

§ 1.43-4 Qualified enhanced oil recovery costs.

(a) *Qualifying costs*—(1) *In general.* Except as provided in paragraph (e) of this section, amounts paid or incurred in any taxable year beginning after December 31, 1990, that are qualified tertiary injectant expenses (as described in paragraph (b)(1) of this section), intangible drilling and development costs (as described in paragraph (b)(2) of this section), and tangible property costs (as described in paragraph (b)(3) of this section) are “qualified enhanced oil recovery costs” if the amounts are paid or incurred with respect to an asset which is used for the primary purpose (as described in paragraph (c) of this section) of implementing an enhanced oil recovery project. Any amount paid or incurred in any taxable year beginning before January 1, 1991, in connection with an enhanced oil recovery project is not a qualified enhanced oil recovery cost.

(2) *Costs paid or incurred for an asset which is used to implement more than one qualified enhanced oil recovery project or for other activities.* Any cost paid or incurred during the taxable year for an asset which is used to implement more than one qualified enhanced oil recovery project is allocated among the projects in determining the qualified enhanced oil recovery costs for each qualified project for the taxable year. Similarly, any cost paid or incurred during the taxable year for an asset which is used to implement a qualified enhanced oil recovery project and which is also used for other activities (for example, an enhanced oil recovery project that is not a qualified enhanced oil recovery project) is allocated among the qualified enhanced oil recovery project and the other activities to determine the qualified enhanced oil recovery costs for the taxable year. See § 1.613-5(a). Any cost paid or incurred for an asset which is used to implement a qualified enhanced oil recovery project and which is also used for other activities is not required to be allocated under this paragraph (a)(2) if the use of the property for nonqualifying activities is *de minimis* (e.g., not greater than 10%). Costs are allocated under this paragraph (a)(2) only if the asset with respect to which the costs are

paid or incurred is used for the primary purpose of implementing an enhanced oil recovery project. See paragraph (c) of this section. Any reasonable allocation method may be used. A method that allocates costs based on the anticipated use in a project or activity is a reasonable method.

(b) *Costs defined*—(1) *Qualified tertiary injectant expenses.* For purposes of this section, “qualified tertiary injectant expenses” means any costs that are paid or incurred in connection with a qualified enhanced oil recovery project and that are deductible under section 193 for the taxable year. See section 193 and § 1.193-1. Qualified tertiary injectant expenses are taken into account in determining the credit with respect to the taxable year in which the tertiary injectant expenses are deductible under section 193.

(2) *Intangible drilling and development costs.* For purposes of this section, “intangible drilling and development costs” means any intangible drilling and development costs that are paid or incurred in connection with a qualified enhanced oil recovery project and for which the taxpayer may make an election under section 263(c) for the taxable year. Intangible drilling and development costs are taken into account in determining the credit with respect to the taxable year in which the taxpayer may deduct the intangible drilling and development costs under section 263(c). For purposes of this paragraph (b)(2), the amount of the intangible drilling and development costs for which an integrated oil company may make an election under section 263(c) is determined without regard to section 291(b).

(3) *Tangible property costs*—(i) *In general.* For purposes of this section, “tangible property costs” means an amount paid or incurred during a taxable year for tangible property that is an integral part of a qualified enhanced oil recovery project and that is depreciable or amortizable under chapter 1. An amount paid or incurred for tangible property is taken into account in determining the credit with respect to the taxable year in which the cost is paid or incurred.

(ii) *Integral part.* For purposes of this paragraph (b), tangible property is an integral part of a qualified enhanced

oil recovery project if the property is used directly in the project and is essential to the completeness of the project. All the facts and circumstances determine whether tangible property is used directly in a qualified enhanced oil recovery project and is essential to the completeness of the project. Generally, property used to acquire or produce the tertiary injectant or property used to transport the tertiary injectant to a project site is property that is an integral part of the project.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b). Assume for each of these examples that the qualified enhanced oil recovery costs are paid or incurred with respect to an asset which is used for the primary purpose of implementing an enhanced oil recovery project.

Example 1. Qualified costs—in general. (i) In 1992, X, a corporation, acquires an operating mineral interest in a property and undertakes a cyclic steam enhanced oil recovery project with respect to the property. X pays a fee to acquire a permit to drill and hires a contractor to drill six wells. As part of the project implementation, X constructs a building to serve as an office on the property and purchases equipment, including downhole equipment (e.g., casing, tubing, packers, and sucker rods), pumping units, a steam generator, and equipment to remove gas and water from the oil after it is produced. X constructs roads to transport the equipment to the wellsites and incurs costs for clearing and draining the ground in preparation for the drilling of the wells. X purchases cars and trucks to provide transportation for monitoring the wellsites. In addition, X contracts with Y for the delivery of water to produce steam to be injected in connection with the cyclic steam project, and purchases storage tanks to store the water.

