

income for a depletion reserve pursuant to discretionary authority to do so in the governing instrument

No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion.

(5) *Mineral or timber property held by estate.* In the case of a mineral property or timber property held by an estate the deduction for depletion under section 611 shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate from such property which is allocable to each.

(d) *Definitions.* As used in this part, and the regulations thereunder, the term:

(1) *Property* means—(i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614 (b), (c), (d), or (e); and (ii) in the case of timber, an economic interest in standing timber in each tract or block representing a separate timber account (see paragraph (d) of § 1.611-3). For rules with respect to waste or residue of prior mining, see paragraph (c) of § 1.614-1. When, in the regulations under this part, either the word *mineral* or *timber* precedes the word *property*, such adjectives are used only to classify the type of *property* involved. For further explanation of the term *property*, see section 614 and the regulations thereunder.

(2) *Fair market value* of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(3) *Mineral enterprise* is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) *Mineral deposit* refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

(5) *Minerals* includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§ 1.611-2 Rules applicable to mines, oil and gas wells, and other natural deposits.

(a) *Computation of cost depletion of mines, oil and gas wells, and other natural deposits.* (1) The basis upon which cost depletion is to be allowed in respect of any mineral property is the basis provided for in section 612 and the regulations thereunder. After the amount of such basis applicable to the mineral property has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year (see subparagraph (3) of this paragraph), and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year (see subparagraph (2) of this paragraph). In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

(2) As used in this paragraph, the phrase *number of units sold within the taxable year*:

(i) In the case of a taxpayer reporting income on the cash receipts and disbursements method, includes units for

which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year, and

(ii) In the case of a taxpayer reporting income on the accrual method, shall be determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his method of inventory accounting under section 471 or 472

The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

(3) *The number of units of mineral remaining as of the taxable year* is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the number of units sold within the taxable year as defined in this section.

(4) In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the cost depletion allowance in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in rock pressure during the taxable year and the denominator of which is equal to the expected total decline in rock pressure from the beginning of the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodical pressure determinations.

(5) If an aggregation of two or more separate mineral properties is made during a taxable year under section 614, cost depletion for each such property shall be computed separately for that portion of the taxable year ending immediately before the effective date of the aggregation. Cost depletion with respect to the aggregated property shall be computed for that portion of the taxable year beginning on such effective date. The allowance for cost depletion for the taxable year shall be the sum of such cost depletion computations. For purposes of this paragraph, each such portion of the taxable

year shall be considered as a taxable year. Similar rules shall be applied where a separate mineral property is properly removed from an existing aggregation during a taxable year. See section 614 and the regulations thereunder for rules relating to the effective date of an aggregation of mineral interests and for rules relating to the adjusted basis of an aggregation.

(6) The apportionment of the deduction among the several owners of economic interests in the mineral deposit or deposits will be made as provided in paragraph (c) of § 1.611-1.

(b) *Depletion accounts of mineral property.* (1) Every taxpayer claiming and making a deduction for depletion of mineral property shall keep a separate account in which shall be accurately recorded the cost or other basis provided by section 1012, of such property together with subsequent allowable capital additions to each account and all the other adjustments required by section 1016.

(2) Mineral property accounts shall thereafter be credited annually with the amounts of the depletion so computed in accordance with section 611 or 613 and the regulations thereunder; or the amounts of the depletion computed in shall be credited to depletion reserve accounts. No further deductions for cost depletion shall be allowed when the sum of the credits for depletion equals the cost or other basis of the property, plus allowable capital additions. However, depletion deductions may be allowable thereafter computed upon a percentage of gross income from the property. See section 613 and the regulations thereunder. In no event shall percentage depletion in excess of cost or other basis of the property be credited to the improvements account or the depreciation reserve account.

(c) *Determination of mineral contents of deposits.* (1) If it is necessary to estimate or determine with respect to any mineral deposit as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in place as of that date, the estimate or determination must be made according to the method current in the industry

and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the deposit for the purposes of valuation and depletion shall include as to both quantity and grade:

(i) The ores and minerals *in sight, blocked out, developed, or assured*, in the usual or conventional meaning of these terms with respect to the type of the deposits, and

(ii) *Probable or prospective* ores or minerals (in the corresponding sense), that is, ores or minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development. Such *probable or prospective* ores or minerals may be estimated:

(a) As to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological surveys or other evidence to a high degree of probability, and

(b) As to grade, only in accordance with the best indications available as to richness.

(2) If the number of recoverable units of mineral in the deposit has been previously estimated for the prior year or years, 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, for any taxable year for which it is ascertained either by the taxpayer or the district director from any source, such as operations or development work prior to the close of the taxable year, that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate, then the estimate of the remaining recoverable units shall be revised, and the annual cost depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate until a change in the facts requires another revision. Such revised estimate will not,

however, change the adjusted basis for depletion.

