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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL, NATURAL RESOURCES
CC:LM:NR:HOU:2

FROM: Mark Pitzer, Assistant to the Branch Chief, Branch 6, Office of Passthroughs and Special Industries, CC:PSI:B6

SUBJECT: Classification for depreciation purposes of offshore drilling and/or production platforms owned by an oil and gas producer

This Chief Counsel Advice responds to your memorandum dated December 20, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Should an oil and gas producer who owns an offshore drilling platform classify that platform in asset class 13.0, Offshore Drilling, or asset class 13.2, Exploration for and Production of Petroleum and Natural Gas Deposits, of Rev. Proc. 87-56, 1987-2 C.B. 674, for depreciation purposes?
2. If the answer to Issue 1 is asset class 13.0, does the asset classification of the platform change to asset class 13.2 if and when the drilling platform becomes a production platform?

CONCLUSIONS

An oil and gas producer who owns an offshore drilling platform should classify that platform in asset class 13.2 for depreciation purposes. Because we reach this conclusion, we do not address Issue 2.

FACTS

The following fact pattern is common in the oil and gas industry:

1. An oil and gas producer formulates an exploration plan on an undeveloped offshore lease.

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2. The plan reaches the drilling phase.
3. The producer enters into a contract with an offshore drilling contractor to perform initial drilling.
4. The drilling contractor owns and operates mobile offshore drilling units (MODUs).
5. The contractor drills exploration and confirmation wells for its customer, the producer.
6. A commercial accumulation of hydrocarbons is discovered, and the MODUs are released by the producer in accordance with the fulfillment of the terms of the contract.
7. The producer installs a production platform which remains in place during the economic life of the field.
8. The producer's platform is designed to accommodate a platform drilling rig which will be removed after several additional wells are drilled and the development plan complete.

LAW AND ANALYSIS

Section 167(a) of the Internal Revenue Code provides a depreciation allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income.

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 section 168(a) or 168(g), the applicable depreciation method and recovery period are 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 system of depreciation, the depreciation allowance would be computed

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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.

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). The business activity asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 13.0, Offshore Drilling, includes assets used in offshore drilling for oil and gas such as floating, self-propelled and other drilling vessels, barges, platforms, and drilling equipment and support vessels such as tenders, barges, towboats and crewboats. Oil and gas production assets are excluded from this class. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 7.5 years for purposes of section 168(g).

Asset class 13.1, Drilling of Oil and Gas Wells, includes assets used in the drilling of onshore oil and gas wells and the provision of geophysical and other exploration services; and the provision of such oil and gas field services as chemical treatment, plugging and abandoning of wells and cementing or perforating well casings. The class does not include assets used in the performance of any of these activities and services by integrated petroleum and natural gas producers for their own account. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 6 years for purposes of section 168(g).

Asset class 13.2, Exploration for and Production of Petroleum and Natural Gas Deposits, includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities. This class also includes petroleum and natural gas offshore transportation facilities used by producers and others consisting of platforms (other than drilling platforms classified in Class 13.0), compression or pumping equipment, and gathering and transmission lines to the first onshore transshipment facility. The assets used in the first onshore transshipment facility are also included and consist of separation equipment (used for separation of natural gas, liquids, and solids), compression or pumping equipment (other than equipment classified in Class 49.23), and liquid holding or storage facilities (other than those classified in Class 49.25). Support vessels are not included in this

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class. Assets in this class have a recovery period of 7 years for purposes of section 168(a) and 14 years for purposes of section 168(g).

With respect to the present case, we must consider the question of whether the offshore drilling assets of producers are within the scope of asset class 13.0. This question arises because, while asset class 13.0 can be read broadly to include all offshore drilling (that is, contract drilling and drilling by producers), asset class 13.2 appears to include all drilling assets of producers with no exception for offshore drilling. To answer this question we will examine the historical evolution of the pertinent asset classes.

Rev. Proc. 62-21, 1962-2 C.B. 418, set forth guideline lives and rules for depreciation. The revenue procedure, which aggregated assets by industry for depreciation purposes, stated that the guideline lives set forth therein applied to broad classes of assets rather than to individual assets. Part I of the revenue procedure provided guidelines for four separate groups of assets. Group One covered depreciable assets used by business in general. Group Two covered non-manufacturing activities, excluding transportation, communications, and public utilities. Group Three covered manufacturing. Group Four covered transportation, communications, and public utilities.