(ii) The leasehold acquisition costs are not qualified enhanced oil recovery costs. However, the costs of the permit to drill are intangible drilling and development costs that are qualified costs. The costs associated with hiring the contractor to drill, constructing roads, and clearing and draining the ground are intangible drilling and development costs that are qualified enhanced oil recovery costs. The downhole equipment, the pumping units, the steam generator, and the equipment to remove the gas and water from the oil after it is produced are used directly in the project and are essential to the completeness of the project. Therefore, this equipment is an integral part of the project

and the costs of the equipment are qualified enhanced oil recovery costs. Although the building that X constructs as an office and the cars and trucks X purchases to provide transportation for monitoring the wellsites are used directly in the project, they are not essential to the completeness of the project. Therefore, the building and the cars and trucks are not an integral part of the project and their costs are not qualified enhanced oil recovery costs. The cost of the water X purchases from Y is a tertiary injectant expense that is a qualified enhanced oil recovery cost. The storage tanks X acquires to store the water are required to provide a proximate source of water for the production of steam. Therefore, the water storage tank are an integral part of the project and the costs of the water storage tanks are qualified enhanced oil recovery costs.

Example 2. Diluent storage tanks. In 1992, A, the owner of an operating mineral interest, undertakes a qualified enhanced oil recovery project with respect to the property. A acquires diluent to be used in connection with the project. A stores the diluent in a storage tank that A acquires for that purpose. The storage tank provides a proximate source of diluent to be used in the tertiary recovery method. Therefore, the storage tank is used directly in the project and is essential to the completeness of the project. Accordingly, the storage tanks is an integral part of the project and the cost of the storage tank is a qualified enhanced oil recovery cost.

Example 3. Oil storage tanks. In 1992, Z, a corporation and the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. Z acquires storage tanks that Z will use solely to store the crude oil that is produced from the enhanced oil recovery project. The storage tanks are not used directly in the project and are not essential to the completeness of the project. Therefore, the storage tanks are not an integral part of the enhanced oil recovery project and the costs of the storage tanks are not qualified enhanced oil recovery costs.

Example 4. Oil refinery. B, the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. Located on B's property is an oil refinery where B will refine the crude oil produced from the project. The refinery is not used directly in the project and is not essential to the completeness of the project. Therefore, the refinery is not an integral part of the enhanced oil recovery project.

Example 5. Gas processing plant. C, the owner of an operating mineral interest in a property, undertakes a qualified enhanced oil recovery project with respect to the property. A gas processing plant where C will

process gas produced in the project is located on C's property. The gas processing plant is not used directly in the project and is not essential to the completeness of the project. Therefore, the gas processing plant is not an integral part of the enhanced oil recovery project.

Example 6. Gas processing equipment. The facts are the same as in *Example 5* except that C uses a portion of the gas processing plant to separate and recycle the tertiary injectant. The gas processing equipment used to separate and recycle the tertiary injectant is used directly in the project and is essential to the completeness of the project. Therefore, the gas processing equipment used to separate and recycle the tertiary injectant is an integral part of the enhanced oil recovery project and the costs of this equipment are qualified enhanced oil recovery costs.

Example 7. Steam generator costs allocated. In 1988, D, the owner of an operating mineral interest in a property, undertook a steam drive project with respect to the property. In 1992, D decides to undertake a steam drive project with respect to reservoir volume that was substantially unaffected by the 1988 project. The 1992 project is a significant expansion that is a qualified enhanced oil recovery project. D purchases a new steam generator with sufficient capacity to provide steam for both the 1988 project and the 1992 project. The steam generator is used directly in the 1992 project and is essential to the completeness of the 1992 project. Accordingly, the steam generator is an integral part of the 1992 project. Because the steam generator is also used to provide steam for the 1988 project, D must allocate the cost of the steam generator to the 1988 project and the 1992 project. Only the portion of the cost of the steam generator that is allocable to the 1992 project is a qualified enhanced oil recovery cost.

