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## The Coal Depletion Allowance Deduction

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# THE COAL DEPLETION ALLOWANCE DEDUCTION\*

MARTIN J. McMAHON, JR.\*\*

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### I. INTRODUCTION

Because the federal income tax is levied on net income, no business is required to include the cost of goods sold in its tax base. Most businesses, through inventory accounting, exclude the cost of goods sold from gross income, including in gross income only the excess of receipts over the cost of goods sold.<sup>1</sup> However, the extractive industries, including coal mining, are treated somewhat differently. The concept of cost of goods sold is not applied to the operator of a coal mine. Instead, an analogous concept, the depletion allowance deduction under Internal Revenue Code (I.R.C.) § 611 and I.R.C. § 613 is available to reflect the cost to the coal mine operators of the coal that has been extracted and sold.<sup>2</sup>

Rather than excluding the cost of the coal from gross income, a taxpayer receiving income from the extraction and sale of coal includes in gross income an amount generally equal to the market price of his share of the extracted coal. In computing taxable income the taxpayer deducts the depletion allowance, which is an amount representing the cost of that coal. Unlike the cost of goods sold concept, however, the depletion allowance deduction allowed to the taxpayer to reflect the cost of the coal is not necessarily the actual cost of the coal. Frequently, if not usually, the depletion allowance deduction is computed under the percentage depletion method, which allows a deduction in excess of the actual cost of the coal because it is computed with reference to the taxpayer's income from the extraction and sale of the coal.<sup>3</sup>

<sup>1</sup> Treas. Reg. §§ 1.61-3(a) (1973), 1.471-1 (1960); see 4 B. BITTKER, FEDERAL TAXATION OF INCOME ESTATES AND GIFTS ¶ 105.4.1 (1981).

<sup>2</sup> See *infra* notes 11-14 and accompanying text.

<sup>3</sup> See *infra* notes 9-10 and accompanying text.

The depletion allowance deduction is one of the more complex mysteries of mineral taxation. This article will explain in detail the rules governing the depletion allowance deduction as applied to coal mining. The prime focus of this article is the coal operator's depletion allowance deduction. However, the rules governing depletable coal royalties, will be examined where relevant. After a brief exposition of the general principles of entitlement to the depletion allowance deduction, the first substantive issue to be considered will be the identification of persons involved in the extraction of coal who are entitled to claim the depletion allowance deduction. Because lessors of coal property are not generally entitled to depletion allowance deductions, but treat royalties as proceeds from the sale of a section 1231 asset,<sup>4</sup> very little consideration will be given to the tax treatment of lessors. Next will follow detailed discussions of the rules governing the computation of both cost and percentage depletion deductions. The final section of this article will briefly discuss the issue of identification of separate coal properties for the purpose of computing the depletion allowance deduction.

#### A. *Methods of Depletion*

Section 611 of the Internal Revenue Code provides that, "[i]n the case of mines . . . [and] other natural deposits, . . . there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion . . . according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. . . ."<sup>5</sup> Two methods of computing the depletion allowance deduction are permitted. Under the regulations the depletion allowance is to be computed either on the adjusted depletion basis of the property determined under I.R.C. § 612 or upon a percentage of gross income from the property, as provided in I.R.C. § 613.<sup>6</sup> The former method is commonly called cost depletion and the latter method is termed percentage depletion. A separate computation is required for each "property" as defined in I.R.C. § 614. For any given taxable year the allowable depletion deduction for the property depends whether cost depletion or percentage depletion is greater. If percentage depletion is greater than cost depletion, a depletion deduction based on percentage depletion is mandatory, not elective.<sup>7</sup>

Cost depletion is computed by deducting an appropriate portion of the basis of the mineral property for each unit extracted and sold.<sup>8</sup> Percentage depletion is computed with reference to the gross income from the mineral property, without regard to either basis or the number of units extracted. With coal, the applicable percentage of gross income from the property that is deductible is ten percent.<sup>9</sup> The maximum deduction allowable under percentage

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<sup>4</sup> I.R.C. § 631(c) (1976).

<sup>5</sup> I.R.C. § 611(a) (1976).

<sup>6</sup> Treas. Reg. § 1.611-1(a) (1960).

<sup>7</sup> I.R.C. § 613(a) (1982) (last sentence); Treas. Reg. § 1.611-1(a) (1960).

<sup>8</sup> Treas. Reg. § 1.611-2(a)(1) (1972).

<sup>9</sup> I.R.C. § 613(b)(4) (1976).

depletion, however, is limited to fifty percent of the taxpayer's taxable income from the property, computed without regard to the depletion allowance.<sup>10</sup> Cost depletion, however, although restricted to the amount of the taxpayer's basis in the property, may exceed fifty percent of the taxpayer's taxable income from the property.

### B. *Purpose of the Depletion Allowance*

The original purpose of the depletion allowance was to recognize that mineral deposits are wasting assets and that a mine owner should be entitled to recoup his capital investment free of tax. In *United States v. Ludey*,<sup>11</sup> the Supreme Court, in 1927, analogized mineral deposits to the raw material used by a manufacturing company. Thus, the depletion allowance was similar to the allowance for cost of goods sold, which is deducted from gross receipts in computing gross income.<sup>12</sup> This was true under both the Tariff Act of 1913 and the Revenue Act of 1916, which limited aggregate depletion deductions to the taxpayer's basis in the mineral property.<sup>13</sup> Accordingly, in *Ludey* the Supreme Court stated, "[t]he proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks."<sup>14</sup>

In 1918, however, Congress enacted discovery value depletion, under which the fair market value of the mineral deposit in the ground at the date of discovery was substituted for cost in computing both the annual allowance and the aggregate depletion allowable.<sup>15</sup> The purpose of discovery value depletion was to encourage prospecting and exploration for minerals.<sup>16</sup> Discovery value depletion was replaced with percentage depletion for oil in 1927 and for coal in 1932.<sup>17</sup> In enacting percentage depletion Congress lifted the limitation of aggregate depletion to the cost or discovery value of the deposit, limiting it to not more than fifty percent of the taxable income from the property annually. At this time, the metamorphosis of the depletion allowance from a capital recovery mechanism to a tax incentive device was completed.

Nevertheless, the Supreme Court, and other courts following its lead, continued to refer to the depletion allowance—both cost and percentage deple-

<sup>10</sup> I.R.C. § 613(a) (1976).

<sup>11</sup> 274 U.S. 295, 302-03 (1927).

<sup>12</sup> Treas. Reg. § 1.61-3(a) (1972).

<sup>13</sup> Tariff Act of 1913, ch. 16, §§ IIB, G(b), 38 Stat. 114, 167, 172-73; Revenue Act of 1916, ch. 463 §§ 5(a) Eighth, 12(a) Second, 39 Stat. 756, 759, 767-68.

<sup>14</sup> 274 U.S. at 303.

<sup>15</sup> Revenue Act of 1918, ch. 18, §§ 214(a)(10), 234(a)(9), 40 Stat. 1057, 1066-68, 1077-78.

<sup>16</sup> See S. REP. No. 617, 65th Cong., 3d Sess. 6 (1918), reprinted in 1939-1 C.B. (pt. 2) 117, 120-21; see also Austin, *Percentage Depletion: Its Background and Legislative History*, 21 U. KAN. CTRY L. REV. 22 (1952).

<sup>17</sup> Revenue Act of 1926, ch. 27, §§ 204(b)(2), 214(a)(9), 234(a)(8), 44 Stat. 9, 16, 26-27, 41-43; Revenue Act of 1932, ch. 209, § 114(b)(4), 47 Stat. 169, 202-03. Discovery value depletion was subsequently abandoned for all minerals, and it is no longer permitted. Treas. Reg. § 1.611-1(a) (1960).

tion—as a capital recovery provision.<sup>18</sup> In *Paragon Jewel Coal Co. v. Commissioner*, a case involving percentage depletion, the Court stated, “[t]his court has often said that the purpose of the allowance for depletion is to compensate the owner of wasting material assets for the part exhausted in production, so that when the minerals are gone the owner’s capital and his capital assets remain unimpaired.”<sup>19</sup> Although this statement is true regarding cost depletion, it is entirely erroneous regarding percentage depletion. The reverence with which courts have prefaced most cases dealing with entitlement to percentage depletion deductions with a similar statement has resulted in considerable confusion in determining whether taxpayers who actually extract the mineral from the ground, but never make any cash investment, should be entitled to the depletion allowance.<sup>20</sup>

On occasion, however, the Court has recognized that the percentage depletion allowance is not merely a capital recovery provision. In *Commission v. Southwest Exploration Co.*,<sup>21</sup> the Court recognized that, “[t]he present allowance, however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment on his original investment. The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit.”<sup>22</sup> More recently, in *United States v. Swank*,<sup>23</sup> the Court noted:

Because the deduction is computed as a percentage of his gross income from the mining operation and is not computed with reference to the operator’s investment, it provides a special incentive for engaging in this line of business that goes well beyond a purpose of merely allowing the owner of a wasting asset to recoup the capital invested in that asset.<sup>24</sup>

With the decision in *Swank*, the shibboleth of *Ludey* has, it is hoped, been laid to rest.

### C. Relationship of Depletion Deductions to Basis in the Mineral Deposit

The taxpayer’s basis in the mineral property is reduced by the greater of the amount of depletion which was actually claimed as a deduction in computing taxable income or that which was properly allowable in each taxable year.<sup>25</sup> Both cost and percentage depletion require an adjustment to basis. If the taxpayer claims less than the allowable deduction, his basis is nevertheless re-

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<sup>18</sup> See, e.g., *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 367 (1938); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 602-03 (1946); *Usibelli v. Commissioners*, 229 F.2d 539, 542 (9th Cir. 1955).

<sup>19</sup> 380 U.S. 624, 631 (1965).

<sup>20</sup> For a more detailed discussion of the development of the depletion allowance see McMahon, *Defining the “Economic Interest” in Minerals After United States v. Swank*, 70 Ky. L.J. 23 (1982).

<sup>21</sup> 350 U.S. 308 (1956).

<sup>22</sup> *Id.* at 312.

<sup>23</sup> 451 U.S. 571 (1981).

<sup>24</sup> *Id.* at 576; see also *O’Conner v. Commissioner*, 78 T.C. 1, 7 (1982).

<sup>25</sup> I.R.C. § 1016(a)(2) (1982); Treas. Reg. § 1.1016-3(b) (1957).

duced by the full allowable amount, even if no reduction in tax results.<sup>26</sup> However, if the taxpayer claimed and was allowed more than the properly allowable amount of depletion, his basis will not be reduced by the excess amount claimed if the excessive deduction allowed did not result in any reduction in tax liability for the year.<sup>27</sup>

Cost depletion, unlike percentage depletion, is restricted by I.R.C. § 612 to the taxpayer's basis in the mineral property. Once his basis has been exhausted, cost depletion ceases and the taxpayer will be entitled only to percentage depletion.<sup>28</sup> Percentage depletion deductions in excess of basis do not reduce the taxpayer's basis in the property below zero.

## II. ENTITLEMENT TO DEPLETION: THE CONCEPT OF ECONOMIC INTEREST IN MINERALS

### A. Generally

#### 1. Development of the Concept of Economic Interest

Entitlement to either a cost or percentage depletion allowance deduction hinges on whether the taxpayer has an economic interest in the minerals in place; only a taxpayer with an economic interest is entitled to claim a depletion deduction.<sup>29</sup>

The Regulations define the term "economic interest" as follows:

An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . ., to which he must look for a return of his capital. . . . A person who has no capital investment in the mineral deposit . . . does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction . . . does not convey a depletable economic interest.<sup>30</sup>

Ownership of the mineral deposit is not a prerequisite for finding an economic interest. In *Lynch v. Alworth Stephens Co.*,<sup>31</sup> the Supreme Court held that a lessee of a mineral deposit was entitled to deplete his income from extraction, prior to the enactment of I.R.C. § 611(b)(1) specifically allowing apportionment between the lessee and lessor.

<sup>26</sup> Treas. Reg. § 1.1016-3(b) (1957).

<sup>27</sup> Treas. Reg. § 1.1016-3(b)(1) (1957). Detailed rules for computing the tax benefit allowed and the resulting reduction in basis are provided in Treas. Reg. § 1.1016-3(e) (1957).

<sup>28</sup> Treas. Reg. § 1.611-2(b)(2) (1972).

<sup>29</sup> Treas. Reg. § 1.611-1(b)(1) (1973); *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938); *Thomas v. Perkins*, 301 U.S. 655 (1937); *Palmer v. Bender*, 287 U.S. 551 (1933).

<sup>30</sup> Treas. Reg. § 1.611-1(b)(1) (1973).

<sup>31</sup> 267 U.S. 364 (1925).

Six years later in *Palmer v. Bender*,<sup>32</sup> the Court formulated its now classic test for determining entitlement to depletion:

The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.<sup>33</sup>

Accordingly, the Court permitted the taxpayers, who were lessees of oil leases, to deplete income received pursuant to an agreement transferring all of their rights to the property in exchange for future payments out of one-half of the first oil produced up to \$1,000,000 and an additional royalty of one-eighth of all oil produced.

Significantly, the taxpayers in *Palmer v. Bender* had no cash investment in the oil; they merely had an obligation to pay royalties to the prime lessor upon production. In furtherance of the policy of discovery valuation depletion, the Court treated the value of the oil at the date of discovery as the requisite investment. Since at time of discovery the taxpayers had "complete legal control of the oil in place," they had "acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute."<sup>34</sup> Thus, there is no substance to the requirement of the regulations, which are derived from *Palmer v. Bender*, that the interest in the minerals in place be derived "by investment." It is sufficient if the taxpayer has merely acquired an interest in the mineral in place. Nevertheless, courts, particularly the Tax Court, frequently search for and imply the need for either a direct investment or a "significant related investment," which is a "practical prerequisite to successful exploitation of rights to mine the minerals in place."<sup>35</sup>

In *Kirby Petroleum Co. v. Commissioner*,<sup>36</sup> the Supreme Court extended the economic interest concept to include a net profits interest coupled with a royalty. It stated, "[e]conomic interest does not mean title to the oil in place but the possibility of profit from the economic interest dependent solely upon the extraction and sale of the oil."<sup>37</sup> Subsequently, however, in *Burton-Sutton Oil Co. v. Commissioner*,<sup>38</sup> the Court declined to rely on source of return as the sole test for an economic interest. Holding a net profits interest standing alone was an economic interest, the Court stated:

Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves through their control over the exploitation of the land valuable benefits arising from and dependent upon the extraction of the oil, Congress provided as early as the Revenue Act of 1918 for equitable apportionment of the depletion allowance between them. . . .<sup>39</sup>

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<sup>32</sup> 287 U.S. 551 (1933).

<sup>33</sup> *Id.* at 557.

<sup>34</sup> *Id.* at 558.

<sup>35</sup> *Weaver v. Commissioner*, 72 T.C. 594, 602 (1979).

<sup>36</sup> 326 U.S. 599 (1946).

<sup>37</sup> *Id.* at 604 (footnote omitted).

<sup>38</sup> 328 U.S. 25 (1946).

<sup>39</sup> *Id.* at 33 (footnotes omitted).



The key to the economic interest was the right to royalties, measured by and out of production, which was received in exchange for the prior surrender of control over the extraction, which was, evidently, the requisite capital interest.

*Helvering v. Bankline Oil Co.*<sup>40</sup> provides some guidance in determining when a taxpayer does not have an economic interest. The taxpayer in *Bankline Oil* contracted to process wet gas to extract the oil. It paid the producer less than the prevailing market price and attempted to claim depletion on the difference between its cost and the market price. Although that portion of the processor's income was dependent on future production, the Court held the taxpayer did not have an economic interest, but rather a "mere economic advantage derived from production through a contractual relation to the owner."<sup>41</sup> The taxpayer was found to have neither an investment nor an interest in the well other than the contractual right to purchase output. A feature which distinguishes *Bankline Oil* from cases where taxpayers have been found to have had an economic interest, is that the taxpayer in *Bankline Oil* never had any control over the deposit.

The significance of control over the deposit came to the foreground in *Commissioner v. Southwest Exploration Co.*<sup>42</sup> The taxpayer was a littoral landowner who received an oil royalty in consideration for rights to whipstock drill for offshore oil deposits from its land. Under California law, the taxpayer's property was the only place where wells could be drilled to extract the offshore oil, even though the oil leases were owned by another party and the taxpayer had no interest in them. Finding that the taxpayer made an "indispensable contribution . . . in return for a share of the net profits . . .",<sup>43</sup> the court held that the taxpayer had an economic interest entitling it to depletion. The unique control which the taxpayer had over extraction was sufficient to constitute an interest in the minerals in place. *Southwest Exploration Co.* is one of the few cases finding an economic interest in a taxpayer who did not make a cash investment in the mineral in place entitling the taxpayer to a share of production through royalties or production payments and never had a fee ownership or a leasehold in the mineral.<sup>44</sup>

More recently, however, in *United States v. Swank*, the Court emphasized freedom to sell the extracted mineral at the market price as a key factor in determining whether the taxpayer had an economic interest.<sup>45</sup> The taxpayer, who was found to have an economic interest in minerals in place, was a lessee under a lease which was terminable by the lessor, without cause, on thirty days' prior notice. In *Swank* the Court eschewed reliance on the technical legal right of control in favor of an examination of whether the taxpayer actually

<sup>40</sup> 303 U.S. 362 (1938).

<sup>41</sup> *Id.* at 367.

<sup>42</sup> 350 U.S. 308 (1951).

<sup>43</sup> *Id.* at 317.

<sup>44</sup> For an extensive discussion of the development of the early cases regarding the concept of economic interest see Sneed, *The Economic Interest—An Expanding Concept*, 35 *Tex. L. Rev.* 307 (1957).

<sup>45</sup> 451 U.S. 571 (1981).

enjoyed a share of the sales proceeds from the extracted mineral. *Swank* may signal a new emphasis in the determination of the existence of an economic interest, reviving the *Kirby Petroleum Company* analysis. The Court's opinion in *Swank* is heavily laden with policy analysis indicating that percentage depletion should be allowed to any person who extracts and sells minerals on the open market.<sup>46</sup>

## 2. Interests in Coal Deposits

In addition to fee ownership of coal, which entitles the owner to depletion with respect to his income derived from the extraction and sale of the coal, there are numerous other interests which must be considered. The following paragraphs briefly summarize the treatment accorded various parties claiming to have an economic interest in a coal deposit. With the exception of lessors, each of these interests is analyzed in greater detail in the following sections.

The lessor of a coal deposit receives royalties under the lease agreement. Under *Burnet v. Harmel*,<sup>47</sup> a lessor of a mineral deposit has an economic interest. The lessor of coal will not be entitled to depletion with respect to these royalties, except on coal extracted within one year of the acquisition of the lessor's interest. He will, however, be entitled to the more advantageous capital gains treatment under I.R.C. § 631(c) on royalties received. The allowance of his basis in computing gains results in the lessor receiving the equivalent of cost depletion in addition to the conversion of the income to capital gains. Section 631(c) will not be discussed in any detail in this article.<sup>48</sup>

Occasionally a taxpayer acquires a royalty interest in a coal deposit pursuant to an agreement other than a lease of the deposit itself. For example, the owner of surface rights overlying a coal deposit owned by another might convey an easement to permit strip mining in exchange for a royalty interest. Generally, the holder of such an interest has an economic interest in the minerals in place and the royalties received under such an agreement are subject to the depletion allowance.<sup>49</sup>

Lessees who operate the deposit have an economic interest in the minerals in place and are entitled to the depletion allowance with respect to their mining income from the property.<sup>50</sup> Lessees typically claim percentage depletion rather than cost depletion. A lessee who subleases the coal deposit to another taxpayer is subject to I.R.C. § 631(c) and does not, therefore, claim the depletion allowance for royalties received.<sup>51</sup>

Two or more taxpayers often enter into a joint venture agreement for the

<sup>46</sup> See *infra* notes 65-69 and accompanying text.

<sup>47</sup> 287 U.S. 103 (1932).

<sup>48</sup> For detailed discussion of I.R.C. § 631(c), see Coggin, *Disposition of Coal Interests: Section 631(c)*, 29 TAX LAW. 95 (1975); Coggin, *Federal Income Tax Treatment of the Acquisition and Disposition of Coal Interests: An Examination of I.R.C. § 631(c)*, 82 W. VA. L. REV. 1139 (1980).

<sup>49</sup> See *infra* Section II.C.

<sup>50</sup> I.R.C. § 611(b)(1) (1976); *United States v. Swank*, 451 U.S. 571 (1981); *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925).

<sup>51</sup> Treas. Reg. § 1.631-3(b)(3)(ii)(a) (1980).

purpose of mining a particular coal deposit. Each joint venturer should be entitled to deduct depletion with respect to his mining income from the property.<sup>52</sup> It is irrelevant that the lease or ownership of the mineral deposit is held by only one of the joint venturers.<sup>53</sup>

A contract miner who is paid a fixed fee per ton does not have an economic interest in the mineral in place and is not entitled to claim either cost or percentage depletion with respect to the income he derives from extracting coal.<sup>54</sup> If, however, the contract miner's fee is determined with reference to the sales proceeds from the extracted coal, then he will have an economic interest and should generally be entitled to depletion.<sup>55</sup>

Except in limited circumstances, licensees do not have an economic interest in the minerals in place, and they are not entitled to depletion with respect to their income from mining.<sup>56</sup>

#### B. *Lessees*

Since the *Ludey* decision in 1927, a lessee has held an economic interest in the leased mineral deposit, but for many years certain lease termination clauses presented problems. In *Parsons v. Smith*,<sup>57</sup> the Supreme Court held that contract miners did not have an economic interest in coal in place because "the contracts were completely terminable without cause on short notice."<sup>58</sup> Following *Parsons*, the Internal Revenue Service (hereinafter "IRS") vigorously litigated cases asserting that a lessee, under a lease terminable on short notice without cause, did not have an economic interest. For this purpose the IRS considered one year the dividing line.<sup>59</sup>

The Commissioner's argument in the terminable lease cases was that the taxpayer had only a mere "economic advantage." He contended that a requisite of an economic interest was the right to extract the coal to exhaustion or at least to extract a significant amount. If the lessee's right to extract the mineral was subject to termination with cause on short notice, his right was illusory. This reflected an analysis of the formal rights of the parties, not the actual conduct, because in virtually all of the litigated cases, the lease was not cancelled, and in some cases the coal deposit was mined to exhaustion.

The Tax Court uniformly accepted the Commissioner's logic in terminable

<sup>52</sup> Rev. Rul. 73-32, 1973-1 C.B. 301.

<sup>53</sup> Rev. Rul. 74-469, 1974-2 C.B. 178.

<sup>54</sup> *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965); *Parsons v. Smith*, 359 U.S. 215 (1959).

<sup>55</sup> *Ruston v. Commissioner*, 19 T.C. 284 (1952); see *infra* notes 78-80 and accompanying text.

<sup>56</sup> *Holbrook v. Commissioner*, 65 T.C. 415 (1975) (licensee did not have economic interest); but see *Oil City Sand & Gravel Co. v. Commissioner*, 32 T.C. 31 (1959) (licensee did have economic interest); see *infra* Section IV.

<sup>57</sup> 359 U.S. 215 (1959).

<sup>58</sup> *Id.* at 225.

<sup>59</sup> See Rev. Rul. 74-507, 1974-2 C.B. 179 (holding lessee under successive one year leases, renewed automatically unless terminated, had an economic interest); G.C.M. 26290, 1950-1 C.B. 42, declared obsolete, Rev. Rul. 70-277, 1970-1 C.B. 280.

lease cases.<sup>60</sup> In essence, the Tax Court applied an *ex ante* test to determine whether an economic interest existed by considering only the minimum rights of the taxpayer. By contrast, the Court of Claims concluded that a short notice termination clause did not preclude an economic interest in the lessee. In *Bakertown Coal Co. v. United States*<sup>61</sup> the court applied an *ex post* test and examined what rights had actually been exercised by the taxpayer in question. Under this view the termination clause was irrelevant if not exercised. Significantly, the court noted that if the taxpayer were not allowed a depletion allowance, no one would be allowed a depletion deduction with respect to the income. This logic was followed again in *Swank v. United States*.<sup>62</sup>

The Third Circuit also upheld the Commissioner's argument in *Whitmer v. Commissioner*.<sup>63</sup> The Fifth Circuit, however, in *Winters Coal Co. v. Commissioner* held that a thirty day termination clause in a lease did not deprive the lessee of an economic interest.<sup>64</sup> But two of the three judges on the panel relied not on the lease standing alone, but considered the fact that the lessee purchased the surface rights necessary to operate the strip mine. Because the lessee became an indispensable party to the removal of the coal through his control of the surface, they thought that *Southwest Exploration Co.* was directly applicable.

Finally, in *United States v. Swank*, the Supreme Court held that a lessee under a lease terminable on thirty days notice without cause, had an economic interest in the coal in place which entitled him to claim percentage depletion.<sup>65</sup> Policy considerations predominated in the Court's logic:

Because the deduction is computed as a percentage of his gross income from the mining operation and is not computed with reference to the operator's investment, it provides a special incentive for engaging in this line of business that goes well beyond a purpose of merely allowing an owner of a wasting asset to recoup his investment. . . . Hence eligibility for the deduction is determined not by the amount of the capital investment but by the mine operator's "economic interest" in the coal.

A recognition that the percentage depletion allowance is more than merely a recovery of cost of the unmined coal is especially significant in this case. The question here is whether a deduction for the asset depleted by respondents will be received by anyone. . . .<sup>66</sup>

The Court rejected the government's arguments that the lessee held a "mere economic advantage" and that the lessor's right to terminate the lease gave it

<sup>60</sup> *E.g.*, *Winters Coal Co. v. Commissioner*, 57 T.C. 249 (1971), *rev'd*, 496 F.2d 995 (5th Cir. 1974); *Whitmer v. Commissioner*, 28 T.C.M. (CCH) 1480 (1969), *aff'd* 443 F.2d 170 (3d Cir. 1971); *Mullins v. Commissioner*, 48 T.C. 571 (1967). *See also* *Weaver v. Commissioner*, 72 T.C. 594 (1979) (gravel lease terminable at will distinguished from one terminable on 120 days notice).

<sup>61</sup> 485 F.2d 633 (Ct. Cl. 1973).

<sup>62</sup> 602 F.2d 348 (Ct. Cl. 1979), *aff'd*, 451 U.S. 571 (1981).

<sup>63</sup> 443 F.2d 170 (3d Cir. 1971), *aff'g* 28 T.C.M. (CCH) 1480 (1969).

<sup>64</sup> 496 F.2d 995 (5th Cir. 1974), *rev'g* 47 T.C. 249 (1971).

<sup>65</sup> 451 U.S. 571 (1981), *aff'g* 602 F.2d 348 (Ct. Cl. 1976).

<sup>66</sup> *Id.* at 576 (citation omitted).

the only economic interest as a matter of "practical economics."<sup>67</sup>

*Parsons v. Smith* and *Paragon Jewel Coal Co. v. Commissioner* (both of which held that contract miners operating under contracts terminable on short notice without cause, who received a fixed fee per ton of coal extracted, did not have an economic interest) were distinguished on several grounds. First, the Court said that short notice terminability was not determinative in those cases. The key factor in those cases was the fixed price received by the miners; they lacked a legally enforceable right to share in the value of the mineral deposit. In contrast, the lessees in *Swank* "had a legal interest in the mineral both before and after it was mined and were free to sell the coal at whatever price the market could bear."<sup>68</sup>

Three reasons were given for rejecting the government's argument that as a matter of practical economics only the lessor held an economic interest because of his right to terminate the lease. First, the Court was not convinced that an increase in the market price of coal would guarantee that the lessor could negotiate a higher royalty if he cancelled the lease. The Court found support for this in the lessor's failure to cancel the leases in question despite increased market prices. Second, the Court believed that it would be unfair to deny depletion to a taxpayer who incurred the risk of cancellation while according it to taxpayers who assumed no risk. Finally, the Court concluded that there was no rational basis in linking the right to a depletion deduction to the period of time that the taxpayer operates a mine.

A crucial continuing issue for lessees is whether *Swank* merely establishes a factual safe harbor, that a lessee will have an economic interest under a lease terminable without cause on not less than thirty days notice, provided he has mined coal under the lease for the entire year in question (or the portion of the year following the execution of the lease). Presumably this would also cover the year of termination provided the lessee had operated for a substantial portion of the prior year, or had exhausted the deposit in the year of termination. This is the minimum impact of *Swank*; thirty day or longer termination clauses are irrelevant to the determination of an economic interest if unexercised.<sup>69</sup>

*Swank* does not expressly provide any rule regarding the requisite minimum term for a lease to convey an economic interest. In Revenue Ruling 74-507, the IRS ruled that a lease for one year, renewable as of January 1st unless terminated by notice given ten days prior to the preceding November 1st, was sufficient to convey an economic interest to the lessee.<sup>70</sup> At the other end of the spectrum, in Revenue Ruling 77-341 the IRS ruled that an oral lease under Kentucky law did not convey an economic interest because the lease was not enforceable.<sup>71</sup> Between these two positions, the IRS has also ruled that a six-month lease is sufficient to convey an economic interest if six months is a suffi-

<sup>67</sup> *Id.* at 580.

<sup>68</sup> *Id.* at 583.

<sup>69</sup> See McMahon, *Defining the "Economic Interest" in Minerals After United States v. Swank*, 70 Ky. L.J. 23, 25-30 (1982).

<sup>70</sup> 1974-2 C.B. 179.

<sup>71</sup> 1977-2 C.B. 204.

cient period to exhaust the mineral deposit.<sup>72</sup>

If the fact that the leases were not terminated is crucial, then a short term lease, e.g., month to month, may not be sufficient to constitute an economic interest, unless it is continuously renewed. If continuously renewed, it would be the equivalent of an indefinite lease with a thirty day termination clause. Language in the Court's opinion in *Swank*, however, indicates that actual continued operation is not necessary:

If the authorization of a special tax benefit for mining a seam of coal to exhaustion is sound policy, that policy would seem equally sound whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers operating for successive shorter periods. The Government has suggested no reason why the efficient removal of a great quantity of coal in less than 30 days should have different tax consequences than the slower removal of the same quantity over the prolonged period.<sup>73</sup>

In a footnote to the above quoted passage, the Court stated:

As we have indicated, the depletion deduction is geared to the depletion of the mineral in place, and not to the taxpayer's capital investment. Therefore, we can perceive no reason to impose duration requirements on the availability of the deduction for taxpayers who admittedly otherwise have an "economic interest" in the coal, are dependent on the market to recover their costs, and are actually depleting the mineral in place.<sup>74</sup>

This language indicates the complete abandonment of any requisite period for the lease, notwithstanding an assertion in the dissenting opinion that a one day lease would clearly be insufficient to confer an economic interest on the lessee.

### C. *Contract Miners*

#### 1. Generally

In 1950, the IRS ruled that the right to receive "a specified amount per ton of mineral produced may constitute a right to share in production which marks ownership of a depletable economic interest in the mineral in place." The IRS concluded that the contract miner did "look for his compensation solely to the extraction and sale of mineral" and therefore satisfied the first half of the test for an economic interest. The first half of the test, requiring an interest in the mineral in place, was satisfied only if the contract could not be terminated at will or upon relatively nominal notice.<sup>75</sup> As a result, the lessee or owner excluded from gross income from the property amounts paid to contract miners and contract miners were entitled to percentage depletion with respect to the income. In litigation, primarily involving lessees and owners claiming depletion on the amounts paid to contract miners, the Tax Court has consist-

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<sup>72</sup> Rev. Rul. 72-506, 1972-4 C.B. 178.

<sup>73</sup> 451 U.S. 571, 585.

<sup>74</sup> *Id.* at 585 n.25.

<sup>75</sup> G.C.M. 26290, 1950-1 C.B. 42, *citing* *Eastern Coal Corp. v. Yoke*, 67 F. Supp. 166 (N.D. W. Va. 1946), *declared obsolete*, Rev. Rul. 70-277, 1970-1 C.B. 280. Relatively nominal notice was defined as less than one year. G.C.H. 26290 *supra*.

ently rejected the position of the IRS.<sup>76</sup> Conversely, the Courts of Appeals generally held that contract miners that met the test set forth in the IRS's ruling had an economic interest in the minerals in place and were entitled to the depletion deduction.<sup>77</sup>

Even the Tax Court has held that contract miners have an economic interest where the miners are entitled to fees that varied with the market price at which the extracted coal was sold. In *Ruston v. Commissioner* the lessee entered into an agreement with a contract miner under which the contractor was granted the sole and exclusive right to strip mine the leased coal, but the lease was not assigned and the parties did not enter into a sublease.<sup>78</sup> The contract specifically stated that the lessee retained title to the coal both before and after extraction and retained the sole right to market the coal. The contractor was entitled to receive eighty-three percent of the net profits, however, and the agreement was not terminable without cause. Because the contractor looked only to the *sale of coal for its income*, and the contractor was not entitled to any payment on unsold coal,<sup>79</sup> the Tax Court held that the lessee had transferred an economic interest to the contractor.

Soon after *Ruston*, the Tax Court held in *Brown v. Commissioner*, that a coal mining company had acquired an economic interest under a one-year contract which was renewable annually at the mining company's option. Under the agreement the mining company was to receive seventy-five percent of the amount realized on sale by the lessee with whom it had contracted, less royalties due to the lessor, siding rentals and sales and broker's commissions which constituted roughly 75% of net profits. Significantly, the court's opinion emphasized that under the agreement the contract miner had the *exclusive right* to mine the coal subject to the lease.<sup>80</sup>

In 1959, the Supreme Court decided the landmark case of *Parsons v. Smith*, holding that a contract miner did not have an economic interest. The contract miners involved in one of the consolidated cases had oral contracts for no definite term, subject to cancellation on ten days notice by either party, but operated the deposit for eight years. They received a fixed sum per ton for extracting the coal, subject to adjustment for increased costs. The other case involved a written contract terminable on thirty days notice, under which the contract miner received a fixed sum per ton of coal extracted, subject to ad-

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<sup>76</sup> *E.g.*, *Mammoth Coal Co. v. Commissioner*, 22 T.C. 571 (1954), *rev'd*, 229 F.2d 535 (3d Cir. 1956); *Vincent v. Commissioner*, 19 T.C. 501 (1952), *vacated and remanded sub nom.*, *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir. 1954); *Hamill Coal Corp. v. Commissioner*, 14 T.C.M. (CCH) 218 (1955), *rev'd*, 239 F.2d 347 (4th Cir. 1956); *Morrisdale Coal Mining Co. v. Commissioner*, 19 T.C. 208 (1952).

<sup>77</sup> *E.g.*, *Stilwell v. United States*, 250 F.2d 736 (4th Cir. 1957); *Usibelli v. Commissioner*, 229 F.2d 539 (9th Cir. 1955).

<sup>78</sup> 19 T.C. 284 (1952).

