

under the contract to the highest price paid to a producer for natural gas in the area. The gas sold by A qualifies under section 613A(b)(1)(B) for percentage depletion as gas sold under a fixed contract until its price increases, but is presumed not to qualify thereafter unless A demonstrates by clear and convincing evidence that the price increase in no event takes increases in tax liabilities into account.

Example 2. B is a producer of natural gas which is sold by B under a contract in effect on February 1, 1975. The contract provides that beginning January 1, 1980, the price of the gas may be renegotiated. Such a provision does not disqualify gas from qualifying for the exemption under section 613A(b)(1)(B) with respect to the gas sold prior to January 1, 1980. However, gas sold on or after January 1, 1980, does not qualify for the exemption whether or not the price of the gas is renegotiated.

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§ 1.613A-3 Exemption for independent producers and royalty owners.

(a) *General rules.* (1) Except as provided in section 613A(d) and § 1.613A-4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after that date, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily production (as defined in paragraph (f) of § 1.613A-7) of domestic crude oil (as defined in paragraphs (a) and (g) of § 1.613A-7) as does not exceed the taxpayer's depletable oil quantity (as defined in paragraph (h) of § 1.613A-7), and

(ii) So much of the taxpayer's average daily production of domestic natural gas (as defined in paragraphs (a) and (b) of § 1.613A-7) as does not exceed the taxpayer's depletable natural gas quantity (as defined in paragraph (i) of § 1.613A-7), and the applicable percentage (determined in accordance with the table in paragraph (c) of this section shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(2) Except as provided in section 613A(d) and § 1.613A-4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which

gross income from the property is attributable after that date and before January 1, 1984, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily secondary or tertiary production (as defined in paragraph (k) of § 1.613A-7) of domestic crude oil as does not exceed the taxpayer's depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), and

(ii) So much of the taxpayer's average daily secondary or tertiary production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), and 22 percent shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(3) For purposes of this section, there shall not be taken into account any production with respect to which percentage depletion is allowed pursuant to section 613A(b) or is not allowable by reason of section 613A(c)(9), as in effect prior to the Revenue Reconciliation Act of 1990.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, owns an oil producing property with 100,000 barrels of production to which income was attributable for 1975 and a gas producing property with 1,200,000,000 cubic feet of production to which income was attributable for 1975. Under section 613A(c)(4), the oil equivalent of 1,200,000,000 cubic feet of gas is 200,000 barrels, bringing A's total production of oil and gas to which income was attributable for 1975 to the equivalent of 300,000 barrels of oil. A's average daily production was 821.92 barrels (300,000 barrels ÷ 365 days) which is less than the depletable oil quantity (2,000 barrels) before reduction for any election by A under section 613A(c)(4). Accordingly, A may make an election with respect to A's entire gas production and thereby be entitled to percentage depletion with respect to A's entire 1975 income from production of oil and gas. A's allowable depletion pursuant to section 613A(c) and A's oil and gas properties would be the amount determined under section 613(a) computed at the 22 percent rate specified in section 613A(c)(5), as in effect

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prior to the Revenue Reconciliation Act 1990, for 1975.

Example 2. B, a calendar year taxpayer, owns oil producing properties with 365,000 barrels of production to which income was attributable for 1975. B was a retailer of oil and gas for only the last 3 months of 1975. B's average daily production for 1975 was 1,000 barrels (365,000 barrels÷365 days).

Example 3. C, a calendar year taxpayer, owns property X with 500,000 barrels of primary production to which income was attributable for 1975 and property Y with 200,000 barrels of primary production to which income was attributable for 1975. Property Y had been transferred to C on January 1, 1975, on which date it was a proven property. Therefore, the exemption under section 613A(c)(1) does not apply to C with respect to production from property Y. In determining C's depletable oil quantity for the year, the production from property Y is not taken into account. Thus, C's average daily production for 1975 was 1,369.86 barrels (500,000 barrels÷365).

Example 4. D owns an oil property with producing wells X and Y on it. In 1975 D converts well X into an injection well. Prior to the application of the secondary process, it is estimated that without the application of the process the annual production from well X would have been 50x barrels of oil and from well Y would have been 100x barrels of oil. For the taxable year in which injection is commenced production from well X is 10x barrels and from well Y is 180x barrels. Fortyx barrels of oil [190x barrels of oil (actual production from the property)—150x barrels (estimate of primary production from the property)] qualify as secondary production.

Example 5. E, a calendar year taxpayer, owns a domestic oil well which produced 100,000 barrels of oil in 1980. The proceeds from the sale of 15,000 barrels of that production are not includible in E's income until 1981. The 15,000 barrels produced in 1980 are included in E's average daily production for 1981 and excluded from such production for 1980. The tentative quantity and the percentage depletion rate for 1981 are applicable to the 15,000 barrels of oil.

(b) *Phase-out table.* For purposes of section 613A(c)(3)(A)(i) and § 1.613A-7(h) (relating to depletable oil quantity)—

In the case of production after 1974 and to which gross income from the property is attributable for the calendar year:	The tentative quantity in barrels per day is:
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(c) *Applicable percentage.* For purposes of section 613A(c)(1) and paragraph (a) of this section—

In the case of production after 1974 and to which gross income from the property is attributable for the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

(d) *Production in excess of depletable quantity—(1) Primary production.* (i) If the taxpayer's average daily production of domestic crude oil exceeds his depletable oil quantity, the allowance for depletion pursuant to section 613A(c)(1)(A) and paragraph (a)(1)(i) of this section 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 the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (c) of this section) as the amount of 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.

(ii) If the taxpayer's average daily production of domestic natural gas exceeds his depletable natural gas quantity, the allowance for depletion pursuant to section 613A(c)(1)(B) and paragraph (a)(1)(ii) of this section 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 pursuant to section 613(a) for all of the taxpayer's natural gas produced from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (c) of this section) 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.

(2) *Secondary or tertiary production.* (i) If the taxpayer's average daily secondary or tertiary production of domestic crude oil exceeds his depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), the allowance for depletion pursuant to section 613A(c)(6)(A)(i), as in effect prior to the Revenue Reconciliation Act of 1990, and paragraph (a)(2)(i) of this section 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 pursuant to section 613(a) for all of the taxpayer's secondary or tertiary production of oil from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (a)(2) of this section) as the amount of his depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990) bears to the aggregate number of barrels representing the average daily secondary or tertiary production of domestic crude oil of the taxpayer for such year.

(ii) If the taxpayer's average daily secondary or tertiary production of domestic natural gas exceeds his depletable natural gas quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), the allowance for depletion pursuant to section 613A(c)(6)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990, and paragraph (a)(2)(ii) of this section 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 pursuant to section 613(a) for all of the taxpayer's secondary or tertiary production of natural gas from the property during the taxable year (computed as if section 613 applied to all of the production at the

rate specified in paragraph (a)(2) of this section) as the amount of his depletable natural gas quantity in cubic feet (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990) bears to the aggregate number of cubic feet representing the average daily secondary or tertiary production of domestic natural gas of the taxpayer for such year.

(iii) This paragraph (d)(2) shall not apply after December 31, 1983.

