Field Directive on Cost Depletion - Determination of Recoverable Reserves

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Large and Mid-Size Business Division
July 30, 2004

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, LMSB
DIVISION COUNSEL, LMSB
DIRECTOR, COMPLIANCE, SBSE

FROM: Bobby E. Scott / Bobby E. Scott
Industry Director
Natural Resources and Construction

SUBJECT: Field Directive on Cost Depletion – Determination of Recoverable Reserves

INTRODUCTION

This memorandum is intended to provide direction for the effective use of audit time and resources devoted to the examination of oil and gas taxpayers claiming cost depletion deductions for oil and gas properties. This directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such.

BACKGROUND

For purposes of computing cost depletion, taxpayers are required to include all recoverable units of mineral in the total number of recoverable units at the end of the year. Recoverable units include both proved reserves (developed and undeveloped) and, under appropriate circumstances, additional reserves. (See the Petroleum Industry Coordinated Issue Paper on Cost Depletion – Recoverable Reserves dated January 13, 1997. http://www.irs.gov/pub/irs-isp/pet-cost.pdf)

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 examinations that are costly for both parties in the dispute. Revenue Procedure 2004-19, 2004-10 I.R.B. 563, provides an elective safe harbor that is intended to remove this source of controversy from the examinations of those taxpayers who elect it.

Revenue Procedure 2004-19

Under Rev. Proc. 2004-19, taxpayers may elect a safe harbor to determine the total recoverable reserves for its oil and gas properties. The elective safe harbor applies to all of the electing taxpayer's domestic oil and gas producing properties. If a taxpayer elects the safe harbor provided by section 5 of Rev. Proc. 2004-19, then, for purposes of computing cost depletion (1) the total recoverable units under section 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 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 and (2) the total recoverable units under section 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 specific date will be treated as 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.

An election of the safe harbor provided by Rev. Proc. 2004-19 applies to taxable years ending on or after March 8, 2004 unless the election is revoked under the procedures contained in section 5.01(2) of Rev. Proc. 2004-19.

If the first taxable year for which a taxpayer elects the safe harbor begins before January 1, 2005, the taxpayer may, for the taxable year of election, use economic conditions to revise the estimate of recoverable reserves whether or not there has been a change in geological fact. If the first taxable year for which a taxpayer elects the safe harbor begins after December 31, 2004, the taxpayer may not revise the estimate of remaining recoverable units unless there has been a change in geological fact. The use of economic conditions to revise the estimate of recoverable reserves is only available for the one taxable year beginning before January 1, 2005. See sections 5.02 and 5.03 of Rev. Proc 2004-19.

Nothing in Rev. Proc. 2004-19 precludes the examination and adjustment, if appropriate, of the estimate of "proved reserves" as defined in § 210.4-10(a) of Regulation S-X in order to ensure that the safe harbor provided by Rev. Proc. 2004-19 is properly administered. Further, except as provided in section 5.02 of Rev. Proc. 2004-19, a taxpayer's estimate of a property's remaining recoverable units may be revised only under the circumstances permitted under section 1.611-2(c)(2).

Below is the link to the Revenue Procedure 2004-19.

http://www.irs.gov/irb/2004-10_IRB/ar15.html

RECOMMENDATION

It is recommended that the examiners take the following positions in the determination of recoverable reserves for cost depletion purposes:

- When a taxpayer (as defined in Code § 7701(a) (14)) elects the safe harbor, examiners should insure that it has been properly implemented. This may require a detailed review of computational methods and data transfer procedures. Several examples of the proper use of the safe harbor are included with this

memorandum. (See Attachment 1). This office should be contacted if this safe harbor election does not lead to more efficient audits, or if properties are being transferred between subsidiaries to circumvent the purpose of the safe harbor.
- When a taxpayer does not elect to use the safe harbor provided in Rev. Proc. 2004-19 for all of its domestic oil and gas properties, examiners should follow the Petroleum Industry Coordinated Issue Paper on Cost Depletion - Recoverable Reserves dated January 13, 1997.
- For taxable years ending prior to March 8, 2004, examiners should request assistance of the Petroleum Industry Technical Advisors in resolving the issue.

If there are any questions regarding this matter, please call Robert McCann, PFTG Petroleum Industry Engineer Technical Advisor at 713-209-4464, Robert.McCann@irs.gov, or Paula Farmer, NRC Senior Program Analyst at 713-209-3940, Paula.J.Farmer@irs.gov.

ATTACHMENT 1

The following examples demonstrate the application of the procedures described Rev. Proc. 2004-19 in a variety of circumstances that examiners are likely to see. For purposes of these examples "book reserves" or "book purposes" refers to proved reserves (both developed and undeveloped) as defined in 17 C.F.R. § 210.4-10(a) of Regulation S-X.

SITUATION 1:

For a tax year ending on or after March 8, 2004 and **beginning before 1/1/2005**, a taxpayer elects to use the provisions of the safe harbor for all of its domestic oil and gas properties.

Property A: At the start of the year, remaining proved reserves per books are 110 units. During the year 10 units are produced and sold. There was no indication from operational or development work during the year to indicate that the beginning-of-year estimate required a material change, nor did the taxpayer revise the estimate for any other reason. Proved reserves at year end for book purposes are 100 units as follows:

Beginning-of-year	110 units
Revisions during year	0 units
Amount produced and sold	-10 units
End-of-year	100 units.

For purposes of computing the cost depletion deduction, the end-of-year recoverable units are 105 units (100 units of book proved reserves multiplied by 105%).

