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FEDERAL TAX ADVANTAGES DERIVED IN THE DEVELOPMENT OF NATURAL RESOURCES

JOSEPH BERMAN AND DANIEL S. BERMAN*

I. INTRODUCTION

In considering this subject we must arrive at a conclusion as to how the law proceeds in computing "net" profits from mines, oil and gas wells, timber lands and other natural resources. We must realize that the very process of creating income from these resources has the tendency of destroying the source of such income; therefore, it is only just and equitable to allow to taxpayers engaged in such activities the right to recapture tax-free the value of their wasting capital. This result is obtained by permitting annual depletion deductions.

With regard to these deductions, the principal problems facing such taxpayers are: (1) What is depletion and who may take deductions for it? (2) How is depletion computed under the methods permitted? (3) Which items are capital expenses and which are deductible expenses? (4) What depreciation and loss deductions are allowed? (5) How is the income from natural resources taxed?

II. DEPLETION

Income from mining and the exploitation of similar natural resources is basically the same as income from manufacture. Therefore, the principles involved in computing income and cost are, in the main, identical for "miners and manufacturers." An important feature peculiar to mining is the annual allowance of a certain amount as a deduction for depletion. This right is not constitutionally protected, but in all fairness, there should be compensation to an owner for the exhaustion of his mineral deposits in the course of production. Such compensation, through the depletion deduction, is allowed by Congress as an "act of grace."

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1 Stratton Independence Ltd. v. Howbert, 231 U.S. 399; Stanton v. Baltic Mining Co., 240 U.S. 103; Sec. 29-23(m)-1; I.T. 1835, CB II-2, 148 (1923); Sec. 29-22-7; See also 200 F.2d 821, 125 F.Supp. 432.


The depletion deduction is the prescribed method of recapturing one’s invested capital. It is the only method allowed. While it may give the taxpayer more or less than his cost, it cannot be replaced by a computation which allows all accruing income to be deducted until the cost of the investment is recovered. Such cost may be recovered only through the depletion allowance.\(^4\)

Compensation for consumption of capital is given to the miner as a producer who derives his income exclusively from the production and sale of his mineral products.\(^5\) In the case of corporations, such depreciation deduction is given only to the corporation and not to its individual stockholders.\(^6\) Partners are not allowed any depreciation apart from the partnership.\(^7\)

Economic Interest. A taxpayer who owns an economic interest in mineral deposits or standing timber is entitled to an annual depletion. Therefore, all persons generally having a right to share in minerals produced or in the proceeds of their sale are considered to have a depletable economic interest in such minerals.\(^8\) Thus, for example, lessors of gas and oil property receiving advance royalties are entitled to percentage depletion on such advance payments even though they are paid only in anticipation of production.\(^9\) Depletion is allowed on such bonuses and advance royalties in the year in which they are received.\(^10\)

In the case of mineral and timber property, there will be as many taxpayers taking depletion deductions with respect thereto as there are economic interests in the property. The law provides for equitable apportionment of depletion between lessor and lessee.\(^11\) Any depletion deductions to which life tenants or income beneficiaries are entitled are deductible by them in arriving at their adjusted gross income.\(^12\)

A lessee or other owner of operating rights in mineral property who has or is obligated to advance minimum royalties on a specified number of units of mineral annually, whether or not extracted within the year, may apply any amount paid on account of units not extracted within the year against the royalty on minerals thereafter extracted in either one of the following ways, at his option: (1) He may deduct

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\(^4\) Cook Drilling Co., 38 B.T.A. 291(A) (NA); Wm. Fleming v. Comm., 121 F.2d 7; E. C. Laster, 43 B.T.A. 159(A), affirmed 128 F.2d 4; See also 206 F.2d 246, 209 F.2d 152, 17 T.C. 914.

\(^5\) Burnet v. Henry Harmel, ibid., n.2; Helvering v. Elbe Oil Land Development Co., 303 U.S. 372; See also 19 T.C. 294, 526 and 1045.

\(^6\) Sec. 23(m)-1; W. A. Haynes v. U.S., 50 F.Supp. 238; See also 101 F.Supp. 533, 122 Ct.Cl. 25.


\(^8\) Sec. 29.23(m)-1; E. G. Palmer v. Bender, 287 U.S. 551; 209 F.2d 32 and 33; See also 212 F.2d 60; 107 F.Supp. 232, 119 F.Supp. 59; 21 T.C. 39 and 87.


\(^10\) Sec. 23(m).

\(^11\) Sec. 22(n) (5).

\(^12\) Sec. 24.18.
it from gross income for the year in which it was paid or accrued, or (2) he may deduct it from gross income for the year in which the mineral product with respect to which the amounts were paid was sold. This option applies only to advance royalties paid or accrued in taxable years ending on or after December 31, 1939, and every taxpayer must have elected his method in his return for the first taxable year ending on or after that date in which such advanced royalties were paid or accrued. The taxpayer is considered to have made such election in accordance with the manner in which such items are treated in his return. Failure to deduct any such items for the year paid or accrued will constitute an election to use the second method of treatment listed above. The election so made will be binding on all subsequent years.\(^{13}\)

The operator's or lessee's failure to produce minerals during the year the bonus is paid does not bar the taxpayer-payee from taking depletion concerning the bonus for that year, however.\(^{14}\) As to a person acquiring the economic interest from the taxpayer, any payments made by him to acquire it is a capital investment recoverable only through depletion.\(^{15}\)

Under some contracts, the person obtaining an interest in mineral property for a term of years is required annually to extract and pay for a specified number of units of mineral; or to pay annually a specified amount, which is applied to the purchase price or royalty per unit whenever the mineral is extracted and removed. The payee relinquishing the interest takes a depletion deduction equal to that part of his depletion basis allocable to the units paid for in advance of extraction, and this deduction is taken in the year when the payment is made to him. In subsequent years, of course, the payee may take no further depletion deduction as to those units of mineral, even though they may be extracted or removed in such subsequent year, since they have been paid for in advance and a deduction for them has already been taken.\(^{16}\)

Such contracts, however, must provide for the payment of some specified annual sum as to those units to be extracted in the future. In one case, where the taxpayer transferred an economic interest and the contract contained a minimum royalty clause to the effect that on the lessee's failure to produce the annual minimum tonnage the lessee would be required to pay as an advance purchase price an amount sufficient to bring the year's payments up to a certain level, which advance purchase price would be credited on future production above

\(^{13}\) Sec. 29.23(m)-10(e).


\(^{15}\) Sec. 29.23(m)-10(a).

