

**Internal Revenue Service**

Department of the Treasury

Number: **200206038**  
Release Date: 2/8/2002  
Index Number: 168.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:  
**(202) 622-3110**  
Refer Reply To:  
**CC:PSI:6 PLR-126772-01**  
Date:  
November 8, 2001

Legend:

- Taxpayer =
- D1 =
- D2 =
- D3 =

Dear :

This letter responds to a letter dated D1, and supplemental information, submitted on behalf of Taxpayer requesting a ruling on the appropriate asset class of Rev. Proc. 87-56, 1987-2 C.B. 674, for certain depreciable property which were placed in service by Taxpayer during taxable years D2 and D3.

**Facts**

Taxpayer represents that the facts are as follows:

Taxpayer is a limited liability company engaged in the business of providing drilling fluid products to the oil and gas drilling industry. Specifically, Taxpayer is a developer, manufacturer, and marketer of “drilling” and “completion/work-over” fluids. Taxpayer’s domestic customers, all of which are unrelated to Taxpayer (as the term “related” is defined in section 267 of the Internal Revenue Code), are primarily energy companies that engage in the exploration, development, and production of natural gas, crude oil and natural gas liquids. Taxpayer does not have an ownership interest in oil or gas wells nor does Taxpayer engage in the drilling of such wells.

Drilling fluid is used by Taxpayer’s domestic customers to perform several functions in the rotary drilling process. During the drilling process, the drilling fluid is circulated through the wellbore to bring cuttings out of the wellbore and to the surface. Drilling fluid also is used to cool and lubricate the drill bit, to protect against blowouts (that is, uncontrolled flow of gas and/or oil) by holding back subsurface pressures, and to deposit a mud “cake” on the wall of the bore hole to prevent loss of fluids within the formation. Drilling fluid is commonly referred to as “drilling mud.”

PLR-126772-01

Drilling fluid is a chemical mixture manufactured by combining the minerals bentonite and/or barite and other specialized chemicals with water, synthetic fluids, diesel or mineral oils, and brines. To maximize drilling efficiencies for the specific geophysical conditions encountered by Taxpayer's customers, Taxpayer must determine the exact chemical composition of a particular drilling fluid to be manufactured. The proper chemical mixture of elements blended to the proper weight ensures maximum efficiency and safety during the drilling process. Specifically, the chemical mixture that Taxpayer produces includes: bentonite, to increase the viscosity of the drilling fluids; barite, to increase the density of the drilling fluid that controls formation pressures; organic, acid-based chemicals that minimize the effects of "down-hole" contaminants; caustic soda, to increase the "pH" of the drilling fluids in order that organic acids solubilize; and various other chemicals, to minimize the leakage of the drilling fluid into permeable formations and to make the drilling fluid more compatible with the formation being drilled. After the blending process is complete, a sample of the drilling fluid is tested to ensure compliance with specifications and the drilling fluid is normally shipped to the well sites of Taxpayer's customers.

Completion/work-over fluids are used by Taxpayer's customers during completion and work-over to control formation pressure and to reduce or eliminate certain types of formation damage. Well "completion" occurs when permanent equipment is installed for the production of oil or gas in a newly drilled well. "Work-over" operations occur with respect to a completed well to restore, maintain, or improve production.

The process to create completion/work-over fluids is similar to the process for manufacturing drilling fluid. After reviewing the customer's needs in the planned completion or work-over operation, Taxpayer adds chemicals, brines, and other direct materials to blending pits to create a product with the desired characteristics. The following are some of the items added to the base fluids: saltwater, crude oil, "frac" fluids, acids, and other treatment chemicals. Completion/work-over fluids are typically salt-based liquids that have been blended in various ratios to achieve a specific density and specific crystallization point. In addition, Taxpayer manufactures formate-based blends, which typically consist of either potassium formate or sodium formate or a combination of the two.

Taxpayer has plant facilities which produce the drilling and completion/work-over fluids and does not lease these plant facilities to others for their use. The facilities principally are composed of a series of tanks with special foundations, manifolds, and walkways. The three types of Taxpayer's plants are: liquid mud plants; completion/work-over plants; and bulk storage facilities. Taxpayer represents that during taxable year ending D2, Taxpayer placed in service depreciable assets for use in its drilling and completion/work-over fluids operations including, but not limited to the following: pipe bridges, disposal lines, platforms, walkways, foundations, pumps, compressors, tanks, dust collectors, filters, and agitators.

### **Rulings Requested**

PLR-126772-01

Taxpayer requests the following ruling: Taxpayer's business activity of producing drilling and completion/work-over fluids is described in asset class 28.0, Manufacture of Chemicals and Allied Products, of Rev. Proc. 87-56.

