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Depletion of Minerals

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INTRODUCTION

Like the gold rush of '49, the uranium boom of the 1950's has caused people all over the country, if not the world, to suddenly become aware of the mining industry. All kinds of people, from men with just enough capital to buy geiger counters to wealthy investors and large corporations, have developed a burning interest in prospecting for uranium. Furthermore, the dissemination of information with respect to the various tax advantages available, in some circumstances, to the investor in a mine has caused many individuals with high incomes to become interested in mining.

Because of this great interest in mining that is currently being generated, the accountant, more than ever before, is apt to encounter tax questions relating to mining operations. Consequently, he should be prepared to give some of the answers to these questions as well as to discuss the tax aspects generally.

Since depletion is one of the most important tax factors in the mining industry, this paper should be both timely and useful, especially for those accountants who may not have had an opportunity to gain experience with respect to depletion problems.

HISTORY

Depletion has been constantly changing and expanding since 1913, and the following chronology of events will give you a bird's-eye view of its growth.

Cost depletion first appeared in the Revenue Act of 1913 which provided that it should be limited to 5% of the gross value of the output at the mouth of the mine. This was changed by the 1916 Act which eliminated the limitation and permitted a reasonable allowance for depletion. Discovery depletion was first introduced in the 1918 Act.

The income limitation came into being in the 1921 Act, which provided that discovery depletion should be limited to net income from the property, but not less than cost depletion. The 1924 Act changed this to 50% of net income from the property.

Percentage depletion began, as to oil and gas wells with the 1926 Act, and, as to mines, with the 1932 Act. Only coal, metal, and sulfur mines were included, however. The 1932 Act also authorized a change in depletion where a reestimate of the mineral reserves was made. The 1936 Act provided that the basis of depletable property should be reduced (beginning with 1932) by the full amount of depletion allowed, whether computed by the cost, discovery value, or percentage method.

"Gross income from the property" was first defined in the 1943 Act, and included ordinary treatment processes as part of mining.

The 1950 Act first included certain transportation as part of the mining operation.

The 1954 Code introduced depletion of waste or residue of prior mining, and provided a definition for the term "the property" which provides, in certain circumstances, for a combining of mineral interests into one property. Also, discovery value depletion was eliminated.

All of the Revenue Acts from 1942 to 1954, inclusive, have continually expanded the number of minerals subject to percentage depletion, until now nearly all minerals are so subject. If you have been laboring under the delusion that depletion is confined to oil, I trust you are deluded no longer.

REFERENCES TO LAW

Unless otherwise indicated, Sections of the law referred to in the remainder of this paper relate to the Internal Revenue Code of 1954.

DEFINITIONS OF DEPLETION

There are two kinds of depletion, namely physical depletion and economic depletion.

Physical depletion, with which this paper is not concerned, may be defined as the exhaustion or wasting away of a deposit of minerals, oil, or some other natural resource. This kind of depletion is mainly the concern of those charged with the responsibility for conserving our natural resources.

For accounting and tax purposes we are concerned with economic depletion, which may be defined as the write-off of the basis of a natural resource as the supply diminishes or wastes away. This may be likened somewhat to the expensing of the cost of raw materials consumed in manufacturing.

WHO MAY DEDUCT DEPLETION

The owner of an "economic interest" in the mineral property being depleted is the only one who may deduct depletion with respect to such property.⁽¹⁾ This term, which is not defined in either the 1939 or the 1954 Codes, has been, and, as a matter of fact, still is the subject of much litigation.

The United States Supreme Court in *Palmer v. Bender*⁽²⁾ established the principle that the depletion deduction is available to those persons having the right to share in the minerals produced, and from this decision there evolved the following definition which appears in the regulations⁽¹⁾:

"An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in minerals in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital".

In addition to the foregoing regulation the Internal Revenue Service has issued two leading rulings⁽³⁾ on this subject, and in 1940 the Supreme Court, in *Anderson v. Helvering*⁽⁴⁾, again went into the theory of the depletion deduction and summarized all its earlier depletion decisions.

Stripping contractors: Some minerals, such as coal, are sometimes found relatively near the surface, and there is a process, called strip mining, by which the covering earth, or overburden, is removed and the coal is stripped out.

In many cases the owner of the coal property, or coal company, will execute an agreement with a contractor under which the latter will undertake to remove the overburden and mine the coal. Because the agreement may involve both services and mining, the question immediately arises as to whether the contractor has obtained an economic interest in the coal thereby entitling him to depletion.

The contractor is deemed to have an economic interest where: (1) the contract cannot be terminated at the will of, or upon nominal notice by, the coal company, (2) he obtains a capital interest in the coal, and (3) he must look solely to the extraction and sale of the coal for his compensation⁽⁵⁾. If, under the contract, compensation is derived partly from extraction and sale of coal and partly from removal of overburden and other services, only the portion of compensation attributable to the extraction and sale of coal is subject to depletion⁽⁶⁾.

Conclusions on economic interest: The Court decisions, regulations, and rulings all lead to one overwhelmingly basic principle with respect to "economic interest". That is, a person must own a right to a share of the minerals produced, or a share in the proceeds of sale of such minerals, to which he looks for the return of his investment. The taxpayer need not incur any cost nor have any tax basis with respect to his investment. Also, he may own such a right for tax purposes, even though under state law he doesn't have legal title to the mineral in place⁽¹⁾. However, if a right permits its owner to receive payments from some source other than solely from a share of production, it is not an economic interest⁽⁴⁾.

A good part of the litigation in this area seems to arise because the taxpayer intended to acquire or retain an economic interest when he made the assignment, lease, or what have you, but later found the Commissioner saying he had not. By being thoroughly conversant with the concept of "economic interest", the accountant can render a real service to those clients engaged in mining operations by alerting them on what to watch for when they are engaged in negotiations.

COMPUTATION OF DEPLETION

After it has been determined that the taxpayer possesses the necessary economic interest in the mineral in place, thereby entitling him to a depletion deduction, the next step is to compute the amount of the deduction.

Under the 1954 Code there are two permissible methods of computation, namely, "cost depletion"⁽⁸⁾ and "percentage depletion"⁽⁹⁾. Under the 1939 Code there was a third method, "discovery value depletion"⁽¹⁰⁾. This method applied to mines discovered by the taxpayer after February 28, 1913, which were not subject to percentage depletion. It was provided that the basis for depletion should be fair market value of the property, with certain limitations, at date of discovery or thirty days thereafter. The depletion deduction was limited, however, to 50% of net income from the property, but not less than cost depletion. Since nearly all minerals are now subject to percentage depletion, the 1954 Code eliminated this method.

COST DEPLETION

For book (accounting) purposes depletion is usually computed under the cost method, though percentage depletion is sometimes used.

This method is used for tax purposes only when it produces a higher deduction than the percentage method.

The regulations⁽¹¹⁾ indicate that the computation is to be made by the following formula:

$$CD = \frac{S}{R + S} \times B, \text{ where}$$

CD = Cost depletion

S = Units sold during period

R = Remaining units at end of period (reserve)

B = Adjusted basis of mineral interest at end of period.

Units sold during period

Sales are deemed to be made in the year in which the proceeds are taxable under whatever method of accounting is employed by the taxpayer in keeping his books and filing his returns⁽¹²⁾.

