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TAX ASPECTS OF URANIUM MINING

ALLEN S. KRAKOVER*

Business men in all lines of endeavor realize that their activities have tax consequences. Ordinarily, they think only in terms of their year-end income being subject to tax. Or similarly, they realize that gain on the sale of a business might be subject to tax. But they do not concern themselves with the details surrounding the individual items included in income or permitted as deductions and exclusions. Many of these items are treated the same regardless of the business involved. Thus, the expense of operating an office will be deducted under exactly the same provisions of the tax law by a department store in Oregon and a textile manufacturer in Kentucky. But just as industries have their peculiar problems, so too do some industries work under specialized provisions of tax law. This paper will concern itself with some of the provisions of the Internal Revenue Code of 1954 that have particular effect on the uranium mining industry.

One part of the 1954 Code, Section 621, has been designed to complement the U. S. Government's program to encourage exploration. As is well known, loans of up to 75 per cent of the cost of exploration are available to uranium explorers, such loans to be repaid only out of production of ore discovered. Section 621 assumes that the government does not take away with one hand what is has given with the other. Any amounts received from the U. S. Government or an agency thereof, whether or not repayable and regardless of whether received as a grant or loan, need not be included in the taxpayer's income if such amounts were received to encourage exploration, development or mining of "critical and strategic minerals or metals." In order to qualify for this benefit, the taxpayer must be under an obligation to account for the expenditure of the funds received to the government agency which made them available. This, of course, will ordinarily be a requirement of obtaining the funds in the first place.

Since the taxpayer gets his benefit by not including the amounts received in income, he will not be entitled to claim a deduction when he spends these monies. Accounting-wise, this means that he gets the benefit once and once only. He can't have his cake and eat it too by not including the receipts in income and yet deducting the expenses against other income he might have. The benefit is to have a certain amount of exploratory or development work accomplished, and neither the receipt of the monies or their subsequent expenditure will be reflected in the tax return. Similarly, the taxpayer will not be allowed to increase the cost basis of his properties by capitalizing the amounts that he receives and spends. This would

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merely be an indirect method of attempting to take a deduction for the amounts spent.

Of course, the situation changes if and when any such amounts received from the government are repaid. Such repayments mean that the cost of the exploration and development is actually being borne by the taxpayer. Accordingly, the taxpayer should be entitled to the deduction of the expenses incurred or to their capitalization. The date of the deduction or increase in basis is not the date when the monies are actually spent but rather the date on which repayment is made to the government. This is in keeping with the theory that the expenditure belongs to the taxpayer only when he incurs the economic cost. The deduction or increase in basis is obvbiously limited to the amount of monies repaid by the taxpayer. Of course, any expenditures made following repayment of the grant or loan are not governed by the restrictions or deductibilty imposed by Section 621.

The net effect of these provisions is that the uranium explorer can obtain funds from the government to assist his exploratory efforts. He need not report such amounts received as income; and, to the extent that he repays these amounts, he can claim a deduction on his tax return. It should be noted, however, that the benefits of Section 621 do not apply to any part of the purchase price for the ore. Thus Section 621 would not apply to the 50c per pound development allowance, which the producer receives as part of the purchase price of his ore and which sum he must spend in further exploration and development of his property.[1]

In common with other types of mining, the uranium miner is entitled to deduct what is known as depletion.[2] Depletion applies to wasting assets and is comparable to the depreciation of fixed assets. As a natural resource is mined out, the depletion deduction represents the reduction in the reserves. Thus, the depletion allowance returns to the owner of the wasting asset, his capital investment prorata over the productive life of the resource.

Cost depletion is computed as follows: Assume taxpayer purchases a mine for $10,000, and he estimates recoverable reserves of 10,000 tons of ore. Each ton of ore would carry a depletion rate of $1, so that if 3,000 tons of ore were sold during the taxable year, a cost depletion deduction of $3,000 would be in order. Note that the deduction is attributable to ore sold, not merely mined and stockpiled.

Should it be determined in the following year that 14,000 tons of ore still remain in place, then the rate of depletion per ton would be revised. In this instance, the 14,000 remaining tons compared to the unrecovered capital investment of $7,000 would give a new rate of depletion of 50¢ per ton.

