United Kingdom (UK) North Sea "license," is established under a Joint Operating Agreement (JOA) by the tenants-in-common. That status as tenants-in-common arises upon issuance of the license for development. Accordingly, for a minority interest to be "acquired," the licensees must have (i) received their license for development and (ii) already entered into a JOA.

2. The term "minority interest" used in the transition rule refers to an interest that is less than 50% of the tenancy-in-common interests in the license for development.

3. The transition rule overrides the amendments to IRC Section 291(b) made by the TRA. Any company meeting the transition rule may continue to capitalize 20% of its qualifying foreign IDC and amortizing that capitalized over the 36 months following the date incurred or paid.

INDUSTRY/TAXPAYER POSITION

For Items 2 and 3 above, the Internal Revenue Service has generally taken a taxpayer-favorable position; therefore, little controversy has arisen or is expected with regard to those two aspects of deductions claimed for Transition Period North Sea IDC. With regard to item 1, part or all of the industry has concluded that a bare interest in the license issued by the United Kingdom to "bore for & get petroleum," held as of 12/31/85, is sufficient to qualify all subsequent IDC for treatment pursuant to the Transition Rule. This is to be contrasted with Examination's conclusion that the Joint Operating Agreement must have been in effect before such expenditures qualify for the favored treatment.

DISCUSSION

Legal Chronology

Prior to the 1982 tax act (TEFRA), IDC was fully deductible in the year paid or incurred; IRC Section 263(c), Treas. Reg. 1.263(c) and Treas. Reg. 1.612-4. This full deductibility was reduced by TEFRA and again by the Tax Reform Act of 1984 so that just prior to TRA 1986, 80% of IDC was deductible in the year paid or incurred, and 20% of IDC was to be capitalized and amortized over the 36 months following the date paid or incurred; IRC Section 291(b). TRA 1986 modified IRC Section 291(b) such that 70% of IDC would now be deductible in the year paid or incurred, and 30% of IDC incurred would be capitalized and amortized over the 60 months following the date paid or incurred.

Prior to TRA 1986, IDC incurred outside the United States was treated the same as IDC incurred domestically. TRA 1986 added IRC 263(i) – "SPECIAL RULES FOR INTANGIBLE DRILLING AND DEVELOPMENT COSTS INCURRED OUTSIDE THE UNITED STATES." Specifically, Section 263(i)(1) states that Section 263(c) does not apply to IDC incurred outside the United States, and Section 263(i)(2) provides the two alternative tax treatments available for foreign IDC: 1. Capitalization and recovery through cost depletion; or, 2. Capitalization and recovery through amortization over 10 taxable years, beginning with the taxable year in which the IDC was incurred. In short, capitalization and deferred cost recovery became required for all foreign-incurred IDC after 1986. An exception was provided for certain foreign IDC:

> TRA 1986, Section 411(c)(2), TRANSITION RULE.—The amendments made by this section shall not apply with respect to intangible drilling and development costs incurred by United States companies pursuant to a minority interest in a license for Netherlands or United Kingdom North Sea development if such interest was acquired on or before December 31, 1985.

So, the point of the Issue is clear: if the North Sea IDC qualifies pursuant to the Transition Rule, the capitalization generally required for Foreign IDC does not apply and much earlier deduction is allowable.

Political Origin & Economic Rationale

Apparently in anticipation of expected changes to the deductibility of foreign IDC (IRC 263(i)) to be effected by TRA 1986, a Louisiana constituent contacted Senator Russell Long (Senate Finance Committee) and argued that the proposed changes would retroactively, and adversely, impact economic decisions made years earlier and to which the constituent was committed. The constituent suggested, and actually wrote, a Transition Rule which would grandfather IDC incurred by U.S. companies in the North Sea petroleum areas, providing essentially the same deductibility for such IDC as was available on the date that the commitment to incur such IDC was made. Since the grandfather objective was meant to apply only to those companies who had already made such commitment and who could not control the expenditures, the Transition Rule was made available only to those who held a "minority interest" in a "license for . . .development" which was "acquired on or before December 31, 1985." [All of the above is public information: see <u>Oilgram News</u>, April 10, 1986 @ p.5 and the Congressional Record, among others.] The clear purpose of the Transition Rule seems reasonable: investment decisions, and concurrent investment commitments, should be given a stable tax environment in which to play out when the taxpayer cannot control expenditures pursuant to those commitments.