(3) *Taxable income from the property.* If both oil and gas are produced from the property during the taxable year, then for purposes of section 613A(c)(7) (A) and (B) and paragraph (d) of this section 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 from the property during the taxable year from each. If both gas with respect to which section 613A(b) and § 1.613A-2 apply and oil or gas with respect to which section 613A(c) and this section apply are produced from the property during the taxable year, then for purposes of section 613A(d)(1) and paragraph (a) of § 1.613A-4 the taxable income from the property, in applying the taxable income limitation in section 613(a), shall also be so allocated. In addition, if both primary production and secondary or tertiary production (to which gross income from the property is attributable before January 1, 1984) are produced from the property during the taxable year and the total amount of production is in excess of the depletable quantity, then for purposes of paragraph (d) of this section the taxable income from the property, in applying the taxable income limitation in section 613(a), shall also be so allocated.

(4) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. A owns Y and Z oil producing properties. With respect to properties Y and Z, the percentage depletion allowable pursuant to section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5)) for 1975 was \$100x and \$200x, respectively. A's average daily production for 1975 was 4,000 barrels. A's allowable depletion pursuant to section

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613A(c) with respect to property Y was \$50x (\$100x depletion×2,000 depletable oil quantity/ 4,000 average daily production). A's allowable depletion pursuant to section 613A(c) with respect to property Z was \$100x (\$200x depletion×2,000 depletable oil quantity/ 4,000 average daily production).

Example 2. B owns gas producing properties which had secondary gas production for 1975 of 3,285,000,000 cubic feet, which under section 613A(c)(4) is equivalent to 547,500 barrels of oil. B's average daily secondary production of gas for 1975 was equivalent to 1,500 barrels (547,500 barrels÷365). B elected to have section 613A(c)(4) apply to the gas production. With respect to the production, the percentage depletion allowable pursuant to section 613(a) (computed at the rate specified in section 613A(c)(6)(A), as in effect prior to the Revenue Reconciliation Act of 1990) was \$150x. B also owns an oil producing property which had primary oil production for 1975 of 365,000 barrels. B's average daily production of oil for 1975 was 1,000 barrels (365,000÷365). With respect to the oil property, the percentage depletion allowable pursuant to section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) was \$100x. B's depletable oil quantity for 1975 was 500 barrels (2,000 barrels tentative quantity - 1,500 barrels average daily secondary production). B's allowable depletion pursuant to section 613A(c) with respect to the oil property was \$50x (\$100x depletion×500 depletable oil quantity/ 1,000 average daily production).

Example 3. Assume the same facts as in *Example 2* except that B's primary production was 6,000,000 cubic feet of natural gas daily rather than its equivalent under section 613A(c)(4) of 1,000 barrels of oil and that B elected to have that section apply to such gas. B's allowable depletion pursuant to section 613A(c) with respect to B's primary production is \$50x, the same as in *example 2*.

Example 4. C is a partner with a one-third interest in Partnerships CDE and CFG with each partnership owning a single oil property. C's percentage depletion allowable under section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the the Revenue Reconciliation Act of 1990) for 1975 was \$20x with respect to 495,000 barrels (his allocable share of Partnership CDE production) and \$40x with respect to 600,000 barrels (his allocable share of Partnership CFG production). C's average daily production is 3,000 barrels (1,095,000 total production÷365 days). C's allowable depletion pursuant to section 613A(c) with respect to C's share of the production of Partnership CDE is \$13.33x (\$20x depletion×2,000 depletable oil quantity/ 3,000 average daily production). C's allowable depletion pursuant to section 613A(c) with respect to C's share of the production of Partnership CFG is \$26.67x (\$40x depletion×2,000 depletable oil quantity/ 3,000 average daily production). See § 1.613A-3(e) for the rules on computing depletion in the case of a partnership.

Example 5. H owns a property which, during H's fiscal year which began on June 1, 1975, and ended on May 31, 1976, produced gas qualifying under section 613A(b) and oil qualifying under section 613A(c). For the fiscal year H's gross income from the property was \$400x, of which \$100x was from gas and \$300x was from oil. For the oil his gross income from the property for the period beginning June 1, 1975, and ending December 31, 1975, was \$100x and for the 1976 portion of the fiscal year was \$200x. The percentage depletion allowance (before applying the 50 percent limitation of section 613(a) or the 65 percent limitation of section 613A(d)(1)) was \$22x for the gas, \$22x for the oil in 1975, and \$44x for the oil in 1976. H's taxable income from the property for the fiscal year was \$100x. In accordance with paragraph (d)(3) of this section, the taxable income from the property is allocated \$25x to the gas:

$$\left[\$100x \text{ taxable income from the property} \left(\frac{\$100x \text{ gross income from gas from the property}}{\$400x \text{ total gross income from the property}} \right) \right]$$

\$25x to the 1975 oil:

$$\left[\$100x \text{ taxable income from the property} \left(\frac{\$100x \text{ gross income from 1975 oil from the property}}{\$400x \text{ total gross income from the property}} \right) \right]$$

and \$50x to the 1976 oil:

$$\left[\$100x \text{ taxable income from the property} \left(\frac{\$200x \text{ gross income from 1976 oil from the property}}{\$400x \text{ total gross income from the property}} \right) \right]$$

With the application of the 50 percent of taxable income from the property limitation, the allowable percentage depletion (computed without reference to section 613A) is limited to \$12.50x for the gas, \$12.50x for the oil in 1975, and \$25x for the oil in 1976.

(e) *Partnerships*—(1) *General rule.* In the case of a partnership, the depletion allowance under section 611 with respect to production from domestic oil and gas properties shall be computed separately by the partners and not by the partnership. The determination of whether cost or percentage depletion is applicable is to be made at the partner level. The partnership must allocate to each partner the partner's proportionate share of the adjusted basis of each partnership oil or gas property in accordance with the provisions of paragraphs (e)(2) through (e)(6) of this section. This allocation of the adjusted basis of oil or gas property does not affect a partner's adjusted basis in his or her partnership interest.

(2) *Initial allocation of adjusted basis of oil or gas property among partners*—(i) *General rule.* Each partner shall be allocated his or her proportionate share of the adjusted basis of each partnership domestic oil or gas property. The initial allocation of adjusted basis 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.

(ii) *Allocation methods.* Except as otherwise provided in paragraph (e)(5) of this section, the provisions of this paragraph (e)(2)(ii) govern the determination under paragraph (e)(2)(i) of this section of a partner's proportionate share of the adjusted basis of oil or gas property. Each partner's proportionate share is determined in accordance with the partner's proportionate interest in partnership capital at the time of the allocation unless both—

(A) The partnership agreement provides that a partner's share of the ad-

justed basis of one or more properties is determined in accordance with his or her proportionate interest in partnership income; and

(B) At the time of allocation under the partnership agreement the share of each partner in partnership income is reasonably expected to be substantially unchanged throughout the life of the partnership, other than changes merely to reflect the admission of a new partner, an increase in a partners' interest in consideration for money, property, or services, or a partial or complete withdrawal of an existing partner.

If the requirements of paragraph (e)(2)(ii) (A) and (B) of this section are met, a partner's proportionate share is determined in accordance with his or her proportionate interest in partnership income. The partners' shares of adjusted basis are determined on a property-by-property basis. Accordingly, the basis of one property may be allocated in proportion to capital and the basis of another property may be allocated in proportion to income. See §§ 1.613A-3(e)(5) and 1.704-1(b)(4)(v) for special rules concerning allocation of the adjusted basis of oil and gas properties.

(3) *Adjustments by partnership to allocated adjusted bases*—(i) *Capital expenditures by partnership.* Appropriate adjustments shall be made to the partners' adjusted bases in any domestic oil and gas property for any partnership capital expenditures relating to such property that are made after the initial allocation. These adjustments shall be allocated among the partners in accordance with the principles set forth in paragraph (e)(2)(ii) of this section.

