APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE PAPER

INDUSTRY:	**MINING INDUSTRY**
ISSUE:	**WHETHER COSTS INCURRED DURING A STRIKE ARE DEDUCTIBLE FROM GROSS INCOME FROM THE PROPERTY FOR PURPOSES OF COMPUTING THE 50% TAXABLE INCOME LIMITATION ON PERCENTAGE DEPLETION UNDER I.R.C. §613(a).**
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SETTLEMENT GUIDELINES

THE EFFECT OF COSTS INCURRED DURING A STRIKE ON THE PERCENTAGE OF DEPLETION COMPUTATION.

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STATEMENT OF ISSUE

Whether certain administrative and overhead expenses incurred by a mining company during an employee strike as well as depreciation on idled plant and equipment are deductible from gross income from the property for purposes of computing the 50% taxable income limitation on percentage depletion under I.R.C. **§** 613(a).

EXAMINATION DIVISION'S POSITION

The position of the Examination division is that all such expenses incurred during the period of a strike must be subtracted from gross income to arrive at the 50% taxable income limitation on percentage depletion under I.R.C. **§** 613(a).

LAW

I.R.C. **§** 611 provides that in the case of mines and other natural deposits, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion, according to the particular circumstances in each case. In the case of certain natural deposits, I.R.C. **§** 613 provides that the allowance for depletion shall be a specified percentage of the gross income from the property. The allowance for percentage depletion, however, shall not exceed 50% of the taxpayer's taxable income from the property computed without allowance for depletion. I.R.C. **§** 613(a).

I.R.C. **§** 613(c)(1) defines the term "gross income from the property", in the case of a property other than an oil or gas well, as the gross income from mining. Treas. Reg. **§** 1.613-4(a) further provides that "gross income from mining" is that amount of income attributable to the extraction of ores or minerals from the ground and the application of mining processes, including mining transportation.

In defining "taxable income from the property" for purposes of I.R.C. **§** 613, Treas. Reg. **§** 1.613-5(a) provides, in pertinent part:

The term "taxable income from the property (computed without allowance for depletion)", as used in section 613 and this part, means "gross income from the property" as defined in section 613(c) and **§§** 1.613-3 and 1.613-4, less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. These deductible items include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, taxes deductible under section 162 or 164, losses sustained, intangible drilling and development costs, exploration and development expenditures, etc. Expenditures which may be attributable both to the mineral property upon which depletion is claimed and to other activities shall be properly apportioned to the mineral property and to such other activities.

ANALYSIS

The gross income concept is significant since it is the base to which the specified depletion rates are applied. The concept of taxable income is equally important as the amount of depletion is limited to 50% of taxable income from the property.

The statute does not explicitly define the term "taxable income from the property." Therefore, an analysis of case law is instructive in determining what items are deductible in arriving at "taxable income from the property."

Examination cites Montreal Mining Co. v. Commissioner, 41 B.T.A. 399 (1940), and Rialto Mining Corp. v. Commissioner, T.C. Memo. 1946-496 in support for this position. These cases set forth the principle that liabilities that arise which are directly or indirectly related to the mining process must be taken into account to compute net taxable income from the property even if the costs have no relation to the current years income from mining.

This principle seems well established and based on the responses from the mining industry, it is not the center of disagreement. What the mining industry has focused on as their basis for disagreement is the delineation of whether costs incurred during a labor strike are either -

1. Attributable to mining processes under the theory that labor disputes, contract negotiations and strikes are commonplace in the industry to the degree that such costs are normal operating expenses of a mining company,

or

2. Not attributable to mining processes under the theory that since no production is occurring all costs incurred during the period of the strike should not be included in the computation of net taxable income from mining.

The Service's position articulated in the Examination position paper is that the expenses incurred during a strike are not extraordinary items incurred because of the work stoppage. Rather, they represent fixed overhead costs which arise in the ordinary course of mining. These fixed and continuing costs should not take on a different character because they are incurred during a shutdown due to an employee strike.

The position articulated by industry is that the regulations only require the subtraction of allowable deductions which are attributable to "mining processes." Costs incurred during a strike are not incurred as a result of production and as such the mining industry concludes that the costs should not be included in the computation of "net taxable income from the property."

