OIL & GAS COST RECOVERY

DEPLETION


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Table of Contents

Page

Oil and Gas Recovery - Depletion ................................................................. 1
Economic Interest ....................................................................................... 1
Cost Depletion ............................................................................................ 1
Percentage Depletion ................................................................................ 3
Independent Producers and Royalty Owners Exception .......................... 4
100% Taxable Income Limitation on the Property ................................. 5
Special Taxpayers ...................................................................................... 5
Recapture of Depletion ............................................................................ 7
Family Limited Partnership Example ....................................................... 7
Citations ..................................................................................................... 10

EXHIBITS

26 USC §613A - Limitations on Percentage Depletion In Case Of Oil and Gas Wells ..................................................... I
Decline Curve ........................................................................................... II
Reg 1.611-2(g)(1); 26 U.S.C. 611 ................................................................. III
Treasury Regulations, Subchapter A, Sec. 1.612-3 .............................. IV
Rev. Proc. 2004-19 ................................................................................. V
OIL AND GAS RECOVERY - DEPLETION

In addition to the depreciation (or recovery) allowances for the use of physical properties, the Code provides for an annual allowance for the depletion of the mineral reserves that is intended to return the taxpayer's capital investment in the reserves consumed in the production of income. i

Only the holder of an "economic interest" in the mineral property may take depletion. The annual depletion allowance is the greater of cost or percentage depletion. ii

Cost depletion (sometimes referred to as "unit of production" or UOP depletion) is an allocated portion of the adjusted basis of the depletable property. That basis includes the costs incurred in acquiring the "economic interest" and the capitalized, intangible costs incurred in drilling and developing a mineral deposit.

Percentage depletion (sometimes referred to as "statutory depletion") is a stipulated percentage of the gross income from the property during the taxable year. Therefore, it is necessary to compute percentage depletion based on the income from each separate property rather than upon the combined income from all properties. iii

ECONOMIC INTEREST

An economic interest consists of an interest (i) acquired by investment in the minerals in place, (ii) entitling the owner to income derived from the extraction of the minerals, (iii) to which the owner must look for a return of its capital. iv An economic interest is thus the right to share in the oil and gas produced from the property or the proceeds from the sale of such oil and gas. v The term includes working or operating interests, royalties, overriding royalties, net profits interests, and production payments to the extent not treated as loans under § 636. vi

COST DEPLETION

General
Cost depletion is a cost recovery system based on the number of units produced and sold during the taxable year in relation to the total estimated recoverable reserves. The amount of the cost depletion deduction reduces the adjusted basis of the natural resource property, but not below zero. vii

The adjusted basis for cost depletion is the same as the adjusted basis for the purpose of determining the gain upon a subsequent sale or other disposition of the property, that is, the cost or other initial basis of the property, adjusted for capital expenditures and allowable depletion. viii The basis includes capitalized drilling and development costs. In determining the amount of the adjusted basis applicable to the oil and gas deposit, the taxpayer excludes the cost or value for land for purposes, other than oil and gas production, the amount recoverable through depreciation and through deductions other
than depletion, and the residual value of other property at the end of the oil and gas production.ix

Where a producing property is purchased, the purchase price is allocated between the depletable reserves and the depreciable assets based on relative fair market values. Fair market value should be determined based on cost or comparative values and replacement value of equipment. "Present value" in which future earnings are discounted to present worth can be used only if the fair market value cannot reasonable be determined by any other method.x

The cost depletion amount is computed by dividing the adjusted basis of the property by the "number of units of mineral remaining as of the taxable year," and then multiplying this unit cost figure by the number of units sold during the taxable year. The "number of units of mineral remaining as of the taxable year" is the number of units remaining at the end of the year to be recovered from the property (including units recovered, but not sold), plus the "number of units sold within the taxable year." "The number of units sold within the taxable year" includes, in the case of a cash method taxpayer, the units for which payments were received within the taxable year even though they were produced or sold prior to the taxable year, and excludes the units which were sold but not paid for in the taxable year. In the case of an accrual method taxpayer, the number of units sold is determined from the taxpayer's physical inventories in a manner consistent with its method of accounting, but does not include units with respect to which depletion deductions were allowable prior to the taxable year. In the selection of a unit of mineral for depletion, preference is given to the principal or customary units paid for, such as barrels of oil and thousands of cubic feet of natural gas.xi

The estimated number of recoverable units at the beginning of a year is the same as the number of units at the close of the prior year, assuming no change in the facts on which that estimate was based. The estimate can be revised for material changes based on information derived from operations or development work during the prior year.xii The Service's position is that the amount of recoverable reserves cannot be reestimated based on changes in economic conditions.xiii

The formula is as follows:

\[
\text{Actual Production} \times \frac{\text{Remaining Reserves}}{\text{Remaining Reserves}} = \text{Depletion Deduction}
\]

For a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute cost depletion by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in rock pressure during the taxable year and the denominator of which is equal to the expected total decline in rock pressure from the beginning of the taxable year to the economic limit of production. Taxpayers who compute cost depletion by this
method must keep accurate records of periodic pressure determination. Only cost depletion is allowed on flared natural gas.

Lease Bonus
The bonus paid by the lessee for the acquisition of the lease is capitalized as a leasehold cost recoverable through cost depletion. A lessor who reserves royalties in addition to receiving a bonus payment is allowed cost depletion on the bonus based on the amount that the bonus bears to the sum of the bonus and the royalties expected to be received. This allowance is deducted from the lessor's basis for depletion, and the remaining basis is recoverable through depletion on the royalties received.

Example: A lessor reserves a 1/8 royalty and receives a bonus of $10,000. Its basis in the mineral property immediately before the lease is $21,000 and the royalties it expects to receive are estimated to be $20,000. The cost depletion deduction is $7,000 ($21,000 basis multiplied by a fraction consisting of $10,000 bonus divided by the $30,000 total consisting of the bonus plus estimated royalties). The remaining $14,000 of basis will be recovered through the depletion allowances as the royalties are received.

Cost depletion taken on a bonus received for a lease in an unproven area may be subject to question because of the difficulty of determining the portion of the lease cost applicable to the oil and gas deposit. While the IRS has denied cost depletion on a bonus for unproven property, the courts have sustained a reasonable estimate of future royalties, even when it was estimated that no royalties would be received in the future.

Restoration of Depletion on Bonus
In the event the lease expires, terminates or is abandoned before there has been any production from the property, the lessor must restore to income the depletion deduction on the bonus and increase the basis of its interest in the property by the amount of the restored depletion deduction in the year of expiration, termination or abandonment. It appears that nominal production is sufficient to avoid restoration of the depletion deduction. The IRS has ruled that, when a lessor disposes of its interest in the minerals by sale, gift, devise, or by any other means before the expiration, termination, or abandonment of the lease, neither the transferor nor the transferee is required to restore the depletion deduction to income.