In all likelihood, the authors of the Transition Rule believed the language of the Rule to be clear and expected it to be applied in the generally understood meaning of the terms. Close analysis, however, reveals numerous ambiguities and the possibility of numerous interpretations. Something so seemingly simplistic as "minority interest" is susceptible to several definitions: Is such an interest "less than 50%," or "50% or less?" Does the absence of legal control equate to "minority interest" or is it the absence of effective control? When the language of a statute is ambiguous, courts have looked to legislative history to determine congressional intent. In this instance, however, there is no legislative history, in the formal sense of committee reports, the Blue Book or floor debates, which clarifies or supplements the Transition Rule itself. The contemporaneous news releases noted above provide considerable insight into the point of the whole thing, but do not carry great weight in the event of litigation.

Problem Statement Repeated

1. What is a "license for . . . North Sea development?" Whose laws (U.S. or foreign) are to be applied in determining what such a license is and when it comes into existence?
2. How is it determined when the minority interest or the license is acquired? Is it possible that these may be acquired on different dates? Again, whose laws are to be applied?
3. What is the correct interpretation of a minority interest? Is it necessary that the U.S. company have direct ownership of the minority interest <u>and</u> the license or may ownership be indirect through a foreign subsidiary?
4. How long is a Transition? That is, if all other factors were in place at December 31, 1985, is it intended that the Transition Rule apply to all IDC expenditures incurred pursuant to all drilling efforts until expiration of the license? Or was the Transition period relief intended to apply only to

expenditures committed to be incurred within some reasonable Return-on- Investment computation period?

5. Examination Division has concluded that, if the Transition Rule applies, it overrides all amendments to IRC 291(b) made by TRA 1986. That is, if the Transition Rule applies, IDC will be 80% currently deductible and the remaining 20% to be capitalized and amortized over the following 36 months. Since this is a conclusion favorable to taxpayers, no further discussion will be included in these Guidelines.

LICENSE FOR . . . NORTH SEA DEVELOPMENT, ACQUIRED BEFORE 12/31/85

Treas. Reg. 1.612-4(a) requires that, to be entitled to a deduction for IDC, the taxpayer must have a working interest in the petroleum deposit for which such IDC is being claimed. See Owen, TC Memo. 1990-172 (1990); Stradlings Building Materials, Inc., 76 TC 84 (1981) and cases cited therein. The controversy upon which the Examination CIP centers is the determination of how and at what time-point a "license", as contemplated by the Transition Rule, should be considered the equivalent of an operating interest. The Transition Rule uses the term "license for development"; however, the UK does not issue licenses for development. It only issues licenses for exploration and for production, and development is included within the production license provided certain conditions are met. Since the Transition Rule failed to incorporate the language of any UK or Dutch law or practice into the law (or, as noted above, any legislative history), an extensive discussion of that law & practice and comparison with U.S. law & practice is required. Later in these Guidelines, "Arguments", the underlying premise of the Examination CIP, that "interest in a license for development" at 12/31/85 must be a "working interest in a license for development" at 12/31/85, will also be discussed.

The United Kingdom Offshore Petroleum Licensing Regime

The UK continental shelf is licensed by the Department of Trade & Industry (DTI, formerly known as the State Department of Energy) for purposes of exploration & production. The UK continental shelf is split into over 200 quadrants which are divided into 30 blocks of approximately 250 square kilometers. Offshore production licenses have been generally awarded using a discretionary system; that is, licensees are selected at the discretion of the licensing authorities. The invitation for applications in a license Round is announced by a notice in the *London Gazette*, which lists the blocks on offer and indicates application procedures. The fourth round (1971/72) of licensing experimented with the U.S. system of competitive bids for licenses, but with only moderate success. Subsequent rounds, there have now been 15 or 16 rounds, reverted to mostly the discretionary system.