1. Rev. Rul. 5547, 1955-5 CUM. BULL. 12.
2. IRC Sec .611.

While this method of calculating depletion is always available to the miner operator, and, in fact, must be calculated for comparison purposes, in practice the depletion allowance is usually calculated as a flat percentage of the gross income from the property. The amendments to the code in 1954 increased the allowable percentage of depletion applicable to uranium from 15 per cent to 23 per cent.[3] In addition, the vanadium content of such ore, where the mining operation is conducted within the United States, is also entitled to a percentage depletion allowance of 23 per cent.[4] This means that the uranium miner can exclude from his income 23 per cent of the proceeds from the sale of uranium and vanadium, so that not one cent of this 23 per cent portion of his income is subject to tax. Considering how high tax rates are, percentage depletion is one of the greatest benefits in the entire code.

The first items to be considered in determining the allowance for percentage depletion is a definition of what constitutes the property. The code definition states that property "means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Although the definition is new so far as being an integral part of the code, it conforms substantially with the definition previously found in the regulations promulgated under the 1939 Code. The importance of this definition lies in the fact that the percentage depletion allowance is limited to 50 per cent of the taxable income from the property, and the 50 per cent limitation is computed for each separate property. Incidentally, although there has been a change in language in respect to computing the 50 per cent limitation from 50 per cent of the taxpayer's "net income" to 50 per cent of the taxpayer's "taxable income," the Senate Committee Report indicated that no substantial change was intended. However, the 1954 Code added something new to the concept of property by permitting a special election to aggregate separate operating interests.[5] The code provides that two or more separate operating mineral interests which constitute part or all of an operating unit may be aggregated. This election to treat the separate mineral interests as just one property is permitted provided that any separate mineral interests not included in the aggregation are thereafter reported separately.[6] This aggregation of separate interests can be made even though the interests are not included in a single tract of land and even though the separate tracts in which they are included are not located contiguously.[7] The Senate Commitee Report states that aggregation is contemplated only of interests which may conveniently and economically be operated together as a single working unit. Interests which are geographically widespread would not be considered parts of the same operating unit merely because one set of accounting records was kept by the taxpayer

3. IRC Sec. 613(b).
4. *Ibid.*
5. IRC Sec. 614(b).
6. IRC Sec. 614(b) (1) (B).
7. *Ibid.*

or because the production of such interests were processed at the same treatment plant.

It should be noted that the aggregation permitted is only of operating mineral interests. A separate aggregation of non-operating mineral interests is permitted with the consent of the Treasury Department only upon a showing of undue hardship by the taxpayer and in addition only where the royalty interests pertain to a single tract or two contiguous tracts of land.[8] Several examples of the indicated operation of these provisions were set forth in the Senate Committee Report. In substance, these are as follows:

> 1. Taxpayer owns one tract of land on which there are located three separate ore deposits. The taxpayer is considered to own three separate mineral interests. However, if taxpayer mines all these deposits and maintains only one operating unit with respect thereto, he may elect to aggregate and treat all three separate mineral interests as one property.
> 2. Taxpayer operates as a single mine eight separate tracts of land. He may elect to aggregate all or any of these as one property. Those not so aggregated must be kept separate. If he acquires another tract, he may either include it in the aggregation or keep it separate.
> 3. Taxpayer operates mines A and B as two separate operating units. He cannot aggregate an interest forming part of mine A with an interest forming a part of mine B, because two different operating units are involved.
> 4. Taxpayer operates a mine and leases another part of the same tract to another operator, retaining an overriding royalty. While taxpayer is considered as owning two separate properties, they may not be aggregated, since the royalty interest is not an operating interest.

The election to aggregate must be made with respect to each separate operating mineral interest not later than the time prescribed for filing the return for the later of the first taxable year begining after December 31, 1953, or the first taxable year in which any expenditure for exploration, development or operation is made following acquistion.[9]

Prior to the passage of the 1954 Code, there was some doubt as to whether percentage depletion could be taken or income arising from the waste residue of prior mining such as reworking mine tailings.[10] The Commissioner refused to allow percentage depletion against this type of income even though the Courts had ruled that percentage depletion was allowable.[11] The 1954 Code settled this problem by specifically providing that percentage depletion was applicable to this production.[12] However, only the mine operator who originally mined this material can claim this ad-

8. IRC Sec. 614(c) (1).
9. TD 6118.
10. Rev. Rul. 4, 1953-1 CUM. BULL. 48.
11. Com. v. Kennedy Mining & Milling Co., 125 F.2d 399 (9th Cir. 1942), 4 USTC par. 9271.
12. IRC Sec. 613(c) (3).

vantage. A person who purchases the residue to rework it would not be entitled to percentage depletion.[13] Even a person who purchases a mine and acquires the dump just as an integral part of the transaction cannot claim percentage depletion on reworking the residue. This benefit is strictly limited to the operator who originally produced the ore or his successors in a tax-free transaction. The depletion allowance applicable to the income derived from reworking the waste or residue is the full 23 per cent that applies to all uranium ores.