<sup>79</sup> *See also* *Findley v. Commissioner*, 1951 T.C.M. (P-H) ¶ 51,110.

<sup>80</sup> 22 T.C. 58 (1954); *see also* *Clifton v. Commissioner*, 1958 T.C.M. (P-H) ¶ 58,065 (fee bore "some relationship" to market, even though did not reflect every change and oral contract was not in fact terminated despite power to do so); *Paul E. Barry, Inc. v. Commissioner*, 1955 T.C.M. (P-H) ¶ 55,012 (similar facts); *Virginia B. Coal Co. v. Commissioner*, 25 T.C. 899 (1956).

justment for costs. Mining continued under the contract until all of the coal in the specified area had been extracted. Neither taxpayer had an actual investment in the coal, but both had substantial investment in movable equipment.

The Court rejected the taxpayers' argument that through their contracts to mine the coal and their contribution of the use of their equipment, organization and skills, they made a capital investment in the coal giving rise to an economic interest. Seven factors distinguishing their "economic advantage" from an economic interest were cited:

To recapitulate, the asserted fiction is opposed to the facts (1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was . . . agreed to be in "full compensation for the full performance of all work and for the furnishings of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts. The agreement of the landowners to pay a fixed sum per ton for mining and delivering the coal "was a personal covenant and did not purport to grant [petitioners] an interest in the [coal in place]."<sup>81</sup>

Five years later in *Paragon Jewel Coal Co.*, the Supreme Court issued its second pronouncement on contract miners<sup>82</sup> and added some clarification to the relative significance of the seven factors in *Parsons v. Smith*. In *Paragon Jewel Coal Co.*, the Court held that contract miners using the drift method, who were to receive price per ton that varied with but was not directly related to the market price at which the owner sold the coal, did not have an economic interest. The contracts were for an indefinite period and were completely silent regarding termination. The court of appeals held that the contract miners had an economic interest, finding that the contractors were not terminable and the price to be received was "closely related" to the market price. The Supreme Court, in reversing the court of appeals, implied that the decision regarding terminability was in error. It found the contracts were terminable, but it expressly stated this factor was not important. The Court held, "the right to mine even to exhaustion without more, does not constitute an economic interest."<sup>83</sup> The determinative fact was that the contract miners' fee was not directly related to the market price of coal. The owner was free to sell at any price and retain the entire proceeds in excess of the agreed upon fee. Apparently, this indicated no capital interest in the coal to be returned to the con-

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<sup>81</sup> *Parsons v. Smith*, 359 U.S. 215, 225 (1959).

<sup>82</sup> 380 U.S. 624 (1964).

<sup>83</sup> *Id.* at 634.



tract miner upon sale. The Court noted:

Here, Paragon was bound to pay the posted fee regardless of the condition of the market at the time of the particular delivery and thus the contract miners did not look to the sale of the coal for a return of their investment but looked solely to Paragon to abide by its covenant.<sup>84</sup>

Following *Paragon Jewel Coal Co.*, some courts have continued to cite terminability of the contract on short notice as a factor in denying contract miners a depletion deduction.<sup>85</sup> Even in situations where the contract was clearly not terminable on short notice, contract miners have been held not to have an economic interest if they were to receive only a stated amount per ton of coal extracted.<sup>86</sup> A fixed price, adjusted periodically to reflect general trends in the market, is not sufficient to overcome the sixth factor of *Parsons v. Smith* and give the contract miner an economic interest.<sup>87</sup>

However, *Ruston and Brown*, which held that a contract miner entitled to receive a percentage of the sales proceeds of the extracted coal did have an economic interest, should still be a good law despite the seventh factor cited by the Court in *Parsons*. That criterion was that the contractors "look[ed] only to the landowner for all sums to become due them" and the agreement of the landowners "was a personal covenant and did not purport to grant [the contractors] an interest in [the coal in place]."<sup>88</sup> Taken literally, only a person acquiring title to an undivided share of the extracted mineral can have an economic interest. Such is not the case. In *Burnel v. Harmel*, a 1932 case of continued vitality, the Court held that cash bonus payments under an oil lease were ordinary income notwithstanding that under state law the lease operated to effect a sale of the oil in the ground.<sup>89</sup> Subsequently, in *Burton-Sutton Oil Co., Inc. v. Commissioner*, the Court held that a retained net profits royalty payable in cash constituted an economic interest. In so doing, the Court explicitly stated, "the payment of proceeds in cash, the form of the instrument of

<sup>84</sup> *Id.* at 635.

<sup>85</sup> *E.g.*, *Constantino v. Commissioner*, 445 F.2d 405 (3d Cir. 1971); *United States v. Wade*, 381 F.2d 345 (5th Cir. 1967); *United States Pipe & Foundry Co. v. Patterson*, 203 F. Supp. 335 (N.D. Ala. 1962); *Ramey v. Commissioner*, 47 T.C. 363 (1967), *aff'd*, 398 F.2d 478 (6th Cir. 1968); *Washburn v. Commissioner*, 44 T.C. 217 (1965).

<sup>86</sup> *Adkins v. Commissioner*, 51 T.C. 957 (1969); *Brown v. Commissioner*, 1965 T.C.M. (P-H) ¶ 65,321 (court did not need to reach issue of whether miner had right to exhaust deposit because fixed fee precludes economic interest).

<sup>87</sup> See *Paragon Jewel Coal Co.*, 380 U.S. 624 (1965) (fixed contract price varied "depending somewhat on the general trend of the market price for the coal over extended periods and to some extent on labor costs."); *Constantino v. Commissioner*, 445 F.2d 405 (3d Cir. 1971) (contract miner was frequently paid more than contract price); *McCall v. Commissioner*, 312 F.2d 699 (4th Cir. 1963) (fixed contract price subject to change as market price fluctuated); *United States v. Stallard*, 273 F.2d 847 (4th Cir. 1959) (same); *Adkins v. Commissioner*, 51 T.C. 957 (1969) (contract price to be adjusted in comparable ratio to substantial change in general price level); *Denise Coal Co. v. Commissioner*, 29 T.C. 528 (1957), *aff'd in part, rev'd in part*, 271 F.2d 930 (3d Cir. 1959) (fixed contract price subject to change if market price of lawful maximum price increased); see generally *McMahon, Defining the "Economic Interest" in Minerals After United States v. Swank*, 70 Ky. L.J. 23, 44-52, 72-80 (1982).

<sup>88</sup> 359 U.S. 215, 225 (1959).

<sup>89</sup> 287 U.S. 103 (1932).

transfer and its effect on the title to the oil under local law are not decisive. . . .<sup>90</sup> These principles have never been questioned.

More recently, Revenue Ruling 73-470 emphasized the importance of sharing in the profits of sale at the market price as opposed to requiring acquisition of title to the mineral.<sup>91</sup> In Revenue Ruling 73-470, the IRS held that an oil company had an economic interest under the following circumstances. The company provided all funds necessary to develop oil and gas production in a designated area of a foreign country. Under the law of the foreign country, the oil company could not obtain legal title to the land or hydrocarbons, and the oil company was required to "sell" all output to the foreign country at the prevailing world market price. The agreement was subject to summary termination by the foreign country, but if terminated, it was required to pay the oil company the estimated value of its share of the estimated reserves.

Further support for the continued vitality of *Ruston* and *Brown* is found in Revenue Rulings 73-80 and 77-84. The IRS held in Revenue Ruling 73-80 that a "stated royalty payment for coal . . . mined from the coal land" received in exchange for transfer of an option to purchase the land constituted an economic interest.<sup>92</sup> Significantly, the Revenue Ruling held that I.R.C. § 631(c) was inapplicable because as an option holder, the taxpayer did not have an economic interest, his economic interest *arose* only upon the transferee's subsequent exercise of the option. Thus an economic interest existed in a taxpayer who never had title to the coal at any point in time. Revenue Ruling 77-84 held that an economic interest existed where a taxpayer received a royalty interest on a lease acquired for another through the taxpayer's efforts.<sup>93</sup> The Ruling does not discuss whether the royalty was payable with respect to extraction or sales.

The above Rulings, which were issued after the decisions in both *Parsons* and *Paragon Jewel Coal Co.*, indicate that *Ruston* and *Brown* are still good law, and a contract miner has an economic interest if he is entitled to a percentage of net sales of the coal he has extracted. Furthermore, the percentage share allocated to the contract miner apparently can be on a "net profits" basis and not solely on a "gross sales" basis. This should be so, despite, following *Parsons v. Smith*, the seeming abandonment by the Tax Court of the method of compensation as a test for an economic interest in *Legg v. Commissioner*.<sup>94</sup> In *Legg*, the taxpayer mined coal under an agreement terminable on will by the owner which expressly provided that title to the mined coal would at all times remain in the owner. The agreement originally required a payment to the contractor of three dollars for every ton of merchantable coal extracted. Subsequently, an amendment was executed increasing the contractor's compensation by three-fifths of any increase in the market price of coal, and decreasing it by three-fifths of any fall in the market price. The fee was, accord-

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<sup>90</sup> 328 U.S. 25, 35 (1946).

<sup>91</sup> 1973-2 C.B. 88.

<sup>92</sup> 1973-1 C.B. 308.

<sup>93</sup> 1977-1 C.B. 173.

<sup>94</sup> 39 T.C. 30 (1962).

ingly, retroactively increased to reflect a prior market change. The contract specifically provided, "[t]he parties hereto expressly recognize that the [contractors] always have had a continuous economic interest in said strip and auger job operation . . . ever since its inception" and described the agreement as a "joint adventure."<sup>95</sup>

The Tax Court disagreed with the parties' characterization of the effect of the agreement, finding the facts analogous to, and the case controlled by *Parsons*. The court concluded as a matter of fact that the fee received by the contract miner was a fixed fee rather than one that varied with the market price, because despite contract provisions to the contrary, the price adjustments made in the course of performance did not correlate with fluctuations in market price. More significantly, however, the court stated:

The provisions in the agreement . . . permitting variance in the prices paid petitioners, even if they had been observed, are considered of minor consequence, considering the similarities of other essentials deemed important in *Parsons* . . . , and are not sufficient in and of themselves, to give the petitioners an "economic interest" in the coal deposits here involved.<sup>96</sup>

The reasoning of *Paragon Jewel Coal Co.* raises doubts about the continued vitality of the Tax Court's position in *Legg*, and the interpretation accorded *Parsons* and *Paragon Jewel Coal Co.* by the Supreme Court in *Swank* to distinguish those cases from *Swank* supports the view that a contract miner sharing in a percentage of the proceeds has an economic interest.

This is reinforced by Private Letter Ruling 8216007 in which the IRS ruled that a taxpayer having the right to extract a coal seam to exhaustion, but under an obligation to deliver all coal to the owner in exchange for a specified percentage of the "net proceeds" upon sale, has an economic interest, even though the taxpayer has no right to sell any portion of the extracted coal. The amount was not payable until sale, so the taxpayer looked solely to extraction and sale of coal for the investment. It was irrelevant the taxpayer was guaranteed a minimum payment per ton of coal extracted and delivered to the owner for a limited amount of the coal. The ruling's only reference to title to the coal is a statement that the owner had title prior to extraction.

Considering the irrelevancy of absence of title to the determination of economic interest, the seventh factor in *Parsons* is probably a restatement of the sixth factor, which intended to state that because the fixed sum was payable regardless of market price, the contractors would be paid even if it resulted in a loss to the owner. However, Private Letter Ruling 8216007 indicates that, at least under some circumstances, this is not controlling. The ruling implies that the core of the factor is whether payment is due upon extraction or upon sale. If payment is due only for coal that has been sold, the seventh criterion has presumably been satisfied.

In summary, it would appear that a contract miner has an economic inter-

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<sup>95</sup> *Id.* at 36.

<sup>96</sup> *Id.* at 41.

est if he is entitled to receive a fee determined under a formula, whether or not the fee is a simple percentage, that varies the fee with the market price at which the extracted coal is sold. Presumably, the fee must be payable only with respect to coal actually sold.

Following the Supreme Court decision in *Swank*, the terminability of a contract miner's contract on short notice without cause, the third factor in *Parsons*, may no longer be relevant. Although *Paragon Jewel Coal Co.* held that the right to extract minerals to exhaustion alone did not constitute an economic interest if the contract miner could not share in the market proceeds, it in no way inferred that the presence of a short notice termination clause did not preclude the existence of an economic interest. *Swank* did so hold, at least in the context of a lease. However, in footnote 21 of *Swank*, the Court stated a factor that distinguished *Swank* from *Paragon Jewel Coal Co.* was that in *Swank*, if the lessee was denied depletion, nobody would be entitled to depletion on the income in question.<sup>97</sup> However, in *Paragon Jewel Coal Co.*, the issue presented was merely which taxpayer should be entitled to the allowance.

Although the Court may have noted this distinction, it is a distinction without any significant merit. If terminability is irrelevant for leases, there is no rational basis to say that it remains relevant for contract miners. Short notice termination clauses should, therefore, be irrelevant in determining whether a contract miner has an economic interest.

## 2. Distinguishing Contract Miners From Lessees

Occasionally, an owner or lessee who desires to market or use coal for its own purposes, but does not want to conduct the extraction, leases the coal to an operator and simultaneously executes a contract requiring either the lessee to deliver to the lessor (or a party related to the lessor) all or some portion of the output, or all of the lessor's requirements at a given price per ton. Regardless of whether the lease requires a royalty to be paid on coal delivered to the lessor, a question arises whether the purported lessee is a contract miner.

In *Adkins v. Commissioner*, the taxpayer leased coal property under renewable one year leases, under which no royalties were payable on coal delivered to the lessor.<sup>98</sup> Simultaneously, he executed an output contract to sell all of the extracted coal to the lessor's parent corporation at a fixed sum per ton, subject to an adjustment if substantial changes occurred in the general market price of coal in a comparable ratio as fixed by agreement between the parties. The contract permitted either party to terminate the contract in the event of a failure to agree on price. The taxpayer's lessor paid real estate taxes, royalties and provided mine engineering. The Tax Court held that the taxpayer did not acquire an economic interest because the facts were not substantially different from *Paragon Jewel Coal Co.* Significantly, the lessor had included the amount paid to the sublessee-taxpayer in gross income from the property in computing percentage depletion, thereby asserting that it was not a lessor subject to

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<sup>97</sup> 451 U.S. 571, 583.

<sup>98</sup> 51 T.C. 957 (1969).

I.R.C. § 631(c), but rather an operator.

A similar result was reached in *Bolling v. Commissioner*.<sup>99</sup> The taxpayer entered into a lease for an indefinite term, subject to cancellation on thirty days prior notice, at a fixed royalty of 27 cents per ton. Simultaneously, he granted the lessor an option to purchase the output "at a price or prices to be agreed upon between lessor and lessee."<sup>100</sup> The price actually paid by the lessor was not related to market price on resale, but rather to estimated production costs if the lessor had operated the property. Applying *Parsons*, the court found that the taxpayer was essentially a contract miner, emphasizing that the agreement was terminable on thirty days notice and the taxpayer received merely a fixed amount per ton that was unrelated to the market price. The court was not persuaded that *Southwest Exploration Co.* should be applied by analogy because the contract miner purchased the surface rights and was therefore an indispensable party to the extraction of the coal. Instead, the expense of acquiring the surface rights could be deducted.<sup>101</sup>

A contrary result was reached on slightly different facts in *Thornberry Construction Co., Inc. v. United States*.<sup>102</sup> The lessor, an operator, offered to lease to the taxpayer certain coal property, that it did not want to operate directly, if the taxpayer would sell the output to a valued, but unrelated, customer. The taxpayer independently negotiated an output contract with the customer, at a fixed price and with a cost adjustment clause, but with no other price adjustments. The lessor then leased the property to the taxpayer for two years for a fixed sum per ton royalty, subject to termination if the lessee did not sell the output to the named customer. The taxpayer purchased certain necessary surface rights, prepared the site, and constructed roads. On these facts the court held that the taxpayer had an economic interest. *Thornberry Construction Co.* was distinguished from the other cases because "the lease and assignment conferred upon plaintiff the right to mine the coal and to sell that coal, at whatever price it could obtain therefor, to an independent, unrelated, third party (albeit a valued customer of [the lessor]) and not to [the lessor] itself."<sup>103</sup>

The distinction in *Thornberry Construction Co.* is valid and it illustrates the type of situation in which a lessee may be insulated from both market risks and market benefits.<sup>104</sup> *Bolling* and *Adkins* are not substantially different from *Paragon Jewel Coal Co.*, however, and because terminability, which existed in *Bolling* and *Adkins* (to a more limited extent) was not a key factor under *Paragon Jewel Coal Co.*, the vitality of both of these cases survives *Swank*.

<sup>99</sup> 37 T.C. 754 (1962).

<sup>100</sup> *Id.* at 757.

<sup>101</sup> Even if the surface rights were analogous to *Southwest Exploration Co.*, they should support an economic interest only for an amount of income attributable to them (i.e., an amount equal to the royalty necessary to acquire the surface rights from a third party). See *Omer v. United States*, 339 F.2d 393 (6th Cir. 1964); Private Letter Ruling 7945006 (royalties for surface rights subject to depletion, not section 631(c)).

<sup>102</sup> 576 F.2d 346 (Ct. Cl. 1978).

<sup>103</sup> *Id.* at 353.

<sup>104</sup> See Rev. Rul. 73-470, 1973-2 C.B. 58.

A lessee who merely grants the lessor an option to purchase the output at the lessee's price, presumably the market price, is in a position similar to that of the lessee in *Thornberry Construction Co.* The lessee in such a case clearly has an economic interest and is entitled to depletion, even if the lease is terminable on thirty days' notice.<sup>105</sup> This reinforces the view that the only significant and relevant difference between a contract miner and a lessee is the method of compensation or marketing scheme. The facts in *Bolling*, in which the operator was held to be a contract miner, are not significantly different from *Thornberry Construction Co.*, except with regard to compensation. Both taxpayers were, in form, lessees operating under a lease terminable on thirty days' notice. In *Bolling*, however, the operator was found not to have the freedom to realize the market price of the coal, and he was, therefore, a contract miner.<sup>106</sup>

It is not absolutely necessary, however, to leave the future price of coal indeterminate for a lease coupled with a contract to supply the lessor's coal requirements to confer an economic interest on the lessee. Revenue Ruling 72-477 describes a lease and requirements contract that conferred an economic interest on the lessee.<sup>107</sup> A utility company leased a coal deposit to an unrelated mining company for a term of twenty-one years or until the coal was worked out, subject to a right of extension by the mining company for an additional ten years if the coal had not been worked out in twenty-one years. Under the lease, title to the coal passed to the lessee upon severance. A specified royalty per ton of extracted coal, subject to adjustment based on changes in the Wholesale Price Index, was payable by the lessee to the lessor. (The royalty was specifically stated to be reasonable.)

Under the coal sales agreement, the mining company agreed to sell, and the utility company-lessor agreed to buy, a specified amount of coal annually, subject to the right of the utility to increase the required amount. Any coal extracted in excess of the amount required under the sales contract could be sold to other parties. The price to be paid by the utility for coal was not fixed but was determinable under a formula. The formula price was the sum of the mining company's actual per ton production and delivery costs, a per ton administrative charge, and a per ton profit subject to adjustment based on changes in the Wholesale Price Index. Royalty payments due to the lessor were not treated as a cost under the formula, but the formula resulted in a price "substantially equivalent to the open market price of coal." This was presumably determined at the time the parties entered into the contract. The supply agreement was for a term of twenty-one years, subject to extension for ten years by the utility company, but the IRS concluded that the agreements were not coterminous because even if the sales agreement were terminated, the lessee could continue to mine under the lease.

The conclusion in this ruling is somewhat questionable. The IRS con-

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<sup>105</sup> United States v. Swank, 451 U.S. 571 (1981).

<sup>106</sup> See 37 T.C. 754, 762 (1962). See also *Calvert & Youngblood Coal Co. v. United States*, 6 A.F.T.R. 2d 5746 (N.D. Ala. 1960).

<sup>107</sup> 1972-2 C.B. 310.

cluded that the mining company had acquired "a share of the coal or the proceeds of its sale." Presumably this was based on the variable price. However, the formula price bore no relationship to the market price of coal other than the initial equivalency. If the Wholesale Price Index rose but the market price of coal fell, the price under this contract increased. Thus, the agreement fails the test of *Paragon Jewel Coal Co.* Furthermore, the mining company's right to sell excess production on the open market might have been illusory as in *Bolling*. Reliance on the mere form of the agreement in lease-sales contract combinations should be insufficient; cases in which the entire output is *in fact* sold to the lessor should be scrupulously examined.

Further confusion in determining the dividing line between leases coupled with contracts to sell extracted coal back to the lessor that provide an economic interest and those that do not is added by Revenue Ruling 73-32.<sup>108</sup> The ruling involved a sixteen-year mineral lease from a power company to a joint venture between its wholly-owned subsidiary and an unrelated mining company. Under the lease, the joint venture could exhaust the deposit and was required to pay a royalty for each ton of coal mined and sold. Simultaneously with the execution of the lease, the joint venture agreed to dedicate the reserves to a requirements supply contract with the power company for a period coterminus with the lease. However, the joint venture was permitted to sell a specified amount of coal from the dedicated reserves on the open market each year. The Ruling failed to consider whether such sales were prohibited if they would impair the joint venture's ability to meet the supply contract. "The price paid by the power company for coal supplied by the joint venture was stated in the coal supply agreement."<sup>109</sup> (Presumably this meant a fixed price.)

The subsidiary of the power company supplied all of the necessary equipment; the unrelated mining company provided management; and each venturer supplied one-half of the working capital. A portion of the funds required by the subsidiary was advanced by the parent power company. Out of the joint venture's receipts the subsidiary of the power company was to receive a fixed fee per ton for the use of the mining equipment and the mining company was to receive a fixed fee per ton for its management services, both of which were charged to operating costs. The remaining profit was to be split equally by the venturers. The extracted coal was transported by the joint venture to the power company's processing plant in the state in which it was extracted.

The IRS ruled the joint venture had an economic interest in the coal deposit because the lease was not terminable on short notice and the joint venture looked "for its compensation solely to the extraction and sale of coal." The correctness of this ruling is debatable.<sup>110</sup> It fails to consider the logic em-

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<sup>108</sup> 1973-1 C.B. 301.

<sup>109</sup> *Id.*

<sup>110</sup> The ruling is arguably inconsistent with other rulings in which the IRS has looked at the substance and not the form of the transaction. *See, e.g.,* Rev. Rul. 68-430, 1968-2 C.B. 44, refusing to recognize a sale of mineral property to a subsidiary followed by a lease-back by the parent corporation designed to permit the parent to claim percentage depletion on income from operations while the subsidiary claimed cost depletion on the royalties. Under this arrangement, the IRS

ployed in *Bolling* and *Adkins* that would render the mining company largely indistinguishable from the contract miners in *Paragon Jewel Coal Co.* The mining company was to receive only a percentage of a fixed sum in exchange for extracting the coal subject to the supply contract. The supply contract in the ruling is clearly analogous to the option to purchase the output held by the lessor in *Bolling*. Furthermore, in *Bolling* there was, theoretically, an even greater likelihood that the lessee "could turn to the open market for sales."

It is not possible to completely analogize the facts of the Ruling to *Thornberry Construction Co.* because the supply contract was with the lessor and not with an independent party. The facts are somewhat analogous, however, if the fixed price negotiated between the parties was based on the market value of extracted coal. However, sixteen years is a long period for an operator to obligate himself to sell coal at a fixed price. A price adjustment clause, which bears a direct relationship to fluctuations in the market price of coal, seemingly makes *Ruston* applicable to justify ruling that the mining company had an economic interest. This would probably be justified even if the adjustments were made only at reasonable intervals. If, however, there were an adjustment based on costs, the contract miner cases seem so analogous that the only reasonable conclusion is that this is a contract mining arrangement for a fixed fee. No such distinction, however, was made in the Ruling, which did not consider either situation.

With the similarity of this arrangement to contract mining, there is some doubt whether the IRS would issue the same ruling if the lease to the joint venture were terminable by the lessor on thirty days' notice. *Swank*, however, holds that such terminability is irrelevant, so the result should be the same even if the facts were so changed.

### 3. Treatment of Lessor as Contract Miner for Lessee

Dealing with a somewhat different type of arrangement, in Revenue Ruling 82-180, the IRS held that the lessee of a mineral deposit, who concurrently hired the owner as a contract miner, had an economic interest.<sup>111</sup> The lessor-contract miner was to receive a fixed fee, reasonably calculated to compensate it for the cost of extraction, and to provide a reasonable profit "that [was] not affected by the risks of the market." No open market sales by the lessor-contract miner were permitted; it was required to deliver all of the minerals extracted to the lessee. Accordingly, the owner's economic interest extended only to the royalty received under the lease. Payments for the extraction were not depletable by the owner-contract miner, but were included in the lessee's gross

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ruled that the parent remained the true owner of the property. The Revenue Ruling 73-32 situation is, in a sense, a mirror image of the above transaction, a lease followed by a purchase, in this case of the extracted minerals. By analogy, the power company remained the owner of the coal and was obligated only to pay a contractually determined sum upon extraction and delivery.

<sup>111</sup> Rev. Rul. 82-180, 1982-43 I.R.B. 7. See also Private Letter Ruling 8038161. This ruling reached a similar result but specifically involved a ten-year lease of a mineral deposit usable to the lessee (but not the owner) overlying the mineral deposit which the owner used in its business and did not lease to the lessee of the overlying deposits.



income from the property and are depletable by him.

The fact pattern in the ruling is similar to the fact pattern in the *Food Machinery and Chemical Corp. v. United States* cases.<sup>112</sup> Those cases involved a lessee, rather than an owner, who did not sublease the overlying deposit to the processor who wanted the overlying mineral deposit, but executed a requirements contract under which it agreed to deliver all the mineral extracted for a fixed fee per ton. The purchaser of the extracted mineral expended millions of dollars for processing plants and agreed to pay the royalties due to the lessor. The agreement was coterminous with the lease and the "purchaser" could cure any default in the lease and take over operation of the mine at its own expense if the lessee-seller could not meet the terms of the supply contract. A sublease was not originally used because it was considered impractical, but ten years later the parties cancelled the original agreement and executed a sublease and a contract mining agreement. Even for years in which the original contract was in force, the court of claims held that the "purchaser" had an economic interest and that the lessee-seller had surrendered its economic interest in the underlying deposit. The court concluded the sublease-contract miner arrangement was reflective of the true intent of the earlier arrangements and that in reality the "purchaser" had the economic interest.

This result is in contrast with *Weirton Ice & Coal Supply Co. v. Commissioner*,<sup>113</sup> in which the owner sold certain coal property at a cost to a customer to whom it had been selling the output from the property. Simultaneously, the customer hired the original owner to mine and deliver the coal at a fixed price per ton, subject to adjustment for labor costs. The agreement was terminable by either party on ninety days notice. Both parties contemplated that the land would eventually be reconveyed to Weirton, and it was eventually reconveyed.

The Tax Court held that Weirton Ice and Coal Supply Co., the original owner, did not have an economic interest as a contract miner because it was paid a fixed price and the contract was terminable on short notice. Citing its earlier decision in *Commissioner v. Gregory Run Coal Co.* allowing depletion to a contract miner, the Fourth Circuit reversed. However, the court found the parties contemplated that Weirton would have the continuing exclusive privilege to mine the coal. More importantly, however, the court concluded:

The purpose of National to secure a supply of coal for its steel plant was carried out by the acquisition of title to the several tracts of land at cost, and by the execution of the agreement with Weirton for the extraction of the mineral at a reasonable price. The purpose of Weirton to find a profitable market for the coal in place on the lands which it owned was likewise served, and hence it was willing to transfer the lands to National at cost and to look for the return of its investment in the land and in the operating equipment from the profits of the mining operations, and from the reconveyance of the lands after the extraction of the mineral.<sup>114</sup>

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<sup>112</sup> 348 F.2d 921 (Ct. Cl. 1965); 366 F.2d 1007 (Ct. Cl. 1966).

<sup>113</sup> 231 F.2d 531 (4th Cir. 1956), *rev'g* 24 T.C. 374 (1955).

<sup>114</sup> *Id.* at 535.

Thus, the court of appeals analogized the arrangement to a long-term output contract at a fixed price. This may be a valid analogy when the seller-contract miner is initially entitled to a fee that when combined with the discounted value of the sales price allocable to the minerals in the ground, approximates the price that the market would then attach to a similar output contract. But, a recent Private Letter Ruling indicates that the IRS places great weight on form.<sup>115</sup>

If *Weirton Ice & Coal Supply Co.* has survived *Paragon Jewel Coal Co.* because it looks through the form to find in substance a long-term contract for the sale of coal and not a contract to provide extraction services, *Swank* vindicates the conclusion of the court of appeals that, “[i]t is of no moment that the owner of the mineral . . . had the option to terminate the agreement at any time, for as the events proved, *Weirton* actually mined the coal during all of the taxable years.”<sup>116</sup>

#### D. Joint Ventures

In Revenue Ruling 74-469, the IRS held that both X and Y Corporation held an economic interest under the following facts.<sup>117</sup> X Corporation was the lessee under various mineral leases terminable only for cause. By an agreement terminable only for cause, X granted Y Corporation the right to mine to exhaustion all minerals to which it was entitled under the leases. Y obtained all permits in X's name. X extracted all minerals, using its own equipment and labor, and delivered the minerals to X's stockpile for processing by X's equipment and labor. X was obligated to pay all royalties on the minerals extracted and sold. Pursuant to the agreement, immediately upon extraction all minerals became the property of X and Y individually in specified shares. Both X and Y had the right to sell their respective shares to whomever they wished at whatever price they obtained. An independent agent sold the minerals on the open market for the respective accounts of X and Y.

The IRS also considered economic interest issues in a joint venture in Revenue Ruling 73-32, which is discussed in detail in the preceding section.<sup>118</sup>

There has been uncertainty regarding the identity of the proper party to claim depletion in the captive mine arrangement operated as a joint venture in corporate form by two or more taxpayers. The parent corporations would advance all funds necessary for operating costs and would share the production in proportion to their stockholdings. No open market sales would be made by the operating company and it would make no net profit. At one time, the IRS ruled the parent corporations owning such a joint venture captive mining corporation were the true owners of the economic interest and were entitled to

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<sup>115</sup> Private Letter Ruling 8038161.

<sup>116</sup> 231 F.2d at 535.

<sup>117</sup> 1974-2 C.B. 178.

<sup>118</sup> 1973-1 C.B. 301; see *supra* note 108 and accompanying text; see also *Hudson v. Commissioner*, 11 T.C. 1042 (1948), *nonacq.*, 1949-1 C.B. 5 (gas processor that received an assignment of undivided share of hydrocarbons in place had an economic interest).

claim the depletion allowance on their respective shares of the production.<sup>119</sup> In 1977, however, the IRS reversed its position and ruled that the operating company was the owner of the economic interest, thereby denying the depletion deduction to the parent companies.<sup>120</sup> If, however, the enterprise is not operated in corporate form, under partnership taxation rules the depletion allowance, computed at the level of the captive operating enterprise, will pass through to the parent corporations as partners.

#### E. *Miscellaneous Royalty Interests*

Frequently different parties own the mineral rights and the surface land overlying the coal deposit. Even though the surface owner has no ownership in the coal, he can have an economic interest under the theory of *Southwest Exploration Company*.<sup>121</sup> In *Omer v. United States*,<sup>122</sup> the owner of the surface rights granted to the lessee of the mineral rights the right to use the surface and land strata overlying the coal for the purpose of strip mining the coal. The lessor of the surface rights received a royalty of a fixed sum for each ton of coal mined and sold. The taxpayer reported the royalties as amounts received for disposition of coal with a retained economic interest under I.R.C. § 631(c). Although the court denied the taxpayer the favorable treatment accorded by I.R.C. § 631(c), holding the amounts received were ordinary income, the IRS conceded the taxpayer held an economic interest in the coal under the doctrine of *Southwest Exploration Company* and was entitled to the depletion allowance.<sup>123</sup>

In Revenue Ruling 77-84, the holder of a royalty interest was held to have an economic interest supporting a depletion deduction without having any direct interest in the coal deposit.<sup>124</sup> The taxpayer received a royalty interest in a lease in consideration of negotiating the lease for another party. The royalty interest was held to constitute an economic interest, entitling the taxpayer to the depletion deduction. However, under the ruling the taxpayer had no economic interest when he received a royalty interest in a leasehold in exchange for negotiating *other* leases, and in a third situation, no economic interest was present when the taxpayer received a royalty on all coal sold by the mining company, regardless of whether it was mined under the negotiated leases or purchased and resold.

The contrast between the first and third situations in Revenue Ruling 77-84 is also illustrated by *Cline v. Commissioner*.<sup>125</sup> Herbert and John Cline received a royalty interest on each ton of coal mined from certain leaseholds in consideration for negotiating the leases on behalf of Wolf Creek Collieries Co.

<sup>119</sup> Rev. Rul. 56-542, 1956-2 C.B. 327; Rev. Rul. 68-28, 1968-1 C.B. 5; Rev. Rul. 71-140, 1971-1 C.B. 161.

<sup>120</sup> Rev. Rul. 77-1, 1977-1 C.B. 161.

<sup>121</sup> See *supra* note 42 and accompanying text.

<sup>122</sup> 329 F.2d 393 (6th Cir. 1964), *aff'd* 63-1 USTC ¶ 9113 (W.D. Ky. 1962).

<sup>123</sup> See also Private Letter Ruling 7945006.

<sup>124</sup> 1977-1 C.B. 173.

<sup>125</sup> 67 T.C. 889 (1977), *aff'd*, 617 F.2d 192 (6th Cir. 1980).

Subsequently, in connection with the sale of their stock in Wolf Creek, the Clines' royalty agreement was amended to provide for a lesser royalty, payable on all coal loaded or processed through Wolf Creek's loading docks or tipping facilities. The royalty was payable regardless of whether the coal was mined from the leased mineral property to which the original royalty related, mined from other properties, or purchased. The Tax Court concluded that although the Clines' original royalty agreement constituted an economic interest, the renegotiated royalty on all the coal handled by Wolf Creek was not dependent on the extraction of coal from any specific lease or leases and did not give the taxpayer an economic interest in any coal property.

In Revenue Ruling 73-80, the IRS held that a taxpayer who transferred an option to purchase mineral property in consideration of royalty to be paid by the transferee upon operation following purchase of the property had an economic interest. Even though the option related to coal property, I.R.C. § 631(c) was held to be inapplicable and the royalty was ordinary income subject to depletion.<sup>126</sup>

#### F. Licensees and Similar Rights

There are few cases where an economic interest is asserted by a licensee. In *Holbrook v. Commissioner*, the Tax Court held that the holder of a nonexclusive, nontransferable license to extract coal subject to termination on ten days notice was not entitled to percentage depletion.<sup>127</sup> If the license was not revoked it continued in force until all minable and merchantable coal was extracted. Under the terms of the agreement, the licensee acquired title to the coal only upon extraction and paid a fixed royalty to the licensor (subject to a minimum royalty provision). The licensee expended several thousand dollars and four weeks efforts in preparing the underground mines for operation. He then operated the mine for four years and sold coal on the open market. Most of his equipment was movable.

