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Oil and Gas Reserve Reports in the Tax World

Reserve reports are critical in oil and gas production, but they can also be essential in oil and gas taxation. They are used in the calculation of cost depletion, which is one of two ways of deducting the costs of a property over its production life. Unlike percentage depletion, cost depletion can always be deducted.

Cost Depletion

Cost depletion is calculated on the amount of a property's capitalized leasehold costs and is deducted as the oil or gas is extracted from the property and sold. This means your deduction is based on the amount of the reserves sold in the current period. The recoverable units are defined as an estimate of "probable" or "prospective" amounts based on industry methods that includes quantity and grade. This includes "proved developed" and "proved undeveloped" but goes beyond it.

A Safe Harbor

A safe harbor is available to account for probable or prospective reserves for all domestic oil and gas properties. A taxpayer may elect to estimate a property's total ending reserves as 105% of proved developed and proved undeveloped reserves. The election must be made in a statement attached to a timely filed original return with a copy of the statement sent to the Industry Director, Large and Mid-Size Business, Natural Resources. The election should include the following:

- A statement that the taxpayer is using the safe harbor in Rev Proc 2004-19
- Taxpayer's name, address, and Taxpayer Identification Number
- A contact name and phone number

Once the election is made, it is irrevocable for that year. It can be revoked in a later year with a statement following the rules above, but then the election is not available to the taxpayer for the next five years.

Changing the Estimate

Whether you make the election or not, reserve figures for tax returns are difficult to change. For financial reporting, a company will often revise its estimated reserves based on what will be recoverable given a change in price or costs. This is not available for tax purposes. The only way a taxpayer can revise their reserve figure is when there was a material error in the original geological calculation. You cannot go back and revise the depletion you took in a prior year based on the revised reserves, though the IRS can do this for you.

If you have any questions or would like to discuss if you may be eligible for the EOR credit, please reach out to Megan Williams – MeganW@gmpcpa.com.