Generally, depletion is allowed only on the basis of units actually sold⁽¹³⁾, and not on the basis of units produced. Thus depletion is not allowed for minerals consumed in operating the property⁽¹⁴⁾ or those destroyed prior to sale⁽¹⁵⁾. However, there appears to be an exception to this general rule, since, in at least one case⁽¹⁶⁾, a lessor of coal lands receiving royalties was held entitled to compute depletion on the basis of all the coal mined, even though some of it was consumed by the lessee in the operation of the mine. The Court said that mining and consumption of the coal on the premises by the lessee depleted the taxpayer's capital investment just as much as if it had been sold and removed from the premises. Also, oil and gas companies may take percentage depletion on oil or gas used in refinery operations. Therefore, you may often find in practice that the general rule is not followed.

Mineral reserves

The total recoverable units (barrels, tons, pounds or other measures) of mineral products that are reasonably believed to have existed in the ground on the date the property was acquired, or other valuation date, such as March 1, 1913, are usually referred to as mineral reserves.

Who makes estimate:

Just as the accountant is not an appraiser neither is he a geologist. So he must look to the latter for a reasonable estimate of the reserves, which include ores and minerals in sight, blocked out, developed, or assured, and probable or prospective ores and minerals be-

lieved to exist on the basis of good evidence.

Revision of reserves:

A depletion unit is obtained by dividing the remaining basis of the property by the estimated reserves. When, by reason of operations or development work, it is determined that the recoverable units are greater or less than the original estimate, the reserves must be revised⁽¹⁷⁾. The revision results in a new depletion unit. The new depletion unit usually has no effect on and is not applicable to prior years, even though there may have been deficient depletion allowances in prior years⁽¹⁸⁾.

Retroactive effect:

As usual there is an exception to the general rule that revised reserves have no retroactive effect. This occurs where a material error was made in the computation of the original estimate of the mineral reserves. If this is the case a new estimate may be made and the prior years corrected accordingly. Also, prior years' estimates may be challenged by a Revenue Agent when he examines the returns for such years.

Duty of accountant:

It seems to me that the main duty of the accountant with respect to reserves is to determine that the estimates were made by a competent individual. Also, he should strongly urge that the estimates be revised yearly, if practicable, in order that the basis or capital investment may be fully recovered at the same time the mineral supply is exhausted.

Basis of mineral interest

The amount which may be recovered by way of depletion is the adjusted basis of the minerals being depleted.

Allocation of lump sum acquisition price:

If the mineral deposits alone are acquired for cash, the basis is simply the price paid for such deposits. However, problems of allocation arise when land and/or other assets are acquired, along with the deposits, for a lump sum. For example, where a mineral property comprising plant and equipment, land, and a mineral deposit is acquired, the cost allocable to the plant, equipment, and land must be excluded in order to arrive at the basis of the mineral deposit⁽¹⁹⁾.

Allocation not necessary:

Even though allocation theoretically applies to all cases where land and minerals are both acquired, it frequently happens in practice

that the land, exclusive of the minerals, is practically worthless, with no residual value. In such case it would seem improper to allocate any portion of the acquisition price to the land.

Method of allocation:

The method of allocating a lump sum purchase price to the various assets comprising a mineral property follows the same principles usually applied in allocating lump sum purchase prices for other purposes. That is, the lump sum is allocated according to the relative fair market value of each of the various assets acquired. For example:

$$B = \frac{F}{T} \times L, \text{ where}$$

B = Basis of mineral interest

F = Fair market value of mineral interest

T = Total fair market value of all assets

L = Lump sum purchase price

If the usual method does not give a reasonable result, consideration should be given to some other method. For example, it might be feasible to determine a basis for the mineral interest alone and then allocate the remainder of the lump sum to the other assets.

Fair market value:

In addition to the above-mentioned problems of allocation, which necessitate the use of fair market value, it is not unusual to find that the fair market value of the mineral interest on a particular date represents the basis for depletion. This is so when a mineral interest is acquired by gift, from a decedent, in a taxable exchange (for stock, bonds, other property, etc.), or was acquired prior to March 1, 1913.

Determination of fair market value:

The determination of the fair market value of a mineral interest depends on a number of factors any or all of which may be present in a particular case. The factors, in order of importance according to the Internal Revenue Service⁽²⁰⁾, are as follows: (1) actual bona fide sale price, (2) a bona fide offer to purchase, (3) a bona fide offer of sale, (4) the sale price of similar properties, similarly situated, (5) market values of stocks when same fairly and clearly represent the value of the property, (6) royalties or rentals paid or received, (7) analytical appraisals by the present worth method, and (8) valuations for purposes of state and local taxation and appraisals for Court proceedings.

The method of computation most used by the Commissioner is that of analytical appraisal, number 7 above, because it is often found

that most of the other factors are not readily available. However, it has been ruled that this method should be resorted to only in the event that the fair market value cannot be reasonably ascertained by any other method⁽²¹⁾. The computation is predicated on the discounting of total expected earnings from the property to present value by use of Hoskold's Formula which provides the discount factors in the form of a table. This table together with an explanation of its assumptions and use appears in the tax services. Therefore, it seems sufficient to illustrate its use with the following example dealing with the March 1, 1913 value of a coal mine:

(1) Tons recoverable at March 1, 1913		<u>2,000,000</u>
(2) Total operating profit, 1905 to 1912, inclusive		<u>\$160,000</u>
(3) Per ton operating profit, 1905 to 1912, inclusive (\$160,000 ÷ 800,000 tons)		<u>.20</u>
(4) Total expected earnings (2,000,000 tons at 20¢ a ton)		<u>\$400,000</u>
(5) Total expected earnings discounted at 8% with sinking fund invested at 4%, over 20 years (\$400,000 x (1) .440212)		\$176,084.80
(1) From Hoskold's Table		
Less:		
(6) Value of plant and equipment	\$80,000.00	
(7) Estimated plant renewals	<u>16,084.80</u>	<u>96,084.80</u>
(8) Value of coal at March 1, 1913		<u>\$ 80,000.00</u>
(9) Value per ton at March 1, 1913		<u>.04</u>

Revaluation:

After the fair market value of a mineral property as of a particular date has once been determined, and approved by the Commissioner, in accordance with the known or determinable facts on such date, revaluation as of the same date will not be allowed in the absence of gross error or fraud. This does not mean, however, that a value set by the Commissioner cannot be challenged as to its reasonableness⁽²²⁾.

Book basis versus tax basis:

For book (accounting) purposes the reserve for depletion is usually credited or basis is reduced only by cost depletion, and no further depletion is allowable after the basis is zero. On the other hand, for tax purposes the basis is reduced, but not below zero, by either cost or percentage depletion, whichever is the higher. Thus, book basis and tax basis may be different with a consequent difference in cost depletion and gains or losses from disposition.

Zero basis as affecting percentage depletion:

The deduction for percentage depletion depends solely on mineral sales and not on basis. That is, it is allowable, within limitations, even after the basis has been reduced to zero⁽⁷⁾. This may seem, at first glance, to be a strange quirk in the law. But, it is not strange at all when it is remembered that this deduction is intended as an incentive to encourage the expansion of our natural resources industries.

PERCENTAGE DEPLETION

Percentage depletion is probably one of the most publicized and controversial deductions in the tax law. The controversy, which is not within the scope of this paper, seems to arise principally between those persons who believe it is a necessary incentive to the natural resources industry and those persons who believe it is an inequitable concession to that industry.

Minerals excluded

This method of depletion is provided in Sec. 613, and is allowed at varying rates for all minerals, except:

1. Minerals derived from sea water, the air, or similar inexhaustible sources.
2. Soil, sod, dirt, turf, water, and mosses, which are not considered to be minerals for this purpose.
3. Coal (including lignite), held for more than six months, the disposal of which is treated as a sale under Sec. 631(c) subject to long-term capital gain treatment.

Minerals included and rates

Sec. 613 also contains a complete list of all the minerals subject to percentage depletion together with the applicable rates.