The court concluded that the licensor did not surrender any capital interest in the mineral in place because the license was nonexclusive, nontransferable, and terminable on short notice. Although the coal belonged to the licensee upon extraction, the court was not convinced that the licensee had an economic interest. Furthermore, the court found no investment because the licensee's equipment, including roof supports, was found to be movable. The court expressly distinguished *Winters v. Commissioner*,<sup>128</sup> in which a lessee under a lease terminable on thirty days notice nevertheless had an economic interest because he had acquired the surface rights.

Similarly, in *Rissler & McMurry Co. v. United States*, the Tenth Circuit denied a depletion deduction to a taxpayer removing gravel from a city-owned gravel pit under an oral agreement permitting removal in exchange for a roy-

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<sup>126</sup> 1973-1 C.B. 308.

<sup>127</sup> 65 T.C. 415 (1975).

<sup>128</sup> 496 F.2d 995 (5th Cir. 1974), *rev'g* 57 T.C. 249 (1971).

alty.<sup>129</sup> There was no showing of a capital investment in the mineral in place; the short period which the taxpayer actually operated reflected no intention by the city to surrender any interest in the gravel.

The exclusivity of rights requirement applied by the Tax Court in *Holbrook* conflicts with the Tax Court's earlier decision in *Virginia B Coal Company v. Commissioner*.<sup>130</sup> *Virginia B Coal Company*, which was decided before *Parson* and *Paragon Jewel Coal Company*, involved contract miners. Although the contract miners operated under agreements terminable without cause on ninety days notice, the court concluded that the contractors had an economic interest because their compensation was dependent on the sale of the coal and varied with the market. The court specifically noted that, although from the evidence it was unable to ascertain the quantity of coal the contract miners were to extract "and whether each independent contractor had exclusive rights to conduct strip-mining operations on [the lessee's] property during the period of the agreement,"<sup>131</sup> the method of compensation was conclusive. However, because the contract miners had operated successively rather than concurrently, there was no direct evidence of nonexclusivity either.

In the recent cases where a licensee has been held to have an economic interest, the taxpayer has established exclusivity of the ability to exploit the deposit as a *factual* matter rather than a legal right. Interestingly, all of the cases involve sand and gravel deposits. In *Oil City Sand & Gravel Co. v. Commissioner*, the taxpayer dredged sand and gravel from a riverbed under a permit from the Army Corps of Engineers and Pennsylvania Department of Forests and Waters.<sup>132</sup> Although the taxpayer did not own the riverbed, it owned the only riparian land suitable for marine operations to dredge the sand and gravel. Neither the Army Corps of Engineers permit nor the Department of Forests and Waters permit conferred any property rights upon the taxpayer. The Corps of Engineers permit was expressly nonexclusive and the Department of Forests and Waters permit was nonexclusive by implication. Both permits were silent regarding revocation. Title to the gravel and sand in the river was held by the State and the right to remove it was a public right. Upon removal the sand and gravel became property of the person removing it.

Applying *Southwest Exploration Co.*, the court held that the taxpayer had an economic interest because it had practical exclusive physical and economic control over the deposits. The use of its riparian land was essential to removal of the deposits and the riparian land had special value because of its proximity to the sand and gravel deposits that were being depleted by the dredging operation. The same result was reached on similar facts in *Victory Sand & Concrete, Inc. v. Commissioner*.<sup>133</sup>

Finally, in *Weaver v. Commissioner*,<sup>134</sup> three agreements were involved

<sup>129</sup> 480 F.2d 684 (10th Cir. 1973), *aff'd* 342 F. Supp. 43 (D. Wyo. 1972).

<sup>130</sup> 25 T.C. 899 (1956).

<sup>131</sup> *Id.* at 902.

<sup>132</sup> 39 T.C. 31 (1959).

<sup>133</sup> 61 T.C. 407 (1974).

<sup>134</sup> 72 T.C. 594 (1979).

under which the taxpayer extracted gravel. Although one agreement was de-nominated a lease, and called for "rent," the others were more difficult to so categorize. A second agreement for a term of two years, granted "the exclusive right to extract and remove . . . gravel material from [the described property]," and required that the taxpayer "shall pay Munroe Twenty Cents (\$0.20) for each cubic yard of gravel material extracted and removed." The agreement provided, however, that "the gravel material removed . . . shall remain the property of Munroe . . . until such gravel material is delivered by Weaver to a job site and Weaver has paid Munroe for such material." Both of these agreements were found to confer an economic interest on the basis of exclusivity, absence of short notice terminability (one was terminable on 120 days notice and was held not to be short notice), and the taxpayer's "significant related investment."<sup>135</sup>

The third agreement provided as follows:

Beginning Nov. 1, 1971 and expiring June 1, 1972 Hadwen & Verna Coe agree to sell gravel from their bed at south east portion of their farm located on Co. Rt. #35, Hastings, N.Y. to Lloyd Weaver Construction Co.

Lloyd Weaver Construction Co. agrees to pay to Hadwen and Verno Coe fifteen cents per yard for all gravel material taken. All gravel material taken shall be paid for at the end of each week for material taken preceding week.

Lloyd Weaver to have first option to Renew Contract.<sup>136</sup>

Although the court referred to the Coe agreement as a lease in allowing the depletion deduction, this agreement is difficult to categorize. Significantly, however, although the agreement did not discuss exclusivity, the court, in holding that the taxpayer had an economic interest, construed the "first option" clause to imply exclusivity because the taxpayer owned the necessary access and it was "phraseology seemingly inconsistent with the notion that more than one exploiter of the mineral resources was contemplated."<sup>137</sup>

Looking at these cases together, it is questionable whether a licensee is absolutely precluded from having an economic interest. If, as a practical matter, the licensee has had the exclusive ability to exploit the deposit, the Tax Court has not denied him an economic interest. After *United States v. Swank*, that a license is terminable on short notice should not be relevant in determining whether a licensee has an economic interest, at least if he actually operates under the license without exercise of the licensor's right to terminate. If actual continued operation under a lease with a short notice terminability clause is sufficient to support an economic interest, actual continued operation under a license should also be sufficient.

Furthermore, the distinction between title to the coal after the extraction and a surrender of the interest in the unextracted coal made in *Holbrook* should not survive *Swank*. The Supreme Court expressly said in footnote 25

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<sup>135</sup> *Id.* at 602.

<sup>136</sup> *Id.* at 599.

<sup>137</sup> *Id.* at 606.

that the duration of the interest is irrelevant if the taxpayer otherwise has an economic interest and is dependent on the market to recover his costs.<sup>138</sup> Since *Swank* also expressly acknowledges that an investment by the taxpayer is irrelevant, the "costs" referred to must be operating costs. Therefore, an economic interest exists not by virtue of an abstract interest in the unextracted mineral in the ground, but rather when the taxpayer has *the right to extract the mineral* and reduce it to ownership.<sup>139</sup> The IRS, however, interprets the result in *Swank* as being based significantly on the fact that the lessee had a legal interest in the coal before extraction.<sup>140</sup> Therefore, it is likely that the IRS will continue to contest the assertion of an economic interest in a licensee.

The nonexclusive nature of a license may present some difficulty in finding an economic interest in the licensee. If, however, the preceding analysis regarding title to the mineral is correct, nonexclusivity of the license should also be irrelevant. If depletion is warranted "whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers operating for successive shorter periods,"<sup>141</sup> it is equally warranted whether the entire operation is conducted by one taxpayer over a prolonged period or concurrently by several taxpayers over a shorter period. This assumes that the actual extraction rather than the right to future extraction of an estimatable quantity of mineral that is the hallmark of an economic interest.<sup>142</sup> If so, a terminable license confers an economic interest on the licensee.

### III. COST DEPLETION

#### A. Computation

The cost depletion allowable as a deduction for any taxable year is determined under a formula provided by the regulations.<sup>143</sup> The adjusted basis of the mineral property under I.R.C. § 612 is divided by the number of units remaining as of the taxable year. The result, termed the "depletion unit" is multiplied by the number of units sold during the taxable year. For coal, the relevant unit is the ton. The number of units remaining as of the taxable year is the sum of the units to be recovered at the end of the taxable year (including units extracted but not sold) and the units sold during the year.<sup>144</sup> This computation requires the taxpayer to compute each of the three factors: units sold, basis, and units remaining to be recovered.

Units sold during the taxable year are defined by the regulations with ref-

<sup>138</sup> See *supra* note 74 and accompanying text.

<sup>139</sup> See McMahon, *Defining the "Economic Interest" in Minerals After United States v. Swank*, 70 Ky. L.J. 23, 67-71 (1982).

<sup>140</sup> Private Letter Ruling 8216007.

<sup>141</sup> *United States v. Swank*, 451 U.S. 571, 585 (1981).

<sup>142</sup> See *Virginia B. Coal Co. v. Commissioner*, 25 T.C. 899 (1956); *Smoot v. Commissioner*, 25 B.T.A. 1038 (1932) (holding that the holder of exclusive grant to remove gravel from riverbed granted by riparian landowner who had nonexclusive, revocable license to remove gravel by operation of state statute had a right to deplete the value of his contractual right as gravel was dredged).

<sup>143</sup> Treas. Reg. § 1.611-2(a)(1) (1973).

<sup>144</sup> Treas. Reg. § 1.611-2(a)(3) (1973).

erence to the taxpayer's accounting method.<sup>145</sup> Cash basis taxpayers include units for which payment was received in the year, regardless of the year of production or the year of sale. Accrual basis taxpayers use their inventory method to compute the number of units sold.<sup>146</sup>

The basis of the mineral deposit under I.R.C. § 612 is the adjusted basis of the mineral property used for determining gain and loss under I.R.C. § 1011.<sup>147</sup> In addition to adjustments to basis otherwise required by I.R.C. § 1016, the taxpayer must keep a depletion account and record the basis of the property, which must be reduced by the amount of depletion allowed in prior years.<sup>148</sup> The basis for depletion in a given taxable year is the adjusted basis determined at the end of the year. All adjustments to basis other than the depletion deduction must be made prior to computing the depletion deduction.

To calculate cost depletion a taxpayer must first estimate the number of units "reasonably known, or, on good evidence, believed to have existed in place" no later than the close of the first taxable year of operation of the property.<sup>149</sup> That determination must be made "according to the method current in the industry and in light of the most accurate and reliable information obtainable."<sup>150</sup> That, together with sales, enables the taxpayer to compute the units remaining as of the first taxable year. Thereafter, the number of units remaining for each successive taxable year will be the number of units remaining from the estimate after subtracting sales in intervening years.<sup>151</sup> If, however, in a subsequent year the number of remaining recoverable units is substantially different than the number remaining from the previous estimate, the estimate must be revised. Thereafter, computations of cost depletion will be based on the revised estimate.<sup>152</sup> Revised estimates are not applied retroactively.<sup>153</sup>

In Revenue Ruling 67-157, the IRS, relying on the language of I.R.C. § 611(a) requiring a revised estimate of the remaining recoverable reserves when it is "ascertained as a result of operations or development work that the recoverable units are greater or less than previously estimated," held that a taxpayer could not revise an estimate of recoverable reserves downward based on its analysis of trends in coal prices that indicated that future price changes would render some of the reserves economically unrecoverable (i.e. the projected cost of extraction would exceed the projected market price).<sup>154</sup> Revenue Ruling 67-157 gives an example of the type of information warranting a revised estimate finding a geologic "fault" or "pinch out" of the coal seam indicating

<sup>145</sup> Treas. Reg. § 1.611-2(a)(2) (1973).

<sup>146</sup> See Treas. Reg. § 1.471-7 (1958) (regarding special rules for valuing mine inventories).

<sup>147</sup> Treas. Reg. § 1.612-1(a) (1960).

<sup>148</sup> Treas. Reg. § 1.612-2(b) (1960).

<sup>149</sup> Treas. Reg. § 1.611-2(c)(1) (1973).

<sup>150</sup> *Id.*

<sup>151</sup> Treas. Reg. § 1.611-2(c)(2) (1973).

<sup>152</sup> I.R.C. § 611(a) (1976) (last sentence); Treas. Reg. § 1.612-1(c)(2) (1960).

<sup>153</sup> *Kehota Mining Co. v. Lewellyn*, 30 F.2d 817 (3d Cir. 1929); *Tressler Coal Mining Co. v. Commissioner*, ¶ 48,266 T.C.M. (P-H) (1946); *Trace Fork Mining Co. v. Commissioner*, 15 B.T.A. 872 (1929); *Sterling Coal Co., Ltd. v. Commissioner*, 8 B.T.A. 549 (1927).

<sup>154</sup> 1967-1 C.B. 154.



an absence of coal.<sup>155</sup> The Ruling states any coal reserves classified as measured, indicated or inferred under Geological Survey Bulletin 1136, "Coal Reserves of the United States," which is prepared by the United States Geological Survey, must be included in the estimate of remaining recoverable coal.

Although estimates of recoverable units presumably should be revised if, due to changes in technology or the market, it were to become economically feasible to extract coal previously considered unrecoverable or not economical to extract coal previously considered marketable, changing the estimate of recoverable units based on fluctuations of market price may prove difficult. In *West Virginia Coal Co. v. Commissioner*,<sup>156</sup> the Board of Tax Appeals held that the estimate of recoverable units could not be revised downward when the taxpayer stopped mining at a fault because the taxpayer was not unable to extract the coal on the other side of the fault but chose not to mine the coal because there had been a decrease in the market price of coal.<sup>157</sup> However, in *Trace Fork Mining Co. v. Commissioner*,<sup>158</sup> the Board of Tax Appeals allowed a downward revision where a coal seam was thinner and contained more shale than was previously estimated.<sup>159</sup>

The effect of the decrease in recoverable reserves is to increase the "depletion unit" amount, thus accelerating the aggregate deduction. An increase in estimated reserves decreases the "depletion unit" which decreases annual cost depletion per unit, thus deferring the aggregate deduction. Both section 611(a) and the regulations provide that, notwithstanding a revised estimate of recoverable reserves, the adjusted basis for depletion will not be changed.<sup>160</sup>

### B. Determination of Basis

Section 612 provides that the basis on which depletion is allowed is the adjusted basis provided in I.R.C. § 1011 for the purpose of determining gain or loss. The starting point for adjusted basis is usually cost under I.R.C. § 1012,<sup>161</sup> but basis is determined under I.R.C. § 1014 if the mineral property was acquired by bequest or inheritance, or under I.R.C. § 1015 if the property was

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<sup>155</sup> *Id.*; see also *Staub Coal Co. v. Commissioner*, 16 B.T.A. 584 (1929); *West Virginia Coal Co. v. Commissioner*, 16 B.T.A. 378 (1929).

<sup>156</sup> 16 B.T.A. 378 (1929).

<sup>157</sup> *Id.* at 383-84.

<sup>158</sup> 15 B.T.A. 872 (1929).

<sup>159</sup> *Id.* at 879-80.

<sup>160</sup> Treas. Reg. §§ 1.611-2(c)(2) (1973), 1.612-2(f) (1960). This rule was applied in *Martini v. Commissioner*, 28 T.C.M. (C.C.H.) 1028 (1969). The taxpayer allocated \$6,000 of the cost basis of real property to the estimated gravel reserves of 140,000 cubic yards. Subsequently, after the taxpayer's basis had been exhausted by prior depletion, upon discovery that the gravel reserves were substantially in excess of 140,000 cubic feet, the taxpayer attempted to reapportion his basis allocation to increase the portion of total basis allocated to the gravel deposit. The court held that such a reallocation was prohibited by the regulations. See also *McCahill v. Helvering*, 75 F.2d 725 (8th Cir. 1935) (holding that basis of mineral property for cost depletion originally established upon predecessor of I.R.C. § 1014 could not be increased upon subsequent discovery of substantially greater reserves than originally estimated).

<sup>161</sup> Treas. Reg. § 1.612-1(a) (1960).

acquired by gift.<sup>162</sup> Basis may also be determined under I.R.C. § 1031(d) if the property was acquired in a like-kind exchange.<sup>163</sup> Normal rules for capitalization of acquisition expenses under I.R.C. § 263 are applicable, and items such as commissions paid by a purchaser or lessee and attorneys' fees incurred in the acquisition of the mineral properly are included in the depletable basis.<sup>164</sup>

Only that portion of the basis of the property attributable to the mineral property may be included in the depletable basis under I.R.C. § 612. The regulations provide that the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral production.<sup>165</sup> Thus, when the surface and coal rights are purchased together, the cost must be allocated between the two. If the coal is extracted by a method that does not destroy the surface, depletion is allowed only with respect to the cost basis allocated to the coal.<sup>166</sup> The same principle applies to allocation of basis determined under I.R.C. § 1014, I.R.C. § 1015 or I.R.C. § 1031(d).

Determination of the basis of the coal is more difficult if surface mining methods are used. In *Manchester Coal Co. v. Commissioner*<sup>167</sup> the Board of Tax Appeals included the cost of the surface in the depletable basis because strip mining the coal deposit would completely destroy the surface area.

In *Beaver Dam Coal Co. v. United States*,<sup>168</sup> the Commissioner conceded that the allocable cost of the surface overlying coal to be strip mined should be added to the depletable basis of the coal. At issue was the amount of the surface basis property allocable to the coal deposit. The taxpayer had separately acquired mineral rights and surface rights. In many instances in order to acquire surface rights overlying coal to be strip mined, the taxpayer was required to purchase as a unit, tracts that included land under which there was no coal, paying a premium for the surface that was not overlying the coal and would not be destroyed by mining. The Commissioner argued that the purchase price of each tract should simply be allocated ratably to the surface that would be destroyed. The taxpayer argued that an equitable apportionment required that the premium be allocated wholly to the surface to be destroyed. For example, if the taxpayer was compelled to pay \$10,000 for a hundred acre farm, having an agricultural fair market value of \$3,000 and only forty acres were to be mined, the cost would be apportioned as follows. If the agricultural value of

<sup>162</sup> See *McCahill v. Helvering*, 75 F.2d 725 (8th Cir. 1935) (basis determined under predecessor of I.R.C. § 1014).

<sup>163</sup> See, e.g., *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941) (exchange of undivided fractional share of mineral rights for improved city lot); Rev. Rul. 68-331, 1968-1 C.B. 352 (exchange of leasehold interest in producing oil deposit for improved ranch).

<sup>164</sup> See, e.g., *Fiore v. Commissioner*, ¶ 79,360 T.C.M. (P-H) (1979) (broker's commissions and attorney's fees for purchase of land and mineral (coal) rights; rejecting argument that payments were deductible as development expenses under I.R.C. § 616 (1976) or as advance coal royalties); *Munger v. Commissioner*, 14 T.C. 1236 (1950) (commission paid by lessor added to lessor's basis); Rev. Rul. 67-141, 1967-1 C.B. 153 (commissions paid by lessee to acquire oil lease).

<sup>165</sup> Treas. Reg. § 1.612-1(b)(1) (1960).

<sup>166</sup> *Potts Run Coal Co. v. Comm'r*, 19 BTA 1 (1930) (deep mining), *nonacq.*, X-2 C.B. 90.

<sup>167</sup> 24 B.T.A. 577 (1931), *nonacq.*, XI-1 C.B. 10 (1932).

<sup>168</sup> 370 F.2d 414 (6th Cir. 1966), *rev'g* 237 F. Supp. 106 (W.D. Ky. 1965).

the land was thirty dollars per acre, the residual value of the surface would be \$1,800, the amount allocated at thirty dollars per acre to the surface not destroyed by mining. This would be subtracted from the total purchase price of \$10,000 to yield the cost of the surface rights that would be destroyed by mining that should be added to the depletable basis of the coal.<sup>169</sup> The court of appeals held that the taxpayer was entitled to use an equitable apportionment method, reversing the district court which had allocated the cost ratably. It remanded the case for proceedings to establish the proportionate cost of each portion of land destroyed by mining. On remand the method of apportionment in the example was applied.<sup>170</sup>

The regulations provide that depletable basis does not include the residual value of land and improvements at the end of operations.<sup>171</sup> Present laws governing surface mining require restoration of the surface<sup>172</sup> and, therefore, there will be a residual value of the surface at the end of operations. This residual value, however, is created by expenditures incurred by the operator to restore the surface property. In *Denise Coal Co. v. Commissioner*<sup>173</sup> the Tax Court relying on *Manchester Coal Co.*, held that the taxpayer could add the cost of the surface to the cost of the coal to determine depletable basis, despite the obligation, secured by a bond, to backfill and plant trees, shrubs, or grass. The court did not discuss the residual value of the land, but in its fact findings, the court found that the land would not be usable for agricultural purposes for at least four to eight years after restoration, and if trees were planted, they would have no value until after a substantial number of years had passed.

A second issue in *Denise Coal Co. v. Commissioner* concerned the taxpayer's claim that it could accrue, as a deductible expense, the estimated cost of reclaiming the surface attributable to the coal extracted each year. The Tax Court rejected this argument because the taxpayer had neither restored the surface itself, nor had entered into any contract for restoration giving rise to an obligation to a third party. The obligation to the State of Pennsylvania to restore the surface was not sufficient to support a deduction because it was *in futuro*. Therefore, the deduction was disallowed even though the court acknowledged that the creation of a book reserve for the future expense was a prudent accounting practice.

The Third Circuit reversed the Tax Court on this point and allowed the reserve based on sound accounting principles and, therefore, good tax law. The court distinguished the cases on which the Tax Court relied as cases in which

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<sup>169</sup> *Id.* at 415-16.

<sup>170</sup> 70-2 USTC ¶ 9661 (W.D. Ky. 1970).

<sup>171</sup> Treas. Reg. § 1.612-1(b)(1)(ii) (1960).

<sup>172</sup> See Surface Mining Control and Reclamation Act of 1977, Pub. L. No. 95-87, 91 Stat. 445 (codified at 30 U.S.C. §§ 1201-1328) (Supp. II 1978 & Supp. IV 1980).

<sup>173</sup> 29 T.C. 528 (1957), *aff'd in part, rev'd in part*, 271 F.2d 930 (3d Cir. 1959). It is worth noting that the taxpayer was seeking an immediate loss deduction under the predecessor of I.R.C. § 165(a) for the value of the surface destroyed. The taxpayer's depletion deduction was computed under I.R.C. § 613 not I.R.C. § 611 and I.R.C. § 612, and the addition of the cost basis for the surface to the basis of the coal did not affect the amount of the percentage depletion claimed.

the estimates were not reasonable.<sup>174</sup> The Third Circuit affirmed the Tax Court on the issue of including the basis of the surface in the depletable basis of the mineral property and the concomitant denial of a loss deduction.

A similar result was reached in *Harrold v. Commissioner*,<sup>175</sup> in which the Fourth Circuit allowed the deduction by an accrual basis taxpayer of reasonable estimates for restoring the surface, reversing a Tax Court decision disallowing the deduction.

Recently, in *Ohio River Collieries Co. v. Commissioner*,<sup>176</sup> the Tax Court distinguished its earlier decisions, such as *Denise Coal Co.*, in which it had disallowed the deduction of an accrued reserve for reclamation expenses, and allowed the deduction. The court found that Ohio River Collieries Company satisfied the requirement that the estimated expense had been determined with reasonable accuracy. On the issue of the existence of liability, the court reversed its prior position in *Denise Coal Co.* and *Harrold v. Commissioner* and held that the event of strip mining gave rise to the measure of cost. Since the liability arose upon the mining and the amount was estimated with reasonable accuracy, the reserve was deductible.

This result may be inconsistent with the Supreme Court's decisions in the *Automobile Club*<sup>177</sup> cases and *Schlude v. Commissioner*,<sup>178</sup> disallowing reserve accounting methods in other industries. The IRS continues to rule that the accrued deduction for the reserve is not allowable.<sup>179</sup> Some cases involving deductions for other types of future liabilities, however, have allowed deductions for reserve accruals where the event fixing liability had occurred and the amount of the liability could be determined with reasonable certainty.<sup>180</sup> These later cases allowing the deduction for reserve accruals distinguish the *Automobile Club* cases because they involved attempts to accrue a reserve for the cost of providing services where the obligation was speculative. This logic is persuasive, and as to the timing issue, the cases allowing the accrual of the deduction

<sup>174</sup> See *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir.), cert. denied, 348 U.S. 828 (1954); *Jenkins v. Commissioner*, 13 T.C.M. 61 (1954), aff'd per curiam, 217 F.2d 951 (3d Cir. 1955); *Patsch v. Commissioner*, 19 T.C. 189 (1952), aff'd, 208 F.2d 532 (3d Cir. 1953).

<sup>175</sup> 192 F.2d 1002 (4th Cir. 1951), rev'g 16 T.C. 134 (1951).

<sup>176</sup> 77 T.C. 13369 (1981).

<sup>177</sup> *Automobile Club v. Commissioner*, 353 U.S. 180 (1957); *American Automobile Ass'n. v. United States*, 367 U.S. 687 (1961).

<sup>178</sup> 372 U.S. 128 (1963).

<sup>179</sup> Private Letter Ruling 7831003.

<sup>180</sup> See, e.g., *Wien Consolidated Airlines, Inc. v. Commissioner*, 528 F.2d 735 (9th Cir. 1976) (self insurer allowed deduction for accrued reserve for workman's compensation payments to be made to minor children of employees who had been killed in the course of employment); *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772 (9th Cir. 1975) (same, except reserve included amounts due to employees who had been injured). *Lukens Steel Co. v. Commissioner*, 442 F.2d 1131 (3d Cir. 1971) (allowing deduction for amounts credited to fund for benefit of employees where existence of a liability was fixed but time of payment and identity of payees were not yet determined). *Compare Gateway Transp. Co. v. United States*, 39 A.F.T.R. 2d 77-647 (W.D. Wis. 1976) (deduction for accruals to reserve for common carrier's liability to shipper's for damage to goods disallowed on grounds that some claims in pool would be disallowed; *Crescent Wharf* distinguished).

of a reserve for reclamation expenses appear to be correctly decided.

There is, however, a different problem with allowing an accrued deduction for reclamation expenses. It is possible that neither the taxpayers, the Commissioner, nor the respective courts have addressed this crucial issue. An ordinary deduction for reclamation expenses may not be the theoretically correct result. First, because for cost depletion purposes the value of the surface destroyed by strip mining is considered part of the depletable basis of the coal,<sup>181</sup> the cost of restoring the surface may be properly described as a capital expenditure to obtain the new surface. Thus, contrary to the result in *Denise Coal Company*, an operator who owned the surface rights in fee should be required to capitalize the reclamation expenditures up to an amount equal to the fair market value of the surface after reclamation.<sup>182</sup> Alternatively, if a deduction is allowed, since the surface is to be restored by reclamation expenses, none of the surface basis should be allocated to the depletable basis of the coal deposit. Concomitantly, no portion of the reclamation expenses would be allocated to the basis of the reclaimed surface; its basis would be the basis of the original surface.<sup>183</sup> Although this latter rule may be administratively convenient, it is not theoretically correct and the Third Circuit in *Denise Coal Company* failed to consider the logical inconsistency of allocating surface basis to the depletable basis of the coal deposit *and* allowing deduction of the full amount of the reclamation expenses.

Proper characterization of the expense in excess of the amount, if any, allocated to the basis of the new surface, which is all of the reclamation expenses in the case of an operator who will not own the reclaimed surface, presents an even more difficult question. On one hand, the amount might be characterized simply as an additional cost of acquiring the coal, analogous to a premium value attached to surface rights overlying coal.<sup>184</sup> Viewed as such the amount would be added to the depletable basis of the coal, and any tax benefit of a deduction would be lost to the extent that the taxpayer claimed percentage depletion rather than cost depletion.<sup>185</sup> On the other hand, the excess reclamation costs might be viewed as the reverse of stripping the overburden.

Since the surface fee owner operator already owns the surface, any pre-

<sup>181</sup> *Beaver Dam Coal Co. v. United States*, 370 F.2d 414 (6th Cir. 1966); *Manchester Coal Co. v. Commissioner*, 24 B.T.A. 577 (1931), *nonacq.*, XI-1 C.B. 10.

<sup>182</sup> *Cf.* Treas. Reg. § 1.612-1(b)(1)(ii) (1960) (depletable basis does not include the residual value of land and improvements remaining after mining). Alternatively, under a tax benefit type analysis the operator might be required to capitalize only an amount equal to the original surface basis properly allocated to the depletable basis of the coal for cost depletion purposes.

<sup>183</sup> This would also have the administrative virtue of eliminating the need to resolve in every case the factual issue of the value of the surface to be created. This would be particularly difficult since the amount to be accrued as a cost of the surface will frequently be accrued in a year prior to the actual reclamation and thus the proper accrual would require an estimate of what the value of the surface *will be* when created.

<sup>184</sup> *See* *Beaver Dam Coal Co. v. United States*, 370 F.2d 414 (6th Cir. 1966), *rev'g*, 237 F. Supp. 106 (W.D. Ky. 1965).

<sup>185</sup> Regardless whether the taxpayer claims cost or percentage depletion in any given year, the basis of the surface destroyed by strip mining should be allocated to the depletable basis of the coal under I.R.C. § 612.

mium value should already be reflected in the portion of the surface basis allocated to the coal deposit. The operator who does not own the fee presumably is paying to the surface owner an amount reflecting the full value of use of the surface as a surface overlying a coal deposit. Therefore, treating the reclamation expenses as premium cost for the surface rights that should be allocated to the depletable basis of the coal deposit should be rejected. Rather, the reclamation expenses not capitalized as the basis of the reclaimed surface should be analogized to removal of overburden. Based on this analogy, the expenses would appear to be deductible, since the removal of overburden enters into the cost of goods sold.<sup>186</sup> It is worth noting, however, that this result may, nevertheless, be theoretically improper. If depletable basis is analogous to cost of goods sold, both removal of overburden and reclamation expenses should be capitalized as part of the depletable basis of the coal deposit. However, since removal of overburden is currently not capitalized, for the sake of consistency, it may be appropriate to allow similar treatment for reclamation expenses in excess of the fair market value of the residual surface.

Further consideration should be given to additional factors, however before settling on the treatment of reclamation expenses not in excess of the fair market value of the surface owned by the taxpayer and which was created by the expenditures. If the operator who does not own the surface is permitted to expense the entire reclamation expense, but the surface owner operator is required to allocate a portion of the reclamation expenses to the acquisition of the fee to the surface, the taxable income of the former under section 63 will be less than that of the latter, even though they both incur identical expenses and have identical gross income from mining. This occurs because a surface fee owner claiming percentage depletion, receives no tax benefit in the form of a deduction of the basis of the destroyed surface originally allocated to the depletable basis of the coal, and has been denied a deduction for the expenditure that in effect restores that basis in the surface. However, if the entire reclamation expenses are deducted, but none of the basis of the surface is allocated to the depletable basis of the coal, both operators will have the same taxable income. However, under this rule the surface owner-operator will have a basis remaining in his surface that properly should have been consumed by the depletion allowance deductions.

This suggested rule—permitting a deduction of the full reclamation expenses even if the taxpayer acquires a valuable surface as a result—appears initially to be a fair remedy to an apparently harsh result of a rule requiring capitalization of the expenses to the extent that they are attributable to the fair market value of the reclaimed surface. That seemingly harsh treatment, however, is the proper result, mandated by the nature of the depletion allowance deduction as an alternative to cost depletion. The fundamental nature of the relationship between percentage and cost depletion always results in the appearance of denial of effective tax recovery of the depletable basis of coal when percentage depletion is claimed. It is not, however, truly a denial of re-

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<sup>186</sup> See Rev. Rul. 77-308, 1977-2 C.B. 208 (cost of removing overburden in surface coal mine operation is an operating cost).

covery, but it can give rise to discriminatory effects between two taxpayers, one of whom acquires rights by an expenditure that is deductible or excludable and the other of whom acquires those rights by an expenditure that must be capitalized.<sup>187</sup> Thus, to the extent that the reclamation expenses give rise to a valuable surface, it is difficult to justify allowing a current deduction.

Notwithstanding the preceding analysis, at the present time it appears that all operators may enjoy a deduction for reclamation expenses. The IRS does not seem ready to accept that any portion of the reclamation expenditures are properly capital expenditures that should be allocated to the surface fee, and *Denise Coal Company* apparently permits both allocation of basis of the surface to the depletable basis of the coal deposit and a deduction for the full amount of reclamation expenses. If reclamation costs are expensed, however, they should not generate any additional basis in the surface.<sup>188</sup> Since the basis of the originally destroyed surface has been allocated to the depletable basis of the coal, even if percentage depletion was claimed, the basis of the new surface should be zero. Upon a subsequent sale, therefore, the full amount of the sale proceeds should be included in income. This gives rise not only to a timing distortion, which *Denise Coal Company* ignores, but raises the more serious problem of whether the gain on the subsequent sale should be ordinary income or capital gain.

Even though the land is a section 1231 asset, it would appear that the proper result would be to treat the gain as ordinary income up to an amount equal to the original basis of the surface that was properly allocable to the depletable basis of the coal. Only gain in excess of that amount should be treated as section 1231 gain. This would be consistent with the application of the tax benefit rule,<sup>189</sup> which is a "necessary concomitant of the annual accounting system, to prevent a deduction for a nonexistent cost, contribution or expenditure."<sup>190</sup> However, if an analogy is drawn to section 1245 recapture, ordinary income is generated by the sale of depreciated real property only if the cost was recovered under the accelerated method of I.R.C. § 168(a)(2)(A).<sup>191</sup> Since the expenditure in issue is one that has been expensed under I.R.C. § 162, when it more properly should have been capitalized under I.R.C. § 263, the tax benefit rule analogy is more appropriate, and the subsequent sale of the surface should generate ordinary income to the extent the sales price does not exceed the original basis. However, just as with the capitalization of reclamation expenses as an additional cost of the coal, there is no indication that the Commissioner has yet pursued this line of reasoning.

Unlike the expense of acquiring a surface to be destroyed by strip mining,

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<sup>187</sup> See McMahon, *Defining the "Economic Interest" in Minerals After United States v. Swank*, 70 Ky. L.J. 23, 84-87 (1982).

<sup>188</sup> See *Tennessee-Carolina Transp. Co. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979) (tires expensed by trucking company had zero basis).

<sup>189</sup> See *Hillsboro Nat'l Bank v. Commissioner*, 103 S. Ct. 1134 (1983); 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 5.7.1-5.7.2 (1981).

<sup>190</sup> Feld, *The Tax Benefit of Bliss*, 62 B.U.L. REV. 443, 450 (1982).