\(^{16}\) Sec. 29.23(m)-10(b).
minimum requirements, it was held that "this . . . agreement did not provide for a specified annual sum in full payment for later production," and the taxpayer was therefore not entitled to depletion in the year the advance purchase price was paid.\footnote{17}

In cases where the grant of mineral rights expires, ends or is abandoned before the minerals paid for in advance have been extracted and removed, the payee must adjust his income for such year by restoring to it depletion deductions taken by him in prior years on account of royalties paid for those minerals which were not removed. The effect of this is to require him to report an amount equal to such deductions taken as income in the year of abandonment, expiration or termination, even though these deductions did not originally offset taxable income. This rule applies whether depletion was taken on a cost or percentage basis.\footnote{18}

On the other hand, the Tax Court has held that, where the taxpayer-lessee died after receipt of bonus payments but before any production by the lessee, "it did not constitute a termination of the grant of mineral rights if the lease continued in force in spite of the lessor's death."\footnote{19} In another case, it was decided by the 5th Circuit Court that, "the surrender to the lessor of part of the property covered by the lease does not constitute a termination of the lease."\footnote{20} In spite of this holding, the Tax Court, in another controversy, ruled that, where a part of the property was surrendered, a proportionate part of the depletion deduction taken in advance royalties must be restored to income.\footnote{21} On appeal, however, the 5th Circuit reversed the Tax Court and reaffirmed its prior holding.

Where a taxpayer grants a mineral right while retaining an economic interest in property which may be depleted on a percentage basis, he may take a percentage depletion with respect to bonus or advance royalty payments.\footnote{22} Such depletion is allowed even though there was production in the year the bonus was paid and no assurance of production in the future. The depletion deduction must be restored to income as of the year the lease ends where there was no production from the property.\footnote{23} However, a small amount of production during the continuance of the lease makes it unnecessary for the lessor to

\footnotesize{\begin{itemize}
\item \textit{Mineral Mining Co. v. U.S.}, 143 F.2d 51.
\item \textit{Sec. 29.23(m)-10(c)}; \textit{Bessie P. Douglas v. Comm.}, 322 U.S. 275; See also \textit{21 T.C.} 40.
\item \textit{Estate of Emma Louise G. Seeligson}, 1 T.C. 736(NA) affirmed 141 F.2d 358.
\item \textit{Clara Driscoll v. Comm.}, 147 F.2d 493; 19 T.C. 38, 21 T.C. 622.
\item \textit{Houston Farms Development Co.}, 15 T.C. 321.
\item \textit{Sec. 29.23(m)-10(d)}.
\item \textit{G.C.M. 14448 CB XIV-IX}, 98(1935) ; \textit{Dolores Crabb v. Comm.}, 119 F.2d 772, reversed on other grounds 121 F.2d 1015; See also \textit{21 T.C.} 730; \textit{47 B.T.A.} 916; 136 F.2d 501.
\end{itemize}}
restore to income any part of the bonus paid before the end of the lease.\textsuperscript{24}

A. COST DEPLETION

The Income Tax Law provides that in the cases of mines, gas and oil wells, other natural deposits and timber, a reasonable allowance for depletion, according to the conditions of the case, shall be allowed as a deduction. The extent of this allowance is determined by the Commissioner, with the approval of the Secretary of the Treasury, in rules and regulations issued by him. Generally, it will be in such amounts as will return to the owner of the deposit or interest therein the amount of his investment by the time the deposit is exhausted. The basis of recovery is the same as that provided for determining gain on a sale.\textsuperscript{25}

In addition, the law provides three exceptions to the general rule, which, over the period of the exploitation of the natural resource involved, will aggregate a greater amount than the actual cost or other basis of the property. These are: (1) the allowance of a deduction for discovery value in the cases of certain mines, (2) the allowance of percentage depletion for oil and gas wells, and (3) percentage depletion for certain mines.\textsuperscript{26}

Under the general rule, the method for computing the depletion deduction for the taxable year is as follows: Divide (1) the property's adjusted basis for determining gain on sale or other disposition, by (2) the units of remaining mineral as of the taxable year. The resulting figure is the depletion unit. Multiply this figure by (3) the number of units of mineral sold within the taxable year, and the result is the depletion deduction for that year.\textsuperscript{27}

I. In establishing the adjusted basis for determining gain, the starting point for property acquired before March 1, 1913, is the fair market value of the property as of that date. This assumes that this figure exceeds the original cost of the property as adjusted to that date. In all other cases the adjusted basis is the cost of the property, with the necessary adjustments.

To make certain that depletion is allowed only as against wasting assets which are subject to depletion, it is essential to exclude from the basis: (1) the cost or value of that portion of the land used for purposes other than mineral production; (2) amounts recoverable through depreciation and deductions other than depletion; and (3) the remainder value of other property at the end of operations.\textsuperscript{28} To this basis the taxpayer may add any oil and gas drilling and development costs which he elected to capitalize. By this method, the cost

\textsuperscript{24} Ibid., n.23.
\textsuperscript{25} Sec. 114(b) (1) ; Sec. 29.23(m)-1.
\textsuperscript{26} Sec. 114(b).
\textsuperscript{27} Sec. 23 (m) ; Sec. 114(b) (1) ; Sec. 29.23 (m)-1.
\textsuperscript{28} Sec. 29.23 (m)-2.
basis inherent to the deposit is separated from the cost basis of the entire mineral property; only that part of the entire cost is used which the value of the deposit bears to the value of the entire mineral property at the time it was purchased, and the deduction is thus limited to the wasting mineral deposit.\footnote{Sec. 29.23(m)-6.}

The taxpayer claiming cost depletion must prove that the cost or price of the property involved was fixed by a \textit{bona fide} purchase and sale. Fictitious or inflated costs cannot be used, and the relationship between buyer and seller will be closely scrutinized.\footnote{Ibid., n.29.} Where the exchange was for royalties plus a bonus, depletion is computed in the following manner: As to the bonus, the taxpayer takes a depletion deduction equal to that proportion of the cost or other basis (e.g., discovery basis) which the bonus bears to the sum of the bonus and those royalties expected to be received in the future. This depletion allowance, covering the bonus, is deducted from the depletion basis, and the remaining basis is recovered by depletion deductions for future royalty payments.\footnote{Sec. 29.23(m)-10(a).} Where the sum of the bonus and estimated future royalties is less than the payee’s depletion basis, the entire bonus establishes a tax-free return of capital.\footnote{Murphy Oil Co. v. Burnet, 287 U.S. 299; See also 204 F.2d 578; 119 F.Supp. 59, 212 F.2d 60, 17 T.C. 406; 19 T.C. 526; 21 T.C. 87; 112 F.2d 242.}

Amounts spent in drilling an oil well which are derived from the sale of certificates conferring a percentage interest in the wells production cannot be included in the cost of the well in determining depletion allowable to the seller of the certificates.\footnote{Trans California Oil Co. Ltd., 37 B.T.A. 119(NA).}

In determining the cost of a mineral interest, consideration should be given to any existing litigation which might affect it.\footnote{Champlin Refining Co. v. Comm., 123 F.2d 202; 126 F.Supp. 188.} In one case a taxpayer was allowed to increase the cost basis of a coal mine by adding legal fees incurred in a suit to adjust the purchase price. Expenses incurred in getting an abatement in the purchase price of the property are capital expenses. However, no adjustment was allowed for interest paid under the court decree on the balance of the price determined to be due.\footnote{Tessler Coal Mining Co., T.C. Memo Dkt. No. 11060, Dec. 8, 1948.}

The basis must also be adjusted for depletion in prior years, as well as for capital additions. It must be reduced by allowable depletion where the taxpayer took less than the amount allowed.\footnote{F. A. Gillespie & Sons Co. v. Comm., 154 F.2d 913.}
which the product is sold; e.g., tons of ore, barrels of oil, thousands of cubic feet of gas, etc. To determine the number of units remaining as of the taxable year, add: (1) the units remaining at the end of the year which have yet to be recovered from the property, and (2) the units sold within the taxable year.

Units recoverable at the end of the year must be estimated according to the method common to the industry and in the light of the most accurate and reliable information obtainable. The estimate should include, as to quantity and grade, (1) minerals "in sight," "blocked out," "developed" or "assured," in the ordinary meaning of these terms with respect to the type of deposit; and (2) "probable" or "prospective" ore and minerals. They may be estimated as to quantity only in case there are extensions of known deposits, or new bodies or masses the existence of which is indicated by geological or other evidence to a high degree of probability. As to grade, they may be estimated only in accordance with the best available indications as to richness.

Where there has been an estimate for a prior year or years and there is no change in the facts on which the estimate was based, the recoverable units at the end of the current taxable year will be the number left from the previous estimate. If subsequent operations or developments during the taxable year show an increase or decrease over the prior estimate, a revision of the estimate is required. The depletion allowance for the year in which the revision is made and for subsequent years will be based on the new estimate of remaining recoverable units. The Treasury Department as well as the taxpayer can ask for a revision of a formerly adopted estimate. The increased or decreased depletion allowance resulting from the revision does not apply to years prior to the revision, however. On the other hand, if the information on which a revision is based became known to the taxpayer before the Commissioner discovered it, the revised, decreased depletion allowances are applied retroactively to all open years from the year in which the taxpayer discovered the new information.

As to cash basis taxpayers, the units sold in the taxable year are those for which payment is received in the taxable year, regardless of whether they were actually produced or sold in some prior year or years. Units sold but not paid for in the taxable year are not included.

37 Sec. 113(b)(1)(B).
38 Sec. 29.23(m)-2.
39 Sec. 29.23(m)(9).
40 Ibid., n.39.
41 Sec. 29.23(m)-9; Big Four Oil and Gas Co., 28 B.T.A. 61, affirmed 83 F.2d 891.
42 James R. McCahill, et al., 29 B.T.A 1080, affirmed 75 F.2d 725.
43 Marion A. Burt Beck, 15 T.C. 642(A); Petit Anse Co. v. Comm., 155 F.2d 797.
44 Sec. 29.25(m)-2.
Accrual basis taxpayers should include units sold during the taxable year, whether paid for or not. Units produced, but not sold, during the taxable year are not included. 45

Cost Depletion of Natural Gas. Where the annual production is not metered and cannot be estimated with reasonable accuracy, a different approach is necessary to arrive at cost or ordinary depletion. After obtaining the adjusted basis of the property, multiply it by a fraction, the numerator of which is the decline in closed or rock pressure during the taxable year, and the denominator of which is the expected total decline in the closed or rock pressure from the taxable year to the economic limit of production. For this purpose, accurate records of periodical pressure determinations must be kept. 46

Turpentine Depletion. A producer may amortize the cost or other basis of his property over the period required to exhaust it. If property is acquired in fee, the basis must be allocated to the land, timber and other elements of value. The amount allocated to the timber must then be broken down between the turpentine and wood products, taking into account the difference between round and turpentine timber. Where only turpentine rights are bought or leased, the basis will be the consideration paid.

Because of decreased yield as the height of clipping increases, greater depletion is allowed in earlier years.

Lessors receiving income on a percentage basis should deduct depletion on estimated total production in proportion to actual receipts. 47

B. Discovery Depletion

The chief difference between discovery and cost depletion lies in the basis used in arriving at the depletion deduction. Since the discovery value usually raises the property's fair market value disproportionately to its actual cost it is equitable to allow depletion to be related to discovery value rather than to cost, so that the taxpayer will recover tax-free the higher discovery value. As a result of this higher valuation, taxpayers privileged to use this method never receive less than the deduction arrived at by using the cost method.

The discovery depletion is limited in application to taxpayers who have discovered mines. There are, however, certain mines, for which percentage depletion may be taken, which are excluded by law from being depleted on a discovery basis. 48 It is further limited to mixed minerals, exclusive of oil, gas, timber and any other natural deposits not usually found in mines. 49

45 Inspiration Consolidated Copper Co., 11 B.T.A. 1425.
46 Sec. 28.23(m)-2.
47 Income Tax Information Rel No. 1, Dec. 28, 1949; Sec. 114(b)-2.
48 Ibid., n.47.
49 Parker Gravel Co., 21 B.T.A. 51(A).
The discovery value must be equitably apportioned among the owners of economic interests in the property.\(^{50}\)

A taxpayer owning that type of mine to which discovery depletion is allowed must establish the following factors before he can avail himself of its benefits: (1) that he himself discovered the mine or minerals—the buying on a proven tract or lease will not qualify the buyer for discovery depletion; (2) that the discovery of the mine or minerals was made by the taxpayer after February 28, 1913; and, (3) that the discovery resulted in the fair market value of the property becoming disproportionate to its cost.\(^{51}\)

A discovery is considered made when: (1) a natural deposit of mineral is found, or (2) drilling or exploration above or below ground reveals a mineral deposit not previously known to exist, and its existence was so improbable that it had not and could not have been included in any previous valuation for depletion purposes. In either case, the deposit must exist in quantity and grade sufficient to justify commercial exploitation.\(^{52}\) If at the time of purchase of a tract of land the taxpayer knew of the existence of minerals in it (through test holes bored in the tract by the previous owner) there is no discovery.\(^{53}\) Discovery depletion is allowed only to the taxpayer making the discovery.\(^{54}\) A transferee who receives the property by way of gift or as trustee is precluded from using discovery depletion which the donor has used.\(^{55}\) However, the taxpayer who made the discovery is entitled to use the depletion as long as he retains some economic interest in the minerals discovered.\(^{56}\)

The discovery depletion basis is computed as follows: the fair market value of the property at the date of discovery or within 30 days thereafter is added to any subsequent allowable capital additions to the property. From this sum is subtracted the total depletion deductions which would have been previously allowable to the taxpayer without the application of any net income limitation. Once this adjusted basis is determined, the computation is similar to that used for cost depletion. The adjusted basis is divided by the units of mineral remaining as of the taxable year to get the depletion unit, which is then multiplied by the units sold within the taxable year to arrive at the actual depletion deduction for that year.\(^{57}\)

\(^{50}\) Sec. 29.23(m)-3.

\(^{51}\) Sec. 29.23(m)-3; Sec. 29.23(m)-14.

\(^{52}\) Clarence P. Sidwell, 11 T.C. 826.