Property B: At the start of the year remaining proved reserves are 110 units. During the year 10 units are produced and sold. There was no indication from operational or development work during the year to indicate that the beginning-of-year estimate required a material change. However, during the taxable year there was a negative change in economic conditions and accordingly the taxpayer made a downward revision of proved reserves for book purposes of 15 units. Proved reserves at year end for book purposes are 85 units as follows:

Beginning-of-year	110 units
Revisions during year due to operations and development work	0 units
Revisions during year not due to operations and development work	-15 units
Amount produced and sold	-10 units
End-of-year	85 units

Because of the provision of Section 5.02 of the revenue procedure (**Election of Safe Harbor for Taxable Year Beginning Before January 1, 2005**), the revision due solely to a change in economic conditions is permissible. For purposes of computing the cost depletion deduction, the end-of-year recoverable units are 89.25 units (85 units of book proved reserves multiplied by 105%). Similar results would occur had the revision occurred prior to the beginning of the year and been reflected in the beginning-of-year proved reserves for book purposes. That is, year-end tax reserves would equal year-end book reserves multiplied by 105%.

SITUATION 2:

Assume that the taxpayer and properties described in Situation 1 remain the same for the subsequent tax year (which begins after 12/31/2004) and the taxpayer does not revoke its election to use the provisions of the revenue procedure.

Property A: At the start of the year the remaining proved reserves for book purposes are 100 units. During the year 10 units are produced and sold. There was no revision based on operational or development work during the year and no revision for any other reason. Thus the taxpayer’s estimate of proved reserves at year end for book purposes is 90 units (100 units at beginning-of-year less 10 units produced and sold).

For purposes of computing the cost depletion deduction, the end-of-year recoverable units are 95 units (105 units of tax reserves remaining as of the beginning of the year minus 10 units produced and sold during the taxable year).

Property B: At the start of the year the remaining proved reserves for book purposes are 85 units. During the year 10 units are produced and sold. There was no revision based on operational or development work during the year – however, during the taxable year there was a negative change in economic conditions and taxpayer made another downward revision of proved reserves for book purposes of 15 units. Proved reserves at year end for book purposes are 60 units as follows:

Beginning-of-year	85 units
Revisions during year due to operations and development work	0 units
Revisions during year not due to operations and development work	-15 units
Amount produced and sold	-10 units
End-of-year	60 units

The provision of Section 5.02 of the revenue procedure (**Election of Safe Harbor for Taxable Year Beginning Before January 1, 2005**) does not apply because this tax year began after December 31, 2004. The revision due solely to a change in economic conditions is not permissible for determining recoverable units for computing cost depletion.

For purposes of computing the cost depletion deduction, the end-of-year recoverable units are 79.25 units (89.25 units of tax reserves remaining as of the beginning of the year minus 10 units produced and sold during the taxable year).

SITUATION 3:

Assume that the taxpayer and properties described in Situations 1 and 2 remain the same for the subsequent tax year (which begins after December 31, 2004) and the taxpayer does not revoke its election to use the provisions of the revenue procedure.

Property A: At the start of the year the remaining proved reserves for book purposes are 90 units. During the year another 10 units are produced and sold. During the year operational or development work indicate that the proved reserves are materially greater than the previous estimate, and the taxpayer made an upward revision of 30 units. The taxpayer did not make any other revision to the estimate during the year. Proved reserves at year end for book purposes are 110 units as follows:

Beginning-of-year	90 units
Revisions during year due to operations and development work	30 units
Amount produced and sold	-10 units
End-of-year	110 units

For purposes of computing the cost depletion deduction, the end-of-year recoverable units are 115.5 units (110 units of year-end book proved reserves multiplied by 105%).

Property B: At the start of the year the remaining proved reserves for book purposes are 60 units. During the year 10 units are produced and sold. During the year operational or development work indicate that the proved reserves are materially less than the previous estimate, and the taxpayer made a downward revision of 20 units. There was also a positive change in economic conditions and accordingly the taxpayer made an upward revision of proved reserves for book purposes of 5 units. Proved reserves at year end for book purposes are 35 units as follows:

Beginning-of-year	60 units
Revisions during year due to operations and development work	-20 units
Revisions during year not due to operations and development work	5 units
Amount produced and sold	-10 units
End-of-year	35 units

When recoverable units are properly revised due to operations and development work the new estimate should reflect all the conditions as of that time. For purposes of computing the cost depletion deduction, the end-of-year recoverable units are 36.75 units (35 units of year-end book proved reserves multiplied by 105%).

SITUATION 4:

For tax year 2006 (which begins after December 31, 2004), a taxpayer first elects to use the provisions of the safe harbor for all of its domestic oil and gas properties.

Property C: At the start of year 2006 the remaining book proved reserves are 200 units determined as follows:

Latest estimate based on operations and development work (year-end 2003)	300 units
Amount produced and sold during 2004:	-40 units
Revisions during 2005 not due to operations and development work	5 units
Amount produced and sold during 2005	-30 units
Amount remaining at year-end 2005	200 units

During tax year 2006, 30 units are produced and sold. There was no revision based on operational or development work during the year and no revision for any other reason. Proved reserves at the end of 2006 for book purposes are 170 units as follows:

Beginning-of-year 2006	200 units
Revisions during year due to operations and development work	0 units
Revisions during year not due to operations and development work	0 units
Amount produced and sold	-30 units
End-of-year	170 units

Because of the provision of Section 5.03 of the revenue procedure (Election of Safe Harbor for Taxable Year Beginning After December 31, 2004), the revision that occurred in 2005 that was not due to operations and development work cannot be reflected in the recoverable units used for computing cost depletion. For purposes of computing the cost depletion deduction, the end-of-year recoverable units are 220.50 units (300 units from the most recent estimate based upon operations and development work minus the 90 units produced and sold in 2004, 2005 and 2006, then multiplied by 105%).

Page Last Reviewed or Updated: January 23, 2012