PERCENTAGE DEPLETION

IRC § 611 and the regulations thereto provide that there be allowed as a deduction in computing taxable income in the case of oil and gas properties a reasonable allowance for depletion which shall be computed on either the adjusted depletion basis of the property (i.e., cost depletion as determined under IRC § 612) or upon a percentage of gross income from the property (i.e., percentage depletion as determined under IRC §613A), whichever results in the greater allowance for depletion for any taxable year. Generally, the percentage depletion allowance is preferred by taxpayers since it is not limited to the taxpayer's adjusted basis in the property and often yields the greater
deduction amount. In practice, a taxpayer using the cost depletion method can only take depletion adjustments for so long as that taxpayer has a possible basis in the property whereas a taxpayer can utilize the percentage depletion allowance even if the adjusted basis of the property has been reduced to zero.

The percentage depletion allowance under the independent producer and royalty owner exemption is 15% of the gross income from the property, not to exceed (i) 100% of the taxable income from the property, and (ii) 65% of the taxpayer's taxable income for the year. xxiv

Percentage depletion is allowed on the byproduct of gas wells (LNG).

INDEPENDENT PRODUCERS AND ROYALTY OWNERS EXCEPTION

General
Independent producers and royalty owners (that is, taxpayers who are not retailers or refiners) are entitled to a percentage depletion allowance of 15% of the gross income from so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's "depletable oil quantity," and so much of the taxpayer's average daily production of natural gas as does not exceed the taxpayer's "depletable natural gas quantity." xxv

A taxpayer has an annual depletable oil quantity of 1,000 barrels. The taxpayer can elect annually to use all or some of that amount to determine its depletable natural gas quantity by using a conversion factor of 6,000 cubic feet of gas per barrel. The taxpayer's depletable oil quantity for that year is reduced by the number of barrels it elects to use in determining its depletable natural gas quantity. xxvi The taxpayer makes that election by claiming percentage depletion deductions for the taxable year based upon such election. The election may be on an original or amended tax return or a timely claim for refund. The taxpayer may change the election by filing an amended return or claim for refund. xxvii

Related Parties
If 50% or more of the beneficial interest in two or more corporations, trusts, or estates is owned by the same or related persons (taking into account only persons who own at least 5% of such beneficial interest), the depletable oil quantity must be allocated among those entities in proportion to their respective production of domestic crude oil or natural gas. For purposes of determining ownership interest, an interest owned by or for a corporation, partnership, trust, or estate is considered owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries. xxviii

A person is a "related person" with respect to another person if: (1) they are members of the same controlled group of corporations; or (2) the relationship would result in the disallowance of losses under § 267 or §707(b), except that the family of an individual includes only the individual's spouse and minor children. xxix
Members of the same controlled group of corporation are treated as one taxpayer for purposes of the depletable quantity limitation. The term "controlled group of corporations" has the same meaning as in §1563(a), except that the stock ownership requirement is "more than 50 percent" rather than "at least 80 percent" and §1563(b)(2) (with respect to excluded members) does not apply.

**100% TAXABLE INCOME LIMITATION ON THE PROPERTY**

Percentage depletion for oil and gas is limited to 100% of the taxable income from the property, computed without the depletion allowance. The limitation is computed for each separate §614 property.

**Taxpayer's 65% Taxable Income Limitation**

The depletion allowance under the independent producer and royalty owner exemption cannot exceed 65% of the tax-payer's taxable income for the taxable year, computed without considering any depletion on production that is subject to the exemption, any net operating loss carryback to the taxable year, any capital loss carryback to the taxable year, and, in the case of a trust, any distributions to its beneficiaries. If an amount is disallowed as a deduction for the taxable year because of this taxable income limitation, the disallowed amount may be carried forward and allowed as a deduction for the following year, subject to the 65% of taxable income limitation applied that year. When calculating the greater of cost or percentage depletion, it is necessary to eliminate the effect of the taxable income limitation and the depletable quantity limitation.

**SPECIAL TAXPAYERS**

**Partnerships**

Depletion is computed separately by the partners (and not the partnership) so that each partner can determine on its own whether it meets the test for percentage depletion. The partnership allocates to each partner a proportionate share of the partnership's adjusted basis in each oil or gas property and each partner makes its own determination of whether cost or percentage depletion is applicable. The partnership must allocate the adjusted basis either (i) in accordance with the partner's interest in partnership capital or income under the §613A(c)(7)(D) regulations, or (ii) in accordance with the rules for special allocations under the §704(b) regulations.

Basis is allocated to the partners solely for their determination of depletion. The economic interest continues to be held by the partnership.

Under the regulations to §613A, each partner's share of depletable basis is determined in accordance with that partner's interest in partnership capital at the time of the allocation.

**Basis of Oil and Gas Properties held by Partnerships**

On the exchange of property held by a partner to a partnership in exchange for an interest in the partnership, the tax consequences resulting from such exchange are governed by Subchapter K of the IRC. Specifically, IRC § 721 states the general rule that no gain or
loss is recognized to a partner on the contribution by such partner of property to the partnership in exchange for an interest in the partnership. The basis held by the partner in his or her partnership interest is equal to the adjusted basis of the property contributed to the partnership plus any gain recognized by the partner on the contributions. IRC §722. Likewise, the basis of the property contributed by the partner to the partnership shall be equal to the adjusted basis of the property at the time of contribution plus any gain recognized by the contributing partner on the contribution. IRC §723. In tax jargon, the basis determined pursuant to IRC §722 is often referred to as the "outside basis" and the basis determined under IRC §723 is often referred to as the "inside basis."

When oil and gas property is held by a tax partnership, the inside basis of the property is held by the individuals partners and not the partnership so that each partner determines it depletion allowance. IRC§613A(c)(7)(D).

Determining a Partner's Basis in Depletable Property

- Generally the partnership allocates to each partner his proportionate share of the adjusted basis of each oil and gas property as of the date of acquisition. A partner's initial share of the adjusted basis is determined in accordance with his interest in capital or income and, in the case of contributed property, will be governed by IRC §4704(c). Treas. Reg. §1.613A-3(d) provides that a partner's share of such adjusted basis of each property shall be determined in accordance with his interest in partnership capital.

- Treas. Reg. §1.613A-3(e)(2)(ii) provides, however, that if the partnership agreement provides for an allocation determined in accordance with the taxpayers' proportionate interest in partnership income and such interest is reasonably expected to remain unchanged throughout the life of the partnership, then such an allocation will be respected.

- Adjusted basis of one property may be allocated in accordance with capital and another allocated in accordance with income.

- Where the property is contributed and has an adjusted basis different from its value and is subject to the provisions of IRC §704(c), or where book value and basis differ as a result of partnership revaluation, the principles of IRC §704(c) or Treas. Reg. §1.704-1(b)(4)(i) apply.

S Corporations
Each shareholder in an S corporation must separately compute its depletion deduction. The S corporation must allocate to each shareholder its pro rata share of the adjusted basis of the S corporation in each oil or gas property held by the S corporation.
Trusts and Estates
The depletion allowance for a trust or estate is determined at the trust or estate level and is apportioned between the income beneficiaries and the trust or between the estate and the beneficiaries on the basis of the trust or estate income allocable to each.