(ii) *Admission of a new partner or increase in partner's interest*—(A) *In general.* Upon a contribution of money, other property, or services to the partnership by a new or existing partner

(“contributing partner”) as consideration for an interest in the partnership, the partnership shall allocate, in accordance with paragraph (e)(3)(ii)(B) of this section, a share of the partnership’s basis in each existing oil and gas property to the contributing partner, and each existing partner shall reduce, in accordance with paragraph (e)(3)(ii)(C) of this section, his or her share of the partnership’s basis in such property.

(B) *Allocation of basis to contributing partner.* The partnership shall allocate to a contributing partner his or her proportionate share (determined under paragraph (e)(2)(ii) of this section in accordance with the partner’s proportionate interest in partnership capital or income) of the partnership’s adjusted basis in each existing partnership oil or gas property. For purposes of this allocation, the partnership’s adjusted basis in such property equals the aggregate of its partner’s adjusted bases in the property, as determined under paragraph (e)(3)(iii) of this section.

(C) *Reduction of existing partners’ bases.* Each existing partner’s basis in each existing partnership oil or gas property is reduced by the percentage of the partnership’s aggregate basis in the property that is allocated to the contributing partner. Thus, if one-third of the partnership’s aggregate basis in a property is allocated to a contributing partner because the contributing partner has a one-third interest in partnership capital, after the admission of the contributing partner each existing partner’s basis (including the contributing partner’s pre-existing basis if such partner is also an existing partner) in each property equals the partner’s basis (prior to the admission) reduced by one-third.

(iii) *Determination of aggregate of partners’ adjusted bases in the property—(A) In general.* To determine the aggregate of its partners’ adjusted bases for purposes of this paragraph (e)(3), the partnership must determine each partner’s adjusted basis under either paragraph (e)(3)(iii)(B) (written data) or paragraph (e)(3)(iii)(C) (assumptions) of this section. The partnership is permitted to determine the bases of some partners under paragraph (e)(3)(iii)(B) of

this section and of others under paragraph (e)(3)(iii)(C) of this section. For this purpose, a partner’s basis in an oil or gas property does not include any basis adjustment under section 743(b).

(B) *Written data.* A partnership may determine a partners’ basis in an oil or gas property by using written data provided by a partner stating the amount of the partner’s adjusted basis or depletion deductions with respect to the property unless the partnership knows or has reason to know that the written data is inaccurate. In determining depletion deductions, a partner must treat as actually deducted any amount disallowed and carried over as a result of the 65 percent-of-income limitation of section 613A(d)(1). If a partnership does not receive written data upon which it may rely, the partnership must use the assumptions provided in paragraph (e)(3)(iii)(C) of this section in determining a partner’s adjusted basis in an oil or gas property.

(C) *Assumptions.* Except as provided in paragraph (e)(3)(iv)(B) of this section, a partnership that does not use written data pursuant to paragraph (e)(3)(iii)(B) of this section to determine a partner’s basis must use the following assumptions to determine the partner’s adjusted basis in an oil and gas property:

(1) The partner deducted his or her share of deductions under section 263(c) in the first year in which the partner could claim a deduction for such amounts, unless the partnership elected to capitalize such amounts;

(2) The partner was not subject to the 65 percent-of-income limitation of section 613A(d)(1) with respect to the partner’s depletion allowance under section 611; and

(3) The partner was not subject to the following limitations, with respect to the partner’s depletion allowance under section 611, except to the extent a limitation applied at the partnership level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); the prohibition against claiming percentage depletion on transferred proven property under section 613A(c)(9), prior to its repeal; or the limitations of section 613A(d) (2), (3), and (4) (exclusion of re-tailers and refiners).

(iv) *Withdrawal of partner or decrease in partner's interest*—(A) *In general.* Upon a distribution of money or other property to a withdrawing partner as consideration for an interest in the partnership, the withdrawing partner's adjusted basis in each domestic oil or gas property that continues to be held by the partnership is allocated to the remaining partners in proportion to their proportionate interest in partnership capital or income after taking into account any increase or decrease as a result of the event giving rise to the reallocation. A similar rule shall apply in the case of a diminution of a continuing partner's interest in the partnership.

(B) *Special rule for determining a withdrawing partner's basis in the property.* If a partnership is required to determine a withdrawing partner's adjusted basis using the assumptions under paragraph (e)(3)(iii)(C) of this section, the partnership may rebut the assumption in paragraph (e)(3)(iii)(C)(3) of this section that the withdrawing partner was not subject to the limitations of sections 613A(d)(2), (3), and (4) exclusion of retailers and refiners) by demonstrating that the withdrawing partner was subject to the limitations of sections 613A(d)(2), (3), or (4).

(v) *Effective date.* The provisions of § 1.613A-3(e)(3)(i) through (iv) are effective for taxable years beginning after May 13, 1991. However, a partnership may elect to apply these provisions to taxable years beginning on or before May 13, 1991.

(4) *Determination of a partner's interest in partnership capital or income.* For purposes of this paragraph (e), a partner's interest in partnership capital or income is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. See the factors listed in § 1.704-1(b)(3)(ii).

(5) *Special rules on allocation of adjusted basis to partners.* An allocation or reallocation of the adjusted basis of oil or gas property is pursuant to this paragraph (e) of this section deemed to be in accordance with the partner's proportionate interest in partnership capital or income for purposes of this paragraph (e) where so provided in § 1.704-1(b)(4)(v). In addition, in connec-

tion with a revaluation described in § 1.704-1(b)(2)(iv)(f), the basis of an oil or gas property is allocated among the partners based on the principles used under § 1.704-1(b)(4)(i) of allocating tax items to take into account variations between the adjusted basis of the property and its fair market value. In the case of an oil or gas property contributed to a partnership by a partner, section 704(c) is taken into account in determining the partner's share of the adjusted basis.

(6) *Miscellaneous rules*—(i) Each partner must separately keep records of his or her share of the adjusted basis in each domestic oil or gas property of the partnership, adjust his or her share of such basis pursuant to section 1016 (including adjustments for any depletion allowed or allowable with respect to such property), and use that adjusted basis each year in the computation of his or her cost depletion or in the computation of his or her gain or loss on the disposition (including abandonment) of the property by the partnership.

(ii) The adjusted basis of a partner's interest in a partnership is decreased (but not below zero) pursuant to section 705(a)(3) by the amount of the depletion deduction allowed or allowable to the partner with respect to a domestic oil or gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to the partner under section 613A(c)(7)(D), as adjusted by the partner after the initial allocation. Section 705(a)(1)(C) does not apply to depletion deductions that are not included in a partner's distributive share under section 702. Accordingly, the adjusted basis of a partner's interest in a partnership is not increased under section 705(a)(1)(C) with respect to depletion of oil or gas properties. See § 1.705-1(a)(2)(iii).

(iii) Upon the disposition of an oil or gas property by the partnership, each partner must subtract the partner's adjusted basis in the property from his or her allocable portion of the amount realized from the sale of the property to determine gain or loss. The partner's allocable portion of amount realized must, except to the extent governed by section 704(c) (or related principles

under § 1.704-1(b)(4)(i)), be determined in accordance with § 1.704-1(b)(4)(v). Except as otherwise provided (e.g., section 751), the sale of a partnership interest is not treated as a sale of an oil and gas property.

(iv) In the case of a transfer of an interest in a partnership, the transferor partner's adjusted basis in each partnership oil or gas property carries over to the transferee partner. If an election under section 754 (relating to optional adjustment to the basis of partnership property) is in effect, such basis is adjusted in accordance with section 743.