\(^{53}\) Sec. 29.23(m)-3; May Ryan v. Alexander 118 F.2d 744, cert. denied 314 U.S. 622; See also 195 F.2d 218.

\(^{54}\) Lemuel Scarbrough, 18 B.T.A. 951(NA), dism'd (CCA-5) Dec. 15, 1931; Melville G. Thompson, 10 B.T.A. 25; Luke W. McCrory, Tr., 25 B.T.A. 944, affirmed 69 F.2d 688; E. G. Palmer v. Bender, 287 U.S. 551; Sec. 29.23(m)-3.

\(^{55}\) Ibid., n.55.

\(^{56}\) Ibid, n.55.
In the case of cost basis taxpayers, discovery depletion may not exceed 50% of the taxpayer's net income from the property on which the discovery was made, computed without the depletion allowance. Hence this computation should always be made by cost basis taxpayers. In addition, since discovery depletion can never be less than ordinary depletion on a cost basis, cost basis depletion should also be computed by these taxpayers as a check.\textsuperscript{58}

C. \textbf{Percentage Depletion}

Percentage depletion is based entirely upon the income from mineral property. While cost depletion is intended to return to the taxpayer the cost of the property tax-free and discovery depletion to return the fair market value of the property, percentage depletion is entirely unrelated to any basis and may be computed as long as the property produces income. It therefore offers the possibility of recovering tax-free far more than either the cost or fair market value of the property. When percentage depletion is taken, the taxpayer gets no further deduction, either by way of depletion or depreciation for intangible drilling costs, or development expenses which he has elected to capitalize. The purpose of percentage depletion is to cover all of these.\textsuperscript{59}

Since it is definitely related to income and not production, it may be deducted by a lessee from rents and royalties received, even though the lessee has extracted no minerals during the taxable year.\textsuperscript{60} Such deductions must, of course, be restored to income in the year of termination of the lease if there has been no production from the leased property.\textsuperscript{61}

Below are the types of minerals subject to the percentage method and the percentages allowed for each:

<table>
<thead>
<tr>
<th>Type</th>
<th>Percentage of Gross Income in Taxable Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Oil and gas wells</td>
<td>27½%</td>
</tr>
<tr>
<td>2. Sand, gravel, slate, stone (including pumice and scoria), brick and tile clay, shale, oyster shell, clam shell, granite, marble, sodium chloride; and, if from brine wells, calcium chloride, magnesium chloride and bromine</td>
<td>5%</td>
</tr>
<tr>
<td>3. Coal, asbestos brucite, dolomite, magnesite, perlite, wollastonite, calcium carbonates and magnesium carbonates</td>
<td>10%</td>
</tr>
</tbody>
</table>

\textsuperscript{58} \textit{Ibid.}, n.55.  
\textsuperscript{59} U.S. v. Dakota Montana Oil Co., 288 U.S. 459; See also 192 F.2d 160; 211 F.2d 513; 101 F.Supp. 326; 115 F.Supp. 4; 202 F.2d 257.  
\textsuperscript{60} Wm. E. Herring v. Comm., 293 U.S. 322; See also 119 F.Supp. 59; 21 T.C. 39 and 87.  
\textsuperscript{61} G.C.M. 14448, CBXIV-1, 98(1935).
4. Metal mines, splite, beauxite, fluor-spar, flake graphite, vermiculite, beryl, garnet, feldspar, mica, talc including pyrophyllite, lepidolite, spodumene, barite, ball clay, sagger clay, china clay, phosphate rock, rock asphalt, trona, bentonite, gilsonite, thenardite, borax, fuller's earth, tripoli, refractory and fire clay, quartzite, diatomaceous earth, metal-lurgical grade limestone, chemical grade limestone and potash 15%

5. Sulphur mines or deposits 23%

Where coal royalties come under the special capital gains rule, percentage depletion cannot be taken. The term, "gross income from property" is here used in the same sense that it is ordinarily used for tax purposes, except that it is limited specifically to that portion of the gross income from the property attributable to extraction of minerals.

To arrive at the net income from the property, subtract from the gross income allowable deductions attributable to the particular mineral property and to the processes of ordinary treatment used on the minerals extracted from the property. The allowable deductions include overhead and operating expenses, development costs which are properly charged to expense, depreciation, taxes, losses sustained, etc.; depletion allowances are not included.

II. VALUATION

It is frequently necessary to compute the fair market value of mineral properties, including gas and oil properties, before depletion deductions may be computed. Taxpayers using discovery depletion always need this valuation, and under certain circumstances taxpayers using ordinary depletion will also require it. Taxpayers using percentage depletion may require a fair market valuation where their adjusted basis for gain is the fair market value as of some specified date rather than cost.

The method of computing this figure has been discussed previously. No revaluation of a property will be permitted once a value as of a specific date has been determined and approved, as long as

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62 Sec. 114(b); Sec. 29.23(m)-4; Sec. 29.23(m)-5; Sec. 117(k)(2).
64 Sec. 29.23(m)-1(g).
66 See ante., Cost Depletion.
the property continues under the same ownership for which the value was determined and approved. There are, however, two exceptions to this rule: (1) When there is a subsequent discovery of nonmetallic minerals, other than fluorspar, ball and sagger clay, rock asphalt, coal, sulphur, oil or gas; (2) When there was misrepresentation, fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on the basis of this second exception may be made only with the Commissioner's written approval.67

Many calculations of depletion are made with reference to a "property" which is in reality a taxpayer's interest in several mineral properties. Ordinarily the taxpayer's interest in each separate mineral property is a separate "property" in itself.68 If feasible, it is advisable for a lessor to take a number of small leases rather than one lease covering, for example, an entire oil tract. This breakdown might enable the taxpayer to bypass the arbitrary rule against treating separate wells on a single lease as separate properties for loss and depletion purposes.

III. Expenses and Capital Expenditures

Taxpayers have the following options for deduction of costs incurred in the exploratory period: (1) Exploration costs for ores or other minerals (except oil or gas) incurred or paid during a taxable year and before the beginning of the development state of the mine or deposit are deductible in a sum not over $75,000. (Exploration costs must be those which would not otherwise be deductible in the taxable year except for this provision); or (2) The taxpayer may treat as deferred expenses all or any part of the costs referred to in (1) above, up to the $75,000 limit. The deduction will be taken ratably, as the units of ore or mineral discovered or explored as a result of these costs are sold.

The $75,000 limit applies to the taxpayer, not to each mine owned by him. The first option is the general rule; the second must be elected by the taxpayer. The election is made annually, and is binding only for the taxable year in which it is made.69

Taxpayers who paid or incurred such costs in a year ending after December 31, 1950, without being able to deduct them under the then applicable law, have a choice of action. They may either apply for refunds based on taking the exploration costs as current deductions for those years, or elect to defer the expenses so that they can be deducted proportionately as the units are sold. This election is not exclusive; some of the units may be treated one way, some the other.70

67 Sec. 29.23(m)-8.
68 G.C.M. 22106, C.B. 1941-1, 245; Sec. 23(f) as added by sec. 342(a) of the 1951 Revenue Act.
69 Ibid., n.68.
70 Senate Finance Committee Report No. 781, Pt. 2, 82nd Cong. 1st Sess. 64.
If the taxpayer elects to defer the deduction of exploration costs, it is essential to estimate the number of units of mineral or ore, discovered as a result of the expenditures, in the reserve of the mine or deposit at the end of the year. This estimate is, of course, subject to revision if operation or development work shows the remaining recoverable units to be greater or less than the number left from any previous estimate. The deduction each year after the deferment will be that portion of the total expenses deferred which the units sold are of the units in the reserve.