(d) *Determination of fair market value of mineral properties, and improvements, if any.* (1) If the fair market value of the mineral property and improvements at a specified date is to be determined for the purpose of ascertaining the basis, such value must be determined, subject to approval or revision by the district director, by the owner of such property and improvements in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments or subsequent improvements in methods of extraction and treatment of the mineral product. The district director will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties and improvements, bona fide offers, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property and improvements was in question, the amount at which the property and improvements may have been inventoried or appraised in probate or similar proceedings, and disinterested appraisals by approved methods.

(2) If the fair market value must be ascertained as of a certain date, analytical appraisal methods of valuation, such as the present value method will not be used:

(i) If the value of a mineral property and improvements, if any, can be determined upon the basis of cost or comparative values and replacement value of equipment, or

(ii) If the fair market value can reasonably be determined by any other method.

(e) *Determination of the fair market value of mineral property by the present value method.* (1) To determine the fair market value of a mineral property and improvements by the present value method, the essential factors must be determined for each mineral deposit. The essential factors in determining the fair market value of mineral deposits are:

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(i) The total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed,

(ii) The quantity of mineral expected to be recovered during each operating period,

(iii) The average quality or grade of the mineral reserves,

(iv) The allocation of the total expected profit to the several processes or operations necessary for the preparation of the mineral for market,

(v) The probable operating life of the deposit in years,

(vi) The development cost,

(vii) The operating cost,

(viii) The total expected profit,

(ix) The rate at which this profit will be obtained, and

(x) The rate of interest commensurate with the risk for the particular deposit.

(2) If the mineral deposit has been sufficiently developed, the valuation factors specified in subparagraph (1) of this paragraph may be determined from past operating experience. In the application of factors derived from past experience, full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and selling price of the product marketed during the expected operating life of the mineral deposit. Mineral deposits for which these factors cannot be determined with reasonable accuracy from past operating experience may also be valued by the present value method; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits, the intensity of mineralization, the oil-gas ratio, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the required factors.

(3) Mineral deposits of different grades, locations, and probable dates of extraction should be valued separately. The mineral content of a deposit shall be determined in accordance with para-

graph (c) of this section. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating life of oil and gas wells is also influenced by the natural decline in pressure and flow, and by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions, as described in §§ 1.612-2 and 1.612-4, and deductions for depreciation and depletion, but including cost of repairs. This cost of repairs is not to be confused with the depreciation deduction by which the cost of improvements is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the district director which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(4) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date for which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the improvements and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral enterprise before the date

for which the valuation is made. On the other hand, higher risks ordinarily attach to appraisals upon any other basis.

(f) *Revaluation of mineral property not allowed.* No revaluation of a mineral property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner.

(g) *Statement to be attached to return when valuation, depletion, or depreciation of mineral property or improvements are claimed.* (1) For the first taxable year ending before December 31, 1967, for which a taxpayer asserts a value for any mineral property or improvement as of a specific date or claims a deduction for depletion, or depreciation, there shall be attached to the return of the taxpayer for such taxable year a statement setting forth, in complete, summary form, the pertinent information required by this paragraph with respect to each such mineral property or improvement (including oil and gas properties or improvements). The summary statement shall be deemed a part of the income tax return to which it relates. In addition to such summary statement, the taxpayer must assemble, segregate and have readily available at his principal place of business, all the supporting data (listed in subparagraphs (2), (3), and (4) of this paragraph) which is used in compiling the summary statement. For taxable years after such first taxable year, and ending before December 31, 1967, the taxpayer need attach to his return only an explanation of the changes, if any, in the information previously furnished. For example, when a taxpayer has filed adequate maps with the district director he may be relieved of filing further maps of the same area, if all additional information necessary for keeping the maps up-to-date is filed each year. In any case in which any of the information required by this paragraph has

been previously filed by the taxpayer (including information furnished in accordance with corresponding provisions of prior regulations), such information need not be filed again, but a statement should be attached to the return of the taxpayer indicating clearly when and in what form such information was previously filed. For provisions relating to the data which shall be submitted with returns for taxable years ending on or after December 31, 1967, see subparagraph (5) of this paragraph.