<sup>191</sup> I.R.C. § 1245(a)(5) (1981). There are some exceptions to this rule.

none of the cost of acquiring surface areas to be used to service the mine that do not overly a coal deposit to be strip mined may be allocated to the depletable basis of the coal. Thus, the cost of acquiring land to be used for a dumping area is not added to the depletable cost basis of the coal deposit benefited.<sup>192</sup> A loss deduction may not be taken for diminution in value of such lands as a result of such mining.<sup>193</sup> Any diminution in the value of such land will be deductible as a loss only upon the subsequent sale of the land at a loss.

Where mineral rights are acquired by lease, the cost of the lease is the basis for cost depletion. A lease bonus paid by the lessee is a capital investment in the lease, the cost of which is recovered through depletion.<sup>194</sup> Since lessees typically compute the depletion allowance under I.R.C. § 613, the cost is usually never recovered. But when the lessee pays nothing for the lease, only promising to pay royalties, there is no basis for depletion.<sup>195</sup> Royalties paid to a lessor are not capital expenditures giving rise to basis in the lease.<sup>196</sup> Advance royalties similarly are not capital expenditures, but are instead deducted from gross income from the property in the subsequent year to which they relate.<sup>197</sup>

Payments received for options have been characterized as analogous to lease bonus,<sup>198</sup> and option payments should therefore be included by the payor in the depletable cost basis of the mineral property. This applies both for options to acquire a fee and options to acquire a lease.

Delay rentals are analogous to option payments, but may be deducted currently by the lessee. Therefore, they are not added to the depletable basis of the coal deposit. If, however, the lessee elects to capitalize the delay rental under I.R.C. § 266, the payment will be added to the depletable basis in the lease.<sup>199</sup> The election may be made separately for each year delay rentals are paid for a lease of mineral property, and it may be made for some leases held by the taxpayer, but not for others.<sup>200</sup>

<sup>192</sup> Rev. Rul. 74-282, 1974-1 C.B. 150 (requiring capitalizing and delaying loss recognition until subsequent sale, but allowing depreciation of premium paid due to preexisting pit into which overburden would be dumped); *see also* *Sexton v. Commissioner*, 42 T.C. 1094 (1964), *acq. in result only*, 1970-1 C.B. xvi (taxpayer in rubbish removal business permitted to depreciate premium paid for land with pits into which rubbish could be dumped); *Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965) (per curiam) (treating as deductible expense cost of easement for dumping area).

<sup>193</sup> *Denise Coal Co. v. Commissioner*, 29 T.C. 528, *aff'd on this point*, 271 F.2d 930 (3d Cir. 1959).

<sup>194</sup> Treas. Reg. § 1.612-3(a)(3) (1977).

<sup>195</sup> *E.M.T. Coal Co. v. Commissioner*, 13 B.T.A. 124 (1928); *Marsh Fork Coal Co.*, 11 B.T.A. 685 (1928).

<sup>196</sup> *E.M.T. Coal Co. v. Commissioner*, 13 B.T.A. 124 (1928); *Leechburg Mining Co. v. Commissioner*, 15 T.C. 22 (1950) (royalties paid are excluded from gross income of lessee); Rev. Rul. 68-361, 1968-2 C.B. 264.

<sup>197</sup> Treas. Reg. § 1.612-3(b)(3) (1977).

<sup>198</sup> *Commissioner v. Pickard*, 401 F.2d 615 (10th Cir. 1968).

<sup>199</sup> Treas. Reg. § 1.612-3(c) (1977); *see also* Treas. Reg. § 1.266-1(b) (1960) (other carrying charges that may be capitalized); § 1.266-1(c) (1960) (method of electing to capitalize items under I.R.C. § 266).

<sup>200</sup> Treas. Reg. § 1.612-3(c) (1977); Rev. Rul. 80-49, 1980-1 C.B. 127.



Similarly, the owner of an unproductive mineral property may elect to capitalize interest, real estate taxes and other carrying charges and add them to the depletable basis of the property under I.R.C. § 266. However, because otherwise deductible expenses capitalized under I.R.C. § 266 are never recovered as deductible items if the taxpayer subsequently utilizes percentage depletion, such an election is rarely advantageous for a lessee. It is also rarely advantageous for an owner of the fee claiming cost depletion because the deduction is deferred.

The depletable cost basis of the coal deposit does not include amounts recoverable through depreciation deductions or deferred expenses deductions.<sup>201</sup> Therefore, development expenses subject to I.R.C. § 616, although capitalized in the event of an election under subsection (b), are not included in the depletable basis,<sup>202</sup> and all expenses for machinery and equipment, structures, tipples, railroad sidings and other supporting structures, such as fan houses, powder houses, and transformers are capitalized and the cost is recovered under I.R.C. § 168 (Accelerated Cost Recovery System) (ACRS). If such expenditures are necessary to maintain the normal output of the mine solely because of the recession of the working faces of the mine, they are expensed.<sup>203</sup>

Expenses incurred to drive shafts, tunnels and galleries in preparation for deep mining are development expenditures deductible under I.R.C. § 616,<sup>204</sup> and are not capitalized as part of the depletable basis. The analogous expenses of a strip mine, the cost of removing overburden<sup>205</sup> and of cutting benches,<sup>206</sup> also are not capitalized. Similarly, roads providing access to a coal mine have been held to be development expenses subject to I.R.C. § 616, even though the roads would also be used in the production stage.<sup>207</sup> Roads constructed on land owned in fee and on leased land have been treated identically.

The cost of roads providing access to a mine are deductible as development expenses because the expense would be depletable rather than depreciable absent I.R.C. § 616.<sup>208</sup> Therefore, the cost of roads constructed during the production stage must be capitalized as part of the depletable basis of the coal. Presumably the expense of acquiring an easement on which to construct the road would be accorded the same treatment. This rule would not seem to apply, however, to the cost of an easement and road used to service the mine but

<sup>201</sup> Treas. Reg. §§ 1.612-1(b)(1)(i) (1960); 1.612-2(a) (1960).

<sup>202</sup> I.R.C. § 616(c) (1976).

<sup>203</sup> Treas. Reg. § 1.612-2(a) (1960).

<sup>204</sup> Rev. Rul. 67-35, 1967-1 C.B. 159.

<sup>205</sup> Rev. Rul. 67-169, 1967-1 C.B. 159 (limestone deposit; removing overburden is not a development expense because it does not benefit the deposit generally, but only a particular increment of the deposit); Rev. Rul. 77-308, 1977-2 C.B. 208, 209-10 (coal deposit; costs of stripping overburden described as "operating costs").

<sup>206</sup> *National Lead Co. v. Commissioner*, 23 T.C. 988 (1955), *rev'd on other grounds*, 230 F.2d 161 (2d Cir. 1956); *aff'd on other grounds*, 352 U.S. 313 (1957).

<sup>207</sup> *Amherst Coal Co. v. United States*, 295 F. Supp. 421 (S.D. W. Va. 1969), *aff'd per curiam*, 27 A.F.T.R.2d (P-H) ¶ 71-358 (4th Cir. 1971).

<sup>208</sup> *Id.*

not part of the mine itself.<sup>209</sup> Such expenditures should be capitalized and the cost recovered under I.R.C. § 167 in the case of easements purchased for a specific price and under I.R.C. § 168 for roads.<sup>210</sup> Nevertheless, the Court of Claims has held that the cost of acquiring an easement over adjacent lands necessitated by the expansion of a surface mine need not be capitalized and added to the depletable basis of the coal deposit but may be deducted under the receding working face doctrine.<sup>211</sup> The Tax Court and Sixth Circuit, however, in *Geoghegan & Mathis, Inc. v. Commissioner*,<sup>212</sup> have followed the view of the IRS requiring capitalization of such expenditures as an addition to the depletable basis of the mineral deposit.

Particularly difficult problems of determining the depletable basis of a coal deposit arise when an operating coal mining enterprise is purchased. The cost must be allocated among all of the acquired assets, including the depletable basis of the mineral deposit, the depreciable basis of the mineral deposit, the depreciable basis of tangible property such as machinery or equipment, and property that is neither depletable nor depreciable such as surface rights, easements and goodwill.<sup>213</sup> Under the regulations when an entire mining enterprise is acquired, the cost basis of the interest in the mineral deposit is the proportion of the total cost of the enterprise that bears the same relationship to the total cost which the value of the interest in the mineral deposit bears to the total value of the enterprise at the time of its acquisition.<sup>214</sup> The value of the mineral deposit is ordinarily based upon comparative values, considering the conditions and circumstances known at the time of the acquisition. But if neither comparative value nor any other reasonable method—such as cost, or, in the case of equipment, replacement value—can be used, then analytical appraisal methods, such as the present value method may be used.<sup>215</sup> The regulations provide detailed rules regarding the factors to be considered in valuing

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<sup>209</sup> See *Denise Coal Co. v. Commissioner*, 29 T.C. 528, *aff'd*, 271 F.2d 930 (3d Cir. 1959); Rev. Rul. 74-282, 1974-1 C.B.

<sup>210</sup> Expenditures incurred during the operating stage to acquire an easement over which coal will be removed from the mine should be capitalized and depreciated over the life of the mine. See, e.g., *Panhandle Eastern Pipeline Co. v. United States*, 408 F.2d 690 (Ct. Cl. 1960) (easement depreciable over life of related pipeline). As intangible property the easement is not subject to ACRS under section 168. The depreciation expense would then be considered a transportation expense. Wheelage paid currently would be currently deductible or, in some instances, excluded from gross income under the doctrine of *Southwest Exploration Corp.* See *supra* notes 42, 49 and accompanying text. The cost of any road constructed over the easement should be recovered over the period of easement (taking into account the principles of § 178) or fifteen years, whichever is less, *cf.* I.R.C. § 168(f)(6) (dealing with leasehold improvements); Rev. Rule. 68-281, 1968-1 C.B. 22 (Situation 5) (logging road depreciable over term of timber contract), unless the taxpayer elects to depreciate the road under a method described in I.R.C. § 168(e)(2).

<sup>211</sup> *Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965) (per curiam); *Cushing Stone Co. v. United States*, 535 F.2d 27 (Ct. Cl. 1976).

<sup>212</sup> 55 T.C. 672 (1971), *aff'd*, 453 F.2d 1324 (6th Cir. 1972), *cert. denied*, 409 U.S. 842 (1972) (holding that the expense of relocating an easement held by a power company across the surface over the deposit was neither a development expense nor deductible under the working face doctrine).

<sup>213</sup> E.g., *Copperhead Coal Co. v. Commissioner*, 272 F.2d 45 (6th Cir. 1959).

<sup>214</sup> Treas. Reg. § 1.611-1(d)(4) (1971); Rev. Rul. 69-539, 1969-2 C.B. 141.

<sup>215</sup> Treas. Reg. § 1.611-2(d), (e) (1972).

mineral property by the present value method.

If the interest in the mineral deposit is represented by a lease, then the lease itself must be valued. Since a lessee generally claims percentage depletion, it is to his advantage to minimize the value attributed to the lease. In two separate cases entitled *Island Creek Coal Co. v. Commissioner*,<sup>216</sup> which involved separate but similar acquisitions, the taxpayer argued that the leases themselves had no value aside from nominal consideration ascribed to them in the purchase contract. In both cases the taxpayer argued that the tangible assets acquired in the transaction had a fair market value equal to or in excess of the purchase price. Additionally, it was argued that the coal subject to the leases was worth no more than the royalties payable under the leases. The Tax Court agreed with the taxpayer in both cases concluding that the tangible property had a fair market value at least equal to the purchase price and that the leases had no value because the coal was worth no more than the royalty obligations.

In Revenue Ruling 69-539, however, specifically responding to the *Island Creek Coal Co.* cases, the IRS held that, "[o]nly in rare and extraordinary circumstances will a taxpayer acquire a going enterprise in which the mineral leases have no value apart from the royalty that they specify for the lessor."<sup>217</sup> Even though the depreciable assets may have a value equal to the purchase price, it will not be presumed that the lease has no value. Accordingly, the lease should be valued and a basis allocated to it under the method prescribed by the regulations discussed above. The Ruling cites numerous cases in which the court held a lease to have value above the royalties paid.<sup>218</sup> Nevertheless, the issue remains one of fact. Although the result in the *Island Creek Coal Co.* cases is supported by an affirmative fact finding that the leases had no value based on a comparison of the value of the coal and the royalties paid, this is not the sole determinative factor in valuing a mineral lease. Utilizing the standards specified in the regulations requires that consideration be given to the earning capacity of the enterprise operating the lease, after the purchase based on the conditions and circumstances known at the time of the purchase.<sup>219</sup>

### C. *Exploration Expenses*

I.R.C. § 617(a) allows the taxpayer to elect to currently deduct exploration expenditures incurred before the development stage of the mine is reached. Any such expenditures not deducted pursuant to a valid election must be capi-

<sup>216</sup> 21 T.C.M. (P-H) ¶ 727 (1962); 25 T.C.M. (P-H) ¶ 540 (1966).

<sup>217</sup> 1969-2 C.B. 140.

<sup>218</sup> *E.g.*, *Lynch v. Alworth Stephens Co.*, 267 U.S. 364 (1925); *Marsh Fork Coal Co. v. Commissioner*, 11 B.T.A. 685 (1928), *acq.*, VII-1 C.B. 29, *rev'd on other grounds*, 42 F.2d 83 (1930); *Milby & Dow Coal & Mining Co. v. Commissioner*, 24 B.T.A. 40 (1931), *acq.*, 12-1 C.B. 8.

<sup>219</sup> *See, e.g.*, *Taylor v. Commissioner*, 9 B.T.A. 442 (1927) (finding lease had 1913 value based on net operating profits reasonably expected notwithstanding no finding of royalty at less than prevailing rate); *see also Seneca Coal Mining Co. v. Commissioner*, 2 B.T.A. 513 (1925) (using analytical method to discount earnings to present value as of March 1, 1913).

talized and recovered through depletion.<sup>220</sup>

If the taxpayer has deducted exploration expenditures pursuant to a valid section 617 election, when the mine reaches the producing stage, the deducted exploration expenditures are recaptured under one of two methods. The taxpayer may affirmatively elect to include the amount of the previously deducted expenditures (termed adjusted exploration expenditures) in income for the year in which the mine reaches the producing stage.<sup>221</sup> If the taxpayer so elects, the amount of the adjusted exploration expenditures will be added to the depletable basis of the coal deposit.<sup>222</sup>

Alternatively, if no such election has been made, any depletion deduction otherwise allowable with respect to the mine will be disallowed until the cumulative amount of the disallowed depletion deductions attributable to the mine equals the adjusted exploration expenditures subject to recapture.<sup>223</sup> Under this method of recapture, since the depletable basis of the property has not been increased by the exploration expenditures, the basis of the property is not reduced by the amount of the depletion allowance that has been disallowed.<sup>224</sup> Generally, this alternative is preferable because it defers the incidence of tax. While the first alternative results in increased depletion deductions, it requires an earlier inclusion in income of an amount equal to the aggregate value of the future cost depletion deductions attributable to the basis acquired as a result of the inclusion, without any discounting factor. While this may be desirable if the taxpayer has large losses in the recapture year, the second alternative defers the impact of the recapture and spreads it over several years.<sup>225</sup>

#### IV. PERCENTAGE DEPLETION

##### A. General Rules of Computation

Under I.R.C. § 613 the percentage depletion deduction for coal is equal to ten percent of the taxpayer's gross income from the property.<sup>226</sup> For purposes of computing percentage depletion (and for purposes of I.R.C. § 61) gross income from the property does not include any rents or royalties paid to a lessor.<sup>227</sup> Percentage depletion may not exceed fifty percent of the taxpayer's taxable income from the property (computed without reference to either cost or percentage depletion).<sup>228</sup> If the percentage depletion allowance is less than the cost depletion allowance computed under I.R.C. § 611, a cost depletion deduc-

<sup>220</sup> See Rev. Rul. 77-188, 1977-1 C.B. 76.

<sup>221</sup> I.R.C. § 617(b)(1)(A) (1982). Any such election must cover all mines reaching the producing stage during the year and with respect to which exploration expenditures had been deducted. Treas. Reg. § 1.617-3(a)(2) (1972).

<sup>222</sup> *Id.*

<sup>223</sup> I.R.C. § 617(b)(1)(B), (f)(1) (1976); Treas. Reg. §§ 1.617-3(a)(1)(i), 1.617-3(d) (1972).

<sup>224</sup> I.R.C. § 617(e)(1) (1976); Treas. Reg. § 1.617-3(d)(ii) (1972).

<sup>225</sup> See Treas. Reg. § 1.617-3(a)(1)(i) (1972) (regarding treatment of aggregated properties).

<sup>226</sup> I.R.C. §§ 613(a) (1982), (b)(4) (1972); Treas. Reg. §§ 1.613-1, 1.613-2(a)(1)(iv) (1972).

<sup>227</sup> I.R.C. § 613(a) (1981).

<sup>228</sup> I.R.C. § 613(a) (1981); Treas. Reg. § 1.613-1 (1972).

tion will be taken for the year.<sup>229</sup>

Both cost depletion and percentage depletion require a reduction in the basis of the property at the end of the year. However, even after the depletable basis of the property has been reduced to zero, only percentage depletion is available.<sup>230</sup> In years in which the taxpayer incurs a net operating loss with respect to the property no percentage depletion deduction is allowed. Also both cost depletion and percentage depletion deductions may be reduced as a result of recapture of previously deducted exploration expenses under I.R.C. § 617(b)(1)(B).

I.R.C. § 291(a)(2) requires corporate taxpayers to reduce their percentage depletion deduction otherwise allowable for the taxable year, by fifteen percent of the amount by which the percentage depletion allowance computed under I.R.C. § 613 exceeds the adjusted basis of the property at the close of the year, before the reduction in basis required as a result of claiming the depletion allowance.<sup>231</sup> Thus, after the basis of the property has been reduced to zero, assuming there are no further capital expenditures affecting the basis in the property, the percentage depletion deduction is effectively reduced to eight and one-half percent. This provision does not, however, affect individuals, partnerships and Subchapter-S corporations.

There appears to be a lack of coordination between the disallowance of the otherwise allowable depletion deduction mandated by I.R.C. § 617(b)(1)(B), relating to recapture of previously deducted exploration expenditures, and the reduction of the depletion deduction mandated by I.R.C. § 291(a)(2). If the disallowance under § 617(b)(1)(B) is taken into account first, but the entire depletion deduction for the year is not disallowed, and the reduction under I.R.C. § 291(a)(2) is then applied to the depletion allowance as first reduced under I.R.C. § 617(b)(1)(B), the net allowable deduction is greater than it would be if the I.R.C. § 291(a)(2) reduction is computed with respect to the depletion deduction otherwise allowable under I.R.C. § 613 without regard to the disallowance under I.R.C. § 617(b)(1)(B). Although this must ultimately be resolved by regulations, the intent of I.R.C. § 291(a)(2) was to effectively reduce the percentage depletion allowance to eight and one-half percent from ten percent after the taxpayer's basis had been recovered.<sup>232</sup> Therefore, the reduction under I.R.C. § 291(a)(2) should be applied prior to the disallowance under I.R.C. § 617(b)(1)(B).

Percentage depletion is computed separately for each "property" determined under I.R.C. § 614.<sup>233</sup> The deduction must be separately computed for each property, unless properties have been properly aggregated. This requires individual computations of both gross income and taxable income from each property.

<sup>229</sup> *Id.*

<sup>230</sup> Treas. Reg. § 1.611-2(b) (1972).

<sup>231</sup> See I.R.C. §§ 291(a)(2), (e)(2) (Supp. Dec. 1982).

<sup>232</sup> Compare S. REP. No. 494, 97th Cong., 2d Sess., 73-119 (1982) with H.R. REP. No. 760, 97th Cong., 2d Sess., 478-79 (1982).

<sup>233</sup> Treas. Reg. §§ 1.613-1(a) (1972), 1.611-1(d)(1)(i) (1973).

The percentage depletion deduction is properly taken in the year the coal is sold, not in the year that it was produced.<sup>234</sup> This is based on the theory that depletion follows income. For an accrual basis taxpayer, the proper year of accrual of the income from the sale of coal will determine the year of the depletion deduction for the coal.<sup>235</sup> Accordingly, even if nonmining processes are applied to the coal, requiring that the depletion deduction be computed by reference to the representative market or field price<sup>236</sup> or proportional profits method,<sup>237</sup> rather than the sales price of the processed coal, the proper year for claiming the deduction is the year of sale.<sup>238</sup>

Income and depletion from the extraction and sale of coal should be computed on the accrual basis and not on the cash basis.<sup>239</sup> In those few instances when the holder of a coal royalty with an economic interest is not subject to I.R.C. § 631(c) and is on the cash method of accounting, the proper year for deducting depletion is the year of receipt of the royalty payment.<sup>240</sup> This includes the following: holders of a royalty interest granted in consideration of surface rights,<sup>241</sup> holders of a royalty granted as a commission for negotiating the acquisition of the coal property on which the royalty is based,<sup>242</sup> royalties received by a lessor who does not meet the holding period requirement of I.R.C. § 631(c), and royalties received in exchange for granting an option.<sup>243</sup>

#### B. *Exclusion of Rents or Royalties Paid in Respect of the Property*

The purpose of excluding rents and royalties paid by the taxpayer with respect to the property from gross income received from the property is to prevent two different taxpayers from claiming depletion for the same income.<sup>244</sup> In most extractive industries, royalties received by a lessor are generally subject to depletion by the lessor.<sup>245</sup> However, for coal, the lessor receives

<sup>234</sup> Rev. Rul. 76-533, 1976-2 C.B. 189 (allowing percentage depletion for oil in year of sale rather than year of production and transfer to a storage tank).

<sup>235</sup> See Rev. Rul. 68-565, 1968-2 C.B. 189 (accrual basis lessor not subject to I.R.C. § 631(c) claims depletion deduction in year right to royalties accrues); Rev. Rul. 76-533, 1976-2 C.B. 189 (oil producer claims depletion deduction in year sale results in income under Treas. Reg. § 1.446-1(c)(1)(ii)); *Inspiration Consolidated Copper Co. v. Commissioner*, 11 B.T.A. 1425 (1928).

<sup>236</sup> See Treas. Reg. § 1.613-4(c) (1972).

<sup>237</sup> See Treas. Reg. § 1.613-4(d) (1972).

<sup>238</sup> Rev. Rul. 76-533, 1976-2 C.B. 189 (requiring percentage depletion of oil in year of sale and denying taxpayer's deduction in year of transportation from the property for storage based on Treas. Reg. § 1.613-3(a) (1981)).

<sup>239</sup> Treas. Reg. § 1.471-1 (1960) requires the use of inventories whenever the production or sale of merchandise is an income producing factor and Treas. Reg. § 1.446-1(c)(2)(i) (1973) requires that inventories be computed under the accrual method of accounting.

<sup>240</sup> Rev. Rul. 68-565, 1968-2 C.B. 263.

<sup>241</sup> *Omer v. United States*, 329 F.2d 393 (6th Cir. 1964) (royalty for surface rights); *Martin v. United States*, 409 F.2d 13 (6th Cir. 1969) (same); Rev. Rul. 79-144, 1979-1 C.B. 219.

<sup>242</sup> See *Cline v. Commissioner*, 67 T.C. 889 (1977), *aff'd*, 617 F.2d 192 (6th Cir. 1980) (taxpayer negotiated coal leases as an agent for principal receiving as consideration a royalty on all coal produced and sold from the leased premises); Rev. Rul. 77-84, 1977-1 C.B. 173 (same).

<sup>243</sup> Rev. Rul. 73-80, 1973-1 C.B. 308.

<sup>244</sup> See *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312 (1934).

<sup>245</sup> See, e.g., *Burnet v. Harmel*, 287 U.S. 103 (1932); *Palmer v. Bender*, 287 U.S. 551 (1933);

section 1231 treatment under I.R.C. § 631(c). This preferential treatment serves the same function as percentage depletion, while simultaneously allowing the benefits of cost depletion.<sup>246</sup> Therefore, it is appropriate to exclude from a lessee's gross income royalties paid to a lessor subject to § 631(c).<sup>247</sup> Since the holder of a net profits royalty may deplete only the actual net amount payable to him,<sup>248</sup> the lessee must exclude only that net amount from gross income from the property, and not the higher gross sales necessary to generate, after deductions, the net profit royalty.

Advanced royalties paid with respect to a coal property are excluded from gross income not in the year of payment or accrual, but in the year of sale of the coal to which the royalties relate.<sup>249</sup> Advanced royalties paid under a minimum royalty provision are treated in the same manner as other advanced royalties. This rule applies even if the taxpayer elects to deduct the advanced royalties from gross income for purposes of I.R.C. § 63 in the year of payment or accrual. The regulations allow such an election only for a minimum royalty in a substantially uniform amount extending for the lessor for at least twenty years or the term of the lease, including renewal or extension terms.<sup>250</sup>

Similar treatment is accorded lease bonus payments; the amount excluded during each year is that portion of the bonus allocable to the mineral sold during that year.<sup>251</sup> The allocation, based on spreading the lease bonus over the estimated reserves and excluding each year the amount allocated to the number of tons sold during the year, is much the same as cost depletion.<sup>252</sup> It is important to remember that although the bonus is excluded from gross income from the property under I.R.C. § 613(a) for purposes of computing the depletion allowance, for purposes of computing the lessee's taxable income the bonus allocable to the year of production is neither excluded from gross income under I.R.C. § 61 nor deductible under any section in determining taxable income.<sup>253</sup> There is no deduction because the payment of the bonus is a capital expenditure to be recovered through depletion.<sup>254</sup> Nevertheless, the bonus payment must be excluded from the lessee's gross income from the property because it is depletable to the lessor.<sup>255</sup> The effect of these provisions is to deny a

Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946).

<sup>246</sup> See, H.R. REP. NO. 586, 82d Cong., 1st Sess., 32 (1951), reprinted in 1951-2 C.B. 357, 380; S. REP. NO. 781, 82d Cong., 1st Sess., 42, 43 (1951), reprinted in 1951-2 C.B. 458, 488-89.

<sup>247</sup> Treas. Reg. § 1.613-2(c)(5)(i) (Example) (1977).

<sup>248</sup> See Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Grandview Mines v. Commissioner, 282 F.2d 700 (9th Cir. 1960).

<sup>249</sup> Treas. Reg. §§ 1.613-2(c)(5)(iii), 1.612-3(b)(3) (1977); Rev. Rul. 79-386, 1979-2 C.B. 246.

<sup>250</sup> Rev. Rul. 79-386, 1979-2 C.B. 246; Treas. Reg. § 1.612-3(b)(3) (1977) (rededuction from gross income under section 61).

<sup>251</sup> Treas. Reg. § 1.613-2(c)(5)(ii) (1977); Rev. Rul. 79-73, 1979-1 C.B. 218.

<sup>252</sup> Treas. Reg. § 1.613-2(c)(5)(ii) (Example 1) (1977).

<sup>253</sup> *Id.*; Sunray Oil Co. v. Commissioner, 147 F.2d 962 (10th Cir. 1945), cert. denied, 325 U.S. 861 (1945); Shamrock Oil & Gas Corp. v. Commissioner, 346 F.2d 377 (5th Cir. 1965); Rev. Rul. 73, 1979-1 C.B. 218.

<sup>254</sup> Treas. Reg. § 1.612-3(a)(3) (1977); see Murphy Corp. v. United States, 337 F.2d 677 (8th Cir. 1964).

<sup>255</sup> Treas. Reg. § 1.612-3(a) (1977); but see Canadian River Gas Co. v. Higgins, 151 F.2d 954,

lessee effective tax recovery of the expenditure of a lease bonus when the depletion deduction is computed under I.R.C. § 613.

A production payment retained by a lessor is treated by I.R.C. § 636(c) as a bonus payable in installments.<sup>256</sup> Accordingly, the lessee must include in gross income from the property the proceeds from the sale of coal applied to the production payment.<sup>257</sup> To determine the lessee's annual gross income from the property for the purpose of computing the percentage depletion deduction, the total production payment due is allocated equally to the estimated reserves. That portion of the total payment due that bears the same relationship to the total production payment as the coal produced and sold during the year bears to the estimated reserves at the outset of the lease (or the properly re-estimated amount) is excluded from gross income from the property each year.<sup>258</sup>

Delay rentals are not "rents or royalties" within the meaning of I.R.C. § 613 and do not result in any exclusion from gross income.<sup>259</sup> This usually does not present an issue unless delay rentals are paid for a portion of a year in which production commences. Otherwise, there is no gross income from the property. Delay rentals are deductible by the lessee in computing his overall taxable income, however, unless the lessee elects to capitalize them under I.R.C. § 266,<sup>260</sup> which is generally not advisable.

Royalties excludable from gross income from the property include not only royalties paid to a lessor, but also royalties paid to any other holder of an economic interest. Thus royalties paid to the surface owner<sup>261</sup> or to another person as compensation for negotiating the acquisition of the coal property<sup>262</sup> must be excluded if the royalties are depletable by the recipient.

Occasionally an issue arises regarding whether an item is a royalty excludable from gross income or an expense deductible in computing taxable income. In *Leechburg Mining Co. v. Commissioner* the taxpayer leased completely equipped coal mining property, including plant and equipment for a royalty of ten cents per ton of coal extracted and shipped from the premises, expressly stated in the lease as attributable to the coal deposit, plus an additional roy-

957 (2d Cir. 1945) (Hand, J., dissenting) (suggesting that the lessee should be entitled to exclude the bonus from gross income for all purposes). If the bonus were excluded from the lessee's gross income under section 61, the payment of the bonus could not give rise to any depletable basis under I.R.C. § 612.

<sup>256</sup> This is an exception to the general rule of I.R.C. § 636(a) and (b) (1976) treating carved out production payments and production payments retained in connection with the sale of mineral property, respectively, as loans to the obligor from the holder of the right to payment. *See infra* notes 514-17.

<sup>257</sup> Treas. Reg. § 1.636-2(a) (1973).

<sup>258</sup> Treas. Reg. § 1.613-2(e)(5)(ii) (Example 2) (1977).

<sup>259</sup> Treas. Reg. § 1.612-3(c) (1977); *see, e.g.,* *Sneed v. Commissioner*, 33 B.T.A. 478 (1935) (delay rentals not depletable income to lessor).

<sup>260</sup> Treas. Reg. § 1.612-3(c)(2) (1977).

<sup>261</sup> *See Omer v. United States*, 329 F.2d 393 (6th Cir. 1964); *see supra* Section II.E.

<sup>262</sup> *See Cline v. Commissioner*, 67 T.C. 859 (1977), *aff'd* 617 F.2d 192 (6th Cir. 1980); Rev. Rul. 77-84, 1977-1 C.B. 173; Rev. Rul. 73-80, 1973-1 C.B. 308 (royalty received in consideration of transfer of option); *see supra* Section II.E.



alty of fifteen cents per ton attributable to the rental of the plant, machinery and equipment.<sup>263</sup> The Tax Court rejected the taxpayer's argument that only ten cents of the total royalty paid by the taxpayer-lessee was excludable in computing percentage depletion, concluding that the "'property' here includes the mineral deposit and also the plant and facilities."<sup>264</sup>

If, however, the lessor of the equipment is not also the lessor of the coal deposit, then rental measured as royalties will not be excluded by the lessee from gross income from the property. In *Brown v. Commissioner*, the taxpayer paid siding rentals of the greater of twenty-five dollars per month or seven cents per ton shipped from the siding to a party who was not a lessor of any of the mineral properties.<sup>265</sup> The Tax Court held the Commissioner misapplied *Leechburg Mining Co.* in requiring that the lessee exclude siding rentals from gross income from the property in computing percentage depletion.

Payment of certain obligations of the lessor may also give rise to indirect royalties that are excludable from the lessee's gross income from the property. In *Churchill Farms, Inc. v. Commissioner*, the Tax Court held that the lessor could include in gross income from the property, and thus claim depletion for reimbursement from the lessee of the lessor's legal fees incurred in connection with the lease.<sup>266</sup> The corollary is the lessee must exclude the reimbursed legal fees from gross income. The same result should follow, for example, if the lessee paid broker's commissions with respect to the lease for which the lessor was primarily liable. The same result does not necessarily follow, however, if the obligation of the lessor that the lessee pays is unrelated to the mineral property. In that case the payment would not fall within the court's logic in *Churchill Farms, Inc.*, which described the payment of the legal fees as part of the formula for measuring the lessor's share of the total income from production.<sup>267</sup>

Payment of various taxes by the lessee is somewhat more complicated. Several cases have held that the payment by a lessee of *ad valorem* taxes levied on minerals in place and imposed on the lessor under state law constituted additional royalties to the lessor, includable in the lessor's gross income from the property.<sup>268</sup> The IRS asserted that such payments were not royalties because they were not dependent on production. The various courts, however, rationalized that in the absence of the lessee's agreement to pay the *ad valorem* taxes, the lessor would have demanded and received a higher royalty. Payment of the taxes by the lessee was, therefore, part of the total production

<sup>263</sup> 15 T.C. 22 (1950); see also Rev. Rul. 68-361, 1968-2 C.B. 264 (holding that entire royalty received by lessor of working interest including plant and equipment is includable by the lessor in gross income from the property).

<sup>264</sup> 15 T.C. at 25.

<sup>265</sup> 22 T.C. 58 (1954).

<sup>266</sup> 28 T.C.M. (CCH) 990 (1969), *modified sub. nom.*, *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850 (5th Cir. 1971) (modified without discussion of the issue).

<sup>267</sup> See Rev. Rul. 77-84, 1977-1 C.B. 173 (Situation 2).

<sup>268</sup> *E.g.*, *Burt v. United States*, 170 F. Supp. 953 (Ct. Cl. 1959); *Higgins v. Commissioner*, 33 T.C. 161 (1959); *McLean v. Commissioner*, 54 T.C. 569 (1970), *nonacq.*, 1972-2 C.B. 4; *Handelman v. United States*, 357 F.2d 694 (Ct. Cl. 1966).

to which the lessor was entitled.

Consistent with this rule, in *United States Steel Corporation v. United States* the court held that the lessee paying such *ad valorem* taxes was required to exclude the amount from its gross income from the property in computing percentage depletion.<sup>269</sup>

In Revenue Ruling 72-165 the IRS abandoned its earlier position that required apportionment of the *ad valorem* tax liability between the lessor and lessee based on the respective values of their interests, and announced that insofar as *ad valorem* taxes were imposed on the lessor under state law, the payment of these taxes by the lessee would constitute a royalty in the full amount of the payment.<sup>270</sup> Revenue Ruling 75-182 applied the same rule to a lessee's payment of *ad valorem* taxes imposed on the holder of a net profits interest.<sup>271</sup> In Revenue Ruling 72-165, however, the IRS ruled that such treatment would be accorded only to the extent of income from production; if there is no current production or if the amount of the tax exceeds the income from current production, the IRS asserts that the payment (or the excess of the taxes paid over the amount of income) constitutes a delay rental.<sup>272</sup> This treatment is advantageous to the lessee and disadvantageous to the lessor.

