

APPEALS

Industry Specialization Program Coordinated Issue

Settlement Guidelines

Industry: Mining
Issue: Receding Face Deduction
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UIL No.: 612.03-03
Factual/Legal Issue: Factual

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DEC 13 2002

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DEC 13 2002

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Effective Date: DEC 13 2002

COORDINATED ISSUE
MINING INDUSTRY

RECEDING FACE DEDUCTION
UIL 612.03-03

STATEMENT OF ISSUE

Do X's expenditures for various conveyor system components, as described in scenarios A through D below, qualify for the receding face deduction as provided by Treas. Reg. Section 1.612-2(a)?

COMPLIANCE'S POSITION

The Compliance Coordinated Issue Paper addresses four different scenarios to illustrate typical issues encountered with respect to the receding face deduction. Depending on each particular set of facts and circumstances, the Coordinated Issue Paper determines whether the expenditures for various conveyor system components are either currently deductible under the provisions of Reg. §1.612-2(a) or must be capitalized and depreciated over their useful lives.

The overall facts, the four specific situations and the conclusions reached in the Coordinated Issue Paper are as follows:

Facts

X is an underground/surface miner of mineral Y. X utilizes a conveyor system to transport mineral or waste rock from the "working face" out of the mine. The mineral is removed from the mine for processing and sale. In the case of waste rock, the conveyor system removes the rock for disposal. The term "working face" means the face at the end of a mine tunnel heading or at the end of a full-size excavation.

The conveyor system presently utilized by X consists of a 48-inch mainline belt and belting structure (including idlers and rollers, etc.), which receives material at transfer points from feeder belts that extend to the mining face(s). The system includes belting, belt drive motors, booster drives, belt tensioning devices, and transfer stations.

Scenario A

X is an underground miner of mineral Y. The mine has a 1,500 foot mainline conveyor used to transport mineral Y to the surface. X adds to this mainline system towards the working face by adding a completely new free-standing 250 foot conveyor structure, complete with motor, 500 feet of belting, and a transfer station. Subsequent to making these additions, production at the mine did not increase. The cost of operating the mine remained constant and the mine did not increase in value.

Conclusion as to Scenario A

The cost of the new 250 foot conveyor structure, the motor, the 500 feet of belting, and the transfer station were incurred solely for the purpose of maintaining the capacity of the mine as the working faces receded. Thus, the expenditures met the threshold requirement that they were made solely because of the recession of the face. Further, the expenditures did not increase production at the mine nor decrease the cost of operation and they did not enhance the value of the mine. Therefore, the costs associated with the expansion of the conveyor belt system are deductible under section 1.612-2 of the regulations.

Scenario B

Same as Scenario A, except X extends the mainline conveyor by 250 feet. X purchases 3,500 feet of belting, 250 feet of new conveyor structure that is added to the existing structure, and a new booster drive motor to supplement the main belt drive. The new booster motor accommodates the additional mechanical drive requirements of the 250 foot extension. As part of the extension project, X replaces the entire mainline belt with the 3,500 foot belt. The old mainline belt was replaced as part of the extension project because of its deteriorated condition and to improve its reliability. The 250 foot extension was required to reach the current location of the working face to maintain current production.

Conclusion as to Scenario B

The new 250 feet of conveyor structure, along with its supplemental booster drive motor, was incurred solely because of the recession of the face and the expenditures incurred to add the new conveyor and motor did not increase production, decrease the cost of operation, or enhance the value of the mine. Accordingly, the cost of the additional structure is deductible under Reg. §1.612-2. The cost of the 3,500 feet of belting, however, was incurred, in part, to replace 3,000 feet of worn out belting. Thus, the cost of the 3,500 feet of belting was not incurred solely due to the recession of the working face. Furthermore, the belting expenditure does not meet the test of Reg. §1.612-2(a)(3), since it represents an amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. Accordingly, this expenditure is not eligible as a receding face deduction.