(2) The information referred to in subparagraph (1) of this paragraph is as follows:

(i) An adequate map showing the name, description, location, date of surveys, and identification of the deposit or deposits;

(ii) A description of the character of the taxpayer's property, accompanied by a copy of the instrument or instruments by which it was acquired;

(iii) The date of acquisition of the property, the exact terms and dates of expiration of all leases involved, and if terminated, the reasons therefor;

(iv) The cost of the mineral property and improvements, stating the amount paid to each vendor, with his name and address;

(v) The date as of which the mineral property and improvements are valued, if a valuation is necessary to establish the basis as provided by section 1012;

(vi) The value of the mineral property and improvements on that date with a statement of the precise method by which it was determined;

(vii) An allocation of the cost or value among the mineral property, improvements and the surface of the land for purposes other than mineral production;

(viii) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(ix) The number of units sold and the number of units for which payment was received or accrued during the year for which the return is made (in the case of newly developed oil and gas deposits it is desirable that this information be furnished by months);

(x) The gross amount received from the sale of mineral;

(xi) The amount of depreciation for the taxable year and the amount of cost depletion for the taxable year;

(xii) The amounts of depletion and depreciation, if any, stated separately, which for each and every prior year:

(a) Were allowed (see section 1016(a)(2)),

(b) Were allowable, and

(c) Would have been allowable without reference to percentage or discovery depletion;

(xiii) The fractions (however measured) of gross production from the deposit or deposits to which the taxpayer and other persons are entitled together with the names and addresses of such other persons; and

(xiv) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deductions claimed.

(3) In the case of oil and gas properties, the following information with respect to each property is required in addition to that information set forth in subparagraph (2) of this paragraph:

(i) The number of acres of producing oil or gas land and, if additional acreage is claimed to be proven, the amount of such acreage and the reasons for believing it to be proven;

(ii) The number of wells producing at the beginning and end of the taxable year;

(iii) The date of completion of each well finished during the taxable year;

(iv) The date of abandonment of each well abandoned during the taxable year;

(v) Maps showing the location of the tracts or leases and of the producing and abandoned wells, dry holes, and proven oil and gas lands (the maps should show depth, initial production, and date of completion of each well, etc., to the extent that these data are available);

(vi) The number of pay sands and average thickness of each pay sand or zone;

(vii) The average depth to the top of each of the different pay sands;

(viii) The annual production of the deposit or of the individual wells, if the latter information is available, from the beginning of its productivity to the end of the taxable year, the average number of wells producing during each year, and the initial daily production of each well (the extent to which oil or gas is used for fuel on the premises should be stated with reasonable accuracy);

(ix) All available data regarding change in operating conditions, such as unit operation, proration, flooding, use of air-gas lift, vacuum, shooting, and similar information, which have a direct effect on the production of the deposit; and

(x) Available geological information having a probable bearing on the oil and gas content; information with respect to edge water, water drive, bottom hole pressures, oil-gas ratio, porosity of reservoir rock, percentage of recovery, expected date of cessation of natural flow, decline in estimated potential, and characteristics similar to characteristics of other known fields.

(4) For rules relating to an additional statement to be attached to the return when the depletion deduction is computed upon a percentage of gross income from the property, see § 1.613-6.

(5) A taxpayer who claims a total deduction of more than \$200 for depletion of mines, oil and gas wells, or other natural deposits for the taxable year ending on or after December 31, 1967, and before December 31, 1968, shall submit with his return for such taxable year a filled-out Form M (Mines and Other Natural Deposits—Depletion Data) or Form O (Oil and Gas Depletion Data). See section 6011(a). For the purpose of this subparagraph, the determination under section 631(c) of gain or loss upon the disposition of coal or domestic iron ore with a retained economic interest shall not be regarded as the claiming of a deduction for depletion. Such forms shall be filed for any subsequent taxable year if the Commissioner determines that the forms are required for such year. Where

appropriate, both Form M and Form O shall be filed. Forms M and O shall be deemed to be part of the return to which they relate. If a taxpayer mines more than one mineral, a separate Form M shall be filed for each such mineral. If a taxpayer has both domestic and foreign properties, separate forms shall be filed for each country in which a taxpayer's properties are located. All data relating to a taxpayer's domestic oil and gas properties shall be summarized on a single Form O, and data relating to a taxpayer's domestic mineral properties (other than oil and gas properties) shall be summarized on a single Form M for each mineral. Similarly, all data relating to a taxpayer's oil and gas properties in a specific foreign country shall be summarized on a single Form O, and data relating to a taxpayer's mineral properties (other than oil and gas properties) in a specific foreign country shall be summarized on a single Form M for each mineral. In addition, the taxpayer shall assemble, segregate, and have readily available at his principal place of business, the data listed in subparagraphs (2), (3), and (4) of this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6938, 32 FR 17518, Dec. 7, 1967; T.D. 7170, 37 FR 5373, Mar. 15, 1972]

§ 1.611-3 Rules applicable to timber.

(a) *Capital recoverable through depletion allowance in case of timber.* In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations thereunder. For the method of determining fair market value and quantity of timber, see paragraphs (d), (e), and (f) of this section. For capitalization of carrying charges, see section 1016(a)(1)(A). Amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances. Such amounts include, for example, expenditures made for the preparation of the timber site for planting or for natural seeding and the cost of seedlings. The apportionment of deductions between the several owners of economic interests in stand-

ing timber will be made as provided in paragraph (c) of § 1.611-1.

(b) *Computation of allowance for depletion of timber for taxable year.* (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the cost of the number of units of timber acquired during the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.