COMPUTATION OF PERCENTAGE DEPLETION

The computation is made by first multiplying the gross income from the property during the taxable year, after deducting rents or royalties paid thereon, by the applicable percentage. This amount, however, may not exceed 50% of the taxable income from the property computed without depletion. In any event the amount allowable shall not be less than cost depletion.⁽²⁴⁾

The above computation may be reduced to a rather simple statement which should be easy to remember, and that is:

"The amount deductible is either a percentage of gross income

from the property or 50% of taxable income from such property, whichever is the lesser, but is never less than cost depletion."

In order to make this computation each of the following elements must be defined and computed:

1. Gross income from the property.
2. Rents or royalties deducted.
3. The property.
4. Taxable income.

These elements will now be discussed in the above order.

Gross income from the property

This element was first defined in Sec. 114(b)(4)(B) of the 1939 Code, which was added by the Revenue Act of 1943, and the 1950 Act included therein transportation (not in excess of 50 miles) or ores and minerals.

Sec. 613(c)(1) now defines this element as being gross income from mining⁽²⁵⁾, and mining is defined in Sec. 613(c)(2) as follows:

"The extraction of the ore or mineral from the ground plus the ordinary treatment processes normally applied by the mine owner or operator to obtain a commercially marketable mineral product or products, and plus transportation, not to exceed 50 miles, of the ore or mineral from the point of extraction to the plant or mill in which the ordinary treatment processes are to be applied. The transportation may or may not be by common carrier, and may exceed 50 miles if it can be shown that physical and other requirements necessitate transportation over a greater distance."

If the crude mineral is sold at or near the mine, gross income is simply the selling price and we have no problem.

You are going to find, however, that it is rarely this simple, because it is usually necessary to transport the ore to a mill for treatment in order to get a commercially marketable product. That is, the ore in its raw state is not salable, and because mines are frequently in isolated locations it is not always feasible to construct a mill at the mine location.

Ordinary treatment processes:

Ordinary treatment processes, the value of which may be included in arriving at gross income, are those processes that must be applied to the ore or mineral to obtain a "commercially marketable product".

Sec. 613(c)(4) specifies the ordinary treatment processes included for the following five categories of ores and minerals:

- (1) Coal.
- (2) Sulfur recovered by the Frasch process.
- (3) Iron ore, bauxite, ball and sagger clay, rock asphalt, and other minerals commonly sold in their crude state.
- (4) Lead, zinc, copper, gold, silver, fluorspar ores, potash, and other ores not commonly sold in their crude state.
- (5) Talc, magnesite, and phosphate rock.

In addition to the processes specified in the Code there have been several Court decisions and Internal Revenue Service rulings dealing with ordinary treatment processes with respect to the following: (1) oil treatment of coal⁽³²⁾, (2) brick and tile manufacturing⁽³³⁾, (3) calcium carbonates, shale and clay mined for use in cement manufacturing⁽³⁴⁾, (4) iron ore⁽³⁵⁾, (5) talc-crushing and mining⁽³⁶⁾, and (6) vermiculite concentrate⁽³⁷⁾. Further, the regulations⁽³⁸⁾ set forth in some detail the various allowable and unallowable processes.

Other decisions and rulings will no doubt be forthcoming on allowable ordinary treatment processes, because the Code specifies such processes for only a few minerals and classifies all the rest as between those usually sold in the crude state and those not sold in such state. Further, there is nothing in the law with respect to when a "commercially marketable product" is first obtained, and this leads to many questions, since all processes to that point are allowable whether or not they are specified in Sec. 613(c)(4). It is obvious, therefore, that we must give careful consideration to all processing activities, since activities that are normally characterized as manufacturing may constitute allowable processes, if they are necessary to produce a commercially marketable product⁽⁹⁷⁾.

The Cherokee Brick & Tile Co.⁽³³⁾ case is an important landmark in this area because it upholds the principle that gross income may be the selling price of the end product, where there is no market for the mineral at any stage between extraction from the ground and loading for shipment. Specifically, the Court held that gross income from mining was the selling price of the finished brick and tile, f.o.b. plant, loaded for shipment, whereas the Commissioner contended that only certain processes were includible as "ordinary treatment processes" and the remainder were manufacturing processes so that gross income should be computed at an intermediate point.

The Court, in the Cherokee case, also made a distinction between "ores" and "minerals". This distinction is important because the regu-

lations⁽³⁹⁾ indicate that there shall be excluded as ordinary treatment processes the roasting, pulverizing, pressing into shape, and molding of ores. The Court held that brick and tile clay is a "mineral" and not an "ore", and, therefore, these processes are includible, because the statute does not exclude them in connection with the mining of minerals.

The Internal Revenue Service has announced in Revenue Ruling 55-244 that it will not follow the Cherokee case.

Percentage depletion in the talc industry also extends to the end product of mining, including the necessary crushing and grinding⁽³⁶⁾.

Transportation:

Transportation, up to 50 miles, of the ore or mineral from the point of extraction from the ground to the plant or mill in which the ordinary treatment processes are to be applied is considered to be part of the mining process and, thus, is not deducted in arriving at gross income. The transportation may be either by common carrier or by the taxpayer's own trucks⁽⁴⁰⁾.

Despite the general rule, transportation in excess of 50 miles may be permitted, if the taxpayer satisfies the Commissioner that both the physical and other requirements are such that the ore or mineral must be transported a greater distance⁽⁴⁰⁾. That is, if the taxpayer is able to construct its treatment plant within the 50 mile distance, but merely does not choose to do so, excess transportation will not be allowed. For example, there is a ruling⁽⁴¹⁾ holding that where the construction and operation of a treatment plant within 50 miles of bentonite deposits was not prevented by terrain, lack of water, lack of power, lack of fuel, or any other physical requirement, excess transportation was not allowable.

In essence it would seem that the taxpayer must be prepared to show that the treatment plant is constructed as close to the point of extraction as is physically and economically possible without causing undue hardship.

It is important to note that transportation of a commercially marketable product, regardless of distance, is not permitted. For example, where vermiculite concentrate was sold f.o.b. cars at a railroad 7 miles from the mine, gross income was the sales price less cost of transportation from the mine to the shipping point, since it was a commercially marketable product when it started on the 7 mile journey⁽³⁷⁾.

In order to obtain excess transportation, the taxpayer must file an application, in duplicate, with the Commissioner of Internal Revenue, Washington 25, D.C., attention of the Special Technical Services Division, Engineering and Valuation Branch. If the return is filed before any notice is received from the Commissioner with respect to the application, a copy of the application must be attached to the return. A new application must be filed where, after approval by the Commissioner, there is a material change in any of the facts relied on in the original application⁽⁴⁰⁾.

Computation of gross income:

Now that you have an idea regarding the various factors entering into the determination of gross income from mining, let us return to the actual computation of this element.

It must be kept in mind that certain rents and royalties, if any, are deducted from gross income in arriving at the amount to which the applicable percentage is applied. These rents and royalties will be discussed under their own heading.

If the product in its crude mineral state is merely transported and sold, the selling price minus transportation cost is used, except that if the taxpayer provides his own transportation, profits attributable thereto must also be deducted. For example, the Senate Finance Committee Report on the 1954 Code states that, in the case of uranium, gross income will be determined by reducing the sales price of the ore by the net transportation cost to the taxpayer, such cost being the taxpayer's transportation cost reduced by the hauling allowance allowed by the Atomic Energy Commission. Furthermore, the Internal Revenue Service has held, with respect to the sand and gravel business, that a delivery loss reduces gross income from the property. That is, gross income is sales price less any delivery charge and less any transportation or delivery loss.

