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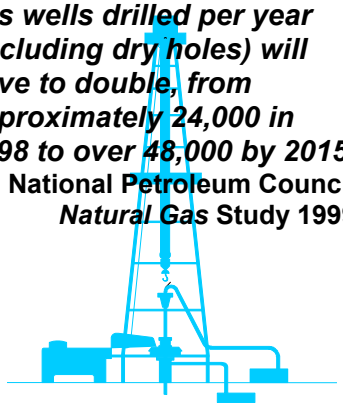
America's Oil & Gas Producers

Tax Treatment of Delay Rentals

The total number of oil and gas wells drilled per year (including dry holes) will have to double, from approximately 24,000 in 1998 to over 48,000 by 2015.
National Petroleum Council *Natural Gas* Study 1999



Producers make delay rental payments to oil and gas lessors prior to drilling or production. Unlike bonus payments (made by the producer in consideration for the grant of the lease) which are generally treated as an advance royalty and thus capitalized, producers have historically been allowed to elect to deduct delay rental payments under Treasury Regulations 1.612-3(c). However, in September 1997, the IRS issued a coordinated issues paper stating that such payments are preproduction costs subject to capitalization under Section 263A of the Internal Revenue Code. The legislative history of Section 263A is unclear and subject to varying interpretation.

Proposal

Clarify that delay rental payments are deductible, at the election of the taxpayer, as ordinary and necessary business expenses.

Reasons for change

In passing the Section 263A uniform capitalization rules, Congress broadly intended to only affect the "unwarranted deferral of taxes." Congress did not intend to grant the IRS the authority to repeal the well-settled industry practice of deducting "delay rentals" as ordinary and necessary business expenses.

Treas. Reg.1.612-3(c) states that, "a delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production." Such payments represent ordinary and necessary business expenses, not an "unwarranted deferral of taxes." Given the clear disagreement over the legislative history and the likelihood of costly and unnecessary litigation to resolve the issue, clarification would eliminate administrative and compliance burdens on taxpayers and the IRS.

Status

Congress needs to pass legislation to clarify that delay rental payments are deductible, at the election of the taxpayer, as ordinary and necessary business expenses to enhance and preserve domestic oil and natural gas production.

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