In *McLean v. Commissioner*,<sup>273</sup> however, the Tax Court did not so limit the *ad valorem* taxes that were included in the lessor's gross income from the property. *McLean* specifically allowed the lessor depletion on the amount of *ad valorem* taxes paid by the lessee for the mineral deposit (but not the *ad valorem* taxes imposed with respect to the surface) in years during which there was no production, drawing various analogies to minimum royalties, lease bonuses and advance royalties.<sup>274</sup> Although all of these analogous items are depletable to the lessor or, more frequently, subject to I.R.C. § 631(c) in the year received or accrued, greater care must be devoted to the analogy to determine the proper treatment of the lessee, particularly because the lessee may not exclude a lease bonus item from gross income. In this case it would appear that the minimum royalty analogy is most appropriate, and the payment should be excluded from gross income of the lessee and included in the lessor's gross income from the property.

Whether *ad valorem* taxes imposed on the lessor with respect to the surface property but paid by the lessee should be included in the lessor's gross

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<sup>269</sup> 270 F. Supp. 253 (S.D.N.Y. 1967), *aff'd*, 445 F.2d 520 (2d Cir. 1971), *cert. denied*, 405 U.S. 917 (1972).

<sup>270</sup> 1975-1 C.B. 177. For the IRS's earlier position see Rev. Rul. 16, 1953-1 C.B. 173 and Rev. Rul. 64-91, 1964-1 C.B. 219 (Part 1).

<sup>271</sup> 1975-1 C.B. 176.

<sup>272</sup> 1972-1 C.B. 177, 178.

<sup>273</sup> 54 T.C. 569 (1970).

<sup>274</sup> The court noted that if there were no subsequent production the depletion deducted with respect to the royalties would be recaptured. See Treas. Reg. §§ 1.612-3(b)(2) (1977), 1.631-3(c)(2) (1980). Some of the courts that were not presented with fact patterns in which *ad valorem* taxes were actually paid in years in which income from production was less than the amount of the taxes have suggested that the government's delay rental theory would be applicable if the facts were so presented. See, e.g., *Handelman v. United States*, 357 F.2d 694 (Ct. Cl. 1966).

income from the property and excluded from lessee's gross income is also an issue. The Tax Court held in *Thornton v. Commissioner* that such taxes were includible in the lessor's gross income from the property.<sup>276</sup> Since it now seems accepted that royalties paid for equipment rental to the lessor of the mineral deposit constitute gross income from the property for the lessor, excludable from the lessee's gross income from the property,<sup>276</sup> *ad valorem* taxes on the surface paid by the lessee should be treated as additional royalties when the lessor leases both the surface and the mineral deposit as in *Thornton*. If, however, the lessor leases only the surface to the lessee, and the lessee has acquired the mineral rights from another source, *ad valorem* taxes imposed on the surface lessor and paid by the lessee should be treated as royalties only if the underlying rental obligation is expressed as a royalty.

Similar treatment is accorded severance taxes and state taxes measured by production or gross receipts from mining for which the lessor is liable;<sup>277</sup> the lessee excludes from gross income from mining such taxes paid on the lessor's behalf. Severance taxes for which the lessee is primarily liable are not excluded from the lessee's gross income from mining.<sup>278</sup>

### C. Items Includable in Gross Income From Mining

The Code and regulations define gross income from the property as "gross income from mining,"<sup>279</sup> which means the "amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation."<sup>280</sup>

#### 1. Lessors and Other Royalty Holders

For lessor or holder of a royalty interest, gross income from mining is not generally difficult to compute. It is the amount of the royalty received or accrued, including bonuses and advance royalties. It also includes certain taxes paid by the lessor on behalf of the lessor, discussed in the preceding section. Furthermore, in Revenue Ruling 68-361, the IRS held that a lessor's "gross income from the property" subject to depletion includes royalties measured by the lessee's production attributable to the leasing together with the mineral

<sup>276</sup> 29 T.C.M. (CCH) 1471 (1970).

<sup>276</sup> See Rev. Rul. 68-361, 1968-2 C.B. 264.

<sup>277</sup> *Louisiana Land and Exploration Co. v. Donnelly*, 394 F.2d 273 (5th Cir. 1968) (severance taxes); *Callahan Mining Corp. v. Commissioner*, 51 T.C. 1005 (1969), *aff'd*, 428 F.2d 721 (2d Cir.) *cert. denied*, 400 U.S. 903 (1970) (gross production tax levied on owner of net profits interest); Rev. Rul. 182, 1975-1 C.B. 176 (gross production tax levied on average net profits interest); see also *Wood v. Commissioner*, 31 T.C. 528 (1958), *rev'd*, 274 F.2d 268 (5th Cir. 1960).

<sup>278</sup> See *Ocean Drilling & Exploration Co. v. United States*, 600 F.2d 1343 (Ct. Cl. 1979) (Taxpayer unsuccessfully argued in an attempt to increase its gross income from the extraction of oil for purposes of computing percentage depletion that oil and gas royalties paid to United States under 43 U.S.C. § 1335(a)(9) (1976), measured by the amount of severance taxes formerly paid to states, was a severance tax rather than a royalty).

<sup>279</sup> I.R.C. § 613(c)(1) (1976 & Supp. IV 1980); Treas. Reg. § 1.613-4(a) (1972).

<sup>280</sup> Treas. Reg. § 1.613-4(a) (1972); I.R.C. § 613(c)(2) (1976 & Supp. IV 1980).

property of plant and equipment.<sup>281</sup> This ruling was based on the decision of *Leechburg Mining Co. v. Commissioner*, which held the lessee was required to exclude such rentals from gross income from the property in computing his depletion deduction.<sup>282</sup> If, however, the lessor of equipment does not concurrently lease the coal deposit with respect to which the plant and equipment are used, the rent for such equipment and plant, even if measured by production, will not be gross income from mining subject to depletion.<sup>283</sup>

The treatment accorded by Revenue Ruling 68-361 is highly advantageous because the lessor is entitled to recover the basis of the equipment and plant through depreciation under I.R.C. § 167, or for plant and equipment first placed in service after 1980 through cost recovery under I.R.C. § 168, rather than through depletion.<sup>284</sup> Thus, the same income flow is sheltered by both depreciation or ACRS deductions and either a depletion deduction or, more often, section 1231 treatment under I.R.C. § 631(c).

Although there are no cases or rulings directly on point, rental for plant and equipment measured by production and includable as gross income from the property should be depletable ordinary income rather than produce capital gains under I.R.C. § 631(c). In *Omer v. United States*<sup>285</sup> and *Martin v. United States*<sup>286</sup> the Sixth Circuit held that royalties attributable to surface rights were not subject to I.R.C. § 631(c). Although in *Omer* the lessor of the surface rights did not concurrently lease the coal deposit to the lessee who paid the royalties, in *Martin* the lessor leased both the coal deposit and surface rights to the lessee. The royalty attributable to the surface rights in *Martin* was, however, separately stated. In Revenue Ruling 79-144, the IRS followed the *Omer* and *Martin* decisions and held that royalties received under a surface lease were not eligible for capital gains treatment under I.R.C. § 631(c) when the lessor concurrently leased the underlying coal deposit in a separate lease subject to § 631(c).<sup>287</sup>

These authorities indicate that where a royalty for the rental of plant and equipment is separately stated in the lease, that royalty will be ordinary income subject to depletion rather than proceeds from the disposal of coal eligible for capital gains treatment under I.R.C. § 631(c). Logically, the result should not differ if there is only one lease and the royalty attributable to the coal extracted and the royalty attributable to the use of plant and equipment are not separately stated. Principles analogous to those that are required to be used to apportion a cost basis on the purchase of coal property, surface rights and plant and equipment for a lump sum purchase price should be applied,<sup>288</sup>

<sup>281</sup> 1968-2 C.B. 264, *revoking* Rev. Rul. 54-548, 1954-2 C.B. 91.

<sup>282</sup> 15 T.C. 22 (1950).

<sup>283</sup> See *Brown v. Commissioner*, 22 T.C. 58 (1954), discussed in text *supra* at note 265.

<sup>284</sup> *Keystone Coal Co. v. Commissioner*, 30 T.C. 1008 (1958), *acq.*, 1968-2 C.B. 2; Rev. Rul. 361, 1968-2 C.B. 264; *see also* *Choate v. Commissioner*, 324 U.S. 1 (1945).

<sup>285</sup> 329 F.2d 393 (6th Cir. 1964).

<sup>286</sup> 409 F.2d 13 (6th Cir. 1969).

<sup>287</sup> 1979-1 C.B. 219.

<sup>288</sup> *See supra* notes 218-21 and accompanying text.

and the portion of the royalty allocable to the plant and equipment ascertained. In a recent private letter ruling, however, the IRS held that the lessor of surface rights and underlying coal rights was not required to make such an apportionment where a single lease instrument required only a stipulated royalty for each ton of coal mined from the property, unapportioned between the surface rights and the deposit.<sup>289</sup> Accordingly, the lessor treated the entire royalty as proceeds from the disposition of coal eligible for capital gains treatment under I.R.C. § 631(c).

The logic of the ruling, however, is not applicable to royalties received as rental for plant and equipment. First, the lease required the lessee to reclaim the surface after strip mining. Thus, concluded the ruling "the lessor will suffer no loss due to the use of his asset during mining." Plant and equipment, however, will depreciate through normal wear and tear. Second, the IRS concluded where the same person owns both the surface and coal deposit, many of the surface rights expressly conveyed, would be "conferred by necessary implication," even absent an express grant. From this, the ruling concludes that the payment of the royalty represented "a sharing of the mineral when produced," and it was "not considered payment for any of the implied rights and privileges obtained by the lessee as a result of the lease." Such logic is not applicable to plant and equipment because the leasing of a coal deposit does not convey any rights in the lessor's plant and equipment by necessary implication. Therefore, the royalty attributable to plant and equipment, if not separately stated, should be determined by apportionment.

## 2. Operators

The computation of gross income from mining for an operator is much more complex than is the computation for a lessor. Subject to reduction for trade and cash discounts, gross income from mining means the amount for which coal is sold by the operator if no nonmining processes or nonmining transportation is applied to the coal.<sup>290</sup> If nonmining processes or nonmining transportation is applied to the coal the entire sales price of the coal does not represent gross income from mining; only a portion of the sales price will be included in gross income from mining.<sup>291</sup> Selling expenses such as broker's commissions, are not excluded from gross income from mining.<sup>292</sup> Recapture of previously deducted mine exploration expenses if the taxpayer elects the income inclusion method of recapture under I.R.C. § 617(b)(1)(A) is excluded from gross income from mining.<sup>293</sup>

a. *Miscellaneous receipts and expenses.* Various other receipts accrued

<sup>289</sup> Private Letter Ruling 7905006.

<sup>290</sup> Treas. Reg. § 1.613-4(b)(1) (1972). For the required adjustments see Treas. Reg. § 1.613-4(e)(7) (1972). These regulations reverse the result in *Montreal Mining Co. v. Commissioner*, 2 T.C. 688 (1943), and Rev. Rul. 60-257, 1960-2 C.B. 197 regarding cash discounts.

<sup>291</sup> See *infra*, Section IV. D.

<sup>292</sup> Rev. Rul. 60-98, 1960-1 C.B. 252 (applying principle to *del credere* agency).

<sup>293</sup> Treas. Reg. § 1.617-3(a)(2) (1972); see generally H.R. REP. No. 1237, 89th Cong., 2d Sess. (1966), reprinted in 1966-2 C.B. 777, 782 (elections shall be in manner prescribed by secretary).

in the operation of a mining business are excluded from gross income from mining. Thus if an operator furnishes housing, food, supplies or services to employees at a price calculated to return its cost or its cost plus a reasonable profit, the receipts from any such nonmineral producing activity are not included in gross income from mining.<sup>294</sup> Concomitantly, the provision of such goods and services at an intentional loss, a form of wages to miners, does not reduce gross income from mining,<sup>295</sup> although it will reduce the taxable income from mining, thus having an indirect limiting effect on the amount of the percentage depletion deduction.

Similarly, *Monroe Coal Mining Co. v. Commissioner* held that proceeds from the sale of discarded mine equipment were not includable in gross income from mining.<sup>296</sup> The court reached this result even though it assumed *arguendo* that the cost had been deducted in prior years and had reduced the *net* income from the property, concluding that such treatment did not compel an inclusion in gross income from the property. The earlier deduction had not reduced the gross income from the property—the base on which percentage depletion is allowed.

Nor does gross income from the property include the cost of using coal on the mine premises. In *Roundup Coal Mining Co. v. Commissioner*,<sup>297</sup> the Tax Court held that a mine operation may not include in gross income from mining any amount expressed in dollars attributable to coal consumed on the mine premises to produce power. The taxpayer had included in gross income from mining the sales value of the coal so consumed. But the Tax Court concluded that the taxpayer had neither income nor a business deduction from the use of the coal and accordingly disallowed the depletion deduction; the cost of the coal to the taxpayer was adequately reflected in the exclusion of royalties paid.

In *Guthrie v. United States*,<sup>298</sup> the Sixth Circuit held that proceeds received from a business interruption insurance policy were not includable in gross income from mining. The taxpayer argued for inclusion because the proceeds were paid due to the destruction by fire of its tipple and screening facility. Following the fire the taxpayer constructed a temporary tipple, but it was able to produce only five grades of coal, as opposed to twenty-seven grades produced prior to the fire, resulting in diminished sales proceeds from its coal production because of decreased prices. Thus, the taxpayer argued, gross income from mining included money received as compensation for the inability to market coal at the higher prices it could obtain from better grading of its coal. Citing the Supreme Court decision in *Helvering v. Mountain Producers Corp.*,<sup>299</sup> the Sixth Circuit concluded that it was not free to fashion a theoretic-

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<sup>294</sup> *Replier Coal Co. v. Commissioner*, 140 F.2d 554 (3d Cir.), cert. denied 323 U.S. 736 (1944); *Dorothy Glen Coal Mining Co. v. Commissioner*, 38 B.T.A. 1154 (1938); Rev. Rul. 56-433, 1956-2 C.B. 332.

<sup>295</sup> Rev. Rul. 56-433, 1956-2 C.B. 332.

<sup>296</sup> 7 T.C. 1334 (1946).

<sup>297</sup> 20 T.C. 388 (1953), acq. and nonacq. on other issues, 1954-1 C.B. 6.

<sup>298</sup> 323 F.2d 142 (6th Cir. 1963).

<sup>299</sup> 303 U.S. 376 (1938) (holding that gross income from the property included only the sales

cal definition of gross income from the property and excluded the insurance proceeds from gross income from the property.

However, *Amherst Coal Co. v. United States* held that damages received by a mine operator in settlement of a breach of contract claim based on the refusal of a purchaser to accept delivery under a contract for the purchase of coal at a fixed price were includable in gross income from mining.<sup>300</sup> The damages were measured by the difference between the contract price and the lower spot marked prices at which the coal was actually sold. The court distinguished *Guthrie* as involving payments in lieu of processing *not performed*, whereas in the instant case, the damages were "in legal effect a part of the sale price for coal actually extracted."<sup>301</sup>

Even if *Guthrie* is not distinguishable, there is some basis for arguing that *Guthrie* is theoretically incorrectly decided and *Amherst Coal Co.* is correctly decided. Arguably, in *Guthrie* the proceeds of the insurance attributable solely to the lost profits from the unapplied mining processes should be a part of the sales price as much as breach of contract damages. A major stumbling block, however, is that the unapplied processes were hypothetical: it could not have been determined with accuracy what actually would have been received had the coal been graded, because it was not graded. Thus as a practical matter it would be impossible for the taxpayer to meet the requisite burden of proof.

The IRS has taken the position in Revenue Ruling 77-57 that *Amherst Coal Company* was incorrectly decided and has ruled that damages received by a mine operator for breach of contract to purchase a mineral are not gross income from mining.<sup>302</sup> The Ruling fails to consider the impact of the enactment of former I.R.C. § 1305(b) in 1957,<sup>303</sup> and its repeal in 1963 as part of the enactment of the general income averaging provisions. Under that provision, which limited the tax on damage awards to the amount of tax that would have been imposed if the damage award had instead been received in the earlier year upon performance of the contract, damages received by the seller upon a purchaser's breach of contract to purchase, less the cost of recovering the damages, were subject to depletion.<sup>304</sup>

The committee reports accompanying the enactment of former I.R.C. § 1305(b) support the view that Congress thought it was merely codifying then current law regarding depletion for damage awards rather than enacting a new substantive rule of law. The reports state, "[s]ubsection (b) of the new section 1305 is intended to make it clear that for the purpose of computing credits and deductions for depletion and other items the award is to have the same character as the income which would have been received or accrued except for

price of oil and did not include that part of the production cost defrayed by a refining company under its contract with the taxpayer to purchase the oil).

<sup>300</sup> 295 F. Supp. 421 (S.D. W. Va. 1969), *aff'd per curiam*, 27 A.F.T.R. 2d (P-H) ¶ 71-358 (4th Cir. 1971).

<sup>301</sup> *Id.* at 445.

<sup>302</sup> 1977-1 C.B. 168.

<sup>303</sup> Pub. L. No. 85-165 § 1, 85th Cong., 1st Sess., 71 Stat. 413.

<sup>304</sup> S. REP. No. 836, 85th Cong., 1st Sess. (1957), *reprinted in* 1957-2 C.B. 1071, 1074.

the breach of contract or duty.”<sup>305</sup> Although there is some weak indication to the contrary, the clearest authority indicates that for years prior to 1957 damages for conversion of natural resources were depletable if the taxpayer proved the amount of damages attributable to the claim for conversion as opposed to other claims adjudicated in the same action.<sup>306</sup>

If the 1957 Act was merely a codification of Congress’ understanding of the then existing law, the subsequent repeal of former I.R.C. § 1305(b) as part of the enactment of the general income averaging provisions in the Revenue Act of 1964, should not affect the result and *Amherst Coal Co.* should be good law. This is the better understanding of the chain of authorities in this area. The committee reports accompanying the Revenue Act of 1964 are silent regarding the intended or expected effect of the changes on depletion for damages,<sup>307</sup> and therefore provide no additional guidance.

Finally, the IRS has ruled that “gross income from the property” includes the excise tax imposed under the Black Lung Benefits Act of 1977, which is separately stated on a sales invoice.<sup>308</sup> The rationale is that the excise tax liability is that of the coal mine operator and may not be assessed on the purchaser of the coal. Accordingly, the statement of the excise tax is merely an increase in sales price, includable in income under I.R.C. § 61. Because the tax is the liability of the producer, its payment does not reduce gross income from the property.

b. *Extraction from Waste and Refuse.* I.R.C. § 613(c)(3) provides that the term “mining” includes the extraction by a mine owner or operator of minerals from the waste or residue of prior mining or treatment processes considered as mining.<sup>309</sup> The statute also expressly provides that such rule does not apply to “extraction of the mineral . . . by a purchaser of such waste or residue or of the rights to extract . . . minerals therefrom.”<sup>310</sup>

Prior to the enactment of I.R.C. § 613(c)(3) the courts had determined a taxpayer’s right to deplete income derived from the extraction of minerals from waste or refuse deposits by reference to his rights in the deposit from

<sup>305</sup> *Id.* (emphasis added).

<sup>306</sup> Compare *Estate of Arnett v. Commissioner*, 31 T.C. 320 (1958) (allowing depletion of damages for conversion of oil, but not on interest on judgment) with *Alphonzo E. Bell Corp. v. Commissioner*, 145 F.2d 157 (9th Cir. 1944) (denying depletion where claim for conversion of oil and other related claims were compromised for a lump sum and the taxpayer failed to prove the amount of the settlement allocable to the claim for conversion of the oil). In *Crossett Timber & Dev. Co. v. Commissioner*, 29 B.T.A. 705 (1934) the Board held that damages paid to a lessor for lessee’s breach of contract in failing to extract oil and gas was not depletable. That decision was clearly correct since there was no depletion of the mineral and the situation in that case is not analogous to *Amherst Coal Co. v. Commissioner*.

<sup>307</sup> See S. REP. No. 830, 88th Cong., 2d Sess. (1964), reprinted in 1964-1 (part 2) C.B. 505, 643-49; H.R. REP. No. 749, 88th Cong., 1st Sess. (1963), reprinted in 1964-1 (part 2) C.B. 125, 23339, 416-33.

<sup>308</sup> Rev. Rul. 79-27, 1979-1 C.B. 217.

<sup>309</sup> See Treas. Reg. §§ 1.613-4(f)(1), -4(i) (1973). If the waste or residue results from a nonmining process no depletion is available for extraction from the waste. Treas. Reg. § 1.613-4(i) (1973).

<sup>310</sup> I.R.C. § 613(c)(3) (1976 & Supp. IV 1980).



which the waste had been produced. In *Kohinoor Coal Co. v. Commissioner*,<sup>311</sup> the Third Circuit Court of Appeals held that a lessee having only the right to extract coal from a culm bank was not entitled to depletion. The deposit was not natural and therefore not a mine, and the taxpayer had no rights to the mine from which the waste was produced.

In *Turkey Run Fuels, Inc. v. United States*,<sup>312</sup> however, the lessor to the taxpayer in *Kohinoor Coal Co.*, was allowed the depletion deduction for the royalties paid by *Kohinoor Coal Co.* for the right to extract coal from the culm bank. The lessor was also the owner of the mine from which the waste had been produced. It was of no consequence that the mine itself was leased to a different taxpayer or that the culm banks had accumulated while the taxpayer's predecessors in interest had owned the mine.

Although in *Turkey Run Fuels, Inc.* it appears that the taxpayer derived ownership through a continuous chain of nontaxable transactions (inheritance and corporate organization and reorganization) back to the opening of the mine, a different situation was presented in *New Idria Quicksilver Mining Co. v. Commissioner*.<sup>313</sup> The taxpayer acquired by purchase a quicksilver mining property, including mines and ore dumps which had been previously produced from the purchased mines. The court allowed the taxpayer's claim for depletion on the income received from working the ore dumps, stating, "[t]here is no legal distinction between the rights of the successor in interest and the original owner with respect to the depletion claimed."<sup>314</sup>

That rule, however, apparently did not survive the enactment of I.R.C. § 613(c). The regulations specifically state the "mining" includes "the extraction by mine owners or operators of ores or minerals from waste or residue of *their* prior mining and by persons who have acquired their right by purchase, even though such waste or residue is acquired merely as an incidental part of the entire mineral enterprise."<sup>315</sup> But if the mineral property (including the waste or refuse) was acquired in a tax-free exchange, such as a corporate reorganization, from a person who was entitled to a depletion allowance deduction upon such ores or minerals produced from such waste or residue, then depletion will be available to the transferee.<sup>316</sup> Presumably this rule should apply whenever both the mines and refuse are transferred in any transaction in which the transferee's basis is determined with reference to the transferor's basis, such as corporate organizations,<sup>317</sup> partnership organizations,<sup>318</sup> gifts,<sup>319</sup> and to trans-

<sup>311</sup> 171 F.2d 880 (3d Cir. 1948), *aff'g* 6 T.C.M. (CCH) 1078 (1947), *cert. denied*, 337 U.S. 924 (1949).

<sup>312</sup> 243 F.2d 147 (3d Cir. 1957), *aff'g* 139 F. Supp. 43 (E.D. Pa. 1946) (Under present law such royalty payments would be accorded capital gains treatment rather than be included in ordinary income and subject to depletion under 631(c).

<sup>313</sup> 144 F.2d 918 (9th Cir. 1944).

<sup>314</sup> *Id.* at 921.

<sup>315</sup> Treas. Reg. § 1.613-4(i) (1973) (emphasis added).

<sup>316</sup> *Id.*

<sup>317</sup> See I.R.C. §§ 351, 362 (1976 & Supp IV 1980).

<sup>318</sup> See I.R.C. §§ 721, 723 (1976).

<sup>319</sup> See I.R.C. §§ 102, 1015 (1976).

fers at death,<sup>320</sup> which are tax free but result in a basis adjustment. Thus, *Turkey Run Fuels, Inc.* should still be good law. Furthermore, if the tax-free nature of the exchange is significant, like kind exchanges under I.R.C. § 1031 may also qualify even though basis is determined with reference to the property exchanged by the transferee and not with reference to the transferor's basis.<sup>321</sup> The presence of "boot" in such transactions, rendering the transaction partially taxable, may create a problem, but there are no authorities providing any direct guidance.

In *Franciosa v. United States*,<sup>322</sup> one of the few cases arising under I.R.C. § 613(c), the court correctly held that a taxpayer who had acquired rights to extract coal from silt deposited in the bed and banks of a river as a result of up-river mining by his grantor and by others was not entitled to depletion. In doing so, however, the court explained that it denied depletion because it was not certain all of the coal and refuse was produced by mines operated by the taxpayer's grantor. The court implied that a different result might be reached under I.R.C. § 613(c) on facts similar to *Kohinoor Coal Co.*<sup>323</sup> Any such suggestion is unwarranted. Not only is the factual distinction irrelevant, but the principle of *Kohinoor Coal Co.* is even more strongly expressed under I.R.C. § 613(c) and the regulations. No successor in interest by purchase is entitled to depletion of income derived by the extraction of coal from refuse or culm banks, even if the refuse is acquired as part of the acquisition of the entire mine. Although the result may seem harsh, the regulations are not an arbitrary and unreasonable interpretation of the disjunctive construction of the second sentence of I.R.C. § 613(c)(3)<sup>324</sup> and the legislative history of the section.<sup>325</sup>

c. *Treatment Processes and Transportation.* Gross income from mining includes not only the income attributable to the extraction of the coal, but also income attributable to treatment processes applied by the mine owner or operator considered as mining and "mining transportation" not in excess of fifty miles from the point of extraction to plants or mills where such treatment

<sup>320</sup> See I.R.C. §§ 102, 1014 (1976 & Supp. IV 1980).

<sup>321</sup> See I.R.C. § 1031(d) (1976).

<sup>322</sup> 231 F. Supp. 952 (E.D. Pa. 1964). The court also rejected the argument that because the coal bearing silt had been in the ground for many years and a great amount of overburden had settled over it, the coal bearing silt had become a natural deposit. *Id.* at 954.

<sup>323</sup> *Id.* at 953.

<sup>324</sup> "The preceding sentence shall not apply to any extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom." I.R.C. § 613(c)(3) (1976 & Supp. IV 1980) (emphasis added).

<sup>325</sup> See H.R. REP. No. 1337, 83d Cong., 2d Sess. A185, A186 (1954), reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4017, 4325.

The term "extraction of ores or minerals from the ground . . . includes the extraction by mine owners or operators of ores or minerals from the waste or residue of their prior mining. Thus a depletion allowance may be permitted when based on the extraction of minerals or ores from waste or residue of mining, such as a tailings dump or culm bank, if performed by the mine owner or operators."

*Id.* (emphasis added). Although the emphasized language in the second sentence standing alone would support a continued application of the *New Idria Quicksilver Mining Co.* rule, the emphasized language in the first sentence supports the regulations. See also S. REP. No. 1622, 83d Cong., 2d Sess. 79 (1954), reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4621, 4712.

processes are applied.<sup>326</sup>

Treatment processes considered as mining with respect to coal are specified in I.R.C. § 613(c)(4)(A) as cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment.<sup>327</sup> A specific definition of each of these processes is provided in Revenue Procedure 78-19.<sup>328</sup> In addition to the processes specified in I.R.C. § 613(c)(4)(A), because coal is customarily sold in the form of a crude mineral product, any of the processes specified in I.R.C. § 613(c)(4)(C) may be applied to coal and be treated as mining.<sup>329</sup>

Under I.R.C. § 613(c)(2) any treatment "necessary or incidental" to the

<sup>326</sup> I.R.C. § 613(c)(2) (1976 and Supp. IV 1980); Treas. Reg. §§ 1.613-4(a), (f)(1) (1973).

<sup>327</sup> I.R.C. § 613(c)(4)(A) (1976 and Supp. IV 1980). See Treas. Reg. § 1.613-4(f)(2)(i) (1973).

<sup>328</sup> 1978-2 C.B. 491. The definitions provided in the Revenue Procedure are as follows:

BREAKING, Sections 613(c)(4)(A) . . . , Sections 1.613-4(f)(2)(i)(a) and 1.613-4(f)(2)(i)(b).

Breaking, with respect to coal, is the first stage in preparation subsequent to mining and prior to cleaning.

*Breaker:* In anthracite mining, the breaker is the structure in which coal is broken, sized, and cleaned for market.

*Coal Breaker:* A coal breaker is a building containing the machinery for breaking coal with toothed rolls, sizing it with sieves, and cleaning it for market.

*Tipple:* Originally the tipple was the place where mine cars were tipped and emptied of their coal. The term is still used in that sense, although it is now more generally applied to the surface structures of a coal mine, including the preparation plant and tracks. It also includes the tracks, trestle, screens, etc., used at the entrance of a colliery where coal is screened and loaded.

. . . .  
CLEANING, Sections 613(c)(4)(A) . . . ; Sections 1.613-4(f)(2)(i)(a) and 1.613-4(f)(2)(i)(b). Also see Section 1.613-4(f)(5)(iv).

Cleaning refers to the removal of slate, bone, and other impurities contained in mine run coal, . . . .

DUST ALLAYING, Section 613(c)(4)(A); Section 1.613(f)(2)(i)(a).

Dust allaying is the application of a fine oil spray or mist to coal for the purpose of reducing or subduing in intensity or severity the amount of dust. Dust allaying is used principally for coal sold on the domestic homeowners' market.

. . . .  
LOADING FOR SHIPMENT, Section 613(c)(4)(A), . . . , and 613(c)(4)(C); Sections 1.613-4(f)(2)(i)(a), 1.613-4(f)(2)(i)(b), and 1.613-4(f)(2)(i)(c)(2).

Loading for shipment is the allowable mining process of conveying the appropriate mineral product into vehicles of transportation.

. . . .  
SIZING, Section 613(c)(4)(A); Section 1.613-4(f)(2)(i)(a).

Sizing is the process of separating mixed particles into groups of particles all of the same size, or into groups in which all particles range between definite maximum and minimum sizes.

. . . .  
TREATING TO PREVENT FREEZING, Section 613(c)(4)(A); Section 1.613-4(f)(2)(i)(a).

A treatment to prevent freezing with respect to coal is the application of calcium chloride or other material to coal to prevent the coal from freezing in the car during transportation.

*Id.* at 492-98.

<sup>329</sup> See Treas. Reg. § 1.613-4(f)(2) (1973).

statutory processes will also be treated as mining.<sup>330</sup> This is a factual determination, but the regulations provide some guidelines:

A process is necessary to another related process if it is prerequisite to the performance of the other process. . . . A process is 'incidental' to another related process if the cost thereof is insubstantial in relation to the cost of the other process, or if the process is merely the coincidental result of the application of the other process. For example, the sprinkling of coal prior to loading for shipment, with dots of paper to identify the coal for trade name purposes will be considered incidental to the loading where the cost of that sprinkling is insubstantial in relation to the cost of the loading process.<sup>331</sup>

Pursuant to I.R.C. § 613(c)(4)(I) the regulations specify a limited number of additional processes that will also be treated as mining.<sup>332</sup> However, none of the processes specified in I.R.C. § 613(c)(5) will be treated as mining unless otherwise provided in the regulations or unless they are necessary or incidental to any of the treatment processes considered as mining.<sup>333</sup> Among the proscribed processes are fine pulverization, blending with other materials, treatment effecting a chemical change and thermal action. For example, coking of coal is a "thermal action" effecting a chemical change that is not a mining process.<sup>334</sup> Similarly, liquification or gasification of coal would be a nonmining process under these standards.

Finally, the regulations provide that the application of any nonmining process cuts off the mining phase of operations and the subsequent application of what would have otherwise been a mining process will not be considered as such.<sup>335</sup> For example, loading coked coal for shipment is not a mining process.

The treatment processes that may be considered as mining are actually considered to be mining only if they are applied by the mine owner or operator.<sup>336</sup> Treatment processes applied by a purchaser are not mining even though they would have been considered as mining if applied by the mine owner or operator.<sup>337</sup> Presumably the owner or operator must retain title through the application of the treatment process. However, the owner or operator should not be required to apply the treatment processes considered as mining with his own employees; the use of an independent contractor should be permitted.

If, however, that contractor is also the purchaser, the treatment process may not be considered mining. Revenue Ruling 74-568 involved a mine owner, X, who leased a coal deposit from Y.<sup>338</sup> Under a separate agreement X sold coal to Y at an agreed upon price of 10.75 x dollars per ton for washed coal

<sup>330</sup> Treas. Reg. § 1.613-4(f)(2)(iii) (1972).

<sup>331</sup> *Id.*

<sup>332</sup> Treas. Reg. § 1.613-4(f)(5) (1972).

<sup>333</sup> Treas. Reg. § 1.613-4(g)(1), (6) (1972).

<sup>334</sup> Treas. Reg. § 1.613-4(g)(6)(viii) (1972).

<sup>335</sup> Treas. Reg. § 1.613-4(g)(2) (1972).

<sup>336</sup> I.R.C. § 613(c)(4) (1980); Treas. Reg. § 1.613-4(f)(2)(i)(1) (1972).

<sup>337</sup> Treas. Reg. § 1.613-4(f)(2)(iv) (1972). *Rowe v. United States*, 655 F.2d 1065 (Ct. Cl. 1981); *Nicewonder v. United States*, 81-2 USTC ¶ 9723 (W.D. Va. 1981).

<sup>338</sup> 1974-2 C.B. 183.

(including 1x dollars per ton for transportation) or 9.25 x dollars per ton for unwashed coal (including 1x dollars per ton for transportation). A third agreement provided that Y would crush and wash on X's behalf coal mined from the leased property and sold to Y at the charge of 1.50 x dollars per ton. The agreement did not provide for crushing and washing coal to be sold to anyone else. The IRS concluded that notwithstanding the existence of separate contracts, in substance, the actual agreement between the parties was for the sale of unwashed coal. Therefore, the crushing and washing costs were excluded from X's gross income from mining. Furthermore, since X did not apply any mining processes at the point of delivery, the transportation component of the delivered price was not mining transportation.<sup>339</sup> One could reasonably conclude that a different result regarding both the washing and crushing costs and the transportation costs may have been reached if X had a general contract with Y for washing substantially all of the coal mined by X, and Y did not purchase substantially all of the coal washed under the agreement.

If the operator applies any nonmining processes to the coal, percentage depletion cannot be computed with reference to the sales price of the coal.<sup>340</sup> Instead the taxpayer must use an alternative method; generally either the representative market or field price method,<sup>341</sup> or the proportionate profits method.<sup>342</sup> Similarly, the sales price of coal may not be used as the base for computing percentage depletion if the coal has been subjected to nonmining transportation.

