

**§ 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 in the case of any trust where any beneficiary of such trust is a member of the family (as defined in section 267(c)(4)) of a settlor who created inter vivos and testamentary trusts for members of the family and such settlor died within the last 6 days of the 5th month in 1970, and the law in the jurisdiction in which such trust was created requires all or a portion of the gross or net proceeds of any royalty or other interest in oil, gas, or other mineral representing any percentage depletion allowance to be allocated to the principal of the trust.

The amount disallowed (as defined in paragraph (q) of § 1.613A-7) shall be carried over to the succeeding year and treated as an amount allowable as a deduction pursuant to section 613A(c) for such succeeding year, subject to the 65-percent limitation of section 613A(d)(1). For rules relating to corporations filing a consolidated return, see the regulations under section 1502. With respect to fiscal year taxpayers, except as pro-

vided in § 1.613A-1 for taxable years beginning before January 1, 1975, and ending after that date, the limitation shall be calculated on the entire fiscal year and not applied with respect to each short period included in a fiscal year. For purposes of basis adjustments and determining whether cost depletion exceeds percentage depletion with respect to the production from a property, any amount disallowed as a deduction after the application of this paragraph shall be allocated to the respective properties from which the oil or gas was produced in proportion to the percentage depletion otherwise allowable to such properties pursuant to section 613A(c). Accordingly, the maximum amount which may be allowable as a deduction pursuant to section 613A(c) after application of this paragraph (65 percent × adjusted taxable income) shall be allocated to properties for which percentage depletion pursuant to section 613A(c) would be allowed in the absence of the limitation contained in section 613A(d)(1) by application of the same proportion. However, once it is determined that after application of this paragraph cost depletion exceeds percentage depletion with respect to a property, the maximum amount determined under the preceding sentence shall be reallocated among the remaining properties, and the portion of the amount disallowed which is allocable to such property shall be the amount by which percentage depletion pursuant to section 613A(c) before application of this paragraph exceeds cost depletion. See example 1 of paragraph (a)(2) of this section. If the taxpayer becomes entitled to the deduction in a later year (*i.e.*, because the disallowed depletion does not exceed 65 percent of the taxpayer's taxable income for that year after taking account of any percentage depletion deduction otherwise allowable for that year), then the basis of the taxpayer's properties must be adjusted downward (but not below zero) by the amount of the deduction in proportion to the portion of the amount disallowed to the respective properties in the year of the disallowance. However, if the property in question was disposed of by the taxpayer prior to the beginning of such later year, the

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amount of the deduction in such later year shall be reduced by the difference between the taxpayer's adjusted basis in the property at the time it is disposed of and the adjusted basis which the taxpayer would have had in the property in the absence of the 65-percent limitation.

(2) The application of this paragraph may be illustrated by the following examples:

*Example 1.* A owns producing oil properties M, N, and O. With respect to property M, the depletion allowable pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was \$60x (cost depletion would have been \$40x). With respect to property N, the depletion allowable pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was \$90x (cost depletion would have been zero). With respect to property O, the depletion pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was \$50x (cost depletion would have been \$10X). A's taxable income (as adjusted under § 1.613A-4(a)(1)) for 1975 was \$100x; accordingly, A's percentage depletion pursuant to section 613A(c) for 1975 must be reduced from \$200x to \$65x (65 percent × \$100 × taxable income). Of that amount, \$19.5x:

$$\left[ 65x \text{ dollars} \left( \frac{\$60x}{\$60x + \$90x + \$50x} \right) \right]$$

is tentatively allocated to property M, \$29.25x:

$$\left[ 65x \text{ dollars} \left( \frac{\$90x}{\$90x + \$60x + \$50x} \right) \right]$$

is tentatively allocated to property N, and \$16.25x:

$$\left[ 65x \text{ dollars} \left( \frac{\$50x}{\$50x + \$90x + \$60x} \right) \right]$$

is tentatively allocated to property O.