If the crude mineral is transported 50 miles or less (or more with the approval of the Commissioner) to a mill where ordinary treatment processes are applied, and then sold, gross income is again simply the selling price⁽⁴²⁾.

If the crude mineral is transported more than 50 miles (without the Commissioner's approval) to a mill and/or is treated beyond the "ordinary treatment processes" before sale, gross income may be computed by reference to the representative market or field price (on the date of sale) of a mineral product of like kind and grade to which

ordinary treatment processes have been applied and which has had no excess transportation. Also, the Internal Revenue Service may permit the use of a field price, even though not all of the product is sold in the same form. That is, if say 15% to 30% of the product is sold in a form that has a field price, whereas the remainder does not have a field price, the price of the former may be used for the whole product. After such a price is obtained, it is only necessary to multiply it by the number of units sold to arrive at gross income⁽⁴²⁾.

Little or no difficulty is encountered in computing gross income in the situations just mentioned. Rather, it is when processing beyond the first commercially marketable point, usually called the cut-off point, and transportation beyond such point are coupled with a lack of a representative market or field price that our computation problems really begin. In this case you must compute the price at the cut-off point. According to the regulations⁽⁴²⁾ this is done by taking the price of the first marketable product and reducing it by the costs and proportionate profit attributable to the unallowable processes. Also, the costs and proportionate profit attributable to any unallowable transportation must be deducted.

If costs are not broken down as between costs incurred to the cut-off point and those incurred after that point, an allocation of total costs must be made. For example, the cost of unallowable transportation may be determined by multiplying the total transportation cost by a fraction whose numerator is the unallowable transportation miles and whose denominator is total transportation miles⁽⁴³⁾.

After costs attributable to the unallowable processing and/or transportation have been determined, either directly or by allocation, they are deducted from total costs to arrive at cut-off point costs. Gross income might then be determined by multiplying the cut-off point costs by the percentage markup of the product that is being sold. For example, if the sales price of the product being sold is 120% of total processing costs, gross income at the cut-off point might be 120% of cut-off point costs.

In some cases several minerals are mixed or blended with other material in the manufacture of the finished product. As an example, calcium carbonates, shale, and clay are mined, crushed, and ground and then blended with other materials to produce cement. The Internal Revenue Service has ruled that gross income must be computed separ-

ately with respect to each component mineral, notwithstanding any such mixing⁽³⁴⁾.

Gross income may, at times, be computed in a rather arbitrary manner, since the regulations provide that the taxpayer can use any method that, to the satisfaction of the Commissioner, clearly reflects gross income. For example, the I.R.S. permits the allocation of gross income as between the cut-off point and the point of sale on the basis of the ratio of cut-off point costs to total costs. However, this method may penalize an efficient producer. For instance in the cement business a producer with a low quarry cost would get less percentage depletion than one with a high quarry cost.

It is fairly easy to visualize the not inconsiderable complications that may arise in computing gross income where there is unallowable processing and transportation, because rarely do the accounts permit the ready determination of costs at the cut-off point. Consequently, the regulations provide that the taxpayer may use a method, other than those indicated therein, if he satisfies the Commissioner that such method clearly reflects gross income⁽⁴⁴⁾.

Thus the computation of gross income is not only not made under any rigid formula, but, on the contrary, must vary according to each different factual situation encountered. That is, the taxpayer should be entitled to develop a method that is both realistic and reasonable in his particular circumstances, and apply it consistently from year to year until there is a material change in such circumstances.

Waste or residue (mine tailings):

Under Sec. 613(c)(3), which is new in the 1954 Code, the term "extraction of the ore or mineral from the ground" now includes the extraction by a "mine owner or operator" of ore or minerals from the waste or residue of prior mining. Thus it is now clear that mine dumps of waste mineral are subject to percentage depletion.

It is immaterial whether the waste or residue results from the removal of ore from the ground or from the application of ordinary treatment processes to such ore. However, waste resulting from non-ordinary treatment processes is not subject to depletion.

It must be emphasized that a waste pile is not a separate property, but is an integral part of the property from which it was extracted⁽²⁹⁾. Consequently, gross income from the original mine workings must be aggregated with gross income from the waste to determine gross income from the property. Likewise, the units produced from the

original mine workings must be combined with those produced from the waste to determine cost depletion.

Since the waste may not be divorced from the original mine workings, a "purchaser" of such waste is not entitled to percentage depletion. The Senate Finance Committee Report on the 1954 Code has made it clear that "purchaser" does not include a person who acquires the whole mine property, including the waste, in a tax-free exchange (for example in a tax-free reorganization) from a person who was entitled to depletion on the waste. Also, the term "purchaser" does not apply to a lessee upon renewal of a mineral lease, if he was entitled to depletion on the waste prior to renewal.

Under Sec. 381(c)(18) a successor corporation acquiring the properties of a predecessor in certain liquidations and reorganizations may continue to deduct depletion on waste or residue in the same manner as a predecessor.

The foregoing rules apply to years beginning after December 31, 1953 and ending after August 16, 1954.

Even though Sec. 23(m) of the 1939 Code and prior provisions relating to depletion were generally interpreted as not being applicable to waste or residue, there were a few instances in which depletion was allowed where the taxpayer owned and operated both the mine and the waste dumps. For example, (1) the taxpayer owned and operated a gold mine, and deposited tailings on its own land; the tailings were reworked years later in a cyanide mill⁽³⁰⁾, and (2) tailings were reworked due to an improved furnacing process several years after the original mining⁽³¹⁾.

Payments to encourage exploration, development,
and mining for defense purposes:

Sec. 621(22)(b)(15) of the 1939 Code) provides that the taxpayer shall not include in his gross income any amounts received from the United States Government as an incentive to explore for, develop, or mine a critical and strategic mineral or metal. The amount received is excludable from gross income even though it is in the form of a loan, which is finally forgiven or discharged⁽²⁶⁾.

Sec. 450(b) of the 1939 Code lists the minerals to which Sec. 621 applies, and the regulations⁽²⁷⁾ provide that other minerals may be added from time to time upon being certified by the Government that they are essential to the defense effort of the United States and are considered to constitute critical and strategic minerals.

The taxpayer must actually undertake, upon approval by the Government, to explore for, develop or produce the strategic minerals involved, and must expend the amounts received for that purpose and in accordance with the terms and conditions laid down by the Government. Also, he must submit an accounting to the appropriate Government agency showing that amounts were properly spent.

If a Sec. 621 payment is added to or included with the purchase price of the strategic mineral, it must be clearly identified as a separate and specific amount paid for the encouragement of exploration for, etc., of the strategic mineral⁽²⁷⁾.

Expenditures of the taxpayer attributable to amounts excludable from gross income under Sec. 621 are not deductible, and neither may they be added to the basis of the property for any purpose. However, if all or any portion of the Sec. 621 payments are later repaid to the Government, the expenditures described in the preceding sentence shall be expensed or capitalized, as the case may be, in the year of and to the extent of the repayment. In determining what is to be capitalized and what is to be expensed, the expenditures are, generally, taken in the order in which they were actually made, unless the taxpayer secures the approval of the Commissioner to use some other method⁽²⁸⁾.

Rents and royalties deducted

Rents:

Rents are not clearly defined in the law. However, it does seem clear that only rents based on production and paid to the owner of an economic interest are deductible in arriving at gross income⁽⁴⁵⁾. Payments not based on production, such as delay rentals, payments for exploration rights, and damages, are not deducted in arriving at gross income, but, rather, are deducted from gross income to arrive at taxable income.