"Mining" includes only transportation of up to fifty miles between the point of extraction and the plants or mills in which treatment processes treated as mining are applied.<sup>343</sup> A greater distance may be allowed if the Commissioner finds that "physical and other requirements" are such that a greater transportation distance is necessary.<sup>344</sup> Apparently the taxpayer must factually demonstrate that it is physically impossible to locate the processing plant within fifty miles of the mine. Economic considerations alone will not be sufficient to justify a greater transportation distance being treated as mining.<sup>345</sup> Thus, the mere fact that the taxpayer already owns a treatment facility located more than fifty miles from the mine and desires to avoid the expense of constructing a duplicate facility will not be sufficient.

Even if the total distance of what would otherwise be mining transportation is more than fifty miles, the first fifty miles will be allowed as mining transportation as long as the coal is subjected to a mining process by the oper-

<sup>339</sup> See Treas. Reg. § 1.613-4(g)(3) (1972).

<sup>340</sup> See Treas. Reg. § 1.613-4(b) (1972).

<sup>341</sup> Treas. Reg. § 1.613-4(c) (1972).

<sup>342</sup> Treas. Reg. § 1.613-4(d) (1972).

<sup>343</sup> I.R.C. § 613(c)(2) (1980); Treas. Reg. § 1.613-4(f)(1)(iii) (1972). See generally Updegraff & Zychick, *Transportation of Crude Mineral Production By Mine Owners And Its Effect on Hard Minerals Depletion Allowance*, 35 TAX LAW. 367, 369-78 (1982).

<sup>344</sup> Treas. Reg. § 1.613-4(h) (1972) (specifies the procedures for filing such an application); see generally Updegraff & Zychick *supra* note 343, at 378-81.

<sup>345</sup> Rev. Rul. 73-557, 1973-2 C.B. 205.

ator at the destination.<sup>346</sup> But transportation primarily for the purpose of marketing, distribution or delivery for the application of nonmining processes is not considered mining.<sup>347</sup> Thus, "mining transportation" does not include the following: transportation of a mineral from the point of extraction to a nonmining facility, from a mining facility to a nonmining facility, from one nonmining facility to another, and from a nonmining facility to a customer.<sup>348</sup> For example, the expenses of transportation of coal by slurry pipeline for the purpose of delivery for sale would be nonmining transportation.<sup>349</sup> Since coal is not generally subjected to any mining process that subsequently requires drying to remove free water, the separation of the coal from the water at the delivery end of the slurry pipeline similarly is not a mining process.<sup>350</sup> It is important to note in this context that mining processes can be applied only by the operator. If a process that would be "mining" if applied by the operator is applied by a purchaser, the application of the process is not mining.<sup>351</sup> If the treatment process is applied by or on behalf of a purchaser, the transportation to the treatment or processing plant, therefore, is not mining transportation but rather, it is transportation primarily for marketing.<sup>352</sup>

This principle is illustrated by two recent cases, *Rowe v. United States*<sup>353</sup> and *Nicewonder v. United States*.<sup>354</sup> In *Rowe* the taxpayer strip mined coal but did not perform any treatment processes. Rather, he transported the coal twenty miles or less to the tipple of Virginia Iron Coal and Coke Company, which inspected the coal and if it was acceptable, bought it and then cleaned, broke, sized, weighed and shipped it to its own customers to whom it had resold the coal. The court rejected the taxpayer's argument that the statute and regulations did not require that the process be applied by the mine owner or operator to be considered mining. Since it was undisputed the coal was sold prior to the application of the processing, the application of the processing, by the purchaser, was not mining. Because the processing was not mining, the transportation to the processing plant could not be mining. The court rejected the taxpayer's contention that this construction was unreasonable because it resulted in different tax treatment for the first fifty miles of transportation from the mine depending on who applied the treatment process, and that Congress could not have intended such a discrimination.

*Nicewonder* presented a similar factual pattern. The taxpayer delivered coal in the state in which it had been extracted by strip mining to two of Clinchfield Coal Company's tipples, where it received a price per ton for the amount which was accepted. The taxpayer, however, maintained one employee

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<sup>346</sup> Rev. Rul. 77-457, 1977-2 C.B. 207.

<sup>347</sup> Treas. Reg. § 1.613-4(g)(3) (1972).

<sup>348</sup> See Treas. Reg. § 1.613-4(d)(3)(i) (1972).

<sup>349</sup> See Rev. Rul. 73-474, 1973-2 C.B. 201.

<sup>350</sup> Compare this situation with that involving a mineral described in I.R.C. § 613(c)(4)(D) (1980).

<sup>351</sup> I.R.C. § 613(e)(4) (1980); Treas. Reg. § 1.613-4(f)(2)(i)(a), (iv) (1972).

<sup>352</sup> Rev. Rul. 74-568, 1974-2 C.B. 183; see *supra* text accompanying note 339.

<sup>353</sup> 655 F.2d 1065 (Ct. Cl. 1981).

<sup>354</sup> 81-2 USTC ¶ 9723 (W.D. Va. 1981).

at one of the tipples, who was stationed at the breaker and whose duties included manual breaking where necessary to permit coal to pass through the screen. The employee was stationed there because Clinchfield Coal Company required either that the coal be delivered in small chunks or that taxpayer supply the labor at the tipple. The court concluded the transportation was primarily for the purpose of marketing; the taxpayer's employee stationed at the tipple merely assisted in unloading. This conclusion rested on the finding that the coal was marketable in its raw state. Furthermore, even if the transportation was not primarily for marketing, the treatment process was applied by the purchaser (not by the taxpayer) and was, therefore, a nonmining activity. Thus, transportation from the mine to the tipple was not mining transportation. Apparently, the taxpayer's employee's activities were considered too *de minimus* to constitute the application of "breaking" by the taxpayer at the tipple, but the court did not directly address this issue in its alternative basis for holding that the transportation was not mining transportation.

In both *Nicewonder* and *Rowe*, the court rejected on procedural grounds—the taxpayer's failure to adequately state the claim in the refund application—the taxpayer's argument that "bench haul," (the portion of the transportation from the point of removal to the mine entrance), should be included in gross income from mining. The taxpayer analogized this to the movement of coal along headings and haulways of a deep mine, which is included in the gross income from deep mining even if the transportation from the mouth of the mine is not mining transportation. The analysis used by the court in *Rowe* lends support, however, to the validity of the claim on substantive grounds. The taxpayer argued that the use of the word "coal haul" in the refund claim included both movement of the coal to the entrance of the mine and then to the tipple. Equating "coal haul" and "transportation," the court found that "transportation" has a narrow meaning which does not include any part of extraction. The court concluded the taxpayer's claim was based on an asserted extraction cost, not a transportation cost, and it was therefore procedurally barred.

#### D. *Computation of Gross Income From Mining Where Nonmining Transportation or Processes have been Applied*

##### 1. Representative Market or Field Price Method

If an operator applies no nonmining processes or nonmining transportation to coal prior to sale, his gross income from mining is the sales price of the coal less cash and trade discounts.<sup>355</sup> If any nonmining process or nonmining transportation has been applied to the coal prior to sale, the sales price does not measure the operator's gross income from mining and a reduction is necessary.<sup>356</sup> The time at which the first nonmining process occurs is termed the "cutoff point." This also identifies the point at which mining transportation ends, but unlike nonmining processes, nonmining transportation does not pre-

<sup>355</sup> Treas. Reg. § 1.613-4(b) (1972).

<sup>356</sup> Treas. Reg. § 1.613-4(e)(1) (1972).

clude a subsequent process from being a mining process.

a. *Nonmining Transportation.* When no nonmining processes have been applied and the only nonmining transportation that has been applied is "purchased transportation to the customer," gross income from mining is the delivered sales price (if otherwise representative of market price) minus the cost of the transportation.<sup>357</sup> If the taxpayer purchased the transportation from another person (other than a person controlled by or controlling the taxpayer), the cost of transportation is simply the amount the taxpayer paid for the transportation. The transportation costs may be separately stated or included in the delivered price. Thus, costs of shipping by common carrier may simply be deducted from the sales price.<sup>358</sup>

If nonmining transportation, including transportation to the customer in conveyances owned by the operator or leased by him, was applied to the coal, the operator's gross income from mining is determined with reference to the representative market or field price received by other producers selling significant quantities of coal of like kind and grade to which no nonmining processes have been applied in the taxpayer's marketing area, reduced by the representative cost of purchased transportation to the other producers.<sup>359</sup> Among the situations covered by this rule is transportation in excess of fifty miles for the purpose of applying processes treated as mining or self-provided transportation to the customer.<sup>360</sup> This rule applies even if the nonmining transportation is purchased transportation in excess of fifty miles for the purpose of applying processes treated as mining. However, the representative market or field price so determined may not exceed the taxpayer's delivered price minus the actual cost of the nonmining transportation.<sup>361</sup>

The same set of rules applies if the taxpayer earned a profit on purchased transportation to the customer,<sup>362</sup> or if the purchased transportation was provided by a person controlling or controlled by the taxpayer, unless the price for such transportation was an arms length charge as determined under I.R.C. § 482.<sup>363</sup> The taxpayer has not earned a profit on the transportation if the transportation charged the purchaser, whether separately stated or included in the sales price, is the same as the arms length charge normally incurred by shippers of the same product in similar circumstances.<sup>364</sup> Transportation otherwise

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<sup>357</sup> Treas. Reg. §§ 1.613-4(e)(2)(i); 1.613-4(c)(1) (1972). "Purchased transportation to the customer" means nonmining transportation "performed solely to deliver the [coal] to the customer, rather than to transport such [coal] for . . . additional processing by the taxpayer . . .," that "is not performed in conveyances owned or leased directly or indirectly, in whole or in part by the taxpayer," and "with respect to which the [operator] ordinarily does not earn any profit." Treas. Reg. § 1.613-4(e)(2)(iii) (1972).

<sup>358</sup> Rev. Rul. 75-115, 1975-1 C.B. 178.

<sup>359</sup> Treas. Reg. § 1.613-4(e)(2)(i) (1972).

<sup>360</sup> *Id.*; Treas. Reg. § 1.613-4(c)(1) (1972).

<sup>361</sup> Treas. Reg. § 1.613-4(e)(2)(i) (last sentence) (1972).

<sup>362</sup> Treas. Reg. § 1.613-4(e)(2)(i) (1972).

<sup>363</sup> Treas. Reg. § 1.613-4(e)(2)(iii)(c) (1972).

<sup>364</sup> Treas. Reg. § 1.613-4(e)(2)(iii) (1972); *see also* Rev. Rul. 75-115, 1975-1 C.B. 178 (no profit earned by taxpayer on shipment by common carrier).



meeting the definition of "purchased transportation to the customer" but provided by a person controlling or controlled by the taxpayer (within the meaning of those terms under I.R.C. § 482) will nevertheless be treated as purchased transportation if the taxpayer can establish that the price charged by the controlled or controlling entity was an arms length charge under the standards of I.R.C. § 482.

The regulations do not discuss the method of computing gross income from mining if the taxpayer has applied nonmining transportation other than purchased transportation to the customer and the only representative price at which a significant quantity of coal of like kind and grade is sold after the application of only mining processes is a representative *delivered* price *after* the application of nonmining transportation other than purchased transportation to the customer. Possibly, this indicates that the determination of a representative market or field price is impossible when all sales in the taxpayer's marketing area are made at a delivered price that includes nonmining transportation other than purchased transportation to the customer. If there is no representative market or field price for coal in the taxpayer's marketing area and he has applied nonmining transportation other than purchased transportation to the customer, then the taxpayer will generally compute gross income from mining under the proportionate profits method.

b. *Nonmining Processes.* If nonmining processes other than transportation have been applied to the coal by the owner or operator prior to sale, gross income from mining must similarly be reduced below the sales proceeds to reflect the increased sales price attributable to such processes. This is normally done with reference to the representative field or market price of coal of like kind and grade after the application of mining processes actually applied by the taxpayer, including mining transportation, but excluding nonmining transportation.<sup>365</sup> The objective of the representative market or field price of computing gross income from mining is to determine the approximate price at which the taxpayer could have sold coal to which no nonmining processes or transportation had been applied. That is his income from mining. His income in excess of that amount is not gross income from mining. Accordingly, the determination is made on the basis of actual competitive sales by the taxpayer and others selling coal of like kind and grade. The representative market or field price method or one of the alternative methods used where there is no representative market or field price will always be used by an integrated manufacturer incorporating or using coal in the production of its finished product, such as a steel manufacturer, or a power utility that operates its own mines.<sup>366</sup>

The regulations provide detailed rules for application of the representative market or field price method to determine the taxpayer's gross income from mining.<sup>367</sup> As with nonmining transportation, when the taxpayer applies nonmining processes if other producers in the taxpayer's marketing area sell sig-

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<sup>365</sup> Treas. Reg. § 1.163-4(c)(1) (1972).

<sup>366</sup> See, e.g., *Woodward Iron Co. v. Patterson*, 173 F. Supp. 251 (N.D. Ala. 1959) (coking coal mined by pig iron manufacturer).

<sup>367</sup> Treas. Reg. § 1.613-4(c) (1972).

nificant quantities of coal after the application of only mining processes, but after purchased transportation to the customer, the taxpayer's representative market price is the representative delivered price of the other producers minus the representative cost of purchased transportation to the customer incurred by those other producers.<sup>368</sup>

Under the regulations a mineral is of like kind and grade as the taxpayer's "if in common commercial practice it is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer's . . . mineral that it is used, or is commercially suitable for use, for essentially the same purposes as the uses to which the taxpayers . . . mineral is put." However, "the fact that taxpayer's . . . mineral is suitable for the same general commercial use as another person's . . . mineral will not cause the two . . . minerals to be considered as like kind and grade if the desirable natural constituents of the two . . . minerals are markedly different substances."<sup>369</sup> This is important with respect to coal. As examples of this distinction the regulations provide that anthracite coal and bituminous coal are not like kind and that bituminous coal without coking qualities is not of like kind with bituminous coal with coking qualities. But if the taxpayer "mines and uses his bituminous coal in the production of coke, all bituminous coals in the same marketing area will be considered of like kind, and all bituminous coals having the same or similar coking quality suitable for commercial use by coke producers will be considered to be of like grade as the coal mined and used by the taxpayer."<sup>370</sup>

There is some case authority further developing the principles regarding coking coal in the preceding sentence of the regulations. In *Alabama By-Products Corp. v. Patterson*, the Fifth Circuit rejected the taxpayer's argument that "like grade" of coking coal should be determined with reference to the end use of the coal.<sup>371</sup> Accordingly, coal used for commercial as well as coking purposes was included in the relevant market. The court held not only that all bituminous coals were of like kind, but it also affirmed the district court's holding that all bituminous coking coals in the Alabama coal fields were of the like grade and were commercially suitable for the manufacture of coke generally. The court said:

To go further and classify coking coals according to their myriad of actual uses would lead to an unworkable system of grading coal, since the requirements of coke vary greatly. There would never be in the case, of coking coal, a mineral product of like kind and grade; we would have a phrase without meaning.<sup>372</sup>

When read against the factual findings made by the district court, the import of this statement seems to be that all coking coals are of like grade. The district court did not include in its specific findings of fact the precise classifica-

<sup>368</sup> Treas. Reg. § 1.613-4(e)(2)(i) (1972).

<sup>369</sup> Treas. Reg. § 1.613-4(c)(2) (1972).

<sup>370</sup> *Id.*

<sup>371</sup> 258 F.2d 892 (5th Cir. 1958), *cert. denied*, 358 U.S. 930 (1959). *Accord* Kaiser Steel Corp. v. United States, 66-1 USTC ¶ 9457 (W.D. Cal. 1966), *rev'd on other issues*, 411 F.2d 335 (9th Cir. 1969).

<sup>372</sup> 258 F.2d at 899.

tions of coking coal involved, but did find that the agglutinating characteristics and carbon content of Alabama coking coals varied widely.<sup>373</sup> The court's definition of "like grade" seems too broad to comport with the current regulations. Perhaps the limit is simply that too find a distinction cannot be made.<sup>374</sup>

*Woodward Iron Co. v. Patterson*<sup>375</sup> raised a similar issue. The court exhaustively analyzed the classification and use of coking coals in Alabama, including the classification of the coking coals in issue, under the Standard Classification of Coals by Rank promulgated in 1957 by the American Society for Testing Materials (ASTM). The scale contained five classifications: low volatile, medium volatile, high volatile A, high volatile B, and high volatile C. Low volatile and high volatile B and C coal are not desirable for coking. Only medium volatile and high volatile A coal was mined in the area where the taxpayer operated. The court also analyzed classifications based on whether the coal involved could make a commercially satisfactory coke when used alone or if it could do so only when blended with certain other coking coals. Coals falling in both of these categories were mined by the taxpayer and by others in the area. The court concluded, nevertheless, that coals of both ASTM rankings were like grade and that coking coals were of like grade notwithstanding the fact that some would produce a commercially satisfactory coke when coked alone and others required blending.

A different result was reached, however, in *Kaiser Steel Corp. v. United States*.<sup>376</sup> The district court in *Kaiser Steel Corp.* utilized methods similar to those utilized in *Woodward Iron Co.*, to determine "like kind and grade" of coking coals. However, the court in *Kaiser Steel Corp.* utilized a more detailed approach, comparing volatility under ASTM standards, sulphur content and plasticity under three tests: agglutinating index, free swelling index and the Geisler plastometer. When the various coals contended to be of like kind and grade were subjected to analysis, the results were compared. The court held that high volatile coal mined by the taxpayer in Utah, Colorado and New Mexico was not of like kind and grade as low volatile coal mined in Oklahoma and Arkansas, because it was not a complete substitute. However, coals of varying chemical compositions, each having particular advantages and thus being competitive were held to be of like kind and grade. These findings were affirmed on appeal.<sup>377</sup> Furthermore, the district court required that the market sales price for high volatile coal mined in the same area as the taxpayer's coal and suitable for coking but sold for commercial purposes had to be included together with sales of similar coal for coking purposes in determining the representative market or field price. This conclusion was also affirmed on appeal.<sup>378</sup> Although the court in *Kaiser Steel Corp.* was correct in finding that the Utah, Colorado

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<sup>373</sup> 151 F. Supp. 641 (N.D. Ala. 1957).

<sup>374</sup> "Fine distinctions between various grades of minerals are to be avoided unless those distinctions are clearly shown to have genuine commercial significance." Treas. Reg. § 1.613-4(c)(2) (1972) (last sentence).

<sup>375</sup> 173 F. Supp. 251 (N.D. Ala. 1959).

<sup>376</sup> 411 F.2d 335 (9th Cir. 1969).

<sup>377</sup> 411 F.2d 335 (9th Cir. 1969).

<sup>378</sup> *Id.*

and New Mexico coals were not of like grade as the Oklahoma and Arkansas coals, its findings that they were not of like kind is not consistent with the regulations unless they were in different marketing areas.

This is significant because the regulations provide that if there is no representative market or field price for minerals of like kind and grade as taxpayer's minerals, but there is a representative market or field price for minerals of like kind, but not grade, then the representative market or field price of the like kind minerals will be used, with appropriate adjustments, if such adjustments may be readily ascertainable.<sup>379</sup> There are no authorities expressly applying this section of the regulations to coal, but it appears the principle may require somewhat more precision than was applied in *Alabama By-Products Corp.* and *Woodward Iron Co.* to treat bituminous coals with different coking qualities as like kind and grade and to then arrive at a rough approximation of representative market price.

Numerous factors to be considered in determining the representative market or field price are specified in the regulations.<sup>380</sup> The prime factor, although it is not determinative, is a weighted average of the competitive selling prices in the relevant market of coal of like kind and grade as the taxpayer's, to which has been applied only mining processes. This method was applied in *Kaiser Steel Corporation* even though some of the market sales, due to market conditions, were not profitable.<sup>381</sup> Only sales under competitive conditions will be taken into account. The regulations provide that sales prices between members of a controlled group, whether involving taxpayer or a competitor, will be deemed competitive where the Commissioner has exercised his authority under I.R.C. § 482 to reallocate income between controlled taxpayers.<sup>382</sup> Exceptional, insignificant, unusual and other sales out of the ordinary course of business will not be included in the comparison.

In determining the representative market or field price, cash and trade discounts allowed by all sellers in transactions upon which the price is based must be subtracted from the sales price.<sup>383</sup> Similarly, if other producers in the taxpayer's marketing area sell coal only after nonmining purchased transportation to the customer, the representative costs of the nonmining transportation, taking into account different modes of transportation and distances, must be deducted from the representative delivered price to determine the representative market or field price.<sup>384</sup>

The regulations do not expressly prescribe a method for determining a representative market or field price when other producer's in the taxpayer's marketing area sell coal only for a delivered price, including nonmining trans-

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<sup>379</sup> Treas. Reg. § 1.613-4(c)(4) (1972).

<sup>380</sup> Treas. Reg. § 1.613-4(c)(3) (1972).

<sup>381</sup> 411 F.2d 335 (9th Cir. 1969).

<sup>382</sup> Treas. Reg. § 1.613-4(c) (1972).

<sup>383</sup> Treas. Reg. § 1.613-4(e)(1) (1972).

<sup>384</sup> Treas. Reg. § 1.613-4(e)(2)(i) (1972); see *Kaiser Steel Corp. v. United States*, 411 F.2d 335 (9th Cir. 1969) (taxpayer's lower transportation costs resulted in finding of higher value for iron ore at the mine; specific formula applied to determine adjustment).

portation other than purchased transportation to the customer. Possibly this indicates that it is impossible to determine a representative market or field price under such circumstances, thereby requiring the use of the proportionate profits method to determine gross income from mining. Arguably, however, a representative market or field price could be ascertained by subtracting from the representative delivered price a hypothetical representative fair market value of the nonmining transportation included in the delivered price.

The identity of the relevant market and the representative market or field price within the market are factual determinations,<sup>385</sup> and the scope of review is therefore limited. In *Kaiser Steel Corporation v. United States*<sup>386</sup> the taxpayer argued that iron ore mined, sold, and consumed in the Great Lakes region should be included in the relevant market for determining the representative market or field price of iron ore mined and used in manufacturing by the taxpayer in California. The district court limited the relevant market to iron ore mined in Utah by another miner from whom the taxpayer had purchased iron ore to meet requirements in excess of its own production. The chemical composition of the Utah iron ore was very similar to the taxpayer's iron ore. Furthermore, not only had Kaiser never purchased Great Lakes iron ore for use in its operations, but there was no evidence of any sales of Great Lakes iron ore in the western United States. On this basis the district court concluded:

The sales of iron ore in the Great Lakes region . . . are of no weight in this case because of the remoteness of the sites of such sales from the area of plaintiff's operations and the absence of any sales or shipments of such ore to plaintiff's operations. The Great Lakes area was an independent market insofar as the plaintiff is concerned, and sales within that independent market area had no economic effect upon plaintiff's market area and did not establish or effect the representative market price for [taxpayer's] iron ore.<sup>387</sup>

The Court of Appeals, affirming this finding because it was not "clearly erroneous," rejected Kaiser's claim that the Great Lakes market should be considered because it "had some influence on western . . . ore prices." Such influence, if there was any, was reflected in the actual prices in the relevant market used by the district court to determine the representative market or field price.<sup>388</sup>

There are limits on the representative market or field price that may be ascertained under the rules prescribed by the regulations. It may never be less than the taxpayer's delivered price minus the actual cost to the taxpayer of providing nonmining transportation to the customer.<sup>389</sup> Furthermore, if when added to the taxpayer's cost of applying nonmining processes and transportation, an amount otherwise determined to be the representative market or field price regularly results in a loss, it will be presumed that the amount so deter-

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<sup>385</sup> Treas. Reg. § 1.613-4(c)(3) (1972).

<sup>386</sup> 411 F.2d 335 (9th Cir. 1969), *rev'g and remanding* 66-1 USTC ¶ 9457 (N.D. Cal. 1966).

<sup>387</sup> 66-1 USTC at 86, 101.

<sup>388</sup> 411 F.2d at 339.

<sup>389</sup> Treas. Reg. § 1.613-4(e)(2)(i) (1972).

mined is not representative.<sup>390</sup> The regulations provide the following example:

[i]f on a regular basis the total of all costs of nonmining processes applied by the taxpayer to coal for the purpose of making coke is \$12 per ton and if the taxpayer's actual sale price for such coke is \$18 per ton, a price of \$7 per ton would not be a representative market or field price for the taxpayer's coal which is used for making coke.<sup>391</sup>

It should be noted that the product sales price used in this test is the taxpayer's actual product, such as steel in the case of an integrated steel producer, and not the first commercially marketable product.<sup>392</sup> The presumption that the provisionally determined representative market or field price is too high can be rebutted by establishing that the loss on nonmining operations is due to unusual nonrecurring factors, such as fire, flood, explosion, earthquake or strike.<sup>393</sup>

In *Bloomington Limestone Corp. v. United States*,<sup>394</sup> the Seventh Circuit described the purpose of the presumption as follows:

The theory of the presumption is that an integrated miner-manufacturer which shows year after year of profit from its mining operation and year after year of loss from its manufacturing operation must be overestimating the price of its raw product, and therefore overestimating the expenses of its manufacturing phase. The hypothesis is that no business would continue a milling operation which resulted in actual losses over a number of years.<sup>395</sup>

Based on this view the court refused to apply the presumption where the taxpayer had eighteen consecutive years of mining profits using the representative market or field price method, but only six years of manufacturing profits in those years. The taxpayer introduced evidence that manufacturing losses were due to a depressed market for its finished product, that it had taken steps to modify its operations in light of the depressed market, and that it did not believe that the depressed market was permanent. Accordingly, the Seventh Circuit concluded that the case did not involve the "sort of inflated or manipulated calculation" at which the presumption of the regulation was aimed.<sup>396</sup> Furthermore, because there were intermittent profitable years, the losses were not regular enough to activate the presumption. This interpretation emphasizes the necessity for "regularity" of the manufacturing loss and rejects any interpretation that would treat the exceptions provided in the regulations as the exclusive causes of manufacturing losses that may avoid the presumption.

However, in *Gray Knox Marble Co. v. United States*,<sup>397</sup> the court applied the presumption where the taxpayer, utilizing the asserted representative mar-

<sup>390</sup> Treas. Reg. § 1.613-4(c)(6) (1972). See also Rev. Rul. 77-296, 1977-2 C.B. 207.

<sup>391</sup> Treas. Reg. § 1.613-4(c)(6) (1972).

<sup>392</sup> Rev. Rul. 77-33, 1977-1 C.B. 165.

<sup>393</sup> Treas. Reg. § 1.613-4(c)(6) (1972).

<sup>394</sup> 445 F.2d 1105 (7th Cir. 1971), *rev'g and remanding on other grounds* 315 F. Supp. 1255 (S.D. Ind. 1970).

<sup>395</sup> *Id.* at 1109.

<sup>396</sup> *Id.* at 1110.

<sup>397</sup> 257 F. Supp. 632 (E.D. Tenn. 1966).

ket or field price, showed substantial mining profits for eight consecutive years while simultaneously showing manufacturing losses that ranged from seventy three percent to one hundred and eight percent of the mining profits, except for the first of the eight years, when the loss was only twenty-five percent of mining profits. Under this rule taxpayers are, in effect, presumed to be willing to operate regularly their mining operations at break even costs or at a loss, but unwilling to operate regularly nonmining operations at a loss. For example, competitive prices for raw coal have been held to be evidence of representative market or field price for an integrated steel producer even though those prices were not profitable to the other miners.<sup>398</sup>

If a taxpayer computes his gross income from mining using the representative market or field price, he must attach a statement to his tax return indicating the comparable prices used in determining the representative market or field price and the source of his information. Relevant supporting data must be readily available at his principal place of business.<sup>399</sup> If there are no competitive sales in the relevant market (including sales by the taxpayer) of coal of like kind and grade to which no nonmining processes have been applied, the representative market or field price method may not be used. But if there are such sales, it cannot be avoided.<sup>400</sup>

## 2. Proportionate Profits Method and Alternative Methods

If it is impossible to determine a representative market or field price, gross income from mining will be computed under the proportionate profits method, unless the use of an alternative method is more appropriate than the proportionate profits method.<sup>401</sup> The standard for determining the appropriateness of an alternative method is whether, considering all of the facts and circumstances, the proportionate profits method or the proposed alternative method will more clearly reject gross income from mining for the taxable year in question.<sup>402</sup> If an alternative method is more appropriate, it can be required at the initiative of the IRS or upon application by the taxpayer to the Office of the Assistant Commissioner (Technical).<sup>403</sup> A taxpayer is not required, however, to obtain advance approval before reporting on an alternative method, but the method must be approved before it will be allowed.<sup>404</sup> Although other alterna-

<sup>398</sup> *Kaiser Steel Corp. v. United States*, 411 F.2d 335 (9th Cir. 1969).

<sup>399</sup> Treas. Reg. § 1.613-4(c)(5) (1972).

<sup>400</sup> Treas. Reg. § 1.613-4(c)(1) (1972); *Alabama By-Products Corp. v. Patterson*, 258 F.2d 892 (5th Cir. 1958), *cert. denied*, 358 U.S. 930 (1959), *aff'g* 151 F. Supp. 641 (N.D. Ala. 1957).

<sup>401</sup> Treas. Reg. § 1.613-4(d)(1) (1972).

<sup>402</sup> Treas. Regs. §§ 1.613-4(d)(1)(ii)(b) and (c) (1972). However, once a particular alternative has been determined by the Office of the Assistant Commissioner (Technical) to be more appropriate than either the proportionate profits method or the method used by the taxpayer, that method will continue to be used unless it (a) consistently fails to clearly reflect gross income from mining and (b) the proportionate profits method or alternate method prepared by the taxpayer more clearly reflects gross income from mining for the taxable year. *Id.* The method of computation is subject to review and change on an annual basis. Treas. Reg. § 1.613-4(d)(1)(iii) (1972).

<sup>403</sup> Treas. Reg. § 1.613-4(d)(1)(ii)(a) (1972). *See* Rev. Proc. 74-43, 1974-2 C.B. 496, for the procedures to obtain approval of the use of an alternative method.

<sup>404</sup> Rev. Proc. 74-43 § 4.02, 1974-2 C.B. 496.

tive methods may be used,<sup>405</sup> the regulations specifically refer to the representative schedule method,<sup>406</sup> using prices outside the taxpayer's market to establish a representative market or field price,<sup>407</sup> and the rate of return on investment method.<sup>408</sup> If a representative market or field price can be ascertained, neither the proportionate profits method nor any alternative method may be used to determine gross income from mining.<sup>409</sup>

The proportionate profits method determines gross income from mining on the principle that each dollar of the total cost to produce and sell the first marketable product earns the same percentage of profit.<sup>410</sup> Under that assumption the following formula is applied to determine gross income from mining:

$$\frac{\text{Mining Costs} \times \text{Gross Sales}}{\text{Total Costs}} = \text{Gross Income From Mining}^{411}$$

"The purpose of the proportionate profits formula is to separate the sales price of a product into its mining and nonmining components."<sup>412</sup> To apply this formula, three factors must be ascertained; gross sales of the first marketable product, mining costs and total costs of the first marketable product.

"Gross sales" are the taxpayer's aggregate competitive sales of his first marketable product,<sup>413</sup> reduced by trade and cash discounts<sup>414</sup> and the cost of purchased transportation for delivery to customers.<sup>415</sup> If the taxpayer applies additional manufacturing processes to the first marketable product, then the actual sales price of the taxpayer's actual product is not used; gross sales are determined by reference to a "constructive sale" price for that portion of the first marketable product used or retained for the taxpayer's operations.<sup>416</sup> The dollar value of constructive sales is determined under the principles of the rep-

<sup>405</sup> Treas. Reg. § 1.613-4(d)(1)(ii)(e) (1972).

<sup>406</sup> Treas. Reg. § 1.613-4(d)(5) (1972).

<sup>407</sup> Treas. Reg. § 1.613-4(d)(6) (1972).

<sup>408</sup> Treas. Reg. § 1.613-4(d)(7) (1972). This subsection of the Regulations is "Reserved" and the specifics for use of the method have not yet been promulgated.

<sup>409</sup> Treas. Reg. § 1.613-4(d)(7) (1972); *United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960); *Woodward Iron Co. v. Patterson*, 173 F. Supp. 251 (N.D. Ala. 1959) (taxpayer could not use proportionate profits method); *Warner Co. v. United States*, 504 F.2d 689 (3d Cir. 1974), *cert. denied*, 421 U.S. 930 (1975) (same); Rev. Proc. 73-43, 1974-2 C.B. 496 (taxpayer cannot obtain approval of alternative method if there is a representative market or fixed price).

<sup>410</sup> Treas. Reg. § 1.613-4(d)(4)(i) (1972).

<sup>411</sup> Treas. Reg. § 1.613-4(d)(4)(ii) (1972).

<sup>412</sup> *North Carolina Granite Corp. v. Commissioner*, 56 T.C. 1281, 1291 (1971); *see also Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156 (1981).

<sup>413</sup> Treas. Reg. § 1.613-4(d)(4)(v)(a) (1972).

<sup>414</sup> Treas. Reg. § 1.613-4(e)(1) (1972).

<sup>415</sup> Treas. Reg. § 1.613-4(e)(2)(ii) (1972). The determination of what constitutes purchased transportation and the method for determining the cost of transportation purchased from another taxpayer controlling or controlled by the taxpayer computing his gross income from mining is determined under Treas. Reg. § 1.613-4(e)(2)(iii) (1972) in the same manner as applies to the representative market or field price method, which is discussed in the text accompanying notes 359-61 *supra*.

<sup>416</sup> Treas. Reg. § 1.613-4(d)(4)(v)(a) (1972); *see, e.g., Standard Lime & Cement Co. v. United States*, 329 F.2d 939 (Ct. Cl. 1964); *United States v. Claycraft Co.*, 364 F. Supp. 1358 (S.D. Ohio 1972).



representative market or field price method,<sup>417</sup> but if there is an actual representative market or field price it will be used. If, however, the first marketable product has been sold between members of a controlled group and the district director has reallocated income with respect to such sales between members of the controlled group under I.R.C. § 482, then the price determined under I.R.C. § 482 will be used to determine gross sales.<sup>418</sup>

The first marketable product is defined as the "product . . . produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area."<sup>419</sup> The first marketable product does not include any product resulting from additional manufacturing or other nonmining processes applied to the product first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area.<sup>420</sup>

For example, if the taxpayer were an integrated steel producer and in the taxpayer's marketing area all coal was consumed by either integrated steel producers or coke producers, there might be no representative market or field price for coal. However, if coke was sold in significant quantities by other manufacturers in the taxpayer's marketing area, then coke and not steel would be the taxpayer's first marketable product. This would be true even if the taxpayer itself sold only steel. Accordingly, the taxpayer's gross sales under the proportionate profits method would be the constructive sales price of the coke consumed in the manufacture of the steel. This price would be determined by applying the principles of the representative field or market price method to sales of coke in the taxpayer's marketing area. Consistent with this method, the constructive price would not include cash or trade discounts or the cost of transportation of delivered coke.<sup>421</sup> If a taxpayer owns an integrated operation which mines coal and converts it to oil or gas, the determination of the first marketable product may be substantially more difficult. However, it only applies where it is impossible to ascertain a representative market or field price for the coal.