(v) For purposes of section 732 (relating to basis of distributed property other than money) and section 734(b) (relating to optional adjustment to basis of partnership property), the partnership's adjusted basis in oil and gas property is an amount equal to the aggregate of its partners' adjusted bases in the property as determined under the rules provided in paragraph (e)(3) of this section.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, B, and C have equal interests in capital in Partnership ABC. On January 1, 1992, the partnership acquired a producing domestic oil property. The partnership's basis in the property was \$90x. The partnership allocated the adjusted basis of the property to each partner in proportion to the partner's interest in partnership capital. Accordingly, each partner was allocated an adjusted basis of \$30x. Each partner must separately compute his or her depletion allowance. The amount of percentage depletion allowable for each partner for 1992 was \$10x. On January 1, 1993, each partner's adjusted basis in the property was \$20x (\$30x minus \$10x). On January 1, 1993, the oil property was sold for \$150x. Each partner's gain was \$30x (\$50x allocable share of amount realized minus the partner's adjusted basis of \$20x). Each partner must adjust the partner's adjusted basis in his or her partnership interest to reflect the gain.

Example 2. The facts are the same as in *Example 1* except that on January 1, 1993, the property was not sold but transferred by the partnership to partner A. A's basis in the property was \$60x (the sum of A's, B's, and C's adjusted bases in the property).

Example 3. The facts are the same as in *Example 1* with the exception that in 1992 C was a retailer of oil and gas and was only entitled to a cost depletion deduction of \$5x. C's gain from the sale of the mineral property on

January 1, 1993, was \$25x (\$50x allocable share of amount realized minus C's adjusted basis of \$25x (\$30x minus \$5x)).

Example 4. D, a calendar year taxpayer, is a partner in Partnership DEF which owns a domestic producing oil property. On January 1, 1993, the partnership's adjusted basis in the property was \$900x. On January 1, 1993, D's adjusted basis in D's partnership interest was \$300x and D's adjusted basis in the partnership's oil property was \$300x. D's allowable percentage depletion for 1993 with respect to production from the oil property was \$50x. On January 1, 1994, D's adjusted basis in D's partnership interest was \$250x and D's adjusted basis in the partnership's oil property was \$250x (\$300x minus \$50x).

Example 5. On January 1, 1990, G has an adjusted basis of \$5x in partnership GH's proven domestic oil property, which is the sole asset of the partnership. On January 1, 1990 G sells G's partnership interest to I for \$100x when the election under section 754 is in effect. I has a special basis adjustment for the oil property of \$95x (the difference between I's basis, \$100x, and I's share of the basis of the partnership property, \$5x). I is not entitled to percentage depletion with respect to I's distributive share of the oil property income because I is a transferee of an interest in a proven oil property. However, I is entitled to cost depletion and for this purpose I's interest in the oil property has an adjusted basis to I of \$100x (\$5x, plus I's special basis adjustment of \$95x).

Example 6. On January 1, 1960, Partnership JK acquired a domestic producing oil property. On January 1, 1990, the partnership's adjusted basis in the property was zero. On January 1, 1990, L is admitted as a partner to the partnership. Since the partnership's adjusted basis in the the oil property is zero, L's proportionate share of the basis in the property is also zero. L is not entitled to percentage depletion because L is a transferee of a proven oil property (see paragraph (g) of this section). Since the property's basis is zero, L is also not entitled to any cost depletion with respect to production from the property.

Example 7. (i) O and P have equal interests in capital in Partnership OP. On January 1, 1991, the partnership acquired an unproven domestic oil property X the basis of which is \$200x to the partnership. The partnership allocates \$100x of the basis of the property to each partner in accordance with each partner's proportionate interest in partnership capital. For the 1991 taxable year, O has a \$10x cost depletion allowance and P has a \$25x percentage depletion allowance. Accordingly, at the end of the 1991 taxable year, O's adjusted basis in the property is \$90x, and P's adjusted basis in the property is \$75x. On January 1, 1992, Q is admitted as an equal

partner. The partnership does not use written data from the partners and must therefore assume that each partner was entitled to \$25x depletion based on the assumptions provided in §1.613A-3(e)(3)(iii). This would result in a \$50x combined depletion allowance for the partners and an aggregate adjusted basis in the oil property of \$150x. Accordingly, the partnership allocates \$50x of the basis of the property to Q, one-third of the aggregate adjusted basis determined by the partnership. O and P must each reduce their basis in the property by one-third. Accordingly, after the admission of Q, O's adjusted basis in the property is \$60x (\$90x minus \$30x), and P's adjusted basis in the property is \$50x (\$75x minus \$25x).

(ii) Assume the same facts as in paragraph (i) of this *Example 7* except that O informs the partnership that its adjusted basis in the property is \$90x (determined without regard to section 613A(d)(1)). The partnership uses the written data provided by O and determines the aggregate adjusted basis in the property to be \$165x (\$90x+\$75x). Accordingly, the partnership allocates \$55x ($\frac{1}{3}$ of \$165x) of the basis of the property to Q, and O and P must each reduce their adjusted basis in the property by one-third, as in paragraph (i) of this *Example 7*. Thus, after the admission of Q, O's adjusted basis in the property is \$60x and P's adjusted basis in the property is \$50x.

(f) *S corporations.* For purposes of section 613A(c)(13), adjustments to shareholders' adjusted bases in any domestic oil or gas property to reflect capital expenditures by S corporations, the addition of a new shareholder or an increase in a shareholder's interest by reason of a contribution to the S corporation, the redemption of a shareholder's interest, or other appropriate transaction shall be made in accordance with principles similar to the principles under §1.613A-3(e) applicable to the entry or withdrawal of a partner.

(g) *Trusts and estates.* (1) In the case of production from domestic oil and gas properties held by a trust or estate, the depletion allowance under section 611 shall be computed initially by the trust or estate. The determination of whether cost or percentage depletion is applicable shall be made at the trust or estate level, but such determination shall not result in the disallowance of cost depletion to a beneficiary of a trust or estate for whom cost depletion

exceeds percentage depletion. The limitations contained in section 613A (c) and (d), other than section 613A(d)(1), shall be applied at the trust or estate level in its computation of percentage depletion pursuant to section 613A and shall also be applied by a beneficiary with respect to any percentage depletion apportioned to the beneficiary by the trust or estate. The limitation of section 613A(d)(1) shall be applied by each taxpayer (*i.e.*, trust, estate or beneficiary) only with respect to its allocable share of percentage depletion under section 611(b) (3) or (4). For purposes of adjustments to the basis of oil or gas properties held by a trust or estate, in the absence of clear and convincing evidence to the contrary, it shall be presumed that no beneficiary is affected by any section 613A (d) limitations or by the rules contained in section 613A(c)(8) and (9) (relating to businesses under common control and members of the same family and to transfers, respectively), as in effect prior to the Revenue Reconciliation Act of 1990, or has any oil or gas production from sources other than the trust or estate.

(2) The provisions of this paragraph may be illustrated by the following examples.

