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TAXATION-PERCENTAGE DEPLETION ALLOWANCE ON INCOME RECEIVED FROM THE REWORKING OF DUMPS AND TAILINGS DEPOSITS

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TAXATION—PERCENTAGE DEPLETION ALLOWANCE ON INCOME RECEIVED FROM THE REWORKING OF DUMPS AND TAILINGS DEPOSITS[1]—A dump of waste material and low-grade ore resulted from mining operations by a lessee in the American Mine. London Extension owned an undivided one-half interest in the claims which made up the mine. In 1940 London acquired the lease on the property. Chicago Mines, a wholly-owned subsidiary of London, then took a lease on the dump, agreeing to pay to London a royalty of twenty per cent of the net smelter returns. Chicago worked the dump for a few months, after which it was worked by London. In filing its income tax return for the year, Chicago claimed a percentage depletion allowance on account of its working of the dump. London claimed a percentage depletion allowance based on the amount it received from Chicago as royalties, plus the amount it received from its own working of the dump. On appeal from a Tax Court decision adverse to the taxpayer, the Court of Appeals for the Tenth Circuit *held* that the controlling question was whether or not the dump was a "mine" within the meaning of section 23(m) of the Internal Revenue Code.[2] The

[1] A tailings deposit is one which contains ores which have previously undergone treatment whereby some, but not all, of their mineral content has been removed. A dump is a pile of material removed from the mine, usually containing waste rock and low-grade ore, none of which has gone through any treatment process.

[2] In computing net income there shall be allowed as deductions: "In the case of mines oil and gas wells, other natural deposits, and timber, à reasonable allowance for depletion. . . ."

court found that the dump was not a "mine" and therefore the depletion allowance was not available. *Chicago Mines Co. v. Commissioner,* (10th Cir. 1947) 164 F. (2d) 785.*

Little difficulty is encountered in applying the provisions of section 23(m) to income received from normal mining operations in which ore is removed from the ground and processed immediately. A real problem arises, however, when the taxpayer claims a percentage depletion allowance on income received from his reworking of a dump of low-grade ore or of a tailings deposit. Decisions in the federal Courts of Appeals for the Ninth and Tenth Circuits involving the propriety of such a deduction appear to be in conflict, giving rise to doubts on the part of taxpayers as to their tax liability on income received from such operations. In the *Atlas* case,[3] which was relied upon by the court in the *Chicago Mines* case, the taxpayer had contracted with the owner of a tailings deposit to treat the tailings in return for a share of the proceeds. Neither the taxpayer nor the owner of the deposit had any economic interest in the mine from which the tailings had come. It was held there that Atlas was not working a "mine" and was not entitled to a depletion allowance. The leading case in the Ninth Circuit is *Commissioner v. Kennedy Mining & Milling Co.*[4] The Kennedy Company had owned a gold mine since prior to 1913 and had apparently worked it continuously. During the years 1935 and 1936 it received the greater part of its income from the reworking of tailings. It claimed a depletion deduction on the income from these tailings and from its normal mining operations. The court did not consider the question of whether or not the tailings deposit was a "mine." Recognizing the fact that the mining of ore and the receipt of income therefrom are rarely, if ever, simultaneous, it held that the tailings were ores from Kennedy's mine just as were the newly-mined ores which Kennedy treated in the same years, and that consequently income from the tailings was merely delayed income from the mine. Moreover, the fact that prior to 1935 part of the gold content had been removed from the tailings was held to be immaterial since the ores so treated remained Kennedy's property and remained ores from the mine. Income from a subsequent treatment was income from the mine, just as was income from the first treatment. The *Atlas* case was distinguished upon the point of ownership by the taxpayer of an economic interest in the mine from which the tailings had come. Later cases in the Ninth Circuit have followed this line of reasoning. In the *Consolidated Chollar* case[5] the taxpayer acquired its lands many years after tailings had been deposited thereon from mines located on other lands. It was held that no deduction for depletion was allow-

* Though the decision in the principal case was rendered in 1947, there have not been subsequent appellate decisions on the same subject. Since the problem continues as one of current interest, it has been thought proper that the case be noted here.—Ed.

[3] Atlas Milling Co. v. Jones, (10th Cir. 1940) 115 F. (2d) 61.

[4] (9th Cir. 1942) 125 F. (2d) 399.