Delay rentals:

It sometimes happens that a prospective lessee of mineral property wishes to lease some promising acreage for a term of years, but does not want to commit himself to the immediate development of the property. In this case, it is usually provided that if mining operations are not begun by a certain date, the lessee must make fixed periodic payments to the lessor for the privilege of deferring such operations. These payments are called "delay rentals" and are distinguished from royalties and bonuses because they are not related to nor dependent on production.

The lessee may have agreed to pay the lessor's share of the ad valorem property taxes on the mineral-bearing lands. If these payments exceed the gross income from production, such excess is treated as a delay rental. The amount not in excess of gross income is treated as additional royalty⁽⁴⁶⁾.

The lessor must treat delay rentals as ordinary rental income not subject to depletion⁽⁴⁷⁾.

The lessee may capitalize or expense such rentals at his election, on the premise that they are carrying charges on nonproductive property. Furthermore, he may make a new election each year, and a different election may be made for each nonproductive property⁽⁴⁸⁾.
Royalties:

It is quite common for a mineral lease to provide that the lessor will be entitled to a designated share of production, either in value or in product, without being required to share the development and operation expenses. This share of production is called a "royalty interest" and payments to the owner of such an interest are royalties, usually referred to as overriding royalties. These royalty payments are deducted in arriving at gross income by the lessee and included in gross income by the lessor.

The lessor is entitled to depletion on royalty income, and may compute it by either the cost or percentage method, whichever produces the greater deduction. The percentage method is generally used because information on the total expected royalties is seldom available. Where the cost method is used, the computation is as follows:

$$D = C \times \frac{R}{R + E}, \text{ where}$$

D = Depletion

C = Basis of mineral interest at beginning of year

R = Royalties received during year

E = Total expected royalties at end of year

Where a cash payment is received upon execution of a lease, the question arises as to whether it is a "down payment" on the purchase price of the mineral interest or an "advance royalty." The question is important because an "advance royalty" is subject to depletion, whereas a "down payment" is not.

In order for the payment to be an "advance royalty," the lessor must retain an interest in the minerals to which he looks for future income. For example, the presence of an overriding royalty makes the

cash payment an advance royalty⁽⁴⁹⁾. On the other hand, if no royalty interest is retained and future payments are in reality instalments on an agreed purchase price, the payment is a "down payment"⁽⁵⁰⁾. It should be kept in mind that, if a corporation lessor is subject to the 52% tax rate, or an individual is subject to a tax rate that is relatively high, a sale with a capital gain tax at 25% may produce more net income after taxes, than would be produced by retention of a royalty interest with its appropriate percentage depletion.

Lease bonus:

A mineral property may be so promising and in such demand that a prospective lessee is willing to pay a bonus, in addition to later royalties, to obtain the lease. Such a bonus is considered to be an advance royalty and, as such, constitutes depletable income to the lessor and deductible royalty by the lessee.

The lessee must deduct a proportionate part of the bonus for each year of production⁽⁵¹⁾. The yearly deduction is computed by the following formula:

$$E = B \left(\frac{S}{U + S} \right), \text{ where}$$

E = Amount to be deducted

B = Remaining undeducted lease bonus

S = Units sold during year

U = Units remaining (reserve) at end of year

In general the lessor may compute his depletion on a lease bonus by either the cost or percentage method, whichever is higher. There is an exception, however, where he receives a bonus on a lease of an unproven area. In this case, the cost method may not be used because the mineral content cannot be reasonably estimated, and, consequently, the mineral value can rarely, if ever, be established⁽⁵²⁾. Also, the percentage method must be used where information as to the amount of total expected royalties is not available. Where the cost method is used the following formula⁽⁵³⁾ applies:

$$D = C \times \frac{B}{B + R}, \text{ where}$$

D = Depletion

C = Basis of mineral interest

B = Bonus

R = Total expected royalties

The depletion on the bonus is, of course, subtracted from the lessor's basis of his mineral interest, and the remaining basis is recoverable through depletion on subsequent royalties.

If a mineral lease is terminated without production, depletion previously allowed on a bonus or advanced royalty must be restored to the lessor's income in the year of termination, and a like amount is restored to the basis of the mineral interest. The fact that the lessor received no tax benefit from the depletion deduction will not prevent the restoration to income⁽⁵⁴⁾. However, any amount of production, no matter how small, avoids the restoration. Furthermore, if the lessor dies before the lease is terminated without production, no restoration is required for the year of death⁽⁵⁵⁾, and, similarly, no restoration need be made when property is disposed of by gift⁽⁵⁶⁾ or in distribution of an estate⁽⁵⁷⁾. As to the beneficiary or donee, there seems to be nothing that would require them to restore any more to income than the depletion deducted by them after acquiring the property. That is, the depletion deducted by the decedent, donor, or estate need not be restored to the income of the beneficiary or donee, if the lease is terminated without production after they acquire it.

Minimum or advanced royalties:

It is not uncommon for a mineral lease to provide that the lessee shall make annual minimum payments to the lessor for a fixed period regardless of production. These payments may constitute a delay rental, instalment bonus, or minimum royalty depending on the terms of the lease.

Payments made prior to production are treated as delay rentals, if the lessee can terminate the lease at the end of any annual period by not making the required minimum payment⁽⁵⁸⁾. If such payments cannot be avoided by terminating the leases, they represent an instalment bonus which takes the same treatment as a lease bonus⁽⁵⁹⁾.

Annual minimum payments made after production begins are minimum royalties which are treated the same as ordinary royalties, to the extent they do not exceed production⁽⁵⁸⁾. If the payments exceed the production applicable to the royalty interest, the treatment of the excess depends on whether it is recoverable from future production.

Excess minimum payments, which are recoverable from the excess of future production over the specified minimum, represent depletable royalty income to the lessor. This is so even though the payments may not be earned by production⁽⁶⁰⁾, and even though the lessor

might subsequently be required to repay a portion of the excess payments if the specified minimum is not produced from the property⁽⁶¹⁾. As to the lessee, he is granted the option of deducting the excess payments from gross income either in the year of payments or in the year the payments are recovered from production⁽⁶²⁾. The election is made in the return for the first year in which payments are made under a minimum royalty clause, and is binding for all subsequent years and for all properties. Failure to deduct such payments in the year paid constitutes an election to deduct in the year of recovery⁽⁶²⁾. Any unrecovered payments, not repayable by the lessor, remaining at the time the lease terminates or is canceled are deductible at that time⁽⁶³⁾.

Excess minimum payments, which are not recoverable from future production, may be treated by the Internal Revenue Service as delay rentals, if the lessee can forfeit the lease by not paying the specified minimum royalties⁽⁶⁴⁾. If the lessee cannot forfeit the lease, it seems likely that the payments will be treated as a lease bonus.

Where minimum royalties are present in a lease agreement, the provisions dealing with them must be very carefully drawn by the attorney, lest the parties be denied the treatment they intend. Furthermore, the accountant must study the provisions closely in order to determine the proper tax treatment in the return.

The property

When gross income, rents and royalties, or taxable income are discussed in connection with depletion, it is understood that these terms always relate to a mineral property. Thus, the definition of "the property" can be an important factor in the computation of depletion, especially percentage depletion. The fact that the properties are located in a foreign country will not deny depletion to a domestic corporation. Definition of property:

"The property" was not defined in the 1939 Code, and, because there are many types of property interests and there may be several mineral deposits in one lease, this led to considerable controversy and litigation.

Sec. 614 is attempting to stanch the flow of controversy by providing the following definition:

"For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

This definition stems from prior Court decisions, regulations⁽⁶⁵⁾, and rulings, and, therefore, they should be helpful in interpreting the new section.

The heart of the definition is separateness. Separate interest! Separate deposit! Separate tract or parcel!

