

had to pay an annual minimum royalty of \$10,000 representing the amount due on 100,000 tons of the particular mineral whether or not B mined and sold that amount. It was further provided that, if B did not mine and sell 100,000 tons in any year, he could mine and sell in any subsequent year the amount of mineral on which he had paid the royalty without the payment of any additional royalty. However, this right of recoupment was limited to minerals mined and sold in any later year in excess of the 100,000 tons represented by the \$10,000 minimum royalty required to be paid for that later year. Assume that in 1956 B paid A the minimum royalty of \$10,000, but mined and sold only 60,000 tons of the mineral and that in 1957 he abandoned the lease without any further production. Since the \$10,000 represents royalties on 100,000 tons of mineral and only 60,000 tons were mined and sold, A must restore in 1957 to his capital account the depletion deductions taken in 1956 on \$4,000 on account of the 40,000 tons paid for in advance but not mined and sold, and must also return the corresponding amount as income in 1957.

Example 2. Assume that B, under the lease in example 1, paid the \$10,000 minimum royalty and mined no minerals in 1956 but that in 1957 B mined and sold 200,000 tons of mineral. If this is B's first such expenditure, B has an option, for the purpose of computing taxable income under section 63, to deduct in 1956 the \$10,000 paid in that year although no mineral was mined, or to take the deduction in 1957 when the mineral, for which the \$10,000 was paid in 1956, was mined and sold. (For treatment under percentage depletion, see example in paragraph (c)(5)(iii) of § 1.613-2.)

(c) *Delay rental.* (1) 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.

(2) Since a delay rental is in the nature of rent it is ordinary income to the payee and not subject to depletion. The payor may at his election deduct such amount as an expense, or under section 266 and the regulations thereunder, charge it to depletable capital account.

(d) *Percentage depletion deduction with respect to bonus and advanced royalty.* In lieu of the allowance based on cost depletion computed under paragraphs (a) and (b) of this section, the payees referred to therein may be allowed a depletion deduction in respect of any

bonus or advanced royalty for the taxable year in an amount computed on the basis of the percentage of gross income from the property as provided in section 613 and the regulations thereunder. However, for special rules applicable to certain bonuses and advanced royalties received in connection with oil or gas properties, see paragraph (j) of § 1.613A-3.

(e) *Cross reference.* In the case of bonuses and advanced royalties received in connection with a contract of disposal of timber covered by section 631(b) or coal or iron ore covered by section 631(c), see that section and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7523, 42 FR 63641, Dec. 19, 1977; T.D. 8348, 56 FR 21938, May 13, 1991]

§ 1.612-4 Charges to capital and to expense in case of oil and gas wells.

(a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used:

(1) In the drilling, shooting, and cleaning of wells.

(2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(b) *Recovery of optional items, if capitalized.* (1) Items returnable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property,

and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items specified in subparagraphs (1) and (2) for the purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs, then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made in the return for the first taxable year beginning after December 31, 1942, in which such a nonproductive well is completed. Such election with respect to intangible drilling and development costs of nonproductive wells is a new election, and, when made, shall be binding for all subsequent years. Any taxpayer who incurs optional drilling and development costs in drilling a nonproductive well must make a clear statement of election under this option in the return for the first taxable year beginning after December 31, 1942, in which such nonproductive well is completed. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent

that they are represented by physical property.

(c) *Nonoptional items distinguished.* (1) Capital items: The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the option provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas.

(d) *Manner of making election.* The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs such costs; no formal statement is necessary. If the taxpayer fails to deduct such costs as expenses in such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(e) *Effect of option and election.* This section does not grant a new option under paragraph (a) of this section or new election under paragraph (b) of this section. Section 3 of the Act of October 23, 1962 (Public Law 87-863, 76 Stat. 1142) granted any taxpayer who had exercised an option to capitalize intangible drilling and development costs under Regulations 111, § 29.23(m)-

16 (1939 Code) or Regulations 118, § 39.23(m)-16 (1939 Code) a new option for the first taxable year ending after October 22, 1962, to deduct such costs as expenses. Unless he has exercised the new option granted by such Act, any taxpayer who exercised an option or made an election under the regulations described in the preceding sentence is, by such option or election, bound with respect to all intangible drilling and development costs (whether made before January 1, 1954, or after December 31, 1953) in connection with oil and gas properties. See section 7807(b)(2). Any taxpayer who has not made intangible drilling and development expenditures in any taxable year beginning after December 31, 1942, prior to his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, must exercise the option granted in paragraph (a) of this section in the return for the first taxable year in which the taxpayer pays or incurs such expenditures. If such return is required by law (including extensions thereof) to be filed before November 1, 1965, the option under paragraph (a) of this section, or the election under paragraph (b) of this section, may be exercised or changed not later than November 1, 1965. The exercise of or change in such option or election shall be effective with respect to the earliest taxable year to which the option or election is applicable in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from such exercise or change is not prevented by any law or rule of law on the date such option is exercised or such election is made. Any such option or election shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years.

[T.D. 6836, 30 FR 8902, July 15, 1965]

§ 1.612-5 Charges to capital and to expense in case of geothermal wells.

(a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease