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Memorandum

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Subject Calculation of Percentage Depletion for Mineral
Taxpayer Corporation
UILC: 611.00-00, 613.02-00, 613.02-06
TIN:
Tax year

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LEGAL ISSUE

Taxpayer Corporation (Taxpayer) mines (mineral) in and is entitled to a depletion allowance per I.R.C. § 611, as computed under Treas. Reg. § 1.613-4. Taxpayer uses some of its mined mineral to manufacture certain products (hereinafter also referred to as "manufactured mineral"), and sells the rest. At issue is how to calculate the percentage depletion allowance. Treasury regulations prescribe three bases for the calculation, those bases being gross income from the property, representative market or field price (RMFP), proportionate profits method (PPM), and if none of the foregoing is possible, any method that clearly reflects income.

Issue 1: Should one percentage depletion-allowance calculation be performed for all of the mined mineral, or should separate percentage depletion-allowance calculations for the mineral used to manufacture products and the sold mineral be performed?

Issue 2: Assuming just one calculation should be performed, how should that calculation integrate and combine the gross profit from the sold mineral and an assumed price (profit) from the manufactured mineral?

Issue 3: Taxpayer sold most of its mineral to at a volume discount price. Assuming separate calculations should be performed, should the percentage depletion allowance for this amount of mineral be calculated based on sale price (gross income from the property)?

Issue 4: Assuming separate calculations should be performed for mineral used by Taxpayer to manufacture products instead of being sold, can a volume discount price be considered as being RMFP per I.R.C. § 613 and as computed under Treas. Reg. § 1.613-4, or should Taxpayer be allowed to use the PPM?

CONCLUSION

Two percentage depletion allowance calculations should be performed, one for the mineral the taxpayer sold (to the large buyer and the smaller ones), and one for the rest that it processed and manufactured before selling. The latter calculation is based on the representative market or field price.

FACTS

Taxpayer owns a mineral interest in , in a certain geologic formation known as . have high mineral content. Taxpayer , use the mineral as a , in , for and , and for . Taxpayer . While Taxpayer uses its mined mineral in the manufacture of products, Taxpayer also sells its mined mineral.

During , Taxpayer sold approximately pounds of mineral to and to other purchasers unrelated to for more than . Taxpayer sold most of the pounds to , and only a small portion to the unrelated purchasers. The total price per pound of mineral sold to all customers was unrounded); the price per pound sold to non- customers was unrounded); and the price per pound sold to was unrounded). The reason for the difference in price between and non- customers is said to have been that obtained a volume discount and the mineral was part of a larger sales contract for a variety of products. Further, in response to IDR ENG-5, Taxpayer appears to contend that the price per pound sold to non- customers constituted the market price for mineral in : "All other customers purchasing mineral from Taxpayer Corporation during paid from per pound **which was market price** (emphasis added)." But in a memorandum to the engineer agent showing an apparent evolution of thought, Taxpayer argued that all of its sales were too minimal to establish a market price.

Taxpayer used approximately pounds of mineral in its own manufacturing business. Thus it sold approximately of its mined mineral.

Taxpayer used RMFP for a number of years, but decided it could not use it anymore and changed to PPM. The reason for doing this was that sales of mineral to were not a representative field price because of a volume (or other) discount, and sales of mineral to others were too insignificant to be representative. Taxpayer manufactured products (such as) with most of its mined mineral, for which a "price" does not exist.

Mineral is separated from by a chemical process. This is a mining process that does not affect sale price. Transport costs are borne by Taxpayer, but are separately stated. Treas. Reg. § 1.613-4(b) precludes the use of sale price to compute the depletion allowance when non-mining processes and transport costs are included; they are not an obstacle under our facts.

In calculating gross income for purposes of the percentage depletion deduction for mineral in , Taxpayer used a price of per pound. Taxpayer claims that this price was based on the median of Taxpayer's "published rate cards for mineral sales to third parties" in the two preceding years (and). The

Notice of Proposed Adjustment assumes that this method indicates Taxpayer's use of the RMFP method of calculating gross income. The NOPA determined, however, that the applicable price per pound under the representative market or field price was per pound. This amount is an arithmetic weighted average of all third-party sales, and includes the price paid by and the price paid by all others.

Taxpayer disagrees with the agent's method of calculation, on the ground that <u>all</u> sales to third parties were insignificant in comparison to the total amount of Taxpayer's mined mineral, and thus could not be indicative of true market price. Taxpayer further insists that its mineral sales to were "tied-in, exceptional and unusual," and that as such those sales could not be considered as evidence of market price under the RPFM. Finally, Taxpayer argues that the PPM method of computing gross income demonstrates an alternative, close connection to the sales prices for third parties and further avers that the sales price was not representative. Applying the PPM, Taxpayer now argues that the sale price is per pound, resulting in an additional depletion deduction.

LAW AND ANALYSIS

The Code allows a deduction for depletion in the case of mines and other natural deposits. I.R.C § 611(a). The percentage depletion rate allowed in the case of mineral from is 5% of gross income from the property. I.R.C. § 613(b)(6). Regulations prescribe the manner in which "gross income from the property" is calculated. Treas. Reg. § 1.613-4. In the case of mineral property other than oil and gas, "gross income from the property" means gross income from mining and is the amount of income that is attributable to the extraction of minerals from the ground and the application of mining processes, including mining transportation. Treas. Reg. § 1.613-4(a).

Issues 1 and 2: The regulations provide three methods of determining gross income from the property for purposes of the percentage depletion allowance. Under the first method, gross income from the property is the amount for which the crude mineral product is sold as it emerges from the mine before application of any nonmining processing or transportation. Treas. Reg. § 1.613-4(b). Under the second method, if the taxpayer processes its mineral by application of a nonmining process or uses it in its operations, then the RMFP determines gross income. Treas. Reg. § 1.613-4(c)(1). Under the third method, PPM applies if it is impossible to determine RMFP. Treas. Reg. § 1.613-4(d). Under PPM, the taxpayer calculates gross income by multiplying gross sales of the first marketable product resulting from processing by the costs and proportionate profits attributable to the processing. Id. at § 1.613-4(d)(4)(i) and (ii). Because an actual sale price exists for some but not all of the mineral, two calculations must be performed.

Issue 3: The parties in Gray Knox Marble Company v. United States, 257 F. Supp. 632 (E.D. Tenn. 1966), agreed that under the first rule set forth in the regulations the actual sale price of the material sold represented the gross income from that property. The court in that case noted that approvingly, since it obviously followed the rule in the regulations that if the taxpayer sells the mineral product, gross income from the property means the amount for which it is sold. This establishes gross income and the percentage depletion deduction for the approximately worth of mineral sold to and others.

Issue 4: Taxpayer did not sell the remaining pounds of mineral, rather it used this amount of mineral in its own manufacturing business; thus, we cannot use the first rule, but must rather decide whether RMFP, the second rule, applies. Per the regulations, RFMP must be determined by reference to prices received from the actual sale of a mineral product of like kind and grade. Treas. Reg. § 1.613-4(c)(2). The criterion that a mineral (the mineral that is sold) is of like kind and grade as the taxpayer's mineral (as actually processed by the taxpayer) is whether, in common commercial practice, that mineral is sufficiently similar in chemical, mineralogical or physical characteristics to the taxpayer's ore or mineral that it used or is commercially suitable for use, for the same purposes as the uses to which the taxpayer's mineral is put. Id.

The objective in computing gross income from mining by the RMFP method is to determine on the basis of an analysis of actual competitive sales by taxpayer or others, the approximate amount for which the taxpayer could have sold his mineral in light of market conditions. Treas. Reg. § 1.613-4(c)(1). The taxpayer's own actual sales of minerals of like kind or grade are to be considered, if determined to be representative, in determining the RMFP. Id. The same applies to the taxpayer's own actual sales of the very mineral in question. It makes no sense to ignore actual sales prices of the very mineral in question to go looking for other minerals of like kind or grade. Add to that the fact that Taxpayer makes no mention of any mineral of like kind or grade, and we will use Taxpayer's actual mineral sales for the rest of our analysis.

Weighted averages of competitive selling prices of minerals similar to the taxpayer's (remember, we're actually using Taxpayer's mineral) while not determinative is an important factor in calculating the RMFP. Treas. Reg. § 1.613-4(c)(3). Exceptional, insignificant, unusual, tie-in, or accommodation sales are to be disregarded. Treas. Reg. § 1.613-4(c)(3). And discounts are to be subtracted from the sale price in computing RMFP under any method of computing the depletion allowance. Treas. Reg. § 1.613-4(e)(1).

The mineral sales agreement with does not show any evidence of an "unusual," "tie-in," or "accommodation" arrangement. Even if "unusual" or "accommodation" could be interpreted as a discount (there is no tie-in), the regulation's specific mention of the way a discount is to be treated rules out any such interpretation. The sales agreement with actually contains no explanation at all for the sales price. There is no mention of "unusual," "tie-in," "accommodation" or even "volume discount" in that agreement. But in IDR response #5 Taxpayer explains that the contract with was entered into in and had a "discounted sales price to that could not have been adjusted until ." Taxpayer further stated in that IDR response that " receives a volume discount on their purchase price of mineral." This is apparently the sole basis for concluding that the price paid Taxpayer for mineral was based on a volume discount. There is no actual document to that effect.

The agent's use of an arithmetic weighted average for determining the market price of mineral must be evaluated. Per Treas. Reg. § 1.613-4(c)(3), a weighted average, although not determinative of RMFP, is still an important factor in determining that price. Perhaps significantly, in describing a weighted average as being only "important" as opposed to "determinative," the regulation mentions "competitive selling prices of ores or minerals of like kind or grade as the taxpayers." The weighted average the agent used is not of ores or minerals of like kind or grade, but is of the actual mineral in question, and of the ones Taxpayer itself actually sold. This should at least make the agent's arithmetic weighted average more "important" than it would otherwise be, if not exactly determinative.

Taxpayer relies on one court case, Gray Knox Marble Company v. United States, 257 F. Supp. 632 (E.D. Tenn. 1966), in addition to the above-cited regulation. In Gray Knox, the taxpayer was required to use the PPM because there was no RMFP. Other miners besides the taxpayer sold quarry block made by the taxpayer in such small quantities that their price could not be considered representative, and the taxpayer itself sold product in such small quantities that its sales could not be considered as being representative.

We do not believe that this case supports Taxpayer. For one, Taxpayer sold pounds of mineral to for . This is not a small quantity. And per the regulation mentioned above, the fact that a volume discount was applied does not prevent this from being a representative market or field price. Taxpayer sold almost pounds to other customers. The use of a weighted average of these two prices demonstrates that calculating an RMFP is not impossible.

In Gray Knox the mineral sought to be compared to the mineral being mined was not the same mineral, but was rather a mineral of a like kind or grade. This makes any connection between this taxpayer and the Gray Knox case more tenuous. In Taxpayer's case, as noted above, the subject mineral being evaluated for RMFP is the very mineral Taxpayer was selling. This makes the argument that the sale price was representative more compelling.

Another reason why the taxpayer's argument fails is it relies on the fact that the amounts of mineral sold are small in comparison to the amounts it used in its own manufacturing business. This is illogical. Just because Taxpayer used more mineral in its own business than it sold does not mean the amount sold was insignificant. After all, the test is "market or field price;" amounts of mineral that do not enter the market and have no field price should not be considered as having any bearing on RMFP. If enough was sold on the open market to establish a field price, that should settle the matter.

We note that the court in Gray Knox did actually consider the percentage of mineral sold as compared to the amount that taxpayer used in its own manufacturing business. We do not think this is controlling, however. If any given taxpayer sells enough to establish a market price, it should not matter what it does with the rest of the mineral. And in Gray Knox there were other factors not here present: there was a "monopolistic aspect," and different grades used in the manufacturing process. These other factors influenced the court's opinion.

Because it is possible to arrive at a RMFP, Taxpayer is incorrect in saying that it can rely on the PPM either to support its original reporting position or to support an increased percentage depletion deduction.

Please call Bill Bissell at (281) 721-7357 for any further clarification you desire.

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