### **Law and Analysis**

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in section 168(a) and the other method is the alternative depreciation system in section 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either the general depreciation system or the alternative depreciation system, the applicable recovery period is determined by reference to class life or by statute. The term "class life" is defined in section 168(i)(1) as meaning the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under section 167(m) (determined without regard to section 167(m)(4) and as if the taxpayer had made an election under section 167(m)) as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. Former section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range (ADR) system of depreciation, the depreciation allowance was based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations provides rules for classifying property under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

The class lives of property subject to depreciation under section 168 are set forth in Rev. Proc. 87-56. This revenue procedure divides assets into two broad categories: (1) asset classes 00.11 through 00.4 that consist of specific depreciable assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of depreciable assets used in specific business activities. An asset that falls within both an asset category (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0) would be classified in the asset category. See Norwest Corp. & Subs. v. Commissioner, 111 T.C. 105, 156-64 (1998).

Rev. Proc. 87-56 prescribes that asset class 28.0, Manufacture of Chemicals and Allied Products, includes assets used to manufacture basic organic and inorganic chemicals; chemical products to be used in further manufacture, such as synthetic fibers and plastics materials; and finished chemical products. This asset class includes assets used to further process man-made fibers, to manufacture plastic film, and to

PLR-126772-01

manufacture nonwoven fabrics, when such assets are located in the same plant in an integrated operation with chemical products producing assets. This asset class also includes assets used to manufacture photographic supplies, such as film, photographic paper, sensitized photographic paper, and developing chemicals. This asset class includes all land improvements associated with plant site or production processes, such as effluent ponds and canals, provided such land improvements are depreciable but does not include buildings and structural components as defined in section 1.48-1(e). Asset class 28.0 does not include assets used in the manufacture of finished rubber and plastic products or in the production of natural gas products, butane, propane, and by-products of natural gas production plants. Property included in asset class 28.0 has a class life of 9.5 years.

The Standard Industrial Classification Manual (SIC) published by the Office of Management and Budget can provide insight into the determination of the proper asset class of Rev. Proc. 87-56 in which property used in a particular business activity should be placed. However, care should be exercised because the SIC differs considerably from the classification techniques used in and depreciation concepts of Rev. Proc. 87-56. For example, while the SIC has precise categorization by primary business activity using language very similar to that found in Rev. Proc. 87-56, Rev. Proc. 87-56 departs dramatically from the categorization scheme in the SIC by establishing separate asset classes for certain specific property (*i.e.*, asset classes 00.11 through 00.4) used in all business activities (*i.e.*, asset classes 01.1 through 80.0). In the 1987 SIC, establishments primarily engaged in manufacturing drilling mud are classified in Major Group 28, Chemicals and Allied Products. The 1987 SIC does not include any reference to manufacturers of completion/work-over fluids.

While the terms “manufacturing” and “production” are not defined in section 168, the definitions of these terms in section 1.48-1(d)(2) for purposes of the investment credit allowed by former section 38 are useful. Section 1.48-1(d)(2) provides, in part, that the terms “manufacturing” and “production” include the making of property by changing the form of an article or by combining or assembling two or more articles.

In Rev. Rul. 74-204, 1974-1 C.B. 11, the Service ruled that a fuel blending operation at an oil storage terminal facility is “manufacturing or production” as defined in section 1.48-1(d)(2). The blending of No. 2 oil and No. 6 oil, to obtain No. 4 oil, a product whose characteristics and uses are different from the other two, is “the making of property by changing the form of an article, or by combining or assembling two or more articles.” See Northville Dock Corporation, 52 T.C. 68 (1969), aff’d per curiam, 427 F.2d 164 (2d Cir. 1970), which reached the same conclusion on this issue.

Similarly, Taxpayer’s operations of creating drilling and completion/work-over fluids can be viewed as “manufacturing” or “production” activities as they involve the combining or mixing of two or more substances to produce substances with entirely different characteristics.

## **Conclusions**

PLR-126772-01

Accordingly, based solely on the representations and relevant law and analysis as set forth above, we conclude that Taxpayer's business activity of producing drilling and completion/work-over fluids is described in asset class 28.0, Manufacture of Chemicals and Allied Products, of Rev. Proc. 87-56. Thus, Taxpayer's depreciable assets are includible in asset class 28.0 except the depreciable assets includible in asset classes 00.11 through 00.4 and any other section 1250 property (e.g., nonresidential real property). However, any depreciable land improvements associated with Taxpayer's plant sites or production processes are includible in asset class 28.0 rather than asset class 00.3.

No opinion is expressed or implied regarding the application of any other provisions of the Code. Specifically, no opinion is expressed or implied concerning whether Taxpayer's property is section 1245 property, section 1250 property, or a depreciable land improvement, or whether Taxpayer's land improvements are associated with Taxpayer's plant sites or production processes.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter ruling is being sent to Taxpayer's authorized representatives. We are also sending a copy of this ruling to the Industry Director, Natural Resources and Construction, LMSB.

Sincerely,  
KATHLEEN REED  
Acting Chief, Branch 6  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures(2):  
Copy of this letter  
Copy of section 6110