Example 1. A is the income beneficiary of a trust the only asset of which is a domestic producing oil property. The trust instrument requires that an amount which equals 10 percent of the gross income from the property be set aside annually as a reserve for depletion. In 1975 the property had production of 1,095,000 barrels of oil. The trust's gross income from the property in 1975 was \$30,000x. In that year, after setting aside \$3,000x of income for the reserve for depletion, the trustee distributed the remaining income to A which represented 80 percent of the trust's net income. The percentage depletion computed by the trust with respect to the production (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) for 1975 was \$6,600x. The trust's average daily production for 1975 was 3,000 barrels (1,095,000 ÷ 365 days). The trust's allowable depletion pursuant to section 613A(c) with respect to the production was \$4,400x:

$$\left[\$6,600x \text{ depletion} \left(\frac{2,000 \text{ depletable oil quantity}}{3,000 \text{ average daily production}} \right) \right]$$

Pursuant to § 1.611-1(c)(4)(ii), the percentage depletion of \$4,400x was apportioned between the trustee and A so that the trustee received \$3,000x (an amount equal to the amount of income set aside for the reserve for depletion) and A received \$1,400x of the depletion deduction. The \$1,400x depletion received by A is attributable to 80 percent of the trust's depletable oil quantity, *i.e.*, 1,600 barrels per day.

Example 2. B, a retailer of oil and gas, is the income beneficiary of a trust the only asset of which is a domestic producing oil property. In 1975 the trustee distributed one-half of the trust's net income and accumulated the other one-half for the benefit of the remainderman. One-half of the percentage depletion computed by the trust with respect to the production from the property was apportioned to B. Since B is a retailer of oil and gas, B is not entitled to deduct any of the percentage depletion apportioned to B. However, B is entitled to take cost depletion with respect to one-half of the production from the oil property, notwithstanding the fact that depletion was computed at the trust level on the basis of percentage depletion.

(h) *Businesses under common control; members of the same family—(1) Component members of a controlled group.* For purposes of only the depletable quantity limitations contained in section 613A (c) and this section, component members of a controlled group of corporations (as defined in paragraph (1) of § 1.613A-7) shall be treated as one taxpayer. Accordingly, the group shares the depletable oil (or natural gas) quantity prescribed for a taxpayer for the taxable year and the secondary production (to which gross income from the property is attributable before January 1, 1984) of a member of the group will reduce the other members' share of the group's depletable quantity.

(2) *Aggregation of business entities under common control.* If 50 percent or more of the beneficial interest in any two or more entities (*i.e.*, corporations, trust, or estates) is owned by the same or related persons (taking into account only each person who owns at least 5 percent of the beneficial interest in an entity and with respect to such person

his or her entire interest) as defined in paragraph (m) (2) of § 1.613A-7, the tentative quantity determined under the table in section 613A(c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among all such entities in proportion to their respective production. This paragraph (h)(2) shall not apply to component members of a controlled group of corporations (as defined in § 1.613A-7 (1)). For purposes of determining 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.

(3) *Allocation among members of the same family.* In the case of individuals who are members of the same family, the tentative quantity determined under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among such individuals in proportion to the respective production of barrels of domestic crude oil (and the equivalent in barrels to the cubic feet of natural gas determined under paragraph (h)(4)(ii) of this section) during the period in question by such individuals.

(4) *Special rules.* For purposes of section 613A (c)(8) and this section—

(i) The family of an individual includes only his spouse and minor children, and

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

(5) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example 1. A owns 50 percent of the stock of Corporation M and 50 percent of the stock of Corporation N. Both corporations are calendar year taxpayers. For 1975 Corporation M's production of domestic crude oil was 8,000,000 barrels (365,000 of which was secondary production) and Corporation N's was 2,000,000 barrels (all of which was primary

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production). The tentative quantity (2,000 barrels per day) determined under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) must be allocated between the two corporations in proportion to their respective barrels of production of domestic crude oil during the taxable year. Corporation M's allocable share of the tentative quantity is 1,600 barrels:

$$\left[2,000 \left(\frac{8,000,000}{10,000,000} \right) \right]$$

and Corporation N's allocable share is 400 barrels:

$$\left[2,000 \left(\frac{2,000,000}{10,000,000} \right) \right]$$

With respect to M's primary production, M's depletable oil quantity is 600 barrels (1,600 barrels - 1,000 barrels [365,000 secondary production ÷ 365 days]). N's depletable oil quantity, unaffected by M's secondary production, is 400 barrels.

Example 2. Assume the same facts as in *Example 1* except that Corporation M is a retailer and Corporation N is not selling its oil through Corporation M. Because Corporation M is a retailer, no portion of the tentative quantity is allocated to Corporation M. Accordingly, Corporation N's depletable oil quantity is the entire 2,000 barrels per day because section 613A (c), which contains the

allocation requirements, is inapplicable to retailers.

Example 3. Corporations O and P are members of a controlled group and are treated as one taxpayer as provided in paragraph (h)(1) of this section. Corporation O owns oil properties A and B. Property A had primary production for 1975 of 800,000 barrels of oil. Property B had secondary production for 1975 of 365,000 barrels of oil. Corporation P owns oil property C which had primary production of 660,000 barrels for 1975. The allowable percentage depletion with respect to property B's secondary production was \$360x. The controlled group's average daily production was 4,000 barrels [(800,000 + 660,000) ÷ 365]. The controlled group's depletable oil quantity was 1,000 barrels [2,000 tentative quantity - 1,000 average daily secondary production (365,000 ÷ 365)]. The allowable percentage depletion pursuant to section 613 (a) (computed as if section 613 applied to all of the production at the rate specified in section 613A (c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) was \$800x with respect to production from property A and \$660x with respect to production from property C.

Corporation O's allowable depletion pursuant to section 613A (c) with respect to property B's secondary production (for which depletion is allowable before primary production) for 1975 was \$360x. Corporation O's allowable depletion pursuant to section 613A (c) with respect to property A was \$200x:

$$\left[\$800x \text{ depletion} \left(\frac{1,000 \text{ depletable oil quantity}}{4,000 \text{ average daily production}} \right) \right]$$

Therefore, Corporation O's allowable depletion pursuant to section 613A (c) was \$560x (\$360x relating to property B plus \$200x relat-

ing to property A). Corporation P's allowable depletion pursuant to section 613A (c) with respect to property C was \$165x:

$$\left[\$660x \text{ depletion} \left(\frac{1,000 \text{ depletable oil quantity}}{4,000 \text{ average daily production}} \right) \right]$$

(i) *Transfer of oil or gas property—(1) General rule—(i) In general.* Except as provided in paragraph (i)(2) of this section, in the case of a transfer (as defined in paragraph (n) of §1.613A-7) of an interest in any proven oil or gas property (as defined in paragraph (p) of §1.613A-7), paragraph (a)(1) of this sec-

tion shall not apply to a transferee (as defined in paragraph (o) of §1.613A-7) with respect to production of crude oil or natural gas attributable to such interest, and such production shall not be taken into account for any computation by the transferee under this section.

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On January 1, 1975, Individual A transfers proven oil properties to Corporation M in an exchange to which section 351 applies for shares of its stock. Since there is no allocation requirement pursuant to section 613A(c)(8) between A (the transferor) and Corporation M (the transferee), the transfer of the proven properties by A is a transfer for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990) and percentage depletion is not allowable to Corporation M with respect to such properties.

Example 2. On January 1, 1975, Corporation N sells proven oil property to Corporation O, its wholly-owned subsidiary. Because the transfer was made between corporations which are members of the same controlled group of corporations, Corporation O is entitled to percentage depletion with respect to production from the property so long as the tentative oil quantity is allocated between the two corporations. If Corporation N were a retailer, the tentative oil quantity would not be required to be allocated between the two corporations (see example 2 of § 1.613A-3(h)(5)), and Corporation O would not be entitled to percentage depletion on the production from the property.

