DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR PAUL K. WEBB
ATTORNEY CC:LM:CTM:SF

FROM: Associate Chief Counsel (Passthroughs and Special Industries)
CC:PSI:7

SUBJECT: Whether the costs associated with transporting, storing and injecting CO_2, and the costs of recycling CO_2 as a tertiary injectant constitute qualified Enhanced Oil Recovery (EOR) costs eligible for the section 43 EOR credit.

This Chief Counsel Advice responds to your memorandum dated January 22, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:
Location:

ISSUE

Whether operating costs incurred by the taxpayer in transporting, storing and injecting CO_2 used as a tertiary injectant and the recycling costs of repressurizing CO_2 qualify as tertiary injectant expenses available for the section 43 credit.

CONCLUSIONS

Under sections 43(c)(1)(C) and 193(b), the operating costs of handling, storing, and injecting CO_2 and the recycling costs of repressurizing CO_2 are qualified EOR costs eligible for the section 43 credit. The operating costs and recycling costs are

qualified tertiary injectant expenses as defined under section 193(b) and for which a deduction is allowable.

FACTS

Taxpayer engages in drilling for and producing oil from various oil fields. At its reservoir located in Location, Taxpayer recovers oil using the CO_2 injection method. Taxpayer injects both newly purchased CO_2 and recycled CO_2 into its reservoir. In injecting newly purchased CO_2, Taxpayer incurs various operating expenses such as labor and energy costs associated with handling the CO_2, storing it, and injecting it into the reservoir.

Taxpayer also maintains a plant at Location to recycle used CO_2. As oil and related materials are produced at the well site, the recovered substances are routed to a separation unit. During the separation process, crude oil and water are separated from the various recovered gases. The recovered gases are then directed to the recycling plant where the recovered CO_2 and miscellaneous entrained gases are repressurized for reuse as a tertiary injectant. You stated that because CO_2 has a significant cost element, and it is reusable once separated from the recovered oil and repressurized, industry participants are economically motivated to recycle the CO_2 for reuse. In order to be made usable again as an injectant, certain liquids, gases and other impurities first must be removed and the CO_2 must be repressurized. This recycled CO_2 then can be mixed with new CO_2 and reinjected into the subject reservoir, thereby continuing its use as a tertiary injectant.

Taxpayer claims the 15 percent credit under section 43 for EOR costs incurred in using newly purchased CO_2 and recycling recovered CO_2. The recycled CO_2 expenses are derived from various compressor systems used to repressurize recovered CO_2, and include labor, miscellaneous repairs, operating fuel (electricity), and like operating costs.

You have requested our advice as to whether the operating costs associated with handling, storing and injecting newly purchased CO_2 and the recycling costs associated with repressurizing recovered CO_2 should qualify for the section 43 credit.

LAW AND ANALYSIS

Section 38(a) allows a business credit against income tax. Sections 38(b)(6) and 43(a) extend the credit to “qualified enhanced oil recovery costs.”

Section 43(c)(1) provides that qualified EOR costs include: (A) amounts paid or incurred for property which is an integral part of a qualified enhanced oil recovery project, and which may be depreciated or amortized; (B) intangible drilling costs

paid or incurred in connection with a qualified enhanced oil recovery project and for which an election may be made under section 263(c); and (C) any qualified tertiary injectant expenses (as defined in section 193(b)) which are paid or incurred in connection with a qualified enhanced oil recovery project and for which a deduction is allowable.

Section 43(c)(2) provides that the term "qualified enhanced oil recovery project" means any project: (1) which involves the application (in accordance with sound engineering principles) of 1 or more tertiary recovery methods (as defined in section 193(b)(3)) which can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which will ultimately be recovered; (2) which is located in the United States (within the meaning of section 638(1)); and (3) with respect to which the first injection of liquids, gases, or other matter commences after December 31, 1990.

Section 193(b)(1) defines the term "qualified tertiary injectant expenses" as "any cost paid or incurred (whether or not chargeable to capital account) for any tertiary injectant (other than a hydrocarbon injectant which is recoverable) which is used as a part of a tertiary recovery method.

Section 193(b)(3) provides that "tertiary recovery method" means (A) any method which is described in subparagraphs (1) through (9) of section 212.78(c) of the June 1979 energy regulations, or (B) any other method to provide tertiary enhanced recovery which is approved by the Secretary for purposes of this section.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Prior to December 2000, section 43(c)(1)(C) provided that qualified EOR costs include, "any qualified tertiary injectant expenses which are paid or incurred in connection with a qualified enhanced oil recovery project and for which a deduction is allowable under section 193 for the taxable year."

Section 43(c)(1)(C) was amended in December 2000 to eliminate the requirement that tertiary injectant expenses be deductible under section 193, and instead to require only that the costs be tertiary injectant expenses as defined in section 193(b), and for which a deduction is allowable. Thus, prior to December 2000, to qualify for the section 43 EOR credit, tertiary injectant expenses had to be deductible under section 193 for the taxable year. After December, however, the EOR credit is available for tertiary injectant expenses that are deductible under any provision of the Code.