Separate interest:

Whether there is a separate interest may depend on the kind of interest, the time it was acquired, from whom it was acquired, and/or the geographical location of the tracts or parcels of land. Also, where a taxpayer's interest is related to the proceeds of production, he may have as many separate mineral interests as there are conveyances to him⁽⁶⁶⁾.

The Internal Revenue Service has long held the view that, generally, each interest is a separate property, unless the taxpayer acquires the same kind of interest, at the same time, from the same assignor, in tracts or parcels of land which are geographically contiguous. Thus where two interests are involved all four tests must be met if they are to be treated as one property.

Kinds of interest:

Since each kind of depletable interest is a separate property, it seems necessary to list and explain the various kinds.⁽⁶⁷⁾ They are: fee simple, royalty or overriding royalty, working (operating rights), net profits interest, and carried interest. Some of these interests are usually found in connection with the oil industry, but they are being explained here because they can be adapted to the mining industry.

Fee simple interest:

In the United States the ownership of land embraces both surface and subsurface rights in a clearly defined tract, and the subsurface rights include the minerals in and under the tract. Thus, if a person owns a tract of land including the subsurface rights, he has a fee simple interest in the land.

The mineral rights may be wholly or partially separated from the surface rights, and it is these mineral rights, or minerals as they are usually called, with which depletion is concerned and in which we have the different kinds of interests discussed hereafter.

Royalty or overriding royalty interest:

A royalty interest is one which entitles its owner to a specified fraction, in kind or in value, of the total production from the property

without his being burdened with any of the expense of development and operation.

An "overriding royalty" is one created from the working interest (explained below), and its term is coextensive with that of such working interest. On the other hand a "royalty" is created from the fee simple interest and its term depends on the lease agreement between the owner of the minerals (lessor) and the owner of the working interest (lessee). Except for this difference they are the same.

Working interest:

The working interest is the interest in the minerals in place that is burdened with the cost of development and operation minus the royalty payable to the lessor. This interest is created when the owner of the minerals grants a lease under which the lessee agrees to develop and operate the property, and, therefore, the lessee is the owner of the working interest. Because he may need capital or for other reasons, the lessee may divide his working interest with others or he may carve it up into other kinds of interests.

Net profits interest:

A net profits interest is an interest in the minerals in place representing a share of gross production measured by the operator's net profits from the operation of the property. That is, it usually represents a specified fraction of such net profit. It is similar to an overriding royalty in that it is created from the working interest and has a comparable life. But dissimilar in that it is burdened with expenses.

The net profits interest owner, of course, receives nothing if there is either no net profit or a net loss, and is not liable for any share of a net loss. However, any accumulated net losses must be offset by future profits before he is entitled to receive any income. This means that he bears expenses only to the extent of his share of income and no more.

Since net profit is involved the instrument creating the interest should be carefully drawn from the standpoint of setting forth definitions for such terms as operating expenses, depreciation, etc. and prescribing accounting procedures to be followed. Also, if the parties intend to create a depletable interest, care must be taken to prevent the net profits interest from being construed as merely a contractual consideration for an assignment of property, rather than an interest in gross production⁽⁶⁸⁾.

Carried interest:

A carried interest is one in which two or more co-owners of a working interest agree that one of the parties will advance all or some part of the development costs on behalf of the others and will look only to their share of future production for recovery of such advances. The person making the advances is the "carrying party", and the person for whom costs are advanced is the "carried party".

Since this kind of interest is not often encountered in the mining industry, it does not seem necessary to enlarge upon it, except to say that there are three different types of such arrangements each of which has been passed on by the Courts. For those who may be interested, the Court decisions are: Manahan Oil Co., 87 C 1159; Herndon Drilling Company, 6TC 628; and Commissioner v. J. S. Abercrombie Co., 162 F. (2d) 338, 35 AFTR 1467, affirming 7 TC 120, acquiesced 1949-1 C.B. 1. Mineral deposit:

It is the job of the geologist or mining engineer to determine the existence of a mineral deposit and whether there is more than one deposit in a particular tract or parcel of land. Thus, the accountant must rely on him to furnish the answer to this part of the property definition, providing he is satisfied that the geologist or engineer is competent. Separate tract or parcel of land:

A separate tract or parcel of land exists where two or more areas are separated geographically, are connected geographically but were acquired from different assignors or at different times⁽⁶⁶⁾, or are not contiguous. For example, in one case a taxpayer acquired, in a single conveyance, a lease of four lots. Two of the lots were contiguous and two touched only at a corner. It was held that the contiguous lots were a single property, but the other two were separate properties⁽⁶⁹⁾. Also, where one tract of land has several deposits of ore existing at varying levels, it appears that each deposit may be treated as a separate property.

Aggregation of mineral interests:

Even though there may be two or more separate mineral interests under the above definition, there are times when it is not practical to treat them as separate interests. For example, it is not economically sound to try to mine coal or sand and gravel within the boundaries of a single tract, where such tract does not contain the whole deposit. Consequently the taxpayer often encountered difficulty with the Internal Revenue Service, with resulting litigation, whenever he attempted to

treat several mineral interests as one property. Some of these attempts were successful, however, and he was permitted to treat the several properties as one⁽⁷⁰⁾.

Operating mineral interests:

It is, perhaps, for this reason that Sec. 614(b) was adopted. It provides that if a taxpayer owns two or more separate operating mineral interests constituting part or all of an operating unit, he may elect to aggregate and treat as one property any two or more of such interests, except that only one aggregation may be formed in each operating unit.

An "operating mineral interest" is one in respect of which the production costs of the mineral are required to be taken into account for the purpose of computing the 50%-of-taxable-income limitation on percentage depletion, or would be so required if the mine or other mineral deposit was in the production stage. Thus, for example, a royalty interest is not an operating mineral interest.

In general, the term "operating unit" applies to an aggregation only of interests which may conveniently and economically be operated together as a single working unit. Thus all separate operating mineral interests which actually constitute part or all of an operating unit may be aggregated, even though such interests may not all lie in the same tract or parcel or in contiguous tracts or parcels. But geographically widespread interests may not be aggregated merely because one set of books is kept or because the products of such interests are processed at the same treatment plant.

In order to form an aggregation of operating mineral interests the taxpayer must make an election. The election may be made any time up to the due date of the return (including extensions of such due date) for whichever of the following years is the later:

- 1 - The first taxable year beginning after December 31, 1953, or
- 2 - The first taxable year in which any expenditure for exploration, development, or operation in respect of the operating mineral interest is made by the taxpayer after acquisition of such interest.

The election, once made, is binding for all subsequent years, unless the Commissioner consents to a change. Furthermore, it is effective not only for percentage depletion, but for cost depletion, depreciation, gains and losses on disposition, and all other purposes as well.

The election is made by attaching a statement to the return showing that the interests aggregated are part or all of one operating unit. Also, a property map and such explanatory data as may be necessary to identify the operating unit should be attached to the return.

If exploration or other expenditures are made on optioned property, no election may be made until the option is exercised. That is, the election should be made in the return (no later than the due date thereof, including extensions) for the first year in which exploration, development or operating expenditures are made subsequent to exercising the option.

If, after election, a part of the aggregation is disposed of, a reasonable portion of the basis of the entire aggregation must be allocated thereto. Also, it appears that no loss deduction will be allowed for worthlessness of part of the aggregation, even though such part may have been a separate property prior to electing aggregation.

The Senate Finance Committee Report on Sec. 614 gives several illustrations with respect to the operation of Sec. 614(b).

Nonoperating mineral interests:

The new Code also provides, in Sec. 614(c), for the aggregation of nonoperating mineral interests.