Determination of the cost inputs for the proportionate profits method is complex. The numerator of the fraction is "the sum of all the costs allocable to those *mining processes* which are applied to produce, sell, and transport the first marketable product;"<sup>422</sup> the denominator is "the total of all the mining and nonmining costs paid or incurred to produce, sell and transport the first marketable product."<sup>423</sup> This requires several allocations.

First, direct costs attributable to manufacturing applied after the first marketable product has been produced are not taken into account in the com-

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<sup>417</sup> Treas. Reg. § 1.613-4(d)(4)(v)(b) (1972).

<sup>418</sup> *Id.*

<sup>419</sup> Treas. Reg. § 1.613-4(d)(4)(iv) (1972).

<sup>420</sup> *Id.*

<sup>421</sup> Treas. Reg. § 1.613-4(e)(1) (1972).

<sup>422</sup> Treas. Reg. § 1.613-4(d)(4)(ii) (1972).

<sup>423</sup> *Id.*

putation.<sup>424</sup> Furthermore, cash and trade discounts, which are excluded from gross sales, are also excluded from the denominator of the fraction.<sup>425</sup> The same rule applies to the cost of purchased transportation to the customer if the taxpayer makes no profit on the transportation. This does not exclude purchased nonmining transportation relating to shipment for additional nonmining processing necessary to produce the taxpayer's first marketable product.<sup>426</sup> The purpose of this exclusion is to prevent the allocation of any profits to purchased transportation.

Costs which are directly allocable to mining, including treatment processes considered as mining under I.R.C. § 613(c)(4) and mining transportation, are allocated to the numerator. Costs which are directly allocable to nonmining processes, including nonmining transportation, are excluded from the numerator. No ranking of costs which results in excluding or minimizing the effect of any costs incurred to produce, sell and transport the first marketable product is permissible.<sup>427</sup> Only actual costs, including depreciation and cost recovery under I.R.C. § 168, are included in the computation. Generally the amount of any item to be included as a cost is the amount for purposes of computing the taxpayer's federal income tax, including depreciation and cost recovery.<sup>428</sup> In computing mining costs, however, the taxpayer should include the amount of cost depletion that would be allowable for the year without regard to the I.R.C. § 613 allowance for percentage depletion, even though that amount will not actually be used to compute the taxpayer's federal income tax.

Costs attributable to nonmining transportation (other than the purchased transportation for delivery to customers which is excluded entirely) are included in total costs.<sup>429</sup> Thus, the profits attributable to mining transportation are attributed to mining, but the profits attributable to nonmining transportation are not. If actual costs for mining and nonmining transportation, respectively, can be ascertained, those costs will be used. Otherwise mining transportation costs will be that portion of total transportation costs that bears the same ratio to total transportation costs as miles of mining transportation bear to the total miles of mining and nonmining transportation.<sup>430</sup> Such an allocation would be used, for example, where the tippie was located more than fifty miles from the mine and the operator had not received permission to treat as

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<sup>424</sup> See *North Carolina Granite Corp. v. Commissioner*, 56 T.C. 1281 (1971), *acq. in result*, 1974-2 C.B. 3, *acq.*, clarified Rev. Rul. 77-179, 1977-1 C.B. 168.

<sup>425</sup> Treas. Reg. § 1.613-4(e)(1) (1972).

<sup>426</sup> Treas. Reg. § 1.613-4(e)(2)(ii), (iii)(b). Rev. Rul. 75-115, 1975-1 C.B. 178.

<sup>427</sup> Treas. Reg. § 1.613-4(d)(4)(i) (1972).

<sup>428</sup> Treas. Reg. § 1.613-4(d)(2) (1972). If, however, a taxpayer was using a reasonable method of computing costs for financial accounting purposes at variance from its method for computing deductions on its federal income tax return and it used that method to determine gross income from mining under the proportionate profits method for taxable years beginning prior to December 1, 1968, it may continue to use that method if it has been used consistently and is applied to the determination of all costs. *Id.*

<sup>429</sup> Treas. Reg. § 1.613-4(d)(3)(i) (1972); see generally *Updegraff and Zychick, Transportation of Crude Mineral Production by Mine Owners and Its Effect on Hard Minerals Depletion Allowance*, 35 TAX. LAW. 367, 381-83 (1982).

<sup>430</sup> Treas. Reg. § 1.613-4(d)(3)(i) (1972).

mining transportation more than fifty miles of transportation for the purpose of treatment processes considered as mining.

Sales costs also require special consideration. Under the regulations the cost for packaging and containers is a nonmining cost, as is the cost of warehousing and bulk loading manufactured goods.<sup>431</sup> The regulations also require that "a reasonable portion" of the selling expenses of a manufactured product be allocated to mining costs;<sup>432</sup> the balance of selling expenses are allocated to nonmining costs. The "reasonable portion" is equal to "typical selling expenses which are incurred by unintegrated miners or producers."<sup>433</sup> No selling costs will be allocated to mining costs if unintegrated operators typically incur no selling costs.<sup>434</sup> Selling expenses are broadly defined in the regulations and include salaries, commissions and other direct costs as well as overhead attributable to sales personnel.<sup>435</sup>

All other costs incurred to produce, sell and transport the first marketable product which cannot be directly attributed to a particular mining process or nonmining process must be apportioned between mining and nonmining costs by a method which is "reasonable under the circumstances."<sup>436</sup> This may require a different method of allocation to be used for different costs incurred within the same year. For example, indirect costs, such as the salary of a corporate officer overseeing all of the taxpayer's processes or trade association dues of an integrated manufacturer, may reasonably be apportioned on the ratio of direct mining costs to direct nonmining costs.<sup>437</sup> Workman's compensation premiums, however, should be apportioned on the basis of direct labor costs,<sup>438</sup> as should other employee benefits not clearly allocable only to employees engaged either in mining or nonmining processes. The principles used to allocate indirect costs in determining taxable income from the property for purposes of applying the "fifty percent of the taxable income from the property limitation" may be helpful in arriving at a reasonable allocation under the proportionate profits method.<sup>439</sup>

## E. *Fifty Percent of Taxable Income Limitation*

### 1. Generally

Regardless of the method used to compute gross income from mining subject to the percentage depletion allowance, the deduction for percentage deple-

<sup>431</sup> Treas. Reg. § 1.613-4(d)(3)(iii) (1972).

<sup>432</sup> Treas. Reg. § 1.613-5(c)(4)(ii) (1972).

<sup>433</sup> *Id.*

<sup>434</sup> Treas. Reg. 1.613-4(d)(3)(iii) (1972).

<sup>435</sup> Treas. Reg. § 1.613-5(c)(4)(iv) (1972).

<sup>436</sup> Treas. Reg. § 1.613-4(d)(4)(iii) (1972).

<sup>437</sup> *Id.*; Treas. Reg. § 1.613-5(c)(6) (1972). The activities of the trade association must relate to the production, treatment and marketing of raw materials, but will be allowed even though one of the principal purposes of the association is to promote the production, marketing and sale of a manufactured product. *Id.*

<sup>438</sup> Treas. Reg. § 1.613-4(d)(4)(iii) (1972).

<sup>439</sup> See *Arvoniam-Buckingham Slate Co. v. United States*, 426 F.2d 484 (4th Cir. 1970).

tion may not exceed the fifty percent of the taxable income from the property (identified under I.R.C. § 614), (hereinafter "fifty percent of taxable income limitation") computed without considering any depletion allowance deduction.<sup>440</sup> Cost depletion, however, is not subject to any such limitation.

The regulations define taxable income from the property as follows:

The term taxable income from the property . . . means 'gross income from the property' . . . , less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. These deductible items include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, taxes deductible under section 162 or 164, losses sustained, . . . exploration and development expenditures, etc. . . . Expenditures which may be attributable both to the mineral property upon which depletion is claimed and to other activities shall be properly apportioned to the mineral property and to such other activities. Furthermore, where a taxpayer has more than one mineral property, deductions which are not directly attributable to a specific mineral property shall be properly apportioned among the several properties. . . .<sup>441</sup>

The starting point for computing "taxable income from the property," is "gross income from the property," not gross income under I.R.C. § 61. A taxpayer holding a nonoperating economic interest in coal property subject to depletion (rather than subject to section 1231 treatment under I.R.C. § 631(c)) has little difficulty in computing taxable income from the property. Generally, gross income from the property and taxable income from the property will be identical. The same rule will apply to a royalty computed on a net profits basis because the holder of a net profits interest includes only the net amounts received in gross income from the property.<sup>442</sup> If the holder of a royalty interest then pays royalties to another taxpayer, the royalties paid are excluded from his gross income from the property and thus are excluded from taxable income from the property.

Because taxable income from the property is computed with reference to "gross income from the property" and not gross income under I.R.C. § 61, holders of both operating interests and nonoperating interests must exclude lease bonus payments made by them in years to which they are properly allocable,<sup>443</sup> even though the amount of any such payment is includable in gross income of the payor under I.R.C. § 61 and is not deductible in determining taxable income under I.R.C. § 63.<sup>444</sup> Royalty payments made by the taxpayer are, of course, excluded from gross income from the property.<sup>445</sup>

<sup>440</sup> I.R.C. § 613(a) (1980); Treas. Reg. § 1.613-1 (1972).

<sup>441</sup> Treas. Reg. § 1.613-5(a) (1972).

<sup>442</sup> See *Grandview Mines*, 32 T.C. 759 (1959), *aff'd*, 282 F.2d 700 (9th Cir. 1960).

<sup>443</sup> Treas. Reg. § 1.613-2(c)(5)(ii) (1977); Rev. Rul. 79-73, 1979-1 C.B. 218.

<sup>444</sup> Treas. Reg. § 1.613-2(e)(5)(ii) (1977). (Example 1).

<sup>445</sup> See Section IV.B. *supra*.

## 2. Deductible items

The regulations require that all allocable deductions attributable to the mining processes, including mining transportation, be deducted from gross income from the property in computing taxable income from the property. Items which are capitalized, rather than deducted in computing taxable income under I.R.C. § 63, are not deducted in computing taxable income from the property. Thus, the cost of all improvements, buildings and equipment serving a mine, and replacements of such items, is not deducted.<sup>446</sup> Subsequent ACRS deductions under I.R.C. § 168 to recover the cost of such property are deductible in the year in which the deduction is properly taken. Deductible expenses which relate both to mining and nonmining activities must be apportioned between the two activities and only the portion of the expenses attributable to mining activities is deducted. Furthermore, if a deduction item is attributable to two or more mineral properties, it must be allocated between them. Gross income from the property and taxable income from the property are both computed on each property separately. In addition to the items specified as deductions in computing taxable income from the property in the regulations quoted *supra*, several other items are specifically mentioned.

Selling expenses incurred by a producer of coal must be subtracted from gross income from the property in computing taxable income from the property.<sup>447</sup> Because the fifty percent of taxable income limitation is computed on a property-by-property basis, selling expenses which benefit more than one property must be apportioned between the properties.<sup>448</sup> If the taxpayer is an integrated manufacturer, only an amount equal to the typical selling expenses incurred by unintegrated miners must be subtracted; if integrated miners typically incur no selling expenses, no deduction is necessary.<sup>449</sup> Selling expenses include sales management salaries, rent of sales offices, clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and any similar expenses, including an allocable share of overhead for supporting services, but not delivery costs.<sup>450</sup>

Similarly, indirect expenses benefiting more than one property, such as officers' and general administrative employees' salaries, office supply expenses, and depreciation or ACRS deductions, that are deductible in computing taxable income from mining must be apportioned between the properties.<sup>451</sup> Furthermore, if such expenses are incurred by an integrated producer, any expenses not directly attributable to mining must be apportioned between mining and nonmining activities.<sup>452</sup>

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<sup>446</sup> See Treas. Reg. § 1.612-2(a) (1977); *Harman Coal Co. v. Commissioner*, 200 F.2d 415 (4th Cir. 1952).

<sup>447</sup> Treas. Reg. § 1.613-5(c)(4)(i) (1972).

<sup>448</sup> Treas. Reg. § 1.613-5(a) (1972); *Occidental Petroleum Co. v. Commissioner*, 55 T.C. 115 (1970), *acq.* 1971-1 C.B. 2.

<sup>449</sup> Treas. Reg. § 1.613-5(c)(4)(ii) (1972).

<sup>450</sup> Treas. Reg. § 1.613-5(c)(4)(iii) (1972).

<sup>451</sup> *Id.*; G.C.M. 22956, 1941-2 C.B. 103.

<sup>452</sup> See Treas. Regs. §§ 1.613-5(a) (apportionment); and 1.613-5(c)(4)(ii) (1972) (selling

Trade association dues paid by a coal producer are also deductible in computing taxable income from mining and are subject to the apportionment rules.<sup>463</sup> If an integrated manufacturer incurs trade association dues, "a reasonable portion" of the dues must be subtracted from gross income from mining in determining taxable income from mining. This applies if the activities of the association relate to the production, treatment and marketing of raw materials. Some deduction must be made, however, even if one of the primary purposes of the trade association is to promote the production, marketing or sale of a finished product. The regulations suggest that one reasonable method of apportionment is based on the proportion that the direct costs of mining processes and nonmining processes bear to each other.

Although the regulations provide that operating expenses attributable to mining are deductible, numerous questions regarding identification of operating expenses have arisen. Miner's wages and employer's payments to pension funds for miners are clearly deductible.<sup>464</sup> Similarly, expenses of a receiver for an insolvent oil and gas company have been held to be deductible where the company had substantially no other business.<sup>465</sup>

On occasion, however, a question arises regarding how to compute wages. In *Mallory v. United States*<sup>466</sup> a partner's guaranteed share, payable as a salary without regard to profits of the partnership for his services in connection with the partnership's mining activities, was not deductible in computing taxable income from the property. This treatment is consistent with the purpose of I.R.C. § 707(c) which governs such payments for purposes of partnership taxation.

In *Replier Coal Co. v. Commissioner*<sup>467</sup> the taxpayer furnished miners with dynamite and supplies, for which it charged them a price that produced a profit. The taxpayer also rented mine lamps to the miners. Charges for the items were deducted from the wages owed to the employees. The court upheld the Commissioner's position requiring the gross amount of wages, unreduced by the charges for the supplies and lamp rental, to be deducted from gross income. Under the taxpayer's method, which would have deducted only the net wages payable plus the cost of supplies, the ceiling of the fifty percent of taxable income limitation would have been increased by the amount of profits derived from providing the supplies.

However, when the taxpayer receives a trade or cash discount upon the purchase of mining supplies or services that are deductible, only the net amount payable is deducted.<sup>468</sup> Similarly, the income tax credit or refund

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expenses).

<sup>463</sup> Treas. Reg. § 1.613-5(c)(6) (1972).

<sup>464</sup> *Occidental Petroleum Co. v. Commissioner*, 55 T.C. 115 (1970).

<sup>465</sup> *C.A. Hughes & Co. v. Commissioner*, 14 T.C.M. (CCH) 20,893(M) (1955).

<sup>466</sup> 238 F. Supp. 87 (M.D. Ga. 1965).

<sup>467</sup> 140 F.2d 554 (3d Cir.), *cert. denied*, 323 U.S. 736 (1944), *aff'g* 1 T.C.M. (CCH) 12-903-J (1942).

<sup>468</sup> Treas. Reg. § 1.613-5(c)(1) (1972); Rev. Rul. 68-214, 1968-1 C.B. 299; *see also* *Monroe Coal Mining Co. v. Commissioner*, 7 T.C. 1334 (1946).

under I.R.C. §§ 39 and 6421(a) for federal gasoline excise taxes is treated as a reduction in the price of the gasoline.<sup>459</sup>

Taxes deductible under I.R.C. §§ 162 or 164 are deducted to the extent allocable to mining. Thus, state income and franchise taxes, federal social security and unemployment taxes, and state and local real and personal *ad valorem* property taxes must be deducted.<sup>460</sup> *Ad valorem* property taxes paid by a lessee on behalf of a lessor are not deducted. Because such taxes are treated as additional royalties and are excluded from the lessee's gross income, a deduction in computing taxable income would result in taking such taxes into account twice.

If, however, any taxes have been capitalized under I.R.C. § 266, then the amount of such taxes will not be deducted.<sup>461</sup> Similar treatment should be accorded delay rentals that the taxpayer has elected to capitalize.<sup>462</sup> Generally, there is no good reason for a coal operator to capitalize real property taxes or delay rentals, so this provision should not often be applicable.

Interest incurred in a mining operation is deductible, whether incurred to obtain funds for mine development, to purchase equipment, to purchase the mine or to provide operating capital.<sup>463</sup> This includes interest on corporate bonds, discounts on issuance of bonds, premiums on redemption of bonds, and amortizable costs of issuing the bonds.<sup>464</sup> Interest on corporate bonds must be allocated between mining and nonmining activities and then between separate mining properties.<sup>465</sup> Interest on a federal income tax deficiency is deducted if the deficiency relates to income from mining.<sup>466</sup> If, however, the deficiency results from an adjustment to any item that must be allocated between mining and nonmining activities, then only a portion of the interest on the deficiency will be deducted. When the taxpayer has more than one property, interest not

<sup>459</sup> Rev. Rul. 66-226, 1966-2 C.B. 239. For an accrual basis taxpayer the credit or refund generally reduces the price of gasoline purchased during the year in which the right to the credit or refund accrues. If, however, a taxpayer has consistently taken such refunds or credits into account in the following year, that method will be permitted so long as it does not materially distort income.

Gasoline taxes that are refundable or for which a credit is allowed are not deductible. I.R.C. § 280D. If no credit or refund is available, however, the taxes including state taxes, are deductible under I.R.C. § 162.

<sup>460</sup> *Commissioner v. Montreal Mining Co.*, 2 T.C. 688 (1944), *aff'd*, 44-2 USTC ¶ 9490 (6th Cir. 1944); *Grison Oil Corp. v. Commissioner*, 42 B.T.A. 1117 (1940).

<sup>461</sup> Treas. Reg. § 1.613-5(c)(5) (1972).

<sup>462</sup> In Rev. Rul. 55-118, 1955-1 C.B. 320, *declared obsolete in* Rev. Rul. 76-566, 1976-2 C.B. 450, the IRS ruled that delay rentals were carrying charges on unproductive property subject to capitalization under I.R.C. § 266 at the taxpayer's election.

<sup>463</sup> *Guanacevi Mining Co. v. Commissioner*, 127 F.2d 49 (9th Cir. 1942), *aff'g* 43 B.T.A. 517 (1941) (development expenses); *St. Mary's Oil & Gas Co. v. Commissioner*, 42 B.T.A. 270 (1940) (mineral property purchase money); *Central State Collieries, Inc. v. Commissioner*, B.T.A.M. (P-H) ¶ 41,251 (1941) (equipment); *Lumaghi Coal Co. v. Commissioner*, 124 F.2d 645 (8th Cir. 1942).

<sup>464</sup> *Sheridan-Wyoming Coal Co., v. Helvering*, 125 F.2d 42 (D.C. Cir. 1941); *St. Louis, Rocky Mountain & Pacific Co. v. Commissioner*, 28 T.C. 28 (1957).

<sup>465</sup> *St. Louis Rocky Mountain & Pacific Co. v. Commissioner*, 28 T.C. 28 (1957).

<sup>466</sup> *Holly Development Co. v. Commissioner*, 44 B.T.A. 51 (1941) (only activity was production of oil and gas).

directly attributable to a particular property must be fairly apportioned between them.<sup>467</sup>

Under the regulations losses sustained in mining must be deducted. This generally refers to loss deductions under I.R.C. § 165, not net operating loss carryovers under I.R.C. § 172, which are not deducted in computing taxable income from the property.<sup>468</sup> The IRS has ruled that deductible losses include losses intentionally incurred on the sale of goods and services, such as housing, goods, and supplies provided to workers.<sup>469</sup> This view has been accepted by the Tax Court.<sup>470</sup> In effect, the loss is treated as additional wages paid to the miners and attributable to mining. If however, the taxpayer has operated with the intent to provide such goods or services to workers at a profit, the activity will be segregated, treated as a nonmining activity, and its losses, if any, unintentionally incurred will not be deductible in computing taxable income from mining, but will be deductible by the taxpayer in computing taxable income under I.R.C. § 63.

Losses occasioned by abandonment or damage to mine equipment must be deducted in computing taxable income from the property.<sup>471</sup> This is consistent with the requirement that depreciation under I.R.C. § 167 and cost recovery under I.R.C. § 168 be deducted.<sup>472</sup> Similarly, expenditures for equipment necessary to maintain normal output solely because of recession of the working forces of the mine that qualify under Treasury Regulation § 1.612-2(a) for deduction as ordinary and necessary business expenses must also be deducted in computing taxable income from the property.<sup>473</sup>

In *Montreal Mining Co. v. Commissioner*,<sup>474</sup> the Tax Court held that amounts paid in settlement of former employees' occupational disease claims were deductible in the year of the settlement rather than for the prior years in which the workers were engaged in mining. This result is consistent with the general application of the taxpayer's method of accounting to the determination of taxable income from the property. Similarly, wage awards representing back pay are deducted in the year of the award, not in the prior year to which the claims relate.<sup>475</sup>

Exploration and development expenses are taken into account in computing taxable income from the property in the year in which they are deducted under I.R.C. § 617 or § 616, respectively.<sup>476</sup> Because an election to defer development expenses deductions during the development stage applies only to the

<sup>467</sup> G.C.M. 22956, 1941-2 C.B. 103.

<sup>468</sup> Rev. Rul. 60-164, 1960-1 C.B. 254.

<sup>469</sup> Rev. Rul. 56-433, 1956-2 C.B. 332.

<sup>470</sup> *American Gilsonite Co. v. Commissioner*, 28 T.C. 194 (1957), *aff'd on this point*, 259 F.2d 654 (10th Cir. 1958).

<sup>471</sup> *Elk Lick Coal Co. v. Commissioner*, 23 T.C. 585 (1954).

<sup>472</sup> Treas. Reg. § 1.613-5(a) (1972).

<sup>473</sup> *Commissioner v. Harman Coal Corp.*, 200 F.2d 415 (4th Cir. 1952).

<sup>474</sup> 41 B.T.A. 399 (1940).

<sup>475</sup> *Rialto Mining Co. v. Commissioner*, T.C.M. (P-H) ¶ 46,148 (N.L.R.B. award).

<sup>476</sup> Treas. Reg. § 1.613-5(c)(2) (1972).



excess of development expenses over net receipts from the mine,<sup>477</sup> an election to defer the deduction cannot be used to accelerate the year in which a depletion deduction may be taken by raising the taxable income ceiling in the year the expense is incurred with the concomitant reduction in a future year in which the expenses is deducted. However, since net operating loss carryovers are not considered in computing taxable income from the property,<sup>478</sup> a taxpayer who does not elect to defer excess development expenses receives the benefit of the deduction under I.R.C. § 63 in the year to which the net operating loss is carried. The taxpayer does not suffer the burden of reducing the fifty percent of taxable income limitation on percentage depletion in that year.

Because exploration expenses are deductible under I.R.C. § 617(a)(1) only if incurred prior to the beginning of the development stage of the mine, the deduction of such expenses in computing the limit on percentage depletion will be taken into account only in a taxable year in which the mine passes from exploration to production. If, however, exploration expenditures have all been deducted in a taxable year prior to the first production, then the fifty percent of taxable income limitation will never be affected by exploration expenses. If the taxpayer elects to recapture the deducted exploration expenses under the method specified in I.R.C. § 617(b)(1), taxable income under I.R.C. § 63 for the year of the election is increased by the amount of the previously deducted exploration expenditures, but gross income from the property—the starting point for computing taxable income from the property—is not affected.<sup>479</sup> Thus, the taxpayer has taxable income, against which the percentage depletion deduction is not allowable, equal to the previously deducted exploration expenses.

Alternatively, the taxpayer may recapture the previously deducted exploration expenses under I.R.C. § 617(b)(1)(B) by reducing the otherwise allowable depletion deduction for the property by the amount of the previously deducted exploration expenses on a dollar-for-dollar basis once the mine reaches the producing stage. Although recapture may be spread over two or more years, the effect on income is the same; aggregate taxable income over the recapture period is increased by the amount of the previously deducted exploration expenditures. In neither case have the exploration expenditures also reduced taxable income from mining, unless some exploration expenditures were incurred in the year the mine reached the production stage.

If a mine reaches the production stage in the same year that mine exploration expenses have been deducted pursuant to an election, however, aggregate depletion deductions allowable for property will be less than what they would have been either absent the election or if identical expenses had been incurred in a taxable year prior to the first year of production. However, this disadvantage may be offset by the advantage of having had the current deduction for exploration expenses in earlier years, which will not be recaptured in income until a future year. This advantage can exist, however, only when the deducted

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<sup>477</sup> I.R.C. § 616(b) (1981).

<sup>478</sup> Rev. Rul. 60-164, 1960-1 C.B. 254.

<sup>479</sup> Treas. Reg. § 1.617-3(a)(2) (1972).

exploration expenditures exceed ten percent of the gross income from the mine in the year in question. Even then, whether an advantage exists depends on the magnitude of the excess and the number of years for which the exploration expenses will offset the depletion allowance. Furthermore, in making this analysis, consideration must be given to the effect of aggregating properties under I.R.C. § 614.

### 3. Offset of Recapture Income

Although profits from the sale of mining equipment are not included in gross income from mining, the sum of the deductions that are taken into account in computing taxable income from mining is reduced by any income from the sale of property treated as ordinary income under I.R.C. § 1245, that is properly allocable to the property.<sup>480</sup> Thus, the ceiling on the depletion allowance is increased by the amount of recapture income. This reflects the prior deducton of depreciation or cost recovery that reduced taxable income from mining and hence the ceiling on the depletion deduction in a prior year.<sup>481</sup> Although this previously took into account only depreciation recapture on personal property, under I.R.C. § 1245(a)(5), added by the Economic Recovery Tax Act of 1981, it now encompasses recapture on improvements to real estate subject to ACRS, the cost of which has not been recovered under the straight line method.<sup>482</sup> There is no additional offset of recapture income against the allowance of these deductions in computing taxable income under I.R.C. § 63, however, where the full benefit of the deductions remains available. The inclusion of I.R.C. § 1245 recapture income in gross income under I.R.C. § 61 effects the appropriate offset for purposes of computing taxable income.

The determination of the amount of recapture income allocable to a specific mineral property is complex; the regulations are detailed and include numerous examples. Absent aggregation of mineral properties, the basic rule is that the portion of recapture gain allocable to a specific mineral property is that portion of the total recapture gain that bears the same ratio to the total recapture gain as the depreciation or cost recovery deductions taken for the depreciable asset and previously deducted from gross income from mining in a prior year,<sup>483</sup> or if cost depletion had been taken in a prior year, which would

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<sup>480</sup> I.R.C. § 613(a) (1976); Treas. Reg. § 1.613-5(b) (1972). Section 1245 also recaptures as ordinary income amounts deducted under I.R.C. § 179, *see* I.R.C. § 1245(a)(2) and the basis reduction of one half of the amount of the investment tax credit required by I.R.C. § 48(q)(9) (1976).

<sup>481</sup> *See* S. REP. NO. 1881, 87th Cong. 2d Sess. 100 (1962), *reprinted in* 1962-3 C.B. 707, 806.

Prior reductions in the taxable income ceiling attributable to expenditures for machinery and equipment deducted under the recession of the working face doctrine, however, are not so reflected in an offset against deductions in computing taxable income from the property equal to the gain realized upon the subsequent sale of such property. Because such equipment was expensed and not a depreciable capital expenditures, the gain upon the subsequent sale of such property is not subject to recapture as ordinary income under section 1245. *See* I.R.C. §§ 1245(a)(2)(A), (a)(2)(E) (1976 & Supp. IV 1980).

<sup>482</sup> If improvements to real estate are depreciated under the unit of production method pursuant to an election under section 168(e), section 1245 recapture does not apply.

<sup>483</sup> Treas. Reg. § 1.613-5(b)(1), (2) (1972).

have been taken into account if percentage depletion had been claimed in the prior year, bears to the total depreciation or cost recovery allowed with respect to the depreciable asset.<sup>484</sup> The original allocation of the depreciation or cost recovery deduction between properties is to be made on the basis of the number of hours in the year the asset was utilized for the benefit of the respective properties.<sup>485</sup> If the asset was used to benefit different properties in different years, the recapture income is allocated between the properties in the same ratio that deductions originally taken were allocated.<sup>486</sup>

If the I.R.C. § 1245 recapture attributable to a particular mineral property in a certain year exceeds the sum of the deductions from gross income from the property taken into account in computing taxable income from the property, the excess is not carried forward or back and the tax benefit is lost.<sup>487</sup> Furthermore, if the taxpayer disposes of the mineral property in a taxable year prior to the sale of the depreciable asset giving rise to the depreciation recapture, the recapture income may not be used to offset deductions taken into account in computing taxable income from mining for any other mineral property of the taxpayer; the tax benefit is lost. However, if the depreciable asset was used in connection with a mineral property, part of which the taxpayer no longer owns and part of which he still owns, the entire amount of the depreciation recapture may offset deductions in computing taxable income from the property which the taxpayer still owns.<sup>488</sup>

If the depreciable asset was used in both mining and nonmining activities, for example, a truck hauling coal more than fifty miles for application of a mining process, only a portion of the recaptured income reduces expenses taken into account in determining taxable income from mining. Since the original apportionment was based on hours of use in mining and nonmining activities respectively, the same ratio is applied to allocate recaptured income between mining and nonmining.<sup>489</sup>

If the depreciable asset was used with respect to properties which were subsequently aggregated, the entire recaptured gain will be allocated to the aggregated property. If one of the aggregated properties is sold prior to the disposition of the depreciable asset, recapture attributable to the use of the asset, to benefit the property no longer owned during the period of aggregation, is allocated to the remaining property previously aggregated with the property no longer owned.<sup>490</sup> When the depreciable asset was used to benefit previously aggregated properties that have been disaggregated, the depreciation recapture allocable to the period of aggregation is allocated among the properties in the same ratio as the basis of the aggregated properties was apportioned among

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<sup>484</sup> *Id.*

<sup>485</sup> Treas. Reg. § 1.613-5(b)(7) (Example 1) (1972).

<sup>486</sup> Treas. Reg. § 1.613-5(b)(7) (Example 3) (1972).

<sup>487</sup> Treas. Reg. § 1.613-5(b)(3) (1972).

<sup>488</sup> Treas. Reg. § 1.613-5(b)(4) (1972).

<sup>489</sup> Treas. Reg. § 1.613-5(b)(7) (Example 2) (1972).

<sup>490</sup> Treas. Reg. § 1.613-5(b)(7) (Example 4) (1972).

the properties upon disaggregation.<sup>491</sup>

A situation not explained in the regulations is the allocation of recaptured income upon the sale of a depreciable asset used in connection with aggregated properties upon the prior disposition of one of the aggregated properties, when the depreciable asset was used prior to aggregation in conjunction with the property that has been sold prior to the sale of the asset. Presumably, in such a case none of the recapture allocated to the preaggregation period should offset any of the expenses deducted from gross income from the aggregated properties to determine the fifty percent of taxable income limitation on the aggregated properties, even though the full recapture is included in gross income under I.R.C. § 61.

The same logic underlying the offsetting of recapture income against deductions in computing the fifty percent of taxable income limitation should also be applicable to any gain that is treated as ordinary income recognized as a result of the sale of an item of property the cost of which was previously expensed. Such an adjustment would, for example, be particularly appropriate with regard to any gain from property properly expensed under the receding face doctrine.<sup>492</sup> To the extent the amount realized on the sale does not exceed the previously deducted amount, the amount realized should be treated as ordinary income under the tax benefit rule.<sup>493</sup> The analogy to section 1245 recapture income is particularly apt. There is, however, no authority supporting such an adjustment. Because expensed equipment is not capitalized and its cost recovered under I.R.C. § 167 or § 168, the income from the sale of such equipment, although ordinary income under the tax benefit doctrine, is not section 1245 recapture income<sup>494</sup> and, in light of the fact that the adjustment for section 1245 recapture income is specifically and narrowly sanctioned by statute, claiming such an adjustment for expensed equipment has no basis in law.

#### 4. Apportionment of Indirect Costs

Proper allocation of indirect costs is primarily an accounting problem. The leading case dealing with the apportionment of indirect costs is *Occidental Petroleum Co. v. Commissioner*.<sup>495</sup> At issue was the proper allocation among numerous coal mines operated by the taxpayer of payments by the employer to the United Mine Workers of America Welfare and Retirement Fund equal to forty-cents per-ton of coal produced for use or sale; selling expenses; and general administrative and overhead costs, including officers' compensation, cleri-

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<sup>491</sup> Treas. Reg. §§ 1.613-5(b)(4)(ii); 1.613-5(b)(7) (Example 5); see Treas. Reg. § 1.614-6(a)(2) (1972) (allocation of basis among properties upon disaggregation).

<sup>492</sup> See Treas. Reg. § 1.612-2(a) (1960) for deductions under the receding face doctrine.

<sup>493</sup> See, e.g., *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979) (corporation had ordinary income on sale of previously expensed truck tires and tubes).

<sup>494</sup> See I.R.C. § 1245(a)(2)(A), (a)(2)(E) (the gain on equipment expensed under I.R.C. § 179, however, is section 1245 recapture income).

<sup>495</sup> 55 T.C. 115 (1970), acq., 1971-1 C.B. 2..

cal and support wages and salaries, rents, repairs, taxes, interest, pension plan contributions, insurance benefits, and depreciation.

The court grouped the mines into the following three categories: those that produced high grade (metallurgical) coal; those that produced low grade (steam) coal; and those that produced both. Based on the evidence, the court also concluded that the direct expenses of producing high grade coal were greater than the direct expenses of producing low grade coal. A similar conclusion was reached regarding the expenses of selling the respective coals. The court also found that general administrative personnel tended to give less attention to efficient mines than they gave to inefficient mines.<sup>496</sup>

First, the court concluded that the UMW pension payments were direct rather than indirect costs. The taxpayer argued that since fifty-five percent of the employees who benefited from the payments were employed away from the mine face, including those who were employed at idle mines and who worked in the central machine shop, the expenses should be treated as indirect expenses and allocated among the mines in proportion to direct costs. Since the payments were based on total tonnage produced, irrespective of means or cost of production, the court concluded that they could be traced to a particular "cost center" and were, therefore, direct expenses. Because the payments were based solely on tonnage, that was the proper factor to be used to allocate the cost among the various mines.<sup>497</sup>

The court likewise concluded that selling expenses were direct expenses. However, because the court was persuaded by the evidence that the additional expertise necessary to sell high quality coal generally resulted in higher selling costs than were incurred for low quality coal, it employed a different apportionment formula. Sales expenses were then allocated among the three groups into which the court had divided the mines relative to other direct expenses. However, since there was no persuasive evidence regarding the relative variations of sales effort expended for the various mines in each group, within each group the portion of total selling expenses allocated to the group was further allocated relative to tonnage.<sup>498</sup> Because the decision of the Tax Court was so heavily based on the evidence, it would appear that records showing time expended in selling the output of various mines might result in a different method of allocation. However, when the owner of two or more mines treats the coal produced as fungible in making sales, then an allocation based on tonnage appears to be most reasonable.

