# **1 Taxation of Mining Operations § 2.03**

***Taxation of Mining Operations* > *CHAPTER 2 COMPUTATION OF THE DEPLETION DEDUCTION***

**§ 2.03 Percentage Depletion**

1. **Governing Principles**

1. **In General**

Statutory or percentage depletion is computed by multiplying the appropriate percentage depletion rate by the gross income from property attributable to the taxpayer’s interest.[[1]](#footnote-2)64 The rates for the various minerals are as follows:

**“(b) Percentage depletion rates.—**The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

**(1) 22 percent—**

(A) sulphur and uranium; and

(B) if from deposits in the United States—anorthosite, clay, laterite, and nephelite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite, talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, molybdenum, nickel, platinum, and platinum group metals, tantalum, thorium, tin, titantium, tungsten, vanadium, and zinc.

**(2) 15 percent—**if from deposits in the United States—

(A) gold, silver, copper, and iron ore, and

(B) ***oil*** shale (except shale described in paragraph (5)).

**(3) 14 percent—**

(A) metal mines (if paragraph (1)(B) or (2)(A) does not apply), rock asphalt, and vermiculite; and

(B) if paragraph (1)(C), (5), or (6)(B) does not apply, ball clay, bentonite, china clay, sagger clay, and clay used or sold for use for purposes dependent on its refractory properties.

**(4) 10 percent—**asbestos (if paragraph (1)(B) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

**(5) 7 1/2 percent—**clay and shale used or sold for use in the manufacture of sewer pipe or brick, and clay, shale, and slate used or sold for use as sintered or burned lightweight aggregates.

**(6) 5 percent—**

(A) gravel, peat, pumice, sand, scoria, shale (except shale described in paragraph (2)(B) or (5)), and stone[[2]](#footnote-3)64.1 (except stone described in paragraph (7));

(B) clay used, or sold for use, in the manufacture of drainage and roofing tile, flower pots, and kindred products; and

(C) if from brine wells—bromine, calcium chloride, and magnesium chloride.

**(7) 14 percent—**all other minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, lime-stone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(B) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term “all other minerals” does not include—

(A) soil, sod, dirt, turf, water, or mosses;

(B) minerals from sea water, the air, or similar inexhaustible sources, or

(C) ***oil*** and gas wells.

For the purposes of this subsection, minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake within the United States shall not be considered minerals from an inexhaustible source.”[[3]](#footnote-4)65

Problems of interpretation arise in determining whether a substance is “stone” and consequently a 5 percent substance under § 613(b)(6) or a 14 percent mineral falling into the § 613(b)(7) category of “all other minerals, including, but not limited to, …” Then, if the latter, the issue is whether it is pulled back into the 5 percent category because it is “used or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes.” These latter uses are described by the Tax Court as construction uses.[[4]](#footnote-5)65.1 A 1983 General Counsel Memorandum addressing the treatment of granite manufactured into roofing granules describes the difficulties of interpretation:

Our review of cases in this area indicates that there is a great deal of confusion on several fundamental legal problems. First, where there is an overlap in the statute, i.e., stone with a five percent depletion rate under (b)(6) and “quartzite” with a fourteen percent depletion rate under (b)(7), which section prevails? In answering this question, how important is it that the generic substance, i.e., sand, gravel, or stone is found as such in its natural state as opposed to being crushed or further processed into such state by the taxpayer? Also, with reference to “stone,” what changes were made in 1954 over prior law, and to what extent are cases involving 1939 Code provisions relevant today? To what extent, if at all, is there a parallel between’stone’ receiving a five percent depletion rate under (b)(6), and “riprap, rubble,” etc. under (b)(7) also receiving a five percent depletion rate? To what extent is the use of the product by the purchaser from the mine owner relevant, and how important is the question of competition between industries in determining depletion rates? We find no clear answers to any of these questions in spite of the numerous court decisions and revenue rulings, yet all of these questions are present in varying degrees in the present case. Our conclusion in this case is not free from doubt, and we suggest a legislative revision to more clearly answer the questions raised herein.[[5]](#footnote-6)65.2

The GCM determined that the granite which was manufactured into roofing granules by crushing, screening, dyeing, and ***oiling*** was “other mineral” rather than stone. The GCM concluded that it was “other mineral” rather than “stone” because the specific mention of granite in Section 613(b)(7) governs over the general category of stone in Section 613(b)(6). Therefore, the 14 percent rate would be appropriate unless it fell into one of the categories of rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. The GCM concluded that roofing granules do not fall into any of those categories.

The difficult question is determining whether the Section 613(b)(7) mineral falls is used or sold for use as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. In deciding whether a use is one of these or a “similar purpose,” according to a 1994 Field Service Advisory, the Service asks:

A mineral will be subject to a depletion rate of five percent if either of two tests is met. First, if the functional or end use of the mineral is rip rap, ballast, road material, rubble, or concrete aggregate, the mineral will be subject to a five percent depletion rate. Second, where the mineral is not actually used for an enumerated purpose, if the use of the mineral is similar to (reasonably commercially competitive with) that of rip rap, ballast, road material, rubble, or concrete aggregate, it will be subject to the lower depletion rate. *Langenfelder v. Commissioner*, 69 T.C. 378, 390 (1977). In this regard, the test is not whether the mineral competes in the marketplace with other five percent minerals for any use. Rather, the test is whether it competes in the marketplace with other five percent minerals for uses similar to those enumerated in the statute. *Id.* at 390.[[6]](#footnote-7)65.3

An Action on Decision involving a Federal District Court case from the Fourth Circuit further describes its interpretation of the 5-percent exception to Section 613(b)(7):

During years in suit, section 613(b), IRC 1954 provided 15 percent depletion rate for quartzite but reduced it to 5 percent if it was “… used … as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. …” Court determined that “similar purposes” words of statute, strictly construed, mean that the end use of quartzite must be almost exactly the same as rip rap, ballast, road material, rubble or concrete aggregates if they are to be excluded from 15 percent rate. Government argued that “or for similar purposes” includes any uses which are reasonably or commercially competitive with the uses specifically enumerated. The Government’s position reflects the holding in G. & W. H. Corson, Inc. v. Commissioner, 453 F.2d 578, 28 AFTR2d 6040 (3rd Cir., 1971), *aff’g* 54 T.C. 668 (1970), the rationale of which was specifically rejected by this Court. The *Corson* decision represents the Government’s view.[[7]](#footnote-8)65.4

The Tax Court as well as the Third Circuit have applied the Revenue Service test of reasonably or commercially competitive uses.[[8]](#footnote-9)65.5

In one of the Tax Court decisions, *Bryan Rock Products, Inc.,* the Court ruled that the test is actual use not potential use so the production of red dolomitic limestone for landscaping qualified for the 14-percent rate since that use was not a functional substitute for one of the enumerated uses, i.e., it did not compete commercially with any of the enumerated uses, but rather was used for a decorative purpose rather than a construction purpose.[[9]](#footnote-10)65.6 The Court noted approvingly in the opinion that Taxpayer used the 5-percent rate for its sale of some of the rock for use as driveway and road base rock, concrete aggregate, utility and bedding rock.[[10]](#footnote-11)65.7 It is also noteworthy that the Tax Court in a decision affirmed by the Third Circuit concluded that dolomite limestone at issue in the case was used as a concrete aggregate and as a component of a trademarked base material for roads and runways and thus was entitled only to the 5-percent rate even though its particular chemistry generated supplementary benefits which substitute 5 percent minerals could not provide.[[11]](#footnote-12)65.8

Two District Court decisions from the Fourth Circuit, one of which was affirmed by the Fourth Circuit, have applied a narrower interpretation of “rip rap, ballast, road material, rubble or concrete aggregate, or for similar purposes.”[[12]](#footnote-13)65.9 One of the conclusions of law in one of these decisions outlines this difference with the Tax Court and Third Circuit:

8. The language used in Section 613(b)(6) (now Section 613(b)(7)) provides a “use” test. As such, competition is not a significant consideration. Rather, the “use” test depends on whether the purpose for the mineral sold is similar in a conventional sense to rip rap, ballast, road material, rubble, or concrete aggregates. This court is aware of, and declines to follow, the contrary holding in *G. & W. H. Corson, Inc. v. Commissioner* [Dec. 30,034], 54 T. C. 668 (1970), now on taxpayer’s appeal to the Court of Appeals for the Third Circuit.[[13]](#footnote-14)65.10

It is also noteworthy that the Fourth Circuit decision responded to the Government’s argument of reasonably competitive use by noting the minerals in question, marble and quartzite chips sold for 50 and 25 times, respectively, more than concrete aggregates and therefore were not competitive.[[14]](#footnote-15)65.11 The Service has ruled that it will not follow this Fourth Circuit decision.[[15]](#footnote-16)65.12

Effective for tax years beginning after 1983, for non-Subchapter S corporations, the percentage depletion deduction for coal (including lignite) and iron ore is to be reduced by 15 percent of the excess of the percentage depletion deduction over the adjusted basis of the property as determined at the end of the tax year and without regard to the depletion deduction for that year.[[16]](#footnote-17)65.13 For tax years beginning after 1986, the reduction is increased to 20 percent.[[17]](#footnote-18)65.14

Geothermal heat is also statutorily depletable effective for tax years ending on or after October 1, 1978, as a result of the Energy Tax Act of 1978.[[18]](#footnote-19)66 The depletable substance is defined in the Act as “… natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure).”[[19]](#footnote-20)67 The rate prescribed is 22 percent for taxable years beginning in calendar years 1978, 1979, and 1980, 20 percent for 1981, 18 percent for 1982, 16 percent for 1983, and 15 percent for 1984 and thereafter.[[20]](#footnote-21)68 The limitations imposed in 1975 by Section 613A on ***oil*** and gas percentage depletion do not apply to geothermal heat.

In view of the requirement that depletion be taken no more than once on the production from a particular mineral property,[[21]](#footnote-22)69 the holder of an economic interest computes depletion only on his share of the proceeds.[[22]](#footnote-23)70 He must exclude from his gross income from property the income attributable to the economic interests of others in the property.[[23]](#footnote-24)71 In addition, for Section 61 gross income purposes, such amount is excludable by the payor and necessarily includable by the payee since it is the latter’s economic interest that has earned this production income.[[24]](#footnote-25)72 The following is an example of the application of the exclusion requirement:

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| **Example:**  C obtains mining lease from B who reserves a $.10 per ton overriding royalty. Pursuant to the lease a royalty of $.50 per ton was due the lessor A. C extracts 100,000 tons of leased mineral in 1978 which is sold for $10 per ton. From the total received of $1,000,000, C must exclude the amount due on the override to B, *i.e.*, $10,000, and the amount due on the royalty to A, *i.e.*, $50,000, from his gross income from property for purposes of depletion and from his gross income for tax purposes. As a consequence, the figure against which C applies the appropriate percentage depletion rate in determining his statutory or percentage depletion deduction is $940,000. |

After multiplying the gross income from property by the appropriate rate and obtaining the amount tentatively to be deducted, the taxpayer must apply the 50 percent of taxable income from property limitation to determine whether the amount tentatively deductible should be reduced.[[25]](#footnote-26)73 The application of this statutory limitation is discussed herein below in this chapter.[[26]](#footnote-27)74

1. **Mining Terms**

In 1978, the Revenue Service issued Revenue Procedure 78-19, 1978-2 C.B. 491, to standardize definitions of mining terms used in the Code or the regulations.[[27]](#footnote-28)75 The text of this pronouncement provides the Revenue Service’s view of the accepted definitions of most of the mining terms used in Section 613 and the accompanying regulations.[[28]](#footnote-29)76

1. **Gross Income From Property**

1. **History and Development of Law**

Since 1932, percentage depletion has been allowable on coal, metal mines, and sulfur,[[29]](#footnote-30)77 with other minerals being added to the list in 1942 and thereafter.[[30]](#footnote-31)78 The base for the prescribed depletion rate since its inception has been “gross income from property.”[[31]](#footnote-32)79 This was defined by the Treasury Department as the amount of the sales proceeds of the crude mineral produced, including certain ordinary treatment processes. If the taxpayer processed the mineral beyond the prescribed processes, then gross income was determined by a representative market or field price before the application of processes other than those prescribed.[[32]](#footnote-33)80 In 1943 the Treasury definition was codified substantially as described above.[[33]](#footnote-34)81

In the hard mineral context before 1960, “gross income from property” was defined as “gross income from mining,” which in turn was explained in the Code as follows:

“The term ‘mining’ includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain a commercially marketable mineral product or products ......................”[[34]](#footnote-35)82

“Ordinary treatment processes.” The term ‘Ordinary treatment processes’ includes the following:

(C) In the case of iron ore, bauxite, $ lead: *and minerals which are customarily sold in the form of a crude mineral product*—sorting, concentration, and sintering to bring to shipping grade and form, and loading for shipment (emphasis by author);

(D) In the case of lead, zinc, $ lead: *and ores which are not customarily sold in the form of the crude mineral product* (emphasis by author) $ lead:”[[35]](#footnote-36)83

The above provisions provoked uncertainty and consequent litigation as to the proper cut-off point for purposes of depletion. These two provisions describing “ordinary treatment processes” appear to differentiate between “minerals” and “ores.” If the product in question could be described as a “mineral” rather than an “ore” and if it was not “customarily sold” in its crude mineral form, then arguably the miner-manufacturer could take depletion on his finished product. This required a showing that the manufacturing and processing applied to the mineral were necessary in order to obtain a “commercially marketable product.” Seven circuits (First, Fourth, Fifth, Seventh, Eighth, Ninth, and Tenth) held in effect that “minerals” were not “ores” within the contemplation of the 1939 and 1954 Codes.[[36]](#footnote-37)84 These courts also held that “minerals” not customarily sold in the crude form might be entitled to depletion in their finished form if such finishing processes were those “normally applied by miner owners or operators in order to obtain the commercially marketable mineral product or products.”

Although the phrase “commercially marketable product” was generally construed to mean the “first commercially marketable product,”[[37]](#footnote-38)85 the decisions cited from the above Circuits were favorable for the taxpayer in terms of the cut-off point. This was because of the requirement of a showing of a complete or substantial lack of a market for the product before application of substantial processing,[[38]](#footnote-39)86 or because a sale on the market existing for the unfinished product would not be profitable and, therefore, the unfinished product was not “commercially marketable.”[[39]](#footnote-40)87

The Cannelton Sewer Pipe Co. case involving the cut-off point for mined fire clay and shale was decided in 1960 by the United States Supreme Court.[[40]](#footnote-41)88 The taxpayer, an integrated miner-manufacturer, argued that it was entitled to compute its “gross income from mining” on the sales proceeds of the finished sewer pipe rather than the value of the raw fire clay and shale. It contended that the raw fire clay and shale was not commercially marketable because it could not be sold profitably without being processed into pipe. The Court, reversing the Seventh Circuit, found that commercial marketability depended on the point at which the normal nonintegrated miner sold the product of his mine and not on profitability of the sale.[[41]](#footnote-42)89 Since it was shown that most of the fire clay and shale produced in the region was sold in the raw form, the Court concluded that the fire clay and shale of the taxpayer was a mineral “customarily sold in the form of a crude mineral product,” and therefore only the specific processes set out in clause (iii) of Section 114(b)(4)(b) of the 1939 Code and subparagraph (c) of Section 613(b)(4) of the 1954 Code would be considered “mining.”[[42]](#footnote-43)90

Though the Supreme Court in *Cannelton* dispensed with the profitability aspect of the commercial marketability test, it failed to respond directly to the question raised when a taxpayer demonstrated the lack of a market. There remained after the decision a considerable basis for arguing that where a substantial market for the raw mineral was lacking, the depletion base could include the cost of such finishing processes as are shown to be necessary to commercial marketability.

This question was largely obviated, however, by an amendment to Section 613(c), known as the Gore Amendment, which was enacted as part of the Public Debt and Tax Rate Extension Act of 1960, effective January 1, 1961.[[43]](#footnote-44)91 The following is Section 613(c):

**“(c) Definition of Gross Income From Property.—**For purposes of this section—

**“(1) Gross income from the property.—**The term “gross income from the property” means, in the case of a property other than an ***oil*** or gas well, the gross income from mining.

**“(2) Mining.—**The term “mining” includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

**“(3) Extraction of the ores or minerals from the ground.—**The term “extraction of the ores or minerals from the ground” includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

**“(4) Treatment processes considered as mining.—**The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under Section 611:

“(A) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

“(B) in the case of sulfur recovered by the Frasch process—cleaning, pumping to vats, cooling, breaking, and loading for shipment;

“(C) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment;

“(D) in the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the minerals from other material from the mine or other natural deposit;

“(E) the pulverization of talc, the burning of magnesite, and the sintering and nodulizing of phosphate rock, the decarbonation of trona, and the furnacing of quicksilver ores;

“(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

“(G) in the case of clay to which paragraph (5) or (6)(b) of subsection (b) applies—crushing, grinding, and separating the mineral from waste, but not including any subsequent process;

“(H) in the case of ***oil*** shale—extraction from the ground, crushing, loading into the retort, and retorting, but not hydrogenation, refining, or any other process subsequent to retorting; and

“(I) any other treatment process provided for by regulations prescribed by the Secretary or his delegate which, with respect to the particular ore or mineral, is not inconsistent with the preceding provisions of this paragraph.

**“(5) Treatment processes not considered as mining.—**Unless such processes are otherwise provided for in paragraph (4) (or are necessary or incidental to processes so provided for), the following treatment processes shall not be considered as “mining”: electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping.”

The Gore Amendment, setting out more clearly the cut-off point, closed the door to depletion of many manufacturing costs by specifically and exclusively prescribing the treatment processes to be considered as mining processes along with such other processes as are necessary or incidental thereto. The Gore Amendment obviated the problem arising from the 1939 and 1954 Codes due to the separate use of the words “ores” and “minerals.”[[44]](#footnote-45)92 The treatment processes in question were made applicable to both “ores” and “minerals.” Furthermore, this and subsequent amendments added new categories of mining processes for certain minerals and specified certain other processes which are to be nonmining or manufacturing unless necessary or incidental to mining processes.

After considerable debate and discussion, the Treasury Department proposed regulations on October 1, 1971,[[45]](#footnote-46)93 which construed Section 613(c) as amended. These proposed regulations were finalized on March 10, 1971.[[46]](#footnote-47)94 With several minor exceptions, these regulations comprehensively cover gross income from mining for integrated operations. The regulations do not take into account a 1974 amendment to Section 613 explicitly allowing mining treatment for the decarbonation of trona.[[47]](#footnote-48)95 Additionally, they do not cover the rate of return on the investment method of computing gross income from property for the integrated miner.[[48]](#footnote-49)96

Gross income from property for geothermal steam wells is computed in the same manner as for ***oil*** and gas wells.[[49]](#footnote-50)96.1 The cut-off point for the latter is the sale in the vicinity of the well.[[50]](#footnote-51)96.2 If the steam is not sold on the premises, then the representative market or field price method must be used.[[51]](#footnote-52)96.3

1. **The Nonintegrated Miner**

The nonintegrated miner is one who sells his mineral before applying any nonmining or manufacturing processes to it. He sells it before the cut-off point as prescribed in the statute for purposes of determining gross income from mining. The Gore Amendment obviated most questions regarding the cut-off point for particular minerals. If the miner sells his mineral at or before the cut-off point, after application of only mining processes, the amount against which he applies the appropriate percentage depletion rate is the amount for which the mineral is sold.[[52]](#footnote-53)97 The gross income from property has been ruled by the Revenue Service to include the increase in price for coal resulting from the operator’s adding in the excise tax for black lung disease.[[53]](#footnote-54)98 If the miner applies only mining processes but sells the mineral in several different forms, his gross income from mining remains, nevertheless, the total amount received on the sale. An example of this situation is set forth in the regulations:

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| **Example:**  99Treas. Reg. § 1.613-4(b)(1).  “A miner of gypsum sells several sizes of crushed gypsum and also, as an incidental by-product resulting from the crushing operation, gypsum fines. His gross income from mining is the total amount for which the crushed gypsum and fines are actually sold.”[[54]](#footnote-55)99 |

1. **Specific Processes Considered as Mining**

For ores and minerals customarily sold in the form of a crude mineral product, Section 613(c)(4)(C) of the Code considers mining as sorting, concentrating, sintering, loading for shipment and other processes substantially equivalent to the first three.[[55]](#footnote-56)100 If a significant portion of the ore or mineral is sold or used in a clearly nonmining process before its “inherent mineral content” is altered by a form of beneficiation, concentration, or ore dressing, it satisfies the test and is considered as being customarily sold in the crude form.[[56]](#footnote-57)101 The regulations provide that applied processes such as crushing which do not alter the inherent mineral content do not remove the ore or mineral from this Section 613(c)(4)(C) category of mining processing.[[57]](#footnote-58)102

Proposed regulations published in July of 1968[[58]](#footnote-59)103 which were withdrawn and replaced by other proposed and subsequently withdrawn regulations published in October of 1968,[[59]](#footnote-60)104 listed the following minerals (in addition to those specified in the Code) as falling within Section 613(c)(4)(C): sodium chloride, sand and gravel, bentonite, china clay,[[60]](#footnote-61)104.1 clay used or sold for its refractory properties, fullers earth, limestone, marble, stone (where the latter three are sold or used as broken or crushed stone products), aplite, asbestos, barite, brucite, celestile corundum, diatomaceous earth, feldspar, gilsonite, graphite, gypsum, kyanite, mica, mollusk shells (except shells used in making cement), novaculite, olivine, peat, perlite, pumice, quartzite, quartz sand and pebbles used or sold for purposes dependent upon their chemical or refractory properties, rock asphalt, rock salt (halite), sandstone, slate (except slate for which specific provision is made elsewhere), soapstone, tripoli, vermiculite, wollastonite, and zircon. This now withdrawn listing may indicate what the Revenue Service currently is including in this category.

The current regulations define the terms “sorting” and “concentrating” as processes for the elimination of waste or the separation of two valuable minerals.[[61]](#footnote-62)105 Examples of such processes given are hand or mechanical sorting, magnetic separation, gravity concentration, jigging, the use of shaking or concentrating tables, the use of spiral concentrators, the use of sluices or sluice boxes, sink and float processes, and flotation processes such as bubble skin and froth flotation.[[62]](#footnote-63)106 The above sorting and concentration processes will be considered mining activities only where applied to bring the ore or mineral to “shipping grade and form.”[[63]](#footnote-64)107 The regulations define a concentration process as one which is designed to remove a substantial amount of impurities or foreign matter associated with the ores or minerals in their natural state.[[64]](#footnote-65)108 A refining process should be distinguished from a concentrating process since Section 613(c) expressly renders it a nonmining process. Refining is defined in the regulations as a process designed to remove small amounts of impurities in order to achieve a high degree of purity.[[65]](#footnote-66)109

Sintering is defined in the regulations as a process of heating to achieve an agglomeration of fine particles to the extent that incipient, but not complete, fusion occurs.[[66]](#footnote-67)110 As with sorting and concentration, sintering is a mining process only if necessary to bring the mineral or ore to “shipping grade and form.” An example provided is that of finely ground iron ore concentration which prior to shipment from the concentration plant must be sintered in order to prevent a loss of the particles. On the other hand, sintering applied in the course of a nonmining process will not qualify, *e.g.*, sintering to expand or harden clay in the course of manufacturing building material.

The processes set out in Section 613(c)(4)(C) must be designed to bring the mineral or ore to “shipping grade and form” in order to constitute mining processes. “Shipping grade and form” has been defined in the regulations as bringing the ore to the quality or size at which the ore is shipped to a customer or used in a nonmining process.[[67]](#footnote-68)111 In order for “loading for shipment” to qualify, it must immediately follow the sorting, concentrating, sintering and substantially equivalent processes which are applied to bring a crude mineral to “shipping grade and form.”[[68]](#footnote-69)112

Section 613(c)(4)(D) of the Code covers minerals not customarily sold in the form of a crude mineral product. The processes set out in this subparagraph are mining processes only if they are applied for the purpose of separating or extracting the valuable mineral from the ore or from other material taken from the mine.[[69]](#footnote-70)113 In addition to the processes set out in Section 613(c)(4)(D), any process that is substantially equivalent to any of them is also mining. The Tax Court has ruled that the solvent extraction process applied to remove tungsten and vanadium was substantially equivalent to precipitation and therefore mining.[[70]](#footnote-71)113.1 The court so concluded even though: (1) the solvent extraction process involved a chemical reaction which would otherwise be disqualifying because it resulted in a chemical change as discussed at § 2.03[2][b][vii], *below;* (2) precipitation involved the use of inorganic compounds and solvent extraction involved organic compounds; and (3) solvent extraction acted upon a liquid and produced a liquid whereas precipitation acted upon a liquid and produced a solid.[[71]](#footnote-72)113.2 The same court has ruled that the use of the Claus method for extracting sulfur from hydrogen sulfide, i.e., by introducing sulphur dioxide as a chemical reagent to react with the hydrogen sulfide, was substantially equivalent to precipitation and therefore mining.[[72]](#footnote-73)113.3 The Tax Court so decided even if there was a chemical change and even though the Claus process acted on a gas and produced a gas.[[73]](#footnote-74)113.4

Based on these two Tax Court cases, it would seem that a process although effectuating a chemical change can still be considered mining if it is substantially equivalent to a mining process.

