

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 611; 1.611-2.)

Rev. Proc. 2004-19

SECTION 1. PURPOSE

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

SECTION 2. BACKGROUND

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

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

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

.04 *Reserve Estimates.* Section 1.611-2(c)(1) contains the rules for estimating the total recoverable units of mineral products reasonably known, or on good evidence believed, to exist with respect to each property. The estimate or determination must be made according to the method current in the industry and

in light of the most accurate and reliable information obtainable. Under the regulations, the estimate of total recoverable units includes all reserves that are proved and, under appropriate circumstances, probable or prospective reserves in addition to the reserves that are proved.

.05 Revisions of Reserve Estimates.

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

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

.06 Differences between Tax and Financial Accounting for Reserves. Generally, accounting for reserves for purposes of the depletion allowance differs from accounting for reserves for financial purposes in two important respects. First, while the regulations require the inclusion of probable or prospective reserves in addition to proved reserves for purposes of the depletion allowance, the United States Securities and Exchange Commission (SEC)

generally requires the reporting of only proved reserves for financial purposes. Second, the revision of a reserve estimate for purposes of the depletion allowance is permitted under fewer circumstances than is the revision of a reserve estimate for financial reporting purposes. While the SEC may require or permit the revision of a reserve estimate in the case of changes in the price of the mineral or the cost of its extraction, such circumstances are not sufficient basis for revision of a reserve estimate for purposes of the depletion allowance.

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

SECTION 3. SCOPE

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

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

SECTION 4. TOTAL RECOVERABLE UNITS SAFE HARBOR

.01 If a taxpayer makes an election in accordance with section 5 of this revenue procedure, then, for purposes of computing cost depletion:

(1) The total recoverable units under § 1.611–2(c)(1) that each of the taxpayer's domestic oil and gas producing properties is estimated to contain as of a specific date will be treated as being equal to 105 percent of the property's "proved reserves" (both developed and undeveloped) as defined in 17 C.F.R. § 210.4–10(a) of Regulation S-X, as of that date;

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

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

SECTION 5. METHOD OF ELECTION AND REVOCATION

.01 In General.

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

taxpayer's domestic oil and gas producing properties.

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

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

.03 Election of Safe Harbor for Taxable Year Beginning After December 31, 2004. If the first taxable year for which a taxpayer elects the safe harbor provided in this revenue procedure begins after December 31, 2004, the taxpayer must determine, for each domestic oil and

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

SECTION 6. EFFECTIVE DATE

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

SECTION 7. PAPERWORK REDUCTION ACT

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

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the

collection of information displays a valid OMB control number.

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

The estimated total annual reporting burden is 50 hours.

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

The estimated annual frequency of responses is on occasion.

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

SECTION 8. DRAFTING INFORMATION

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