Example 8. Carbon dioxide pipeline. In 1992, E, the owner of an operating mineral interest in a property, undertakes an immiscible carbon dioxide displacement project with respect to the property. E constructs a pipeline to convey carbon dioxide to the project site. E contracts with F, a producer of carbon dioxide, to purchase carbon dioxide to be injected into injection wells in E's enhanced oil recovery project. The cost of the carbon dioxide is a tertiary injectant expense that is a qualified enhanced oil recovery cost. The pipeline is used by E to transport the tertiary injectant, that is, the carbon dioxide to the project site. Therefore, the pipeline is an integral part of the project. Accordingly, the cost of the pipeline is a qualified enhanced oil recovery cost.

Example 9. Water source wells. In 1992, G, the owner of an operating mineral interest in a property, undertakes a polymer augmented waterflood project with respect to the prop-

erty. G drills water wells to provide water for injection in connection with the project. The costs of drilling the water wells are intangible drilling and development costs that are paid or incurred in connection with the project. Therefore, the costs of drilling the water wells are qualified enhanced oil recovery costs.

Example 10. Leased equipment. In 1992, H, the owner of an operating mineral interest in a property undertakes a steam drive project with respect to the property. H contracts with I, a driller, to drill injection wells in connection with the project. H also leases a steam generator to provide steam for injection in connection with the project. The drilling costs are intangible drilling and development costs that are paid in connection with the project and are qualified enhanced oil recovery costs. The steam generator is used to produce the tertiary injectant. The steam generator is used directly in the project and is essential to the completeness of the project; therefore, it is an integral part of the project. The costs of leasing the steam generator are tangible property costs that are qualified enhanced oil recovery costs.

(c) *Primary purpose—(1) In general.* For purposes of this section, a cost is a qualified enhanced oil recovery cost only if the cost is paid or incurred with respect to an asset which is used for the primary purpose of implementing one or more enhanced oil recovery projects, at least one of which is a qualified enhanced oil recovery project. All the facts and circumstances determine whether an asset is used for the primary purpose of implementing an enhanced oil recovery project. For purposes of this paragraph (c), an enhanced oil recovery project is a project that satisfies the requirements of paragraphs (a) (1) and (2) of section 1.43-2.

(2) *Tertiary injectant costs.* Tertiary injectant costs generally satisfy the primary purpose test of this paragraph (c).

(3) *Intangible drilling and development costs.* Intangible drilling and development costs paid or incurred with respect to a well that is used in connection with the recovery of oil by primary or secondary methods are not qualified enhanced oil recovery costs. Except as provided in this paragraph (c)(3), a well used for primary or secondary recovery is not used for the primary purpose of implementing an enhanced oil recovery project. A well

drilled for the primary purpose of implementing an enhanced oil recovery project is not considered to be used for primary or secondary recovery, notwithstanding that some primary or secondary production may result when the well is drilled, provided that such primary or secondary production is consistent with the unit plan of development or other similar plan. All the facts and circumstances determine whether primary or secondary recovery is consistent with the unit plan of development or other similar plan.

(4) *Tangible property costs.* Tangible property costs must be paid or incurred with respect to property which is used for the primary purpose of implementing an enhanced oil recovery project.

If tangible property is used partly in a qualified enhanced oil recovery project and partly in another activity, the property must be primarily used to implement the qualified enhanced oil recovery project.

(5) *Offshore drilling platforms.* Amounts paid or incurred in connection with the acquisition, construction, transportation, erection, or installation of an offshore drilling platform (regardless of whether the amounts are intangible drilling and development costs) that is used in connection with the recovery of oil by primary or secondary methods are not qualified enhanced oil recovery costs. An offshore drilling platform used for primary or secondary recovery is not used for the primary purpose of implementing an enhanced oil recovery project.

(6) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Intangible drilling and development costs. In 1992, J incurs intangible drilling and development costs in drilling a well. J intends to use the well as an injection well in connection with an enhanced oil recovery project in 1994, but in the meantime will use the well in connection with a secondary recovery project. J may not take the intangible drilling and development costs into account in determining the credit because the primary purpose of a well used for secondary recovery is not to implement a qualified enhanced oil recovery project.

Example 2. Offshore drilling platform. K, the owner of an operating mineral interest in an offshore oil field located within the United States, constructs an offshore drilling platform that is designed to accommo-

date the primary, secondary, and tertiary development of the field. Subsequent to primary and secondary development of the field, K commences an enhanced oil recovery project that involves the application of a qualified tertiary recovery method. As part of the enhanced oil recovery project, K drills injection wells from the offshore drilling platform K used in the primary and secondary development of the field and installs an additional separator on the platform.