No process achieving such a high degree of beneficiation that, in effect, it is smelting or refining, will be considered to be a mining process.[[74]](#footnote-75)114 Contrary to the published position of the Revenue Service, the Tax Court has concluded that storage and loading for shipment are mining processes for Section 613(c)(4)(D) minerals as well as for Section 613(c)(4)(C) minerals despite the fact that Section 613(c)(4)(D) fails to mention loading for shipment.[[75]](#footnote-76)114.1

Succeeding subparagraphs of the Code prescribe specific processes for particular minerals.[[76]](#footnote-77)114.2 The final Section (C)(4) provision empowers the Treasury Department to treat any process as a mining process as long as such treatment is not inconsistent with the other provisions in Section 613(c)(4).[[77]](#footnote-78)114.3 The purpose for so authorizing the Treasury is to avoid discrimination in the treatment of mineral producers where there is use of different processing techniques to accomplish the same results or where there is production of different but competing minerals. Also, the power should be exercised in order to deal with changes in mining technology.[[78]](#footnote-79)115 Although the now withdrawn discussion draft provided a procedure for the taxpayer to petition the Commissioner for recognition of a particular process as mining under Section 613(c)(4)(I),[[79]](#footnote-80)116 the final regulations make no provision therefore. Rather, the following processes are set forth as mining pursuant to the authorization provided in Section 613(c)(4)(I):

“(1) Crushing and grinding, but not fine pulverization (which is defined below and classified as a nonmining process);

(2) Size classification processes applied to the products of an allowable mining process;

(3) Drying to remove free water, provided that such drying does not change the physical or chemical identity or composition of the mineral;[[80]](#footnote-81)116.1 and

(4) Washing or cleaning the surface of mineral particles provided no change of the chemical or physical properties of the particles takes place.”[[81]](#footnote-82)117

1. **Necessary and Incidental Processes**

Section 613(c) of the Code provides that the processes specified therein and other “processes necessary or incidental thereto” will be considered mining processes. The statute and regulations acknowledge that a process which is specified in the Code as nonmining may qualify as mining if necessary or incidental to a mining process.[[82]](#footnote-83)118 The example quoted above involves this situation since fine pulverization is specified as a nonmining process in the Code.[[83]](#footnote-84)119 Yet, because such fine pulverization is incidental to a mining process, it is considered mining. Thus, if a nonmining process can be demonstrated to be necessary or incidental to a mining process, the miner need not resort to one of the constructive sales price formulas outlined below[[84]](#footnote-85)120 to determine his gross income from property.

A process is a necessary process if it is essential to the performance of a mining process.[[85]](#footnote-86)121 One of the two examples in the regulations involves iron ore which must be concentrated by fine pulverization in order to be of shipping grade and form. Since the iron ore cannot be concentrated and thus brought to shipping grade and form without the fine pulverization, such process is also a mining process. The second example involves the storing of a mineral to await application of mining processes where the mining process cannot be effectively applied without storage. In such case the storage will be considered a mining process. A third example is the sintering of finely ground iron ore concentrate in order to bring the ore to shipping grade and form.[[86]](#footnote-87)121.1 If to be effective to bring to shipping form the sintering and pelletizing of the finely pulverized iron ore requires blending with bentonite and under certain circumstances limestone, it would seem reasonably arguable that the blending would also be necessary and therefore mining despite the exclusion of blending in the Code and regulations.[[87]](#footnote-88)121.2 If the blending is determined to not qualify as necessary or incidental, then it may disqualify mining processes applied after it pursuant to the “sudden death rule”.[[88]](#footnote-89)121.3

A process is defined by the regulations as being “incidental” to a mining process, and therefore itself a mining process, if either of two prerequisites is satisfied. Either the cost of the process in question must be insubstantial when compared with the cost of its related mining process, or the process must be merely the coincidental result of a process.[[89]](#footnote-90)122 An example of the former provided by the regulations is the sprinkling of coal prior to loading for shipment with dots of paper to identify the coal for trade-name purposes where the cost of sprinkling is insubstantial relative to the cost of loading. Although some definitions of the requisite relationship between the mining process and the incidental process applied concomitantly would be helpful, one might infer from the above example the requirement of some degree of necessity of the nonmining to the mining process before this category of incidental process qualifies.[[90]](#footnote-91)122.1 Second and alternatively, the process will be “incidental” if it is merely the coincidental result of the application of the other process. A specific example of the latter situation is the example from the regulations quoted above involving the gypsum fines which result from the crushing of the gypsum.[[91]](#footnote-92)123

1. **Mining Transportation**

If the mineral or ore is transported from the point of extraction to the plant or mill where mining processes are applied, and if the distance from the point of extraction to the plant or mill is not in excess of 50 miles, the transportation is itself a mining process.[[92]](#footnote-93)124 However, transportation is a nonmining process to the extent that it exceeds 50 miles unless the taxpayer is able to convince the Commissioner that “both the physical and other requirements” necessitate transportation over the greater distance.[[93]](#footnote-94)125 To obtain mining treatment for the excess transportation, the taxpayer must file an original and a copy of an application with the Commissioner which sets forth in detail the facts which demonstrate the physical and other requirements which prevented the plant or mill’s being located closer to the point of extraction.[[94]](#footnote-95)126 Transportation within the mileage limit from the point of extraction to the plant or mill where the “substantially equivalent” processes of Section 613(c)(4)(C) and those of Section 613(c)(4)(I) are applied is also mining transportation according to the now withdrawn discussion draft of the regulations published in March of 1969.[[95]](#footnote-96)127 On the other hand, it is clear that transportation to market even after the application of only mining processes is nonmining.[[96]](#footnote-97)128

Problems arise with respect to transportation when the ore is taken to a processing facility from the mine where a relatively insignificant mining process is applied and then delivery of the processed ore is made to the buyer. The question also arises when a substantial nonmining process follows a relatively insignificant mining process, both occurring after transportation within the mileage limit. The final regulations provide that if the “primary purpose” of the transportation is “marketing, distribution, or delivery for application of only nonmining processes,” the transportation will be considered nonmining.[[97]](#footnote-98)129 Justification in the statute for this “primary purpose” limitation is difficult to find. The regulations deny mining treatment for transportation merely because during the course thereof some extraneous matter is removed by the forces of nature, and thus, arguably, such transportation is in effect a concentration process which qualifies.[[98]](#footnote-99)130

1. **Discounts**

The regulations provide that gross income must be reduced by the amount of any trade or cash discount actually allowed by the miner on the sale of his mineral or ore.[[99]](#footnote-100)131 This requirement applies to any allowance, whether or not nominally a trade or cash discount, if it has the effect of a trade or cash discount.[[100]](#footnote-101)132 The position of the Revenue Service and the courts for a number of years was that gross income had to be reduced by the amount of any trade discount allowed, but that it did not have to be reduced by the amount of any allowed cash discount because the latter was considered in effect as an interest payment to the buyer for the use of the prepaid purchase money by the seller.[[101]](#footnote-102)133 If the amount of the cash discount can be deemed interest income to the miner-seller, then the regulations are probably correct, *i.e.*, when payment is deferred with the result that the discount is lost. However, if such amount is in effect interest to the buyer, then arguably the prior approach taken by the Revenue Service would seem correct. Nevertheless, the regulations do constitute an attempt to reverse court decisions on the treatment of cash discounts.

1. **Selling Expenses**

For the nonintegrated miner, the expenses of selling his mineral need not be excluded from his base for depletion, *i.e.*, his gross income from mining.[[102]](#footnote-103)134 Selling expenses can include sales management salaries, rent of sales office, sales and clerical expenses, salesman’s salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses and other similar expenses together with a portion of expense of the supporting services, if any.[[103]](#footnote-104)135 Trade Association dues, if any, of the nonintegrated miner are also included in his gross income from mining.[[104]](#footnote-105)136 However, the expense of delivery to the purchaser is not included.[[105]](#footnote-106)137 If the person to whom the miner-taxpayer makes delivery is not in substance a sales agent but rather a purchaser, then only the net amount received is included in the miner’s gross income from property.[[106]](#footnote-107)138

1. **Sales Between Members of Controlled Group**

A miner who sells his mineral or ore to which he has applied only mining processes to a controlled taxpayer which manufactures the mineral or ore into a finished product by the application of nonmining processes may not use his actual sales proceeds as his base for depletion. Rather, he should use the representative market or field price to determine his gross income from property.[[107]](#footnote-108)139 If the Commissioner has determined a price pursuant to his authority under Section 482, the regulations prescribe the use of that price as one of the competitive sale prices for purposes of determining the representative market or field price. If the representative market or field price method is inappropriate, he should use the proportionate profits method or another method approved by the Commissioner to determine his gross income.[[108]](#footnote-109)140 If the Commissioner has determined a price pursuant to his authority under Section 482, then that price must be used as the actual amount for which the first marketable product is sold for purposes of applying the proportionate profits method.[[109]](#footnote-110)141

For tax years beginning on or before April 21, 1993, the regulations under Section 482 direct the Commissioner or District Director to make references to the principles set out in the regulations dealing with gross income from property[[110]](#footnote-111)142 for guidelines in setting a price for a mineral product sold at the cut-off point in a controlled group transaction such as the hypothetical situation set out above.[[111]](#footnote-112)143 Thus, it was clear that Regulations Subsection 1.613-4 provided the basis for both Revenue Service and taxpayer determinations as to the pricing of an ore or mineral sold at the cut-off point in transactions between related parties. This reliance on the 1.613-4 regulations was confirmed by regulatory history.[[112]](#footnote-113)143.1

However, for tax years beginning after October 6, 1994, the Section 482 regulations have not contained the reference to the Section 1.613-4 regulations. Though the 1.613-4 regulations clearly continue as described above to prescribe use of the representative market or field price method or failing that the proportionate profits method even when the Commissioner has exercised his Section 482 authority, the current omission of the reference to them in the Section 482 regulations has caused some to question whether the Section 1.613-4 regulations continue to take precedence for purposes of both Sections 613 and 482. The authors believe that the Section 1.613-4 regulations continue to take precedence as before.

In any event the word “controlled” is defined quite broadly as including any type of control, direct or indirect, whether legally enforceable or not and however exercised or exercisable.[[113]](#footnote-114)144 It is the reality of the control and not its mode or form that is significant.[[114]](#footnote-115)145 Provision is made for a presumption of control if income or deductions have been arbitrarily shifted.[[115]](#footnote-116)146

1. **Specific Nonmining Processes**

The following are described as nonmining processes in the statute: electrolytic deposition, roasting, calcining, electric or thermal smelting, refining, polishing, fine pulverization, blending with other materials, treatments effecting chemical change, thermal action, and molding or shaping. Each of these processes is defined in the regulations[[116]](#footnote-117)147 and in Revenue Procedure 78-19 quoted above.[[117]](#footnote-118)148 If, however, a process is substantially equivalent to a mining process or necessary or incidental to a process which is substantially equivalent to a mining process, it also will constitute a mining process even though it is specified in this provision as nonmining.[[118]](#footnote-119)148.1

The regulations also provide that where a process, nominally a mining process, is applied after a nonmining process, the former will also be considered a nonmining process. This has been described as the “Sudden Death Rule.”[[119]](#footnote-120)148.2 Exception is made, however, to this rule where the result of its application would result in discrimination between “similarly situated producers of the same mineral.”[[120]](#footnote-121)149 An example of the exception would be the sintering (ordinarily a mining process) of roasted (a nonmining process) ore where the roasting is necessary to achieve the shipping grade and form achieved by competitive sintered ore which requires no roasting. Here notwithstanding the sequence of processes, in order to avoid discrimination, sintering will be considered a mining process.[[121]](#footnote-122)150 However, the roasting will be considered a nonmining process.[[122]](#footnote-123)151 Another exception is made in the case of a mining process preceded only by nonmining transportation.[[123]](#footnote-124)152 In such case the mining treatment is not disqualified.

1. **The Integrated Miner**

If in the processing of his mineral or ore the miner goes beyond the cut-off point and applies any nonmining process including nonmining transportation, he may not use actual sales proceeds of such processed mineral as the base for applying the prescribed rate of depletion, *i.e.*, his gross income from mining.[[124]](#footnote-125)153 Rather, he must use one of the alternative methods for calculating his gross income from mining which yields a figure which is supposed to represent the amount the miner would have received had he sold the mineral or ore at the cut-off point. The following is an outline of these various methods in the hierarchical order prescribed in the regulations.

1. **Representative Market or Field Price**

If before the sale of his mineral ore the miner applies nonmining processes including nonmining transportation, he is required to compute his gross income from mining by the use of the representative market or field price where possible.[[125]](#footnote-126)154 The purpose, of course, is to discover the approximate price at which the miner could have sold his mineral product after the application of only mining processes. This price is determined by looking at competitive sales at the cut-off point of minerals or ores of “like kind and grade” as the miner’s, and by looking at the miner’s own sales, if any, of mineral or ore of “like kind and grade” at the cut-off point.[[126]](#footnote-127)155 If “in common commercial practice, (a mineral) is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer’s … that it is used or is commercially suitable for use for essentially the same purposes as the uses to which the taxpayer’s ore or mineral is put,” it is of “like kind and grade.”[[127]](#footnote-128)156 The regulations provide that, generally, in order to determine whether another mineral or ore is of “like kind and grade,” reference will be made to industrial specifications and to chemical and physical data of the mineral in question.[[128]](#footnote-129)157

The regulations permit a mineral or ore to be of “like kind and grade” even though the miner applies slightly different size reduction or beneficiation processes.[[129]](#footnote-130)158 The regulations also provide that even though the miner sells or uses his mineral or ore for different purposes, such fact will not, in and of itself, prevent another person’s ore or mineral from being considered to be of “like kind and grade.”[[130]](#footnote-131)159 Distinctions that have no commercial significance may be ignored.[[131]](#footnote-132)160 In limitation of the arguments over similarities of minerals or ores, the regulations provide that if the desirable natural constituents of the minerals or ore are markedly different, then notwithstanding common suitability for a general commercial use, the minerals or ores will not be of “like kind and grade,” *e.g.*, anthracite and bituminous coals.[[132]](#footnote-133)161 On the other hand, use may be made of the price of an ore or mineral of like kind but not like grade if there are no minerals of “like kind and grade” and if readily ascertainable adjustments can be made for the differences in mineral content.[[133]](#footnote-134)162

If the ore or mineral of another miner is found to be of “like kind and grade,” the determination must be made as to whether the taxpayer-miner’s ore or mineral would be in competition with it under commercially accepted standards if the taxpayer had sold his ore or mineral at or before the cut-off point.[[134]](#footnote-135)163 The regulations also frame the economic criteria for representative market or field prices by requiring that they are the result of “competitive transactions.”[[135]](#footnote-136)163.1 The fact that the taxpayer’s selling at the representative price would have been unprofitable does not appear relevant.[[136]](#footnote-137)164 However, if the sales being proposed were monopolistic sales, the sale prices received will probably not be accepted as representative market or field prices because they are not competitive.[[137]](#footnote-138)164.1 If there is only one buyer who offers a “take-it-or-leave-it” price, the price obtained will probably not be useable.[[138]](#footnote-139)164.2

A sale price being evaluated as a possible representative market or field price must be for more than an insignificant quantity of mineral as compared with the quantity being handled by the taxpayer. The tax court refused to find a representative market or field price for granite because there was no showing of sales in sufficient quantities to establish a market price (without a specification of relative quantities).[[139]](#footnote-140)164.3 A federal district court found that the 3.18 percent to 9.3 percent of the total dimension stone that the taxpayer sold over the years in question was not processed and therefore, because it constituted an insignificant quantity, its sale was not useable.[[140]](#footnote-141)164.4 On the other hand, the Third Circuit found prices obtained for limestone by two unintegrated miners in the taxpayer’s market area to be representative market or field prices because the tonnage of limestone produced by these two miners was 25.7 percent of the limestone produced by the taxpayer and 7.3 percent of the total tonnage produced by taxpayer and two other integrated miners in the market area.[[141]](#footnote-142)164.5

For prices received in sales to qualify as representative market or field prices, they must occur in “relevant markets,” i.e., they must be, among other things, accessible to the taxpayer.[[142]](#footnote-143)164.6 The meaning of “relevant markets” and “accessibility to the taxpayer” is not entirely clear. Assuming a sale of minerals of like kind and grade occurs at the cut-off point and is otherwise competitive as described above but it is either transported by the miner before sale or transported by the purchaser to its processing plant, is that sale made in a relevant market? Does it make a difference that the taxpayer’s costs of transportation to that purchaser would be less, the same, or more than the miner’s costs of transportation? What price is used as the sale price—the miner’s f.o.b. price or delivered price? What if the purchaser bears the cost of transportation? Are the purchaser’s costs added back to the sale price to construct the representative market or field price?[[143]](#footnote-144)164.7

Unless the miner’s sale must be in taxpayer’s community, it is difficult to determine how transportation costs are handled in constructing the representative market or field price. It would seem that the regulations contemplate the possibility of a market being relevant to the taxpayer even though sales by the taxpayer or by competitors involve nonmining transportation costs.[[144]](#footnote-145)164.8 In other words, it would seem a fair inference that a market may be treated as relevant to the taxpayer even though it is not in taxpayer’s community. If that is the case, then what geographic limits on sales may be used? As noted above, the regulations talk about the need for relevance to the taxpayer of the market in which the miner’s sale occurred, including the accessibility of that market to the taxpayer.[[145]](#footnote-146)164.9 A technical advice memorandum confirms the above:

The clear language of § 1.613-3 states that, if the ***oil*** and gas is not sold in the immediate vicinity of the well, then gross income from the property should be determined using a representative market or field price (“RMFP”). An RMFP is “the price that is actually paid by buyers for the same commodity in the same market.” See *Shamrock* ***Oil*** *and Gas Corp. v. Commissioner of Internal Revenue*, 35 T.C. 979, 1032 (1961) [CCH Dec. 24,730] aff’d 65-2 USTC 9476, 346 F.2d 377]. An RMFP is proven through the examination of actual transactions. Id. An RMFP is calculated by taking a weighted average, based on quantity, of all contracts in which a comparable mineral was sold in the taxpayer’s locality. See *Hugoton Production Co. v. United States*, 65-2 USTC 9566, 349 F.2d 418, 420]. This includes all contracts in effect during the year in question, including those existing contracts with unfavorable pricing terms, and not just contracts entered into during that year. See *Panhandle Eastern Pipeline Co. v. United States*, 69-1 USTC 9276, 408 F.2d 690, 701-708]. Essentially, an RMFP is determined by examining sales of gas that are comparable in time, quantity, quality and availability to marketing outlets, and represents the price that similar gas brought at the mouth of the well in the field. See Shamrock, 35 T.C. at 1033 [CCH Dec. 24,730]. An RMFP is not the same as a fair market value. Id. at 1032. Considerations of what a buyer could have or should have paid for the mineral are entirely irrelevant. Id.

As seen in the Shamrock case, a particular sale must meet two general requirements to be included in the calculation of an RMFP. The sales must be of the same commodity and they must be sold in the same market to qualify. The holdings of Shamrock and similar cases regarding the elements of the RMFP are codified in § 1.613-4(c). The first element, that the sale be of the same commodity, requires that the mineral be of like kind and grade. Generally, § 1.613-4(c)(2) states that a mineral is of a like kind and grade if, in common commercial practice, it is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer’s ore or mineral that it is used, or is commercially suitable for use, for essentially the same purposes as the uses to which the taxpayer’s ore or mineral is put. The second element to be shown for inclusion into an RMFP is that the mineral be sold in the same market. Under § 1.613-4(c)(3), in determining the representative market or field price for the taxpayer’s ore or mineral, consideration will be given only to prices of ores or minerals with which, under commercially accepted standards, the taxpayer’s ore or mineral would be considered to be in competition. The taxpayer’s market is defined by economics, supply and demand, and the existence and availability of a market, rather than by geographic boundaries. See Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198 (5th Cir. 1946).

Determining an RMFP is inherently factual. Determining an RMFP in the case of a geothermal deposit, would involve an examination of actual contracts for the sale of a geothermal resource in the vicinity of the wellhead which is commercially suitable for the taxpayer’s use. Further, these sales would necessarily be from geothermal deposits in actual competition with Taxpayer. If no wellhead sales of comparable geothermal resources exist that would be in competition with the Taxpayer, then there is no RMFP.[[146]](#footnote-147)164.10

It would seem that if the criteria of relevance and accessibility have any meaning, transportation costs must be taken into account. If the taxpayer, an integrated miner/manufacturer, would have costs of transporting the mineral to the miner’s purchaser would exceed the miner’s actual transportation costs, then the miner’s sale price should not constitute a representative market or sale price for the taxpayer. Otherwise, there would not seem to be a clear and precise geographic limit on useable markets. If the miner’s transportation costs exceed those that the taxpayer would pay to ship the mineral to miner’s purchaser, then it would seem that miner’s sale price adjusted as described immediately below would qualify if the other factors are satisfied.

Economically, it would also seem appropriate to add to the representative market or field price the excess of miner’s transportation costs over the transportation costs the taxpayer would pay. This is because the value of the taxpayer’s mineral at the cut-off point would seem to equal miner’s sale price at the place of delivery to purchaser (or miner’s f.o.b. sale price plus purchaser’s cost of transportation) minus the transportation costs the taxpayer would pay to ship the mineral to the miner’s purchaser. This would seem to be what the miner’s purchaser would pay for the taxpayer’s mineral f.o.b. The Ninth Circuit appears to have confirmed this approach.[[147]](#footnote-148)164.11

The general goal of the RMFP regulations would appear to accommodate this approach:

The objective in computing gross income from mining by the representative market or field price method is to ascertain, *on the basis of an analysis of actual competitive sales by the taxpayer or others* [emphasis by authors], the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if, prior to the application of nonmining processes, the taxpayer had sold the quantities and types of ores and minerals to which he applied nonmining processes.[[148]](#footnote-149)164.12

However, the regulatory provision dealing with RMFP method and transportation costs is arguably contrary:

If the transportation by the taxpayer is not purchased transportation to the customer, or if the taxpayer does not sell the ore or mineral until after the application of nonmining processes, and if other producers in the taxpayer’s marketing area sell significant quantities of an ore or mineral of like kind and grade after the application of only mining processes but after purchased transportation to the customer, the representative delivered price at which the ore or mineral is sold by those other producers reduced by representative costs of purchased transportation to the customer paid or incurred by those producers shall be used by the taxpayer as the representative market or field price for his ore or mineral in applying paragraph (c) of this section. Furthermore, appropriate adjustments shall be made to take into account differences in mode of transportation and distance. When applying this subdivision, the representative market or field price so computed shall not exceed the taxpayer’s delivered price less his actual costs of transportation to the customer.[[149]](#footnote-150)164.13

If in the markets relevant to the taxpayer there are several different prices for mineral or ore of the miner’s kind and grade, the regulations provide that an important factor in the determination of the representative market or field price is a weighted average of these prices. Such average would include the price the miner received on arm’s-length sales at the cut-off point of his own like kind and grade mineral.[[150]](#footnote-151)165 Not only must the taxpayer-miner’s sale be at arm’s-length to be included in the weighted average, but also the comparative sales of ore or mineral of like kind and grade by other nonintegrated miners must be competitive. The regulations provide that more weight will be given to sales involving substantially unrelated buyers and sellers, no one of whom controls a substantial portion of the buyer’s or seller’s market.[[151]](#footnote-152)166 Additionally, “exceptional, insignificant, unusual, tie-on, or accommodation sales should be disregarded.”[[152]](#footnote-153)167

According to the regulations, a presumption is raised that a price so determined is not the representative market or field price when the total of the price determined to be the representative market or field price for the miner-taxpayer’s ore or mineral plus the aggregate nonmining costs actually incurred regularly exceed the taxpayer’s actual sales price.[[153]](#footnote-154)168

The example given is that of coal for coke which costs $12 per ton to process. If the miner-taxpayer’s actual sales price is $18 per ton, a price of $7 per ton would be presumed not to be a representative market or field price as the total of the non-mining costs ($12) and the representative market or field price ($7) is—at $19—greater that the actual selling price of $18. However, the presumption is rebutted according to the regulations by a showing of unusual, peculiar, and nonrecurring factors that caused the loss, such as fire, flood, explosion, earthquake, or strike.[[154]](#footnote-155)169 Also, if losses incurred at the inception of operations explain the disparity, then the presumption should be rebuttable. The District Court for the Southern District of Indiana has held that despite the absence of an unusual, peculiar, and nonrecurring event, an integrated limestone miner who for several of the tax years in question was operating at a loss could use the representative market or field price method. The justification was that the losses were not fabricated by the use of the method but rather were due to depressed market conditions for his manufactured limestone.[[155]](#footnote-156)170 The Seventh Circuit affirmed on this issue holding that the manufacturing losses were not regular enough to even raise the above presumption.[[156]](#footnote-157)171

In determining whether there is a nonmining loss, the types of nonmining costs includable are crucial. Strictly from an operational standpoint, a taxpayer would close a nonmining operation if the value added did not consistently exceed the cash, that is, variable costs. In such a financial analysis, fixed costs are sunk costs and do not enter into a “make or buy” analysis. For example, accelerated depreciation on nonmining assets would cause an apparent loss that should not enter into a validation test of the taxpayer’s representative market or field price. An analysis of this type was made in dictum by the Court of Claims.[[157]](#footnote-158)171.1 Unfortunately, however, this analysis was extraneous to the decision since the court determined that the mineral was not of like kind and grade. The dictum was not restated in the affirming decision of the Court of Claims.[[158]](#footnote-159)171.2

Thus, while it is logical to use the “no nonmining loss” rule to test the representative market or field price, this test should use cash costs only, not all costs. For example, copper concentrates are normally sold based on the Comex price less an agreed upon smelting charge. Due to sunk costs, it would appear, based on the regulatory validation test, that the actual sales price would not be a representative market or field price. Consequently, the producer could not use it on concentrates he processes. Nevertheless, that producer will almost certainly continue to use that smelter if the cash costs are lower than the agreed upon smelter charge. In this case, it is apparent that a “no nonmining loss” validation test which includes in part fixed or sunk costs does not reflect reality.