Finally, the court considered general administrative and mine overhead, which are indirect expenses, and concluded that there are defects in adopting any uniform allocation formula for all such expenses. Nevertheless, it rejected the Commissioner's argument that the expenses should be allocated among the mines based on respective tonnage produced. Emphasizing that the method of apportionment was based on the particular facts, the court adopted the tax-

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<sup>496</sup> *Id.* at 118-20.

<sup>497</sup> *Id.* at 124-26.

<sup>498</sup> *Id.* at 126-27.

payer's method of allocation based on direct costs, including the pension benefit payments and selling expenses. The prime reasons for adopting the "proportionate to direct costs" method of allocating indirect costs appear to have been the persuasive evidence that the taxpayer's administrative personnel devoted to inefficient mines rather than to efficient mines, that inefficient mines having had a higher per unit direct cost than did efficient mines, and that the taxpayer's method reflected industry accounting practices.<sup>499</sup>

Although rejecting the Commissioner's argument, the court acknowledged there is merit to allocating different expenses by different methods. For example, bad debts are clearly unrelated to direct expenses and would be better allocated by a different method. Indirect supervisory personnel expenses should be allocated based on time expended for each separate property, while workman's compensation and mine safety expenses should be allocated on the basis of accident records and time actually expended. Depreciation and interest would be better allocated based upon the respective investment in each separate property. This final category needs even further refinement. For example, interest and depreciation on general administrative offices seem to be better allocated relative to direct costs; while general bond interest might be better allocated relative to investment. However, the court indicated that such refinements in allocation should be generally determined by rule-making rather than in judicial proceedings.<sup>500</sup>

An integrated manufacturer must allocate indirect costs between mining and nonmining activities.<sup>501</sup> The proper allocation of indirect expenses between mining and nonmining activities is also primarily an accounting problem. The method of allocation of selling costs and trade association dues has been discussed above, in regard to identifying expenses deductible in computing taxable income from the property. The allocation of transportation expenses is properly made in the manner described in the discussion of the representative market or field price and proportionate profits methods of computing gross income from mining.<sup>502</sup> Only the cost of the mining transportation included in gross income from mining is to be deducted in computing taxable income from the property.<sup>503</sup>

In *Tennessee Consolidated Coal Co. v. Commissioner*,<sup>504</sup> the Tax Court rejected the Commissioner's argument that indirect costs should be universally allocated between mining and nonmining activities in proportion to direct costs. Instead, based on evidence presented by the taxpayer, the court approved allocation to mining of varying percentages of the deductible expenses for power purchased, superintendent's salary, building repairs, officers' salaries, state franchise taxes, state and county taxes, office salaries, stationary and printing and certain payroll taxes. However, since the taxpayer introduced no

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<sup>499</sup> *Id.* at 128-29.

<sup>500</sup> *Id.* at 130-32.

<sup>501</sup> Treas. Reg. § 1.613-5(a) (1972).

<sup>502</sup> See *supra* notes 345-56, 359-66 and accompanying text.

<sup>503</sup> Treas. Reg. § 1.613-5(a) (1972).

<sup>504</sup> 15 T.C. 424 (1950).

evidence probative that any allocation other than relative to direct cost was proper for vacation pay, general office expense, certain depreciation expenses, clerks, contributions, office expense, insurance, miscellaneous expense, certain bonuses and legal expenses, the Commissioner's allocation for these items was sustained.<sup>505</sup>

##### 5. Expenses Not Deducted in Computing Taxable Income from the Property

A number of expenses are not deductible from gross income from the property in computing the fifty percent of taxable income limitation. The exclusion of these items from the computation is advantageous to the taxpayer because the items remain, nevertheless, deductible in computing taxable income under I.R.C. § 61. As noted above, net operating loss carrybacks and carryforwards are not deducted.<sup>506</sup> This treatment, to the extent that the net operating loss is attributable to expenses deductible in computing taxable income from the property in the year in which the net operating loss was incurred, is overly generous. Perhaps the rationale for the ruling is the administrative complexity in apportioning the net operating loss when the taxpayer is involved in both mining and nonmining activities, but considering the complexity and detail of computations already required, it would actually be only a minor burden. More likely, since percentage depletion is an incentive provision, carrying over losses to reduce depletion in prior or future years would be antithetical to the purposes of I.R.C. § 613.<sup>507</sup>

As discussed previously selling expenses attributable to the manufactured product are also nondeductible. These expenses do not contribute to gross income from mining and are, therefore, not deducted in computing taxable income from mining.<sup>508</sup> Similarly, the Fourth Circuit held in *Island Creek Coal Co. v. Commissioner*<sup>509</sup> that business interruption fire insurance premiums are not deductible. Likewise, in *North Carolina Granite Corporation v. Commissioner*,<sup>510</sup> the court held that legal fees incurred to determine the proper depletion deduction for federal income tax purposes are not deductible in computing taxable income from the property. The IRS, however, asserts that such expenses are indirect administrative expenses which must be allocated between mining and nonmining income.<sup>511</sup> If a taxpayer had only income from mining, the view of the IRS would require all of the legal and accounting expenses incurred in connection with the determination of the taxpayer's income tax liability be deducted in computing taxable income from mining.

<sup>505</sup> *Id.* at 434-35.

<sup>506</sup> Rev. Rul. 60-164, 1960-1 C.B. 254.

<sup>507</sup> Percentage depletion is very clearly a tax expenditure designed to encourage exploration, development and extraction of natural resources. See McMahon, *Defining the "Economic Interest" in Minerals after United States v. Swank*, 70 Ky. L.J. 23, 30-33 (1982).

<sup>508</sup> Treas. Reg. § 1.613-5(c)(4)(ii) (1982).

<sup>509</sup> 382 F.2d 35 (4th Cir. 1967), *rev'g* 43 T.C. 234 (1964).

<sup>510</sup> 56 T.C. 1281 (1974) *nonacq.*, 1972-2 C.B. 5, *nonacquiescence explained* Rev. Rul. 77-179, 1977-1 C.B. 168.

<sup>511</sup> Rev. Rul. 77-179, 1977-1 C.B. 168, 170.

Charitable contributions by a taxpayer engaged in mining are not attributable to mining and are therefore not deducted in computing taxable income from mining.<sup>512</sup> Not every payment to a charitable organization is a contribution, however, and if the payment is actually in consideration of services it must be deducted. For example, if a hospital renders medical services having a value of \$2,000 to an injured miner and the employer pays the hospital \$3,000, the \$1,000 for which no consideration was received is a contribution, but the \$2,000 for medical services must be deducted in computing taxable income from mining.<sup>513</sup> Within the limits of I.R.C. § 170, however, charitable contributions remain fully deductible in computing taxable income under I.R.C. § 63.

Revenue Ruling 80-317 held that damages payable by a mineral producer for failure to deliver the amount of mineral required under a contract were not deductible in computing taxable income from mining.<sup>514</sup> The damages payment was not a cost of producing the mineral; rather it was the result of not producing the mineral.

## 6. Production Payments—Payor's Treatment

The proper treatment of production payments is governed by I.R.C. § 636. Whether or not the payor of a production payment must reduce gross income from the property by a portion of the payment in computing taxable income from the property depends upon the treatment accorded to the payment under I.R.C. § 636.

If the production payment was retained by the payee in a transaction involving the sale of the coal property to the operator, the payment is treated as a purchase money mortgage loan.<sup>515</sup> The portion of each payment representing interest is deducted from gross income from the property in computing taxable income from the property. In determining the allocation of interest, the provisions of I.R.C. § 483 are applicable.<sup>516</sup> Thus, if inadequate interest is stated, interest will be imputed at the then currently applicable rate.<sup>517</sup> The entire amount of the production payment, including the interest portion, and the operating expenses attributable to the production payment, is included in the payor's gross income from the property. The operating expenses attributable to the production payment are deductible in computing taxable income from the property and in computing taxable income under I.R.C. § 63.<sup>518</sup>

A production payment retained by a lessor, however, is treated by the lessee as a lease bonus payable in installments.<sup>519</sup> The amount of the payments

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<sup>512</sup> *United States Potash Co. v. Commissioner*, 29 T.C. 1071 (1958), *acq.*; 1960-1 C.B. 6; *Island Creek Coal Co. v. Commissioner*, 30 T.C. 370 (1958); Rev. Rul. 60-74, 1960-1 C.B. 253.

<sup>513</sup> Rev. Rul. 60-74, 1960-1 C.B. 253, 254.

<sup>514</sup> 1980-2 C.B. 202.

<sup>515</sup> I.R.C. § 636(b) (1976).

<sup>516</sup> Treas. Reg. § 1.636-1(a)(ii) (1973).

<sup>517</sup> See generally Treas. Reg. § 1.483-1 (1981).

<sup>518</sup> See *Brooks v. Commissioner*, 424 F.2d 116 (5th Cir. 1970) *rev'g* 50 T.C. 927 (1968); Rev. Rul. 35, 1971-1 C.B. 51.

<sup>519</sup> I.R.C. § 636(c) (1976); Treas. Reg. § 1.636-2(a) (1973).



are included in the lessee's gross income under I.R.C. § 61,<sup>520</sup> but not in gross income from the property.<sup>521</sup> The interest portion of the production payment is capitalized as part of the bonus along with the principal portion,<sup>522</sup> and since no part of the production payment was included in gross income from the property, the interest portion is not deducted in computing taxable income from the property or in computing taxable income under I.R.C. § 63.

A production payment carved out to finance development or exploration transfers an economic interest in the property.<sup>523</sup> Thus, the production payment is excluded from the operator's gross income from the property and from his gross income under I.R.C. § 61. Because the entire payment is excluded from gross income from the property, and is thus excluded from the base on which depletion is computed, no deduction from gross income is appropriate.

Such treatment is accorded, however, only to production payments for which the consideration is pledged for use in the exploration and development of the burdened property; if there is any other permissible use, the carved out production payment will be treated as a mortgage loan.<sup>524</sup> Thus, a production payment for which the consideration is to be used for production, is treated as a loan, the consequences of which are described above in connection with production payments treated as purchase money mortgages. In Revenue Ruling 74-549, the IRS held that a carved out production payment, the proceeds of which were used to purchase equipment and to finance the removal of overburden, was to be treated as a loan.<sup>525</sup>

## V. IDENTIFICATION OF THE "PROPERTY" FOR COMPUTING THE DEPLETION DEDUCTION

### A. *Separate Properties*

Both cost and percentage depletion are computed with references to individual mineral "properties," rather than with reference to all of the taxpayer's properties taken together. The identification of each "property" with respect to which a separate depletion computation is necessary is governed by I.R.C. § 614. It is possible, however, under certain circumstances for the taxpayer to elect to aggregate separate properties and compute depletion on the aggregated properties as if they were one property.<sup>526</sup>

Section 614(a) defines the "property" as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."<sup>527</sup> An "interest" is an "economic interest in a mineral deposit."<sup>528</sup> If a

<sup>520</sup> Treas. Reg. § 1.636-2(a) (1973).

<sup>521</sup> Treas. Reg. § 1.613-2(c)(5)(ii) (1973).

<sup>522</sup> Treas. Reg. § 1.636-2(a) (1973).

<sup>523</sup> I.R.C. § 636(a) (1976) (last sentence).

<sup>524</sup> I.R.C. § 636(a) (1976); Treas. Reg. § 636-1(b)(7) (1973).

<sup>525</sup> 1974-1 C.B. 186; *see also* Rev. Rul. 77-308, 1977-2 C.B. 208 (removal of overburden not development expense); Rev. Rul. 67-169, 1967-1 C.B. 159 (same).

<sup>526</sup> *See* I.R.C. § 614(c) (Supp. 1980).

<sup>527</sup> The same definition appears in Treas. Reg. § 1.611-1(d)(7) (1973) and § 1.614-1(a)(3) (1973). This definition is based on the definition promulgated by the IRS in G.C.M. 22106, 1941-1

taxpayer has both an operating interest and a nonoperating interest in a particular mineral deposit, they are treated as separate interests.<sup>529</sup> Thus, for example, if the taxpayer leases a coal deposit to a partnership, the partners of which are the taxpayer and another person, and the partnership operates the deposit,<sup>530</sup> the taxpayer has two separate interests, a royalty interest subject to I.R.C. § 631(c) and an operating economic interest subject to depletion. This rule can be very advantageous for taxpayers.

A taxpayer owning the fee or holding a lease into a coal deposit and desiring to operate the deposit will frequently find it to his advantage to split his interests through the use of a wholly owned corporation to serve either as the lessor or operator, thus securing for the lessor entity the advantages of I.R.C. § 631(c) treatment permitting effective recovery of the depletable basis of the coal deposit and capital gains treatment of the royalties in excess of basis, while the lessee operator claims percentage depletion on the operating income.<sup>531</sup> For the operator who so arranges the structure of his business, this is truly a case of "having your cake and eating it too," since cost depletion and percentage depletion are effectively claimed against substantially the same income.

A separate "tract or parcel of land" is identified by the manner of acquisition. The regulations provide as follows:

All contiguous areas (even though separately described) included in a single conveyance or grant or in separate conveyances or grants at the same time from the same owner constitute a single separate tract or parcel of land. Areas included in separate conveyances or grants (whether or not at the same time) from separate owners are separate tracts or parcels of land even though the areas described may be contiguous.<sup>532</sup>

The regulations provide numerous examples of the operation of these rules.<sup>533</sup> Under the regulations neither the taxpayer's operating unit nor the fact that

C.B. 245, *declared obsolete*, Rev. Rul. 66-661, 1968-2 C.B. 607 and G.C.M. 24094, 1944 C.B. 250, *declared obsolete*, Rev. Rul. 70-277, 1970-1 C.B. 280. Prior to the enactment of I.R.C. § 614(a) the courts generally rejected this definition in favor of one based on the operating unit concept. *See, e.g., Helvering v. Jewel Mining Co.*, 126 F.2d 1011 (8th Cir. 1942), *rev'g* 43 B.T.A. 1123 (1941); *Black Mountain Corp. v. Commissioner*, 5 T.C. 1117 (1945), *non acq.*, 1942-2 C.B. 6; *Amherst Coal Co. v. Commissioner*, 11 T.C. 209 (1948).

<sup>529</sup> Treas. Reg. § 1.614-1(a)(2) (1973). *See supra* Section II regarding the meaning of "economic interest."

<sup>529</sup> *See* Treas. Reg. § 1.614-1(a)(3) (1973); § 1.614-1(a)(5) (Ex. 3) (1973); *Lloyd Corp., Ltd. v. Riddell*, 347 F.2d 455 (9th Cir. 1965) (taxpayer who owned one-half interest in fee and entire interest in lease had two separate interests); *Helvering v. Jewel Mining Co.*, 126 F.2d 1011 (8th Cir. 1942), *rev'g* 43 B.T.A. 1123 (1941) (lessee operated coal mine on portion of tract and subleased another portion of tract); *see also* Treas. Reg. § 1.614-3(a)(1) (1978) (prohibiting the aggregation of an operating interest and a nonoperating interest).

<sup>530</sup> The facts of this hypothetical are adapted from Rev. Rul. 73-32, 1973-1 C.B. 301; *see supra* notes 118-20 and accompanying text.

<sup>531</sup> *See Whiteside & Jackson, Tax Shelters in the Mineral Industry, OIL & GAS/NATURAL RESOURCES TAXES (P-H) ¶ 2039 (1983).*

<sup>532</sup> Treas. Reg. § 1.614-1(a)(3) (1973).

<sup>533</sup> Treas. Reg. § 1.614-1(a)(5) (Ex. 1)-(Ex. 9) (1973).

only one coal deposit underlies several different tracts of land are significant in identifying the property, absent an election under I.R.C. § 614(c) to aggregate separate properties or fragment one property. Thus, if the taxpayer conducts mining operations as a single operating unit on eight contiguous tracts overlying one coal deposit, but his interest in each tract was acquired from a different transferor, he is operating eight separate properties.<sup>534</sup> Whether the interests are in fee or leasehold is irrelevant. Similarly, three noncontiguous tracts overlying the same deposit acquired from a single transferor in one transaction are treated as three separate properties.<sup>535</sup> If, however, the taxpayer acquires contiguous tracts overlying a single deposit in one transaction, he has a single property even if his transferor had two separate properties because the transferor had acquired his interest in each tract from different transferors.<sup>536</sup> This rule applies, however, only if the transferor held the fee.<sup>537</sup> The regulations, distinguish between a lease from the fee owner, which can effect the unification of what were two separate properties for the lessor and an assignment of the leases to two contiguous tracts leased from different fee owners. In the latter case the tracts remain separate properties for the assignee of the leases.<sup>538</sup>

There is one important exception to the aggregation of properties effected by a transfer as described in the preceding paragraph. If the properties' bases in the hands of the transferee are determined by reference to their bases in the hands of the transferor, then the properties must be treated as separate properties by the transferee if they were so treated by the transferor.<sup>539</sup> This rule is of particular importance when the holder of separate, but contiguous, properties overlying a single deposit contributes them to a partnership in exchange for a partnership interest or to a corporation in a transaction in which no gain is recognized under I.R.C. § 351. In either case the properties remain separate properties in the hands of the partnership or corporation due to the carryover basis rules.<sup>540</sup>

Even though one coal deposit is often divided among several properties, identification of mineral deposits is not irrelevant in defining separate properties. Each separate deposit must be treated as a separate property, even if the deposits underlie a single tract or parcel of land.<sup>541</sup> Thus, each separate coal seam underlying one surface tract is a separate property. A culm bank or waste deposit is not treated as a separate coal deposit, however, but is part of the coal deposit from which it was extracted.<sup>542</sup>

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<sup>534</sup> Treas. Reg. § 1.614-1(a)(5) (Ex. 2), (Ex. 5), (Ex. 8) (1973). For the definition of an "operating unit," see Treas. Reg. § 1.614-2(c) (1965).

<sup>535</sup> Treas. Reg. § 1.614-1(a)(5) (Ex. 4) (1973).

<sup>536</sup> *Id.*, (Ex. 7).

<sup>537</sup> *Id.*, (Ex. 6).

<sup>538</sup> *Id.*, (Ex. 9).

<sup>539</sup> Treas. Reg. § 1.614-1(a)(4) (1973).

<sup>540</sup> I.R.C. §§ 723 (partnership); 358 (corporations) (1976).

<sup>541</sup> Treas. Reg. § 1.614-1(a)(3) (last sentence); § 1.614-1(a)(5) (Ex. 7) (1973).

<sup>542</sup> Treas. Reg. § 1.614-1(c) (1973). See *supra* notes 309-24 and accompanying text for a discussion of the circumstances under which extraction from waste deposits is treated as mining for the purposes of the depletion deduction.

### B. *Elective Aggregation of Properties*

The tendency of I.R.C. § 614(a) to multiply the number of properties is counterweighed by the provisions of I.R.C. § 614(b) permitting the elective aggregation of operating interests in mines.<sup>543</sup> Aggregation is limited, however, to interests which constitute all or part of an "operating unit" of the taxpayer. Separate operating units are identified with reference to the taxpayer's own method of mining operations. Sharing common supply, maintenance, processing, treatment and storage facilities and common field personnel are indicia that separate mineral interests or mines are part of a single operating unit. Geographically separated operating interests merely sharing a single set of accounting records, a single exclusive organization and sales or processing facility are not part of the same operating unit.<sup>544</sup> As long as the operating unit requirement has been met, it is not necessary that the separate interests to be aggregated be included in a single parcel or tract of land or that they be contained in contiguous tracts or parcels of land.<sup>545</sup>

The number of aggregated properties within any operating unit may depend on the number of mines in the unit. If the taxpayer elects to aggregate interests, all interests comprising a single mine, including interests subsequently becoming part of the mine, must be aggregated.<sup>546</sup> If, however, two or more mines are contained within a single operating unit, the taxpayer may aggregate the interests comprising each mine separately or the taxpayer may elect to aggregate all mines within the unit as one property.<sup>547</sup> Under the regulations a "mine" is defined as "any excavation or other workings or series of related excavations or related workings. . . ."<sup>548</sup> The particular facts and circumstances of the case determine the number of "excavations" or "workings" that constitute a single mine. Among the factors to be considered are the nature and position of the deposit or deposits; the method of mining; the location of the excavations or other workings in relation to the deposit or deposits; and the topography of the area.<sup>549</sup> The taxpayer's determination of the composition of a mine is accepted unless there is clear and convincing evidence to the con-

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<sup>543</sup> I.R.C. § 614(b) refers to "operating mineral interests." This term is defined by I.R.C. § 614(d) to include:

only an interest in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer for the purposes of computing the 50 percent limitation provided for in section 613, or would be so required if the mine, well, or other natural deposit were in the production stage.

See also Treas. Reg. § 1.614-3(e) (1978) (mine defined); § 1.614-2(b) (1965) (operating mineral interest defined). Under certain more limited circumstances nonoperating interests are also subject to aggregation under I.R.C. § 614(e). See Treas. Reg. § 1.614-5 (1961).

<sup>544</sup> See Treas. Reg. § 1.614-3(d) (1978); § 1.614-2(c)(1) (1965). See also Rev. Proc. 64-23, 1964-1 C.B. 689.

<sup>545</sup> Treas. Reg. § 1.614-3(a)(1) (1978).

<sup>546</sup> *Id.* See also Treas. Reg. § 1.614-3(a)(2) (1978) (aggregation in subsequent taxable years).

<sup>547</sup> Treas. Reg. § 1.614-3(a)(1) (1978).

<sup>548</sup> Treas. Reg. § 1.614-3(e) (1978). "Excavations" or "workings" include "quarries, pits, shafts, and wells (except oil and gas wells)." *Id.*

<sup>549</sup> *Id.*

trary. The operation of these rules is illustrated by Revenue Ruling 74-215.<sup>550</sup>

In Revenue Ruling 74-215 the taxpayer operated an open pit mine and an underground mine both of which extracted ore from a single deposit as a single operating unit. The operating unit consisted of eighteen separate tracts of land and thus eighteen interests. The taxpayer was permitted to separately aggregate the interests operated as an open pit mine and an underground mine. Among the reasons two different "mines" existed were that the ore quality differed and the operation of each mine required different techniques, personnel and equipment.

Nevertheless, a strip mine and a deep mine that are in fact treated as a single operating unit by the taxpayer may be aggregated as one property if the taxpayer so elects.<sup>551</sup> The taxpayer has the freedom to choose whether two mines, each consisting of separate interests but included in one operating unit, will be aggregated as one property or two properties.

When two or more properties have been aggregated, the unadjusted basis of the aggregated property is the sum of the unadjusted bases of the separate interests that have been aggregated. The adjusted basis of the aggregated property is its unadjusted basis, adjusted for all prior adjustments to basis, including those required by prior depletion deductions claimed for each interest.<sup>552</sup> After aggregation, all adjustments to bases are computed on the adjusted basis of the aggregated property.<sup>553</sup>

Because the "depletion unit" for cost depletion is determined by dividing the adjusted basis of the mineral property at the beginning of the taxable year by what is essentially equivalent to the number of tons of coal remaining to be recovered at the beginning of the year,<sup>554</sup> aggregation can significantly affect the cost depletion deduction available in any given year. If only cost depletion is claimed, however, this is merely a timing difference. Total depletion over the lives of the aggregated properties will always be equal to the sum of the adjusted bases of the separate properties regardless whether they are aggregated.<sup>555</sup>

On the other hand, when percentage depletion is claimed (either alone or intermixed with cost depletion), aggregation of properties can affect the total amount of depletion deductions claimed over the life of the deposit or deposits to be extracted. This result arises primarily from the effect of aggregation on the computation of the fifty percent limitation. But it may also occur if a property on which cost depletion would exceed percentage depletion is aggregated with one or more other properties, and percentage depletion is claimed on the aggregate property. It is impossible to determine definitely, in advance,

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<sup>550</sup> 1974-1 C.B. 149.

<sup>551</sup> See *Douglas Coal Co. v. United States*, 429 F. Supp. 322 (N.D. W. Va. 1977).

<sup>552</sup> Treas. Reg. § 614-6(a)(1) (1980).

<sup>553</sup> *Id.*

<sup>554</sup> See *supra* notes 143-51 and accompanying text.

<sup>555</sup> See *Coggin*, 90-6th T.M., *Mineral Properties Other Than Oil and Gas—Operation B-301* (1980).

whether aggregation will increase or reduce the aggregate amount of percentage depletion allowable. The result depends on the relative gross and taxable incomes from each of the properties. Total percentage depletion deductions will generally be increased if allowable percentage depletion on some of the separate properties will be significantly limited by the fifty percent limitation but fifty percent of the combined taxable income of the aggregated properties will near or exceed ten percent (in the case of coal) of the gross income from the combined properties. Aggregating a more profitable property with less profitable properties may increase the depletion deduction. However, aggregation of a property that is operating at a loss or at a *very low profit margin*, and thus claiming cost depletion, with other properties that have not been subject to the fifty percent limitation *may* result in a reduction of the taxable income from the aggregated property to the point where the fifty percent limitation limits the depletion allowance deduction for the aggregated property to less than the sum of the allowable depletion deductions computed for the properties separately.<sup>556</sup>

The rules regarding aggregation of separate properties discussed in the preceding paragraphs are only a summary of the complex provisions governing aggregation. Particular problems not discussed in this article arise with respect to the requirements of a timely election,<sup>557</sup> aggregation of additional interests following the initial election,<sup>558</sup> invalid aggregations,<sup>559</sup> and computation of basis, holding period and abandonment losses for aggregated properties.<sup>560</sup> The regulations provided detailed rules for most of these problems.

### C. Election to Separate A Single Property

If the owner of an operating interest is or will be extracting the deposit in a single property by operating two or more mines, the taxpayer may elect under to I.R.C. § 614(c)(2) to have each mine treated as a separate property.<sup>561</sup> Following the election, depletion deductions will be separately computed for each mine. Thus, the taxpayer may elect to separate a mine in the development stage from an already operating mine to avoid a reduction in the fifty percent limitation that would be caused by the deduction of development expenses. However, if the mine is part of a property previously aggregated under I.R.C. § 614(c)(1), an election to treat the mine as a separate property may be made only with the consent of the commissioner; and such consent will not be

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<sup>556</sup> For several examples of divergent results based on differing relationships of gross income from the properties to taxable income from the properties, see *id.* at A-49, B-101 to B-301.

<sup>557</sup> I.R.C. § 614(c)(3) (1982); see Treas. Reg. § 1.614-3(f) (1978).

<sup>558</sup> See Treas. Reg. § 1.614-3(a)(2) (1978).

<sup>559</sup> See Treas. Reg. § 1.614-3(f)(8) (1978).

<sup>560</sup> See Treas. Reg. § 1.614-6 (1980).

<sup>561</sup> I.R.C. § 614(c)(2). For the election to be made the taxpayer must have made expenditures for development or operation of each of two mines. See also Treas. Reg. § 1.614-3(b)(1) (1978). The regulations provide that if there is more than one mineral deposit in a particular tract or parcel of land, an election under I.R.C. § 614(c)(2) regarding one deposit has no application to the other deposit. This is because the existence of two deposits gives rise to two properties despite their convergence in one tract or parcel of land. See *supra* note 538 and accompanying text.

granted where the purpose of the election is based on the tax consequences.<sup>562</sup>

If an election to separate mines in a single property is made, all of the coal deposit and tract or parcel of land to which it relates must be allocated among the separate properties created by the election.<sup>563</sup> The adjusted basis of the property with respect to which the election was made must be apportioned among the properties created by the election proportionate to the relative fair market values of the separate properties created by the election.<sup>564</sup>

Since a property is treated as a separate property for all purposes once it has been validly separated under I.R.C. § 614(c)(2), the taxpayer may subsequently aggregate the mine with other separate properties in the same operating unit, or, if the facts warrant, because the mine itself has developed into two or more separate mines, the taxpayer may elect under I.R.C. § 614(c)(2) to separate the property again, into two properties, each with a separate mine or mines.<sup>565</sup> The rules relating to the time for filing an election to aggregate and separate properties will prevent a mine, which has been separated from other mines in the same original property, from being aggregated with such mines in a subsequent year without the consent of the Commissioner.<sup>566</sup> This, together with the requirement that the Commissioner's consent be obtained for any separation of previously aggregated properties, prevents manipulation of the identity of properties from year to year for tax avoidance purposes.<sup>567</sup>

## VI. CONCLUSION

This article has attempted to provide a detailed view of the substantive rules regarding entitlement to the coal depletion allowance deduction and the elements that enter into the computation of the deduction. Despite efforts to be complete, however, there are many remaining questions, and in the case of aggregation of properties, a substantial number of detailed administrative rules have not been addressed. Many of these questions relate to proper accounting methods in allocating income and expenses between properties and between mining and nonmining activities for purposes of computing the gross income from the property and fifty percent of the taxable income from the property, both of which are necessary elements of computing the percentage depletion allowance deduction.

Most of the substantive questions left unanswered are in that posture, however, not because the applicable rules are unstated, but because the question relates to effect of application of the rule on the depletion deduction calculation. Will taking a particular item into account increase or decrease the depletion deduction? Furthermore, when will the effect be felt, now or later? This is particularly true with items subject to elective treatment, such as re-

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<sup>562</sup> Treas. Reg. § 1.614-3(b)(1) (1978).

<sup>563</sup> Treas. Reg. § 1.614-3(b)(2) (1978).

<sup>564</sup> Treas. Reg. § 1.614-3(b)(3) (1978).

<sup>565</sup> Treas. Reg. § 1.614-3(b)(1) (1978).

<sup>566</sup> I.R.C. § 614(c)(3) (1976 & Supp. IV 1980); Treas. Reg. § 1.614-3(f) (1978).

<sup>567</sup> *Contra* Day Mines, Inc. v. Commissioner, 42 T.C. 337, 352-53 (1964) (aggregation made for purpose of reducing taxes is valid).

capture of exploration expenses under I.R.C. § 617, deferral of development expenses under I.R.C. § 616, and aggregation and separation of properties under I.R.C. § 614. Many of these questions cannot be answered in the abstract, but only may be answered with examples. If any rules of thumb exist, they would be too numerous to be useful. I hope, however, that the discussion in this article will be of assistance in analyzing depletion allowance problems and computations.

Some other questions raised in this article are more troubling. They relate to the proper—that is, theoretically correct—treatment of items in computing depletion allowance deductions. This is a difficult issue to address in coal taxation, and indeed, in all of natural resources taxation because many of the substantive rules are artificial. They often deviate from normative rules of taxation applicable to other industries. For example, I.R.C. § 613(a) provides that I.R.C. § 1245 recapture income attributable to a property should be offset against deductions in computing the fifty percent limitation on percentage depletion. This is eminently logical since the depletion deduction previously taken reduced the fifty percent limitation in a prior year, and the existence of recapture income in a subsequent year indicates that in the earlier years depreciation was overstated. However, gains on the sale of equipment which was expensed under the receding face doctrine are not offset in the same manner, despite the gain, equal to the amount realized, being treated as ordinary income under the tax benefit rule to the extent that it does not exceed the previously deducted cost. Logically, this gain should be treated in the same manner as I.R.C. § 1245 gain. Why is there a difference? There is a difference because I.R.C. § 613 specifically refers to I.R.C. § 1245 recapture and to nothing else, and the receding face doctrine is an artificial rule, deviating from the general rule requiring capitalization and cost recovery under I.R.C. § 168. Neither the accelerated deduction under the receding face doctrine, nor the concomitant denial of any offset of subsequent gains against taxable income from the property is totally logical, but perhaps rough justice is done. The price of the accelerated deduction today means less depletion in the future.

Another and more troubling example of an unresolved problem—also involving a capitalization versus expensing issue—is the treatment of reclamation expenses for strip mines. Neither the IRS nor the courts have yet viewed these as capital expenditures. Indeed, the analogy to deductible stripping of overburden is too appealing. But the answer is not that reclamation is properly deductible because stripping overburden is deductible. Correctly treated, both items should be both capitalized and added to the depletable basis of the coal deposit. But proper treatment of reclamation expenditures would create the appearance of inconsistency because stripping overburden is already erroneously accorded treatment as a currently deductible operating expense. Furthermore, from the viewpoint of most operators, proper treatment of reclamation expenses would be highly disadvantageous. They are deducting percentage depletion, and would probably be doing so even if the reclamation costs were capitalized. In such event the issue of whether to capitalize or currently deduct the reclamation expense does not present a question of whether the amount will be deducted now or later, but rather a question of whether it will ever be



deducted. Furthermore, even if the taxpayer switches to cost depletion as a result of the capitalization of the reclamation expenses, he does so at the expense of losing the benefit of percentage depletion. He may gain one deduction but he has lost another.

The reclamation expenses issue is merely one facet of the exacerbation of the tension between current deduction and capitalization of expenses adding to the value of the deposit that is caused by treating percentage depletion as an alternative to cost depletion. The purpose of percentage depletion is to provide an incentive for exploration, development and extraction of natural resources, including coal.<sup>668</sup> However, since percentage depletion and cost depletion are mutually exclusive, the greater the taxpayer's capital investment in the mineral deposit, the less the benefit received from claiming a percentage depletion deduction. There is something internally inconsistent in this structure. Cost depletion, because of its function analogous to the cost of goods sold, should be allowed in all events. The incentive provision, percentage depletion, should be separately applied, not mutually exclusive. In addition to the illogic of the mutually exclusive alternative availability of cost and percentage depletion deductions, the present regime exerts undue pressure on taxpayers to seek, and Congress to grant, current deductions for capital expenditures that would otherwise be added to the depletable basis of the mineral deposit.<sup>669</sup> The solution to this problem is to separate cost and percentage depletion and allow cost depletion deductions in all events. The incentive purpose of percentage depletion, if Congress continues to believe it is warranted, should be provided by an *additional* deduction of a percentage of either the gross or taxable income derived from the extraction of natural resources. Such a system would not only be substantially more equitable but, if properly constructed, it would be more easily administered because it would significantly relieve the pressure to permit current deductions for items properly capitalized as part of the depletable basis of the mineral deposit and the complexity that results from responding to that pressure.

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<sup>668</sup> See *supra* notes 11-24 and accompanying text; McMahon, *Defining the "Economic Interest" in Minerals After United States v. Swank*, 70 Ky. L.J. 23, 30-33, 84-87 (1982).

<sup>669</sup> See, e.g., I.R.C. § 616 (1982) (deduction of development expenditures for natural resources other than oil and gas); I.R.C. § 617 (1982) (deduction of exploration expenditures for any deposit of ore or other mineral); I.R.C. § 263(c) (1982) (deduction of intangible drilling and development costs for oil, gas and geothermal wells).