Internal Revenue Service

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Department of the Treasury
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Third Party Communication: None
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Person To Contact:
ID No.
Telephone Number:

Refer Reply To:
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Date:
October 19, 2010

Corporation =

Taxpayer =

Other Shareholder =

Successor =

LLC =

Former Lessee =

Agency =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Month A =

State A =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

A# =

Dear :

This letter responds to your request for a private letter ruling under section 172(f) of the Internal Revenue Code (the Code)[1]. Specifically, you have requested a ruling pertaining to certain costs incurred and deductible with respect to dismantling an offshore drilling platform as well as certain other costs. To the extent those deductible costs generate an NOL, you have requested a ruling that the portion of the NOL generated by such deductible costs generates a specified liability loss within the meaning of section 172(f), and therefore qualifies for a 10-year NOL carryback period under section 172(b)(1)(C). You have not requested a ruling regarding whether such costs are deductible. To the extent such costs are deductible, you have not requested a ruling regarding the character of those deductions.

FACTS

Corporation was incorporated on Date 1 in State A. Corporation elected to be taxed as an S corporation beginning on Date 2. Throughout its history Corporation engaged in the oil and gas exploration and production business. Corporation conducted these activities in the federal waters of the Outer Continental Shelf (OCS).

Prior to Date 3, Taxpayer and Other Shareholder owned 100 percent of the stock of Corporation. On Date 3, Other Shareholder died and Other Shareholder's ownership interest in Corporation was acquired by Successor pursuant to State A law. Pursuant to State A law, Taxpayer was the sole beneficiary of Successor with respect to the ownership interest in Corporation.

Successor and Taxpayer formed LLC which was treated as a partnership for federal income tax purposes. LLC was formed to acquire the assets and business of Corporation through merger. For federal income tax purposes Corporation was treated as liquidated on Date 4 as part of the merger transaction, and thereafter the business formerly conducted by Corporation was conducted by LLC as a partnership.

[1] Unless provided otherwise, references to sections refer to sections of the Internal Revenue Code of 1986.

In Year 1, pursuant to the Asset Purchase Agreement Corporation acquired from Former Lessee an oil and gas lease (the Lease) with respect to an area on the OCS together with certain property used to conduct oil and gas activities on the leased area. Upon acquisition of the Lease, Corporation became the lessee under the Lease with the United States as the lessor. The property acquired from Former Lessee included an offshore drilling platform (Platform) used in the leased area. During the period beginning in Year 1 and ending in Year 2, Corporation drilled additional oil and natural gas wells in the leased area.

The Asset Purchase Agreement required Corporation to remove all devices, works, and structures from premises no longer subject to the Lease in accordance with applicable regulations and orders within a period of one year after termination of the lease in whole or in part. However, with appropriate regulatory approvals, the Asset Purchase Agreement allowed Corporation to maintain devices, works, and structures on the leased area for drilling or producing on other leases.

In addition, pursuant to federal regulations, upon the abandonment of operations at the leased area, Corporation was obligated to perform the following decommissioning activities:

(1) To permanently plug and abandon A# wells drilled from Platform located on the leased property in accordance with 30 CFR § 250.1710 through 1717;

(2) To remove the deck and flare boom from Platform in accordance with 30 CFR § 1725 through 1730;

(3) To clear the sea floor of all other obstructions in accordance with 30 CFR § 250.1740 through 1743;

(4) To remove decommissioned pipelines in accordance with 30 CFR § 250.1750 through 1754; and

(5) To remove contaminated soil in accordance with 30 CFR § 250.300.

For purposes of this ruling, the obligations set forth above will be referred to as decommissioning liabilities.

As the successor to Corporation, LLC became liable to perform these tasks when it acquired the business of Corporation. Effective the close of business on Date 5, Taxpayer acquired Successor's interest in LLC and became the sole owner of LLC. LLC is a disregarded entity for federal income tax purposes. LLC has terminated oil and gas operations on the Lease and does not intend to use any of the property formerly used for oil and gas operations on the lease in other business operations. In Month A LLC relinquished the Lease and abandoned the property. LLC has executed the

necessary agreements with the Agency and has obtained the necessary Agency permits to enable it to begin undertaking the decommissioning operations listed above. LLC anticipates that it will incur costs to complete those tasks during its Year 3 through Year 4 taxable years.