Where the miner-taxpayer’s only nonmining process applied is nonmining transportation to the customer which would qualify as “purchased transportation,” the calculation of the representative market or field price is simplified. In such case his sale price reduced by the costs of the transportation is the representative market or field price.[[159]](#footnote-160)172 If the miner-taxpayer’s nonmining transportation is not “purchased transportation” but there is a competitor selling mineral or ore of like kind and grade with his only nonmining process being “purchased transportation,” then the representative market or field price is the competitor’s sale price less the cost of the purchased transportation.[[160]](#footnote-161)173 Purchased transportation is defined as nonmining transportation from the taxpayer’s mine or plant to the customer:

(a) which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer, (b) which is performed solely to deliver the taxpayer’s minerals or mineral products to the customer, rather than to transport … for packaging or other additional processing by the taxpayer (other than incidental storage or handling), and (c) with respect to which the taxpayer ordinarily does not earn any profit.[[161]](#footnote-162)174

The regulations state that if the transportation is provided by a person either controlled by or controlling the miner-taxpayer, such will be deemed to be accomplished in conveyances owned or leased by the miner-taxpayer unless the latter can demonstrate that the transportation cost was an arm’s-length charge.[[162]](#footnote-163)175 Reference is made to the standard for an arm’s-length charge set out in the regulations.[[163]](#footnote-164)176 Additionally, a taxpayer will not be deemed ordinarily to have earned a profit on transportation merely because charges therefore are not separately stated.[[164]](#footnote-165)177

The following example from the regulations illustrates the application of the representative market or field price method where the “purchased transportation” problem is involved:

|  |
| --- |
| **Example:**  178Treas. Reg. § 1.613-4(e)(2)(iv), ex. 2.  B is engaged in the mining of an ore of mineral N and in the production of its concentrate. B retains all but an insignificant amount of his concentrate for use in his own nonmining operations. Other producers in B’s marketing area sell significant amounts of N concentrate of like kind and grade, both on an f.o.b. mine or plant basis and on a delivered basis. In this case, the prices for both the f.o.b. and the delivered sales made by other producers, with the delivered prices reduced by the cost of purchased transportation to the customer, shall, if such prices are otherwise representative, be taken into account when establishing the representative market or field price for the N concentrate produced and used by B.[[165]](#footnote-166)178 |

If the comparative nonintegrated miner has allowed a discount which is not otherwise accounted for, such discount must be subtracted from the sales price in order to calculate the representative market or field price.[[166]](#footnote-167)179 If the representative market or field price method is to be used, a summary statement must be attached to the return indicating the price or prices used and their source.[[167]](#footnote-168)180 Supporting data for the summary must be kept available at the taxpayer’s principal place of business.[[168]](#footnote-169)181

1. **Proportionate Profits Method**

In some industries the processing typically goes beyond the cut-off point with the result that a representative market or field price for the mineral or ore at the cut-off point is unavailable. Subject to the exception noted below, in such cases and whenever a representative market or field price cannot be determined, the proportionate profits method of determining gross income from mining should be applied.[[169]](#footnote-170)182 If in some tax year both the taxpayer’s established method (if any) and the proportionate profits method fail to clearly reflect gross income from mining an alternative method may be approved.[[170]](#footnote-171)183 The alternative methods are listed and discussed briefly in § 2.03[2][b][iii]. The proportionate profits method is predicated on the assumption that every dollar of cost incurred to produce the mineral product earns the same percentage of income. This assumption is unrealistic but simple, and has been made in other contexts where an allocation of profits is necessitated by the tax laws.

The regulations prescribe that the integrated miner’s gross sales including both actual and constructive sales of his first marketable product or group of products should be multiplied by a fraction, the numerator of which is the sum of all mining costs and the denominator of which is the total of all costs including nonmining costs:[[171]](#footnote-172)184

Gross Income = Gross Sales × Mining Costs/Total Costs.

The “first marketable product or group of products” is defined in the regulations as being the product or group of essentially the same products produced with nonmining processes in the form first marketed in significant quantities in the integrated miner’s marketing area.[[172]](#footnote-173)185 Bulk and packaged products are considered essentially the same product. However, products additionally refined, beneficiated, altered, or manufactured are not. For example, a cement manufacturer sells cement in bulk and bags, and also in concrete blocks. Only the bulk and bagged cement constitutes the first marketable produce or group of products.[[173]](#footnote-174)186 The Tax Court has recently concluded that the “first marketable product or group of products” is that product which is the least refined and for which there is a significant market.[[174]](#footnote-175)187 The case involved an integrated granite miner who sold 75 percent of the granite mined after applying a relatively low cost rough manufacturing process, and 25 percent after a high cost, highly polished manufacturing process. There being no representative market or field price, the Tax Court concluded that the price for the roughly finished product constituted the base for application of the proportionate profits formula, *i.e.*, the granite at that stage constituted the first marketable product.

In determining the amount of any cost or sale, members of a controlled group shall be treated as divisions of a single taxpayer.[[175]](#footnote-176)187.1 The term “controlled” includes any kind of control, direct or indirect whether or not legally enforceable and however exercisable or exercised. It is the reality of the control which is decisive. A presumption of control arises if income or deductions have been arbitrarily shifted. The term “group” means the organizations, trades or businesses owned or controlled by the same interests.[[176]](#footnote-177)187.2 Thus, if a cement manufacturer separately incorporates his limestone operation, “selling” the limestone to the cement manufacturer, unless a representative field or market price exists for limestone, he must still use the proportionate profits method for calculating depletion, and the product he will calculate depletion on is cement. Further, the costs that will go into the mining costs over total costs formula will be the limestone mining subsidiary’s costs plus the cement manufacturers’ costs. The sale of limestone from the mining subsidiary to the cement manufacturing company will be ignored. This requirement could have some interesting effects. For example, does this mean interest expense from related but legally separate taxpayers is included in the depletion calculation? From the language in the Regulations it would appear that if expenses have been arbitrarily shifted this would be the result. Thus, intercompany charges and intercompany rental of mining equipment will be disregarded, with the related parties’ costs being substituted for the intercompany charges in the proportionate profits calculation.

The term “actual or constructive gross sales” is defined as the total of the integrated miner’s actual sale to others of the first marketable product or group of products plus his constructive sales of the same, used or retained for further nonmining processing.[[177]](#footnote-178)188 The regulations explain constructive sales as occurring when the miner-taxpayer does not actually sell part of his first marketable product or group of products but rather is deemed to have sold that part to himself for further use in his integrated operations.[[178]](#footnote-179)189 According to the regulations the taxpayer should use the principles governing the determination of representative market or field price to determine the sale price for the first marketable product which has not been actually, but rather constructively, sold.[[179]](#footnote-180)190 Where sales occur between controlled taxpayers, then the appropriate price is that set by the Commissioner under Section 482 or, if none, then that price determined by the regulatory principles governing the determination of the representative market or field price.[[180]](#footnote-181)190.1

In computing the miner-taxpayer’s gross income by the proportionate profits method or any other method based on costs, only costs actually incurred can be used.[[181]](#footnote-182)191 Additionally, the regulations provide that tax records rather than book records should be used in determining depreciation.[[182]](#footnote-183)192 The regulations do provide that the miner-taxpayer may continue to use a reasonable method for determining costs on the basis of amounts computed for cost control or similar financial or accounting books or records, if such method was in use on November 30, 1968, used consistently since then, and is determinative of all such costs.[[183]](#footnote-184)193

Mining transportation is treated as a mining cost for the purpose of computation by a method based on costs, and conversely, nonmining transportation is nonmining cost.[[184]](#footnote-185)194 Also, if the miner taxpayer has purchased transportation for his first marketable product or group of products, he may exclude the costs of such purchased transportation from the proportionate profits formula.[[185]](#footnote-186)195 This is reasonable since purchased transportation contains no element of profit for the miner and thus should not in effect have profit allocated to it by inclusion in the formula.

The cost of ores, minerals, or materials for which the miner is not entitled to a depletion allowance (purchased material), the cost of processing them, and any cost of their transportation are nonmining costs when using a method based on costs like the proportionate profits method.[[186]](#footnote-187)196 Also, if a mining process is applied to an admixture of material that is depletable and material that is not, the cost of such mining process must be apportioned between the two with the result that profits are apportioned with the application of the proportionate profits formula.[[187]](#footnote-188)197 The Revenue Service recommends the apportionment of the cost of processing on the basis of the relative tonnage of the depletable and nondepletable material in the absence of the existence of a better method of apportionment.[[188]](#footnote-189)198 The regulations specifically prescribe that costs of material and labor for bagging, packaging, and palletizing, costs of bulk loading of manufactured products, and costs of warehousing and distribution of manufactured products are all nonmining costs which are includable in the formula, with the result that profits attributable thereto reduce the allowable depletion deduction.[[189]](#footnote-190)199 The United States Supreme Court has confirmed the prescription in the regulations that bulk and bagged products constitute the same product.[[190]](#footnote-191)200 Consequently, the costs incurred for bags and bagging go into the denominator and into the gross sales price of the proportionate profits formula. Additionally, costs incurred for storage, distribution, and sales of bulk and bagged cement are considered completely nonmining expenses and not allocable between mining and nonmining since there are no nonintegrated miners in the industry typically incurring these expenses.[[191]](#footnote-192)201

Selling expenses for a refined or manufactured mineral product should be allocated to mining to the extent that such costs are incurred by the typical nonintegrated miner, with the balance of such costs going to nonmining according to the regulations.[[192]](#footnote-193)202 If the particular industry does not have nonintegrated miners, then such costs are presumptively nonmining with the burden on the taxpayer to prove otherwise.[[193]](#footnote-194)203 The regulation prescribes the same treatment for trade association dues.[[194]](#footnote-195)204 Also, allowances to customers constituting, in effect, trade or cash discounts, if not otherwise taken into account, should be excluded from total costs of producing the first marketable product or groups of products. The total cost is the denominator of the proportionate profits formula. Also, such allowances should be excluded from gross sales proceeds of the first marketable product or group of products if not otherwise accounted for, such gross sales including both actual and constructive sales.[[195]](#footnote-196)205

1. **Alternative Methods**

Where the proportionate profits method “consistently fails to reflect clearly the gross income,” and where the proposed method consistently does reflect clearly the gross income, the Revenue Service will accept such alternative method.[[196]](#footnote-197)206 A comparison should be made between the result of the application of such proposed method with the gross income figure reached by competitors.[[197]](#footnote-198)207 The Revenue Service indicated that it will give primary consideration to methods based on representative charges for ores, minerals, products, or services.[[198]](#footnote-199)208 In addition, the miner should apply principles set out in the regulations dealing with the representative market or field price method in his determination of such charges.[[199]](#footnote-200)209 However, the showing in practice appears extremely difficult to make. A justification on the ground of an increased depletion deduction has not proven persuasive.

Several alternative methods are set forth in the regulations. These methods are not arranged in a hierarchical fashion and do not preclude the proposal of an unlisted method.[[200]](#footnote-201)210 The first is the representative schedule method which is available primarily to those industries using a schedule-type pricing method to determine the price paid to nonintegrated mineral producers for their crude mineral product. Representative finished product prices, penalties, charges, and adjustments, established in arm’s-length transactions, are used to determine the market or field price for the crude mineral product. The second entails an examination of the representative market or field price in a market other than the taxpayer’s if the marketing conditions are substantially the same. Although no reference is made to a “like kind and grade” requirement, presumably such would exist since the example used involves iron ore of like kind and grade. The last method specified is the rate of return on investment method. Although the regulations reserved comment on this method, the withdrawn 1969 discussion draft described it as involving the subtraction from gross sales of the first marketable product or group of products of the sum of aggregate nonmining costs and an amount of profit determined by the appropriate rate of return for the investments in nonmining facilities.[[201]](#footnote-202)211 The discussion draft provided that the rate of return depends on the circumstances including risk involved, purpose of facilities, and rate of return actually realized by U.S. industry and the type industry in question. Additionally, the rate of return is subject to periodic review.[[202]](#footnote-203)212

1. **Taxable Income From Property**

1. **In General**

Section 613(a) of the Code provides that the statutory or percentage depletion deduction shall not exceed “50 percent of the taxpayer’s taxable income from property (computed without allowance for depletion).”[[203]](#footnote-204)213 The Code goes on to prescribe that the total deductions made in determining taxable income from property should be decreased by any Section 1245 type gain on mining property. Additionally, it requires that in no event should the depletion deduction be less than allowable pursuant to the cost depletion method.

The regulations define taxable income from property as gross income from property less all allowable deductions which are attributable to the mining process other than depletion.[[204]](#footnote-205)214 Examples given are mining transportation, operating expenses, certain selling expenses, overhead, depreciation, taxes deductible under Sections 162 and 164, losses sustained, ***oil*** and gas intangible development costs and exploration and development costs.[[205]](#footnote-206)215 Specific instruction is given as to the treatment of certain expenditures as noted below. However, the regulations do provide for an allocation when expenditures are attributable to mining and other activities and/or to mining activities on several separate mineral properties.[[206]](#footnote-207)216

In 1992, the Fifth Circuit Court of Appeals decided *Shell* ***Oil*** *Co. v. Commissioner*[[207]](#footnote-208)217 which has substantial implications for the computation of the 50 percent of taxable income from property limitation. The case directly involved the computation of the net income limitation of the windfall profits tax (WPT). The WPT Code Section 4988(b) adopts the Section 613(a) rules relating to deductible expenses and their apportionment or allocation. Consequently, the holding in this case constitutes precedent as to the appropriate interpretation of the 50 percent of taxable income from property limitation for depletion purposes. Of course, it was in Shell ***Oil***’s interest for WPT purposes to deduct as much as possible in order to reduce their WPT. Shell ***Oil*** is an integrated ***oil*** company and consequently not entitled to percentage depletion on its ***oil*** and gas production.

The issue in the case concerned abandoned G&G expenses, i.e., the expenses which are “orphaned” because incurred for exploration on lands for which a decision ultimately is made to not acquire an interest therein. Specifically, the issue was whether abandoned G&G expenses are deducted in computing the net income limitation of the windfall profit tax due on producing properties. The holding in this case may indicate how “orphaned” Section 617 exploration (and arguably other) expenses related to mining are treated for purposes of the 50 percent of taxable income from property limitation.

The Court quoted Regulations Section 1.613-5 and numbered the sentences for purposes of analysis:

[1] The term “taxable income from the property”...................... means ‘gross income from the property’ ...................... less all allowable deductions ...................... which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. [2] The deductible items include operating expenses, certain selling expenses, administrative and financial overhead, … exploration and development expenditures, etc. [3] See paragraph (c) of this section for special rules ...................... [4] 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. [5] 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.[[208]](#footnote-209)218

The Court held that abandoned G&G expenses are “attributable to mining processes” because of sentence [1].[[209]](#footnote-210)219 Disagreeing with the Tax Court and the Commissioner, the Fifth Circuit ruled that the phrase “with respect to which depletion is claimed” does not require that the abandoned G&G expenses be incurred on a specific depletable property but rather that the “costs simply be attributable to the depletable property.”[[210]](#footnote-211)220 Noting that the Commissioner allows the deduction of expenses “much more remote from specific producing properties or even production in general than abandoned G&G”, citing health insurance for Shell’s accountants and maintenance costs of Shell’s office buildings housing its executives, it stated that these G&G expenses benefit producing properties much more directly than administrative expenses.

With regard to sentence [4], the Commissioner argued that Shell’s preliminary exploration activities which generated G&G costs were “other activities.”[[211]](#footnote-212)221 Contrasting the phrase “mineral properties” in sentence [4] with the term “mineral processes” in sentence [1], he argued that abandoned G&G costs are not incurred on specific producing mineral properties and therefore must constitute “other activities”. The Fifth Circuit agreed with the Tax Court and held that the term “other activities” means only nonmining activities, citing earlier versions of the regulations covering taxable income from property.[[212]](#footnote-213)222 Then the Commissioner argued with regard to sentence [5] that the abandoned G&G expenses should go into a third cost center.[[213]](#footnote-214)223

The Fifth Circuit, however, concluded that only two categories were possible under sentence [5], that the G&G in question are not “other activities” by reason of sentence [4], and consequently that they are entirely allocable to the producing properties.[[214]](#footnote-215)224

In the authors’ judgment, *Shell* ***Oil*** is wrongly decided on this issue. The case can be argued to require that any expenses—whether having a direct relationship to mining or not, which are not incurred on specific producing property(ies) and which are not attributable to other of taxpayer’s business operations—be allocated to all of taxpayer’s producing properties for purposes of the 50 percent of taxable income from property limitation. Neither sentence [1] nor [4] of the above regulations requires this result. There is no more reason to include “orphaned” G&G expenses which provide no benefit to, or impact upon, the producing mine or well in question than any other sort of “orphaned” expense does. It is the authors’ understanding that the purpose of the taxable income from property limitation was to simply limit the percentage depletion deduction generated by each producing property by reducing that property’s production income by the expenses attributable to, or giving rise to, that production income. The Court in *Shell* ***Oil*** noted that the “orphaned” G&G expenses were more directly related to the specific ***oil*** and gas production operation than was the cost of health insurance for Shell’s executives. But the fact was that a portion of the cost of health insurance indirectly benefited the production in question. In any case, even the General Counsel, the Revenue Service, and the courts have vacillated on this issue of includible expenses for purposes of the 50 percent of taxable income from property limitation.[[215]](#footnote-216)225

A second issue in the *Shell* ***Oil*** case involved the apportionment of overhead, again for WPT purposes directly and taxable income from property purposes indirectly. With regard to the apportionment formula, the parties stipulated to a “modified direct expense method.” The stipulated formula was the following:

|  |  |  |
| --- | --- | --- |
| Total allocable overhead | × | Direct op. costs of indiv. prop. |
|  |  | Shell’s total op. costs[[216]](#footnote-217)226 |

However, the parties disagreed as to whether IDCs should be a direct operating cost. Shell argued that it should not be included because it only had 200 employees involved in drilling (it generally contracts out its drilling work) whereas it had 10,000 employees involved in its exploration and production departments. Shell argued that the apportionment method need only be “proper” under sentences [4] and [5], *above.* The Fifth Circuit agreed stating that the method need not be the “fairer” or “fairest” but rather merely “defensible” under cost accounting principles.[[217]](#footnote-218)227 Noting, “Considerable leeway is permitted in the construction of a ‘proper’ apportionment method,” the Court remanded the issue back to the Tax Court.[[218]](#footnote-219)228

The Federal Circuit in *BP Exploration and* ***Oil****, Inc. v. United States*[[219]](#footnote-220)229 ruled that an interest payment by a parent corporation on a debt of that parent corporation, which was incurred for the benefit of the subsidiary was not deductible by the subsidiary for purposes of the windfall profits tax. The holding was based on the settled principle that a taxpayer may only deduct expenses which he has incurred.[[220]](#footnote-221)230

Percentage depletion on all minerals produced from the same property is limited in the aggregate to 50 percent of taxable income from the property.[[221]](#footnote-222)231 This includes income from minerals on which no depletion is allowed—an integrated ***oil*** company’s ***oil*** and gas income, for example, or dirt, turf or soil.[[222]](#footnote-223)232 If coal or iron ore and some other mineral subject to percentage depletion are produced from the same property, and if the 50-percent limitation is applicable, an allocation of this limitation to coal and iron ore will be required due to the 20-percent cutback under Section 291(b)(2). In view of the fact that any portion of a depletion deduction lost because of the application of the 50-percent limitation is lost forever, it is extremely important to plan expenditures and production schedules carefully in order to prevent such losses where possible.

1. **Specific Expenditures**

1. **Discounts**

The regulations[[223]](#footnote-224)233 and a revenue ruling[[224]](#footnote-225)234 indicate that discounts received on the purchase of mining supplies reduce the cost of such items for purposes of computing taxable income from property.

1. **Intangibles**

Intangible drilling and development costs incurred for geothermal resources and ***oil*** and gas wells which are deducted under the statutory option[[225]](#footnote-226)235 are also deducted in determining taxable income from property.[[226]](#footnote-227)236 Problems can arise if a nonproducing well is drilled on a tract that has producing wells. The Revenue Service has ruled that when the dry hole is drilled through the producing horizon in search of a distinctly separate new deposit, the costs allocable thereto are not chargeable to the producing property for purposes of the 50 percent limitation.[[227]](#footnote-228)237

1. **Exploration and Development Expenditures**

Exploration and development expenses which are deducted under Sections 617 and 616 of the code are deducted in determining taxable income from property.[[228]](#footnote-229)238 Since exploration expenditures are ultimately recaptured and then included in the basis of the mineral property, one might object to the requirement that such expenditures which are deducted reduce gross income from property for purposes of the 50 percent limitation. However, the recapture requirement which is discussed below[[229]](#footnote-230)239 only applies to the extent that the depletion deduction has been reduced because of the 50 percent limitation.[[230]](#footnote-231)240 As a consequence, the taxpayer is not hurt by a decision to deduct such costs.

1. **Selling Expenses**

Any selling expenses incurred with respect to minerals to which only mining processes are applied must be deducted in determining taxable income from property.[[231]](#footnote-232)241 The same treatment is prescribed in the regulations for minerals to which nonmining processes have been applied if only “insubstantial value” has been added thereby.[[232]](#footnote-233)242 If substantial value has been added by nonmining processes, then the taxpayer must allocate the selling expense between mining and nonmining.[[233]](#footnote-234)243 The regulations provide that such allocation is to be made simply on the basis of the amount of such expense incurred by the nonintegrated miner.[[234]](#footnote-235)244 If the latter incurs no expense, then such costs may be ignored in the computation.[[235]](#footnote-236)245 Although delivery costs are not included in the regulations as selling expenses,[[236]](#footnote-237)246 items such as sales management expenses, rent of sales offices, sales clerical expenses, salesmen’s salaries, sales commissions and bonuses, advertising expenses, and sales traveling expenses are given as examples.[[237]](#footnote-238)247

1. **Taxes**

State income taxes,[[238]](#footnote-239)248 foreign income taxes which are claimed as a deduction,[[239]](#footnote-240)249 state real estate taxes,[[240]](#footnote-241)250 state personal property taxes, state franchise taxes, social security and unemployment compensation taxes, and federal capital stock taxes[[241]](#footnote-242)251 to the extent based on income from production, on production on mining property, or on mining activities must be deducted in computing taxable income from property. Additionally, severance and other production taxes must be so treated[[242]](#footnote-243)252 unless the taxpayer is paying taxes attributable to another to whom such payment is treated as production income. Excise taxes paid by the coal producer for black lung disease must be deducted from gross income from property.[[243]](#footnote-244)253 This result is probably required even though the sale price of the coal does not reflect the operator’s increased cost due to this tax.[[244]](#footnote-245)254 Refunds or credits on gasoline taxes are treated as reductions in the cost thereof for purposes of computing taxable income from property.[[245]](#footnote-246)255 Based on a 1977 Technical Advice Memorandum, it appears that the Revenue Service will not require a deduction for taxes paid unless the payor of the taxes is the entity owning the economic interest and directly receiving the production.[[246]](#footnote-247)256 Therefore, state income taxes imposed on partners are not deductible in computing taxable income from property at the partnership level.[[247]](#footnote-248)257 The regulations do provide that taxes which are taken as credits or which are capitalized need not be subtracted for purposes of the 50 percent limitation.[[248]](#footnote-249)258

1. **Trade Association Dues**

These expenses are treated like selling expenses, except that the regulations do suggest if an allocation is necessary that it be made based on the ratio of direct mining costs to total direct costs.[[249]](#footnote-250)259

1. **Interest**

Interest allocable to investments in mineral properties should be deducted in computing taxable income from property.[[250]](#footnote-251)260 Also, prepayment penalties imposed on money used[[251]](#footnote-252)261 and interest on income tax deficiencies where taxpayer has no other substantial activities must be so treated.[[252]](#footnote-253)262 However, only the net interest cost is required to be deducted. Thus any interest that is earned by investing the borrowed funds should be netted against gross interest expense.[[253]](#footnote-254)263

As part of the Tax Cuts and Jobs Act of 2017 (TCJA), Section 163(j) was amended to provide a limitation on all business interest expense. Business interest expense is limited to business interest income plus 30% of adjusted taxable income (ATI) (plus floor plan financing).[[254]](#footnote-255)264 In 2020, Section 163(j) was further amended by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act),[[255]](#footnote-256)264.1 which provided special rules relating to the 30% of ATI limitation for taxable years beginning in 2019 or 2020. In general, the CARES Act raises the interest expense limitation to 50% of ATI for taxable years beginning in 2019 or 2020 and allows taxpayers to elect to use 2019 ATI when determining the interest expense limitation for taxable years beginning in 2020.[[256]](#footnote-257)264.2

Adjusted taxable income is the taxable income of the taxpayer excluding: (1) any item of income, gain, deduction of loss not properly allocable to a trade or business; (2)any business interest expense or business interest income; (3)the amount of any net operating loss deduction under Section 172; (4) the amount of any deduction under Section 199A; for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion; and (5) computed with any adjustments provided by the Secretary of the Treasury.[[257]](#footnote-258)265 Business interest is any interest paid or accrued on indebtedness properly allocable to a trade or business (and specifically does not include investment interest described in Section 163(d)).[[258]](#footnote-259)266 Business interest disallowed in any given year is carried forward to subsequent years and considered business interest in those years subject to the same limitation.[[259]](#footnote-260)267 A trade or business subject to business interest limitation does not include the trade or business of performing services as an employee, electing real property and farming businesses and certain rate regulated utilities.[[260]](#footnote-261)268 Special rules are provided for partnerships and S corporations where the limitation is determined at the partnership or S corporation level.[[261]](#footnote-262)269

As noted above, the business interest limitation for taxable years beginning after December 31, 2017 and before January 1, 2022 will be determined based on adjusted taxable income determined without regard to the deduction for depreciation, amortization and depletion. For taxable years beginning after December 31, 2021 adjusted taxable income used to determine the interest expense limitation will be determined with the deduction for depreciation, amortization and depletion. Treas. Reg. § 1.613-5(a) specifically identifies “financial overhead” as an expense that is allocable to determine the net income from mining and the 50% net income limitation. For those mining operations which have debt financing and interest expense allocable to mining net income, it appears that there could be a “simultaneous equation” needed to determine the two limitations for taxable years beginning after December 31, 2021.[[262]](#footnote-263)270

The IRS and Treasury released final and proposed regulations that address, among other things, the determination of adjusted taxable income (ATI) for purposes of the limitation under Section 163(j).[[263]](#footnote-264)271 In these regulations the determination of ATI starts with “tentative taxable income” (TTI) that is determined before the application of Section 163(j) and the regulations (i.e., treating all business interest as deductible).[[264]](#footnote-265)271.1 This indicates that a taxpayer will determine its net income limitation for percentage depletion and its depletion allowance taking into account interest expense before any limitation imposed under Section 163(j).

The regulations provide guidance on the relationship of the business interest expense limitation to other provisions affected by interest expense.[[265]](#footnote-266)271.2 Generally, Section 163(j) applies only to business interest expense that would otherwise be deductible in the current tax year, absent the section’s application. Section 163(j) applies after the various provisions that subject interest expense to disallowance, deferral, capitalization or some other limitation. For example, business interest expense does not include interest that has been capitalized under Section 263A or Section 263(g).[[266]](#footnote-267)271.3

The regulations clarify that when determining ATI deductions for depreciation amortization and depletion are added back in taxable years before January 1, 2022. In an important departure from the 2018 proposed regulations depreciation, amortization and depletion allowances that are absorbed into inventory and cost of goods sold are included in the deductions that are added back in arriving at ATI.[[267]](#footnote-268)271.4 Although percentage depletion is not capitalized into ending inventory mining operations must generally include depletion allowances in cost of goods sold.[[268]](#footnote-269)271.5 The final regulations provide that for taxable years beginning before January 1, 2022 the depletion allowance is included in the depreciation, amortization and depletion that is added back in arriving at ATI.