Class 2 of Group Two pertained to contract construction, including general building, special trade, heavy construction, and marine contractors. Class 2(a), General Contract Construction, provided a 5-year guideline life and excluded assets used only in marine contract construction. Class 2(b), Marine Contract Construction, provided a 12-year guideline life and included assets used only in marine contract construction.

Class 17 of Group Three of Rev. Proc. 62-21 pertained to petroleum and natural gas. A distinction was drawn between, and different guideline lives were provided for, the drilling equipment of contract drillers and the drilling equipment of producers that performed drilling services for their own account. Class 17(a), Drilling, Geophysical and Field Services, provided a 6-year guideline life and was worded as follows:

Includes the drilling of oil and gas wells on a contract, fee or other basis and the provision of geophysical and other exploration services. Includes oil and gas field services, such as chemically treating, plugging and abandoning wells and cementing or perforating well casings. Excludes integrated petroleum and natural gas producers which perform these services for their own account.

Class 17(b), Exploration, Drilling and Production, provided a 14-year guideline life and was worded as follows:

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Includes the exploration, drilling, maintenance and production activities of petroleum and natural gas producers. Includes gathering pipelines and related storage facilities of such producers. Excludes gathering pipelines and related storage facilities of pipeline companies.

In its original form, Class 17(a) excluded integrated producers; however, Class 17(b) included only 'producers.' To clarify this apparent omission of integrated producers, Supplement I to Rev. Proc. 62-21, found at 1963-2 C.B. 740, added integrated producers to Class 17(b).

Supplement I also provided that Class 2 of Group Two excluded force account construction (construction by own labor force). In addition, Supplement 1 provided that Class 2(b) included barges, boats, and other vessels used in marine contract construction.

Appendix II to the original Rev. Proc. 62-21 was a compilation of 59 questions and answers to assist taxpayers in applying the provisions of the revenue procedure. Supplement II, found at 1963-2 C.B. 744, was a compilation of additional questions and answers, numbered 60 through 86. Question 79, set forth below, dealt with the following drilling contractor scenario:

Question:

Guideline Class 17(a), Group Three, Part I of the Revenue Procedure, does not apply to integrated petroleum and natural gas producers who perform drilling, geophysical and field services for their own account. How does this rule affect a taxpayer whose major business activity is drilling, or performing geophysical or other exploration services for others, but who performs some drilling or other services for his own account.

Answer:

Where a taxpayer provides drilling, geophysical, or other petroleum field services, both for others and for his own account, the assets used in connection with the providing of these services should be classified according to their primary use as either Class 17(a), Drilling, Geophysical and Field Services – 6 years, or Class 17(b), Exploration, Drilling and Production – 14 years. The primary use may be determined in any reasonable manner.

Subsequently, Rev. Proc. 66-18, 1966-1 C.B. 646, provided that floating or self-propelled drilling vessels and barges, platforms, and support vessels used in

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offshore oil or gas exploration would no longer be allocated between Class 17(a) and 17(b) of Group Three, but would hereinafter be included in Class 2(b) of Group Two. It stated that:

[f]loating or self-propelled drilling vessels and barges, platforms, and support vessels, such as those used in the exploration of oil or gas in offshore operations, are classified in Group 2, Class 2(b), Marine Contract Construction, with a guideline class life of 2 years. Included is the vessel itself and all drilling equipment related thereto. Tenders, barges, towboats, crew boats and other vessels used to transport supplies, equipment, and personnel in offshore operations are classified in the same class. For activities of this kind, this classification includes equipment used in both force account and contract construction.

In 1971 the Asset Depreciation Range System of depreciation was established. This depreciation system was based on broad industry classes of assets. Rev. Proc. 71-25, 1971-2 C.B. 553, was published to set forth the asset guideline classes, asset guideline periods, and asset depreciation ranges referred to in section 1.167(a)-11(b)(4). Rev. Proc. 71-25 continued the distinction drawn between drilling assets of contractors and those of producers, as can be seen from the following excerpts from the revenue procedure's asset guideline class descriptions:

13.0 Petroleum and natural gas production and related activities:

(no description given)

13.1 Drilling of oil and gas wells:

Includes assets used in the drilling of oil and gas wells on a contract, fee or other basis and the provision of geophysical and other exploration services; and the provision of such oil and gas field services as chemical treatment, plugging and abandoning of wells and cementing or perforating well casings; but not including assets used in the performance of any of these activities and services by integrated petroleum and natural gas producers for their own account.

