Rev. Rul. 79-200, 1979-1 C.B. 364

Private foundations; net investment income; basis of depletable property. An exempt private foundation that, prior to 1970, was not subject to tax and claimed no depletion deduction on its royalty interest in oil and gas properties recorded depletion on its books using the percentage method. The foundation need only decrease its original basis in the properties by the amount of the cost depletion allowable, and not the percentage depletion shown on its books, for purposes of determining the net investment income under section 4940 of the Code.

Advice has been requested by a private foundation, as defined in section 509(a) of the Internal Revenue Code of 1954, concerning the method it should use to compute the basis of depletable property for purposes of determining the cost depletion deduction used in determining 'net investment income' under section 4940.

The foundation keeps its books on a calendar year basis. Prior to January 1, 1970, the foundation acquired, under the terms of a will, royalty interests in oil and gas properties. The foundation recorded such interests on its books at their fair market value as of the date of the testator's death. For each taxable year from the date of acquisition of such interests through December 31, 1969, the foundation recorded depletion on its books as determined under section 613 of the Code (relating to percentage depletion). As of December 31, 1969, the recorded percentage depletion exceeded the amount that would have been recorded had the foundation used the cost method of depletion as provided by section 611. From the date of its inception, the foundation has not been subject to federal income tax by reason of having been recognized as exempt from such tax under section 501(c)(3).

Section 4940 of the Code, which is effective for taxable years beginning after December 31, 1969, imposes on each private foundation a tax equal to 2 percent of the net investment income of such foundation for the taxable year.

Section 4940(c)(3)(B)(ii) of the Code provides that, for purposes of computing a private foundation's net investment income, a deduction for depletion provided by section 611 shall be allowed, but such deduction shall be determined without regard to section 613 (relating to percentage depletion).

Section 53.4940-1(e)(2)(iii) of the Foundation Excise Tax Regulations provides that the basis to be used for purposes of the depletion deduction shall be the basis determined under the rules of Part II of subchapter 0 of chapter 1, subject to the provisions of section 4940(c)(3)(B) of the Code, and without regard to section 362(c). This section of the regulations further provides that a private foundation must reduce its basis by an amount equal to the cost depletion, without regard to whether the foundation deducted such depletion during the period prior to its first taxable year beginning after December 31, 1969. However, under the same section of the regulations, where a private foundation has previously taken a depletion deduction in excess of the amount that would have been taken had the cost method been employed, such excess depletion also shall be taken into account to reduce basis.

Beal Foundation v. United States, 559 F.2d 359 (5th Cir., 1977), upholds the validity of section 53.4940-1(e)(2)(iii) of the Foundation Excise Tax Regulations, while denying a private foundation's claim for a refund, based on an unclaimed depletion deduction, of tax imposed on its net investment income under section 4940 of the Code.

In the instant case, in order to compute the cost depletion deduction provided for under section 4940(c)(3)(B)(ii) of the Code, it is necessary for the foundation to determine the basis of its depletable properties as of January 1, 1970. Under the terms of section 53.4940-1(e)(2)(iii) of the regulations, the foundation must reduce its basis in such properties by an amount equal to the cost depletion, notwithstanding that the foundation did not deduct such depletion for taxable years prior to January 1, 1970. See Beal Foundation v. United States.

The issue presented is whether, in addition to reducing the basis of its depletable properties by the amount equal to the cost depletion, the foundation must further reduce the basis of such properties by the amount the percentage depletion recorded on its books exceeded the amount that would have been recorded had the cost method been employed.

In applying the particular provision of section 53.4940-1(e)(2)(iii) of the regulations, which states that a private foundation must reduce the basis of depletable property by percentage depletion deductions taken in excess of cost depletion deductions, the word 'deductions' means those deductions actually taken by the foundation for purposes of determining amounts subject to federal tax. Since, in taxable years prior to January 1, 1970, the foundation was not subject to and did not pay federal income tax, it took no depletion 'deductions' for those years, but merely recorded depletion on its books. Thus, the foundation did not take any depletion deductions during this period in excess of the amount that would have been taken had the cost method been employed.

Accordingly, in determining the basis of its depletable properties for purposes of computing the cost depletion deduction provided for in section 4940(c)(3)(B)(ii) of the Code, the foundation should not reduce the basis of such properties by the amount of percentage depletion recorded on its books in excess of the amount of depletion that would have been recorded had the cost method been employed.