Example 3. B, owner of a proven oil property, died on January 1, 1975. Pursuant to the provisions of B's will, B's estate transferred the oil property on April 1, 1975, into a trust. On July 1, 1976, pursuant to a requirement in B's will, the trustee distributed the oil property to C. The transfer of the oil property by the estate to the trust and the later distribution of the property by the trust to C are transfers at death. Therefore, the trust was entitled to compute percentage depletion with respect to the production from the oil property when the property was owned by the trust and C is entitled to percentage depletion with respect to production from the oil property after the trust distributes the property to C.

Example 4. On January 1, 1975, property which produces oil resulting from secondary processes was transferred to D. The exemption under section 613A(c) applies to D because section 613A(c)(9) (relating to transfers of oil or gas property), as in effect in 1975, does not apply with respect to secondary production. In addition, even if at the time of the transfer the production from the property was primary and D applied secondary processes to the property transferred and obtained secondary production, D would be entitled to percentage depletion with respect to the secondary production.

Example 5. On July 1, 1975, E and F entered into a contract whereby F is given the privilege of drilling a well on E's unproven prop-

erty, and if F does so F is to own the entire working interest in the property until F has recovered all the costs of drilling, equipping, and operating the well. Thereafter, 50 percent of the working interest would revert to E. In accordance with the contract, 50 percent of the working interest reverted to E on July 1, 1976. F is entitled to percentage depletion because the transfer of the working interest to F occurred when the property was unproven on July 1, 1975, which is the date of the contract establishing F's right to the working interest. E is entitled to percentage depletion with respect to this working interest since the reversion of such interest with respect to which E was eligible for percentage depletion is not a transfer. However, if on the date of the contract E's property was proven (although not proven when E acquired the property), F would not be entitled to claim percentage depletion with respect to any of the working interest income. Nonetheless, E would still be entitled to percentage depletion with respect to E's working interest since the reversion of the interest is not a transfer.

Example 6. On January 1, 1975, G subleased an oil property to H, retaining a $\frac{1}{8}$ royalty interest with the option to convert G's royalty into a 50-percent working interest. On July 1, 1975, the property was proven and on July 1, 1976, G exercised G's option. G is entitled to claim percentage depletion with respect to G's working interest since the conversion of the royalty interest which is eligible for percentage depletion pursuant to section 613A(c) into an interest which constituted part of an interest previously owned by G is not a transfer pursuant to § 1.613A-7(n)(8).

Example 7. I and J (both of whom are minors) are beneficiaries of a trust which owned a proven oil property. The oil property was transferred to the trust on January 1, 1975, by the father of I and J. For 1975, the trustee allocated all the income from the oil property to I. For 1976, the trustee allocated all the income from such property to J. On January 1, 1977, the trustee distributed the property to I and J as equal tenants in common. Since I, J, and their father are members of the same family within the meaning of section 613A(c)(8)(C), the transfer of the property to the trust by the father, the shifting of income between I and J, and the distribution of the oil property by the trust to I and J are not transfers for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990). However, the distribution of the oil property will constitute a transfer to each distributee on the date on which the distributee reaches majority under state law.

Example 8. In 1975, K transferred a proven oil property productive at 5,000 feet to L. Subsequent to the transfer, L drilled new

wells on the property finding another reservoir at 10,000 feet. The two zones were combined under section 614 as a single property. L is not entitled to percentage depletion on the gross income attributable to the production from the productive zone at 5,000 feet, but is entitled to percentage depletion on the gross income attributable to the production from the productive zone at 10,000 feet because that zone was not part of the proven property until the date of development expenses by L, which is after the date of the transfer. Accordingly, L's maximum allowable percentage depletion deduction for 1975 would be zero percent of gross income from the property with respect to the production from 5,000 feet, plus 22 percent of gross income from the property with respect to the production from 10,000 feet. This maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.*, 50 percent of "taxable income from the property (computed without allowance for depletion)," such taxable income being the overall taxable income resulting from the sale of production from both zones, and would also be subject to the limitations provided in section 613A. The production from the productive zone at 5,000 feet is not taken into account in determining K's depletable oil quantity for the year.

Example 9. On July 1, 1975, M transferred an oil property with a fair market value of \$100x to N. On February 1, 1976, N commenced production of oil from the property. The fair market value of the property on February 1, 1976, as reduced by actual costs incurred by N for equipment and intangible drilling and development costs, was \$300x. Because the value of the property on transfer was not 50 percent or more of the value on February 1, 1976, the property transferred to N was not a proven property (see § 1.613A-7(p)). However, if there had been only marginal production from the property so that the fair market value of the property on February 1, 1976, was \$40x rather than \$300x, the property transferred to N would have been a proven property provided the other requirements of a proven property were met.

Example 10. O is the owner of a remainder interest in a trust created January 1, 1970. On that date, the trust held oil and gas properties. On January 1, 1976, O's interest for the first time entitled O to the trust's income from oil and gas production from the properties. The reversion of the remainder interest to O is not a transfer (see § 1.613A-7(n)(7)). Accordingly, the transfer of the interest in oil and gas property to O is deemed to have occurred on January 1, 1970, the date O's interest was created.

Example 11. On January 1, 1976, P, Q, and R entered into a partnership for the acquisition of oil and gas leases. It was agreed that the sharing of income will be divided equally among P, Q, and R. However, it was further

agreed that with respect to the first production obtained from each property acquired P will receive 80 percent thereof and Q and R each will receive 10 percent thereof until \$100x has been received by P. Assume these allocations have substantial economic effect under section 704 of the Code and the regulations thereunder. On February 1, 1976, Partnership PQR acquired an unproven property and production therefrom was shared pursuant to the partnership agreement. P is entitled to percentage depletion with respect to the production allocated to him since the transfer of right to the production is deemed to have been made on the date the partnership agreement became applicable to the specific property, at which time the property was unproven. See § 1.613A-7(n) for rules relating to the definition of transfer. Similarly, when \$100x has been obtained and Q and R each commence receiving 33⅓ percent of the revenue, Q and R are entitled to percentage depletion with respect to their entire interests. However, if the property had been proven when acquired by the partnership, P, Q, and R would not be entitled to claim any percentage depletion with respect to production from the property.

Example 12. On December 30, 1960, S placed producing oil property in trust for the benefit of S's nephew, T, and executed a trust agreement which required the trustee of the trust to transfer the oil property to T on January 1, 1975. The trustee's transfer of the oil property to T on January 1, 1975, is deemed to have occurred on December 30, 1960 (see § 1.613A-7(n)). Since the transfer is deemed to have occurred before January 1, 1975, section 613A(c) applies with respect to the production from the oil property. Moreover, if the trustee was not required to transfer the oil property on a specific date but was given discretion to select the date of transfer, the transfer of such property would still be deemed to have occurred on December 30, 1960. However, the result would be different if the trust agreement had provided that the trustee, at the trustee's discretion, may transfer the oil property to T on January 1, 1975, but is not under any obligation to transfer the property to T on January 1, 1975, or on any other date. Since the transfer was discretionary, the date of the actual transfer governs.

Example 13. On January 1, 1974, U acquired an oil property. On February 1, 1974, U granted V an option to purchase the oil property. V exercised V's option on March 2, 1975, and subsequently the oil property was conveyed to V. The date of the transfer was March 2, 1975, the day V exercised V's option (on which date both parties were bound).

Example 14. On July 1, 1974, W executed a deed conveying oil and gas property to X. W delivered the deed to X on January 1, 1975. Under state law, the mere execution of the deed without delivery did not give X any

rights in the property. Title to the oil property passed to X on the date of delivery. Therefore, the date of transfer was January 1, 1975.

