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 REFDATE 121119
 SUBJECT Shale Gas Well Drilling Classification
 SECTION 66.2(5) "Canadian development expense"; 248(1) "oil or gas well"

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA. Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: Are the costs of drilling and completing a shale natural gas well considered CDE?
 POSITION: Question of fact, but generally yes.
 REASONS: In general, expenses to drill and complete a shale gas well may qualify under subparagraph (a)(ii) of the definition of CDE, if that particular well meets the purpose test set out in the definition of an "oil or gas well" in subsection 248(1) of the Act and if the expenditure was not on account of CEE or SR&ED.

XXXXXXXXXX

2012-045935
 T. Posadovsky

November 19, 2012

Dear XXXXXXXXXXXX:

Re: Shale Gas Drilling Classification

This is in reply to your email of August 16, 2012 concerning the classification of costs associated with shale gas wells. Specifically, you wish to know whether expenses incurred to drill and complete a shale gas well would be classified as Canadian development expense ("CDE"), as defined in subsection 66.2(5) of the Income Tax Act (the "Act").

Background

It is our understanding that shale gas is natural gas formed from being trapped within subsurface shale rock formations. As shale rock has low permeability, horizontal drilling is often used to expose the wellbore to as much of the reservoir as possible. New technologies in hydraulic fracturing ("fracking") are also being used to create extensive artificial fractures around well bores in order to improve permeability and increase the rate of production.

Our Comments

Subject to certain restrictions, an "oil or gas well" is defined under subsection 248(1) of the Act to mean any well drilled for the purpose of producing petroleum or natural gas, or of determining the existence, location, extent or quality of a natural accumulation of petroleum or natural gas. Among other things, an expense incurred by a taxpayer in drilling and completing an oil or gas well, including building temporary access roads to the well and preparing a site in respect of the well, may

be classified as CDE by virtue of the definition of that term in subsection 66.2(5) of the Act. However, where the drilling of a well results in the discovery that a natural underground reservoir contains petroleum or natural gas, a dry hole, or the well is shut in or abandoned within specified time limits and without having produced, such expenses may qualify as Canadian exploration expense ("CEE") under paragraph (d) of the definition of that term in subsection 66.1(6) of the Act. In the case where a well is drilled for the purpose of applied research or experimental development of a new technology, the costs of work associated with such activities may meet the definition of scientific research and experimental development ("SR&ED") defined in subsection 248(1) of the Act.

In summary, where a shale gas well is drilled for the purpose of producing natural gas or determining the extent or quality of natural gas, the cost of drilling and completing such a well would generally qualify as CDE. However, as indicated above, whether or not a particular expense will be CDE, CEE or in respect of SR&ED is a question of fact that can only be resolved by examining all of the relevant circumstances of a particular situation.

We trust that our comments will be of assistance.

Yours truly,

Fiona Harrison, C.A.
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