For federal income tax purposes, LLC reports on the calendar year and uses an accrual method of accounting. The submission did not contain a representation regarding the method of accounting used by Corporation to compute its federal taxable income.

LAW AND ANALYSIS

Section 172(b)(1)(C) provides that the portion of any NOL that qualifies as a specified liability loss shall be carried back to each of the 10 taxable years preceding the taxable year of the loss. For NOLs arising in taxable years ending on or after October 22, 1998, section 172(f) defines a specified liability loss as the sum of certain deductions to the extent taken into account in computing the NOL for the taxable year. In addition to deductions associated with product liability, these deductions include any amount allowable as a deduction under chapter 1 of the Code (other than under section 468(a)(1) or 468A(a)) which is in satisfaction of a liability under a federal or state law requiring--

(I) the reclamation of land,
(II) the decommissioning of a nuclear power plant (or any unit thereof),
(III) the dismantlement of a drilling platform,
(IV) the remediation of environmental contamination, or
(V) a payment under any workers compensation act (within the meaning of section 461(h)(2)(C)(i)).

For this purpose a liability shall be taken into account only if--

(I) the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year [the 3-year act or failure to act requirement], and

(II) the taxpayer used an accrual method of accounting throughout the period or periods during which such act (or failure to act) occurred.

The amount of the specified liability loss for any taxable year cannot exceed the amount of the NOL for the taxable year.

In order for a liability to qualify as a specified liability loss, the act (or failure to act) giving rise to such liability must occur at least 3 years before the beginning of the taxable year. It is the position of the Service that the final act or failure to act in the chain of causation leading to the creation of a given liability from which it can be

determined that the taxpayer has a legal obligation qualifies as "the act or failure to act" for section 172(f) purposes[2].

Legal liability for decommissioning obligations occur when such liabilities “accrue” as specified in 30 CFR § 250.1702. Pursuant to that regulation decommissioning liabilities accrue when the party to be charged with liability performs any of the following activities:

(a) Drills a well;

(b) Installs a platform, pipeline, or other facility;

(c) Creates an obstruction to other users of the OCS;

(d) Is or becomes a lessee or the owner of operating rights of a lease on which there is a well that has not been permanently plugged according to this subpart, a platform, a lease term pipeline, or other facility, or an obstruction;

(e) Is or becomes the holder of a pipeline right-of-way on which there is a pipeline, platform, or other facility, or an obstruction; or

(f) Re-enters a well that was previously plugged according to this subpart.

Under paragraph (d) and (e) above, when Corporation acquired the Lease from Former Lessee in Year 1 Corporation became liable to remove the Platform and any pipeline or other facility that Former Lessee had previously installed in the leased area. Corporation also became liable to plug any unplugged wells previously drilled by Former Lessee and also became liable to remove any other obstruction to other users of the OCS that Former Lessee may have placed in the leased area.

In the case of an S corporation, section 1366(b) provides that the character of any item of income, loss, deduction etc. included in a shareholder's pro rata share shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation. Consequently, had Corporation not liquidated and had it incurred the costs at issue, if

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[2] Notice 2005-20, 2005-1 C.B. 635 Q&A 4 provides as follows:

Q-4. Which act in the chain of causation leading to the creation of a liability constitutes "the act or failure to act" giving rise to that liability within the meaning of former § 172(f)(1)(B)(i)?

A-4. The act or failure to act resulting in the establishment of a legal liability constitutes the act or failure to act within the meaning of former § 172(f)(1)(B)(i). For example, in the case of a trespass, the act of trespassing constitutes the relevant act for purposes of former § 172(f)(1)(B)(i), not the judgment of a court.

Corporation had satisfied the 3-year act or failure to act requirement the shareholders of Corporation would also have been treated as satisfying that requirement.

However, under the facts of this case Corporation merged into LLC. For federal income tax purposes, Corporation is treated as liquidating, that is, distributing all of its assets and liabilities to its shareholders followed by the contribution of those assets and liabilities by the shareholders to a partnership. Treas. Reg. § 301.7701-3(g)(ii). Nonetheless, in our view, for section 172(f) purposes the act giving rise to the decommissioning liabilities at issue still occurs when such liabilities "accrue" as specified in 30 CFR § 250.1702.