Section 193(b)(1) defines the term "qualified tertiary injectant expenses" to mean any cost paid or incurred for any tertiary injectant (other than a hydrocarbon

injectant which is recoverable) which is used as a part of a tertiary recovery method. Additionally, section 193(b)(3)(A) defines the term “tertiary recovery method” to include any method which is described in subparagraphs (1) through (9) of section 212.78(c) of the June 1979 energy regulations (as defined by section 4996(b)(8)(C) as in effect before its repeal). We note that carbon dioxide injectants are described in subparagraph (8) of section 212.78(c).

It is important to determine the purpose of section 193 and how it relates to section 43. The legislative history of section 193 shows that Congress was aware of the distinction between the costs of acquiring an injectant, which prior to the enactment of section 193, were capitalized, and the costs of using injectants, which were deductible prior to and after the enactment of section 193.

In explaining its understanding of the then current law concerning the treatment of tertiary injectant costs, the Senate Report discussing section 193 described the following costs:

> 1. Costs of injectants with a transitory effect on production, e.g., alkaline solutions or CO_2, generally are deductible currently;
> 2. Costs related to injecting a substance with a transitory effect on production are deductible currently;
> 3. Costs of producing and reinjecting gas or hydrocarbon liquids utilized in a recycling process, i.e., where the gas is produced from the property, are deductible currently; and
> 4. Expenditures for some injectants which affect production for more than one year generally must be capitalized and recovered through depreciation over the period for which they affect production.

S. Rep. No. 96-394; 96th Congress 1st Sess. 97 (1979), 1980-3 C.B. 131, 215.

The Senate Report further notes that the costs related to preparing and injecting a tertiary injectant can be currently deducted under sections 162 and 263(c); however, the costs of obtaining tertiary injectants must be capitalized. Thus, the purpose of section 193 is to provide that expenditures for tertiary injectants are deductible in the taxable year in which they are injected into the reservoir; namely to make deductible those costs that were not otherwise deductible. Accordingly, section 193(c) provides that “no deduction shall be allowed under [section 193(a)] with respect to any expenditure with respect to which a deduction is allowed or allowable to the taxpayer under any other provision of this chapter.”

You state that the phrase “tertiary injectant expenses as defined under section 193" refers only to the actual costs of purchasing a tertiary injectant and not the costs of using the injectant, i.e., handling, storing, and injecting the injectant. You base your conclusion on the language used in section 193(a), which states that qualified

tertiary injectant expenses mean “any cost paid or incurred **for** any tertiary injectant.” (Emphasis added). You further state that costs incurred to handle, store, or inject an injectant are not costs “for” an injectant within the meaning of section 193, but rather costs for using an injectant.

We do not believe that the definition of tertiary injectant expenses was intended to have such a limited meaning. The phrase “qualified tertiary injectant expense” means “any cost paid or incurred (whether or not chargeable to a capital account) for any tertiary injectant which is used as part of a tertiary recovery method.” Section 193(b). By using the words “any cost” and “for any tertiary injectant,” this definition encompasses a broad category of costs. Conceivably the costs could include, not only the cost of buying CO_2, but also the costs incurred in preparing and handling the steam and the CO_2.

It is not the use of the word “for” in section 193(a) that limits the section 193 deduction to the costs of obtaining the injectant, but it is section 193(c), which denies a deduction for costs that are otherwise deductible. Section 43 only requires that the tertiary injectant expenses be those defined under section 193(b), and section 193(c)’s limitation would be inapplicable in determining qualified expenses under section 43(c)(1)(C).

Furthermore, under your analysis the result in this case would be the same both before and after the amendment of section 43(c)(1)(C). Prior to the amendment of section 43(c)(1)(C), the EOR credit was allowable only with respect to tertiary injectant expenses that are deductible under section 193, namely, the costs of obtaining the injectant. If we were to assume that the phrase “tertiary injectant expenses as defined under section 193(b)” also refers only to the costs of obtaining the injectant, then the results under section 43(c)(1)(C) as amended would be very similar to the results before section 43(c)(1)(C) was amended. It is unlikely that Congress intended no ultimate difference in the results when it amended section 43(c)(1)(C).

The general rule for currently deductible costs is found in section 162. Under this provision, a deduction is allowed for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. The monthly expenses with respect to the CO_2 are related to the operation of wells for the production of oil and must be currently expensed. With the amendment, section 43 allows such costs to be used to determine the credit because the costs are tertiary injectant expenses and are allowed as deductions.

Accordingly, our position is that the operating costs of handling, storing, and injecting CO_2 and the recycling costs of repressurizing CO_2 should be included in the computation of the EOR credit because they are qualified tertiary injectant expenses for which a deduction is allowable.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

Brenda Stewart
Assistant to Chief, Branch 7
Office of Associate Chief Counsel
(Passthroughs and Special Industries)