Even though the cost or percentage depletion determination is made at the trust or estate level, that determination will not disallow cost depletion to a beneficiary for whom cost depletion exceeds percentage depletion.

Income in Respect of Decedent
A person receiving income in respect of a decedent may take percentage depletion on the income to which it relates as if the income recipient had the same economic interest in the property as the decedent (whether or not the income recipient also receives the property). However, if the decedent used cost depletion in the year of his death, any depletion deduction to which the decedent was entitled at the date of his death would be allowable in computing his taxable income for his last taxable year and to no one else.

Community Property
When the economic interest is community property, each spouse owns "property" within the meaning of §614, and the depletion allowance is determined separately for each spouse.

RECAPTURE OF DEPLETION
Under §1254(a)(1) depletion previously deducted must be recaptured ad ordinary income on the disposition of the property with respect to which the depletion was taken. The amount recaptured is the lesser of: (1) the amount by which the depletion deduction reduced the property's adjusted basis; or (2) the gain realized.

Note: Under this rule, percentage depletion deductions taken after the property's basis is reduced to zero are not recaptured.

FAMILY LIMITED PARTNERSHIP EXAMPLE:
Individual owns a mineral interest in certain property and receives a 3M lease bonus in year 1. He forms an FLP in year 2 transferring the mineral interests and gifts 12.25% FLP interests to trusts for his children. The valuation determined the gift was valued at $188,000 for gift tax purposes. The property is leased and in year two, drilling is complete and the FLP begins to receive oil royalties. At this time it is expected that the partnership will receive $2,063,096 in future oil royalties as its share of 296,800 barrels of oil to be produced over a 7-year period.

The following is an illustration of the mechanics of cost depletion on the lease bonus and depletion (cost or percentage) on the yearly payments, Basis and Gift mechanics.
Cost Depletion on lease bonus assumes taxpayer has basis in the mineral interest (not land) before the lease was signed. Formula is as follows:

\[
\frac{3 \text{ Mil}}{3\text{M} + 2.01 \text{M}} \times 1\text{M} = 200,000
\]

<table>
<thead>
<tr>
<th>Basis Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Basis</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less: Cost Depletion on Bonus</td>
<td>$(200,000)</td>
</tr>
<tr>
<td>Remaining Basis for Cost Depletion</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

Cost Depletion Year 1

\[
\frac{110,000 \text{ bbl's}}{186,800} \quad \text{or} \quad 0.59 \times 800,000 = 472,000
\]

<table>
<thead>
<tr>
<th>Depletion Component</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Bonus</td>
<td>$200,000</td>
</tr>
<tr>
<td>Production</td>
<td>472,000</td>
</tr>
<tr>
<td>Total</td>
<td>672,000</td>
</tr>
</tbody>
</table>

Illustration assumes no 65% limitation.
<table>
<thead>
<tr>
<th>Year</th>
<th>Royalty Income</th>
<th>Cost Depletion</th>
<th>% Depletion</th>
</tr>
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<tbody>
<tr>
<td>2013</td>
<td>$414,812</td>
<td>$672,000</td>
<td>$62,220</td>
</tr>
<tr>
<td>2014</td>
<td>$260,119</td>
<td>$150,000</td>
<td>$39,018</td>
</tr>
<tr>
<td>2015</td>
<td>$195,204</td>
<td>$125,000</td>
<td>$29,281</td>
</tr>
<tr>
<td>2016</td>
<td>$158,529</td>
<td>$53,000</td>
<td>$23,779</td>
</tr>
<tr>
<td>2017</td>
<td>$135,263</td>
<td></td>
<td>$20,289</td>
</tr>
<tr>
<td>2018</td>
<td>$125,145</td>
<td></td>
<td>$18,772</td>
</tr>
<tr>
<td>2019</td>
<td>$115,785</td>
<td></td>
<td>$17,368</td>
</tr>
<tr>
<td>2020</td>
<td>$107,124</td>
<td></td>
<td>$16,067</td>
</tr>
<tr>
<td>2021</td>
<td>$99,111</td>
<td></td>
<td>$14,867</td>
</tr>
<tr>
<td>2022</td>
<td>$91,698</td>
<td></td>
<td>$13,755</td>
</tr>
<tr>
<td>2023</td>
<td>$84,839</td>
<td></td>
<td>$12,726</td>
</tr>
<tr>
<td>2024</td>
<td>$78,493</td>
<td></td>
<td>$11,774</td>
</tr>
<tr>
<td>2025</td>
<td>$72,621</td>
<td></td>
<td>$10,893</td>
</tr>
<tr>
<td>2026</td>
<td>$67,189</td>
<td></td>
<td>$10,078</td>
</tr>
<tr>
<td>2027</td>
<td>$62,164</td>
<td></td>
<td>$9,325</td>
</tr>
<tr>
<td>Total</td>
<td>$2,068,096</td>
<td>$1,000,000</td>
<td>$310,212</td>
</tr>
</tbody>
</table>

Depletion Difference \( ($689,788) \)

Difference \( $689,788 \)

Tax Rate 34\% \( \times 0.34 \)

Savings \( $234,528 \)

Assumptions:
25\% Annual Decline
Tax Rate 34\%
No Depletion Deduction limitation in any year.
CITATIONS

i Regs. §1.611-1(a)(1).

ii Regs §1.611-1(a)(1); §§613(a) and 613A(d)(1).

iii The determination of the property unit is important in areas other than cost or percentage depletion, such as determination of gain or loss on the sale of a property, loss as the result of worthlessness of a property, allocation of capitalized geological and geophysical costs, and recapture of previously deducted intangible drilling and development costs in the event of a sale of a property.

iv §613(a). This limitation was suspended for taxable years beginning after Dec. 31, 1997 and before Jan. 1, 2002 for domestic oil and gas production from marginal properties. §613A(c)(6)(H)

v Palmer v. Bender, 287 U.S. 551 (1933); Comr. v. Williams, 82 F.2d 328 (5th Cir. 1936); GCM 22730, 1941-1 C.B. 214.

vi See PLR 200102010.

vii Regs. §1.611-2(b)(2).

viii §§ 612, 1011(a), 1016(a)(1), (2); Regs. §1.612-1(a).

ix Regs. § 1.612-1(b).

x Rev. Rul. 69-539, 1969-2 C.B. 141; Regs. § 1.611-2(d). See Island Creek Coal Co. v. Comr., 25 T.C.M. 540 (1966), and Island Creek Coal Co. v. Comr., 21 T.C.M. 727 (1962), where little or no basis was attributed to depletable coal reserves based on equipment value. See also Clemente, Inc. v. Comr., 50 T.C.M. 497 (1985) (use of residual method to determine depletable basis for gravel).

xi Regs. §1.611-2(a)(1), (2), (3).

xii Regs. §1.611-2(c)(2).


xiv Regs. §1.611-2(a)(4).

xv Regs. §1.612-3(3). Percentage depletion is not available for any lease bonus, advance royalty, or other amount payable without regard to production from the property. §613A(d)(5); Regs. §1.613A-3(j).

xvi Regs. §1.612-3(a)(1).

