

Effective Date: January 13, 1997

**COORDINATED ISSUE
PETROLEUM INDUSTRY
COST DEPLETION - RECOVERABLE RESERVES**

ISSUES

Whether a taxpayer is required to include proved reserves and "probable and prospective" reserves in its original and subsequent reserve estimates when computing cost depletion under IRC 611(a).

Whether a taxpayer is permitted to revise the original reserve estimate based solely on changes in economic factors, without operations or development work indicating the physical existence of a materially different quantity of reserves than originally estimated.

CONCLUSION

Proved developed, proved undeveloped and "probable and prospective" reserves are regularly estimated using methods current in the industry. For purposes of computing cost depletion, the taxpayer is required to include all recoverable units of minerals 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.

For purposes of cost depletion, the taxpayer is not permitted to revise its reserve estimate based solely on changes in economic factors, without operations or development work indicating the physical existence of a materially different quantity of reserves than originally estimated to purchase the property or develop the property.

DISCUSSION

IRC section 611(a) provides that, "In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion..., according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary."

The method for calculating cost depletion is set out in Treas. Reg. section 1.611-2(a)(1). Cost depletion for a given year is computed by dividing the basis of the

tax property by the number of units of minerals remaining as of the taxable year. Treas. Reg. 1.611-2(a)(3) defines remaining units as the number of units remaining at the end of the tax year to be recovered from the property plus the number of units sold within the taxable year. The resulting depletion unit is then multiplied by the number of units of minerals sold within the taxable year.

The method for determining recoverable units is found in Treas. Reg. section 1.611-2(c)(1). That regulation provides, in part, that "the estimate or determination [of recoverable units] must be made according to the method current in the industry and in the light of the most accurate and reliable information obtainable." The estimate is to include, as to both quantity and grade, (i) those ores and minerals "in sight", "blocked out", "developed", and "assured" in the usual or conventional meaning of these terms with respect to the type of the deposit, and (ii) probable or prospective ores or minerals (hereafter "additional reserves") that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development. The quantity of the additional reserves are included only if they are extensions of known deposits, or are new bodies or masses whose existence is indicated by geological surveys or other evidence to a high degree of probability.

Treas. Reg. section 1.611-2(c)(2) provides that if there has been no known change in the facts upon which the prior estimate was based, the recoverable units of minerals in the deposit will be the number remaining from the prior year. However, reestimation is allowed for any year for which it is ascertained from any source, such as operations or development work, that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate.

In many cases the taxpayer has determined, on the basis of good evidence, that certain deposits contain substantial reserves in excess of those categorized as proved developed reserves. Treas. Reg. section 1.611-2(c)(1) requires the inclusion of such reserves in the determination of the recoverable units of the taxpayer's properties to compute the cost depletion deduction under section 611(a) of the Code.

A. Proved Reserve Categories

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 estimate or determination is 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 the reserves described in Treas. Reg. 1.611-2(c)(1) and should be included in the recoverable units for computation of the cost depletion deduction.

B. Additional Reserves

The specific language of Treas. Reg. section 1.611-2(c) provides that other categories of reserves are includable in the recoverable units, under appropriate circumstances.

Treas. Reg. section 1.611-2(c)(1) requires that a reserve estimate be made according to the methods current in the industry. Inclusion of reserves should be made on the basis of good evidence. Additional reserve quantities, identified in Treas. Reg. section 1.611-2(c)(1)(ii)(a), are commonly determined in the industry and fall into two general categories: 1) extensions of known deposits, and 2) new bodies or masses.

Taxpayers regularly estimate additional reserves using methods current in the industry and use those estimates when evaluating a prospect or obtaining financing. These reserve estimates are required by Treas. Reg. section 1.611-2(c)(1) to be considered in the estimate of recoverable units when computing cost depletion. The examiner should closely review the taxpayer's reserve estimation, in light of the operations or development work prior to the close of the taxable year, and include additional reserves required by the applicable regulation, consistent with industry standards and supported by the taxpayer's actual practices.

C. Revisions to the Estimate of Recoverable Units

A different issue arises when the taxpayer reduces its original estimate of recoverable units because of a change in current oil or gas prices. That reduction in recoverable units is based solely on economics and not on operations or development work. It is not based on a material change in the physical existence or the quantity of the originally estimated reserves. Therefore, it is not an allowable revision to recoverable units.

In Martin Marietta Corp. v. United States, 7 Cl. Ct. 586, 85-1 USTC 9284 (Cl. Ct. 1985) the court concluded that I.R.C. section 611(a) and Treas. Reg. Section 1.611-2(c)(2) preclude reestimates of mineral reserves when essential geological facts remained unchanged. The Court determined that the statute and the regulation were intended to remedy mistakes of geological fact, that is, situations where the actual size of the mineral deposit in place, as originally estimated, is later determined, on the basis of more complete exploratory studies, for example, to be greater or less than earlier information indicated. See also Virginia Coal Co. v. Commissioner, 16 BTA 378 (1929); GCM 33140, I-1843 (Nov. 24, 1965).