Example 15. Y, owner of a proven oil property, transferred Y's interest therein on July 25, 1975, to a revocable trust of which Y is treated as the owner under section 676. Y is not deemed a transferee and section 613A(c) applies to Y because immediately preceding the transfer Y was entitled to percentage depletion on the production from the property.

Example 16. On January 1, 1975, a proven oil property was transferred to Z; therefore, section 613A(c)(1) did not apply with respect to the production from such property. After Z's death, neither Z's estate nor its beneficiaries are entitled to percentage depletion with respect to the decedent's oil property since Z was a transferee of proven property.

Example 17. Partnership ABC, owner of proven oil and gas properties, admitted D as a partner in 1975 in consideration of cash. The shares of Partners A, B, and C of the partnership income were proportionately reduced so that D had a 25 percent interest in the income. D is not entitled to percentage depletion with respect to D's share of partnership oil and gas income because D is a transferee for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990). See §1.613A-7(n).

Example 18. On January 1, 1975, E and F formed Partnership EF to which E contributed proven oil property. For 1975, pursuant to the partnership agreement 70 percent of the mineral income from the property was allocated to E and 30 percent of the mineral income from the property was allocated F. F is not entitled to percentage depletion with respect to production from the property because F is a transferee of an interest in proven property. However, E is not a transferee of an interest in proven property because E was entitled to percentage depletion on the oil produced with respect to the property immediately before the transfer. Therefore, E is entitled to percentage depletion with respect to the income allocated to E. However, if in 1976 the partnership agreement were revised so that E's interest in the income was increased by 10 percent, E would not be entitled to percentage depletion with respect to the additional 10 percent interest because E is a transferee with respect thereto.

Example 19. G is the owner of a $\frac{1}{3}$ interest in a partnership owning a proven oil property, and as such is entitled to $\frac{1}{3}$ of the income from the property. G received a distribution on July 1, 1975, from the partnership of a $\frac{1}{3}$ interest in the proven oil property. Although the transfer of such interest is a transfer for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990), G is still entitled to percentage depletion with respect to the $\frac{1}{3}$ interest in the oil production from the prop-

erty since G was entitled to percentage depletion on such production with respect to such property immediately before the transfer. If the entire property were distributed to G, G's percentage depletion allowance would still be based on only $\frac{1}{3}$ of the oil produced.

Example 20. H and I contributed property X and property Y respectively to Partnership HI. The partnership agreement provides that all the gross income from property X is to be allocated to H and all the gross income from property Y is to be allocated to I. Assume these allocations have substantial economic effect under section 704 of the Code and the regulations thereunder. For 1975 H and I each received \$100x gross income. Although the contributions of the properties by H and I are transfers for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990), both H and I are entitled to percentage depletion with respect to the \$100x income received since each was entitled to a percentage depletion allowance with respect to the property contributed immediately before the transfer. However, if no special allocation of income were made but H and I are to share equally in the income from both properties, each would be entitled to a depletion allowance based on only one-half of the production with respect to the property he had contributed. If property X produces \$100x of gross income from the property and property Y produces \$200x of gross income from the property, H would be entitled to percentage depletion but only with respect to \$50x (50 percent of \$100x) of gross income from the property and I would be entitled to percentage depletion with respect to \$100x (50 percent of \$200x) of gross income from the property.

(2) *Transfers after October 11, 1990—(i) General rule.* Section 613A(c) (9) and (10), as in effect prior to the Revenue Reconciliation Act of 1990 (relating to prohibition of percentage depletion on transferred proven properties) has been repealed effective for transfers after October 11, 1990. Accordingly, a transferee of a proven oil or gas property transferred after October 11, 1990 is permitted to claim percentage depletion with respect to production from the property. For purposes of transfers of property occurring before October 12, 1990 under section 613A(c)(10), prior to its repeal, the disposition of stock after October 11, 1990 by a transferor will not result in a reduction in the depletable quantity of the transferee corporation under section 613A(c)(10)(F).

(ii) *Transfer.* The term "transfer" has the same meaning as under §1.613A-7(n).

(iii) *Transferee.* A person shall not be treated as a transferee with respect to a transferred property to the extent that such person held an interest in the property but was not entitled to a percentage depletion allowance on mineral produced with respect to the property immediately before the transfer. Thus, for example, if a taxpayer who is not entitled to claim percentage depletion on a proven property transfers the property to a partnership for an interest in the partnership, the taxpayer is not a transferee with respect to the property in the hands of the partnership.

(iv) *Effective date.* The provisions of paragraph (i)(2) of § 1.613A-3 are effective for transfers occurring after May 13, 1991. However, a taxpayer may elect to apply these provisions to transfers occurring after October 11, 1990 and on or before May 13, 1991.

(v) *Examples.* The examples below illustrate the provisions of this subparagraph. The examples ignore the application of any restriction on percentage depletion other than the proven property transfer rule.

Example 1. On December 31, 1991, A transfers a proven oil property to B. B may claim percentage depletion with respect to production from the property regardless of whether production from the property was eligible for percentage depletion in A's hands (even if A were a retailer or refiner of oil or gas).

Example 2. On October 10, 1990, A transfers a proven oil property to B. B may not claim percentage depletion with respect to production from the property.

Example 3. On January 1, 1990, C purchases a proven oil property. Because C is a transferee of a proven property, production from the property is not eligible for percentage depletion in C's hands. On December 31, 1991, C contributes the property to Corporation M, an S corporation in which C owns 100 percent of the stock. The contribution of the property is a transfer, but C is not a transferee with respect to the property in the hands of the corporation. Accordingly, C may not claim percentage depletion with respect to production from the property. However, if prior to the contribution C had been entitled to claim percentage depletion with respect to production from the property, C would be entitled to claim percentage depletion with respect to production from the property after the contribution.

Example 4. On December 31, 1991, C contributes a proven oil property (with respect to which C is not entitled to claim percentage

depletion) to Corporation N, an S corporation in which C owns 30 percent and D owns 70 percent of the stock. The contribution of the property is a transfer, but C is not a transferee with respect to the property in the hands of the corporation. Accordingly, C may not claim percentage depletion with respect to C's share of the production from the property. D is a transferee with respect to the property in the hands of Corporation N, and may claim percentage depletion with respect to D's share of production from the property.

Example 5. On December 31, 1991, D transfers a proven oil property (with respect to which D is not entitled to claim percentage depletion) to DE, an equal partnership between D and E. E is a transferee with respect to the property and may claim percentage depletion with respect to production from the property allocated to E under the DE partnership agreement. D is not a transferee with respect to the property, and may not claim percentage depletion with respect to production from the property allocated to D under the DE partnership agreement. However, if D had been entitled to claim percentage depletion with respect to production from the property, then D would be entitled to claim percentage depletion with respect to production from the property in the hands of DE.

Example 6. On January 1, 1990, Corporation P contributes a proven property to Corporation O, its wholly owned subsidiary. Under § 1.613A-7(n)(4), the contribution is not treated as a transfer, but only for so long as the tentative quantity is required under section 613A(c)(8) to be allocated between P and O. On December 31, 1991, P sells 90% of the O stock to an unrelated person; accordingly, the tentative quantity is no longer required under section 613A(c)(8) to be allocated between P and O. After the sale of O stock, production from the property in O's hands is eligible for percentage depletion because a transfer of a proven property is deemed to occur upon the transfer of the stock.