xvii Regs. §1.612-3(a)(1)


xx U.S. v. Luday, 274 U.S. 295 (1927) (the appropriate depletion charge is necessarily a rough estimate); Collums v. U.S., 480 F. Supp. 864 (D.Wyo. 1980) (depletion on wildcat acreage based on no estimated royalties); but cf. TAM 8532011 (no cost depletion where no expected royalties).

xxi Regs. §1.612-3(a)(2).


xxiv §§613A(c)(1) and 613(a).

xxv § 613A(c)(1).

xxvi § 613A(c)(3); Regs. §1.613A-7(h) and (i).

xxvii Regs. §1.613A-5.

xxviii §613A(c)(8)(B); Regs. §1.613A-3(h)(2).

xxix §613A(c)(8)(D)(ii); Regs. §1.613A-7(m)(2).

xxx §613A(c)(8)(A); Regs. §1.613A-3(h)(1).

xxxi §613A(c)(8)(C) and (D)(iii); Regs. §1.613A-3(h)(3).

xxxii §613(a). For marginal wells, the taxable income limitation is suspended for taxable years beginning after Dec. 31, 1997, and before Jan. 1, 2002. §613A(c)(6)(H).

xxiii In Louisiana Land & Explor. Co v. Comr., 102 T.C. 21 (1994), acq. in part and nonacq. in part, AOD 1995-008, the Tax Court held that a taxpayer's taxable income from each property includes income from the sale of all minerals produced from that property. The court determined that oil, gas and sulfur produced from that property. The court determined that oil, gas and sulfur produced from the same wells were produced from a single property, notwithstanding the fact that sulfur was separately depleted. The IRS, in its nonacquiescence, state that it will continue to maintain that income from hard minerals and from oil and gas cannot be combined for purposes of computing the taxable income limitation for each separate §614 mineral property.

xxiv §613A(d).

xxv Regs. §1.613A-4(a)(1)(i). When cost depletion on any property exceeds percentage depletion under the independent producer exemption, determined without considering the depletable quantity limitation or the taxable income limitation, the amount of allowable cost depletion is deducted in determining taxable income for purposes of this limitation.

xxvi §613A(c)(7)(D); Regs. §1.613A-3(e)(1). Where the partnership has a §754 election in effect, the adjustment to the depletable basis is made by the transferee partner and not the partnership. Regs. §1.743-1(j)(5). The transferee partner must attach a statement to its return for the year of transfer setting out the computation of the basis adjustment and the specific properties to which the adjustment is allocated. Regs. §1.743-1(k)(1)(ii).

xxvii Regs. §1.613A-3(e)(2), (3) and (4).

xxviii Regs. §1.613A-3(e)(5) (referencing Regs. §1.704(b)(4)(v)).

xxix §611(b)(3) and (4); Regs. §1.611-1(c)(4) and (5).

xf Regs. §1.613A-3(g)(1).

xfi Regs. §1.691(b)-1(b).

xli This rule generally applies to property placed in service after Dec. 31, 1986. Depletion was not recaptured before 1986.
26 USC § 613A - LIMITATIONS ON PERCENTAGE DEPLETION IN CASE OF OIL AND GAS WELLS

a) General rule
Except as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613.

(b) Exemption for certain domestic gas wells

(1) In general
The allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) regulated natural gas, and

(B) natural gas sold under a fixed contract,

and 22 percent shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(2) Natural gas from geopressed brine
The allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to any qualified natural gas from geopressed brine, and 10 percent shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of such section.

(3) Definitions
For purposes of this subsection—

(A) Natural gas sold under a fixed contract
The term “natural gas sold under a fixed contract” means domestic natural gas sold by the producer under a contract, in effect on February 1, 1975, and at all times thereafter before such sale, under which the price for such gas cannot be adjusted to reflect to any extent the increase in liabilities of the seller for tax under this chapter by reason of the repeal of percentage depletion for gas. Price increases after February 1, 1975, shall be presumed to take increases in tax liabilities into account unless the taxpayer demonstrates to the contrary by clear and convincing evidence.

(B) Regulated natural gas
The term “regulated natural gas” means domestic natural gas produced and sold by the producer, before July 1, 1976, subject to the jurisdiction of the Federal Power Commission, the price for which has not been adjusted to reflect to any extent the increase in liability of the seller for tax under this chapter by reason of the repeal of
percentage depletion for gas. Price increases after February 1, 1975, shall be presumed
to take increases in tax liabilities into account unless the taxpayer demonstrates the
contrary by clear and convincing evidence.

(C) Qualified natural gas from geopressed brine

The term "qualified natural gas from geopressed brine" means any natural gas—

(i) which is determined in accordance with section 503 of the Natural Gas Policy Act of
1978 to be produced from geopressed brine, and

(ii) which is produced from any well the drilling of which began after September 30, 1978,
and before January 1, 1984.

(c) Exemption for independent producers and royalty owners

(1) In general

Except as provided in subsection (d), the allowance for depletion under section 611 shall
be computed in accordance with section 613 with respect to—

(A) so much of the taxpayer’s average daily production of domestic crude oil as does not
exceed the taxpayer’s depletable oil quantity; and

(B) so much of the taxpayer’s average daily production of domestic natural gas as does
not exceed the taxpayer’s depletable natural gas quantity;

and 15 percent shall be deemed to be specified in subsection (b) of section 613 for
purposes of subsection (a) of that section.

(2) Average daily production

For purposes of paragraph (1)—

(A) the taxpayer’s average daily production of domestic crude oil or natural gas for any
taxable year, shall be determined by dividing his aggregate production of domestic crude
oil or natural gas, as the case may be, during the taxable year by the number of days in
such taxable year, and

(B) in the case of a taxpayer holding a partial interest in the production from any property
(including an interest held in a partnership) such taxpayer’s production shall be
considered to be that amount of such production determined by multiplying the total
production of such property by the taxpayer’s percentage participation in the revenues
from such property.
(3) Depletable oil quantity

(A) In general

For purposes of paragraph (1), the taxpayer’s depletable oil quantity shall be equal to—

(i) the tentative quantity determined under subparagraph (B), reduced (but not below zero) by

(ii) except in the case of a taxpayer making an election under paragraph (6)(B), the taxpayer’s average daily marginal production for the taxable year.

(B) Tentative quantity

For purposes of subparagraph (A), the tentative quantity is 1,000 barrels.

(4) Daily depletable natural gas quantity

For purposes of paragraph (1), the depletable natural gas quantity of any taxpayer for any taxable year shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer’s depletable oil quantity to which the taxpayer elects to have this paragraph apply. The taxpayer’s depletable oil quantity for any taxable year shall be reduced by the number of barrels with respect to which an election under this paragraph applies. Such election shall be made at such time and in such manner as the Secretary shall by regulations prescribe.