The timeline for a licensing round is approximately as follows: the DTI makes a preliminary announcement outlining the areas likely to be included in the round. This is followed approximately three months later by the formal announcement in the *Gazette* noted above. Companies then have about six to eight months to assemble joint venture groupings, assess the quality of the blocks on offer, and put together detailed applications. The DTI reviews the applications and awards production licenses. Placement of the licenses is based upon the applicant's qualifications: technical competence, financial ability to undertake the project, the projections submitted with the application, and other factors such as may be applicable.

There are two types of offshore licenses. An exploration license lasts for three years with an option to extend for an additional three years and permits only initial exploratory work such as seismic survey and very shallow drilling. Essentially all UK petroleum companies hold a single generic exploration license. Such a license entitles the holder to explore, to the extent noted, on any unlicensed acreage, subject to UK governmental approval. It is non-exclusive in the sense that any other holder of such a license may explore the same acreage.

Production licenses, those awarded in the licensing rounds, are much more significant, entitling the holder to exclusive right to "search for and bore for and get petroleum . . ." in the area for which granted. The Regulations pursuant to which production licenses are issued provide for an initial term of six years, at the end of which up to half of the licensed area has to be surrendered. The license may then be extended for a second term of twelve years; and, if development has then commenced [it would be rare if it hadn't], for an additional period of eighteen years; further extensions are possible. The production license gives the licensee the right to "search for, and bore for, and get petroleum . . ." in the licensed offshore area. The Regulations also include Model Clauses, which are incorporated into and form a part of the license and deal with most aspects of the exploration/production process: the right to "search for, bore for, and get"; the term of the license and provision for surrender; payments, including royalties; accounting for production & sales; work obligations (including timelines); restrictions on the assignment of license rights; and, essentially, all aspects of the business interactions between the owner of minerals and those who would exploit those minerals. As can be observed, and because the owner of the mineral interest is a government, the licenses contain features of both regulatory law and contract law.

Petroleum exploration & development projects in the North Sea are usually carried out by consortia, usually in the form of joint ventures; though some of the major petroleum companies undertake projects on their own. Presumably, this results because of the large capital outlay initially required before any revenue returns. At the time a licensing round is announced, interested parties will generally put together a Joint Bidding Agreement and apply for (bid on) the tract in which they have a mutual interest. If successful in the receipt of a production license on one or more tracts, this same alliance will generally join together in a Joint Operating Agreement (JOA) to explore, develop & produce petroleum from that tract, subject to the restrictions of the license. The JOA is the instrument which defines the rights & obligations among the parties; to that point, only the obligations between the parties & the UK government had been defined, by the licenses. The JOA is the first point at which percentages of ownership are defined. The production license is issued jointly to all parties on the application; the JOA severs the undefined joint ownership and creates a tenancy-in-common in the percentages specified.

Having received a production license and joined in a Joint Operating Agreement, the joint venture writes a proposed development plan for the tract and submits it to the governmental authority. [This development plan, filed with the State Department of Energy, is often called "Annex B" in common usage. The terms "Annex A" & "Annex B" originated in the procedures developed by the Department in 1976 as part of the implementation of model clauses 14 & 15 for the early North Sea fields then in development.] Approval for the development plan may require a period of three-to-six months. No evidence is available which would indicate that a development plan has ever been rejected and the production license withdrawn. Revisions, additions, changes may sometimes be required before approval by DTI, but, historically, no licensee(s) has had its license revoked once awarded. Each participant, of course, has its own financial needs & reserves. As a result, it is not certain that each party will participate in all wells drilled in the tract defined by a particular license, though that is generally the case.

NOTE: The above information has been gleaned from: Daintith, Terence and Willoughby, Geoffrey; United Kingdom Oil and Gas Law, Part 1, Chapters 2, 5, 6 & 7, 1984 Edition with 1988 & 1989 Updates, Publisher: Sweet & Maxwell, London. And: Bland, David; UK Oil Taxation, Chapter 4, 1991 Edition, Publisher: Longman, London. And: Development of the Oil and Gas Resources of the United Kingdom, UK Department of Energy Publication, 1984 & 1991 Editions, HMSO Publications, London.