13.2 Exploration for petroleum and natural gas deposits: Includes assets used for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities, when these are related

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activities undertaken by petroleum and natural gas producers.

15.0 Contract Construction:

Includes such assets used by general building, special trade, heavy construction and marine contractors; does not include assets used by companies in performing construction services on their own account.

15.1 Contract construction other than marine
(no description given)

15.2 Marine contract construction
(no description given)

Rev. Proc. 71-25 was superceded by Rev. Proc. 72-10, 1971-1 C.B. 721, which was published to implement the Class Life Asset Depreciation Range System authorized by former section 167(m). Rev. Proc. 72-10 modified asset class 13.1 by adding the word "onshore" to its description. Asset class 13.2 remained unchanged. Also, a description was added to asset class 15.2 providing that the class included floating, self-propelled and other drilling platforms used in offshore drilling for oil and gas.

Rev. Proc. 77-10, 1977-1 C.B. 548, superceded Rev. Proc. 72-10 and modified the description of assets included in asset class 15.2 to be consistent with Rev. Proc. 66-18. The revenue procedure also deleted asset class 15.0 and transferred the pertinent part of its description to asset class 15.1. Revised asset class 15.2 was described as follows:

15.2 Marine Contract Construction:

Includes assets used by general building, special trade, and heavy construction contractors predominantly in marine construction work. Does not include assets used by companies in performing marine construction services for their own account except for floating, self-propelled, and other drilling platforms and support vessels used in offshore drilling for oil and gas which are included whether used for their own account or others.

Rev. Proc. 78-5, 1978-1 C.B. 557, revised asset class 13.2 of Rev. Proc. 77-10 to include petroleum and natural gas offshore transportation facilities used by petroleum and natural gas producers and others in the offshore pipeline transportation of oil and natural gas. The revenue procedure states that these assets were formerly included in asset class 46.0, Pipeline Transportation. Revised asset class 13.2 read as follows:

13.2 Exploration for and Production of Petroleum and
Natural Gas Deposits:

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Includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities. Also includes petroleum and natural gas offshore transportation facilities used by producers and others consisting of platforms (other than drilling platforms classified in Class 15.2), compression and pumping equipment, and gathering and transmission lines to the first onshore transshipment facility. The assets used in the first onshore transshipment facility are also included and consist of separation equipment (used for separation of natural gas, liquids, and solids), compression or pumping equipment (other than equipment classified in Class 49.23), and liquid holding or storage facilities (other than those classified in Class 49.25). Does not include support vessels.

The “others” referred to in the description of asset class 13.2 include pipeline companies. In addition, the parenthetical language in the description makes it clear that drilling contractors’ drilling platforms continued to be included in asset class 15.2.

Rev. Proc. 77-10 was also modified by Rev. Proc. 80-58, 1980-2 C.B. 854, the stated purpose of which was to delete existing asset classes 15.1, Contract Construction other than Marine, and 15.2, Marine Contract Construction, and to establish two new classes for assets used in construction (asset class 15.0) and in offshore oil and gas drilling (asset class 13.0). Rev. Proc. 80-58 noted that asset class 15.2 included assets used in offshore oil and gas drilling. Thus, the assets used in offshore oil and gas drilling that had been included in former asset class 15.2 were moved to new asset class 13.0. The new asset classes established by Rev. Proc. 80-58 were described as follows:

13.0 Offshore Drilling:

Includes assets used in offshore drilling for oil and gas such as floating, self-propelled and other drilling vessels, barges, platforms, and drilling equipment and support vessels such as tenders, barges, towboats and crew boats. Excludes oil and gas production assets.

15.0 Construction:

Includes assets used in construction by general building, special trade, heavy and marine construction contractors, operative and investment builders, real estate subdividers and developers, and others except railroads.