In support of its position industry cites Revenue Ruling 80-317. The Service in Rev. Rul. 80-317, 1980-2 C.B. 202, ruled that the payment of damages for breach of contract is not attributable to mining processes and is not deductible from gross income from mining in computing the taxable income limitation. The expenditure was not an ordinary and necessary cost of mineral extraction and was not related to production of income from an extracted mineral, but rather the payment was the result of lack of production.

The mining industry argues that expenses for salaries, maintenance, depreciation and other costs which continue during a strike are not related to mining processes, since there is no mineral production during a strike. Such expenses are occasioned by the lack of production and are not associated with income from an extracted mineral. It is therefore asserted that these expenses should not be deducted from gross income for purposes of I.R.C. **§** 613(a).

The mining industry takes this expanded view by looking to the GCM 38,469 (August 12, 1980) which provided the underlying reasoning of Revenue Ruling 80-317. That GCM states:

> Nevertheless, the case law noted above clearly indicates that to be deductible the expenditure normally must be incurred in the process of production of a mineral, and the damages cost in this case was incurred because of the lack of production. In view of the above authorities, we conclude that whether an item is deductible from gross income from mining for purposes of computing the 50% limitation under section 613(a), is

> dependent on production of natural resources, and, to the production of income from such resources. Absent production in the present case, there clearly can be no income produced.

As additional support of their position, the mining industry also cites Island Creek Coal v. Commissioner, 382 F.2d 35 (4th Cir. 1967). In Island Creek, the court held that premiums paid for business interruption fire insurance were not deductible from gross income from mining in computing taxable income from the property for percentage depletion purposes. In reaching its decision the court reasoned that any expense incurred to produce income that is not income from mining is not an expense of mining. Therefore, since proceeds from business interruption insurance are not mining income, the expenses incurred on producing that income, namely the insurance premiums, are not mining expenses.

Using the above cited rationale, the mining industry concludes that strike costs are incurred only when there is no production and no income is being generated and as such should be excluded under the same rationale.

The problem with this rationale is that it ignores the fact that strike costs are incurred so that production can occur and that such expenses benefit future production which will produce gross income from mining.

In support of its position, Examination cites Elk Lick Coal Company v. Commissioner, 23 T.C. 585 (1954). The Tax Court, in Elk Lick determined that losses sustained by a taxpayer upon abandonment of certain mining equipment and plant components were deductible from gross income in determining taxable income from mining for purposes of computing the depletion allowance. The Court found that the losses were deductible from gross income, because they were directly related to the mining and preparation of coal and were required to be taken into account under Treas. Reg. 111, § 29.23(m)-1(g) under the 1939 Code, which provided that "losses sustained" were to be deducted from gross income.

In distinguishing Elk Lick, the Fourth Circuit in Island Creek stated that Elk Lick did not involve a segregation of related receipts and disbursements. The Court explained:

> When mining equipment is purchased, it is an expense of mining; the entire cost is then devoted to mining. The cost must be capitalized and is recoverable for tax purposes only upon subsequent deductions for depreciation and ultimate abandonment. The capitalization requirement, however, simply postpones to later years portions of the deduction of the cost of the equipment; it does not change the character of the original cost as an expense of mining. There is a different situation when a profit is realized

> upon the sale of equipment withdrawn from the mining operation. The profit is not a mining profit. It does not arise out of the extraction and included treatment processes, but withdrawal of equipment from the mining operation does not change the character of the expense of its initial acquisition. It was a mining expense when incurred, and subsequent events do not partially convert it into something else.

Island Creek Coal Co. v. Commissioner, 382 F. 2d 35 at 38.

This rationale would support the conclusion that depreciation and other fixed costs that are directly related to the mineral property (e.g., amortization expense and lease expense) or mining processes (e.g., selling expenses) that continue during the period of the strike should be deducted in arriving at taxable income from the property. Since there is no non mining income against which to match these expenses, then it would seem that the Service's position is more consistent with the position taken by the Tax Court in Island Creek than the position taken by the mining industry. However, with regard to indirect administrative and overhead costs that are incurred during the strike and expenses that are incurred only by reason of the strike, the issue is less certain. Four years after the Island Creek Coal decision the Tax Court rendered its opinion in North Carolina Granite Corp. v. Commissioner, 56 T.C. 1281 (1971).