Contrasted with U.S. Offshore Petroleum Licensing

The Examination CIP provides its interpretation of the U.S. licensing regime:

> The term "license" has been defined as an authorization that grants permission or authority to carry out an activity; see Federal Land Bank of Wichita v. Kiowa County, 368 U.S. 146, 154 n.23 (1961). Thus a license granting an operating interest may be viewed as a form of contract permitting the election to deduct IDC under section 1.612-4(a). However, the license referred to by the transition rule is a license for development, not a license to grant an operating interest (e.g. a leasehold). The transition rule looks to who has permission to develop the lease, not to who is required to pay the development costs. What emerges from this analysis is a distinction between a license and a related operating interest in a lease, since a license interest holder would still not be eligible to deduct IDC if no operating interest existed.
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> A distinction exists in U.S. law between a lease and a license for development. This distinction is made in both the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C.A. 1331 (1986) and in the Coastal Zone Management Act, 16 U.S.C. 1453 (13) (1985). Under OCSLA, a multiple step regime is imposed consisting of four distinct stages of development of an offshore oil well as follows: (1) formulation of a five year leasing plan by the Department of the Interior; (2) lease sales; (3) exploration of the lease; and (4) development and production. Under stage (2), a lessee must submit preliminary exploration, development and production plans for approval. If those plans are not approved, no further activity in the nature of development or production is permitted. Under stages (3) and (4), the lessee must submit for approval separate plans for exploration and for

development and production; see Secretary of the Interior v. California, 464 U.S. 310 (1984). A significant pair of quotations emerges from that decision:

> "Since 1978, the sale of a lease has been...carefully separated from the issuance of a federal license or permit to explore for, develop or produce gas or oil on the OCS." [464 U.S. at 336 (1984)].
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> "[T]he purchase of an OCS lease, standing alone, entails no right to explore for, develop, or produce oil and gas resources on the OCS." [464 U.S. 340 (1984)].

See also Village of False Pass v. Clark, 733 F.2d 605, 608-09 (9th Cir. 1984).

Finally, the Supreme Court concluded that although the distinction between a lease and a license seemed "exceedingly fine", it was a distinction that Congress had codified "with great care". 464 U.S. at 335-336 (1984).

It is clear that some of the above is interpretative, rather than legal fact. As the Examination CIP states, a comparison of the two licensing and legal frameworks will be required.

Argument.

There appears to be two lines of analysis, often intertwined, within the Examination CIP. The first examines the rights, obligations and authorization of the Production Licenses issued by the UK governing body. That analysis concludes that such License does not confer, standing alone, the right to "develop" the licensed acreage; at least not absent additional licensee action & governmental approval. Furthermore, the CIP states:

> The term "license for development" used in the transition rule refers to a specific governmental authorization to begin development. Accordingly, to be eligible for transition rule relief, a taxpayer must have obtained a specific developmental authorization from the governmental agency which has jurisdiction over the North Sea Area. This authorization must be obtained on or before the December 31, 1985, cutoff date.

Secondly, and underpinning the CIP conclusion just stated, is the conclusion that the term "license for development" as used in the Transition Rule requires that the licensee be in the position to deduct IDC (on the acreage in question) at 12/31/85; i.e., that it have a working interest in the acreage at that time:

> The transition rule applies to IDC expenses under Section 263(c) and Regulation 1.612-4. Regulation 1.612-4(a) generally provides that IDC may be deducted by an operator who holds a working or operating interest in any tract of land either as a fee owner or under a lease or any other form of contract granting working or operating rights. The existence of a working or operating interest implies the existence of an interest burdened by the costs of development. . . .The approval of the development plan must have been obtained on or before the cutoff date. . . .

Response to these conclusions need not be complex nor complicated:

1. There is nothing in the Transition Rule defining development, nor any real authority for the proposition that “license for development” equates to “working interest.” The CIP reaches that conclusion only through analysis & analogy.

2. If the license has been acquired before 12/31/85, there is no requirement that the licensee be in a position to deduct IDC at 12/31/85. The only license available is a production license, not exactly the same as is received in the U.S. licensing/leasing scheme of things, but the only license available. “It is therefore useful to be guided by comparison to the U.S. government's licensing regime for offshore areas in the outer continental shelf (OCS),” as the CIP states. Such comparison, however, is inexact.

