Computing Oil and Gas Tax Depletion Deductions for Partnerships

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Overview

- Look briefly at Section 613A(c) and its history
- Drill down - Section 613A(c)(7)(D) and the regulations thereunder.
- Depletion interaction with Sections 704(b) and 704(c)
- Practical applications – shortcuts
- When shortcuts don’t work

All references to Section or Sections are to the Internal Revenue Code of 1986, unless otherwise indicated.

Section 613A(c) – the IPRO Exemption

- In 1975, percentage depletion on oil and natural gas was repealed, with limited exceptions for fixed contract natural gas, regulated natural gas and independent producers and royalty owners (“IPRO”).
- Practically, the IPRO exemption applies to all producers and royalty owners, except for a few in number.

Summary of Oil and Gas Depletion

- The holder of an economic interest in an oil and gas property may take a depletion deduction.
- The annual depletion allowance is the greater of cost or percentage depletion computed on a property-by-property basis (if percentage depletion is allowable with respect to the taxpayer and/or the property)
- Generally, percentage depletion is **only available to independent producers and royalty owners (taxpayers who are not retailers or refiners)** – Sec. 613A(c)
- Percentage depletion is available only on domestic production
- Percentage depletion is 15% of the gross income from the property.
- The percentage depletion allowance cannot exceed 100% of the taxable income from the property, with this limitation suspended on marginal production for certain periods prior to January 1, 2012.
- IPRO percentage depletion is only available on the average daily production for the year that does not exceed the taxpayer's "depletable quantity" of oil and/or natural gas.
- IPRO percentage depletion is limited to 65% of the taxpayer's taxable income, as adjusted for this computation.

Section 613A(c)(7)(D) - Genesis

- Congress decided that a partnership should not compute and report IPRO percentage depletion, considering that the IPRO depletion is quantity-limited for each taxpayer/partner and possibly believing that a partnership computation may be interpreted as allowing IPRO percentage depletion to partners that are not IPRO.

Section 613A(c)(7)(D) – 1975 – Take One

- IPRO partners compute IPRO percentage depletion
- Partnership computes the non-IPRO percentage depletion
- That worked about as well as a screen door on a submarine.

Section 613A(c)(7)(D) - 1976 - Take Two and Final Version

- In the case of a partnership, the depletion allowance shall be computed separately by the partners and not by the partnership.

Section 613A(c)(7)(D), cont.

- The partnership shall allocate to each partner his/her proportionate share of the adjusted basis of each partnership oil or gas property.
- The allocation 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.

Section 613A(c)(7)(D), cont.

- A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital or income and, in the case of property contributed to the partnership by a partner, Section 704(c)(relating to contributed property) shall apply in determining such share.

Section 613A(c)(7)(D), cont.

- Each partner shall separately keep records of his share of the adjusted basis in each oil and gas property of the partnership, adjust such share of the adjusted basis for any depletion taken on such property, and use such adjusted basis each year in the computation of his cost depletion or in the computation of his gain or loss on the disposition of such property by the partnership.
- For purposes of Section 732 (relating to basis of distributed property other than money), the partnership's adjusted basis in mineral property shall be an amount equal to the sum of the partners‘ separate adjusted basis in such property as determined under Section 613A(c)(7)(D).

Where There is Statute, There Are Regulations - Eventually

- Regulations under Section 613A originally proposed in 1977
- Regulations withdrawn and re-proposed in 1991
- Regulations finalized in 1992

Aggregation v. Entity

- The result of Section 613A(c)(7)(D) is that a partnership for purposes of the oil and gas depletion calculation is treated as an aggregation of partners, not as a separate entity.
- Primary implications are that partners:
  - Compute their own depletion
  - Adjust their partnership interest basis by depletion taken
  - Adjust the basis in their share of the underlying oil and gas properties by their depletion taken

Partnership Furnishes Information Needed to Compute Depletion

- Reg. Sec. 1.613A-3(l) provides that the partnership (or the operator in the case of joint operations “electing out” of partnership treatment or in the case of royalty owners) will furnish to the respective parties for each Section 614 property their shares of:

Partnership Furnishes Information Needed to Compute Depletion, continued

- Gross income
- Operating expenses
- Depreciation
- Allocated overhead
- Estimated reserves
- Production in barrels or cubic feet

Partnership Furnishes Information Needed to Compute Depletion, continued

- Original share of property's adjusted basis
- Share of adjustments to property's adjusted basis
- The percentage by which existing partners must reduce their bases in each partnership oil or gas property upon entry of a partner by contribution
- Upon disposition of an oil or gas property by the partnership, the allocable portion of the amount realized from the sale of the property (but not the gain amount, which the partner computes because it adjusts its share of basis by the depletion that it computes and deducts)

Allocation of Basis

- The Section 613A(c) regulations give fairly extensive guidance on the allocation of basis.
- The substance of the Section 613A(c) regulations predates the present Section 704(b) regulations.
- Basically, if the allocation of basis meets the requirements for substantial economic effect under the Section 704(b) regulations, the allocation works for Section 613A(c)(7)(D).
- See Reg. Sec. 1.613A-3(e)(5) and Reg. Sec. 1.704-1(b)(4)(v).