Because Corporation acquired the Lease in Year 1, and because the liabilities at issue will be satisfied in Year 3 through Year 4, the 3-year act or failure to act requirement will be satisfied with respect to any decommissioning liabilities that accrued within the meaning of 30 CFR § 250.1702(d) through (e).

For the period after Corporation acquired the Lease Taxpayer failed to specify when Corporation took actions resulting in legal liability for decommissioning obligations. However, to the extent any decommissioning liability accrues, within the meaning of 30 CFR § 250.1702, at least 3 years before the beginning of the taxable year in which the liability is satisfied, the 3-year act or failure to act requirement of section 172(f) is satisfied with respect to that liability.

Because the decommissioning liabilities at issue are imposed under federal regulations, the liabilities constitute liabilities under federal law within the meaning of section 172(f). The next question is whether those liabilities fall within the five specified types of liabilities set forth in section 172(f)(1)(B)(i)(I)-(V).

Costs incurred to dismantle Platform as well as the associated deck and flare boom constitute costs in satisfaction of a liability to dismantle a drilling platform within the meaning of section 172(f)(1)B)(i)(III).

Land reclamation is not a well defined term. Land reclamation may include re-establishing dry land from land that has become submerged. However, that is not the type of land reclamation that Congress had in mind when it enacted section 172(f). By using the term "land reclamation" Congress intended to cover costs of restoring land to its pre-disturbed state, for example, mining reclamation costs. By using the term "land reclamation" rather than attempting to list specific types of land reclamation activities, Congress ensured that it would not unintentionally omit a type of land reclamation activity for which it would have provided relief had it considered it.

Although placing subsurface land into its pre-disturbed state may not have been specifically contemplated by Congress when it enacted the statute, such costs fall within the class of costs for which Congress generally intended relief. Therefore, costs

incurred to restore subsurface land to its pre-disturbed state qualify as land reclamation costs.

Costs to remediate environmental contamination may include not only costs to remove pollutants from the environment but also costs to prevent such pollutants from entering the environment in the first place. Consequently, costs incurred to seal pipelines in place to prevent hydrocarbon residues from escaping into the environment qualify as environmental remediation costs as well as cleanup costs to remove hydrocarbons that have escaped into the ocean.

Therefore, costs incurred to permanently plug and abandon the A# wells drilled on the leased premises in accordance with 30 CFR § 250.1710 through 1717 constitute costs incurred in satisfaction of a liability to remediate environmental contamination within the meaning of section 172(f)(1)(B)(i)(IV). Likewise, costs incurred to remove contaminated soil in accordance with 30 CFR § 250.300 constitute costs incurred in satisfaction of a liability to remediate environmental contamination within the meaning of section 172(f)(1)(B)(i)(IV).

Costs incurred to remove decommissioned pipelines in accordance with 30 CFR § 250.1750 through 1754 constitute costs incurred in satisfaction of a liability to remediate environmental contamination within the meaning of section 172(f)(1)(B)(i)(IV). Such costs also constitute costs incurred in satisfaction of a liability requiring the reclamation of land within the meaning of section 172(f)(1)(B)(i)(I).

Finally, costs incurred to clear the sea floor of all other obstructions in accordance with 30 CFR § 250.1740 through 1743 constitute costs incurred in satisfaction of a liability requiring the reclamation of land within the meaning of section 172(f)(1)(B)(i)(I). To the extent those costs serve to prevent or remove environmental contamination they also constitute costs incurred in satisfaction of a liability to remediate environmental contamination within the meaning of section 172(f)(1)(B)(i)(IV).

To generate a specified liability loss, such costs must be deductible and must be taken into account in computing an NOL. We are not ruling, nor have we been asked to rule, on whether such costs are deductible or whether, if such costs are deductible, what the character of those deductions are. However, provided that Corporation used the accrual method of accounting in taking decommissioning liabilities into account, and provided that the liabilities at issue all have "accrued", within the meaning of 30 CFR § 250.1702, at least 3 years before the beginning of the taxable year in which such liabilities are satisfied then we rule as follows:

> Costs incurred and deductible in satisfaction of the decommissioning liabilities set forth above that generate an NOL constitute a specified liability loss, within the meaning of section 172(f), and therefore qualify for a 10-year carryback period pursuant to section 172(b)(1)(C).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

William A. Jackson
Chief, Branch 5
(Income Tax & Accounting)