(6) Oil and natural gas produced from marginal properties

(A) In general

Except as provided in subsection (d) and subparagraph (B), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(i) so much of the taxpayer’s average daily marginal production of domestic crude oil as does not exceed the taxpayer’s depletable oil quantity (determined without regard to paragraph (3)(A)(ii)), and

(ii) so much of the taxpayer’s average daily marginal production of domestic natural gas as does not exceed the taxpayer’s depletable natural gas quantity (determined without regard to paragraph (3)(A)(ii)),

and the applicable percentage shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.
(B) Election to have paragraph apply to pro rata portion of marginal production

If the taxpayer elects to have this subparagraph apply for any taxable year, the rules of subparagraph (A) shall apply to the average daily marginal production of domestic crude oil or domestic natural gas of the taxpayer to which paragraph (1) would have applied without regard to this paragraph.

(C) Applicable percentage

For purposes of subparagraph (A), the term “applicable percentage” means the percentage (not greater than 25 percent) equal to the sum of—

(i) 15 percent, plus

(ii) 1 percentage point for each whole dollar by which $20 exceeds the reference price for crude oil for the calendar year preceding the calendar year in which the taxable year begins.

For purposes of this paragraph, the term “reference price” means, with respect to any calendar year, the reference price determined for such calendar year under section 45K (d)(2)(C).

(D) Marginal production

The term “marginal production” means domestic crude oil or domestic natural gas which is produced during any taxable year from a property which—

(i) is a stripper well property for the calendar year in which the taxable year begins, or

(ii) is a property substantially all of the production of which during such calendar year is heavy oil.

(E) Stripper well property

For purposes of this paragraph, the term “stripper well property” means, with respect to any calendar year, any property with respect to which the amount determined by dividing—

(i) the average daily production of domestic crude oil and domestic natural gas from producing wells on such property for such calendar year, by

(ii) the number of such wells,

is 15 barrel equivalents or less.
(F) Heavy oil

For purposes of this paragraph, the term “heavy oil” means domestic crude oil produced from any property if such crude oil had a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

(G) Average daily marginal production

For purposes of this subsection—

(i) the taxpayer’s average daily marginal production of domestic crude oil or natural gas for any taxable year shall be determined by dividing the taxpayer’s aggregate marginal production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and

(ii) in the case of a taxpayer holding a partial interest in the production from any property (including any interest held in any partnership), such taxpayer’s production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer’s percentage participation in the revenues from such property.

(H) Temporary suspension of taxable income limit with respect to marginal production

The second sentence of subsection (a) of section 613 shall not apply to so much of the allowance for depletion as is determined under subparagraph (A) for any taxable year—

(i) beginning after December 31, 1997, and before January 1, 2008, or


(7) Special rules

(A) Production of crude oil in excess of depletable oil quantity

If the taxpayer’s average daily production of domestic crude oil exceeds his depletable oil quantity, the allowance under paragraph (1)(A) with respect to oil produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613 (a) for all of the taxpayer’s oil produced from such property during the taxable year (computed as if section 613 applied to all of such production at the rate specified in paragraph (1) or (6), as the case may be) as his depletable oil quantity bears to the aggregate number of barrels representing the average daily production of domestic crude oil of the taxpayer for such year.
(B) Production of natural gas in excess of depletable natural gas quantity

If the taxpayer's average daily production of domestic natural gas exceeds his depletable natural gas quantity, the allowance under paragraph (1)(B) with respect to natural gas produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613 (a) for all of the taxpayers' natural gas produced from such property during the taxable year (computed as if section 613 applied to all of such production at the rate specified in paragraph (1) or (6), as the case may be) as the amount of his depletable natural gas quantity in cubic feet bears to the aggregate number of cubic feet representing the average daily production of domestic natural gas of the taxpayer for such year.

(C) Taxable income from the property

If both oil and gas are produced from the property during the taxable year, for purposes of subparagraphs (A) and (B) the taxable income from the property, in applying the taxable income limitation in section 613 (a), shall be allocated between the oil production and the gas production in proportion to the gross income during the taxable year from each.

(D) Partnerships

In the case of a partnership, the depletion allowance shall be computed separately by the partners and not by the partnership. The partnership shall allocate to each partner his proportionate share of the adjusted basis of each partnership oil or gas property. The allocation is to be made as of the later of the date of acquisition of the oil or gas property by the partnership, or January 1, 1975. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital or income and, in the case of property contributed to the partnership by a partner, section 704 (c) (relating to contributed property) shall apply in determining such share. Each partner shall separately keep records of his share of the adjusted basis in each oil and gas property of the partnership, adjust such share of the adjusted basis for any depletion taken on such property, and use such adjusted basis each year in the computation of his cost depletion or in the computation of his gain or loss on the disposition of such property by the partnership. For purposes of section 732 (relating to basis of distributed property other than money), the partnership's adjusted basis in mineral property shall be an amount equal to the sum of the partners' adjusted basis in such property as determined under this paragraph.

(8) Business under common control; members of the same family

(A) Component members of controlled group treated as one taxpayer

For purposes of this subsection, persons who are members of the same controlled group of corporations shall be treated as one taxpayer.
(B) Aggregation of business entities under common control

If 50 percent or more of the beneficial interest in two or more corporations, trusts, or estates is owned by the same or related persons (taking into account only persons who own at least 5 percent of such beneficial interest), the tentative quantity determined under paragraph (3)(B) shall be allocated among all such entities in proportion to the respective production of domestic crude oil during the period in question by such entities.

(C) Allocation among members of the same family

In the case of individuals who are members of the same family, the tentative quantity determined under paragraph (3)(B) shall be allocated among such individuals in proportion to the respective production of domestic crude oil during the period in question by such individuals.

(D) Definition and special rules

For purposes of this paragraph—

(i) the term “controlled group of corporations” has the meaning given to such term by section 1563 (a), except that section 1563 (b)(2) shall not apply and except that “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears in section 1563 (a),

(ii) a person is a related person to another person if such persons are members of the same controlled group of corporations or if the relationship between such persons would result in a disallowance of losses under section 267 or 707 (b), except that for this purpose the family of an individual includes only his spouse and minor children.

(iii) the family of an individual includes only his spouse and minor children,

(iv) each 6,000 cubic feet of domestic natural gas shall be treated as 1 barrel of domestic crude oil.

(9) Special rule for fiscal year taxpayers

In applying this subsection to a taxable year which is not a calendar year, each portion of such taxable year which occurs during a single calendar year shall be treated as if it were a short taxable year.

(10) Certain production not taken into account

In applying this subsection, there shall not be taken into account the production of natural gas with respect to which subsection (b) applies.
(11) Subchapter S corporations

(A) Computation of depletion allowance at shareholder level

In the case of an S corporation, the allowance for depletion with respect to any oil or gas property shall be computed separately by each shareholder.

(B) Allocation of basis

The S corporation shall allocate to each shareholder his pro rata share of the adjusted basis of the S corporation in each oil or gas property held by the S corporation. The allocation shall be made as of the later of the date of acquisition of the property by the S corporation, or the first day of the first taxable year of the S corporation to which the Subchapter S Revision Act of 1982 applies. Each shareholder shall separately keep records of his share of the adjusted basis in each oil and gas property of the S corporation, adjust such share of the adjusted basis for any depletion taken on such property, and use such adjusted basis each year in the computation of his cost depletion or in the computation of his gain or loss on the disposition of such property by the S corporation. In the case of any distribution of oil or gas property to its shareholders by the S corporation, the corporation’s adjusted basis in the property shall be an amount equal to the sum of the shareholders’ adjusted bases in such property, as determined under this subparagraph.