Exploration costs under either option of the new provision can only be deducted or deferred for four years. Exploration costs in a taxable year can be deducted if within any four preceding years, whether or not consecutive, the taxpayer has taken a current deduction under option or an election to defer. This limitation also applies if the taxpayer acquired a mineral property from an individual or corporation in certain tax-free transactions and the transferor had exercised either option within four preceding years.71

Mine Development Expenses After 1950. Taxpayers have an election to treat the development expenses of mines or other natural deposits (except oil and gas wells) in one of two ways, once ores or minerals in commercial quantities have been disclosed: (1) They may take an immediate deduction for them during the year in which they are incurred or paid,72 or (2) treat the current year's development expenses as deferred expenses deductible in the years when the units or minerals which were originally benefited by the expenditures are sold, in proportion to the amount sold each year.73

Under the first option, all development expenses during the development stage are deductible regardless of net receipts from the mine during that period. When the mine passes to the production stage, this deduction covers only those extraordinary expenses which under pre-1951 law had to be deferred and is deducted ratably as the minerals benefited by them are sold.74

Under the second option only the excess of expenses over receipts from the ores in a taxable year during or after the development period may be treated as a deferred deduction. During the development state, the expenses not in excess of receipts are fully deductible in the taxable year.75

The taxpayer may not treat the cost of buying or improving depreciable business property for use in the development as development

71 Ibid., n.70.
72 Ibid., n.70.
73 Sec. 23(cc) (2) as added by sec. 309(a) of the 1951 Revenue Act.
75 Ibid., n.73, 74.
expenses under either option. He may, however, treat the amount of depreciation on such property as development expenses.\textsuperscript{76}

The first option is the general rule. The second can only be used on election by the taxpayer.\textsuperscript{77}

Neither option may be used unless the taxpayer actually paid or incurred the development expenses. It is not enough to pay for them as part of the price of a mine for which another made the expenditure. Where a taxpayer who has paid or incurred these expenses elects the second option and later leases the property retaining a royalty, he may continue to use the option.\textsuperscript{78}

These methods of handling development expenses are applicable to taxable years ending after December 31, 1950,\textsuperscript{79} for expenses incurred or paid after that date.\textsuperscript{80} They replace completely the pre-1951 non-statutory rule set up in the Treasury Regulations which required the excess of development expenses over receipts from sale of ores during the development period to be capitalized and recovered through depletion of the mineral or ore.

Where development expenses have been paid or incurred after December 31, 1950, and were capitalized under the old rule, the taxpayer has a choice of either filing a refund claim based on taking the expenses as a current deduction for that year, or electing to treat the excess of development expenses over receipts for that year as a deferred expense. In the latter case, he will not receive a refund, but he will preserve the right to deduct these deferred expenses ratably as the units are sold, in addition to any percentage depletion to which he may be entitled. The Commissioner will presumably provide for retro-active deferment elections for years ending after December 31, 1950.

In mining, as in any other business, a deduction may be taken for expenses that constitute ordinary and necessary business expenses.\textsuperscript{81} No deduction may be taken for any amount paid out for new buildings or for permanent improvements made to increase the value of the property, these being capital expenses.\textsuperscript{82}

Royalty payments are deductible as business expenses where they are a charge in connection with the operation of the taxpayer's business and are based upon minerals produced. Deductions for depreciation such as wear and tear of physical property used in the extraction of oil or minerals should be separate and distinct from the depletion allowances taken for the extraction of the mineral, oil, or gas deposit.\textsuperscript{83}

\textsuperscript{76} \textit{Ibid.}, n.73.
\textsuperscript{77} \textit{Ibid.}, n.73.
\textsuperscript{78} \textit{Ibid.}, n.74, p. 22.
\textsuperscript{79} Sec. 309(d), 1951 Rev. Act.
\textsuperscript{80} Sec. 23(cc) (1) as added by sec. 309(a) of the 1951 Rev. Act.
\textsuperscript{81} Sec. 23(a) (1) (A); Sec. 29.23(a)-1.
\textsuperscript{82} Sec. 24(a) (2); Sec. 29.24-2.
\textsuperscript{83} Sec. 29.23(m)-17; Sec. 29.23(m)-18; Sec. 29.23(m)-23.
In no case may depreciation deductions be taken which will reduce the cost or other basis of the depreciable property below its market value when it becomes obsolete or is abandoned for the purpose of mining or extracting oil.\textsuperscript{84}

Accurate accounts must be kept of depletion and depreciation, etc. Loss on abandonment of mineral property may be written off in the year in which it is sustained. It must, however, be reduced by all allowable depreciation, percentage or otherwise.\textsuperscript{85}

Income from transfers of an economic interest in mineral property, in the form of royalties and bonuses, is taxable as ordinary income, subject to depletion deductions, and may not be computed under the rules applicable to a sale or exchange of capital assets. Where a taxpayer actually sells his interest, he will not be entitled to depletion on the sums paid to him, but the sale will be subject to capital gain or loss treatment.

Federal Government payments for critical and strategic minerals and metals for defense purposes are excluded from gross income for taxable years beginning after December 31, 1950. In order to be so excluded, however, they must be subject to an accounting, to be made by the taxpayer to an appropriate government agency. Expenses attributed to such production are not deductible as expenses, nor may they be added to the basis of the taxpayer's property for gain or loss or for depletion or depreciation.\textsuperscript{86} Income from land leased from a state is not exempt.\textsuperscript{87}

Payments for permission to explore are ordinary income.\textsuperscript{88}

A taxpayer, other than a corporation, who prospects or locates claims, or explores and discovers undeveloped claims, demonstrates the principal value of oil or gas property which, prior to his efforts, was worth relatively little. The surtax on earnings gained from the sale of the oil or gas property thus developed may not exceed 30% of the selling price. This tax limitation is intended to encourage and stimulate the prospecting for oil or gas properties.

