

into capital gains to the extent of the leveraged amounts.

Aside from foreclosure of a nonrecourse debt, however, a nonproductive well provides no opportunity for converting an ordinary income stream into capital gain. Accordingly, the final regulations provide that section 1254 costs attributable to nonproductive wells are not recapturable, except in certain limited risk situations.

V. Depreciation

Some commentators argue that depreciable costs associated with drilling should not be separated from depletable costs in calculating the hypothetical depletion deduction. Commentators also point out that it is difficult to identify the amount of intangible drilling and development costs that could have been deducted as depreciation, because it is not current industry practice to separate depreciable costs from depletable costs. In response to these comments, the final regulations do not require depreciable costs to be separated from depletable costs in calculating the hypothetical depletion deduction.

VI. Property Interest Subject to Recapture

Under the proposed regulations, each operating mineral interest in an "oil, gas, or geothermal property," as well as any nonoperating mineral interest retained by a lessor or sublessor of a property to which intangible drilling and development costs were properly chargeable when held by such person prior to the creation of the lease or sublease, is subject to recapture.

In *Houston Oil and Minerals Corp. v. Commissioner*, 92 T.C. 1331 (1989), *aff'd*, 922 F.2d 283 (5th Cir. 1991), *Louisiana Land and Exploration Co. v. Commissioner*, 92 T.C. 1340 (1989), and *Southland Royalty Co. v. United States*, 91-1 U.S.T.C. ¶ 50,083 (Cl. Ct. 1991), the Internal Revenue Service took the position that section 1254 requires recapture of intangible drilling and development costs upon the disposition of a nonoperating mineral interest carved out of an operating mineral interest. The courts, however, held instead that the disposition of an overriding royalty interest carved out of an operating mineral interest to which intangible drilling and development costs were charged does not trigger recapture because the overriding royalty interest is not "oil, gas, or geothermal property" within the meaning of section 1254(a)(3).

The Tax Court in *Houston Oil and Minerals Corp.*, 92 T.C. at 1339, and

Louisiana Land and Exploration Co., 92 T.C. at 1348, and the Claims Court in *Southland Royalty Co.*, 91-1 U.S.T.C. at 87,337, noted that because the Tax Reform Act of 1986 amended section 1254 to include within the definition of "oil, gas, or geothermal property" property the basis of which has been adjusted for depletion, nonoperating mineral interests come within the ambit of section 1254 after 1986. Consequently, the courts reasoned, the issue considered in these cases would arise only with respect to property placed in service before 1987.

The regulations have been amended to treat a nonoperating mineral interest carved out of an operating mineral interest with respect to which section 1254 costs have been deducted as property to which section 1254 costs are properly chargeable. Thus, the final regulations make clear that natural resource recapture property includes a nonoperating mineral interest if the nonoperating mineral interest was carved out of an operating mineral interest to which section 1254 costs were properly chargeable by the holder of the operating mineral interest. See § 1.1254-1(b)(2). Consistent with the opinions in the litigated cases, however, this provision will be effective only with respect to property placed in service after December 31, 1986.

VII. Disposition

Commentators urge that the regulations state who is liable for recapture if an operating mineral interest shifts automatically or at the option of the person who will receive the interest, as, for example, a farm-out. In response to these comments, the final regulations provide that liability for potential recapture of intangible drilling and development costs attributable to the entire operating mineral interest held by the carrying party prior to reversion or conversion remains attributable to the reduced operating mineral interest retained by the carrying party after a portion of the operating mineral interest has reverted to the carried party or after the conversion of an overriding royalty interest that converts, at the option of the grantor or successor in interest, to an operating mineral interest after a certain amount of production.

VIII. Like Kind Exchanges and Involuntary Conversions

Commentators state that under § 1.1254-4(d) of the proposed regulations liability for recapture of intangible drilling and development costs remains with the property with respect to which the costs were incurred

and does not transfer to the property received in a like kind exchange or involuntary conversion. However, under the final regulations recapture liability transfers to the property received by the transferor who received the benefit of the deductions for section 1254 costs. This result is consistent with the section 1245(b)(4) and § 1.1245-2(c)(4) rules for recapture of depreciation. Because section 1254(b)(1) states that the regulations should prescribe rules similar to rules in section 1245 (b) and (c) for like kind exchanges, involuntary conversions, and other nontaxable transfers, the final regulations more closely mirror the section 1245 recapture rules for such transactions.

IX. Filing Requirements

The proposed regulations provide allocation rules for the recapture of section 1254 costs on the sale of a portion of, or an undivided interest in, natural resource recapture property. Under the proposed regulations, a taxpayer is required to attach to the tax return documents sufficient to establish allocation of intangible drilling and development costs to the disposed of portion or undivided interest, notwithstanding that the intangible drilling and development costs do not in fact relate to that portion or undivided interest. Commentators suggest that it is more practical simply to require a taxpayer to state on the tax return that the section 1254 costs do not relate to the property disposed of and to retain verifying documentation. In response to the commentators' suggestion, the final regulations contain a book and records retention requirement.

Effective dates: These regulations are effective January 10, 1995 and §§ 1.1254-1 through 1.1254-3 and § 1.1254-5 apply to any disposition of natural resource recapture property occurring after March 13, 1995. The rule in § 1.1254-1(b)(2)(iv)(A)(2), concerning a nonoperating mineral interest carved out of an operating mineral interest with respect to which an expenditure has been deducted, applies to any disposition occurring after March 13, 1995 of property (within the meaning of section 614) that is placed in service by the taxpayer after December 31, 1986. For dispositions of natural resource recapture property occurring on or before March 13, 1995, taxpayers must take reasonable return positions taking into consideration the statute and its legislative history.

Special Analyses

It has been determined that this Treasury decision is not a significant