(d) Limitations on application of subsection (c)

(1) Limitation based on taxable income

The deduction for the taxable year attributable to the application of subsection (c) shall not exceed 65 percent of the taxpayer’s taxable income for the year computed without regard to—

(A) any depletion on production from an oil or gas property which is subject to the provisions of subsection (c),

(B) any deduction allowable under section 199,

(C) any net operating loss carryback to the taxable year under section 172,

(D) any capital loss carryback to the taxable year under section 1212, and

(E) in the case of a trust, any distributions to its beneficiary, except in the case of any trust where any beneficiary of such trust is a member of the family (as defined in section 267(c)(4)) of a settlor who created inter vivos and testamentary trusts for members of the family and such settlor died within the last six days of the fifth month in 1970, and the law in the jurisdiction in which such trust was created requires all or a portion of the gross or net proceeds of any royalty or other interest in oil, gas, or other mineral representing any percentage depletion allowance to be allocated to the principal of the trust.
If an amount is disallowed as a deduction for the taxable year by reason of application of the preceding sentence, the disallowed amount shall be treated as an amount allowable as a deduction under subsection (c) for the following taxable year, subject to the application of the preceding sentence to such taxable year. For purposes of basis adjustments and determining whether cost depletion exceeds percentage depletion with respect to the production from a property, any amount disallowed as a deduction on the application of this paragraph shall be allocated to the respective properties from which the oil or gas was produced in proportion to the percentage depletion otherwise allowable to such properties under subsection (c).

(2) Retailers excluded

Subsection (c) shall not apply in the case of any taxpayer who directly, or through a related person, sells oil or natural gas (excluding bulk sales of such items to commercial or industrial users), or any product derived from oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense)—

(A) through any retail outlet operated by the taxpayer or a related person, or

(B) to any person—

(i) obligated under an agreement or contract with the taxpayer or a related person to use a trademark, trade name, or service mark or name owned by such taxpayer or a related person, in marketing or distributing oil or natural gas or any product derived from oil or natural gas, or

(ii) given authority, pursuant to an agreement or contract with the taxpayer or a related person, to occupy any retail outlet owned, leased, or in any way controlled by the taxpayer or a related person.

Notwithstanding the preceding sentence this paragraph shall not apply in any case where the combined gross receipts from the sale of such oil, natural gas, or any product derived therefrom, for the taxable year of all retail outlets taken into account for purposes of this paragraph do not exceed $5,000,000. For purposes of this paragraph, sales of oil, natural gas, or any product derived from oil or natural gas shall not include sales made of such items outside the United States, if no domestic production of the taxpayer or a related person is exported during the taxable year or the immediately preceding taxable year.

(3) Related person

For purposes of this subsection, a person is a related person with respect to the taxpayer if a significant ownership interest in either the taxpayer or such person is held by the other, or if a third person has a significant ownership interest in both the taxpayer and such person. For purposes of the preceding sentence, the term "significant ownership interest" means—

(A) with respect to any corporation, 5 percent or more in value of the outstanding stock of such corporation,
(B) with respect to a partnership, 5 percent or more interest in the profits or capital of such partnership, and

(C) with respect to an estate or trust, 5 percent or more of the beneficial interests in such estate or trust.

For purposes of determining a significant ownership interest, an interest owned by or for a corporation, partnership, trust, or estate shall be considered as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be.

(4) Certain refiners excluded

If the taxpayer or one or more related persons engages in the refining of crude oil, subsection (c) shall not apply to the taxpayer for a taxable year if the average daily refinery runs of the taxpayer and such persons for the taxable year exceed 75,000 barrels. For purposes of this paragraph, the average daily refinery runs for any taxable year shall be determined by dividing the aggregate refinery runs for the taxable year by the number of days in the taxable year.

(5) Percentage depletion not allowed for lease bonuses, etc.

In the case of any oil or gas property to which subsection (c) applies, for purposes of section 613, the term “gross income from the property” shall not include any lease bonus, advance royalty, or other amount payable without regard to production from property.

(e) Definitions

For purposes of this section—

(1) Crude oil

The term “crude oil” includes a natural gas liquid recovered from a gas well in lease separators or field facilities.

(2) Natural gas

The term “natural gas” means any product (other than crude oil) of an oil or gas well if a deduction for depletion is allowable under section 611 with respect to such product.

(3) Domestic

The term “domestic” refers to production from an oil or gas well located in the United States or in a possession of the United States.

(4) Barrel

The term “barrel” means 42 United States gallons.
EXHIBIT II
EAGLE FORD SHALE TYPE CURVES

ANNUAL DECLINE RATES:

Year 1: 73%
Year 2: 33%
Year 3: 27%
Year 4: 21%
Year 5: 17%

Note: Internally estimated type curves.
EAGLE FORD SHALE TREND

Oil Window - La Salle and Frio Counties, Texas

Goodrich Acreage: 55,000 gross (39,000 net) acres
EXHIBIT III
Reg. Sec. 1.611-2(g)(1); 26 U.S.C. 611

(1) For the first taxable year ending before December 31, 1967, for which a taxpayer asserts a value for any mineral property or improvement as of a specific date or claims a deduction for depletion, or depreciation, there shall be attached to the return of the taxpayer for such taxable year a statement setting forth, in complete, summary form, the pertinent information required by this paragraph with respect to each such mineral property or improvement (including oil and gas properties or improvements). The summary statement shall be deemed a part of the income tax return to which it relates. In addition to such summary statement, the taxpayer must assemble, segregate and have readily available at his principal place of business, all the supporting data (listed in subparagraphs (2), (3), and (4) of this paragraph) which is used in compiling the summary statement. For taxable years after such first taxable year, and ending before December 31, 1967, the taxpayer need attach to his return only an explanation of the changes, if any, in the information previously furnished. For example, when a taxpayer has filed adequate maps with the district director he may be relieved of filing further maps of the same area, if all additional information necessary for keeping the maps up-to-date is filed each year. In any case in which any of the information required by this paragraph has been previously filed by the taxpayer (including information furnished in accordance with corresponding provisions of prior regulations), such information need not be filed again, but a statement should be attached to the return of the taxpayer indicating clearly when and in what form such information was previously filed. For provisions relating to the data which shall be submitted with returns for taxable years ending on or after December 31, 1967, see subparagraph (5) of this paragraph.