\section*{IV. Timber}

The taxpayer is required to include his timber in one or more timber accounts. Depletion is computed separately for each account and the results are then totaled to give the depletion deduction for that year.\textsuperscript{89} The first step is to obtain the depletion unit for a particular account. This is done as follows: (1) The adjustable basis (for determining gain) of the timber on hand at the beginning of the taxable

\textsuperscript{84} Ibid., n.83.
\textsuperscript{85} Frank Lyons, 10 T.C. 634.
\textsuperscript{86} Sec. 22(b) (15).
\textsuperscript{87} Burnet v. A. T. Hergins Trust, 288 U.S. 508.
\textsuperscript{88} Mrs. J. C. Pugh, St. Ex'rx, et al, 17 B.T.A. 429, affirmed 49 F.2d 76.
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year is added to (2) the cost of the units of timber acquired during the year and (3) any additions to capital. This result is divided by the sum of (4) the total units of timber on hand at the beginning of the taxable year and (5) the number of units acquired during the year (plus or minus the units which should be added or deducted to correct the estimate of the available remaining units in the account). This figure is the depletion unit for the taxable year. To determine the deduction, merely multiply the number of units cut during the year by the depletion unit. All these calculations, of course, are within the framework of a particular account, and must be computed separately for each such account.

If the taxpayer elects to treat the cutting of timber as a sale or exchange, the depletion deduction is the fair market value of the timber cut during the taxable year. The fair market value of the timber as of the first day of the taxable year in which it is cut should be used. If timber owned by a taxpayer for more than six months is disposed of under a contract which retains for him an economic interest in the timber, no depletion deduction is allowed with respect to the timber so disposed of. Factors governing the computation of fair market value are: (1) the cost of the timber properties, which must be shown by the taxpayer to be the result of a bona fide purchase and sale in which the property passed in fact and form to an owner other than the seller; (2) the cost of the timber, which must not be included in any part of the cost of the land for depletion purposes; (3) carrying charges which the taxpayer may capitalize or deduct at his option, and these are a property addition to capital if the taxpayer chooses to capitalize them; (4) Where accounts are kept on a monthly basis, the taxpayer may at his option also keep the depletion accounts on a monthly basis; (5) Although depletion of timber takes place when it is cut, for purposes of accounting depletion is considered to take place when, in the process of exploitation, the amount of timber cut is first definitely determined. In computing timber depletion, the taxpayer must estimate for each timber account the total units of timber on the ground on March 1, 1913, or on the date of acquisition of the property, whichever is applicable.

The cost or other basis of development not represented by physical

\[\text{Sec. 29.23(m)-21.}\]
\[\text{Ibid., n.89.}\]
\[\text{Ibid., n.89.}\]
\[\text{Sec. 29.23(m)-1.}\]
\[\text{Sec. 29.23(m)-20; Sec. 29.113(b) (1)-1.}\]
\[\text{Ibid., n.93.}\]
\[\text{Sec. 29.23(m)-20; Sec. 29.113(b) (1)-1.}\]
\[\text{Sec. 29.23(m)-21.}\]
\[\text{Sec. 29.23(m)-26.}\]
property having an inventory value may be recovered through depreciation.

The taxpayer has an option, subject to the Commissioner's approval, to recover his cost or other basis in either of the following ways: (1) At a depreciation rate established by current exhaustion of stumpage, or (2) at a rate calculated under the usual rules for depreciation, or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner.

The taxpayer must keep accurate ledger accounts showing the cost or other basis of the timber property, plants, improvements and equipment. It is also necessary to record the allowable capital additions to each account and all other necessary adjustments to basis. The best method of accomplishing this is to set up separately the quantity of timber, the quantity of land and other resources, if any, and allocate a proper part of the total cost to each.

The depreciation and depletion deductions should be credited to either depletion and depreciation accounts or to similar reserve accounts. When the sum of depreciation and depletion credits equal the cost or other basis of the property as adjusted for capital additions, no further depreciation or depletion will be allowed.96

Timber depletion may be based, in certain cases, on the fair market value as of the date of valuation, without regard to any subsequent changes. For taxable years beginning after December 31, 1943, owners of timber property or timber rights may, under certain circumstances, treat the cutting of timber as a sale or exchange of property.

Once any election is made, however, it is binding for all subsequent years unless the Commissioner permits it to be revoked because of undue hardship caused the taxpayer. After revocation, no further election may be made by the taxpayer unless the Commissioner consents.

When the election is made, the taxpayer's recognized gain or loss is the difference between the adjusted basis for depletion of the timber cut during the taxable year and its fair market value as of the first day of such taxable year. The adjusted basis for depletion of the timber cut is based on: (1) the units cut during the taxable year which are considered as sold or exchanged under the election, and (2) the depletion units for the timber accounts from which the timber in question is cut.

The fair market value of the timber as of the first day of the taxable year in which the timber is cut must be determined by the taxpayer subject to the Commissioner's approval upon his examination of the return.

96 Sec. 29.23 (m)-28.
In cases where coal or timber is sold, the retention of an economic interest will enable the taxpayer to avail himself of capital gain treatment. Any exploration and development costs, as well as new deductions allowed under the 1951 Act for exploration and development costs will also be taken into account. In such cases, the rule of Section 117(j)(1) applies, so that any gain from timber proceeds, coal royalties, and from the sale of any depreciable business property would be taxed as long term capital gain, while a net loss would be deductible in full.

Taxpayers who have reported coal royalties received or accrued after December 31, 1950, as ordinary income may apply for refunds based on treating them as capital gains under the new law. It makes no difference that the coal may have been mined before this date as long as the royalties were received or accrued after that date.

Timber owners who contemplate entering into cutting contracts should make certain that at least six months elapse between the time they acquire the timber and the signing of the contract. Otherwise, payments under the contract may be taxable in full even though the timber is not actually cut and sold until more than six months from the date of acquisition.

V. RECENT DECISIONS

The Bureau has held that a sale of severed soil by a landowner results in ordinary income, but the seller is entitled to a depletion deduction on the cost depletion basis, since soil in place is considered a natural deposit subject to depletion. The depletion deduction will likewise be allocated to one who doesn't own the land, if he has an economic interest in the property. This rule, however, does not apply to a case where the landowner sells the right to remove the soil and the buyer severs it. On the basis of the distinction made in timber cases, this kind of soil could result in a capital gain.

A District Court has held that a mining engineer who arranged a minimum lease for an operating company and took as his compensation a fractional royalty on production had an economic interest subject to depletion.

Where a taxpayer corporation contracted by assignment from a lessee of mining rights to strip a coal mine, receiving a percentage of the net selling price, the Tax Court held that "it had a depletable interest in spite of the fact that the lessee did not get the lessor's consent to the assignment, as the lease required, since the lessor was aware of the assignment and did business with the taxpayer."
Where a note was received by a taxpayer in return for his interest in certain strip mining leases and a marketing agreement, the Tax Court held that it was the proceeds of a sale which ended the taxpayer's interest in the mining and was not subject to depletion.\textsuperscript{104} The Tax Court has also held that "an income beneficiary of an estate was entitled to depletion where the income from the estate was partially derived from depletable assets."\textsuperscript{105}

Unless the taxpayer proves the various component factors essential to the computation of discovery depletion, a deduction will not be allowed. The Tax Court will approximate from the evidence, but will not guess at it. It is essential to prove (1) a definite date of discovery, (2) the fair market value within 30 days of discovery, (3) the amount of remaining unmined mineral, and (4) the number of units sold, failure of which, of course, would prevent the computation of a deduction.\textsuperscript{106}

Discovery depletion was allowed in one case where the taxpayers acquired the land for agricultural purposes only and thereafter limestone deposits were discovered on it.\textsuperscript{107}

The percentages stated in the 1951 Revenue Act applied to the years straddling January 1, 1951, and this should create refund opportunities for affected taxpayers.