If a taxpayer owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more contiguous tracts or parcels of land, he may, on a showing of undue hardship, request permission from the Commissioner to treat all such interests as one property. Permission, once granted, is binding for all subsequent years unless the Commissioner consents to a different treatment. Furthermore, the aggregation is not confined to depletion, but applies for all other purposes as well.

A nonoperating mineral interest is any interest which does not come within the definition of an operating mineral interest. In other words, it is an interest not burdened with production costs, such as a royalty.

Undue hardship will not be deemed to exist because of a mere tax disadvantage⁽⁷¹⁾. Thus it would appear that a showing must be made that some other serious economic inequity or disadvantage is created by the separate property treatment.

The rule that applies to a disposition of a part of an aggregation of operating mineral interests, as discussed above, also applies here.

The aggregation of mineral interests presents another area of flexibility in the computation of depletion, and is one in which careful study and judgment may produce substantial tax benefits. Of course, the goal is to obtain a greater depletion deduction, and though an aggregation of interests may give rise to greater gross income, the effect on taxable income must not be overlooked. For if some of the interests are now operating at a loss, or are expected to operate at a loss, the 50%-of-taxable-income limitation may arise from the aggregation, and depletion would be less than before.

Taxable income from the property

As was previously pointed out in the definition, percentage depletion is limited to 50% of taxable income from the property. Therefore, the computation of taxable income for this purpose can be very important.

Computation of taxable income:

Taxable income, as used here, means the gross income from the property less allowable deductions attributable to such property. Allowable deductions include those attributable to the ordinary treatment processes, overhead and operating expenses, and development costs which may properly be expensed, but do not include depletion⁽⁷²⁾.

For a taxpayer owning an interest not burdened by production costs, such as a royalty or net profits interest, gross income and taxable income therefrom will usually be the same.

Deductions:

It must be kept in mind that we are speaking here of taxable income from each mineral interest. Consequently, any deduction which is not applicable to mineral extraction is not required to be deducted in arriving at taxable income. For example, it has been held that charitable contributions need not be deducted⁽⁷³⁾.

The usual items which are required to be deducted, to the extent they relate to the property, consist of operating expenses, overhead, depreciation, and losses. Other items which have been ruled deductible are:

1. Interest on bonds, and amortization of bond discount and expense⁽⁷⁴⁾.
2. Bad debts, dues, assessments, attorneys' fees, capital stock taxes, and interest on money borrowed for development⁽⁷⁵⁾.
3. Damage claims of employees injured in prior years while working on taxpayer's mineral property⁽⁷⁶⁾.

4. Interest paid on prior years' Federal income tax deficiencies (taxpayer's only activity was oil and gas production)⁽⁷⁷⁾.
5. Interest paid on money borrowed to purchase a producing oil and gas property⁽⁷⁸⁾.
6. Depreciation on lease equipment⁽⁷⁹⁾.
7. Back wages paid under a National Labor Relations Board settlement⁽⁸⁰⁾.
8. Officers' salaries, interest expenses, and office expenses⁽⁸¹⁾.
9. State income, franchise, real estate, personal property, unemployment, and miscellaneous taxes and Federal social security and capital stock taxes⁽⁸²⁾.
10. Foreign income taxes⁽⁸³⁾.

Some of the above deductions, such as interest on prior years' taxes, constitute more or less unexpected deductions arising from prior years' transactions, which may have an adverse effect on current year's taxable income. This effect may be offset to some extent by the use of separate properties for depletion, since, in some instances, the deductions may be attributable to nonproducing properties. Furthermore, deductions not subject to attribution will be allocated among the separate properties with, perhaps, less chance of bringing the 50%-of-taxable-income limitation into play than if there was only one property.

Credits and exemptions:

Under the 1939 Code certain credits and exemptions, such as the personal exemption and dividends received credit, were deducted from net income to arrive at the amount subject to tax. Under the 1954 Code these exemptions and credits are classified as deductions and are deducted along with the other deductions in arriving at taxable income on the tax return. However, these items are not to be treated as deductions in arriving at taxable income from the property.

Taxes and carrying charges:

Under Sec. 266 the taxpayer may elect to capitalize certain taxes and carrying charges, and if he does so, they will not be deducted in determining taxable income. Since this election is not binding from year to year and is rather flexible, it may be advantageous with respect to nonproductive properties. That is, no benefit would accrue from deducting these expenditures, due to lack of income, whereas capitalization would increase the basis of the property, thereby resulting in greater cost depletion and reduced gain on disposal of the property.

This advantage may be mitigated, however, by the net operating loss carry-over provisions.

Mine exploration expenditures:

Expenditures made during the taxable year to ascertain the existence, location, extent, or quality of an ore deposit or other minerals constitute exploration expenditures, providing they are paid or incurred prior to the beginning of the development stage of the mine. The regulations⁽⁸⁴⁾ indicate that the development stage begins when it has been established that the ore or minerals exist in commercially marketable quantities.

Exploration expenditures do not include those which are specifically allowed as a deduction under some other section of the Code. For example, taxes. Also, they do not include those made for depreciable property. However, if such property is used in exploration, the depreciation thereon would be includible.

These expenditures, which might, at first glance, appear to be capitalizable, are subject to special rules.

Sec. 615(a), effective for years beginning after December 31, 1953, provides that, initially, exploration expenditures up to \$100,000 are deductible in the taxable year they are paid or incurred. This \$100,000 limitation applies to the total of all such expenditures for the taxable year, and is not, for example, an amount allowable for each mine. Any excess over \$100,000 must be capitalized into the cost of the particular mine involved, and thus becomes a part of the basis subject to depletion. This section replaced Sec. 23(ff) of the 1939 Code which provided a \$75,000 limitation.

Sec. 615(b) permits the taxpayer to elect to treat as deferred expenses any portion of exploration expenditures up to \$100,000. Thus a taxpayer has an option either to deduct or defer all or any part of such expenditures.

If the taxpayer makes the election just described, the regulations⁽⁸⁵⁾ indicate that the amount of deferred expenses deductible each year shall be determined as follows:

$$D = E \times \frac{S}{U + S}, \text{ where}$$

- D = Amount of deferred expenses deductible
- E = Unexpensed exploration expenditures at beginning of year
- S = Units of ore or mineral sold during taxable year
- U = Units of ore or mineral remaining at end of year (both unrecovered and recovered but unsold)

You will recall that in computing cost depletion it was stated that the original estimate of the mineral reserves should be revised each year, if possible. This same rule applies to factor U, above,

Deferred expenses are not included as part of the adjusted basis of the mine or deposit for the purpose of computing cost depletion, but they are includible in the basis for all other purposes⁽⁸⁶⁾. Also, the basis is not reduced by excessive amortization of deferred expenses without tax benefit⁽⁸⁷⁾.

The election is only binding for the taxable year in which it is made. However, even though the taxpayer has a new election each year, Sec. 615(c) limits it to four years. That is, after the taxpayer has paid or incurred exploration expenditures in four different years Sec. 615 can no longer be applied, and all such expenditures paid or incurred after the fourth year must be capitalized and become part of the basis subject to cost depletion. The four years may not necessarily be consecutive, because there may be years in which no exploration expenditures were paid or incurred⁽⁸⁸⁾. In determining whether the four years have elapsed, the taxpayer may have to tack on the years in which a transferor or predecessor applied Sec. 615. This happens when mineral property is acquired in any one of the various transactions that require the transferee to use the same basis as the transferor, or where Sec. 381(c)(10), which may require the carryover of the election in certain corporate acquisitions, applies.