The Tax Court in *Shell* ***Oil*** *Company v. C.I.R*.,[[269]](#footnote-270)272 held that Shell could treat interest expense incurred in the acquisition of ***oil*** and gas properties as financial overhead allocable to all activities, in accordance with cost accounting principles.[[270]](#footnote-271)273 The regulations require an apportionment of expenditures that are attributable both to mining processes and to other activities.[[271]](#footnote-272)274 The dispute in the case was over the proper interpretation of the word “attributable.”[[272]](#footnote-273)275 The Court held in favor of the taxpayer, holding that since neither the Code, Regulations, nor case law provided guidance on the interpretation of “attributable,” the taxpayer’s reliance on cost accounting principles was reasonable. The Court refused to follow the Service’s contention that a “stated purpose” clause was evidence that the interest was a direct cost of the acquisition, holding that such a position was too prone to manipulation by taxpayers, who would omit or include the clause to best fit their purposes.[[273]](#footnote-274)276

1. **Strike Costs**

On June 22, 1993 the Internal Revenue Service (IRS) issued an Industry Specialization Program Coordinated Issues Paper (ISP Paper) on the deductibility of strike costs in the percentage depletion computation. The IRS obviously argued that strike costs are to be charged against gross income to arrive at taxable income from the property. The IRS attempts to distinguish the non-deductibility of business interruption insurance premiums and payment of damages for breach of contract from strike costs, although all are costs incurred not because of mining but because of not mining.[[274]](#footnote-275)277

In 1997, an ISP settlement guideline for the mining industry determined that a mining company should subtract from gross income all expenses incurred during the period of a strike to arrive at the 50-percent taxable income limitation on percentage depletion under I.R.C. Section 613(a).[[275]](#footnote-276)278 These expenses include depreciation on idled plant and equipment, as well as certain administrative and overhead expenses. The guidelines, however, are withheld under 5 U.S.C. 552(b)(5), (b)(7)(A), and (b)(7)(E).

1. **Section 197 Amortization of Goodwill**

Code Section 197 entitles a taxpayer to a 15-year amortization deduction with respect to intangible assets, i.e., Class VI assets under the Section 1060 regulations, including workforce in place, customer-based intangibles (sales contracts), supplier-based intangibles, and covenants not to compete, and Class VII assets including goodwill and going concern value. For a non-integrated miner these deductions would reduce net income from mining. In the purchase of an integrated miner/manufacturer a question arises as to whether the Section 197 deduction is chargeable against mining or non-mining income or some combination. Presumably the amortization should be allocated and/or apportioned against mining or nonmining income based on the underlying assets that make up the goodwill, i.e., workforce, customer-based intangibles, etc.

If an integrated miner/manufacturer has an RMFP, deducting these costs against non-mining income will increase the amount of percentage depletion. If an integrated miner/manufacturer is forced to use proportionate profits, claiming the amortization as a mining cost will increase gross income from mining and thus taxable income. The ability to fragment this amortization deduction and the requirement to deduct these costs against mining/non-mining income has not been addressed by the IRS. In determining the amount of Section 197 assets, however, the authors find it difficult to believe that pure goodwill (i.e., not workforce in place, supply contracts, covenants, etc.) exists in a purchase of a commodity business like coal, gold, or copper mining; rather, they believe that the value of such a business is in the minerals in the ground.

1. **Miscellaneous**

Overhead allocable to the mining operations of the taxpayer,[[276]](#footnote-277)279 back wages paid under an NLRB settlement,[[277]](#footnote-278)280 salaries of officers,[[278]](#footnote-279)281 legal expenses,[[279]](#footnote-280)282 employee benefits,[[280]](#footnote-281)283 amounts paid on occupational disease claims,[[281]](#footnote-282)284 abandonment losses claimed on discarded mining equipment,[[282]](#footnote-283)285 and other expenses to the extent allocable to the taxpayer’s mining operations must be deducted in the computation.

On the other hand, charitable contributions have been held not deductible for this purpose.[[283]](#footnote-284)286 Net operating losses have been ruled not includable in the computation[[284]](#footnote-285)287 although two tentative versions of the regulations which were subsequently withdrawn did require that such losses attributable to the property be deducted.[[285]](#footnote-286)288 A federal district court has concluded that a partner’s guaranteed salary need not be deducted in the computation.[[286]](#footnote-287)289 The Tax Court has determined that expenses of a tax controversy which involved taxpayer’s mining operations need not be deducted for these purposes because such expenses were not essential to the production of mining income.[[287]](#footnote-288)290 The Revenue Service has nonacquiesced in this holding, ruling that such expenses are in the nature of general administrative expenses.[[288]](#footnote-289)291 The Fourth Circuit has concluded that premiums paid by a coal miner for business interruption insurance are not deductible for purposes of the 50 percent of taxable income from property limitation.[[289]](#footnote-290)292 The Revenue Service has ruled that damages paid by a mine owner due to his inability to deliver mineral as required by the contract need not be deducted for purposes of the limitation.[[290]](#footnote-291)293 In both of the two situations, the expenses did not relate to production but rather the lack thereof. Additionally, the Service has ruled that gains and losses on futures contracts and options used to hedge price risk are not taken into account in computing taxable income from property.[[291]](#footnote-292)294

As part of the Tax Cuts and Jobs Act of 2017, Congress added a new deduction under Section 250 for domestic corporations which is 37.5% of foreign derived intangible income (FDII). The deduction is for taxable years beginning after December 31, 2017 and before January 1, 2026. For taxable years beginning after December 31, 2025 the deduction is reduced to 21.875% of FDII.[[292]](#footnote-293)295

There is a detailed discussion on how taxpayers compute the deduction under Section 250 located in Chapter 12 in Section 12.05[2][c]. The deduction is essentially based on gross income derived from exporting net of allocable deductions. The statute does not describe how a taxpayer is to allocate deductions to the FDII determination. The limitation imposed on interest expense provided in Section 163(j) is based on adjusted taxable income (ATI) as discussed above in [b][vii]. As noted above, the final regulations under Section 163(j) do not provide a rule to coordinate the limitation on interest expense with other “taxable income-based” provisions in the Internal Revenue Code. The Treasury and IRS indicated in the preamble to the final regulations that such a coordination rule required further study. Until a rule is provided the preamble indicates that “taxpayers may choose any reasonable approach (which could include an ordering rule or the use of simultaneous equations) for coordinating taxable income-based provisions as long as such approach is applied consistently for all relevant taxable years”.[[293]](#footnote-294)295.1

It would seem that the depletion allowance might also be a deduction allocated to FDII and the related limitations. The percentage depletion allowance is subject to a limitation based on gross income from mining “… . less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes … .”[[294]](#footnote-295)296 There will need to be guidance provided by the Treasury and the IRS to determine whether and how these limitations are applied in order to solve what would appear to be a simultaneous equation.

The US has had similar export incentives in the past that addressed the interaction between the depletion allowance limitation and the determination of those incentives (deduction or exclusion). The Foreign Sales Corporation (FSC) regime (repealed as of October 1, 2000) provided for a deduction for 23% of the taxpayer’s qualified export property income (combined taxable income-CTI). Similarly, the Extraterritorial Income Exclusion (ETI) regime (repealed as of January 1, 2005) provided for an exclusion from a taxpayer’s gross income equal to 15% of the taxpayer’s net income from the sale of qualified foreign trade property. Note that both of these export incentive regimes were repealed because World Trade Organization rulings that they were both illegal foreign trade subsidies.

The FSC deduction regime had guidance that specifically provided the depletion allowance was a deduction properly allocated to qualified export property income.[[295]](#footnote-296)297 There was no guidance issued with respect to the ETI regime and the determination of the net income from the sale of qualified foreign trade property. However, the Technical Explanation of the Senate Amendment to H.R. 4986, “FSC Repeal and Extraterritorial Income Exclusion Act of 2000” provides that taxpayers and the IRS were to apply the principles of the then present-law regulations and other administrative guidance under Sections 921 through 927 (relating to the repealed FSC regime) until more detailed administrative guidance was provided.[[296]](#footnote-297)298 The ETI regime was repealed before guidance was issued but practitioners generally agreed that the depletion allowance attributable to qualified foreign trade property would burden the net income subject to the exclusion since the FSC deduction guidance provided that result.

With regard to the determination of the depletion net income limitation there was no specific guidance issued however the prevailing view was that these export incentives were not deductions “… attributable to mining processes” as required in the regulations. The ETI regime was an exclusion from gross income and not a deduction; the depletion allowance regulations very specifically define gross income from mining.[[297]](#footnote-298)299

Under the FSC regime the Internal Revenue Service considered for purposes of computing the related supplier’s allowable percentage depletion deduction under Section 613 whether the related supplier’s taxable income from the sale of the export property should include the profit earned by the FSC under the transfer pricing rules of Section 925. This approach was rejected since the amount of the related supplier’s percentage depletion deduction would be partially dependent on income earned by the FSC which is exempt from taxation under Section 921.[[298]](#footnote-299)300 Based on that guidance it was believed that percentage depletion was calculated based on the related supplier’s taxable income before the FSC deduction.

1. **Bonus Exclusion**

It might be argued that the allocable portion of bonus excluded by payer from his gross income from property should be added back in determining taxable income from property. This is arguably so since, as discussed in Chapter 3, such amounts are not excluded in determining taxable income for tax purposes.[[299]](#footnote-300)301 Nevertheless, the regulations prescribe that taxable income from property be determined by using as a base figure gross income from property.[[300]](#footnote-301)302 Gross income from property for a particular year according to the regulations is determined in part by excluding the allocable amount of bonus.[[301]](#footnote-302)303 Thus, the regulations appear to require that the allocable portion of bonus excluded in determining gross income from property remain excluded in determining taxable income from property for purposes of depletion. The Revenue Service ruled in 1979 that bonus should also be excluded for purposes of taxable income from property.[[302]](#footnote-303)304

1. **Planning**

Before the Tax Reform Act of 1984, a taxpayer, whether on the accrual or cash method of accounting, could sometimes avoid the impact of the 50 percent limitation by contracting for and then prepaying (if cash method) expenditures.[[303]](#footnote-304)305 However, now the timing of the deduction of expenses generally must be keyed to the timing of the economic performance for which the expenditure was made.[[304]](#footnote-305)306 Of course the timing of expenditures can still be controlled regardless of accounting method simply by varying the commencement and completion dates of projects involving exploration work.

The miner should consider incurring initial exploration or development expenses in a tax year preceding the year for commencement of production to the extent that such planned expenditures appear to be excessive. Alternatively, such expenditures should be spread over a longer term so as to avoid this negative impact. As noted below in the chapter discussing separate mineral properties, some flexibility exists due to the prescriptions governing separate mineral properties and aggregations thereof.[[305]](#footnote-306)307 A district court decision confirms a revenue ruling illustrating such flexibility.[[306]](#footnote-307)308 The court concluded that intangible expenses incurred in drilling a second well in a tract should not reduce the gross income from property from a producing well for purposes of the 50 percent limitation. This was because the second well was not intended to produce the known reservoir but rather to explore for and discover a new reservoir.[[307]](#footnote-308)309

In *Shell* ***Oil***, Shell was allowed to allocate interest expense to producing properties owned directly by it in a Net Income Limitation (NIL) calculation under the Windfall Profit Tax (WPT).[[308]](#footnote-309)310 Section 4988(b) of the Windfall Profits Tax adopts the I.R.C. Section 613(a) rules relating to deductible expenses and their apportionment or allocation. Consequently, the holding in this case constitutes precedent as to the appropriate interpretation of the 50 percent of taxable income from property limitation for depletion purposes. The allocation was made to all assets owned by Shell including the stock of its subsidiaries. To avoid having interest allocated to percentage depletion calculations, all properties should be owned by debt-free subsidiaries. On appeal the Fifth Circuit required Shell pursuant to the above regulation to allocate geological and geophysical costs to producing properties under the NIL calculation of the WPT.[[309]](#footnote-310)311 Of course, by basing its decision on the depletion regulations, the court is indicating that this allocation is necessary for depletion purposes as well. This would suggest that taxpayers keep producing properties and prospects in separate subsidiaries to avoid such allocations.

1. **Adjustment to Basis**

The taxpayer must reduce his basis in the mineral property by the amount allowed to the extent of the tax benefit in any year, or the amount allowable, whichever is greater.[[310]](#footnote-311)312 Thus, if excess depletion was taken over the amount allowable, such excess must be reflected by an adjustment to basis if such excess resulted in a tax benefit.[[311]](#footnote-312)313 The fact that the tax benefit results from a carryover or carryback of losses does not appear to be relevant.[[312]](#footnote-313)314 By the same token, if the taxpayer does not take his full allowable deduction, basis must nevertheless be adjusted[[313]](#footnote-314)315 unless such deduction was disallowed by the Revenue Service.[[314]](#footnote-315)316

In view of this mandatory adjustment requirement, it is somewhat anomalous that the Revenue Service currently does not require a restoration to income of depletion allowable on a bonus payment if the taxpayer did not take the allowable depletion deduction and did not adjust his capital account at the time of the payment.[[315]](#footnote-316)317 There is no necessary violence done to the adjustment requirement thereby, however, in that taxpayer is not required to take the deduction but rather just to make the adjustment. Also, the basis, after the dust settles, is what it would have been had the adjustment been made initially and then readjusted.

A taxpayer who has deducted an expense from Section 613 gross income from property for the purpose of applying the 50 percent limitation is required to make a later adjustment to the basis in his mineral property if such deduction reduced the amount of depletion allowable and if it is later determined that the deduction was inappropriate when taken.[[316]](#footnote-317)318

The taxpayer may take statutory depletion even if he has no cost basis in the property.[[317]](#footnote-318)319 Additionally, if the basis in the property has been eliminated by previous depletion deductions, subsequent statutory depletion does not reduce the basis to less than zero.[[318]](#footnote-319)320 According to the Revenue Service, there is a qualification to this limit on basis adjustment. If the taxpayer makes a capital addition to the mineral property at a time when the total depletion deductions exceed the original basis in the property, such investment must be credited against the excess in computing his basis in the property.[[319]](#footnote-320)321 Clearly, if a taxpayer is contemplating selling the property in a situation in which there is such an excess, the taxpayer is well advised to avoid expenditures allocable to the basis in the mineral property because of the loss of such for purposes of reducing gain on the sale. In any event, the allowability of depletion beyond the cost basis in the property clearly renders the depletion deduction uniquely advantageous.

1. **Amount Depletable**

1. **In General**

The amount depletable appears to be the amount for which the mineral is sold either directly or indirectly, as discussed below, if the sale takes place after mining processes only are applied. If nonmining processes are also applied, then of course the amount depletable must be determined by one of the methods prescribed in the regulations.[[320]](#footnote-321)322

1. **Problems with Net Receipts and Tolling Arrangements**

Most of the problem stems from the 1938 United States Supreme Court decision of *Helvering v. Mountain Producer’s Corp.*[[321]](#footnote-322)323 One such question involves the applicability of the basic substance over form principle to cases in which value is added to the miner’s mineral by another through a mining process and then, ostensibly, the mineral is sold. The question whether, in substance, the sale occurs before or after the processing must be answered separately. Another question arising from the case is whether the taxpayer may ever take depletion on an amount exceeding the net amount received on a sale of the mineral.

*Helvering v. Mountain Producer’s Corp.*[[322]](#footnote-323)324 involved a taxpayer who, owning certain ***oil*** and gas leases, agreed to sell production therefrom to another. The buyer agreed to drill and operate all wells on the leasehold, to take delivery of the taxpayer’s production at the outlet gates of the measuring tanks, and to pay an amount based on what the buyer received for gasoline and kerosene after processing. The taxpayer sought to take depletion not only on the amount actually received from the buyer but also on the additional costs of production incurred by the buyer. He argued that the production costs were incurred before the buyer acquired title to the ***oil*** and, thus, that the buyer was acting as agent of seller. In effect, the taxpayer had hired the buyer to carry out operations on the property for the difference between the fair market value of the production on the surface and the lesser amount actually received by the taxpayer from the buyer.

The Court agreed with the Commissioner who argued that the buyer was acting for its own benefit and that the cash received by the taxpayer was the purchase price. The Court noted that Congress intended to impose a simple formula for the determination of gross income from property which avoids administrative difficulties and which may result in a figure which is either “more or less than the market value according to the bearing of particular contracts.”[[323]](#footnote-324)325 The Court stated:

“We do not think we are at liberty to construct a theoretical gross income by recourse to the expenses of production operations. The Refining Company (buyer) for its own purposes undertook the expense of those operations, and Wyoming Associated (taxpayer) was content to receive as it’s own return the cash payments for the ***oil*** produced, leaving to the … (buyer) the risks of production.”[[324]](#footnote-325)326

Mountain Producer is troublesome, however, whenever a taxpayer contracts with another for some mining process and the latter remits to the taxpayer a net amount after deducting the cost of such processing. This question arises when, as in Mountain Producer, the processor purchases the mineral, formally, at least, after the application of the mining process. It also arises when the taxpayer sells to a buyer, formally, at least, after the application of a mining process by a processor to whom the buyer pays the processing charges, and then deducts such cost from the price due the taxpayer. The question again arises when the taxpayer grants a lease of mineral property through a broker who deducts an amount from the royalty payable to the taxpayer. Finally, this question must be answered in the situation in which the lessee agrees to pay ad valorem or production taxes due on the lessor’s share of the minerals.

In all of these situations, the lower courts, in construing Mountain Producer, are applying a benefit test, *i.e.*, for whose benefit were such costs incurred, the payor’s or the taxpayer’s.[[325]](#footnote-326)327 According to these courts, this often involves the question of who owns the mineral in substance at the time the process is applied. Various factors are examined by the courts in answering these questions as noted in the cited cases, *e.g.*, the location of the risk of loss. In those cases in which lessee paid ad valorem or production taxes attributable to lessor, there is some anomaly, discussed below, if reference is made to the principles currently governing net profits interests and the *Cocke-Abercrombie* carrying arrangement.[[326]](#footnote-327)328

In most of the situations discussed above, the lower courts cited appear to construe Mountain Producer as simply involving the question of when the sale took place, before or after the added mining process. The substance-over-form principle was perceived by most of these courts as the key issue in Mountain Producer. However, Mountain Producer goes beyond this issue to the one involving the depletability of amounts over and above the actual cash receipts even in those cases in which the sale substantively took place after application of the added mining process. This view is based on the above quoted language in Mountain Producer which stresses the impracticability from an administrative point of view of using a determinant other than cash received. In other words, the tax planner who is seeking to maximize the depletion deduction where the miner-client is using an independent mining processor and then selling the mineral, should not only avoid the substance-over-form problems but also so cast the transaction that processing fees are clearly identified and, if possible, paid separately and not as a credit against the purchase money due.

1. **Mineral Consumed by Miner**

Another situation in which *Mountain Producer*[[327]](#footnote-328)329 has caused difficulty is that involving a miner who expends some of his mineral in his operations, whether for mining or manufacturing, *e.g.*, as fuel. May the miner construct a price for such mineral and take depletion thereon? The Fifth Circuit in *A. Duda & Sons, Inc. v. United States* has concluded that a taxpayer who ran a vegetable farm using natural deposits of peat and muck topsoil, which were depleting because of oxidation, could not take cost depletion thereon because the Code requires extraction as a prerequisite to depletion.[[328]](#footnote-329)330 The holding, which is in accord with an older revenue ruling,[[329]](#footnote-330)331 rather exhaustively reviews the history of the depletion provisions, concluding that because of administrative convenience, extraction must occur.[[330]](#footnote-331)332

Even with extraction, the Tax Court in *Roundup Coal Mining Co.* has concluded that coal mined and burned as fuel on the premises for the mining operations was not subject to depletion.[[331]](#footnote-332)333 Unfortunately, the taxpayer did not brief this issue in the case. The Tax Court stated:

“Petitioner’s gross income included an amount on which he realized no income. He made no sale and received no income as such. This was merely a bookkeeping entry, at best, as petitioner could not realize any income on a sale to itself.”[[332]](#footnote-333)334

The court goes on to quote the Supreme Court in *Mountain Producer* concerning the latter’s unwillingness to construct a “theoretical gross income.” It then notes that on the taxpayer’s books, the transaction was a wash resulting in no profit or loss.

Despite the absolute purport of the above holding, a federal district court in *Woodward Iron Co. v. Patterson* later concluded that coal mined by taxpayer and consumed in the manufacture of pig iron did qualify for depletion.[[333]](#footnote-334)335 The prior Tax Court decision in *Roundup Coal Mining Co.* was not mentioned. Difficulty arises if one attempts to distinguish the two cases. The Fifth Circuit case of *United States v. Henderson Clay Products*, acknowledging the difficulty, proposes that two cases may be distinguished on the ground that in the Tax Court case of *Roundup Coal Mining Co.*, the cost of the coal burned as fuel in the coal mining operations was reflected in the price of the coal mined and sold.[[334]](#footnote-335)336 Thus, the taxpayer in that case got depletion deduction indirectly.[[335]](#footnote-336)337 However, the coal consumed in the manufacture of pig iron did not generate a depletion deduction because depletion is not allowable on pig iron.[[336]](#footnote-337)338 It seems clear that the Fifth Circuit does not require a direct sale of the mineral as a prerequisite.[[337]](#footnote-338)339

The Revenue Service has commented on the question in three rulings.[[338]](#footnote-339)340 In the most recent of the three a taxpayer was allowed depletion on dry gas consumed as fuel in his gasoline absorption plant.[[339]](#footnote-340)341 The Revenue Service therein seem to require that either the mineral in question must be sold or it must contribute to the value of some product which is sold.[[340]](#footnote-341)342 The second ruling involved a railroad which mined rock, sand, and gravel and used it in building and maintaining roadbeds.[[341]](#footnote-342)343 Depletion was allowed thereon because such minerals contributed to the production of income resulting from the sale of transportation services. The earliest ruling dealt with a farmer who sought depletion on peat soils which were depleting because of oxidation.[[342]](#footnote-343)344 The Revenue Service concluded that depletion was not allowable because the peat soil had not been extracted. However, there is indication that the Revenue Service agrees with the distinction made in *Henderson Clay Products*, above.[[343]](#footnote-344)345 If the mineral is consumed in the production of mineral which itself is depletable, then to avoid double depletion the mineral consumed is not depletable.

The Tax Court decision in *Roundup Coal Mining Co*. discussed above, appears to carry *Mountain Producer* to the extreme in concluding that there were no sales proceeds to deplete in as much as there had been no direct sale of the mineral product.[[344]](#footnote-345)346 If this view perseveres in that court, then arguably depletion is not allowable on any mineral consumed in the taxpayer’s operations. The Tax Court appears to require not only extraction but also a direct sale of the mineral as a prerequisite to depletion. The Fifth Circuit certainly requires extraction as a prerequisite to depletion.[[345]](#footnote-346)347 Additionally, because it did not repudiate but instead distinguished the Tax Court case, the Fifth Circuit would appear to allow depletion in the indirect sale situations only where the product actually sold was not itself depletable.[[346]](#footnote-347)348 In other words, to avoid double depletion the Fifth Circuit apparently would allow depletion on a mineral consumed in a manufacturing process but not in a mining process. The Revenue Service, on the other hand, appears to require extraction and at least an indirect sale. A product must be sold and the mineral consumed must have contributed to the value of that product.[[347]](#footnote-348)349 This appears to be the case whether the product has been refined beyond the mining stage or not.

In the view of the authors, the Fifth Circuit’s position based on double depletion is incorrect because the depletion can be inevitable. For example, if the taxpayer consumes coal purchased from another as fuel in his own mining operations, depletion certainly would be allowable to the seller of the coal used as fuel and likewise to the taxpayer on the coal he mines and sells. If the taxpayer mined the fuel coal through a separate tax entity and sold it to himself, depletion would be allowable on both. Why should the taxpayer in the Tax Court situation then be at a disadvantage? Additionally, there is a market value for coal regardless of the costs of production incurred by a particular miner. Thus, it seems questionable to disallow depletion in the Tax Court situation on the fuel coal on the grounds of double depletion. This is because the contribution of the fuel coal to the value of the coal sold is tenuous, and because the use of the fuel coal itself is rather fortuitous. Of course, the Tax Court appears to go further than the Fifth Circuit and disallow depletion on all indirect sales. This seems incorrect for one main reason, *i.e.*, it is easily avoidable by establishing several tax entities. Also, however, the Code clearly contemplates depletion on minerals contributing even in the most insignificant way to certain finished products.

1. **Damages and Insurance Proceeds**

As long as damages represent proceeds from production, if the taxpayer has an economic interest, such amounts will be depletable.[[348]](#footnote-349)350 The net amount received by a plaintiff taxpayer from a defendant innocent trespasser plus the trespasser’s costs of production have been held depletable.[[349]](#footnote-350)351 On the other hand, if the taxpayer does not hold an economic interest, then depletion will not be allowable. The Board of Tax Appeals has held that a taxpayer could not take depletion on amounts received from production which were paid pursuant to a decree awarding a fixed dollar amount out of production as damages for breach of a mineral property sales contract.[[350]](#footnote-351)352 This is a correct result in view of the taxpayer’s right to look to the defendant personally for the amount due.[[351]](#footnote-352)353 If the damages or insurance proceeds do not represent production, then depletion is not allowable. The Sixth Circuit has concluded that business interruption insurance proceeds due because of losses to mining equipment resulting from a fire were not depletable.[[352]](#footnote-353)354 This also seems a correct result in view of the fact that any mineral not produced because of the slowdown due to the fire remained in the ground to be produced.

Difficulties can arise, however, if the proceeds represent contract damages measured by either a loss of production or a loss of a portion of the value of the production. The breach of the implied ***oil*** and gas lease covenant to drill offset wells results in a permanent loss of production. However, the Board of Tax Appeals has ruled that amounts received as damages therefor are not depletable.[[353]](#footnote-354)355 The Revenue Service has ruled that amounts received by the seller as damages for breach of the contract to purchase coal are not depletable.[[354]](#footnote-355)356 When the contract purchaser reneged on the agreement, the taxpayer sold the coal on the open market for less than the contract price, recovering the difference in court. The Revenue Service citing *Mountain Producer* ruled that the damages were not actual sales proceeds and therefore not depletable. A federal district court in a decision affirmed by the Fourth Circuit concluded on identical facts that such proceeds were depletable.[[355]](#footnote-356)357 The approach of the Revenue Service appears to be the better one.