In North Carolina Granite Corp. v. Commissioner, 56 T.C. 1281 (1971), the Tax Court held that the expenses incurred by a taxpayer in resolving federal income tax controversies were not required to be deducted from gross income from mining. Although the tax controversies were centered on the mining part of the taxpayer's business enterprise, they did not produce any taxable income and, thus, were not "essential to the production of income from mining." The Service did not acquiesce on this issue, since the tax controversy expenses were considered to be indirect administrative expenses that benefited both the taxpayer's mineral property and non mining operations and an allocation should have been made with that portion of the expenses attributable to the mineral property deducted from gross income from mining for purposes of the 50% limitation on percentage depletion. Rev. Rul. 77-179, 1977-1 C.B. 168.

Notwithstanding the Service's nonacquiescence, the Tax Court's opinion in North Carolina Granite raises some concern as to how successful the Service will be in maintaining that all costs incurred during a strike should be deducted in arriving at "net taxable income from the property." The Service can rely heavily upon the Island Creek decision regarding the depreciation and other fixed costs that are directly related to the mineral property or mining processes that continue to be incurred during a strike. The character of these expenses should not change due to a temporary labor condition when future mining income is in fact the reason these expenses continue to be incurred.

With regard to indirect administrative and overhead expenses and expenses that are only incurred by reason of the strike, North Carolina Granite may present some hazards of litigation.

Island Creek and Revenue Ruling 80-317 can be distinguished as inconsistent with Service position that all expenses incurred during a mining strike are deductible in arriving at "taxable income from the property." Both conclusions attempt to match non mining income with non mining expenses. However, the same rationale is not applied in North Carolina Granite which is partly the basis of the Service's nonacquiescence.

The mining industry also raises the argument that the temporary regulations under I.R.C. § 263A provide substantial authority, by analogy, for their position that strike costs are not required to be deducted from gross income from the property in computing the taxable income limitation. The industry points to the specific references to depreciation on temporarily idled equipment found in Temp. Treas. Reg. § 1.263A-1T(b)(2)(v)(F) and strike costs in subsection (I) of that regulation, which except such items from the general requirement that certain direct and indirect costs be capitalized, i.e., charged to a capital account or basis or added to inventory costs with respect to property that is produced or acquired for resale. Temp. Treas. Reg. § 1.263A-1T(b). It is concluded that these costs are not related to production activities for purposes of I.R.C. § 263A, and therefore, these same costs should not be deemed attributable to mining processes under Treas. Reg. § 1.613-5(a).

The Service's position is that the uniform capitalization rules of I.R.C. § 263A do not provide authority for the exclusion of strike expenses from the computation of the taxable income limitation for percentage depletion. I.R.C. § 263A has no direct bearing upon percentage depletion and does not define the boundaries of the costs which must be included in the computation of the taxable income limitation under I.R.C. § 613. Treas. Reg. § 1.613-5(a) requires gross income from the property to be reduced by all allowable deductions related to mining processes, including mining transportation, with respect to which depletion is claimed. The expenses to be deducted from gross income under Treas. Reg. § 1.613-5(a) are not limited to those production or resale costs that re required to be capitalized under I.R.C. § 263A. In fact, there are several categories of expenses which are expressly exempted from capitalization under I.R.C. § 263A, but are still required by Treas. Reg. § 1.613-5(a) to be deducted from gross income from the property for purposes of the taxable income limitation under I.R.C. § 613. The following are examples of such expenses: marketing, selling and advertising expenses; exploration and development expenditures; and losses sustained.

Furthermore, final regulations under I.R.C. § 263A were adopted on August 6, 1993, by

T.D. 8482. Treas. Reg. § 1.263A-1(e)(3)(iii)(G) defines strike expenses to include "only costs associated with hiring employees to replace striking personnel (but not wages of replacement personnel), costs of security and legal fees associated with settling strikes." This definition is much narrower than the definition that appeared in the temporary regulations and does not include all of the "fixed" costs at issue.

SETTLEMENT POSITION

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