Regulations Address Adjustments to Allocated Adjusted Bases of Properties

- Reg. Sec. 1.613A-3(e)(3)
- Capital Expenditures
- Reallocation upon admission of a new partner or increase in partner's interest by contribution. Each partner gives up a share of his share of adjusted basis.
  - Actual written data from existing partners, or
  - Assumption that all partners took the maximum amount of depletion

Regulations Address Adjustments to Allocated Adjusted Bases of Properties, cont.

- Withdrawal of partner or diminution of a continuing partner's interest in the partnership
  - Similar rules to contribution, except the partnership can rebut the assumption that the partner was an IPRO.

Basis of Property Distributed to Partner

- Rules similar to admission allocations.
  - Actual written data from partners, or
  - Assume that maximum depletion taken.
- Using the maximum depletion assumptions can cause basis to be lost upon partner admission or withdrawal (or diminution of interest), or property distribution.

Adjustment of Partner's "Outside Basis" for Oil and Gas Depletion

- The allocation of depletable basis to partners does not reduce their outside basis in the partnership.
- Section 705(a)(3) provides for a decrease (but not below zero) in outside basis by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the partner's allocated (or reallocated) share of the basis of such property.

Percentage Depletion and Capital Account Accounting under Section 704(b)

- Section 704(b) effectively requires that a partnership's tax items are allocated in a manner that is consistent with how partners share such tax items in an economic sense.
- The regulations under Section 704(b) provide that an allocation of income, gain, loss, deduction or credit must have substantial economic effect. The regulations provide that an allocation generally has economic effect only if capital accounts are maintained, in addition to other requirements.

Percentage Depletion and Capital Account Accounting under Section 704(b), cont.

- The Section 704(b) rules effectively require the construction of a "fair value" balance sheet. The resulting "704(b) book capital accounts" must be maintained by the partnership to have economic effect.

Percentage Depletion and Capital Account Accounting under Section 704(b), cont.

- Reg. Sec. 1.704-1(b)(2)(iv)(k) requires that the capital accounts be adjusted for depletion.
  - The partnership may make a binding election to use either the simulated cost depletion method or the simulated percentage depletion method on a property-by-property basis.
  - Alternatively, the partnership can use the partners' actual depletion.
  - If 704(b) book capital accounts are being used, the above concepts must be adapted for the Section 704(b) book capital account accounting.

Section 704(c) – My, Oh My!

- Except for a brief flirtation with 704(b) book capital accounts, up until now, we have blithely assumed that, with respect to any properties contributed to the partnership, fair market value is equal to adjusted tax basis upon contribution.
- Section 704(c) addresses the pre-contribution gains and losses imbedded in contributed property. Generally, differences between fair market value and basis are allocated to the contributing party. Such differences are also considered in allocating tax depreciation, depletion, and amortization with respect to contributed property.

Section 704(c), cont.

- Generally, the built-in gain or loss is addressed by following one of the following specific types of allocations:
  - Traditional Method
  - Traditional Method with Curative Allocations
  - Remedial Allocation Method; or
  - Any Reasonable Method (based on whose judgment?)

Section 704(c), cont.

- You may also be confronted with the implications of a “reverse 704(c)” election to apply the rules of 704(c) to contributions to a partnership having appreciated property.
- Section 704(c) allocations trump any conflicting Section 613A(c)(7)(D) allocations.
  - The interaction between the two authorities is not easily reconciled.

Practical Considerations

- In this practitioner's experience, most oil and gas partnerships' tax returns are prepared using a commercial or proprietary tax preparation software to compute a tentative depletion deduction for each partner that is provided to the partners, who can and do use it as the depletion deduction "computed by each partner." Tentative gains and losses on sales of oil and gas properties are also presented by the partnerships.

Practical Considerations, cont.

- Most commercial partnership tax return preparation software applications compute a depletion deduction for each partner to use.
  - Usually, the depletion deduction presented is an aggregation of depletion from all properties, sometimes showing the amount of aggregate cost depletion and of aggregate percentage depletion deductible, assuming no limitations apply. The information provided to each partner is less than that called for under Reg. Sec. 1.613A-3(i).
  - While not often presented to partners, at least some of the commercial software packages can produce a partner's property-by-property computation of depletion.

Practical Considerations, cont.

- Most of the time, you can use the deduction amount provided by the tax preparation software, but not always. For example, the deduction provided by the partnership likely will not take into account partner level considerations, such as:
  - The partner’s election to capitalize and amortize IDC under Section 59(e);
  - The application of the 65 percent-of-income limitation under Section 613A(d)(1);

Practical Considerations, cont.

– A Section 754 election not reflected directly in the basis of the partnership's properties;
– The depletable quantity limitations of Section 613A(c);
– The exclusion of retailers and refiners from IPRO depletion.
– Possible application of basis, at-risk and/or passive activity limitations.

Summary

- A partnership for purposes of the oil and gas depletion calculation is treated as an aggregation of partners, not as a separate entity.
- Generally, allocations of basis, income, gain, loss and credits need to satisfy the Section 704(b) substantial economic effect requirements.
- Most of the time, a partner can use the tentative depletion deduction usually provided by the partnership; however, be aware of and look for the exceptions.
- Examples in Reg. Sec. 1.613A-3(e)(7) and Reg. Sec. 1.704-1(b)(5), Example (19), provide some fairly basic illustrations of the concepts which have been the topic of this presentation.
- May the good Lord help you if you are faced with an oil and gas partnership having Section 704(c) properties and a Section 704(c) allocation method other than the Traditional Method.

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