Since cost depletion of \$40x with respect to property M exceeded the percentage depletion of \$19.5x allowable on such property, A claimed the cost depletion. Accordingly, the only percentage depletion deduction allowable to A pursuant to section 613A(c) for 1975 is with respect to properties N and O. Therefore, the \$65x ceiling applies to the percentage depletion allowable on properties N and O. Of that amount, \$41.79x:

$$\left[ 65x \text{ dollars} \left( \frac{\$90x}{\$90x + \$50x} \right) \right]$$

is allocated to property N, and \$23.21x:

$$\left[ 65x \text{ dollars} \left( \frac{\$50x}{\$50x + \$90x} \right) \right]$$

is allocated to property O.

Accordingly, A is allowed a total depletion deduction of \$105x (\$40x cost depletion on property M + \$41.79x percentage depletion on property N + \$23.21x percentage depletion on property O). The amount disallowed to A under section 613A(d)(1) is \$95x (\$200x aggregate depletion allowable before application of section 613A(d)(1) - \$105x [ \$40x cost depletion allowable on property M + \$41.79x percentage depletion allowable on property N after application of section 613A(d)(1) + \$23.21x depletion allowable on property O after application of section 613A(d)(1)]). For purposes of basis adjustments, \$20x (\$60x percentage depletion before limitation - \$40x cost depletion allowed) of the amount disallowed is allocated to property M. The balance of the amount disallowed of \$75x is allocated \$48.21x:

$$\left[ 75x \text{ dollars} \left( \frac{\$90x}{\$90x + \$50x} \right) \right]$$

to property N, and

$$\left[ 75x \text{ dollars} \left( \frac{50x}{\$50x + \$90x} \right) \right]$$

to property O.

*Example 2.* The amount disallowed to B as a deduction under this paragraph is \$50x for 1975 and \$125x for 1976 (including the \$50x carried over from 1975). B may carry forward the \$125x as a deduction to 1977 and subsequent years.

*Example 3.* C is a fiscal year taxpayer whose fiscal year ended on May 31, 1975. For purposes of applying the 65 percent of taxable income limitation, the period beginning January 1, 1975, and ending May 31, 1975, is treated as a short taxable year. The depletion allowable pursuant to section 613A(c) without regard to section 613A(d)(1) for such short taxable year was \$80x and A's taxable income (as adjusted under § 1.613A-4(a)(1)) during such short taxable year was \$100x. Only \$65x (65 percent × \$100x adjusted taxable income) of the deduction pursuant to section 613A(c) was deductible for such portion of 1975, in addition to any percentage depletion allowable for June 1, 1974, through December 31, 1974. With respect to the taxable year commencing June 1, 1975, and ending May 31, 1976, the 65 percent limitation is applied to the taxable income for the entire taxable year.

*Example 4.* Under the trust law of State X, a trustee is required to allocate 22 percent of gross mineral income to the principal of a trust for purposes of maintaining a reserve for depletion and the depletion deduction is entirely allocated to the trustee. In 1975 the gross income of a trust in State X the only assets of which were oil properties was \$1,000. The trust's allowable percentage depletion pursuant to section 613A(c) without regard to section 613A(d)(1) was \$220. The trust incurred expenses of \$150 for the taxable year and made distributions to beneficiaries (who are not described in the exception for family members set forth in paragraph (a)(1)(iv) of this section) of \$630 (\$1,000 gross income - \$220 allocated to principal - \$150 expenses). The trust's deduction for personal exemption under section 642(b) is \$300. For purposes of applying the 65 percent limitation, the trust's taxable income was \$550 (\$1,000 gross income - \$150 expenses - \$300 exemption). The limitation under section 613A(d)(1) was \$357.50 (65%×\$550 taxable income). Accordingly, the trust's percentage depletion allowance was unaffected by the 65 percent limitation.