The situation seems distinguishable from the trespasser case discussed above. Theoretically, in the trespasser case the amount awarded is a direct substitute for production in vindication of the plaintiff’s property rights therein; it is payable for the wrongful extraction and sale of the mineral. In the breach of the contract to purchase situation, there is no necessary tie to extraction and sale. Rather, the loss is suffered because of the inability to sell due to the purchaser’s breach although the damages may indeed be, but need not necessarily be, measured by the amount received on a subsequent sale.[[356]](#footnote-357)358 Contract law prescribes the measure as the excess of the contract price over the fair market value. Of course, the fair market value can be demonstrated by the price received on a subsequent sale.[[357]](#footnote-358)359 In other words, the proceeds received in this breach of contract action simply do not represent proceeds of a sale of mineral and thus should not be depletable.[[358]](#footnote-359)360

1. **Futures Contracts**

According both to a private ruling and a Chief Counsel Attorney Memorandum, a taxpayer who sells a contract or buys or sells an option on future production may not take depletion on the gain therefrom. Depletion remains allowable on the sale of the mineral itself. Options and futures contracts are viewed as insurance hedging price risk.[[359]](#footnote-360)361 This is consistent with the extraction and indirect sale requirement discussed above in section 2.03[5][c]. Additionally, the two pronouncements by the Service note that gains and losses from hedging transactions are not adjustments in calculating taxable income from property for purposes of the 50% limitation.

1. **“Rents or Royalties”**

Section 613(a) of the Code sets forth the requirement for depletion purposes that “any rents or royalties paid or incurred by the taxpayer in respect of the property” be excluded. It is not clear what the meaning of the word “rent” is for purposes of Section 613(a). If the taxpayer has acquired lease rights in production and processing equipment in addition to the minerals pursuant to a mineral lease, then the fact that the royalty he is paying is either expressly or in substance economically allocable in part of payment for the equipment is irrelevant to his having to exclude the royalty payments made.[[360]](#footnote-361)362 If these payments are directly dependent on production they must be excluded by the lessee and are depletable by the lessor.[[361]](#footnote-362)363 If, on the other hand, a lessor of equipment is a stranger to the title of the mineral property itself, it would appear that amounts paid to him for use of such equipment may not be depletable even though dependent upon production and cast in the form of a royalty.[[362]](#footnote-363)364 In terms of the existing law, there is no clear authority one way or the other for the treatment of payments unrelated to production which are made for use of equipment and as a part of the mineral lease. This is so whether such payments are due unconditionally or conditionally, i.e., whether or not the obligation to pay survives the lease.[[363]](#footnote-364)365 Where such payments are conditional, they have more of the characteristics of, in effect, minimum royalty than delay rental or rental. Thus, they should be depletable by the payee-lessor and excludable by the lessee-payor.[[364]](#footnote-365)366 In any event, the word “rents” in Section 613(a) in terms of existing law appears superfluous in that the result in the above cited cases was not dependent on the presence of the word in the statute.[[365]](#footnote-366)367 The Revenue Service seems in accord with this view.[[366]](#footnote-367)368 It may, however, have significance in a future case dealing with payments for use of equipment which are unrelated to production and unconditionally due.[[367]](#footnote-368)369

1. **Black Lung Excise Tax**

As a result of the Black Lung Benefits Act of 1977,[[368]](#footnote-369)370 an excise tax is imposed on the sale of coal to finance benefits for victims of black lung disease.[[369]](#footnote-370)371 The excise tax applies to all coal except lignite mined in the United States that is sold or used after March 31, 1978.[[370]](#footnote-371)372 For coal mined from underground mines, the tax is either $ 1.10 per ton or 4.4 percent of the price of the coal sold, whichever is less. For coal mined from surface mines, the tax is either $.55 per ton or 4.4 percent, whichever is lower.[[371]](#footnote-372)373 The coal operator is liable for the tax.

The Revenue Service has ruled that the coal operator who pays the tax and passes along the cost thereof to the coal purchasers may include the total received from the purchaser in his gross income from property.[[372]](#footnote-373)374 Additionally, the tax paid is subtracted in determining taxable income from property for purposes of the 50 percent limitation.[[373]](#footnote-374)375

The Service has issued a Market Segment Specialization Program (MSSP) audit guide for the coal excise tax.[[374]](#footnote-375)376 The examples and citations in the guide provide guidance to tax examiners on issues affecting the coal mining industry relating to the Coal Excise Tax. Specifically, the guide provides guidance on twelve potential audit issues, general audit guidelines, sample IDR requests, a glossary of mining terms, and background on the coal mining industry. Among the stated potential audit issues are: (1) the excess moisture deduction; (2) producer vs. contract miner; (3) sales price inclusive of federal excise tax; (4) purchased coal; (5) transportation costs in sales price; (6) freeze dried additive; (7) raw vs. clean tonnage; (8) mix of underground and surface coal; (9) riverbed dredging; (10) refuse pile coal; (11) thermo-dryer coal; and (12) claim for refund.

Coal that is in the “stream of export” is not subject to the coal excise tax. In 1998 the courts held that the coal excise tax applied to exported coal was a violation of Article 1, Section 9, Clause 5 of the US Constitution (export clause).[[375]](#footnote-376)377 Coal is in the stream of export when sold by the producer if the sale is a step in the exportation of the coal to its ultimate destination in a foreign country. For example, coal is placed into the stream of export when (1) the coal is loaded on an export vessel and title is transferred from the producer to a foreign purchaser, or (2) the producer sells the coal to an export broker in the United States under terms of a contract showing that the coal is to be shipped to a foreign country. Exportation may be evidenced by (1) a copy of the export bill of lading issued by the delivering carrier, (2) a certificate signed by the agent or representative or the export carrier showing the actual exportation of the coal, (3) a certificate of landing signed by a customs officer of the foreign country to which the coal is exported, or (4) in the case in which the foreign country has no customs administration, a statement of the foreign consignee showing receipt of the coal.[[376]](#footnote-377)378

Taxation of Mining Operations

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1. 64Gross income from property is discussed in § 2.03[2][a], *below.* [↑](#footnote-ref-2)
2. 64.1In Bryan Rock Products, Inc. v. Comm., T.C. Memo 1997-51, the Tax Court held that a mining company that sells red dolomite rock both as a concrete aggregate and for landscaping purposes can deplete its dolomite used for landscaping at 14 percent, and not at 5 percent as is required for the concrete aggregate. The Tax Court stated that the proper test when classifying rocks or minerals for percentage depletion purposes is the “use test,” which focuses on the actual use of the rocks and whether they “compete commercially with common stone in the specific use placed at issue.” In this case, the Court reasoned that Bryan Rock did not sell the landscaping rocks for a purpose similar to rip rap, ballast, road material, rubble, or concrete aggregates, and it should not be depletable at 5 percent. [↑](#footnote-ref-3)
3. 65I.R.C. § 613. In Rev. Rul. 76-246, 1976-1 C.B. 176, the Revenue Service concluded that material containing some sand but not meeting industrial specifications therefor was not sand for purposes of percentage depletion. In Rev. Rul. 79-382, 1979-2 C.B. 245, the Revenue Service concluded that lava rock crushed, ground, and used in molding figurines was depletable at the 5 percent rate. In Rev. Rul. 82-17, 1982-1 C.B. 95, the Revenue Service concluded that carbon dioxide is not a “gas” under I.R.C. § 613A but rather falls into the “all other minerals” category of I.R.C. § 613(b)(7). Consequently, I.R.C. §§ 616 and 617 would apply rather than § 263(c). Nahcolite, a sodium carbonate mineral, is ruled to be in the category of “all other minerals” and, therefore, entitled to a 14 percent rate in Rev. Rul. 84-87, 1984-1 C.B. 142. In Martin Marietta Corp. v. United States, 85-1 U.S.T.C. ¶ 9219 (Ct. Cl. 1985), the Claims Court concluded that magnesium hydroxide both produced from brine and processed to obtain magnesium oxide was entitled to the five percent rate being equivalent in the statute to magnesium chloride in § 613(b)(6)(C) rather than the 15 (now 14) percent rate of all other minerals. In Louisiana Land and Exploration, 90 T.C. 630 (1988), sulfur produced and sold from sour ***oil*** and gas wells was ruled subject to § 613 rather than § 613A. Additionally, the 22 percent rate of § 613(b)(1) rather than the 14 percent rate of § 613(b)(7) was ruled allowable. At 1995-2 C.B. 1, the Service nonacquiesced in the Court’s use of § 613 to govern depletion allowable on minerals other than ***oil*** and gas being produced from ***oil*** and gas wells. As noted by the Tax Court in Texaco Inc. v. C.I.R., 101 T.C. 571, 577, fn. 9, (1993), tar sands qualifying for the § 29 tax credit also qualify for the 14-percentage depletion rate under § 613(b)(7) rather than the percentage depletion prescribed in § 613A according to the legislative history of § 29 (previously § 44D). P.L.R. 200503003 seems to indicate that hydrocarbons covered by § 29 cannot by definition constitute crude ***oil*** covered by § 613A. However, in the latter ruling the Service does not go on to make explicit the conclusion that therefore § 29 tar sand is covered by § 613(b)(7). In *Mitsubishi Cement Corporation & Subs. v. Commissioner*, TC Memo 2017-160, the Tax Court determined that applicable depletion percentage rate for taxpayer’s mined calcium carbonates was 14% based on the plain language in Section 613(b)(7). The taxpayer argued the rate provided in the regulations (Treas. Reg. § 1.613-2(a)(3)-15%) was appropriate but the Court pointed out the regulations pre-dated the change in the statute so were, in effect, obsolete. [↑](#footnote-ref-4)
4. 65.1C.J. Langenfelder & Son, Inc. v. Commissioner, 69 T.C. 378, 390 (1977); Bryan Rock Products, Inc. v. C.I.R., T.C. Memo 1997-51. [↑](#footnote-ref-5)
5. 65.2GCM 39091. [↑](#footnote-ref-6)
6. 65.3F.S.A. (1-3-94). [↑](#footnote-ref-7)
7. 65.4Action on Decision dated May 2, 1972, confirming this competitive use test and rejecting the holding in Bonsal v. United States, 72-1 USTC ¶ 9175 (W.D.N.C. 1972), discussed *below* at n.65.9 and in associated text, which had interpreted more narrowly the “similar purpose” exception to § 613(b)(7). [↑](#footnote-ref-8)
8. 65.5Bryan Rock Products, Inc. v. C.I.R., T.C. Memo 1997-51; C.J. Langenfelder & Sons, Inc., 69 T.C. 378 (1977); G. & W.H. Corson, Inc. v. Commissioner, 54 T.C. 668, 675 (1970), *affd.* 453 F.2d 578 (3d Cir.1971). The Tax Court in *G. & W.H. Corson, Inc.* sets out the rationale for the competitive use test:

   The purpose of the “use test” incorporated into § 613(b)(7) was to prevent such discrimination. It seems clear that Congress intended the “use test” contained in section 613(b) (7) to be interpreted in such a way that products competing with minerals which were entitled to only a 5-percent rate would not enjoy a competitive advantage merely because under § 613(b)(7) the producer of “other minerals” is entitled for purposes not so competitive to use the 15 percent depletion rate. Because of the general congressional intent we consider it proper to interpret the phrase “and similar uses” in the exception contained in § 613(b)(7) in such a way as to include those uses reasonably commercially competitive with the uses specifically enumerated. [↑](#footnote-ref-9)
9. 65.6N.65.5, *above*. [↑](#footnote-ref-10)
10. 65.7*Citing* the *Corson* case, n.65.5, *above,* the Tax Court in Verlus H. Reagan v. C.I.R., T.C. Memo 1973-266, acknowledges that the producer of a particular mineral may be entitled to both the 5-percent and the 14-percent rates depending on the uses made of the particular mineral. Taxpayer in *Reagan* mined and sold limerock for road construction purposes as well as for agricultural lime and quicklime. The Service appears to agree in PLR 9450002 that the same mineral may qualify in part for 14 percent and in part for 5 percent depending on the actual use made of the mineral. [↑](#footnote-ref-11)
11. 65.8G. & W.H., Inc. v. Commissioner, n.65.5, *above.* [↑](#footnote-ref-12)
12. 65.9W. R. Bonsal Co. v. United States, 72-1 U.S.T.C. ¶ 9175 (W.D.N.C.1972); Maryland Green Marble Corp. v. United States, 74-2 USTC ¶ 9559 (W.D.Va. 1974), *aff’d* 528 F.2d 51 (4th Cir. 1975). [↑](#footnote-ref-13)
13. 65.10W. R. Bonsal Co. v. United States, n.65.9, *above*. [↑](#footnote-ref-14)
14. 65.11528 F.2d, at 54, n.65.9, *above*. [↑](#footnote-ref-15)
15. 65.12Rev. Rul. 78-291, 1978-2 C.B. 186. F.S.A. (1-3-94) observed as follows:

    The Service does not follow [the Fourth Circuit in] *Maryland Green Marble*. Rev. Rul. 78-291, 1978-2 C.B. 186. Service position is that in *Maryland Green Marble*, the chips were being utilized for a use similar to a concrete aggregate, and that the focus is on the use of the mineral as opposed to price competition. The fact that the mineral is not commercially competitive with a five percent mineral in a given use is irrelevant when the use is enumerated in the statute. [↑](#footnote-ref-16)
16. 65.13I.R.C. § 291(a)(2). [↑](#footnote-ref-17)
17. 65.14Pub. L. No. 99-514, § 412(b) (10-22-86). [↑](#footnote-ref-18)
18. 66Pub. L. No. 95-618, § 403, 92 Stat. 3203 (Nov. 7, 1978), *adding* I.R.C. § 613(e). [↑](#footnote-ref-19)
19. 67*Ibid.* [↑](#footnote-ref-20)
20. 68*Ibid.* [↑](#footnote-ref-21)
21. 69I.R.C. § 613(a); Helvering v. Twin Bell ***Oil*** Syndicate, 293 U.S. 312 (1935). [↑](#footnote-ref-22)
22. 70*Ibid.*; Treas. Reg. §§ 1.611-1(c), 1.613-2(c)(5)(i). [↑](#footnote-ref-23)
23. 71*Ibid.* There are, however, several contexts in which the depletable gross income can exceed the total production. See the discussion of bonus and minimum royalty in Ch. 3, *below*. This was also possible before the 1969 Tax Reform Act with regard to carved out production payments. See P.G. Lake, Inc. v. Commissioner, 356 U.S. 260 (1958). [↑](#footnote-ref-24)
24. 72I.R.C. § 613(a); Helvering v. Twin Bell ***Oil*** Syndicate, 293 U.S. 312 (1935); Treas. Reg. §§ 1.611-1(c), 1.613-2(c)(5)(i). [↑](#footnote-ref-25)
25. 73I.R.C. § 613(a). [↑](#footnote-ref-26)
26. 74See § 2.03[a]. [↑](#footnote-ref-27)
27. 75Rev. Proc. 78-19, 1978-2 C.B. 491. [↑](#footnote-ref-28)
28. 76*Ibid.* [↑](#footnote-ref-29)
29. 77Revenue Act of 1932, § 114(b). [↑](#footnote-ref-30)
30. 78Revenue Act of 1942, § 145(a). [↑](#footnote-ref-31)
31. 79Revenue Act of 1932, § 114(b). [↑](#footnote-ref-32)
32. 80Treas. Reg. 77, Art. 221(g). [↑](#footnote-ref-33)
33. 81Int. Rev. Code of 1939 § 114(b)(9)(B). [↑](#footnote-ref-34)
34. 82Int. Rev. Code of 1939 § 114(b)(4)(B): I.R.C. § 613(c)(2). [↑](#footnote-ref-35)
35. 83Int. Rev. Code of 1939 § 114(b)(4)(B)(iii) and (iv); I.R.C. § 613(c)(4)(C) and (D). [↑](#footnote-ref-36)
36. 84Dragon Cement Co. v. United States, 244 F.2d 513 (1st Cir. 1957), *cert. denied*, 355 U.S. 833 (1957); Townsend v. Hitchcock Corp., 232 F.2d 444 (4th Cir. 1956);, United States v. Cherokee Brick & Tile Co., 218 F.2d 424 (5th Cir. 1955); United States v. Merry Bros. Brick & Tile Co., 242 F.2d 708 (5th Cir. 1957), *cert. denied*, 355 U.S. 824 (1957); United States v. Cannelton Sewer Pipe Co., 268 F.2d 334 (7th Cir. 1959), *rev’d and remanded*, 364 U.S. 76 (1960); Commissioner v. Iowa Limestone, 269 F.2d 398 (8th Cir. 1959); Bookwalter v. Centropolis Crusher Co., 272 F.2d 391 (8th Cir. 1959); New Idria Quicksilver Mining Co. v. Commissioner, 144 F.2d 918 (9th Cir. 1944); United States v. Sapulpa Brick & Tile Corp., 239 F.2d 694 (10th Cir. 1956). [↑](#footnote-ref-37)
37. 85*Ibid.* [↑](#footnote-ref-38)
38. 86Dragon Cement Co. v. United States, 244 F.2d 513 (1st Cir. 1957), *cert. denied*, 355 U.S. 833 (1957); United States v. Cherokee Brick & Tile Co., 218 F.2d 424 (5th Cir. 1955); United States v. Merry Bros. Brick & Tile Co., 242 F.2d 708 (5th Cir. 1957), *cert. denied*, 355 U.S. 824 (1957); New Idria Quicksilver Mining Co. v. Commissioner, 144 F.2d 918 (9th Cir. 1944); and United States v. Sapulpa Brick & Tile Corp., 239 F.2d 694 (10th Cir. 1956). [↑](#footnote-ref-39)
39. 87United States v. Cannelton Sewer Pipe Co., 268 F.2d 334 (7th Cir. 1959), *rev’d and remanded*, 364 U.S. 76 (1960); Commissioner v. Iowa Limestone, 269 F.2d 398 (8th Cir. 1959); Bookwalter v. Centropolis Crusher Co., 272 F.2d 391 (8th Cir. 1959). [↑](#footnote-ref-40)
40. 88United States v. Cannelton Sewer Pipe Co., 364 U.S. 76 (1960). [↑](#footnote-ref-41)
41. 89*Ibid.* [↑](#footnote-ref-42)
42. 90*Ibid.* [↑](#footnote-ref-43)
43. 91Pub. L. No. 86-564, § 302(a), 74 Stat. 290. [↑](#footnote-ref-44)
44. 92See the text, *above*, to which n.84 is appended. [↑](#footnote-ref-45)
45. 9336 Fed. Reg. 19257–19264. [↑](#footnote-ref-46)
46. 94Treas. Reg. § 1.613-4. [↑](#footnote-ref-47)
47. 95I.R.C. § 613(c)(4)(E). See Rev. Rul. 81-235, 1981-2 C.B. 140, in which the Revenue Service has concluded that the calcining, purification, and recalcining of trona are mining processes under the 1974 amendment. [↑](#footnote-ref-48)
48. 96Treas. Reg. § 1.613-4(d)(7), dealing with the “rate of return on investment method” of determining gross income from mining. [↑](#footnote-ref-49)
49. 96.1Rev Rul 85-10, 1985-1 CB 180. *See* IRM 4.41.1.3.7.1.3 for a discussion of gross income from property in the context of ***oil*** and gas wells. [↑](#footnote-ref-50)
50. 96.2*Id.* [↑](#footnote-ref-51)
51. 96.3*Id.* See § 2.03[2][c][i] *below.* [↑](#footnote-ref-52)
52. 97Riley v. Douglass, 221 F.2d 146 (9th Cir. 1955); Treas. Reg. § 1.613-4(b)(1). See also Estate of Thomas E. Arnett, 31 T.C. 320, 333 (1958), *acq.* [↑](#footnote-ref-53)
53. 98Rev. Rul. 79-27, 1979-1 C.B. 217. [↑](#footnote-ref-54)
54. [↑](#footnote-ref-55)
55. 100I.R.C. § 613(c)(4)(C). [↑](#footnote-ref-56)
56. 101Treas. Reg. § 1.613-4(f)(3)(iv). [↑](#footnote-ref-57)
57. 102*Ibid.* [↑](#footnote-ref-58)
58. 10333 Fed. Reg. 10703, now withdrawn. [↑](#footnote-ref-59)
59. 10433 Fed. Reg. 14707, now withdrawn. [↑](#footnote-ref-60)
60. 104.1Rev. Rul. 82-181, 1982-2 C.B. 117, the Revenue Service ruled china clay to be a § 613(c)(4)(C) mineral. [↑](#footnote-ref-61)
61. 105Treas. Reg. § 1.613-4(f)(3)(i). [↑](#footnote-ref-62)
62. 106*Ibid.* [↑](#footnote-ref-63)
63. 107*Ibid.* In Rev. Rul. 83-100, 1983-2 C.B. 101, air separation of pulverized china clay was ruled nonmining since it was not used by many other miners in the area to bring the mineral to shipping grade and form. Rev. Rul. 83-100 is revoked in Rev. Rul. 85-192, 1985-2 C.B. 173. The Revenue Service in the latter ruling changes its position and now concludes that processes necessary to bring the mineral to shipping grade and form should be determined by the taxpayer’s operation rather than by the industry practice. In accord with Rev. Rul. 85-192 is GCM 39521, 86 Tax Notes 29 (1986). [↑](#footnote-ref-64)
64. 108Treas. Reg. § 1.613-4(f)(3)(i). See Rev. Proc. 78-19, 1978-2 C.B. 491, quoted in § 2.03[1][b] *above.* [↑](#footnote-ref-65)
65. 109Treas. Reg. § 1.613-4(g)(6)(iii). See Rev. Proc. 78-19, 1978-2 C.B. 491, quoted in § 2.03[1][b] *above.* [↑](#footnote-ref-66)
66. 110Treas. Reg. § 1.613-4(f)(3)(ii). *See* Rev. Proc. 78-19, 1978-2 C.B. 491, quoted in § 2.03[1][b] *above.* Jones and Laughlin Steel, Inc. v. United States, 53 A.F.T.R.2d 84-935, 84-1 U.S.T.C. ¶ 9282 (W.D. Pa. 1984), ruled Treas. Reg. § 1.613-4(f)(3)(ii) invalid as contrary to the statute to the extent that the regulation limited sintering of iron ore fines, which qualified as a mining process only to that extent necessary to ship the fines, i.e., that necessary to bring the ore to shipping form, not that necessary additionally to bring the ore to shipping grade. The court relied on the words of the statute and the history of Treasury’s unsuccessful efforts to constrict the scope of the statute by regulation. [↑](#footnote-ref-67)
67. 111Treas. Reg. § 1.613-4(f)(3)(iii). It may be noteworthy that the regulations describe shipping grade and form as the quality or size for shipping using the disjunctive “or” rather than the conjunction “and.” There is some indication that the Revenue Service is exploiting the difference to obtain some flexibility in dealing with these cases. *See* Rev. Proc. 78-19, 1978-2 C.B. 491, quoted in § 2.03[1][b] *above.* [↑](#footnote-ref-68)
68. 112*Compare* Ayers Materials Co., 62 T.C. 557 (1974), *with* Matagorda Shell Co., *nonacq.* 29 T.C. 1060 (1958). [↑](#footnote-ref-69)
69. 113Treas. Reg. § 1.613-4(f)(4). [↑](#footnote-ref-70)
70. 113.1Union Carbide Corp. v. C.I.R., 75 T.C. 220 (1980), *aff’d per curiam on another issue*, 671 F.2d 67 (2d Cir. 1982). [↑](#footnote-ref-71)
71. 113.2*Id.* [↑](#footnote-ref-72)
72. 113.3Louisiana Land & Exploration Co. v. C.I.R., 102 T.C. 21, 50–54 (1994), *acq.* A.O.D. 1995-008. [↑](#footnote-ref-73)
73. 113.4*Id.* [↑](#footnote-ref-74)
74. 114*Ibid.;* In Martin Marietta Corp. v. United States, 85-1 U.S.T.C. ¶ 9219 (Cl. Ct. 1985), the taxpayer produced magnesium oxide by processing magnesium hydroxide recovered from a brine by precipitation, dewatering processes, and kiln treating. The cut-off point was determined to be after dewatering, which increased the solid content by filtering to 50 percent and prior to kiln treating. The dewatering that follows the precipitation was determined to be necessary and incidental to the latter, which was a mining process. To the extent that the taxpayer’s use of the additive dolime in the precipitation process was necessary to it as the reagent, the use was a mining cost. To the extent, however, that the dolime served as an additional source of magnesium, it was not a mining cost. The allocation was determined by an apportionment by relative weight of the reagent and the magnesium in the dolime.

    In Louisiana Land & Exploration Co. v. C.I.R., n.113.3, *above*, the Claus method of extracting sulphur was found not to constitute refining since further processing would be needed to produce pharmaceutical-grade sulphur. In Ideal Basic Industries, Inc., 82 T.C. 352 (1984), leaching and crystallization processes to produce soluble and chemical grade muriate of potash were held to be mining processes. *Ideal Basic* cites and discusses Barton Mines Corporation v. C.I.R.:

    We do not agree, as respondent would have us, that a concentration process which beneficiates an ore to 98 percent [FN10] is mining under§ 613(c)(4)(D) but one that beneficiates the ore to 99.9 percent is, as a matter of law, nonmining. In Barton Mines Corp. v. Commissioner, 53 T.C. 241 (1969), affd. in part, revd. in part, and remanded in part 446 F.2d 981 (2d Cir. 1971), the Court of Appeals rejected a similar notion put forth by the Commissioner:

    [N]othing in the statute indicates that an arbitrary percentage should determine which methods constitute beneficiation by concentration, and so construed, the regulation would be without statutory foundation. [446 F.2d at 989.]

    As Barton Mines directs, we view petitioner’s operation “as a whole, not each of its elements in isolation.” 446 F.2d at 989. The crystallization process is a continuation of the steps involved in the beneficiation of the ore Page # 27 from a KCl content of 31 percent to a final concentrate at 99.9 percent. [82 T.C., at 368.]