Because the offshore drilling platform was used in the primary and secondary development of the field and was not used for the primary purpose of implementing tertiary development of the field, costs incurred by K in connection with the acquisition, construction, transportation, erection, or installation of the offshore drilling platform are not qualified enhanced oil recovery costs. However, the costs K incurs for the additional separator are qualified enhanced oil recovery costs because the separator is used for the primary purpose of implementing tertiary development of the field. In addition, the intangible drilling and development costs K incurs in connection with drilling the injection wells are qualified enhanced oil recovery costs with respect to which K may claim the enhanced oil recovery credit.

(d) *Costs paid or incurred prior to first injection—(1) In general.* Qualified enhanced oil recovery costs may be paid or incurred prior to the date of the first injection of liquids, gases, or other matter (within the meaning of § 1.43-2(c)). If the first injection of liquids, gases, or other matter occurs on or before the date the taxpayer files the taxpayer's federal income tax return for the taxable year with respect to which the costs are allowable, the costs may be taken into account on that return. If the first injection of liquids, gases, or other matter is expected to occur after the date the taxpayer files that return, costs may be taken into account on that return if the Internal Revenue Service issues a private letter ruling to the taxpayer that so permits.

(2) *First injection after filing of return for taxable year costs are allowable.* Except as provided in paragraph (d)(3) of this section, if the first injection of liquids, gases, or other matter occurs or is expected to occur after the date the taxpayer files the taxpayer's federal income tax return for the taxable year with respect to which the costs are allowable, the costs may be taken into account on an amended return (or in

the case of a Coordinated Examination Program taxpayer, on a written statement treated as a qualified return) after the earlier of—

(i) The date the first injection of liquids, gases, or other matter occurs; or

(ii) The date the Internal Revenue Service issues a private letter ruling that provides that the taxpayer may take costs into account prior to the first injection of liquids, gases, or other matter.

(3) *First injection more than 36 months after close of taxable year costs are paid or incurred.* If the first injection of liquids, gases, or other matter occurs more than 36 months after the close of the taxable year in which costs are paid or incurred, the taxpayer may take the costs into account in determining the credit only if the Internal Revenue Service issues a private letter ruling to the taxpayer that so provides.

(4) *Injections in volumes less than the volumes specified in the project plan.* For purposes of this paragraph (d), injections in volumes significantly less than the volumes specified in the project plan, the unit plan of development, or another similar plan do not constitute the first injection of liquids, gases, or other matter.

(5) *Examples.* The following examples illustrate the provisions of paragraph (d) of this section.

Example 1. First injection before return filed. In 1992, L, a calendar year taxpayer, undertakes a qualified enhanced oil recovery project on a property in which L owns an operating mineral interest. L incurs \$1,000 of intangible drilling and development costs, which L may elect to deduct under section 263(c) for 1992. The first injection of liquids, gases, or other matter (within the meaning of § 1.43-2(c)) occurs in March 1993. L files a 1992 federal income tax return in April 1993. Because the first injection occurs before the filing of L's 1992 federal income tax return, L may take the \$1,000 of intangible drilling and development costs into account in determining the credit for 1992 on that return.

Example 2. First injection after return filed. In 1993, M, a calendar year taxpayer, undertakes a qualified enhanced oil recovery project on a property in which M owns an operating mineral interest. M incurs \$2,000 of intangible drilling and development costs, which M elects to deduct under section 263(c) for 1993. The first injection of liquids, gases, or other matter is expected to occur in 1995. M files a 1993 federal income tax return in April 1994. Because the first injection of liq-

uids, gases, or other matter occurs after the date on which M's 1993 federal income tax return is filed in April 1994, M may take the \$2,000 of intangible drilling and development costs into account on an amended return for 1993 after the earlier of the date the first injection of liquids, gases, or other matter occurs, or the date the Internal Revenue Service issues a private letter ruling that provides that M may take the \$2,000 into account prior to first injection.

Example 3. First injection more than 36 months after taxable year. N, a calendar year taxpayer, owns an operating mineral interest in a property on which N undertakes an immiscible carbon dioxide displacement project. In 1994, N incurs \$5,000 in connection with the construction of a pipeline to transport carbon dioxide to the project site. The first injection of liquids, gases, or other matter is expected to occur after the pipeline is completed in 1998. Because the first injection of liquids, gases, or other matter occurs more than 36 months after the close of the taxable year in which the \$5,000 is incurred, N may take the \$5,000 into account in determining the credit only if N receives a private letter ruling from the Internal Revenue Service that provides that N may take the \$5,000 into account prior to first injection.

(e) *Other rules—(1) Anti-abuse rule.* Costs paid or incurred with respect to an asset that is acquired, used, or transferred in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit are not qualified enhanced oil recovery costs, regardless of whether the costs would otherwise be creditable for a single taxpayer or more than one taxpayer.