The definition of what constitutes gross income from the property for the purpose of taking percentage depletion includes some additional benefits for the uranium operator which are not apparent on the surface. The term "mining" is not limited to just the extraction of ores from the ground but also includes those ordinary treatment processes normally applied to obtain a commercially marketable product.[14] Thus, the increment in value arising from milling processes is subject to percentage depletion. Additionally, the term "mining" includes transportation of the ore not in excess of 50 miles from the mine to the mill where the ordinary treatment processes will be applied.[15] A distance in excess of 50 miles can be counted in cases where the Commissioner finds that for physical and other reasons the ore must be transported such greater distances from the point of extraction to the mill.[16] This provision obviously points to the urnaium industry, inasmuch as the schedule of payments set up by the Atomic Energy Commission includes a haulage allowance of 6¢ per ton mile up to a distance of 100 miles. The Senate Finance Committee Report indicates that in the case of uranium, the sales price of the ore should be reduced by the net cost of transportation, the net cost of transportation being defined as the taxpayer's transportation cost reduced by the hauling allowance received from the Atomic Energy Commission.

A very important question, of course, is who is entitled to claim the depletion allowance. It is generally established that depletion is allowable only to a person who can show that he has an economic interest in the minerals in place.[17] Section 611 (b), for instance, provides that the depletion deduction is to be equitably apportioned between lessor and lessee. A new provision of the 1954 Code provides for the apportionment of the depletion allowance as between a decedent's estate and the beneficiary thereof.[18] Under the 1339 Code, apportionment was allowed as between a trust and the beneficiaries thereof but not as between an estate and its beneficiaries. This new provision means that the benefit of the depletion allowance will not be lost to an estate as could have happened under the 1939 Code. This could have happened where the estate distributed all of the income to the beneficiaries. The estate would then have no taxable

13. *Ibid.*
14. IRC Sec. 613 (c) (4).
15. IRC Sec. 613 (c) (2).
16. *Ibid.*
17. Palmer v. Bender, 287 U.S. 551, 3 USTC par. 1026 (1933).
18. IRC Sec. 611 (b) (4).

income from which to deduct the depletion allowance, and the beneficiaries would not be entitled to claim the allowance, not being the owners of the property. There is one difference as regards the method of apportionment as it applies to trusts and as it applies to estates. In the case of a trust, the code provides that the depletion deduction should be apportioned between the trust and its beneficiaries in accordance with the provisions of the trust instrument.[19] It is only in cases in which the trust instrument is silent that the allowance would be apportioned on the basis of the share of income allocated to each of the parties. In the case of an estate, the provisions of the testamentary instrument are completely disregarded, and the apportionment is made directly on the basis of the income allocated to each of the parties.[20]

Numerous questions concerning the depletion allowance arise following assignments of mineral interests. One problem concerns the taxation of any lump sum payment the assignor might receive upon executing the assignment. If the transaction constitutes a sale, the assignor will not be entitled to claim depletion on the proceeds received. Where the assignor has sold a capital asset held for more than six months, however, he need not regret his inability to claim depletion, inasmuch as he ordinarily could avail himself of the more advantageous long term capital gain provisions of the Internal Revenue Code. Where the transaction is construed as a lease rather than a sale, however, the initial lump sum received is regarded as advance royalty to which the depletion deduction is applicable.[21] The distinguishing feature between a sale and a lease is whether the assignor has retained an economic interest in the minerals. Thus, if the assignor is to receive payments in the future which payments are dependent upon production, he is considered to have retained his economic interest in the minerals in place, the transaction is considered a lease transaction and the original lump sum payment is subject to the depletion allowance.[22] Where on the other hand, the consideration to be received by the assignor is fixed and absolute and does not in any way depend upon production from the property, the transaction would be considered a sale with the proceeds not subject to depletion.[23]