*Example 5.* In 1980 the gross income of the estate of D was \$1,000. The only assets of the estate were oil properties. The estate's adjusted basis in the oil properties was \$0. The estate's allowable percentage depletion pursuant to section 613A(c) without regard to section 613A(d)(1) was \$220. The estate incurred expenses of \$150 for the taxable year and made distributions to beneficiaries of \$425. The distributions thus equaled one half of the net income of the estate (ignoring depletion). Under section 611(b)(4), the percentage depletion is apportioned equally between the estate and its beneficiary. The distribution amount of \$425 is deductible under section 661(a) in computing the taxable income of the estate. For purposes of applying the 65 percent limitation to the percentage depletion apportioned to the estate, the estate's taxable income was \$0 (\$1,000 gross income - \$150 expenses - \$425 distribution - \$600 exemption). The limitation under section 613A(d)(1) was therefore also \$0 (65%×\$0 taxable income). Accordingly, the \$110 amount is disallowed to the estate for the taxable year but may be carried forward by the estate as a deduction to 1981 and subsequent years. The beneficiaries shall apply the 65 percent limitation to the \$110 percentage depletion apportioned to them based on their respective taxable incomes.

*Example 6.* In 1975 E sold an oil property for which E's adjusted basis was \$20x. The amount disallowed for 1975 to E under section 613A(d) was \$10x. The amount of the carryover under that section to 1976 was \$0 (\$10x disallowed amount - \$10x [\$20x adjusted basis of property on sale - \$10x adjusted basis which taxpayer would have had in the property in the absence of the 65-percent limita-

tion]). However, if the adjusted basis of the property on disposition had been \$0, the amount of the carryover to 1976 would have been \$10x (\$10x disallowed amount - \$0 adjusted basis of property on sale).

*Example 7.* In 1975 F owned producing properties M, N, O, P, Q, and R. With respect to property M, the allowable cost depletion was \$100x (the allowable percentage depletion pursuant to section 613A(c) without regard to the depletable quantity and taxable income limitations contained in section 613A(c)(1), (6) and (d)(1) would have been \$90x). With respect to property N, the allowable percentage depletion pursuant to section 613A(c) before applying section 613A(d)(1) was \$80x (cost depletion would have been \$0). With respect to property O, the allowable cost depletion was \$60x (the allowable percentage depletion pursuant to section 613A(c) would have been \$70x, except that the application of section 613A(d)(1) reduced allowable percentage depletion to less than \$60x). With respect to property P, the allowable percentage depletion pursuant to section 613A(b) was \$55x (cost depletion would have been \$40x). With respect to property Q, which produces both gas subject to section 613A(b)(1)(B) and oil subject to section 613A(c), the allowable percentage depletion was \$45x (cost depletion would have been \$40x). With respect to property R, the allowable cost depletion was \$40x (the allowable percentage depletion pursuant to section 613A(c) would have been \$50x, except that the application of section 613A(c)(7)(A) reduced allowable percentage depletion to less than \$40x). Under paragraph (a)(1)(i) of this section, for purposes of applying the 65 percent limitation under section 613A(d)(1), F's taxable income must be reduced by the allowable depletion with respect to property M (for which cost depletion exceeded percentage depletion even in the absence of section 613A(c)(1), (6), and (d)) and property P (for which all depletion is determined pursuant to section 613A(b)), but shall not be reduced by the allowable depletion with respect to properties N, O, Q, and R.

(b) *Retailers excluded.* (1) Section 613A(c) and § 1.613A-3 shall not apply in the case of any taxpayer who is a retailer as defined in paragraph (r) of § 1.613A-7.

(2) The application of this paragraph may be illustrated by the following examples (those that involve sales through retail outlets assume, unless otherwise stated, that the \$5,000,000 gross receipts requirement section 613A(d)(2) is met):

*Example 1.* A, owner of producing oil and gas properties, also owns 5 percent in value of the stock of Corporation M, a retailer of

oil and gas. None of A's production is sold through Corporation M. Since A may benefit from Corporation M's sales of oil and gas through A's ownership interest in Corporation M, A is considered to be selling oil or natural gas through Corporation M, a related person. Accordingly, the exemption under section 613A(c) does not apply to A, even though none of A's production is sold through Corporation M.

*Example 2.* Assume the same facts as in *Example 1* except that A has gross receipts of \$2 million from sales of oil for the taxable year from A's retail outlets and Corporation M has gross receipts of \$4 million from sales of oil for the taxable year from its retail outlets. For purposes of the \$5 million gross receipts requirement of section 613A(d)(2), A is treated as having gross receipts of \$6 million. Accordingly, the exemption under section 613A(c) does not apply to A.