Reg. Sec. 1.611-2(g)(2); 26 U.S.C. 611

(2) The information referred to in subparagraph (1) of this paragraph is as follows:

(i) An adequate map showing the name, description, location, date of surveys, and identification of the deposit or deposits;

(ii) A description of the character of the taxpayer's property, accompanied by a copy of the instrument or instruments by which it was acquired;

(iii) The date of acquisition of the property, the exact terms and dates of expiration of all leases involved, and if terminated, the reasons therefore;

(iv) The cost of the mineral property and improvements, stating the amount paid to each vendor, with his name and address;

(v) The date as of which the mineral property and improvements are valued, if a valuation is necessary to establish the basis as provided by section 1012;

(vi) The value of the mineral property and improvements on that date with a statement of the precise method by which it was determined;
(vii) An allocation of the cost or value among the mineral property, improvements and the surface of the land for purposes other than mineral production;

(viii) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(ix) The number of units sold and the number of units for which payment was received or accrued during the year for which the return is made (in the case of newly developed oil and gas deposits it is desirable that this information be furnished by months);

(x) The gross amount received from the sale of mineral;

(xi) The amount of depreciation for the taxable year and the amount of cost depletion for the taxable year;

(xii) The amounts of depletion and depreciation, if any, stated separately, which for each and every prior year;

(a) Were allowed (see section 1016(a)(2)),

(b) Were allowable, and

(c) Would have been allowable without reference to percentage or discovery depletion;

(xiii) The fractions (however measured) of gross production from the deposit or deposits to which the taxpayer and other persons are entitled together with the names and addresses of such other persons; and

(xiv) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deductions claimed.
EXHIBIT IV
Sec. 1.612-3 Depletion; treatment of bonus and advanced royalty

(a) Bonus. (1) If a bonus in addition to royalties is received upon the grant of an economic interest in a mineral deposit, or standing timber, there shall be allowed to the payee as a cost depletion deduction in respect of the bonus an amount equal to that proportion of his basis for depletion as provided in section 612 and §1.612–1 which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee’s basis for depletion and the remainder of the basis is recoverable through depletion deductions as the royalties are thereafter received. (But see paragraph (e) of this section.) For example, a taxpayer leases mineral property to another reserving a one-eighth royalty and in addition receives a bonus of $10,000. Assuming that the taxpayer’s basis with respect to the mineral property is $21,000 and that the royalties expected to be received are estimated to total $20,000, the depletion on the bonus would be $7,000:

\[ \frac{21,000 \text{ (basis)} \times 10,000 \text{ (bonus)}}{30,000 \text{ (bonus plus estimated royalties)}} \]

The remaining $14,000 of basis will be recovered through depletion as the royalties are received.

(2) If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination, or abandonment.

(3) In the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit or standing timber recoverable through the depletion allowance. See paragraph (c)(5)(ii) of §1.613–2 in cases in which percentage depletion is used.
(b) Advanced royalties. (1) If the owner of an operating interest in a mineral deposit or standing timber is required to pay royalties on a specified number of units of such mineral or timber annually whether or not extracted or cut within the year, and may apply any amounts paid on account of units not extracted or cut within the year against the royalty on the mineral or timber thereafter extracted or cut, the payee shall compute cost depletion on the number of units so paid for in advance of extraction or cutting and shall treat the amount so determined as an allowable deduction for depletion from the gross income of the year in which such payment or payments are made. No deduction for depletion by such payee shall be claimed or allowed in any subsequent year on account of the extraction or cutting in such year of any mineral or timber so paid for in advance and for which deduction has once been made. (But see paragraph (e) of this section.)

(2) If the right to extract minerals or to cut timber against which the advanced royalties may be applied expires, terminates, or is abandoned before all such minerals or timber have been extracted or cut, the payee shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of any units of mineral or timber paid for in advance but not extracted or cut, and a corresponding amount must be returned as income for the year of such expiration, termination or abandonment. (But see paragraph (e) of this section.)

(3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. For special rules applicable when the payor is a sublessor of coal or domestic iron ore, see paragraph (b)(3) of §1.631–3. Every taxpayer who pays or accrues advanced royalties resulting from a minimum royalty provision must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending after December 31, 1939, in which the advanced royalties are paid or accrued. The taxpayer's treatment of the advanced royalties for the first year shall be deemed to be the exercise of the election. Accordingly, a failure to deduct the advanced royalties for that year will constitute an election to have all the advanced royalties treated as deductions for the year of the sale of the mineral product in respect of which the advanced royalties are paid or accrued. See section 7807(b)(2). For additional rules relating to elections in the case of partners and partnerships, see
section 703(b) and the regulations thereunder. The provisions of this subparagraph do not allow as deductions from gross income amounts disallowed as deductions under other provisions of the Code, such as section 461 (relating to general rule for taxable year of deduction), section 465 (relating to deductions limited to amount at risk in case of certain activities), or section 704(d) (relating to limitation on allowance to partners of partnership losses).

(4) The application of subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

**Example 1.** B leased certain mineral lands from A under a lease in which A reserved a royalty of 10 cents a ton on minerals mined and sold by B. The lease also provided that B 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.

EXHIBIT V
Rev. Proc. 2004–19
SECTION 1. PURPOSE

This revenue procedure provides an elective safe harbor that the owner of an oil and gas property may use in determining the property’s recoverable reserves for purposes of computing cost depletion under § 611 of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 In General. Section 611(a) and the regulations thereunder allow as a deduction in computing taxable income a reasonable allowance for depletion in the case of oil and gas wells according to the peculiar conditions in each case.

.02 Computation of Cost Depletion. Under § 1.611–2(a) of the Income Tax Regulations, a taxpayer claiming the deduction for cost depletion computes the amount allowed with respect to each oil and gas property by reference to both the total number of recoverable units that the property is estimated to contain and the number of units sold from the property during the taxable year.

.03 Depletion Accounts. A taxpayer is required under § 1.611–2(b) to keep accounts for the depletion of each property and to adjust those accounts annually for units sold and for depletion claimed.

.04 Reserve Estimates. Section 1.611–2(c)(1) contains the rules for estimating the total recoverable units of mineral products reasonably known, or on good evidence believed, to exist with respect to each property. The estimate or determination must be made according to the method current in the industry and in light of the most accurate and reliable information obtainable. Under the regulations, the estimate of total recoverable units includes all reserves that are proved and, under appropriate circumstances, probable or prospective reserves in addition to the reserves that are proved.

.05 Revisions of Reserve Estimates. (1) Under § 1.611–2(c)(2), if the number of recoverable units of mineral in the deposit has been previously estimated, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the deposit as of the taxable year will be the number remaining from the prior estimate. However, § 611 provides that, in any case in which it is ascertained as a result of operations and development work that the recoverable units are greater or less than the prior estimate, then the estimate will be revised and the revised estimate will be used for subsequent periods. Under § 1.611–2(c)(2), a revision is made only when operations or development work indicates that the remaining recoverable units as of the taxable year are materially greater or less than the number remaining from the prior estimate. The revised estimate is used until a change in facts requires another revision.

(2) In Martin Marietta Corporation v. United States, 7 Cl. Ct. 586 (1985), the United States Claims Court interpreted § 611(a) and § 1.611–2(c)(2) as intended to remedy mistakes
of geological fact: situations where the actual size of the mineral deposit in place, as originally estimated, is later determined on the basis of more exploratory studies, for example, to be greater or less than earlier information indicated. The court distinguished situations where revisions are made under the statute and regulations from those in which the mineral property has experienced a mere diminution in value or even a retreat into worthlessness.