The treatment accorded the initial lump sum payment need not necessarily be the same as that accorded future payments. For instance, suppose an assignment is made of mineral operating rights in consideration of an initial cash payment of $20,000.00 plus 1/8 of the assignor's gross proceeds from the sale of extracted minerals until an additional $30,000.00 is paid. The assignment provides that the additional $30,000.00 is payable only from 1/8 of production, and that if there should not be sufficient production that the assignee would not be personally liable for any unpaid balance

19. IRC Sec. 611 (b) (3).
20. IRC Sec. 611 (b) (4).
21. Arthur N. Trembley, 7 TCM 972.
22. Cook Drilling Co., 38 BTA 291 (1938) (Acq.).
23. Cullen v. Com., 118 F.2d 651 (5th Cir. 1941), 41-1 USTC par. 9364.

of the $30,000.00. In this situation, the initial recepit of $20,000.00 would be treated as proceeds from the sale of an asset and as such subject to the capital gains provisions but not to the depletion provisions of the Internal Revenue Code. The $30,000.00, however, would constitute ordinary income subject to depletion.[24]

The terminology used in making the assignment can be important where there is any doubt as to whether a lease or a sale was intended. However, terminology is not controlling, and what is clearly a sale cannot be made into a lease simply by calling a transaction a lease. Similarly, peculiarities of local law are not controlling. For example, in some states the granting of rights to extract minerals results in the transfer of legal rights to the minerals. However, for tax purposes the instrument of conveyance might still be considered a lease regardless of this local provision of law.[25] Generally, any payments which are dependent on production will be regarded as depletable income; even payments based on net profits from production may be subject to depletion.[26] Operating rights, of course, are not only the kind of transferable mineral interests in property. Royalty interests may also be assigned, but there is no question but that the unlimited assignment of a royalty interest or of a fraction thereof constitutes the sale of a capital asset.[27]

In those cases in which the initial cash payment constitutes gain on the sale of an asset and the future payments constitute ordinary income against which the depletion allowance may be claimed, the taxpayer must make an allocation of the basis of his interest. Part of the basis must be allocated against the future cash payments. Inasmuch as such future payments are subject to the depletion allowance, the taxpayer is provided with the means of recovering that portion of his cash investment which has been allocated to the periodic payments.

What is known as a "lease and option agreement" is a type of contract that is quite commonly used in the mining industry. Such a contract usually provides that the lessee is to be permitted to develop and operate the property; that the lessee has an option to acquire full ownership by paying an agreed sum; that until such agreed sum is paid the lessee will pay a percentage of the production to the owner; that any payments made by the lessee will apply against the full amount of the purchase price while alternatively at any time the lessee has the right to move off the property without further obligation. Both the commissioner and the tax court agree that the seller retains an economic interest in the property by reason of the provision that part of the price is payable out of a percentage of the minerals produced.[28]

24. Cullen v. Com., 121 F.2d 9 (5th Cir. 1941), 41-1 USTC par. 9364.
25. Burton-Sutton Oil Co. v. Co., 328 U.S. 25, 46-1 USTC par. 9243 (1946).
26. Burnet v. Harmel, 287 U.S. 103, 3 USTC par. 990 (1932).
27. J. E. Murphy, 9 BTA 610 (1927) Acq.
28. G.C.M. 23,999, 1943 CUM. BULL. 144 and L. D. Godshall, 13 TC 681 (1949).

Any initial payment which might have been made under such a lease and option agreement constitutes part of the total purchase price and as such is subject to capital gains treatment rather than to a percentage depletion allowance. The periodic payments, of course, being out of production, are subject to the depletion allowance.