*Example 3.* Corporation N, a retailer of oil and gas, owns 5 percent in value of the stock of Corporation O, owner of producing oil and gas properties. None of Corporation O's production is sold through Corporation N. Since Corporation O has no direct or indirect ownership interest in Corporation N, and therefore does not benefit from Corporation N's sales of oil and gas, and since none of Corporation O's production is sold through Corporation N, the exemption under section 613A(c) applies to Corporation O.

*Example 4.* Corporation P, a producer of oil, owns 70 percent in value of the stock of Corporation Q. Corporation Q owns 30 percent in value of the stock of Corporation R. Corporation R owns 30 percent in value of the stock of Corporation S, a retailer of oil and gas. P indirectly owns 6.3 percent (70 percent  $\times$  30 percent  $\times$  30 percent) in value of the stock of Corporation S. Since P may benefit from Corporation S's sales of oil and gas through P's indirect ownership interest in Corporation S, P is not entitled to percentage depletion.

*Example 5.* B is the owner of certain oil and gas properties in Texas and is also the owner of a service station in Washington, DC, which B leases to Corporation T. None of B's production is sold to Corporation T. The exemption under section 613A(c) applies to B. However, if sales of B's production were made to Corporation T and the gross receipts from such sales of B's production to Corporation T exceed 5 million dollars, the exemption under section 613A(c) would not apply to B because B is selling oil or natural gas to a person given authority to occupy a retail outlet leased by the taxpayer, B.

*Example 6.* C has a  $\frac{1}{8}$  royalty interest and Corporation U has a  $\frac{7}{8}$  working interest in an oil property. Corporation V, a retailer of oil, owns 5 percent in value of the stock of Corporation U. C has no interest in either corporation. All of the production from the property is sold through Corporation V, C re-

ceiving from Corporation U  $\frac{1}{8}$  of its receipts therefrom. The exemption under section 613A(c) does not apply to Corporation U because Corporation U is selling oil of natural gas through Corporation V, a related person that is a retailer. However, the exemption applies to C because C, as owner of a nonoperating mineral interest, is not treated as an operator of a retail outlet merely because C's oil and gas is sold on C's behalf through a retail outlet operated by an unrelated person.

*Example 7.* D owns and operates retail grocery stores where refined oil may be purchased. D also owns oil and gas producing properties. If the sales of refined oil at each store location constitute less than 5 percent of the gross receipts from all sales made at that store, D is not considered a retailer by reason of such sales.

*Example 8.* Lessee E sells natural gas to lessor F directly from a wellhead gathering pipelines system for F's local agricultural use, in transactions incidental to the acquisition of a natural gas lease. The sales of natural gas to F are not sales through a retail outlet.

*Example 9.* Corporation W produces natural gas, some of which it sells at retail. For purposes of determining whether Corporation W is a retailer selling gas through a retail outlet within the meaning of § 1.613A-7(r), the business office of Corporation W where a purchaser would normally contact the corporation with respect to its sales to the purchaser is considered the place at which those sales of natural gas are made.

*Example 10.* G, husband, is the sole owner and operator of a retail outlet which sells oil and gas. H, wife, owns producing oil and gas properties. G is not related to H for purposes of section 613A(d).

*Example 11.* I, husband, and J, wife, are community property owners of 10 percent in value of the stock of Corporation X which is a retailer of oil and gas. I and J are each treated as owning 5 percent of Corporation X. Therefore, neither I nor J qualify for the exemption under section 613A(c).

*Example 12.* Corporation Y, an electing small business corporation as defined in section 1371 (as in effect prior to the enactment of the subchapter S Revision Act of 1982), owns producing oil and gas properties. K, a retailer of oil and gas, is a 50 percent interest shareholder of Corporation Y. None of Corporation Y's production is sold through K. Corporation Y is eligible for percentage depletion.

*Example 13.* Corporation Z, a producer of natural gas, makes bulk sales of natural gas to industrial users. For purposes of determining whether Corporation Z is a retailer under § 1.613A-7(r), the bulk sales are disregarded.