The lack of adequate legislative history has led to some fastidious parsing of the Transition Rule itself. Is “development” intended as a prepositional phrase to modify “license” and thereby narrow the meaning thereof, or is it simply intended to identify a geographic location, as in “North Sea development?” Examination’s CIP asserts:

> Given the established distinction between a lease and license in U.S. law, it is reasonable to conclude that Congress had that distinction in mind in adopting the transition rule, . . .In this light, the "license for development" required by the rule can only be identified with the specific authorization of the U.K. to develop a given area. . . .

That’s possible, but it’s just as likely that Congress had in mind the acquisition of whatever license was necessary to begin development of whatever acreage had been awarded. One conclusion seems no more likely than the other, or that Congress gave any great thought to the wording at all. There is no dispute that, in the UK North Sea petroleum area, a licensee can have a minority interest in a production license without having a working interest (as defined for IRC §612). Clearly, there is uncertainty and there are litigating hazards in the position that the Examination CIP has taken on this issue.

MINORITY INTEREST

The transition rule requires that the U.S. company hold a minority interest in the license for development, but does not define minority interest. When a statute does not define a term, Congress is assumed to have used the common meaning of the word. Dictionary definitions describe “minority interest” based on the concept of inability to control the management of the venture, as in the determination of what IDC will be incurred and when. In general, we might assume that any voting interest in the venture of less than 50% would constitute a minority interest, and this is the conclusion reached in Examination’s CIP. This is not absolutely certain. What constitutes a “minority interest” in the sense of a “non-controlling interest” may be different in one context than in another. For example, in the Internal Revenue Code, Subchapter C, “minority interest” is defined as 20% or less for some purposes. In our case, the joint operating agreement for a particular lease might require more a simple majority (more than 50%) to adopt a development plan. With the possibility of such an agreement, “minority interest” is less clearly defined and the outcome of this issue will depend on the facts of the situation.

TRANSITION PERIOD

The header for TRA 1986, Section 411(c)(2), reads TRANSITION RULE. The preferred dictionary definition for "transition" is "a passage from one state, stage, subject or place to another." So, it is clear that Congress did not intend that U.S. companies receive favorable treatment for IDC incurred in North Sea development forever, just through a "transition period." As noted above, the Transition Rule was intended to alleviate the adverse economic impact of investment decisions made when different tax results were factored into the investment computations. As also noted earlier, the objective was to provide essentially the same deductibility for IDC incurred in North Sea development as was available on the date that a commitment to incur such IDC was made. The grandfather objective was meant to apply only to those companies who had already made such commitment and who could not control the expenditures.

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Question: How long is a transition period, in this case?
Answer: Long enough to give the taxpayer the benefit of the tax law in effect at the time the commitment to incur IDC was entered into, to the extent that such tax law impacted the investment computations and, therefore, the willingness to commit funds to the project.

There are at least three reasons that the Transition Rule, Section 411(c)(2) of TRA 1986, should have greater application to the years immediately following passage than to later years:

1. The intuitive feeling that a Transition Rule is meant to bridge a <u>reasonable</u> period between the old law and the new;
2. The great likelihood that any participant actually committed to a drilling program will not waste time moving from drilling wells to production: first, because it takes production to produce revenue; and, secondly, because the license required progress to be retained; and,
3. The time value of money as used in the investment computations upon which the IDC commitments are supposed to be predicated.

To illustrate #3, at a 25% return-on-investment expectation (not an unreasonable requirement for something so risky as mineral exploration), $1.00 projected to be received (or spent) more than 10 years hence is worth less than 10 cents today. One can experiment with various rates-of-return and time-distances, but it seems evident that amounts to be spent much longer than 8-to-10 years after 1985 probably didn't enter into IDC investment decisions made before 1986. The point of #2 is that those companies involved in & committed to drilling programs when the Transition Rule was enacted will, in all likelihood, have completed such programs and incurred most or all IDC to which they were committed as of 12/31/85; i.e., the Transition Rule will have served its purpose.

SETTLEMENT GUIDELINES

IDC must meet four criteria to fall within the Transition Rule. It must have been incurred (i) by a United States company, (ii) pursuant to a minority interest, (iii) in a license for Netherlands or U.K. North Sea development, (iv) where the minority interest was acquired on or before December 31, 1985. With the undefined, or poorly defined, terms and the paltry legislative history, it is obvious that there will be hazards in the event of litigation of this issue, for both government & taxpayer.

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