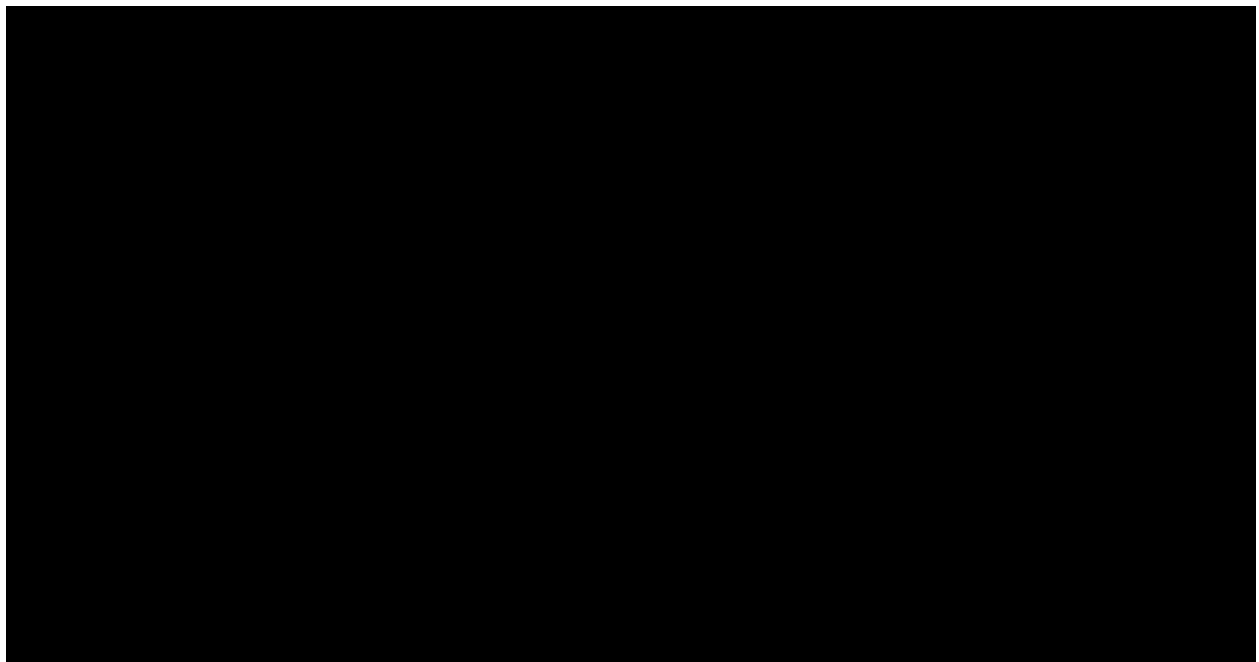
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Rev. Proc. 77-10 was superceded by Rev. Proc. 83-35, 1983-1 C.B. 745. Asset classes 13.0 and 15.0 in Rev. Proc. 83-35 were the same as set forth in Rev. Proc. 80-58. Asset class 13.2 was the same as set forth in Rev. Proc. 78-5, as modified by Rev. Proc. 80-58. Rev. Proc. 87-56 contains the same descriptions of asset classes 13.0, 13.2, and 15.0 that are contained in Rev. Proc. 83-35.

Our review of the evolution of the pertinent asset classes shows that, since the inception of the asset classes, different classes have been provided for the drilling assets of contract drillers and producers. The distinction established by Rev. Proc. 62-21 was maintained in subsequent revenue procedures. Further, drilling platforms were classified by Rev. Proc. 66-18 and subsequent pronouncements as marine contract construction assets. These platforms were moved to asset class 13.0 from asset class 15.2 by Rev. Proc. 80-58. The drilling platforms of production companies cannot be described as contract assets.

The distinction drawn between the drilling assets of contract drillers and producers for depreciation purposes is understandable because of the significant difference between the use of producer-owned offshore equipment, often dual purpose in nature (drilling and production), fixed in place over the life of the producing property, and the use of contractor-owned drilling equipment, which is mobile and continually in use as it searches for oil and gas in harsh environments. Taking cognizance of this difference, the drilling assets of contract drillers are presently included in asset classes 13.0 and 13.1, while the drilling assets of producers are included in asset class 13.2. Accordingly, offshore drilling platforms owned by oil and gas producers should be classified under asset class 13.2.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS





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Please call if you have any further questions.

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