Example 7. On October 10, 1990, G transfers a proven oil property to his minor son, H. G had been entitled to claim percentage depletion with respect to production from the property. Under § 1.613A-7(n)(5), H is permitted to claim percentage depletion for so long as G and H are related persons under section 613A(c)(8)(C). On December 31, 1991, H reaches majority and is no longer related to G under section 613A(c)(8)(C). H is entitled to continue to claim percentage depletion on production from the property because the property is treated as being transferred to H on December 31, 1991.

Example 8. On December 31, 1991, I sells a proven property to J, her husband. I had not been entitled to claim percentage depletion with respect to production from the property. Under § 1.613A-7(n)(5), the sale is not a

transfer because it is made between persons related under section 613A(c)(8). Accordingly, J may not claim percentage depletion with respect to production from the property. If, however, I had been entitled to claim percentage depletion with respect to production from the property, J would be entitled to claim percentage depletion with respect to production from the property.

Example 9. On December 31, 1991, L inherits a proven property from K. K had not been entitled to claim percentage depletion with respect to production from the property. Under § 1.613A-7(n)(1), the inheritance is not a transfer. Accordingly, L may not claim percentage depletion with respect to production from the property. If, however, K had been entitled to claim percentage depletion with respect to production from the property, L would be entitled to claim percentage depletion with respect to production from the property.

Example 10. On December 31, 1991, Corporation R, a calendar year taxpayer, made an S election effective for the taxable year beginning January 1, 1992 and succeeding taxable years. Since Corporation R is deemed to have transferred its oil and gas properties on January 1, 1992, the shareholders of Corporation R are eligible to claim percentage depletion with respect to the production from the properties.

Example 11. Assume the same facts as in *Example 10* except that Corporation R makes the S election on December 31, 1989, effective for the taxable year beginning January 1, 1990 and succeeding taxable years. Since Corporation R is deemed to have transferred its oil and gas properties on January 1, 1990, the shareholders of Corporation R are not eligible to claim percentage depletion with respect to the production from the properties.

(j) *Percentage depletion with respect to bonuses and advanced royalties—(1) Amounts received or accrued after August 16, 1986.* In computing the percentage depletion allowance pursuant to section 613A(c) with respect to amounts received or accrued after August 16, 1986, there shall not be taken into account any advance royalty (to the extent that actual production during the taxable year is insufficient to earn such royalty), lease bonus, or other amount payable without regard to production, even though the amount may be taken into account for purposes of sections 61 and 612 (relating to definitions of gross income and cost depletion, respectively).

(2) *Amounts received or accrued before August 17, 1986.* (i) A lease bonus or advanced royalty received or accrued be-

fore August 17, 1986, with respect to oil or gas property shall be taken into account for purposes of percentage depletion in the taxable year such payment is includible in income. Percentage depletion shall be determined according to the depletion rate and depletable oil and natural gas limitations of section 613A(c)(1) and § 1.613A-3(a) applicable on the date of such inclusion. The payee of the bonus or advanced royalty shall apply the depletable oil and natural gas quantity limitations by attributing a specific number of barrels of oil or cubic feet of natural gas to the lease bonus or advanced royalty. The determination of the number of barrels of oil or cubic feet of natural gas shall be based on the average price of oil or gas produced from the property during the taxable year. If oil or gas is not produced from the property during that year, or if the oil or gas is not sold before conversion or transportation from the premises, the number of barrels of oil or cubic feet of gas shall be based on a price (as of the date of the bonus or advanced royalty) determined under the constructive pricing principles applicable under section 613(a), generally the representative market or field price. In the case where no oil or gas has been produced in such year, the constructive price applicable to the type of production expected to be produced from the property shall apply. However, if the first actual production from the property in a later year is different from the type of production upon which the conversion of the bonus or advanced royalty into barrels of oil or cubic feet of gas was based and the period of limitations on assessment has not expired (see section 6501) for the year in which the lease bonus or advanced royalty is includible in income, the taxpayer should promptly file an amended return, if necessary. In the amended return the conversion shall be recomputed taking into account the pricing applicable to the actual production. For purposes of paragraph (f) of § 1.613A-7, the number of barrels of oil or cubic feet of natural gas attributed to a lease bonus or advanced royalty is deemed to have been extracted on the date the bonus or advanced royalty is includible in the payee's income.

(ii) For purposes of applying the depletable oil and natural gas quantity limitations in taxable years after the year in which the advanced royalty payment is included in income, the payee of an advanced royalty which is recouped out of future production shall not include production which recoups the advanced royalty in such later years. The payor of a bonus or advanced royalty that is not recouped from future production may reduce the production to be taken into account for purposes of applying the depletable quantity limitations in each year in which the payor's gross income from the property is adjusted under § 1.613-2(c)(5)(ii) to reflect the bonus paid by an amount determined by dividing the portion of the bonus required to be excluded from the payor's gross income from the property by the price of oil or gas applicable to the payee for converting the bonus into barrels of oil or cubic feet of gas.

(iii) See § 1.612-3 (a)(2) and (b)(2) for rules relating to the requirement that certain depletion deductions allowed with respect to lease bonuses and advanced royalties be restored to income.

(k) *Special rules for fiscal year taxpayers.* In applying this section 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.

(l) *Information furnished by partnerships, trusts, estates, and operators.* Each partnership, trust, or estate producing domestic crude oil or natural gas, and each operator of a well from which domestic crude oil or natural gas was produced, shall provide each partner, beneficiary, or person holding a nonoperating interest, as the case may be, with all information in its possession necessary to determine the amount of his depletion deduction allowable with respect to such crude oil or natural gas. For example, for each property a partnership is required to provide each partner with partnership information relating to the partner's allocable share of gross income from the property, the partner's allocable share of operating expenses, the partner's allocable share of depreciation, the partner's share of allocated overhead, the

partner's share of estimated reserves, the partner's share of production in barrels or cubic feet for the taxable year, the partner's original share of the partnership adjusted basis of properties producing domestic crude oil or domestic natural gas, the partner's allocable share of any adjustments made to the basis of such properties by the partnership, and the percentage by which existing partners must reduce their bases in a partnership oil or gas property upon entry of a partner by contribution. In addition, upon the disposition of an oil or gas property by the partnership, the partnership shall inform each partner of his allocable portion of the amount realized from the sale of the property.

[T.D. 8348, 56 FR 21939, May 13, 1991; 57 FR 4913, Feb. 10, 1992; 57 FR 9599, Mar. 19, 1992, as amended by T.D. 8437, 57 FR 43900, Sept. 23, 1992; 57 FR 60474, Dec. 21, 1992; 58 FR 6678, Feb. 1, 1993]

§ 1.613A-4 Limitations on application of § 1.613A-3 exemption.

(a) *Limitation based on taxable income.*

(1) The aggregate amount of a taxpayer's deductions allowed pursuant to section 613A(c) for the taxable year shall not exceed 65 percent of the taxpayer's taxable income (reduced in the case of an individual by the zero bracket amount for taxable years beginning after December 31, 1976, and before January 1, 1987) for the year, adjusted to eliminate the effects of:

(i) Any depletion with respect to an oil or gas property (other than a gas property with respect to which the depletion allowance for all production is determined pursuant to section 613A(b)) for which percentage depletion would exceed cost depletion in the absence of the depletable quantity limitations contained in section 613A(c) (1) and (6) (as in effect prior to the Revenue Reconciliation Act of 1990) or the taxable income limitation contained in section 613A(d)(1);

(ii) Any net operating loss carryback to the taxable year under section 172;

(iii) Any capital loss carryback to the taxable year under section 1212; and

(iv) In the case of a trust, any distributions to its beneficiaries, except