    In Ranchers Exploration and Development Corp. v. United States, 634 F.2d 487 (10th Cir. 1980), the court concluded that solvent extraction and electrowinning of copper oxide ore are mining processes. In Union Carbide Corp., 75 T.C. 220 (1980), solvent extraction, precipitation, crystallization, and drying of vanadium and tungsten ores were ruled mining processes. Rev. Rul. 83-99, 1983-2 C.B. 100, the Revenue Service ruled that it will follow the holdings in Union Carbide and Ranchers Exploration that solvent extraction processes are mining. However, Rev. Rul. 83-99 concluded that electrowinning is nonmining. This ruling is consistent with Rev. Rul. 77-13, 1977-1 C.B. 162, in which the Revenue Service ruled that the secondary crystallization of fertilizer grade KC1 to produce chemical grade KC1 is refining and therefore nonmining. In addition, Rev. Rul. 77-13 concluded that Section 613(c)(4)(D) mining processes were those involving the separation or extraction of the mineral from the ore. Consequently, the process of compaction of fine screenings of KC1 not involving separation or extraction but rather simply to produce a third commercial grade of fertilizer was nonmining. In Rev. Rul. 82-175, 1982-2 C.B. 115, the Revenue Service ruled that the process of crystallization by chilling the brine to produce hydrated sodium sulfate followed by the leaching and re-crystallization to produce anhydrous sodium sulfate and the subsequent drying process are mining processes under §§ 613(c)(4)(D) and 613(c)(4)(I). This conclusion regarding second crystallization was distinguished from that in Rev. Rul. 77-13, *above*, since a substantial amount of water was removed in the process. [↑](#footnote-ref-75)
75. 114.1*Contrast* Rev. Rul. 73-538, 1973-2 C.B. 197, and Rev. Rul. 77-13, 1977-1 C.B. 162, *with* Ideal Basic Industries, Inc., 82 T.C. 352 (1984). [↑](#footnote-ref-76)
76. 114.2IRC § 613(c)(4)(E–H). [↑](#footnote-ref-77)
77. 114.3IRC § 613(c)(4)(I). See also: Treas Reg § 1.613-4(f)(5). [↑](#footnote-ref-78)
78. 115Discussion Draft Treas. Reg. § 1.613-3(f)(5)(i)(a)–(e); 34 Fed. Reg. 5737 (March 27, 1969), now withdrawn. [↑](#footnote-ref-79)
79. 116Discussion Draft Treas. Reg. § 1.613-3(f)(5)(i)(a)–(e); 34 Fed. Reg. 5737 (March 27, 1969), now withdrawn. [↑](#footnote-ref-80)
80. 116.1In Rev. Rul. 73-538, 1973-2 C.B. 197, the Revenue Service concluded that drying potash to remove free moisture without changing physical or chemical identity is mining and not thermal action under § 613(c)(5). In Rev. Rul. 76-444, 1976-2 C.B. 190, however, it was ruled that the process of drying bentonite at temperatures that alter the mineral both physically and chemically in order to expel the water of crystallization does not qualify as mining. [↑](#footnote-ref-81)
81. 117Treas. Reg. § 1.613-4(f)(5)(i)–(iv). [↑](#footnote-ref-82)
82. 118I.R.C. § 613(c)(5); Treas. Reg. § 1.613-4(g)(1). *See also:* Louisiana Land and Exploration Co. v. C.I.R., n.113.3, *above*, wherein heating prior to application of the Claus process, to maintain hydrogen sulfide in a gaseous state, was ruled incidental (though not necessary) to the Claus process since the cost thereof was only 2 to 3 percent of the total cost of the processing of the hydrogen sulfide gas. In addition, *Louisiana Land* concluded that a reaction furnace process was necessary to the Claus process because it produced the sulfur dioxide, which was necessary to the Claus process. Moreover, the cooling of the sulfur dioxide was also necessary to the Claus process. [↑](#footnote-ref-83)
83. 119I.R.C. § 613(c)(5). In Rev. Rul. 83-100, 1983-2 C.B. 101, the Revenue Service concluded that fine pulverization of china clay was nonmining since it was not necessary or incidental to mining process of bringing the china clay to shipping grade and form. Rev. Rul. 83-100 ruled that the determination whether a nonmining process such as fine pulverization is necessary or incidental to a mining process is determined by the industry practice of the miners in taxpayer’s area. *Accord*: GCM 39009. Rev. Rul. 83-100 was revoked in Rev. Rul. 85-192, 1985-2 C.B. 173, which ruled that the taxpayer’s practice was determinative, not the industry practice. *Accord*: GCM 39521 which revoked GCM 39009. [↑](#footnote-ref-84)
84. 120See § 2.03[2][c]. [↑](#footnote-ref-85)
85. 121Treas. Reg. § 1.613-4(f)(2)(iii). See Rev. Proc. 78-19, 1978-2 C.B. 491, quoted in § 2.03[1][b] *above.* [↑](#footnote-ref-86)
86. 121.1Treas. Reg. § 1.613-4(f)(3)(ii). [↑](#footnote-ref-87)
87. 121.2**I.R.C. § 613(c)(5)**; Treas. Reg. § 1.613-4(g)(1). *See*: Rev. Rul. 73-266, 1973-1 C.B. 306. Alternatively, the cost of the blending might be considered as incidental to the costs of bringing the ore to shipping grade and form. *See* the discussion, *supra*, in footnote 118. [↑](#footnote-ref-88)
88. 121.3Treas. Reg. § 1.613-4(g)(2). See the discussion of the “sudden death rule,” *infra*, in this Chapter at § 2.03[2][b][vii]. [↑](#footnote-ref-89)
89. 122*Ibid.* [↑](#footnote-ref-90)
90. 122.1In Barton Mines Corporation v. C.I.R., 446 F.2d 981, 993 (2nd Cir. 1971), *aff’g, rev’g, and rem’g* 53 T.C. 241 (1969), some additional texture was added to the regulatory definition, “Properly construed, the term ‘incidental’ describes a process that takes place prior to a milling process and although not essential or indispensable to the mining process is designed to facilitate its performance.” *Accord:* PLR 200219004, F.S.A. (6-28-94). In the latter rulings the Service also indicates the necessary cost comparison to determine whether a process is incidental is between the process in question and the subsequent mining process(es) which is (are) facilitated (to which the process in question is related), not all mining processes subsequent to the process in question. [↑](#footnote-ref-91)
91. 123See § 2.03[2][b][i] *above.* [↑](#footnote-ref-92)
92. 124Treas. Reg. § 1.613-4(f)(1)(iii). Rev. Rul. 75-338, 1975-2 C.B. 240, now approves mining treatment for a calcium carbonate slurry from the mine to a cement plant. In Rowe v. United States, 81-2 U.S.T.C. ¶ 9545 (Ct. Cl. 1981), the court concluded that the mining process must be applied by the miner and not by a purchaser from the miner in order for transportation costs to qualify. *Accord:* Nicewonder v. United States, 80-2 U.S.T.C. ¶ 9793 (W.D. Va. 1981); Herbert J. McClelland, 83 T.C. 958 (1984). In the latter case, the taxpayer also unsuccessfully argued that trucking coal from a surface mine over taxpayer’s bench and on public and private roads to the purchaser was analogous to the transportation of coal through the tunnels of an underground mine and therefore mining because it occurred during the extraction process. [↑](#footnote-ref-93)
93. 125*Ibid.;* *see* Rev. Rul. 73-557, 1973-2 C.B. 205, wherein the Revenue Service concluded that physical factors must be at least partially responsible for the excess distance; economic considerations were ruled irrelevant. See also Rev. Rul. 80-183, 1982-2 C.B. 202, wherein the taxpayer had a mining and processing concession in a foreign country. The latter required that the taxpayer locate his processing facilities more than 50 miles from the mine. In addition, the taxpayer gained economic benefit apart from the tax effect thereby. The Revenue Service concluded that the transportation was mining.

    Absent approval by the Commissioner, transportation in excess of 50 miles is nonmining even though that portion of the transportation within the limit, i.e., the first 50 miles, nevertheless qualifies. Rev. Rul. 77-457, 1977-2 C.B. 207; Rev. Rul. 84-26, 1984-1 C.B. 142, *revoking* Rev. Rul. 73-474, 1973-2 C.B. 200; Matagorda Shell Co., 29 T.C. 1060 (1958), *nonacq.* 1966-1 C.B. 4, *overruling its decision in* American Gilsonite Co., 28 T.C. 194 (1957), *aff’d on other grounds*, 259 F.2d 654 (10th Cir. 1958), *cert. denied*, 359 U.S. 925 (1959). In American Gilsonite Co., the Tax Court concluded that all transportation was disqualified for being in excess of the 50-mile limit. [↑](#footnote-ref-94)
94. 126Treas. Reg. § 1.613-4(h). [↑](#footnote-ref-95)
95. 127Discussion Draft Treas. Reg. § 1.613-3(f)(5)(ii)(g); 34 Fed. Reg. 5737 (3-27-69), now withdrawn. [↑](#footnote-ref-96)
96. 128I.R.C. § 613(c)(2); Treas. Reg. §§ 1.613-4(f)(1)(iii), 1.613-4(g)(3). The following cases are pre-Gore Act cases, and all but the first are pre-*Cannelton* (see § 2.03[2][a]): Winnsboro Granite Corp. v. C.I.R., 283 F. 2d 307 (4th Cir. 1960); Zonolite Co. v. United States, 211 F. 2d 508 (7th Cir. 1954); Greensboro Gas Co. v. C.I.R., 79 F.2d 701 (3rd Cir. 1935), *cert. denied*, 296 U.S. 639; Consumer’s Natural Gas Co. v. C.I.R., 78 F.2d 161 (2d Cir. 1935), *cert. denied*, 296 U.S. 634; James Evans, Sr., 11 T.C. 726 (1948). See also Rev. Rul. 75-6, 1975-1 C.B. 178 (dealing with a producer’s compression of natural gas to get it into a buyer’s pipeline). [↑](#footnote-ref-97)
97. 129Treas. Reg. § 1.613-4(g)(3). In Rev. Rul. 84-26, 1984-1 C.B. 142, *revoking* Rev. Rul. 73-474, 1973-2 C.B. 200, the Revenue Service concluded that transportation in excess of 50 miles between mining processes was nonmining only to the extent of the excess. The transportation up to the 50-mile limit was ruled mining because the process applied after the transportation was a mining process (more than incidental to the nonmining transportation under Treas. Reg. § 1.613-4(g)(3)) and qualified under Treas. Reg. § 1.613-4(g)(2).

    In Herbert J. McClelland, 83 T.C. 958 (1984), the Tax Court upheld the validity of the quoted regulation. In addition, the court concluded that if the “process” applied was simply to facilitate delivery, i.e., after transportation the hammering of the few lumps of coal too large to fit through the grate at the top of purchaser’s storage bin, the process of hammering was not mining but rather part of the delivery for sale. [↑](#footnote-ref-98)
98. 130*Ibid.* [↑](#footnote-ref-99)
99. 131Treas. Reg. § 1.613-4(e)(1). [↑](#footnote-ref-100)
100. 132*Ibid.* [↑](#footnote-ref-101)
101. 133United States v. California Portland Cement Co., 413 F.2d 161 (9th Cir. 1969); General Portland Cement Co. v. United States, 438 F.Supp. 27 (N.D. Tex. 1977); California Portland Cement Co. v. Riddell, 3 A.F.T.R.2d 438 (S.D. Cal. 1958); Standard Lime & Cement Co. v. United States, 329 F.2d 939 (Ct. Cl. 1964); California Portland Cement Co. v. United States, 19 A.F.T.R.2d 1316 (D.C. Cal. 1967); Montreal Mining Co., 2 T.C. 688 (1943) (this case contains an excellent discussion of the reason for the distinction between trade and cash discounts), *acq.* Rev. Rul. 60-257, 1960-2 C.B. 197. [↑](#footnote-ref-102)
102. 134Treas. Reg. § 1.613-5(c)(4)(i); Rev. Rul. 60-98, 1960-1 C.B. 252. [↑](#footnote-ref-103)
103. 135Treas. Reg. § 1.613-5(c)(4)(iv). [↑](#footnote-ref-104)
104. 136Treas. Reg. § 1.613-5(c)(6). [↑](#footnote-ref-105)
105. 137Treas. Reg. § 1.613-5(c)(4)(iv). See also § 2.03[2][b][iii] *above.* [↑](#footnote-ref-106)
106. 138Camp Concrete Rock Co. v. United States, 276 F.2d 211 (5th Cir. 1960). [↑](#footnote-ref-107)
107. 139Treas. Reg. §§ 1.613-4(b)(2), 1.613-4(j). [↑](#footnote-ref-108)
108. 140Treas. Reg. § 1.613-4(b)(2). [↑](#footnote-ref-109)
109. 141Treas. Reg. § 1.613-4(d)(4)(v)(*b*). See § 2.03[2][c], *infra*. [↑](#footnote-ref-110)
110. 142Treas. Reg. § 1.613-4. [↑](#footnote-ref-111)
111. 143See Treas. Reg. § 1.482-2A(e)(1)(ii), (v). [↑](#footnote-ref-112)
112. 143.1Technical Memorandum attached to T.D. 7170 noted as follows:

     Section 1.613-4(b)(2) condenses what was formerly two separate sentences into one sentence for clarity and to eliminate a possible circularity in cross references between this section and the regulations under section 482. This change is in furtherance of the decision to make absolutely clear the requirement that the rules of section 613 take precedence over the rules under section 482 in determining the sales price of minerals sold to an affiliate before the application of nonmining processes. Although taxpayers strongly protested this decision, it is considered proper and highly desirable because the specific rules under section 613 are much more appropriate for the minerals industry than are the rules under section 482 which are designed to apply to all businesses in general. [↑](#footnote-ref-113)
113. 144Treas. Reg. § 1.613-4(j). [↑](#footnote-ref-114)
114. 145*Ibid.* [↑](#footnote-ref-115)
115. 146*Ibid.* [↑](#footnote-ref-116)
116. 147See Treas. Reg. § 1.613-4(g)(6). [↑](#footnote-ref-117)
117. 148See § 2.03[1][b]. In Rev. Rul. 73-538, 1973-2 C.B. 197, the drying of potash was ruled mining; however, other processes effecting chemical change were ruled nonmining. The delamination of china clay was ruled fine pulverization and therefore nonmining in Rev. Rul. 82-181, 1982-2 C.B. 117. Fine pulverization of china clay that was neither necessary nor incidental to a mining process was ruled nonmining in Rev. Rul. 83-100, 1983-2 C.B. 101. However, Rev. Rul. 83-100 has been revoked by Rev. Rul. 85-192, 1985-2 C.B. 173. See also the authorities discussed above in ns.114, 116.1 *above.* [↑](#footnote-ref-118)
118. 148.1See Louisiana Land & Exploration Co. v. C.I.R., n.113.3, *above* Union Carbide Corp. v. C.I.R., n.113.1, *above*. [↑](#footnote-ref-119)
119. 148.2See 1994 WL 1725500 (6-28-94),

     Assuming that the roasting in this case is a nonmining process, Service position is that all subsequent process are treated as nonmining. Treas. Reg. § 1.613-4(g)(2). This is the so-called “sudden death” rule. The courts, however, have rejected a mechanical application of the regulation. See Barton Mines, 55 [Sic 53] T.C. at 258, 446 F.2d at 995 [See also p. 990]; Union Carbide, 75 T.C. at 239. Even if the Service prevails on the issue of whether roasting is a nonmining process, there is the potential that the Tax Court would not classify the taxpayer’s leaching and solvent extraction processes as nonmining simply because they follow a nonmining process. As a result of these cases, the litigation hazard regarding the application of the “sudden death” rule is significant. [↑](#footnote-ref-120)
120. 149Treas. Reg. § 1.613-4(g)(2). See also Rev. Rul. 76-389, 1976-2 C.B. 189; Rev. Rul. 73-538, 1973-2 C.B. 197, wherein processes that would otherwise be mining were applied after nonmining processes and consequently were disqualified. [↑](#footnote-ref-121)
121. 150*Ibid.* [↑](#footnote-ref-122)
122. 151*Ibid.* [↑](#footnote-ref-123)
123. 152Treas. Reg. § 1.613-4(g)(2). See Rev. Rul. 84-26, n.129, *above.* [↑](#footnote-ref-124)
124. 153Treas. Reg. § 1.613-4(c)(1). [↑](#footnote-ref-125)
125. 154Treas. Reg. § 1.613-4(c)(1); Warner Co. v. United States, 504 F.2d 689 (3rd Cir. 1974) (limestone), *cert. denied*, 421 U.S. 930 (1975); Kaiser Steel Corp. v. United States, 411 F.2d 335 (9th Cir. 1969) (iron ore and coal); Alabama By-Prod. Corp. v. Patterson, 151 F. Supp. 641 (N.D. Ala. 1957), *aff’d*, 258 F.2d 892 (1959), *cert. denied*, 358 U.S. 930 (1959) (coal); Mankato Stone Co. v. United States, 69-2 U.S.T.C. 9659 (D.C. Minn. 1969) (stone); Woodville Lime Prod. Co. v. United States, 263 F. Supp. 311 (N.D. Ohio 1966) (dolomite); United States Pipe & Foundry Co. v. Patterson, 203 F. Supp. 335 (N.D. Ala. 1962) (coal, iron ore, and dolomite); Scott v. United States, 60-2 U.S.T.C. 9731 (N.D. Ala. 1960) (limestone); Woodward Iron Co. v. Patterson, 173 F. Supp. 251 (N.D. Ala. 1959) (coal iron ore); Ayers Material Co., 62 T.C. 557 (1974) (oyster shells); Riverton Lime & Stone Corp., 28 T.C. 446 (1957), *nonacq.* (limestone); James Ruane, Sr., T.C. Memo 1958-175 (coal). *See also* F.S.A. 200146046. *See* § 2.03[2][b][iii], *above,* for a discussion of mining and nonmining transportation. [↑](#footnote-ref-126)
126. 155Treas. Reg. § 1.613-4(c)(1). *See also* P.L.R. 9520031 and PLR 9518012 wherein the taxpayer’s own arms-length sales of copper concentrate constituted its representative market or field price. [↑](#footnote-ref-127)
127. 156Treas. Reg. § 1.613-4(c)(2). See also Alabama By-Prod. Corp. v. Patterson, 151 F. Supp. 641 (N.D. Ala. 1957), *aff’d*, 258 F.2d 892 (5th Cir. 1958), *cert. denied*, 358 U.S. 930 (1959); United States Pipe & Foundry Co. v. Patterson, 203 F. Supp. 335 (N.D. Ala. 1962); Woodville Lime Prod. Co. v. United States, 263 F. Supp. 311 (N.D. Ohio 1966).

     In Martin Marietta Corp. v. United States, 7 Cl. Ct. 573 (1985), the taxpayer who was producing and selling magnesium oxide processed from magnesium hydroxide was not permitted to use as a representative sale price the market price of magnesium hydroxide because of the failure to satisfy both the like kind and grade requirement and the competitive sales requirement. [↑](#footnote-ref-128)
128. 157*Ibid.* [↑](#footnote-ref-129)
129. 158*Ibid.* [↑](#footnote-ref-130)
130. 159Kaiser Steel Corp. v. United States, 411 F.2d 335 (9th Cir. 1969). [↑](#footnote-ref-131)
131. 160*Ibid;* *see* Ideal Basic Industries, Inc., 82 T.C. 352 (1984); PLR 8603001. [↑](#footnote-ref-132)
132. 161*Ibid.* [↑](#footnote-ref-133)
133. 162Treas. Reg. § 1.613-4(c)(4). [↑](#footnote-ref-134)
134. 163Treas. Reg. § 1.613-4(c)(3). [↑](#footnote-ref-135)
135. 163.1*Ibid*. [↑](#footnote-ref-136)
136. 164Warner Co. v. United States, 504 F.2d 689 (3rd Cir. 1974), *cert. denied*, 421 U.S. 930 (1975); Kaiser Steel Corp. v. United States, 411 F.2d 335 (9th Cir. 1969). [↑](#footnote-ref-137)
137. 164.1Martin Marietta Corp. v. United States, n.157, *above*; Gray Knox Marble Co. v. United States, 257 F. Supp. 632 (E.D. Tenn. 1966). [↑](#footnote-ref-138)
138. 164.2Petroleum Exploration v. United States, 404 F. Supp. 93, 96 (N.D.W. Va. 1975, *aff’d per curiam*, 551 F.2d 308 (4th Cir. 1977). See AOD 1977-67 (Mar. 24, 1977), which appears to approve this aspect of the Court’s analysis in *Petroleum Exploration*. [↑](#footnote-ref-139)
139. 164.3North Carolina Granite Corporation v. Commissioner, 56 T.C. 1281, 1288 (1971). [↑](#footnote-ref-140)
140. 164.4Gray Knox Marble Co. v. United States, 257 F. Supp. 632 (E.D. Tenn. 1966). The case involved the determination of the first marketable product for proportionate profits purposes but the principles for these purposes would appear to be the same as for determining the representative market or field price. See PLR 8148010. [↑](#footnote-ref-141)
141. 164.5Warner Company v. United States, 504 F.2d 689 (3rd Cir. 1974). [↑](#footnote-ref-142)
142. 164.6Treas. Reg. § 1.613-4(c)(3). [↑](#footnote-ref-143)
143. 164.7It should be recalled, as noted above in the text to which n.164 is appended, that the fact that the miner’s f.o.b. sale price would not be profitable for the taxpayer will probably not be relevant. [↑](#footnote-ref-144)
144. 164.8See Treas. Reg. § 1.613-4(c)(1) referring to Treas. Reg. § 1.613-4(e)(2). See also Warner Company v. United States, 504 F.2d 689, 696 (3rd Cir. 1974). [↑](#footnote-ref-145)
145. 164.9See the text to which n.164.6 is appended. [↑](#footnote-ref-146)
146. 164.10PLR 200308001. [↑](#footnote-ref-147)
147. 164.11Kaiser Steel Corporation v. United States, 411 F.2d 335, 340 (9th Cir. 1969). [↑](#footnote-ref-148)
148. 164.12Treas. Reg. § 1.613-4(c)(1). [↑](#footnote-ref-149)
149. 164.13Treas. Reg. § 1.613-4(e)(2)(i). The last sentence of the above regulatory provision would seem to require a taxpayer whose only nonmining was her actual transportation costs to the purchaser to limit her RMFP to her own net amount of sales price less actual transportation costs. This arguably is contrary to at least the spirit of the *Kaiser* case. [↑](#footnote-ref-150)
150. 165Treas. Reg. § 1.613-4(c)(3). Rev. Rul. 79-216, 1979-2 C.B. 224, provides that Treas. Reg. § 1.482-2(e)(2) rather than Treas. Reg. § 1.482-2(e)(1)(v), discussed in § 2.03[2][b][vi], is applicable in determining the constructive sale price. Rev. Rul. 87-71, 1987-2 C.B. 148, *revokes* Rev. Rul. 79-216 and concludes that only uncontrolled sales made to purchasers of mineral in the geographic area of the purchasers may be considered in establishing an arm’s-length price for controlled sales transactions. [↑](#footnote-ref-151)
151. 166*Ibid.* [↑](#footnote-ref-152)
152. 167*Ibid.* [↑](#footnote-ref-153)
153. 168Treas. Reg. § 1.613-4(c)(6). See also United States v. Henderson Clay Prod., 324 F.2d 7 (5th Cir. 1963), *cert. denied*, 377 U.S. 917 (1964); Henderson Clay Prod. v. United States, 377 F.2d 349 (5th Cir. 1967). Both of these cases precede the above regulatory provision although the latter decision refers to the proposed version of these regulations. In Exxon v. United States, 88 F.3d. 968 (Fed. Cir. 1996), the Court analyzed at length Treas. Reg. § 1.613-3(a) which only applies to ***oil*** and gas and which does not contain the cited presumption. It concluded that even though the representative market or field price for the gas as determined by the taxpayer exceeded the taxpayer’s actual sales price, it was required by the regulations to accept the taxpayer’s representative market or field price. See, however, Rev. Rul. 90-62, 1990-2 C.B. 158, wherein the Service applied the 1963 Henderson Clay case to ***oil*** and gas. [↑](#footnote-ref-154)
154. 169Treas. Reg. § 1.613-4(c)(5). [↑](#footnote-ref-155)
155. 170Bloomington Limestone Corp. v. United States, 315 F. Supp. 1255 (S.D. Ind. 1970). [↑](#footnote-ref-156)
156. 171445 F.2d 1105 (7th Cir. 1971). [↑](#footnote-ref-157)
157. 171.1Henderson Clay Products, Inc. v. United States, 79-2 U.S.T.C. 9625 (Ct. Cl. 1979). [↑](#footnote-ref-158)
158. 171.2633 F.2d 565 (Ct. Cl. 1980). [↑](#footnote-ref-159)
159. 172Treas. Reg. § 1.613-4(e)(2)(i); Ayers Materials Co., 62 T.C. 557 (1974); Ideal Basic Industries, Inc., 82 T.C. 352 (1984). [↑](#footnote-ref-160)
160. 173Treas. Reg. § 1.613-4(e)(2)(i). See also Kaiser Steel Corp. v. United States, 411 F.2d 335 (9th Cir. 1969); P.L.R. 8619003. [↑](#footnote-ref-161)
161. 174Treas. Reg. § 1.613-4(e)(2)(iii). [↑](#footnote-ref-162)
162. 175*Ibid.* [↑](#footnote-ref-163)
163. 176Treas. Reg. § 1.482-1(b)(1). [↑](#footnote-ref-164)
164. 177*Ibid.* [↑](#footnote-ref-165)
165. [↑](#footnote-ref-166)
166. 179Treas. Reg. § 1.613-4(e)(1). See the discussion of discounts § 2.03[2][b][iv], *above.* [↑](#footnote-ref-167)
167. 180Treas. Reg. § 1.613-4(c)(4). [↑](#footnote-ref-168)
168. 181*Ibid.* [↑](#footnote-ref-169)
169. 182Treas. Reg. § 1.613-4(d)(1). See also Henderson Clay Prod., Inc. v. United States, 80-2 U.S.T.C. 9565 (Ct. Cl. 1980) (ball clay); North Carolina Granite Corp. 56 T.C. 1281 (1971), *acq.* 1974-2 C.B. 3; Rev. Rul. 77-13, 1977-1 C.B. 162 (muriate of potash); Rev. Rul. 76-389, 1976-2 C.B. 189 (granite and marble). See also the cases cited in n.154.