Uranium ore deposits are considered by the Bureau as metal mines for percentage depletion purposes. Where an ore contains two or more minerals which are subject to different percentage depletion rates, depletion on each mineral must be computed separately, and applied on the income derived from each mineral. The amount derived from each mineral is a question of fact which can normally be ascertained by examining the sales contract.\textsuperscript{108}

The Tax Court has held that "a landlord is not entitled to depletion on production in which, under the lease, he has no interest."\textsuperscript{109} Where a lease of mineral bearing lands provided that the lessee pay the lessor's share of \textit{ad valorem} property taxes, however, the Bureau ruled that, to the extent that there was enough gross income to cover the tax payment, it was additional depletable income to the lessor and excluded from the lessee's income. If the gross income didn't cover the tax payment, it would be treated as delay rental — non-depletable income to the lessor, deductible expense as to the lessee.\textsuperscript{110} In another case, the Tax Court ruled that "coal from its own mine used as fuel in

\textsuperscript{104} J. E. Vincent et al., 19 T.C. 501; 20 T.C. 557; 22 T.C. 61.
\textsuperscript{105} Brad Love Sneed, T.C. Memo Dkt. No. 27716, June 23, 1953.
\textsuperscript{106} Anna C. Troup, T.C. Memo Dkt. No. 33113, Mar. 13, 1953.
\textsuperscript{107} Susan Smith et al. v. U.S., D.C. Iowa, June 24, 1952.
\textsuperscript{108} Rev. Rul. 76, IRB1953-10, 18.
\textsuperscript{109} LeDanois Land & Stone Co., 18 T.C. 669, affirmed 215 F.2d 475.
\textsuperscript{110} Rev. Rul. 16, IRB1953-3, 29.
operating the mine cannot be included in gross income from the property, since the taxpayer cannot realize income from a sale to itself.\textsuperscript{111}

Where a taxpayer acquired a lease of tidelands oil from the State of California and, in order to drill offset wells into the leased tidelands, acquired the well sites by easement from the owners of the shore property in return for a percentage of net profits, the Tax Court held that amounts paid under the easement need not be excluded from the taxpayer's depletable gross income. The shoreline owners had no interest in the tidelands leased from the state, and hence the payments to them were not "royalties or rents based upon an economic interest."\textsuperscript{112}

In another case the taxpayer was a coal company engaged in deep mining. Strip mining on its properties was carried on by subcontractors who received a fixed sum per ton for strip-mined coal delivered to the taxpayer at the railroad loading. The Commissioner reduced the taxpayer's gross income subject to depletion by the amounts paid to the subcontractor on the theory that the payments were in the nature of a royalty. The Tax Court disagreed. The subcontractors had acquired no interest in the coal in place. They were not allowed to mine or sell for their own account or to receive any portion of the proceeds. Theirs was a simple subcontract to mine and deliver coal in which they had no interest at a set price. The entire amount of the coal production was held includible in gross income.\textsuperscript{113}

Where a taxpayer mined one iron ore body located under five separately acquired leased and fee interests through two connected shafts, the Tax Court ruled that it was a single property.\textsuperscript{114} Where, however, a coal company mined three seams of coal through three shafts, the products of which were mixed and marketed as a common product, the Tax Court held that the company was not permitted to treat its interest as a single property for depletion purposes.\textsuperscript{115}

The Bureau has ruled that the initial rent payment on a mineral lease must be capitalized and is recoverable only through depletion or by deduction on abandonment.\textsuperscript{116}

Where a taxpayer contended in the alternative, (1) that the cost of removing overburden from an iron strip mining operation in the years 1942-1943 was a deferred expense recoverable over actual production, or (2) that the development period ended with the production

\textsuperscript{111} Roundup Coal Mining Co., 20 T.C. No. 52.

\textsuperscript{112} Southwest Exploration Co., 18 T.C. 961 (N.A) affirmed 220 F.2d 58.

\textsuperscript{113} Morrisdale Coal Mining Co., 19 T.C. 208; 19 T.C. 485; 19 T.C. 523; 21 T.C. 396; 22 T.C. 490; 22 T.C. 577; 24 T.C. No. 40.

\textsuperscript{114} Hanna Iron Ore Co., T. C. Memo Dkt. No. 36017, April 16, 1953.

\textsuperscript{115} Buffalo Chilton Coal Co., 20 T.C. No. 53.

\textsuperscript{116} Bureau Letter Rulings of April 1 and March 19, 1952.
of the first iron ore and thereafter stripping the overburden was an operating expense, the Tax Court refused to decide either issue, holding that the taxpayer had not produced sufficient evidence to allow the court to decide what the similarity was between the stripping operations and development of a conventional mine. It also held that the production of some ore was not inconsistent with continued development.\textsuperscript{117}

The courts hold the following mining expenses to be capital in nature: (1) Modernizing of equipment in the interest of economy and efficiency owing to changes in the seams and manpower shortages, (2) Construction of rock slope in an old mine. The latter was required to be capitalized because it was not shown to be required to maintain current production.\textsuperscript{118}

These mining expenses have been held to be deductible: (1) Laying of a temporary track for the purpose of storing empty coal cars during a car shortage—held to be an expense of maintaining normal production since without the cars being readily available a cutback would have been necessary; (2) Installation of a new airshaft and blower to maintain ventilation at the retreating faces of the mine.\textsuperscript{119}

Where the taxpayer corporation was the assignee of a strip mining lease held by its principal shareholder and paid him an overriding royalty for the right to operate under the lease, as well as paying rental for the use of a coal tipple, the Tax Court found both types of payment properly deductible.\textsuperscript{120}

When a taxpayer buys an interest in another's oil operation, his payment is immediately deductible only to the extent that it represents his share of the intangible drilling costs spent during the year. Otherwise it is merely a cost of acquiring his interest and is recoverable only through depletion, depreciation or loss deduction on abandonment of the oil interest as worthless.\textsuperscript{121} If the buyer wants a deduction for the part of his payment which is intended to cover drilling, he should insist on provisions which bind him to drill and make him liable for his share of the drilling expenses. That part of his payment which covers his share of the drilling operations should then be deductible. Unless a clear election between expensing and capitalizing intangible drilling costs is made, it will be presumed that the taxpayer elected to capitalize. However, even if this election to capitalize is made, the costs of a dry hole may be deducted as a loss.\textsuperscript{122} If it is desired to expense intangible drilling costs, on the other hand, it is wise to attach a statement to the

