

Example 1. B, a calendar year taxpayer who uses the cash receipts and disbursements method of accounting, uses an approved tertiary recovery method for the enhanced recovery of crude oil from one of B's oil properties. During 1980, B pays \$100x for a tertiary injectant which contains 1,000y units of hydrocarbon; if separated from the other components of the injectant before injection, the hydrocarbons would have a fair market value of \$80x. B uses this injectant during the recovery effort during 1981. B has not made any election under section 263(c) with respect to the expenditures for the injectant, and no section of chapter 1 of the Code other than section 193 allows a deduction for the expenditure. B is unable to demonstrate that the value of the injected hydrocarbons recovered during production will be less than \$80x. B's deduction under section 193 is limited to the excess of the cost for the injectant over the fair market value of the hydrocarbon component expected to be recovered ($\$100x - \$80x = \$20x$). B may claim the deduction only for 1981, the year of the injection.

Example 2. Assume the same facts as in *Example 1* except that through engineering studies B has shown that 700y units or 70 percent of the hydrocarbon injected is non-recoverable. The recoverable hydrocarbons have a fair market value of \$24x (30 percent of \$80x). The recoverable hydrocarbon portion of the injectant is 24 percent of the cost of the injectant ($\$24x$ divided by $\$100x$). The injectant does not contain a significant amount of recoverable hydrocarbons. B may claim a deduction for \$100x, the entire cost of the injectant.

Example 3. Assume the same facts as in *Example 1* except that through laboratory studies B has shown that because of chemical changes in the course of production the injected hydrocarbons that are recovered will have a fair market value of only \$40x. B may claim a deduction for \$60x, the excess of the cost of the injectant ($\$100x$) over the fair market value of the recoverable hydrocarbons ($\$40x$).

Example 4. B prepares an injectant from crude oil and certain non-hydrocarbon materials purchased by B. The total cost of the injectant to B is \$100x, of which \$24x is attributable to the crude oil. The fair market value of the crude oil used in the injectant is \$27x. B is unable to demonstrate that the value of the crude oil from the injectant that will be recovered is less than \$27x. The injectant contains more than an insignificant amount of recoverable hydrocarbons because the value of the recoverable crude oil ($\$27x$) exceeds \$25x (25 percent of \$100x, the cost of the injectant). Because the cost to B of the hydrocarbon component of the injectant ($\$24x$) is less than the fair market value of the hydrocarbon component in the

form in which it is recovered ($\$27x$), the cost rather than the value is taken into account in the adjustment required under paragraph (c)(1) of this section. B's deduction under section 193 is limited to the excess of the cost of the injectant over the cost of the hydrocarbon component ($\$100x - \$24x = \$76x$).

(Secs. 193 and 7805, Internal Revenue Code of 1954, 94 Stat. 286, 26 U.S.C. 193; 68A Stat. 917, 26 U.S.C. 7805)

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§ 1.194-1 Amortization of reforestation expenditures.

(a) *In general.* Section 194 allows a taxpayer to elect to amortize over an 84-month period, up to \$10,000 of reforestation expenditures (as defined in § 1.194-3(c)) incurred by the taxpayer in a taxable year in connection with qualified timber property (as defined in § 1.194-3(a)). The election is not available to trusts. Only those reforestation expenditures which result in additions to capital accounts after December 31, 1979 are eligible for this special amortization.

(b) *Determination of amortization period.* The amortization period must begin on the first day of the first month of the last half of the taxable year during which the taxpayer incurs the reforestation expenditures. For example, the 84-month amortization period begins on July 1 of a taxable year for a calendar year taxpayer, regardless of whether the reforestation expenditures are incurred in January or December of that taxable year. Therefore, a taxpayer will be allowed to claim amortization deductions for only six months of each of the first and eighth taxable years of the period over which the reforestation expenditures will be amortized.

(c) *Recapture.* If a taxpayer disposes of qualified timber property within ten years of the year in which the amortizable basis was created and the taxpayer has claimed amortization deductions under section 194, part or all of any gain on the disposition may be recaptured as ordinary income. See section 1245.

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