*Example 14.* L, a calendar year taxpayer, is the owner of a producing oil property. On September 1, 1976, L purchased a chain of

gasoline service stations. Therefore, L was a retailer of oil and gas for the last 122 days of 1976. L's gross income from the oil property for the taxable year was \$150x and L's taxable income from the property was \$30x. L is treated as a retailer with respect to \$50x of gross income from the property ( $\$150x \times 122/366$ ) and \$10x of taxable income from the property ( $\$30x \times 122/366$ ). Therefore, L is entitled to percentage depletion with respect to \$100x of gross income from the property ( $\$150x$  minus  $\$50x$ ). However, the allowable percentage depletion is limited by the 50 percent of taxable income from the property limitation to \$10x (50 percent times \$20x taxable income ( $\$30x$  minus  $\$10x$ )).

*Example 15.* Corporation M is a partner in Partnership MNO which is the owner of an operating interest in a producing oil property. Corporation P, a retailer of oil and gas, owns 5 percent in value of the stock of Corporation M. Partnership MNO sells its production to Corporation P. Corporation M is retailing oil through Corporation P, a related person, because its share of the oil is being sold on its behalf by the partnership through a retail outlet operated by a person related to Corporation M. Therefore, the exemption under section 613A(c) does not apply to Corporation M.

*Example 16.* AA and BB are beneficiaries of a trust which is a retailer of oil and gas. AA has an interest in the income of the trust for AA's lifetime which, actuarially determined, represents more than 5 percent of the beneficial interests in the trust. BB's interest in the trust, which entitles BB to 5 percent of the corpus of the trust 5 years after AA's death, represents less than 5 percent of the beneficial interests in the trust prior to AA's death and represents more than 5 percent after AA's death. The trust is a related person of AA but not BB while AA is alive. Accordingly, during AA's lifetime BB is not disqualified from the exemption provided by section 613A(c), but AA is.

*Example 17.* Assume the same facts as in *Example 16*, except that AA's interest in the income of the trust represents 4 percent of the beneficial interests in the trust. AA is disqualified from the exemption provided by section 613A(c) with respect to the income from the trust but not with respect to income from other sources.

(c) *Certain refiners excluded.* (1) Section 613A(c) and § 1.613A-3 shall not apply in the case of any taxpayer who is a refiner as defined in paragraph (s) of § 1.613A-7.

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

*Example 1.* Corporation M owns a refinery which has refinery runs in excess of 50,000 barrels on at least one day during the tax-

able year. Corporation M also owns a 5 percent interest in Corporation N, owner of producing oil and gas properties. None of Corporation N's production is sold to Corporation M. The exemption under section 613A(c) does not apply to Corporation N because Corporation M, a related person of Corporation N, engages in the refining of crude oil.

*Example 2.* A and B are equal partners in Partnership AB, which owns oil and gas producing properties. A owns a refinery which has refinery runs in excess of 50,000 barrels on at least one day during the taxable year and which buys all of Partnership AB's production. B has no ownership interest in any refinery. B is not a refiner.

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#### § 1.613A-5 Election under section 613A(c)(4).

The election under section 613A(c)(4) is an annual election which the taxpayer may make by claiming percentage depletion deductions for the taxable year based upon such election. The election may be made, on an original or amended tax return or a claim for credit or refund, at any time prior to the expiration of the statutory period (including any extensions thereof) for the filing of a claim for credit or refund by the taxpayer. The election may be changed by the taxpayer by filing an amended return or a claim for credit or refund. The election allows the taxpayer to treat as his depletable natural gas quantity an amount equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the election applies. The election applies to secondary or tertiary production, as well as primary production, but in determining the taxpayer's depletable natural gas quantity with respect to secondary or tertiary production the taxpayer's depletable oil quantity shall be determined without regard to section 613A(c)(3)(A)(ii) with respect to production from secondary or tertiary processes.

[T.D. 7487, 42 FR 24264, May 13, 1977]

#### § 1.613A-6 Recordkeeping requirements.

(a) *Principal value of property demonstrated.* In the case of a transfer (as defined in § 1.613A-7(n)) after December 31, 1974, of an interest in an oil or gas property (as defined in § 1.613A-7(p)),