\textsuperscript{117} \textit{Supra}, n.114.
\textsuperscript{118} \textit{Comm. v. H. E. Harman Coal Corp.}, 200 F.2d 415; \textit{supra}, n.111.
\textsuperscript{119} \textit{New Pittsburgh Coal Co. v. U.S.}, 200 F.2d 146; \textit{supra}, n.111.
\textsuperscript{120} J. E. Vincent \textit{et al}, 19 T.C. 501; \textit{supra}, n.104.
\textsuperscript{121} Suney Platt, 18 T.C. 1229, affirmed 207 F.2d 697.
\textsuperscript{122} Hawkeye Petroleum Corp., 18 T.C. 1223(NA), appeal dismissed 205 F.2d 697.
return stating specifically the election to expense. Cost of wells drilled as a condition of the lease must be capitalized.\textsuperscript{123}

Even though the regulations covering the pre-1943 option refer to an election to be made by "the taxpayer," the election could be made by a joint venture or partnership.\textsuperscript{124}

Where a taxpayer retained the surface property after abandoning the mine, a loss sustained as a result of the abandonment in the year in which the mine ceased to be workable was denied.\textsuperscript{125} Where, however, mineral rights were sold and an economic interest in the minerals retained, the entire proceeds were ruled to be depletable ordinary income.\textsuperscript{126}

Expenses of making a "timber cruise" or inspection of property in order to estimate its timber potential are held as ordinary and necessary expenses, if not connected with a sale.\textsuperscript{127} Capital gain treatment given to timber cutting is limited to owners of the timber only.\textsuperscript{128}

VI. \textsc{Changes Made by the 1954 Code}

Depletion: Sections 611-613 of the new Code extend the allowance for depletion to deposits of waste and residue which are worked by the mine owner or operator. A purchaser of such waste or residue or of rights thereto is not entitled to depletion. The Senate Finance Committee states that the allowance is available, however, to a successor in interest in a tax-free exchange. Such waste deposits are not considered to be a separate property, but a part of the property from which the waste was extracted. "Discovery value" depletion is eliminated in this area because it has been replaced by percentage depletion. The new law specifically provides for apportionment of the depletion allowance between an estate and the heirs, legatees and devisees according to the income of the estate allocable to each.

Section 613(b), Percentage Depletion: The rate of depletion for oil and gas continues at 27\%\%. The 23\% rate, however, formerly available only for sulphur has been extended to sulphur and uranium.

\textsuperscript{123} \textit{Southwest Exploration Co., supra, n.112.}
\textsuperscript{124} \textit{Bentex Oil Corp., 20 T.C. No. 76.}
\textsuperscript{125} \textit{Talache Mines Inc. v. U.S., 108 F.Supp. 25.}
\textsuperscript{126} \textit{Arthur E. Moreton, T.C. Memo Dkt. No. 29488, July 14, 1952.}
\textsuperscript{127} \textit{G.C.M. 27322, CB1952-2, 62; Joseph Hamme, T.C. Memo Dkt. No. 36037, March 30, 1953; Tungsten Mining Corp., T.C. Memo Dkt. No. 37144, March 30, 1953.}
\textsuperscript{128} \textit{Robinson Land & Lumber Co. of Alabama, Inc., v. U.S., D.C. Ala., April 28, 1953.}
\textsuperscript{129} \textit{Helga Carlen, 20 T.C. No. 77.}
and, if from deposits in the United States, to anothosite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, beryl, celestite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, zircon and ores of the following metals: antimony, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium and zinc. When these minerals are produced from deposits outside the United States, the applicable depletion rate will depend upon whether they fall into the specific 15% group for metals, the 10% group for asbestos or the general 15% group for other nonmetals.

Bentonite has been placed in the specific group of metals subject to the 15% rate. Chemical grade limestone, metallurgical grade limestone and slate have been removed from the specific 15% group but are entitled to the 15% rate under a general grouping. Sodium chloride has been moved from the specific 5% group to the specific 10% group. Granite and marble have been similarly moved. They also fall into the general 15% group, therefore. Stone, unless used or sold for use by the mine owner or operator as dimension or ornamental stone, has been placed in the specific 5% group. In addition, a general 15% group has been established for all other nonmetallic minerals which are not covered by a specific rate.

All of the minerals named in the specific 5, 10 and 15 percent groups are entitled to the specific rate of depletion regardless of the purpose for which they are used. The use of minerals in the general 15% group, however, determines whether they are entitled to the 15% rate or are depletable only at the 5% rate. If the minerals in the general group are used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete, aggregates or for similar purposes, the rate of depletion is 5%, except that in cases where they are sold on bid in direct competition with a bona fide bid to sell a mineral in the specific 15% group the depletion rate is 15%.

The minerals in this general 15% group, to which the “use” test applies, include but are not limited to: aplite, barite, borax, calcium, carbonates, refractory and fire clays, diatomaceous earth, dolomite, feldspar, fuller's earth, garnet, gilsonite, limestone, magnesite, magnesium carbonates, marble, phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension or ornamental stone), thenardite, trioli, and trona. Also, if from deposits outside the United States so that they do not fall within the 23% group, bauxite, beryl, flake graphite, fluor spar, lepidolite, mica, spodumene and talc, including pyrophyllite, are included.

Soil, sod, dirt, turf, and water or mosses are expressly excluded
from the all inclusive group of nonmetallic minerals to which the 15% depletion rate is allowable. Nor does that group include minerals from sea water, air or similar inexhaustible sources. Percentage depletion is not allowable with respect to such materials. However, depletion based on cost may be allowable. The Commissioner has held that cost depletion can be taken on topsoil when severed and sold.

Section 613(c), Gross Income From Property: This definition, on which percentage depletion is computed, has been expanded to include gross income from the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The extraction must be by the mine owner or operator, and not by the purchaser of the time tailings or of the right to extract ores or minerals therefrom. The Report of the Senate Finance Committee states that the term “purchaser” does not include a person who acquires the whole mine property, including the waste or residue, in a tax-free exchange; as, for example, under a tax-free reorganization, from a person who was entitled to depletion on the waste or residue. Nor does the term “purchaser” apply to a lessee, upon the renewal of a mineral lease, if such lessee was entitled to depletion with respect to the waste or residue prior to the renewal of the lease.

Since a waste pile is not considered a separate property, but a part of the property from which it was extracted, the gross income from both the original mine and the residue must be aggregated in determining the gross income from the property.

Several changes were made in the statutory definition of “ordinary treatment processes.” First, it now specifically includes the pulverization of talc, the burning of magnesite, and the sintering and nodulizing of phosphate rock. Second, the ordinary treatment processes specified with regard to sulphur has been limited to sulphur recovered by the Frasch process. Where sulphur is recovered by other processes, they will be allowed or disallowed as “ordinary treatment processes” in accordance with the general provisions relating thereto. Third, in the case of coal, “ordinary treatment processes” expressly includes dust allaying and treatment to prevent freezing, as well as cleaning, breaking, sizing and loading for shipment.

Section 615, Exploration Expenditures: The amount of mine exploration expenditures which a taxpayer may elect to deduct in the current year was increased to $100,000, and a new rule was established with regard to exploration expenditures which have been deducted by a taxpayer’s transferor.