(2) *Costs paid or incurred to acquire a project.* A purchaser of an existing qualified enhanced oil recovery project may claim the credit for any section 43 costs in excess of the acquisition cost. However, costs paid or incurred to acquire an existing qualified enhanced oil recovery project (or an interest in an existing qualified enhanced oil recovery project) are not eligible for the credit.

(3) *Examples.* The following examples illustrate the principles of paragraph (e) of this section.

Example 1. Duplicating or unreasonably increasing the credit. O owns an operating mineral interest in a property with respect to which a qualified enhanced oil recovery project is implemented. O acquires pumping units, rods, casing, and separators for use in connection with the project from an unrelated equipment dealer in an arm's length transaction. The equipment is used for the

primary purpose of implementing the project. Some of the equipment acquired by O is used equipment. The costs paid by O for the used equipment are qualified enhanced oil recovery costs. O does not need to determine whether the equipment has been previously used in an enhanced oil recovery project.

Example 2. Duplicating or unreasonably increasing the credit. P and Q are co-owners of an oil property with respect to which a qualified enhanced oil recovery project is implemented. In 1992, P and Q jointly purchase a nitrogen plant to supply the tertiary injectant used in the project. P and Q claim the credit for their respective costs for the plant. In 1994, X, a corporation unrelated to P or Q, purchases the nitrogen plant and enters into an agreement to sell nitrogen to P and Q. Because this transaction duplicates or otherwise unreasonably increases the credit, the credit is not allowable for the amounts incurred by P and Q for the nitrogen purchased from X.

Example 3. Duplicating or unreasonably increasing the credit. The facts are the same as in *Example 2*. In addition, in 1995, P and Q reacquire the nitrogen plant from X. This constitutes the acquisition of property in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit. Therefore, the credit is not allowable for amounts incurred by P and Q for the nitrogen plant purchased from X.

Example 4. Duplicating or unreasonably increasing the credit. R owns an operating mineral interest in a property with respect to which a qualified enhanced oil recovery project is implemented. R acquires a pump that is installed at the site of the project. After the pump has been placed in service for 6 months, R transfers the pump to a secondary recovery project and acquires a replacement pump for the tertiary project. The original pump is suited to the needs of the secondary recovery project and could have been installed there initially. The pumps have been acquired in a manner designed to duplicate or otherwise unreasonably increase the amount of the credit. Depending on the facts, the cost of one pump or the other may be a qualified enhanced oil recovery cost; however, R may not claim the credit with respect to the cost of both pumps.

Example 5. Acquiring a project. In 1993, S purchases all of T's interest in a qualified enhanced oil recovery project, including all of T's interest in tangible property that is an integral part of the project and all of T's operating mineral interest. In 1994, S incurs costs for additional tangible property that is an integral part of the project and which is used for the primary purpose of implementing the project. S also incurs costs for tertiary injectants that are injected in connection with the project. In determining the credit for 1994, S may take into account

costs S incurred for tangible property and tertiary injectants. However, S may not take into account any amount that S paid for T's interest in the project in determining S's credit for any taxable year.

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§ 1.43-5 At-risk limitation. [Reserved]

§ 1.43-6 Election out of section 43.

(a) *Election to have the credit not apply*—(1) *In general.* A taxpayer may elect to have section 43 not apply for any taxable year. The taxpayer may revoke an election to have section 43 not apply for any taxable year. An election to have section 43 not apply (or a revocation of an election to have section 43 not apply) for any taxable year is effective only for the taxable year to which the election relates.

(2) *Time for making the election.* A taxpayer may make an election under paragraph (a) of this section to have section 43 not apply (or revoke an election to have section 43 not apply) for any taxable year at any time before the expiration of the 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for filing the return for the taxable year. The time for making the election (or revoking the election) is prescribed by section 43(e)(2) and may not be extended under § 1.9100-1.

(3) *Manner of making the election.* An election (or revocation) under paragraph (a)(1) of this section is made by attaching a statement to the taxpayer's federal income tax return or an amended return (or, in the case of a Coordinated Examination Program taxpayer, on a written statement treated as a qualified amended return) for the taxable year for which the election (or revocation) applies. The taxpayer must indicate whether the taxpayer is electing to not have section 43 apply or is revoking such an election and designate the project or projects to which the election (or revocation) applies. For any taxable year, the last election (or revocation) made by a taxpayer within the period prescribed in paragraph (a)(2) of this section determines whether section 43 applies for that taxable year.