[5] Consolidated Chollar Gould & Savage Min. Co. v. Commissioner, (9th Cir. 1943) 133 F. (2d) 440.

able on income from the working of these tailings. The court had no trouble in distinguishing the *Kennedy* case. It held that the deposits were not a "mine" within section 23(m).[6] The taxpayer had no economic interest in the mine from which the tailings had originally come, so income from the tailings could not be considered income from a mine. The rule of the *Kennedy* case was followed again in the Ninth Circuit in *New Idria Quicksilver Mining Company v. Commissioner.*[7] Low-grade ores had been accumulated in a dump by New Idria's predecessor in interest. They were processed by New Idria and a depletion deduction was allowed on the income therefrom on the authority of the *Kennedy* case, the rule of which was extended by the holding of the court here that there was no legal distinction between the rights of the successor in interest and the rights of the original owner with respect to depletion claimed. Thus it appears that both courts will allow a depletion deduction only on income from a mine. But the Tenth Circuit requires that the income be derived immediately from the mine, while the Ninth Circuit is satisfied with income which could be considered to be derived only mediately from the mine. The Tenth Circuit scrutinizes the immediate source of the ore, the place from which it is dug, scraped, dredged or scooped and taken to the mill for processing. The Ninth Circuit looks to the original source of the ore, the place at which it was first found as a natural deposit and mined. A determination of the proper approach to the problem requires some consideration of the policy aspects of the statute. The deduction, as is invariably stated by the courts which refuse to allow it, is given as a matter of legislative grace. The statute is based upon the premise that the owner of a valuable natural deposit, such as a mine, which is fixed and limited in quantity, is entitled to take into account, in making out his tax return, the fact that every removal of income-producing ore from his mine results in a lessening of the intrinsic value of his property. He has a wasting asset on his hands and can profit only by its exhaustion. He is allowed a deduction from gross income on this account. If the taxpayer elects to take the percentage deduction[8] the allowance is not discontinued when he has recovered the cost of the property. It goes on until the mine is exhausted. To this extent it can be assumed that Congress intended to adopt a policy of encouragement to domestic mineral industries. There seems to be no good reason to apply the policy to underground deposits while denying its application in the case of surface deposits such as dumps and tailings deposits. In the normal course of events, the extraction of the ore and the appearance of a commercially marketable product, from which

[6] There is authority in both circuits to the effect that neither a dump nor a tailings deposit is a "mine" within the meaning of §23(m). It is submitted that there is room for reconsideration of this point, especially in the case of water-borne tailings deposits, which bear a striking resemblance to natural placer deposits and must be mined in a similar fashion. It could well be argued that these mineral values which became personalty when severed from the earth have again taken on the attributes of realty and should come within the scope of the term "other natural deposits," as used in §23(m).

[7] (9th Cir. 1944) 144 F. (2d) 918.

[8] I.R.C. §114(b)(4).

a gross income can be obtained, are not simultaneous. Ore is often stockpiled before being processed. There should be no time limit set on the period during which the taxpayer may hold the ore he has mined, as mere ore, without processing it. If he holds it in a dump or in an ore-bin for a long period and later mills it, the income which he then receives is still income from the mine, not income from the dump or from the ore-bin. Whether the ore is dumped or stockpiled with the intention of later working it, or because it is impossible at that time to process it economically, any return later secured from it is a measure of the depletion of the mine and is, in any real sense, income from the mine. The same reasoning applies in the case where the taxpayer has not dumped or stored his ore, but has run it through imperfect milling processes and retained the tailings. Income received from reworking the tailings at a later date is merely delayed income from the mine. It is submitted that the proper test of eligibility for this deduction is the one laid down by the Court of Appeals for the Ninth Circuit in the cases discussed above. Under this test the claimant must show that the income which he receives from the working of the dump or tailings deposit is a measure of the depletion of a capital asset in which he has an economic interest. Such a test would be fairly simple to administer, since the fact of an economic interest in land can be proved or disproved with comparative ease. The fact of an intention to process or re-process at a later date, when ore is dumped or tailings are deposited, suggested by the court in the Tenth Circuit[9] as a condition to eligibility, involves subjective proof of the state of mind of a taxpayer at a time which may be as remote as thirty or forty years past. With or without the intent, a subsequent processing of dump ore or tailings is a mere continuation of the original extractive process, and income therefrom is a measure of the depletion of the mine for which credit has not previously been taken.

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[9] Chicago Mines Co. v. Commissioner, (10th Cir. 1947) 164 F. (2d) 785.