.06 Differences between Tax and Financial Accounting for Reserves. Generally, accounting for reserves for purposes of the depletion allowance differs from accounting for reserves for financial purposes in two important respects. First, while the regulations require the inclusion of probable or prospective reserves in addition to proved reserves for purposes of the depletion allowance, the United States Securities and Exchange Commission (SEC) generally requires the reporting of only proved reserves for financial purposes. Second, the revision of a reserve estimate for purposes of the depletion allowance is permitted under fewer circumstances than is the revision of a reserve estimate for financial reporting purposes. While the SEC may require or permit the revision of a reserve estimate in the case of changes in the price of the mineral or the cost of its extraction, such circumstances are not sufficient basis for revision of a reserve estimate for purposes of the depletion allowance.

.07 Probable or Prospective Reserves. The appropriate quantity of probable or prospective reserves to be included in an oil and gas property’s total recoverable units for purposes of computing cost depletion has been a source of controversy between taxpayers and the Service. When present, the issue has been resolved through the examinations which are costly for both parties in the dispute. This revenue procedure provides a safe harbor which is intended to remove this source of controversy from the examinations of taxpayers who elect it.

SECTION 3. SCOPE

.01 In General. A taxpayer’s estimate of an oil and gas property’s probable or prospective reserves determined under the safe harbor provided in this revenue procedure may be used only for purposes of the depletion allowance. This revenue procedure has no application to the determination of the fair market value of any oil and gas property or for any other purpose not specifically authorized herein.

.02 Effect of Other Statutory and Regulatory Rules. Except with respect to estimated total recoverable units (within the meaning of § 1.611–2(c)(1)) and revised estimates (within the meaning of § 1.611–2(c)(2)), this revenue procedure has no effect on the rules provided in § 611 and the regulations thereunder.

SECTION 4. TOTAL RECOVERABLE UNITS SAFE HARBOR

.01 If a taxpayer makes an election in accordance with section 5 of this revenue procedure, then, for purposes of computing cost depletion:
(1) The total recoverable units under § 1.611–2(c)(1) that each of the taxpayer’s domestic oil and gas producing properties is estimated to contain as of a specific date will be treated as being equal to 105 percent of the property’s “proved reserves” (both developed and undeveloped) as defined in 17 C.F.R. § 210.4–10(a) of Regulation S-X, as of that date;

(2) The total recoverable units under § 1.611–2(c)(2) that each of the taxpayer’s domestic oil and gas producing properties is estimated, on a revised basis, to contain as of a taxable year will be deemed to be equal to 105 percent of the property’s “proved reserves” (both developed and undeveloped) as defined in Regulation S-X, as of that taxable year.

.02 Nothing in this revenue procedure precludes the examination and adjustment, if appropriate, of the estimate of proved reserves, as defined in Regulation S-X, in order to ensure that this revenue procedure is properly administered. Except as provided in section 5.02 of this revenue procedure, a taxpayer’s estimate of a property’s remaining recoverable units may be revised only under the circumstances permitted under §1.611–2(c)(2).

SECTION 5. METHOD OF ELECTION AND REVOCATION

.01 In General.
(1) Election. To elect the safe harbor provided in this revenue procedure for taxable years ending on or after March 8, 2004, a taxpayer must attach a statement to its timely filed (including extensions) original federal income tax return for the first taxable year for which the safe harbor is elected. The statement must indicate that the taxpayer is electing the safe harbor provided by Rev. Proc. 2004–19, and include the taxpayer’s name, address, taxpayer identification number, and contact name and telephone number. A copy of the statement must be sent to the Industry Director, Large and Mid-Size Business, Natural Resources, 1919 Smith Street, HOU 1000, Houston, Texas 77002. Once a taxpayer files a first return electing the safe harbor for a taxable year, the taxpayer may not revoke the election for the taxable year. The election is effective for the taxable year of election and all subsequent taxable years until revoked and applies to all of the taxpayer’s domestic oil and gas producing properties.

(2) Revocation. To revoke a safe harbor election, a taxpayer must attach a statement to its timely filed (including extensions) original federal income tax return for the first taxable year for which the safe harbor is revoked. The statement must indicate that the taxpayer is revoking the safe harbor provided by Rev. Proc. 2004–19, and include the taxpayer’s name, address, taxpayer identification number, and contact name and telephone number. A copy of the statement must be sent to the Industry Director, Large and Mid-Size Business, Natural Resources, 1919 Smith Street, HOU 1000, Houston, Texas 77002. If a taxpayer revokes its election, the taxpayer may not re-elect the safe harbor for the next five taxable years following the taxable year of revocation.

.02 Election of Safe Harbor for Taxable Year Beginning Before January 1, 2005. If the first taxable year for which a taxpayer elects the safe harbor provided in this revenue procedure begins before January 1, 2005, the taxpayer may, for the taxable year of
election, revise the estimate of remaining recoverable units for any of the taxpayer’s domestic oil and gas producing properties whether or not there has been a change in geological fact indicating that the remaining recoverable units as of the taxable year for any given property is materially greater or less than the number remaining from the prior estimate. The taxpayer must use the economic and operating conditions (such as prices and costs) applicable to the taxable year of election in determining the estimate of total recoverable units.

.03 Election of Safe Harbor for Taxable Year Beginning After December 31, 2004. If the first taxable year for which a taxpayer elects the safe harbor provided in this revenue procedure begins after December 31, 2004, the taxpayer must determine, for each domestic oil and gas producing property, the last taxable year preceding the taxable year of election as of which the taxpayer revised an oil and gas property’s total recoverable units (the year of last revision) pursuant to § 1.611–2(c)(2). The taxpayer determines the property’s remaining recoverable units for the year of last revision using the safe harbor rules set forth in section 4 of this revenue procedure. The taxpayer then applies the rules set forth in § 1.611–2(b) for all subsequent taxable years to determine the property’s remaining recoverable units for the taxable year of election. Similar procedures apply if the taxpayer’s estimate of the property’s remaining recoverable units is based on the taxpayer’s original estimate of its total recoverable units under §1.611–2(c)(1). The taxpayer may not, for the taxable year of election, revise the estimate of remaining recoverable units for any of the taxpayer’s domestic oil and gas producing properties unless there has been a change in geological fact indicating that the remaining recoverable units as of the taxable year for any given property is materially greater or less than the number remaining from the prior estimate.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after March 8, 2004.

SECTION 7. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545–1861.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 5. The information in section 5 is required to be submitted to the applicable service center in order to elect (or revoke) the safe harbor. This information will be used to determine whether a taxpayer estimated the total recoverable units for each of its domestic oil and gas producing properties under the safe harbor. The likely respondents are businesses or other for-profit institutions.
The estimated total annual reporting burden is 50 hours.

The estimated annual burden per respondent varies from .25 hours to .75 hours, depending on individual circumstances, with an estimated average burden of .5 hours to complete the statement. The estimated number of respondents is 100.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential under 26 U.S.C.§6103.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jolene J. Shiraishi of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Shiraishi at (202) 622–3120 (not a toll-free call).

March 8, 2004

565 2004-10 I.R.B.