

tax effects related to the properties involved should be deducted in computing the full cost ceiling.

Question 1: What specific types of income tax effects should be considered in computing the income tax effects to be deducted from estimated future net revenues?

Interpretive Response: The rule refers to income tax effects generally. Thus, the computation should take into account (i) the tax basis of oil and gas properties, (ii) net operating loss carryforwards, (iii) foreign tax credit carryforwards, (iv) investment tax credits, (v) minimum taxes on tax

preference items, and (vi) the impact of statutory (percentage) depletion.

It may often be difficult to allocate net operating loss carryforwards (NOLs) between oil and gas assets and other assets. However, to the extent that the NOLs are clearly attributable to oil and gas operations and are expected to be realized within the carryforward period, they should be added to tax basis.

Similarly, to the extent that investment tax credit (ITC) carryforwards and foreign tax credit carryforwards are attributable to oil and gas operations and are expected to be realized within the carryforward period,

they should be considered as a deduction from the tax effect otherwise computed. Consideration of NOLs and ITC or foreign tax credit carryforwards should not, of course, reduce the total tax effect below zero.

Question 2: How should the tax effect be computed considering the various factors discussed above?

Interpretive Response: Theoretically, taxable income and tax could be determined on a year-by-year basis and the present value of the related tax computed. However, the "shortcut" method illustrated below is also acceptable.

Assumptions:

Capitalized Costs of Oil and Gas Assets			\$500,000
Accumulated DD&A			(100,000)
Book basis of oil and gas assets			400,000
Related deferred income taxes			35,000
Net book basis to be recovered			<u>\$365,000</u>
NOL carryforward*			\$ 20,000
Foreign tax credit carryforward*			\$ 1,000
ITC—Carryforward*	\$2,000		
Present value of ITC relating to future development costs	1,500		\$ 3,500
Estimated preference (minimum) tax on percentage depletion in excess of cost depletion			\$ 500
Tax basis of oil and gas assets			\$270,000
Present value of statutory depletion attributable to future deductions			\$ 10,000
Statutory tax rate (percent)			46%
Present value of future net revenues from proved oil and gas reserves			\$272,000
Cost of properties not being amortized			\$ 55,000
Lower of cost or estimated fair value of unproved properties included in costs being amortized			\$ 49,000
CALCULATION			
Present value of future net revenue			\$272,000
Cost of properties not being amortized			55,000
Lower of cost or estimated fair value of unproved properties included in costs being amortized			49,000
Tax Effects:			
Total of above items			\$376,000
Less: Tax basis of properties	(270,000)		
Statutory depletion	(10,000)		
NOL carryforward	(20,000)	(300,000)	
Future taxable income		76,000	
Tax rate (percent)		× 46%	
Tax payable at statutory rate		(34,960)	
ITC		3,500	
Foreign tax credit carryforward		1,000	
Estimated preference tax		(500)	
Total tax effects			<u>(30,960)</u>
Cost Center Ceiling			\$345,040
Less: Net book basis			365,000
REQUIRED WRITE-OFF, net of tax**			<u>(\$ 19,960)</u>

* All carryforward amounts in this example represent amounts which are available for tax purposes and which related to oil and gas operations.
 ** For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes.

2. Exclusion of Costs From Amortization

Facts: Rule 4–10(c)(3)(ii) indicates that the costs of acquiring and evaluating unproved properties may be excluded from capitalized costs to be

amortized if the costs are unusually significant in relation to aggregate costs to be amortized. Costs of major development projects may also be incurred prior to ascertaining the

quantities of proved reserves attributable to such properties.

Question: At what point should amortization of previously excluded costs commence when proved reserves