The election is made by a clear indication in the return, or by filing a statement with the District Director of Internal Revenue with whom the return was filed not later than six months after the return is filed for the year of election. The statement must show the amount of deferred expenses, and the names, location, extent, and nature of the mineral deposit⁽⁸⁹⁾.

The purchaser of a mineral property, in applying the four-year limitation, may disregard any deduction taken or election exercised by the seller.

Revenue Ruling 106, 1953-1 CB 177 states that Sec. 615 is applicable to minerals or ores used as a source of uranium.

Exploration expenditures are, of course, incurred at a time when there is no income from mineral property involved. Consequently, if the taxpayer does not have other income to offset these expenditures, it may be advantageous to exercise the election to defer. This is so because, since there is already a loss, no tax benefit would be obtained

from taking a deduction, whereas deferral would increase the basis of the property and give the taxpayer a deduction against future income. Thus, if the taxpayer decides to dispose of the property, he would have less taxable gain, and, if he decides to operate the property, he would have less future taxable income

It must be kept in mind, however, that, even though the taxpayer has a loss in the year of expenditure, the net operating loss carry-over provisions may permit an offset against future income. Furthermore, deferral will reduce future taxable income from the property which, because of the 50%-of-taxable-income limitation, could have an adverse effect on depletion. These things may mitigate, to some extent, the advantages of deferral noted above.

Mine development expenditures:

Under earlier laws all development expenditures in excess of receipts from minerals sold were capitalized up to the time the mine reached the developed or producing stage.

A mine is considered to have reached the developed stage when its intended annual output or capacity can be maintained. Normal output or capacity may be determined from various factors, such as the capacity of the plant, available market, transportation facilities, and opening to the mine.

After the developed or producing stage is reached, excessive expenditures may not be capitalized, unless it can be shown that they contribute to increased output or capacity. If they merely keep the mine developed up to normal capacity or to a point where normal output can be maintained, they must be expensed. Where excessive expenditures incurred during the producing stage are properly capitalizable, they may be allocated to a definite period or deducted ratably as the ore benefited by the expenditure is sold. Where this is not feasible, they should be added to the basis subject to cost depletion. For example, in a metal mine where an aggressive development campaign is carried on thereby resulting in a constantly increasing quantity of developed and blocked-out ore, there is a constant addition to capital.

Sec. 616, which is the same as Sec. 23(cc) of the 1939 Code, provides, in subsection (a), that all expenditures paid or incurred by a taxpayer during the taxable year for the development of a mine or other natural deposit are deductible, provided they are paid or incurred after the development stage begins. These expenditures are deductible in both the development and production stages⁽⁹⁰⁾.

Under Sec. 616(b) a taxpayer can elect to treat as deferred expenses the expenditures just described, which are normally deductible in full, to the extent they exceed the net receipts during the taxable year from the ores or minerals produced from the mine or deposit involved. It bears emphasizing that the election applies only to the excess expenditures, and those not in excess of net receipts must be deducted in full.

If the election to defer excess expenditures is exercised, the deduction for each year is determined under the same formula as that set forth above with respect to mine exploration expenditures⁽⁹¹⁾.

The statements that were previously made in connection with mine exploration expenditures concerning the following are equally applicable to development expenditures:

- (a) Deductions specifically allowed under other sections of the Code, such as taxes.
- (b) Depreciable property and depreciation thereon.
- (c) Addition of deferred expenses to basis.
- (d) Excessive amortization of deferred expenses without tax benefit.
- (e) Years for which election is binding.
- (f) Manner of making election and time for filing.
- (g) Revenue Ruling 106.
- (h) Effect on purchaser of a mineral property of election exercised by seller.

Expensing of machinery and equipment:

Every accountant knows that an electric locomotive, mine cars, and steel rails should be capitalized and depreciated. However, there is an important exception in the mining industry, which is that expenditures for machinery and equipment bought for the sole purpose of maintaining normal production may be deducted in the year of purchase and installation⁽⁹²⁾.

Village operations:

Generally, any gain realized on village operations, will not be included in mining income. However, a loss from such operations must be deducted in arriving at taxable income from the property.

Carry-over of election to successor:

If a corporation acquires a mineral property in a tax-free liquidation of a subsidiary or other reorganization specified in Sec. 381, and the transferor corporation had made an election under Sec. 616, such

election carries over to the acquiring corporation and it must continue the amortization⁽⁹³⁾.

The closing remarks made with respect to exploration expenditures also seem equally applicable to development expenditures.

Allocation of indirect expenses:

Where a taxpayer is engaged in the operation of more than one mineral property and/or other activities as well, it is necessary to allocate the indirect expenses⁽⁷²⁾.

Indirect expenses are those items of overhead or general operating expenses which cannot be directly attributed to a particular property or activity. It is important to recognize the distinction between attribution and allocation, and to make certain that all expenses subject to attribution are so treated. For those expenses that are properly attributed to a particular property or activity should escape any allocation controversy with the Internal Revenue Service.

If taxpayer is engaged in both mineral activities and some other activity, such as manufacturing, the indirect expenses must first be allocated between these two activities⁽⁹⁴⁾. The regulations indicate that the allocation is made on the basis of direct operating expenses attributable to each activity. This allocation should be very carefully made so that the mining activity will not be burdened with more than its proper share of the costs.

Having arrived at the portion applicable to mineral activities, the second step is to allocate such portion to processing, nonproducing properties, and producing properties, since it is only the portion applicable to production that enters into the computation of depletion. This allocation may also be made on the basis of direct operating expenses applicable to each operation.

The third step is to allocate the portion applicable to production among the various producing properties⁽⁹⁵⁾. This allocation may be made on the basis of relative production, which can be measured in either units or dollars.

It is of the utmost importance to remember that the methods of allocation specified in the regulations do not constitute rigid rules, but, rather, represent methods which are generally acceptable. Thus, the taxpayer should be permitted to make his allocations on any basis that is reasonable in his circumstances and is consistently applied from year to year.

INFORMATION TO BE SUBMITTED WITH RETURN

The regulations⁽⁹⁶⁾ require certain specific information to be submitted with the income tax return in support of the depletion deduction.

For this purpose the Internal Revenue Service has provided Form M. It is intended that one of these forms be completed and attached to the return for each mineral property involved. However, taxpayers having many properties have found it to be very burdensome to prepare a separate form for each property. Consequently, it is the prevailing practice to attach schedules to the return summarizing the principal information required by the form and the regulations, with the remainder of the required information retained in the taxpayer's files for examination by the Revenue Agent. This practice has met the approval of the Internal Revenue Service, but it must be emphasized that this administrative approval does not remove the responsibility of the taxpayer to have all of the required information available for inspection by the Agent.

CONCLUSION

Consideration has been given in the foregoing paragraphs to the many problems and details involved in the computation of depletion. To make certain that the main theme of this paper is not obscured, a little summing up seems in order.

Our present high tax rates, especially as to individuals, coupled with percentage depletion allowances and other tax incentives, seem to have greatly stimulated investments in the mining industry. Furthermore, the uranium boom has created a renewed interest in mining.

The number of minerals subject to percentage depletion has been increased from time to time in recent years until now nearly all minerals are subject. For example, such commonplace products as sand, gravel, and clay are now subject to both cost and percentage depletion.

The computation of depletion is flexible, particularly as to the determination of gross income, where ordinary treatment processes are involved, and as to the allocation of basis and indirect expenses. Careful computations in this area can result in real tax savings.

For these reasons, among others, depletion has become one of the most important deductions in the tax law, and every competent accountant should be informed on the subject. Failure to do so may result

in the loss of clients, either because of inability to discuss and provide answers to their depletion problems, or because taxes have been over-paid due to slighted computations.

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