A search of the Revenue Code reveals yet further provisions which are of special interest and advantage to the uranium producer. One of these is the provision relating to exploration expenditures which covers any costs paid or incurred to ascertain the existence, location, extent, or quality of any ore or mineral deposit prior to the beginning of the development stage. The beginning of the development stage is generally determined by reference to the time when the existence of ores or minerals in commercially marketable quantities is discovered. The 1954 Code increased to $100,000 the amount of exploration expense which can be immediately written off against income.[29] The taxpayer is entitled to this write-off for each of four years which need not necessarily be consecutive. Any portion of the $100,000 amount not used in any one year, however, cannot be carried over to succeeding years. The manner in which this provision is phrased causes it to apply to each individual taxpayer rather than to each individual property.[30] Thus, the fact that some preceding owner might have claimed this special deduction in regard to any certain property does not prevent a subsequent owner, whose basis is different than that of the preceding owner, from claiming similar special treatment. The tax advantage of this deduction to a high bracket taxpayer is obviously quite apparent. It should be kept in mind, however, that any amounts deducted reduce net income so that the taxpayer should make his election regarding this deduction with an eye to its effect on the percentage depletion deduction and its concomitant limitation to 50 per cent of the taxable income. Alternatively of course, the taxpayer can always elect to capitalize his exploration expenditures.[31] In such event, the amount capitalized is deductible on a ratable basis as the units of produced ores discovered by reason of the expenditures are sold.[32] This election accordingly involves the making of an estimate as to the amount of reserves discovered, the estimate, of course, being subject to revision.

Another provision quite similar to the above mentioned deduction for exploration expenditures is the deduction permitted for development expenses. This provision comes into play after the existence of ore in commercially marketable quantity has been disclosed.[33] The limitations that affect the exploration expenditure deduction are not applicable here. In fact, there is no limit either on the amount that can be deducted nor on the number of years in which such a deduction can be claimed. Develop-

29. IRC Sec. 615 (a).
30. IRC Sec. 615 (c).
31. IRC Sec. 615 (b).
32. *Ibid.*
33. IRC Sec. 616 (a).

ment expenditures do not stop when the mine reaches the production stage, but continue until it reaches a level of full production. As in the case of exploration expenditures, these expenses can be either capitalized or deducted currently.[34] The election to defer the deduction must be made for the total amount of the development costs.[35]

Even after a mine is in full production, special treatment is available to the mine operator. Expenditures which ordinarily would have to be capitalized are to be charged off currently if they result only in maintaining the established output as the working face of the mine recedes.[36] This benefit is conditioned upon all of the following three factors being present:

1) The expenditures do not increase production or decrease the cost of operations.
2) The expenditures do not increase the value of the mines.
3) The expenditures are not made for the purpose of restoring the mine property or of making good exhaustion thereof for which a depreciation deduction has already been allowed.

The fact that such expenditures may be substantial or be for items ordinarily classed as capital assets is not controlling. So long as their purpose is only to maintain established production, they are currently deductible. This deduction is based on the reasoning that if the expenditures were capitalized instead of being currently deductible, the cost of ore removal would be pyramided with respect to the ore that was farthest back in the mine. The accounting records would then indicate that the ore mined from locations near the head of the mine had yielded an abnormal profit, while ore mined from father back might possibly even show a loss. The full amount spent can be deducted currently even though the equipment purchased may have a useful life of many years. Thus, in one instance, the cost of purchasing and installing electric locomotives, mine cars and rails in a mine was allowed to be charged off to expense.[37] Where, however, the equipment was purchased to improve the quality of the product but did not affect the output, it was held that the cost of the equipment would have to be capitalized.[38]

The foregoing discussion has been concerned with portions of the tax code that apply to all uranium producers, regardless of the form in which they operate. Space does not permit a discussion of how form changes the tax picture, but change it, it does. The taxes assessed against a uranium producer operating as an individual or partnership will differ sharply from the taxes assessed against the corporate producer. In fact, it can be said that this paper has dealt only with those phases of the tax law concerned with the operation of a mine. Completely left out by reason of lack of space are those portions of the tax picture that deal with realizing profits

34. IRC Sec. 616(b).
35. *Ibid.*
36. Reg. 118, Sec. 39.23(m)-15.
37. Marsh Fork Coal Co. v. Lucas, 42 F.2d 83 (4th Cir. 1930) 2 USTC par. 550.
38. Ritter Lumber Co., 30 BTA 231 (1934).

by the sale of the property or by making the instant sale of a part of the property possible by utilizing the advantages of the corporate form and the stock market. Each of these are subjects in themselves and each of them should be given serious consideration by the taxpayer who wishes to preserve part of the fruits of his efforts for himself. Throughout all of the tax law there exists provisions of which the uranium producer can take advantage. Some of them, as discussed above, are particularly tailored for the mine operator. Taken all together, they form a picture in which the government is backing the uranium ore producer, providing him special advantages, urging him on with special incentives. The tax provisions have been drafted to help him, not stifle him.