

- (2) Special rule for dispositions to certain tax exempt organizations.
- (3) Transfers described.
- (4) Special rules for section 332 transfers.
- (d) Limitation for like kind exchanges and involuntary conversions.
  - (1) General rule.
  - (2) Disposition and acquisition of both natural resource recapture property and other property.

**§ 1.1254-3 Section 1254 costs immediately after certain acquisitions.**

- (a) Transactions in which basis is determined by reference to cost or fair market value of property transferred.
  - (1) Basis determined under section 1012.
  - (2) Basis determined under section 301(d), 334(a), or 358(a)(2).
  - (3) Basis determined solely under former section 334(b)(2) or former section 334(c).
  - (4) Basis determined by reason of the application of section 1014(a).
- (b) Gifts and certain tax-free transactions.
  - (1) General rule.
  - (2) Transactions covered.
- (c) Certain transfers at death.
- (d) Property received in a like kind exchange or involuntary conversion.
  - (1) General rule.
  - (2) Allocation of section 1254 costs among multiple natural resource recapture property acquired.
- (e) Property transferred in cases to which section 1071 or 1081(b) applies.

**§ 1.1254-4 Special rules for S corporations and their shareholders.** [Reserved].

**§ 1.1254-5 Special rules for partnerships and their partners.**

- (a) In general.
- (b) Determination of gain treated as ordinary income under section 1254 upon the disposition of natural resource recapture property by a partnership.
  - (1) General rule.
  - (2) Exception to partner level recapture in the case of abusive allocations.
  - (3) Examples.
- (c) Section 1254 costs of a partner.
  - (1) General rule.
  - (2) Section 1254 costs of a transferee partner after certain acquisitions.
- (d) Property distributed to a partner.
  - (1) In general.
  - (2) Aggregate of partners' section 1254 costs with respect to natural resource recapture property held by a partnership.

**§ 1.1254-6 Effective date of regulations.**

**§ 1.1254-1 Treatment of gain from disposition of natural resource recapture property.**

(a) *In general.* Upon any disposition of section 1254 property or any disposition after December 31, 1975 of oil, gas, or geothermal property, gain is treated as ordinary income in an amount equal to the lesser of the amount of the section 1254 costs (as defined in paragraph (b)(1) of this section) with respect to the property, or the amount, if any, by which the amount realized on

the sale, exchange, or involuntary conversion, or the fair market value of the property on any other disposition, exceeds the adjusted basis of the property. However, any amount treated as ordinary income under the preceding sentence is not included in the taxpayer's *gross income from the property* for purposes of section 613. Generally, the lesser of the amounts described in this paragraph (a) is treated as ordinary income even though, in the absence of section 1254(a), no gain would be recognized upon the disposition under any other provision of the Internal Revenue Code. For the definition of the term *section 1254 costs*, see paragraph (b)(1) of this section. For the definition of the terms *section 1254 property, oil, gas, or geothermal property, and natural resource recapture property*, see paragraph (b)(2) of this section. For rules relating to the *disposition* of natural resource recapture property, see paragraphs (b)(3), (c), and (d) of this section. For exceptions and limitations to the application of section 1254(a), see § 1.1254-2.

(b) *Definitions*—(1) *Section 1254 costs*—(i) *Property placed in service after December 31, 1986.* With respect to any property placed in service by the taxpayer after December 31, 1986, the term *section 1254 costs* means—

(A) The aggregate amount of expenditures that have been deducted by the taxpayer or any person under section 263, 616, or 617 with respect to such property and that, but for the deduction, would have been included in the adjusted basis of the property or in the adjusted basis of certain depreciable property associated with the property; and

(B) The deductions for depletion under section 611 that reduced the adjusted basis of the property.

(ii) *Property placed in service before January 1, 1987.* With respect to any property placed in service by the taxpayer before January 1, 1987, the term *section 1254 costs* means—

(A) The aggregate amount of costs paid or incurred after December 31, 1975, with respect to such property, that have been deducted as intangible drilling and development costs under section 263(c) by the taxpayer or any other person (except that section 1254 costs do not include costs incurred with respect to geothermal wells commenced before October 1, 1978) and that, but for the deduction, would be reflected in the adjusted basis of the property or in the adjusted basis of certain depreciable property associated with the property; reduced by

(B) The amount (if any) by which the deduction for depletion allowed under

section 611 that was computed either under section 612 or sections 613 and 613A, with respect to the property, would have been increased if the costs (paid or incurred after December 31, 1975) had been charged to capital account rather than deducted.

(iii) *Deductions under section 59 and section 291.* Amounts capitalized pursuant to an election under section 59(e) or pursuant to section 291(b) are treated as section 1254 costs in the year in which an amortization deduction is claimed under section 59(e)(1) or section 291(b)(2).

(iv) *Suspended deductions.* If a deduction of a section 1254 cost has been suspended as of the date of disposition of section 1254 property, the deduction is not treated as a section 1254 cost if it is included in basis for determining gain or loss on the disposition. On the other hand, if the deduction will eventually be claimed, it is a section 1254 cost as of the date of disposition. For example, a deduction suspended pursuant to the 65 percent of taxable income limitation of section 613A(d)(1) may either be included in basis upon disposition of the property or may be deducted in a year after the year of disposition. See § 1.613A-4(a)(1). If it is included in the basis then it is not a section 1254 cost, but if it is deductible in a later year it is a section 1254 cost as of the date of the disposition.

(v) *Previously recaptured amounts.* If an amount has been previously treated as ordinary income pursuant to section 1254, it is not a section 1254 cost.

(vi) *Nonproductive wells.* The aggregate amount of section 1254 costs paid or incurred on any property includes the amount of intangible drilling and development costs incurred on nonproductive wells, but only to the extent that the taxpayer recognizes income on the foreclosure of a nonrecourse debt the proceeds from which were used to finance the section 1254 costs with respect to the property. For this purpose, the term *nonproductive well* means a well that does not produce oil or gas in commercial quantities, including a well that is drilled for the purpose of ascertaining the existence, location, or extent of an oil or gas reservoir (e.g., a delineation well). The term *nonproductive well* does not include an injection well (other than an injection well drilled as part of a project that does not result in production in commercial quantities).

(vii) *Calculation of amount described in paragraph (b)(1)(ii)(B) of this section (hypothetical depletion offset)*—(A) *In general.* In calculating the amount