     A taxpayer who produced and sold magnesium oxide processed from magnesium hydroxide was required to use the proportionate profits method in Martin Marietta Corp. v. United States, n.157, *above.*

     Noting that gross income from property for geothermal resources is calculated in the same way that it is calculated for ***oil*** and gas, PLR 200308001 approves the taxpayer’s use of a method comparable to the proportionate profits method where a representative market or field price could not be established. Taxpayer produced geothermal resources, processed it, and then generated electricity which it sold. See the text above in this chapter to which n.164.10 is appended. [↑](#footnote-ref-170)
170. 183Treas. Reg. § 1.613-4(d)(1)(ii)(c). [↑](#footnote-ref-171)
171. 184Treas. Reg. § 1.613-4(d)(4)(ii). [↑](#footnote-ref-172)
172. 185Treas. Reg. § 1.613-4(d)(4)(iv).

     The Claims Court in Martin Marietta Corp. v. United States, 7 Cl. Ct. 573 (1985), ruled that the first marketable product from the sale of magnesium oxide produced by precipitation, dewatering, and ultimately calcining was that sale, rather than a constructive sale price at the cut-off point, because the statute contemplates a nonmining process being applied prior to obtaining this first marketable product. [↑](#footnote-ref-173)
173. 186*Ibid. See* the discussion and authorities in n. 199, *below*. [↑](#footnote-ref-174)
174. 187North Carolina Granite Corp., 56 T.C. 1281 (1971), *acq.* 1974-2 C.B. 3. [↑](#footnote-ref-175)
175. 187.1Treas. Reg. § 1.613-4(d)(4). [↑](#footnote-ref-176)
176. 187.2Treas. Reg. § 1.613-4(j)(1) and (2). [↑](#footnote-ref-177)
177. 188Treas. Reg. § 1.613-4(d)(4)(v). [↑](#footnote-ref-178)
178. 189*Ibid.* [↑](#footnote-ref-179)
179. 190Treas. Reg. § 1.613-4(d)(4)(v)(b). [↑](#footnote-ref-180)
180. 190.1In *Mitsubishi Cement Corporation & Subsidiaries v. Commissioner*, T.C. Memo 2018-152, the taxpayer was denied additional depletion allowances from increasing the gross sales of its first commercially marketable product from its actual sales to members of its controlled group. Taxpayer failed to establish that its own sales to noncontrolled purchasers were representative of the cement sales in taxpayer’s market for years in issue. The Court would not take them into account in determining representative market prices. The Court ruled that sales value of product sold to related taxpayers is the lesser of the actual price or the representative price—non-controlled sales. Even if the court held that taxpayer had proven representative market prices for the cement sales at issue, any increases to the taxpayer’s gross sales for the purpose of the proportionate profits method would be offset by adjustments required under Treas. Reg. § 1.613-4(e)(1). [↑](#footnote-ref-181)
181. 191Treas. Reg. § 1.613-4(d)(2). In Monsanto Co., 86 T.C. 1232 (1986), taxpayer purchased and used carbon as a reduction agent in furnaces to extract elemental phosphorous from nodulized phosphate rock. As a result of this nonmining process, taxpayer obtained CO gas from the carbon, which it used as a fuel in kilns to nodulize phosphate rock, a mining process. Taxpayer’s 25-year-old method of allocating the cost of the carbon between mining and nonmining was accepted by the Tax Court. In Rev. Rul. 84-36, 1984-1 C.B. 143, however, the taxpayer who burned carbon monoxide gas in a mining process for phosphate, which gas was produced as a by-product of a nonmining process at no extra cost, was not permitted to use value or allocable cost of gas as a mining cost in computing gross income from property by the proportionate profits method. This is because no actual cost for the gas was incurred. No mention was made in the ruling of the source of the CO. [↑](#footnote-ref-182)
182. 192*Ibid.* [↑](#footnote-ref-183)
183. 193*Ibid.* Monsanto Company, n.191, *above.* [↑](#footnote-ref-184)
184. 194Treas. Reg. § 1.613-4(d)(3)(ii). *Accord:* Commissioner v. Portland Cement Co. of Utah, 450 U.S. 156 (1981); U.S. Pumice Co. v. Commissioner, 647 F.2d 32 (9th Cir. 1981). [↑](#footnote-ref-185)
185. 195Treas. Reg. § 1.613-4(e)(2)(ii). [↑](#footnote-ref-186)
186. 196Treas. Reg. § 1.613-4(d)(3)(ii). See also *Mitsubishi Cement Corporation & Subsidiaries v. Commissioner*, TC Memo. 2017-160; the cost of additive materials was included in total costs and non-mining costs for purposes of the proportionate profits method. [↑](#footnote-ref-187)
187. 197*Ibid.* To the extent that the nondepletable material is essential to the mining process and does not constitute an additional source of the first marketable product, its cost has been found to be mining in nature. Martin Marietta Corp. ns.113 and 185 in the Supplement, *above.* [↑](#footnote-ref-188)
188. 198*Ibid.* See also “Depletion in the Cement Industry,” *P-H* ***Oil*** *& Gas Taxes* 2032, for a discussion of the treatment of such costs in the cement industry. [↑](#footnote-ref-189)
189. 199Treas. Reg. §§ 1.613-4(d)(3)(iii), 1.613-4(d)(4)(iv). [↑](#footnote-ref-190)
190. 200Commissioner v. Portland Cement Co. of Utah, 450 U.S. 156 (1981). This decision confirms: Whitehall Cement Mfg. Co. v. U.S., 369 F.2d 468 (3rd Cir. 1966); United States v. California Portland Cement Co., 413 F.2d 161 (9th Cir. 1969). It implicitly overrules: United States v. Ideal Basic Industries, Inc., 404 F.2d 122 (10th Cir. 1968), *cert. denied* 395 U.S. 936 (1969). [↑](#footnote-ref-191)
191. 201*Ibid.* In Rev. Rul. 84-70, 1984-1 C.B. 144, the Revenue Service ruled that dust collection systems applied in both wet and dry processes after introduction of the kiln feed into the kiln in the production of cement are nonmining. [↑](#footnote-ref-192)
192. 202Treas. Reg. §§ 1.613-4(d)(3)(iv), 1.613-5(c)(iv). [↑](#footnote-ref-193)
193. 203Commissioner v. Portland Cement Co. of Utah, N. 199.1, *above.* This decision confirms U.S. Pumice Co. v. Commissioner, 647 F.2d 32 (9th Cir. 1981); Rev. Rul. 84-82, 1984-1 C.B. 145. See also: Treas. Reg. § 1.613-5(c)(6); United States v. California Portland Cement Co., 413 F.2d 174 (9th Cir. 1969). In United States v. Ideal Basic Indus., Inc., 404 F.2d 122 (10th Cir. 1968), *cert. denied*, 395 U.S. 936 (1969), however, the court had concluded that such costs like the costs of bagging should be entirely excluded from the formula. [↑](#footnote-ref-194)
194. 204Treas. Reg. § 1.613-5(c)(6). [↑](#footnote-ref-195)
195. 205*Ibid.* [↑](#footnote-ref-196)
196. 206Treas. Reg. § 1.613-4(d)(1)(ii)(c); *accord*, Portland Cement Co. of Utah v. United States, 378 F.2d 91 (10th Cir. 1967), *cert. denied*, 389 U.S. 975 (1967). North Carolina Granite Corp., 56 T.C. 1281 (1971), *acq.* 1974-2 C.B. 3; Rev. Rul. 75-522, 1975-2 C.B. 241; PLR 7844006; PLR 8423003. [↑](#footnote-ref-197)
197. 207*Ibid.* [↑](#footnote-ref-198)
198. 208*Ibid.* The Revenue Service has now prescribed a procedure whereby approval for a method other than proportionate profits may be obtained if the proposed method more clearly and consistently reflects gross income from property. Rev. Proc. 74-43, 1974-2 C.B. 496. [↑](#footnote-ref-199)
199. 209Treas. Reg. § 1.614-4(d)(1)(ii)(c). [↑](#footnote-ref-200)
200. 210Treas. Reg. § 1.613-4(d)(5)–(7). [↑](#footnote-ref-201)
201. 211Discussion Draft Treas. Reg. § 1.613-3(d)(2)(viii); 34 Fed. Reg. 5735 (3/27/69). [↑](#footnote-ref-202)
202. 212*Ibid.* [↑](#footnote-ref-203)
203. 213By reason of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11522(a) (Nov. 5, 1990), *amending* 1986 I.R.C. § 613(a), for ***oil*** and gas only, the limit has been reduced from 50 percent to 100 percent of taxable income from property. For a brief description of the rules applicable to the taxable income from property limit for ***oil*** and gas percentage depletion, see: Internal Revenue Manual, 4.41.1.3.7.1.4—Net Taxable Income from the Property (02-01-2006).

     In Pub. L. No. 108-357, the American Jobs Creation Act of 2004, Congress replaced the extraterritorial income exclusion (ETI) with a 9 percent domestic deduction to be phased in for a range of domestic production activities which was a broad category ranging from moviemaking to software development to domestic mining operations. The base for the 9 percent deduction was either a net income figure for taxpayer’s production activities or § 63 taxable income. Apparently, the Conference Committee recognized, however, that without a specific statutory change § 199 might result in the 9 percent deduction being included in the calculation of taxable income from property for purposes of the 50 percent limitation. House Conference Report No. 108-755. Consequently, Congress attempted to amend § 613(a) by inserting in the parenthetical after “without allowances for depletion” the language “and without the deduction under section 199” in order to eliminate the possibility that the § 199 deduction would have to be included in the taxable income from property calculation. The Tax Cuts and Jobs Act of 2017 (TCJA) repealed the production activities deduction of Section 199 but added a new Section 199A which is a deduction equal to 20% of certain qualified business income. The deduction is for all taxpayers other than corporations and subject to certain limits based on wages or wages and qualified capital investment. Like the repealed-Section 199 deduction Congress recognized that the new Section 199A deduction might be included in determining the net income limitation to added in the parenthetical “and without regard to Section 199A”. See the discussion below in Ch.6 regarding Section 199A. [↑](#footnote-ref-204)
204. 214Treas. Reg. § 1.613-5(a). Though the extraterritorial income exclusion (ETI) of § 114 of the Code and the foreign sales corporation deduction (FSC) of § 927 of the Code have been repealed, the ETI in 2004 and the FSC in 2000, question still remains whether either or both had to be excluded from gross income from property in order to compute taxable income from property. It would seem, however, that the regulatory prescription that excludible deductions for this purpose be limited to those “attributable to mining processes” as indicated in the quote to which this note is appended should be determinative. Like the §§ 199 and 199A deductions discussed above in the immediately preceding note, the ETI exclusion and the FSC deduction do not seem “attributable to mining processes.” See Ch. 12, Section 12.05[2][c], *below*, for a discussion of the Section 250 deduction for Foreign Derived Intangible Income (FDII). [↑](#footnote-ref-205)
205. 215*Ibid.* In Rev. Rul. 83-134, 1983-2 C.B. 103, the taxpayer who used book costs to compute gross income from property under the proportionate profits method was required to use tax costs in computing taxable income from property. [↑](#footnote-ref-206)
206. 216*Ibid.* *See also* Tennessee Consol. Coal Co., 15 T.C. 424 (1950) (dealing with the need to allocate between mineral and other activities), *acq.* Mel Dar Corp., T.C. Memo 1960-56 (dealing with the need to allocate between mineral and other activities), *rev’d and aff’d on other grounds*, 309 F.2d 525 (9th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963); Occidental Petroleum Corp., 55 T.C. 115 (1970) (dealing with the need to allocate between separate mineral properties), *acq.* 1971-2 C.B. 3. [↑](#footnote-ref-207)
207. 217952 F.2d 885, *rev’g and remanding* 89 T.C. 371 (1987). [↑](#footnote-ref-208)
208. 218952 F.2d, at 888. [↑](#footnote-ref-209)
209. 219952 F.2d, at 889. [↑](#footnote-ref-210)
210. 220*Ibid.*, *citing* GCM 39099 (12-21-83). [↑](#footnote-ref-211)
211. 221952 F.2d, at 890. [↑](#footnote-ref-212)
212. 222*Ibid.* [↑](#footnote-ref-213)
213. 223*Ibid.* [↑](#footnote-ref-214)
214. 224*Ibid.* [↑](#footnote-ref-215)
215. 225GCM 38470 (8-12-80); Rev. Rul. 60-74, 1960-1 C.B. 253; Rev. Rul. 80-317, 1980-2 C.B. 202; F.H.E. ***Oil*** Co. v. C.I.R., 3 T.C. 13 (1944), *aff’d on another issue*, 147 F.2d 1002 (5th Cir. 1945), Acq. 1960-1 C.B. 4, *non-acq*. 1944 C.B. 8 *withdrawn, acq*. 1944 C.B. *withdrawn*; United States Potash Co., 29 T.C. 1071 (1958). See also the other authorities cited and discussed hereinbelow in § 2.03[3][b]. *Compare with:* GCM 39099 (12-21-83), which concludes that GCM 38470 no longer is correct. [↑](#footnote-ref-216)
216. 226952 F.2d, at 891. [↑](#footnote-ref-217)
217. 227952 F.2d at 892, *citing the* Occidental Petroleum Corp case, *above*, N. 213. [↑](#footnote-ref-218)
218. 228952 F.2d, at 893. For a discussion of the Tax Court’s decision in the Shell Case and the issue of the allocation of interest expense, see § 2.03[3][b][vii], *below.* [↑](#footnote-ref-219)
219. 2292001-2 U.S.T.C. 50,509. [↑](#footnote-ref-220)
220. 230*Id.* Chevron U.S.A., Inc. v. United States, No. 93-0660 (S.D. Tex. Feb. 28, 1995), *aff’d mem*., 81 F.3d 154 (5th Cir. 1996), *was cited as authority* for the result. The Court *distinguished* Rev. Rul. 84-68, 1984-1 C.B. 31, and Transamerica Corp. v. United States, 7 Cl. Ct. 119 (1984), in which the subsidiary in each of those rulings was allowed to deduct expenses incurred by the parent because the expenses borne by the parent in each was the expense of the subsidiary. The payment by the parent in each was simply treated as a contribution to the subsidiary’s capital. [↑](#footnote-ref-221)
221. 231Treas. Reg. § 1.613-2(c)(2). [↑](#footnote-ref-222)
222. 232Louisiana Land and Exploration, 102 T.C. 21 (1994), *non-acq.* 1995-2 C.B. 1. See AOD 1995-008 which discusses the nonacquiescence. [↑](#footnote-ref-223)
223. 233Treas. Reg. § 1.613-5(c)(1). [↑](#footnote-ref-224)
224. 234Rev. Rul. 68-214, 1968-1 C.B. 299. [↑](#footnote-ref-225)
225. 235I.R.C. § 263(c). [↑](#footnote-ref-226)
226. 236Treas. Reg. § 1.613-5(c)(2). [↑](#footnote-ref-227)
227. 237Rev. Rul. 77-136, 1977-1 C.B. 167. See also Central ***Oil*** Co. v. United States, 71-1, U.S.T.C. 9257 (D.C. Miss. 1971), *rev’d on other issues*, 460 F.2d 412 (5th Cir. 1972). [↑](#footnote-ref-228)
228. 238Treas. Reg. § 1.613-5(c)(3). [↑](#footnote-ref-229)
229. 239See the discussion of bonus recapture in Ch. 3, *below*. [↑](#footnote-ref-230)
230. 240*Ibid.* [↑](#footnote-ref-231)
231. 241Treas. Reg. § 1.613-5(c)(4). [↑](#footnote-ref-232)
232. 242*Ibid.* [↑](#footnote-ref-233)
233. 243*Ibid.* [↑](#footnote-ref-234)
234. 244*Ibid.* [↑](#footnote-ref-235)
235. 245*Ibid.* *Accord:* Commissioner v. Portland Cement Company of Utah, 450 U.S. 156, 168–169 (1981); Rev. Rul. 84-82, 1984-1 C.B. 145. Before the Portland Cement case, the Service had taken the position that if there were no unintegrated miners, then Treas. Reg. § 1.613-5 did not apply and consequently selling expenses had to be allocated. *See* GCM 36863. However, the Portland Cement case clearly disposes of this earlier position. [↑](#footnote-ref-236)
236. 246Treas. Reg. § 1.613-5(c)(4)(iv). [↑](#footnote-ref-237)
237. 247*Ibid.* [↑](#footnote-ref-238)
238. 248Montreal Mining Co., 2 T.C. 688 (1943), *aff’d*, 44-2 U.S.T.C. 9490 (6th Cir. 1944); Grison ***Oil*** Corp., 42 B.T.A. 1117 (1940). [↑](#footnote-ref-239)
239. 249***Kern*** ***Oil*** Co., Ltd., 9 T.C. 1204 (1947). [↑](#footnote-ref-240)
240. 250Montreal Mining Co., 2 T.C. 688 (1943), *aff’d*, 44-2 U.S.T.C. 9490 (6th Cir. 1944). [↑](#footnote-ref-241)
241. 251*Ibid.* [↑](#footnote-ref-242)
242. 252See Treas. Reg. § 1.613-5(c)(5). [↑](#footnote-ref-243)
243. 253Rev. Rul. 79-27, 1979-1 C.B. 217. [↑](#footnote-ref-244)
244. 254*Ibid.* [↑](#footnote-ref-245)
245. 255Rev. Rul. 66-226, 1966-2 C.B. 239. Presumably this applies to other § 39 credits. [↑](#footnote-ref-246)
246. 256Tech. Adv. Mem. 7808003 (Nov. 11, 1977). [↑](#footnote-ref-247)
247. 257*Ibid.* [↑](#footnote-ref-248)
248. 258Treas. Reg. § 1.613-5(c)(5). [↑](#footnote-ref-249)
249. 259Treas. Reg. § 1.613-5(c)(6). [↑](#footnote-ref-250)
250. 260St. Mary’s ***Oil*** & Gas Co., 42 B.T.A. 270 (1940). In a field service advice dated Dec. 9, 1994, the Chief Counsel ruled that interest paid by a corporate parent on a loan the proceeds of which were contributed to the capital of a subsidiary and member of its consolidated group which subsidiary owned and operated a mineral property could not be allocated to the subsidiary for purposes of the 50 percent of taxable income from property limitation under those § 1.613-5 regulations, the consolidated return regulations, § 483 or § 163 since the debt in substance and form was that of the parent not the subsidiary. [↑](#footnote-ref-251)
251. 261St. Louis, Rocky Mt., & Pac. Co., 28 T.C. 28 (1957). [↑](#footnote-ref-252)
252. 262Holly Dev. Co., 44 B.T.A. 51 (1941). [↑](#footnote-ref-253)
253. 263General Portland Cement Co. v. United States, 628 F.2d 321, 80-2 U.S.T.C. ¶ 9720 (5th Cir. [D. Tex.] 1980); Ideal Basic Industries, Inc., 82 T.C. 352 (1984); see also Dresser Industries, Inc. v. C.I.R., 911 F.2d 1128, 90-2 U.S.T.C. ¶ 50,505 (5th Cir. [T.C.] 1990)—applying *General Portland* rationale to I.R.C. §§ 861 and 994 dealing with netting of interest income and expense by Domestic International Sales Corporations (DISCs). But see Consolidated Edison Company of New York, 92-2 U.S.T.C. ¶ 50,568 (D. N.Y. 1992)—full amount of real estate paid was deductible and discount was considered nontaxable income because it was interest from municipal obligation. [↑](#footnote-ref-254)
254. 264I.R.C. § 163(j)(1); there is an exemption provided for certain small businesses with average annual gross receipts less than $25 million (Section 163(j)(3)). [↑](#footnote-ref-255)
255. 264.1Public Law 116-136 (2020) redesignating Section 163(j)(10), as amended by the TCJA, as new Section 163(j)(11), and adding a new Section 163(j)(10) providing special rules for applying Section 163(j) to taxable years beginning in 2019 or 2020. [↑](#footnote-ref-256)
256. 264.2Section 163(j)(10). [↑](#footnote-ref-257)
257. 265I.R.C. § 163(j)(8)(A) and (B). [↑](#footnote-ref-258)
258. 266I.R.C. § 163(j)(5). [↑](#footnote-ref-259)
259. 267I.R.C. § 163(j)(2). [↑](#footnote-ref-260)
260. 268I.R.C. § 163(j)(7). [↑](#footnote-ref-261)
261. 269I.R.C. § 163(j)(4). [↑](#footnote-ref-262)
262. 270It is important to note that nowhere in the Code or Treasury Regulations is a provision that requires such a simultaneous equation for the determination of taxable income. In F.S.A. 200126015, (March 28, 2001) the interaction of the FSC regime and the § 936 tax credit was discussed and the IRS concluded that that one calculation should be performed before the other. [↑](#footnote-ref-263)
263. 271Final regulations were published in the Federal Register on September 14, 2020 (T.D. 9905; 85 FR 56686) along with accompanying proposed regulations that provide additional guidance on several other aspects of the limitation, including (i) substantially revised rules for applying the limitation to US shareholders of controlled foreign corporations (CFCs), (ii) rules for foreign persons with effectively connected income (ECI), and (iii) specific aspects of the limitation as applied to partnerships, including partnerships engaged in the trade or business of trading personal property (REG-107911–18; 85 FR 56846). These final and proposed regulations replace earlier proposed regulations published on December 28, 2018, (REG-106089-18, 83 FR 67490). The final regulations generally are effective and generally apply to tax years beginning 60 days on or after the date the regulations are published in the Federal Register (November 13, 2020) and the proposed regulations will apply to tax years beginning 60 days on or after the date they are published as final in the Federal Register. Subject to certain requirements, taxpayers generally may apply the final and proposed regulations before their applicability date, or may apply the proposed regulations released in 2018 (2018 Proposed Regulations), but generally must apply any set of regulations in their entirety. On January 19, 2021 Treasury and the IRS published final regulations (2021 final regulations) that finalize much of the 2020 proposed regulations but reserve on several items (TD 9943, 86 FR 5496 (January 19, 2021)). [↑](#footnote-ref-264)
264. 271.1Treas. Reg. § 1.163(j)-1(b)(43) Tentative taxable income is generally determined in the same manner as taxable income under Section 63, but is computed without regard to the application of the section 163(j) limitation, and without regard to any disallowed business interest expense carryforwards. The 2018 proposed regulations specifically coordinated the application of Section 163(j) with the determination of the deduction under Section 250 for foreign derived intangible income (FDII) indicating that the FDII limitation would be determined without regard to Section 163(j) and the regulations (Prop. Reg. § 1.163(j)-1(b)(37)(ii)). In the preamble to the final regulations the Treasury and IRS determined that further study is required to determine an appropriate rule to coordinate Section 250 and other provisions “that limit the availability of deductions based, directly or indirectly, upon a taxpayer’s taxable income (taxable income-based provisions)” with the interest expense limitation rules. Accordingly, the final regulations do not contain a rule to coordinate “taxable income-based provisions” with the interest expense limitation rules. The preamble goes on to indicate that “until such additional guidance is effective, taxpayers may choose any reasonable approach (which could include an ordering rule or the use of simultaneous equations) for coordinating taxable income-based provisions as long as such approach is applied consistently for all relevant taxable years” (see 85 FR 56703). [↑](#footnote-ref-265)
265. 271.2Treas. Reg. § 1.163(j)-3. [↑](#footnote-ref-266)
266. 271.3Treas. Reg. § 1.163(j)-3(b)(5). [↑](#footnote-ref-267)
267. 271.4Treas. Reg. § 1.163(j)-1(b)(1)(iii); the 2018 proposed regulations indicated that depreciation, amortization or depletion expense that is capitalized into inventory under Section 263A would not be a deduction for purposes of arriving at ATI. As a result these amounts would not have been added back in taxable years beginning before January 1, 2022. In addition, in CCA 202123007 (June 11, 2021) the IRS concludes that depreciation would also include the cumulative effect adjustment under Section 481(a) for a change in accounting method for depreciation. [↑](#footnote-ref-268)
268. 271.5Treas. Reg. § 1.263A-1(e)(3)(ii)(J). [↑](#footnote-ref-269)
269. 27289 T.C. 371 (1987) *rev’d on other gds*, 952 F.2d 885 (5th Cir. 1992). For a discussion of the Fifth Circuit’s decision about determining taxable income from property and the regulations under § 1.613, see § 2.03[3][a], *above.* [↑](#footnote-ref-270)
270. 27389 T.C. 371, 387–395. The interest at issue was the result of two loans the taxpayer entered into to finance its acquisition of certain ***oil*** and gas properties. The loans were made based on the taxpayer’s general credit and were not secured by any particular asset. Both credit agreements contained a clause stating that the proceeds of the loan were to be used solely for the purpose of making payments on the loan. The Tax Court held that this clause did not create a legal compulsion in the taxpayer to apply the proceeds in accordance with the provision. However, the Court did intimate that if the loans had been secured by the specific assets acquired, the interest might be deemed a direct cost of that asset. 89 T.C. at 393. [↑](#footnote-ref-271)
271. 274Treas. Reg. § 1.613-5(a). [↑](#footnote-ref-272)
272. 27589 T.C. at 388. The IRS attempted to argue that since the interest expense was traceable directly to the acquisition of specific properties, the interest was not attributable to all activities and should be treated as a direct cost of acquiring those properties. The taxpayer maintained that since the debt was not secured by any particular asset and there was no requirement that the debt be repaid only with funds generated by the asset acquired, the expense was allocable to all activities. The taxpayer further supported its position by referencing the interest allocation regulations under Treas. Reg. § 1.861-8(a)(1), which generally treats interest expense as attributable to all of the taxpayer’s activities. [↑](#footnote-ref-273)
273. 27689 T.C. at 394–95. [↑](#footnote-ref-274)
274. 277See discussion in Section [3][b][x] Miscellaneous below regarding other deductions and business interruption insurance. [↑](#footnote-ref-275)
275. 278See 97 Tax Notes Today 206–233. [↑](#footnote-ref-276)
276. 279Lamaghi Coal Co. v. C.I.R., 124 F.2d 645 (8th Cir. 1942); Tennessee Consol. Coal Co., 15 T.C. 424 (1950), *acq.;* Rocky Mt. ***Oil*** Co., 36 B.T.A. 365 (1937); Mel Dar Corp., T.C. Memo 1960-056. [↑](#footnote-ref-277)
277. 280Rialto Mining Corp., T.C. Memo 1946-148. [↑](#footnote-ref-278)
278. 281Rocky Mt. ***Oil*** Co., 36 B.T.A. 365 (1937). [↑](#footnote-ref-279)
279. 282Crews v. C.I.R., 89 F.2d 412 (10th Cir. 1937). [↑](#footnote-ref-280)
280. 283C.I.R. v. American Gilsonite Co., 259 F.2d 654 (10th Cir. 1958), *cert. denied*, 359 U.S. 925 (1959). Payments to pension plan ruled deductible for taxable income from property in Tech. Adv. Mem. 7842008. In Rev. Rul. 84-46, 1984-1 C.B. 146, the Revenue Service took the position that payments to a Section 404(a)(5) nonqualified deferred compensation plan that are deductible for purposes of computing § 63 taxable income are deductible in computing the taxpayer’s taxable income from property for purposes of the 50 percent limitation. [↑](#footnote-ref-281)
281. 284Montreal Mining Co., 41 B.T.A. 399 (1940). [↑](#footnote-ref-282)
282. 285Elk Lick Coal Co., 23 T.C. 585 (1954). The Tax Court has ruled that salvage income on the sale of maintenance and other supplies, the cost of which was previously deducted for purposes of the 50 percent limitation, cannot be netted against production costs for the year of sale before deducting the latter costs in determining taxable income from property. Island Creek Coal Co., 30 T.C. 370 (1958). This holding seems incorrect in light of the treatment of depreciation recapture as noted in § 2.03[3][a] *above*, discounts as noted above in § 2.03[3][b][i] *above*, and interest income as noted in N. 242 of § 2.03[3][b][vii] *above.* In PLR 9131004, however, a taxpayer was required to capitalize amounts attributable to abandonment losses because the losses were sustained as a result of demolition. § 280b requires demolition cost to be capitalized as land basis. [↑](#footnote-ref-283)
283. 286Island Creek Coal Co., 30 T.C. 370 (1958); U.S. Potash Co., 29 T.C. 1071 (1958), *acq.*, F.H.E. ***Oil*** Co., 3 T.C. 13 (1944), *acq.* 1960-1 C.B. 4. [↑](#footnote-ref-284)
284. 287Rev. Rul. 60-164, 1960-1 C.B. 254. [↑](#footnote-ref-285)
285. 288Proposed Treas. Reg. § 1.613-4, 33 Fed. Reg. 10692 (July 26, 1968); Discussion Draft Treas. Reg. § 1.613-4, 34 Fed. Reg. 5728, 5738 (March 27, 1969). These proposals were not, of course, perpetuated in the current regulations finalized on March 10, 1972. [↑](#footnote-ref-286)
286. 289Mallary v. United States, 238 F. Supp. 87 (D.C. Ga. 1965). [↑](#footnote-ref-287)
287. 290North Carolina Granite Corp., 56 T.C. 1281 (1971). [↑](#footnote-ref-288)
288. 2911974-2 C.B. 5; Rev. Rul. 77-179, 1977-1 C.B. 168, *declared obsolete*, in Rev. Rul. 86-44, 1986-1 C.B. 376. [↑](#footnote-ref-289)
289. 292Island Creek Coal Co. v. Commissioner, 382 F.2d 35 (4th Cir. 1967). [↑](#footnote-ref-290)
290. 293Rev. Rul. 80-317, 1980-2 C.B. 202. [↑](#footnote-ref-291)
291. 294P.L.R. 7842097; Chief Couns. Adv. 200952054. [↑](#footnote-ref-292)
292. 295I.R.C. § 250(a)(3). [↑](#footnote-ref-293)
293. 295.185 FR 56703; The Joint Committee *General Explanation of Pubic Law 115-97* (December 2018) indicates that the limitation on FDII is determined after the limitations imposed under Section 163(j) for interest and Section 172 for net operating losses; “the section 250 deduction is computed after applying the limitation on the deduction for business interest (sec. 163(j)) and the limitation on the deduction for NOLs (sec. 172).” Footnote 1727, page 377. [↑](#footnote-ref-294)
294. 296Treas. Reg. § 1.613-5(a). [↑](#footnote-ref-295)
295. 297Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D). [↑](#footnote-ref-296)
296. 298U.S. Joint Comm. on Taxation, Technical Explanation of the Senate Amendment to H.R. 4986, ¶ 58. [↑](#footnote-ref-297)
297. 299Treas. Reg. § 1.613-4(b). [↑](#footnote-ref-298)
298. 300T.D. 8126, filed with the Federal Register on March 2, 1987. [↑](#footnote-ref-299)
299. 301See Miller’s ***Oil*** and Gas Taxes (CCH 1978), ¶ 10-4. The treatment of bonus payments is covered in detail in Ch. 3, *below*. [↑](#footnote-ref-300)
300. 302Treas. Reg. § 1.613-5(a). However, some argue that this regulatory provision refers to Treas. Reg. §§ 1.613-4 and 1.613-3 but not to Treas. Reg. § 1.613-2(a), where the bonus exclusion rule is set out. Consequently, it is argued that the regulations do not contemplate bonus exclusion for purposes of determining taxable income from property. [↑](#footnote-ref-301)
301. 303Treas. Reg. § 1.613-2(c)(5)(ii). [↑](#footnote-ref-302)
302. 304Rev. Rul. 79-73, 1979-1 C.B. 218. *See also*: Transco Exploration Co. v. Commissioner, 95 T.C. 373 (1990), *aff’d*, 949 F.2d 837 (5th Cir. 1992), holding that bonus is excludable from gross income from property for purposes of determining taxable income from property in the context of the Windfall Profits Tax. [↑](#footnote-ref-303)
303. 305See the authorities cited in ns. 17 and 18 in § 5.01[1] *below.* [↑](#footnote-ref-304)
304. 306See the discussion in § 5.01[1] *below.* [↑](#footnote-ref-305)
305. 307See the discussion in Ch. 4, *below*. [↑](#footnote-ref-306)
306. 308Central ***Oil*** Co. v. United States 71-1 U.S.T.C. ¶ 9257 (D.C. Miss. 1971) *rev’d on other gds*, 460 F.2d 412 (5th Cir. 1972); Rev. Rul. 58-231, 1958-1 C.B. 247, *superseded*, by Rev. Rul. 77-136, 1977-1 C.B. 167. [↑](#footnote-ref-307)
307. 309*Ibid.* [↑](#footnote-ref-308)
308. 310Shell ***Oil*** Co., 89 T.C. 371 (1987) *rev’d on other gds*, 952 F.2d 885(5th Cir. 1992). [↑](#footnote-ref-309)
309. 311952 F.2d 885 (5th Cir. 1992). [↑](#footnote-ref-310)
310. 312I.R.C. § 1016(a)(2); Treas. Reg. § 1.1016-3(e); Winnsboro Granite Corp., 32 T.C. 974 (1959), *aff’d*, 283 F.2d 307 (4th Cir. 1960); Frank Lyons, 10 T.C. 634 (1948). [↑](#footnote-ref-311)
311. 313See also American Sulphur Royalty Co. of Tex., 34 B.T.A. 439 (1936). [↑](#footnote-ref-312)
312. 314Treas. Reg. § 1.1016-3(e)(2). [↑](#footnote-ref-313)
313. 315James Petroleum Corp., 24 T.C. 509 (1955), *acq.* 1956-1 C.B. 4, *aff’d*, 238 F.2d 678 (2d Cir. 1956), *cert. denied*, 353 U.S. 910 (1957). [↑](#footnote-ref-314)
314. 316See Perkins v. Thomas, 86 F.2d 954 (5th Cir. 1936), *aff’d*, 301 U.S. 655. See also Rev. Rul. 67-451, 1967-2 C.B. 267. [↑](#footnote-ref-315)
315. 317Rev. Rul. 73-537, 1973-2 C.B. 197. [↑](#footnote-ref-316)
316. 318Rev. Rul. 77-79, 1977-1 C.B. 34. [↑](#footnote-ref-317)
317. 319Pittsburg Terminal Corp., 60 T.C. 80 (1973), *aff’d*, (3rd Cir. 1974); Winnsboro Granite Corp., 32 T.C. 974 (1959), *aff’d*, 283 F. 2d 307 (4th Cir. 1960); Louisiana Iron & Supply Co., 44 B.T.A. 1244 (1941), *acq.* 1941-2, C.B. 8; Rev. Rul. 75-451, 1975-2 C.B. 330, *superseding* Rev. Rul. 54-421, 1954-2 C.B. 162; GCM 22239, 1940-2 C.B. 105. [↑](#footnote-ref-318)
318. 320*Ibid.* See also Beulah B. Crane, 3 T.C. 585 (1944), *nonacq.* 1945 C.B. 8, *rev’d on other grounds*, 153 F.2d 504 (2nd Cir. 1946), *aff’d*, 331 U.S. 1 (1947). [↑](#footnote-ref-319)
319. 321Rev. Rul. 75-451, 1975-2 C.B. 330, *superseding* Rev. Rul. 54-421, 1954-2 C.B. 162; GCM 22239, 1940-2 C.B. 105. In view of the depletion recapture requirements added to section 1254 by the Tax Reform Act of 1986, Rev. Rul. 75-451 provides a possible disincentive to the Revenue Service when depletion is taken following a capital addition to the property which restores the basis to a positive value. *See* § 5.05, *below*, for a discussion of this recapture requirement. [↑](#footnote-ref-320)
320. 322See § 2.03[2][a]. [↑](#footnote-ref-321)
321. 323Helvering v. Mountain Producer’s Corp., 303 U.S. 376 (1938). [↑](#footnote-ref-322)
322. 324*Ibid.* [↑](#footnote-ref-323)
323. 325*Id.*, at 382. [↑](#footnote-ref-324)
324. 326*Ibid.* There is some question whether the buyer would be able to take depletion on the excess of the value of the production if the taxpayer could not. The Court notes without indicating any agreement or disagreement that the taxpayer assumed that it alone had an economic interest in the property. *Id.*, at p. 380. However, in a landmark ruling, GCM 22730, 1941-1 C.B. 214, 220, the Revenue Service indicated that the buyer did acquire an economic interest. If the buyer did not, though, then, of course, depletion was lost. Nevertheless, *Mountain Producer* could be applied to other tolling-type situations, as discussed in § 2.03[5][b], wherein the party who is applying a mining process but who is remitting a net amount only does not have an economic interest. [↑](#footnote-ref-325)
325. 327U.S. Steel Corp. v. United States, 445 F.2d 520 (2d Cir. 1971), *aff’g* 270 F. Supp. 253 (S.D.N.Y. 1967); Camp Concrete Rock Co. v. United States, 276 F.2d 211 (5th Cir. 1960), *aff’g* 181 F. Supp. 806 (S.D. Fla. 1959); Riley v. Douglass, 221 F.2d 146 (9th Cir. 1955); Burt v. United States, 170 F. Supp. 953 (Ct. Cl. 1959); Winifred E. Higgins, 33 T.C. 161 (1959); Estate of Thomas E. Arnett, 31 T.C. 320 (1958); Morrisdale Coal Mining Co., 19 T.C. 208 (1959); James P. Evans, Sr., 11 T.C. 726 (1948); Oliver Iron Mining Co., 10 T.C. 908 (1948); Barnhart-Morrow Consol., 47 B.T.A. 590 (1942), *aff’d*, 150 F.2d 285 (9th Cir. 1945); Sam Duman, T.C. Memo 1967-161; Rev. Rul. 60-98, 1960-1 C.B. 252; Rev. Rul. 74-568, 1974-2 C.B. 183. [↑](#footnote-ref-326)
326. 328See Ch. 9. [↑](#footnote-ref-327)
327. 329Helvering v. Mountain Producer’s Corp., 303 U.S. 376 (1938). [↑](#footnote-ref-328)
328. 330A. Duda & Sons, Inc. v. United States, 560 F.2d 669 (5th Cir. 1977), *rev’g* 383 F. Supp. 1303 (D. Fla. 1974). [↑](#footnote-ref-329)
329. 331Rev. Rul. 55-730, 1955-2 C.B. 53. [↑](#footnote-ref-330)
330. 332A. Duda & Sons, Inc. v. United States, 560 F.2d 669, at 677–87, (5th Cir. 1977), *rev’g* 383 F. Supp. 1303 (D. Fla. 1974). [↑](#footnote-ref-331)
331. 333Roundup Coal Mining Co., 20 T.C. 388 (1953). [↑](#footnote-ref-332)
332. 334*Id.*, at 398. [↑](#footnote-ref-333)
333. 335Woodward Iron Co. v. Patterson, 173 F. Supp. 251 (N.D. Ala. 1959). [↑](#footnote-ref-334)
334. 336United States v. Henderson Clay Prod., 324 F.2d 7 (5th Cir. 1963). [↑](#footnote-ref-335)
335. 337*Ibid.* [↑](#footnote-ref-336)
336. 338*Ibid.* [↑](#footnote-ref-337)
337. 339United States v. Shurbet, 347 F.2d 103 (5th Cir. 1965), holding cost depletion allowable to a farmer who produced an exhaustible, natural deposit of groundwater and used it in his farming operation; A. Duda & Sons, Inc. v. United States, 560 F.2d 669 (5th Cir. 1977), *rev’g* 383 F. Supp. 1303 (D. Fla. 1974). [↑](#footnote-ref-338)
338. 340Rev. Rul. 68-665, 1968-2 C.B. 280; Rev. Rul. 67-303, 1967-2 C.B. 221; Rev. Rul. 55-730, 1955-2 C.B. 53. [↑](#footnote-ref-339)
339. 341Rev. Rul. 68-665, 1968-2 C.B. 280. Accord: PLR 6709206380A. [↑](#footnote-ref-340)
340. 342*Ibid.* [↑](#footnote-ref-341)
341. 343Rev. Rul. 67-303, 1967-2 C.B. 221. Accord: PLR 6403121740A. [↑](#footnote-ref-342)
342. 344Rev. Rul. 55-730, 1955-2 C.B. 53. [↑](#footnote-ref-343)
343. 345*See* GCM 32742; GCM 39132. [↑](#footnote-ref-344)
344. 346Helvering v. Mountain Producer’s Corp., 303 U.S. 376 (1938). [↑](#footnote-ref-345)
345. 347See the text to which ns. 332 and 339, *above*, are appended. [↑](#footnote-ref-346)
346. 348*Ibid.* [↑](#footnote-ref-347)
347. 349*Ibid.* [↑](#footnote-ref-348)
348. 350For a discussion of the treatment of bonus and royalty received by a lessor in consideration for the lease of the minerals and a transfer of equipment and/or surface rights, see § 8.03[3], *below.* [↑](#footnote-ref-349)
349. 351Estate of Thomas E. Arnett, 31 T.C. 320 (1958), *acq.* 1959-1 C.B. 3; T.W. Blake Jr., 20 T.C. 721 (1953). In P.L.R. 8637124 as clarified in P.L.R. 8642020, the Revenue Service concluded that a court award of damages in favor of a royalty owner and against an operator for a failure to obtain an adequate price for gas produced and sold was depletable. [↑](#footnote-ref-350)
350. 352Pearl ***Oil*** Co., 40 B.T.A. 147 (1939). [↑](#footnote-ref-351)
351. 353See the discussion of the economic interest concept in Ch. 1, *above.* [↑](#footnote-ref-352)
352. 354Guthrie v. United States, 323 F.2d 142 (6th Cir. 1963). In GCM 39649, payments to surface owner for the right to conduct a seismic survey were ruled either ordinary rental or capital gain, depending on whether and to what extent the payments were for actual damage to the land. [↑](#footnote-ref-353)
353. 355Crossett Timber & Dev. Co., 29 B.T.A. 705 (1934). *Accord:* Estate of R.A. Lord, 1940 B.T.A.M. ¶ 40,146; Alphonzo E. Bell Corp., 1942 B.T.A.M. ¶ 42,399. [↑](#footnote-ref-354)
354. 356Rev. Rul. 77-57, 1977-1 C.B. 166. [↑](#footnote-ref-355)
355. 357Amherst Coal Co. v. United States, 295 F. Supp. 421 (S.D. W.Va. (1969), *aff’d per curiam*, (4th Cir. 1971). [↑](#footnote-ref-356)
356. 358See 5 Corbin on Contracts, § 1100. [↑](#footnote-ref-357)
357. 359*Ibid.* [↑](#footnote-ref-358)
358. 360See the discussion in § 3.04, *infra*, of analogous delay rental and shut-in royalty payments. [↑](#footnote-ref-359)
359. 361P.L.R. 7842097; Chief Counsel Atty. Memo 2009-008. In CCA 201722028 the IRS chief council indicates that the calculation of net income or depletion from ***oil*** and gas did not include hedging transactions for purposes of the tax preference for IDDCs. [↑](#footnote-ref-360)
360. 362Leechburg Mining Co., 15 T.C. 22 (1950); Keystone Coal Co., 30 T.C. 1008 (1958), *acq.* 1968-2 C.B. 2; Rev. Rul. 68-361, 1968-2 C.B. 264. See P.L.R. 7905006 wherein the Revenue Service ruled that a portion of the royalty on a coal lease did not have to be treated as rental for use of the surface. In a related matter, in Muldavin v. Commissioner, T.C. Memo 1997-531, the Tax Court held that a couple is limited to a 15-percent ***oil*** depletion for their royalty interest in an ***oil*** and gas lease extended to Shell ***Oil*** Company. [↑](#footnote-ref-361)
361. 363*Ibid.* These authorities indicate that the lessor may also take depreciation on such equipment where it is expressly so leased.

