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Capital Cost Recovery

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<u>Index</u>	<u>Page</u>
Cost Depletion Update	1
Alternative Minimum Tax	10
MACRS Property Disposition Final Regulations	15
Unit of Property Concepts Under the Final Tangible Property Regulations	36

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Cost Depletion Update

Depletion Generally

The minerals primarily produced in the petroleum industry are liquid and gaseous hydrocarbons. These are commonly referred to as oil, gas, and natural gas liquids. An oil and/or gas producing property is a “wasting” asset. The quantity of oil and/or gas found in any natural deposit is finite. As the oil and/or gas is produced and removed from the deposit, the deposit is lessened or depleted. The owner of an economic interest in an oil and/or gas producing property may be entitled to a deduction from income for depletion of such economic interest as the oil and/or gas is produced and sold. Mineral interests, royalties, working interests, overriding royalties, net profits interests, and production payments are all economic interests in mineral deposits.

Once a mineral property becomes productive, the owner or owners of economic interests in that property must recover their cost basis through the depletion deduction (or in the event of sale or other disposition prior to total depletion of the property as provided in the IRC for such sale or other disposition). I.R.C. § 611(a) provides, in the case of oil and gas wells, for a reasonable allowance for depletion as an allowable deduction in computing taxable income.

The Internal Revenue Code provides two specific methods of computing the depletion deduction:

- Cost depletion
- Percentage depletion

Cost Depletion

The cost depletion deduction method assures the owner of an oil and/or gas producing property that the allowable tax deduction is at least equal to the investment in the depleting property and tracks as rapidly as the asset is consumed. The cost depletion method is essentially a “unit of production” method of computing the allowable current tax period deduction. As provided in I.R.C. § 612, generally a taxpayer's basis for the cost depletion computation is the adjusted basis under I.R.C. § 1011.

To compute cost depletion, a “unit cost” must first be computed by dividing the taxpayer's adjusted basis by the number of remaining recoverable units of oil and/or gas. The number of remaining recoverable units for any tax period is the estimated number of recoverable units determined at the end of the tax period plus the number of units produced and sold during the tax period. The unit cost is then multiplied by the number of units sold during the tax period to compute the cost depletion deduction. See Treas. Reg. § 1.611-2(a).

In the computation of cost depletion, the “unit” to be used is the principal unit or units paid for in the products sold. Treas. Reg. § 1.611-2(a). Recoverable units or reserves volumes for hydrocarbons are usually reported as barrels (BBL) for liquids and thousands of cubic feet (MCF) for gases by domestic companies. Reserves may also be recorded in terms of barrel of oil equivalents (BOE) where the gas has been converted to an equivalent liquid volume (based on Btu content) and added to the oil reserves.

The units to be used in the calculation of cost depletion deduction of any taxpayer are only the units which have been and will be produced to the interest owned by that taxpayer.

Example: Taxpayer A owns a royalty of 1/8 of production in Lease Z. Lease Z has produced 8,000 barrels of oil during the current tax period. At the end of the tax period Lease Z contains 80,000 barrels of oil reserves. Taxpayer A's units produced during the current tax period are 1/8 of 8,000 barrels or 1,000 barrels. Taxpayer A's reserves of oil for cost depletion computation are 11,000 which is 1/8 of 80,000 barrels plus 1,000 barrels.

Cost Depletion Formula

$$CD = CP \times [ATB / (CP + FP)]$$

CD = Cost Depletion

CP = Current Production

ATB = Amount of depletable tax basis remaining

FP = Future Production as of end of year

Reserves

“Reserves” as of any date means the number of units currently and expected to be recovered subsequent to that date. The estimates of reserves of oil or gas must be made “according to the method current in the industry and in light of the most accurate and reliable information obtainable.” Treas. Reg. § 1.611-2(c)(1). The estimate (quantity) includes “developed” or “assured” and “probable and prospective” deposits. The “reserves” to be used in the cost depletion computations for any tax period are the “reserves” at the end of that tax period plus the units produced during that tax period. Treas. Reg. § 1.611-2(a)(3).

Industry definitions of proved reserves (proved developed and proved undeveloped) refer to minerals that are reasonably known, or on good evidence believed to exist when the estimates are made according to the method current in the industry and in the light of the most accurate and reliable information obtainable. All proved categories correspond to reserves described in Treas. Reg. § 1.611-2(c)(1) and should be included in the recoverable units for computation of cost depletion deduction. The IRS closely reviews the taxpayer's reserves estimation, in light of operations or development work prior to the close of the taxable year, and includes additional reserves required by

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