     In Mesa Petroleum Co. v. C.I.R., 58 T.C. 374 (1972), the lease provided that the lessors were to receive one-eighth of the proceeds from the actual sale of the gas and its products, reduced by one-eighth of the costs of transporting, processing, and marketing such gas and its products. This formula was used during 1965 by Mesa’s predecessor, pursuant to agreements with the landowners, to compute the royalty payments for all the lessors. Under this formula, the proceeds at the wellhead were 19.27 cents per MCF. The royalty payments, therefore, were 2.40875 cents per MCF (one-eighth of 19.27 cents). Apparently this formula resulted in the lessors’ sharing in profits on the transportation, processing, and marketing though not in the value added by the costs themselves. The problem in the case was due to the fact that the representative market or field price for gas at the wellhead during 1965 was 14 cents per MCF. The Tax Court agreeing with the Service in *Mesa Petroleum* ruled that the amount paid Lessor was excludible from Lessee-Taxpayer’s gross income from property determined using the representative market or field price. This resulted in Lessor’s getting 17.2 percent of the depletable income rather than one-eighth or 12.5 percent and Lessee-Taxpayer’s getting a *pro tanto* reduction in depletable income below the 87.5 percent.

     The Court in *Mesa Petroleum* rejected taxpayer’s alternative arguments that it be allowed to compute its depletion deduction on the basis of (1) seven-eighths of the total gross income from the property computed under the representative market or field price, regardless of the amounts paid the lessors as royalties, or alternatively, (2) seven-eighths of the total gross income from the property computed under a lease formula. On Taxpayer’s first argument, the Court concluded:

     Thus, the lessors were entitled under the leases to royalties in excess of one-eighth of what has been stipulated to have been the representative market or field price. They were entitled to one-eighth of the amounts actually received from the sale of the gas and its products, less a proportionate part of the transportation, processing, and marketing costs.

     The lessors’ rights under those leases measure the extent of their economic interests in the minerals in place. Kirby Petroleum Co. v. Commissioner, *above*, at 604. Under § 613(b)(1), they were entitled to a depletion allowance computed on the basis of 27 1/2 percent of what they were actually paid as royalties, and under the explicit provisions of section 613(a), the amounts paid to the lessors must be excluded from petitioner’s gross income in computing its percentage depletion deduction.

     The payments to the lessors in excess of the customary one-eighth of the production income constituted royalties. The payments were so described in the leases. The amounts so paid were the consideration given the lessors for the privilege of extracting gas from under their lands. The lessors made no investments either in petitioner’s transportation or processing facilities, and had no rights to share in the profits from those operations. Their income flowed solely from the amounts petitioner was willing to pay for the privilege of extracting the gas. *Cf.* Grandview Mines v. Commissioner, 282 F.2d 700, 703–704 (C.A. 9, 1960), *aff’g* 32 T.C. 759(1959).

     For the purpose of apportioning the percentage depletion deduction, no inequity is caused by the provisions of the leases calling for the lessors to be paid royalties on some other basis than one-eighth of the representative market or field price of the gas. Royalty payments may take a wide variety of forms. They may take the form of a bonus (or advanced royalties) for the execution of a lease, Burnet v. Harmel, 287 U.S. 103, 111(1932); they may be a percentage of the profits from the operation, Kirby Petroleum Co. v. Commissioner, *above*; Burton-Sutton ***Oil*** Co. v. Commissioner, *above* at 27; or, as in this case, they may be a percentage of the proceeds derived from the sale of processed gas, William D. Gray, 13 T.C. 265, 274(1949), affd. 183 F.2d 329 (C.A. 5, 1950). In all these situations, the royalty-owners are entitled to deductions for depletion based on what they are actually paid as royalties, and the lessees must deduct “this rent or royalty from their gross income from the sale of … (gas) from the property before taking the lessees’ depletion.” Kirby Petroleum Co. v. Commissioner, *above* at 605.

     The payment of royalties, in the instant case, in excess of one-eighth of the value of the gas at the wellhead does not create an inequity. Such larger payment merely demonstrates that the parties, when they negotiated the lease contracts, considered the exploitation rights conveyed thereby to be more valuable than one-eighth of the gas at the wellhead. Since petitioner acquired economic interests only in the gas not needed to pay the lessors’ royalties, it is entirely equitable that petitioner’s depletion allowance be based on the value of the wellhead gas to which it is entitled after paying such royalties. Burton-Sutton ***Oil*** Co. v. Commissioner, *above* at 34–35; Thomas v. Perkins, 301 U.S. 655, 662 (1937). As stated by the Supreme Court in Kirby Petroleum Co. v. Commissioner, *above* at 604:

     An equitable apportionment is obtained by excluding from the lessee’s gross income from ***oil*** or gas produced from the property, … [citation omitted] “an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property … .”

     Accordingly, we find no merit in petitioner’s contention that, notwithstanding the amounts actually paid to the lessors as royalties, it is entitled to depletion computed on the basis of seven-eighths of the representative market or field price of the gas.

     58 T.C., at 378–380.

     The Court disposed of Taxpayer-Lessee’s second argument by noting that depletable income is limited to the gross income from property as determined in this case by the representative market or field price. The Court stated, “To permit the use of that formula for the purpose of computing percentage depletion would improperly allow petitioner a depletion allowance on its gathering, manufacturing, and marketing profits.” 58 T.C., at 381. [↑](#footnote-ref-362)
362. 364Helen C. Brown, 22 T.C. 58 (1954), *acq.* 1954-2 C.B. 3. This may be a function of the economic interest requirement as it was applied in Southwest Exploration and Paragon Jewel Coal Co., discussed in Ch. 1, i.e., in such cases the lessor of the equipment would not be in the chain of title to the operating interest and his contribution to extraction would not be essential. However, these two cases are not cited in *Brown.* [↑](#footnote-ref-363)
363. 365Unconditionally due payments may be treated as installment purchase money for the equipment acquired to the extent at least of lessor’s unrecovered basis in the equipment. *See* the discussion, *infra*, at § 8.03[3][a]. It would seem that a characterization of such payments as rent would be difficult if the obligation to make the payments is unconditional, i.e., if it could survive the expiration of the mineral lease. [↑](#footnote-ref-364)
364. 366See the discussion of such payments in Ch. 3 *below.* [↑](#footnote-ref-365)
365. 367Ns. 315–317, *above.* [↑](#footnote-ref-366)
366. 368It should be noted that the Service in CCA 200805021 for purposes of determining qualification for Section 1341 treatment compares payments by lessee to lessor for the purchase of lessor’s share of the production with rental payments for the use of property and with royalty payments as a share of production. However the Service does not provide their view of the meaning of the word “rents” in Section 613(a). *See* the discussion of Section 1341(a) and the “claim of right” doctrine above in the Chapter in § 2.01[3][c]. [↑](#footnote-ref-367)
367. 369Arguably, even in this case such an obligation to pay would qualify as bonus. See the discussion of bonus in Ch. 3 *below.* [↑](#footnote-ref-368)
368. 370Pub. L. No. 95-227, 1978-1 C.B. 494, I.R.C. § 4121. This excise tax has been increased and extended several times, most recently in 2008 in PL 110-343, § 113. [↑](#footnote-ref-369)
369. 371Though no mention is made of the tax law governing tolling arrangements between processor-purchasers and miners and gross income from property for depletion purposes (*see* § 2.03[5][b], *above*), PLR 9224004 (6-12-92) deals with the appropriate base for this excise tax in the context of a coal purchaser who washes the coal before purchasing it. The result is consistent with Rev. Rul. 74-568, 1974-2 C.B. 183. [↑](#footnote-ref-370)
370. 372In P.L.R. 9642013, the Service concluded that materials from a refuse pile and burned for purposes of circulating fluidized bed boilers in a bituminous waste-fuel-fired small power production facility were not coal for purposes of the tax and consequently the tax was not due thereon. The refuse pile was originally created as a waste product from the wet beneficiation processes performed on bituminous coal from past mining operations. Reprocessing and recovery operations had been done by several reprocessors since the pile was originally created and a majority of the coal that existed in the original pile had been removed leaving material predominantly other than coal. See also PLR 201826003 where the Service ruled that a a taxpayer that converted waste coal into two different products, one that was used as a fuel and another that was used for agricultural purposes, was not subject to the coal excise tax. The taxpayer’s use of coal waste in its process to produce the fuel product and the taxpayer’s sale of that product were taxable only if the coal waste or the fuel product was “coal” per Section 4121(a) and the taxpayer was a “producer” per Section 4121(a), The Service held that as the coal waste was not “coal” and because the taxpayer was not a producer, its use of coal waste to produce the two products was not taxable per Section 4121(a) and that the taxpayer’s sale of the fuel product was not taxable per Section 4121(a). [↑](#footnote-ref-371)
371. 373I.R.C. Section 4121(e) reduces the excise tax rate to $.50 per ton of underground coal and $.25 per ton of surface coal or 2% of the price, which ever is lower for tax years beginning after December 31, 2020. [↑](#footnote-ref-372)
372. 374Rev. Rul. 79-27, 1979-1 C.B. 217. [↑](#footnote-ref-373)
373. 375*Ibid.* [↑](#footnote-ref-374)
374. 376MSSP Audit Guide for the Coal Excise Tax, 98 TNT 192-66. [↑](#footnote-ref-375)
375. 377*Ranger Fuel Corporation, et al, v. United States*, 33 F. Supp. 2d 466 (E.D. Va. 1998). [↑](#footnote-ref-376)
376. 3782000-21 I.R.B. 1116, Notice 2000-28. [↑](#footnote-ref-377)