Scenario C

Same as Scenario A, except X upgrades the entire mainline belt and extension from 48 inch belting to 60 inch belting. This increase in belt capacity allows X to increase its production rate by 20%, resulting in a corresponding 10% reduction in the overall cost per ton to produce the mineral.

Conclusion as to Scenario C

X is not eligible to deduct any of the expenditures under Reg. §1.612-2. While these expenditures were incurred because of the recession of the working face, they result in a 10% reduction in the overall cost per ton to produce the mineral; hence they fail to satisfy the test of section 1.612-2(a)(2) of the regulations, which requires that the expenditure does not decrease the cost of production of mineral units. These costs must be capitalized as mine equipment.

Scenario D

X is a surface miner of mineral Y. X has a conveyor system used to transport excavated overburden to its waste rock disposal site. Because of capacity constraints and environmental concerns, X can no longer utilize the current waste rock disposal site. In order to maintain its current production rate from the mine, X constructs a new conveyor system to a newly approved alternative disposal site. During this period, mining has continued, and as the case with all mines, the working face receded as the mineral and overburden were removed. The construction of the new conveyor system was necessitated by the lack of capacity and environmental concerns at the first disposal site, even though the working face was contemporaneously receding.

Conclusion as to Scenario D

The cost of the conveyor to the new waste rock disposal site was mandated by capacity constraints at the old site and environmental regulations. Expenditures necessary to maintain production of the mine which are not exclusively related to the movement of the working face are not deductible under Reg. §1.612-2(a) simply because the mining face had receded during the course of mining. Thus, even though the expenditures were required to maintain the normal output of the mine, X is not eligible to deduct any costs under Reg. §1.612-2 since the expenditures were not incurred solely because of the recession of the working face.

INDUSTRY / TAXPAYER POSITION

It has been asserted by industry members that Compliance's interpretation of the phrase "solely because of the recession of the working face of the mine" as set forth in the regulations is simply too narrow. Industry members contend that Compliance's literal application of this phrase fails to take into consideration the purpose behind the receding face doctrine and substantially limits a taxpayer's ability to qualify for the deduction.

DISCUSSION

Background/Facts

Compliance's Coordinated Issue Paper has examined four scenarios and determined whether expenses for various conveyor system components qualify for the receding face deduction under Reg. §1.612-2(a).

An underground/surface miner of a mineral uses a conveyor system to transport mineral or waste rock from the "working face" of the mine. The conveyor system removes the waste rock for disposal. The system consists of a 48-inch mainline belt and belting structure that receives material at transfer points from feeder belts that extend to the mining face.

In Scenario A, the miner adds to its mainline system towards the working face a new free-standing 250 foot conveyor structure complete with motor, 500 feet of belting, and a transfer station. These additions did not increase production at the mine, did not decrease the cost of operation and did not enhance the value of the mine. The Coordinated Issue Paper concluded that the costs associated with the expansion of the conveyor belt system are deductible under Reg. §1.612-2(a) because the costs were incurred solely to maintain the capacity of the mine as the working face receded.

The facts are the same in Scenario B, except the miner extends the mainline conveyor structure by 250 feet, replaces worn belting (the entire mainline belt) and adds a booster motor to accommodate the additional mechanical drive requirements of the 250 foot extension. The Coordinated Issue Paper concluded that the cost of the new 250 feet of conveyor structure, along with the supplemental motor were incurred solely because of the recession of the working face and did not increase production, decrease the cost of operation or enhance the value of the mine. Accordingly, it was determined that these expenditures were deductible under Reg. §1.612-2(a).

Because the belting expenditure was incurred in part to replace 3,000 feet of worn belting, the Coordinated Paper concluded that this cost was not eligible as a receding face deduction as it represents an amount expended in restoring property. Although the remaining 500 feet of belting was utilized to operate the 250 foot new conveyor

structure that qualified as a receding face deduction, this 500 feet of belting must also be capitalized as the entire belting expenditure (3,000 feet related to the worn out belting and 500 feet related to the new 250 foot conveyor structure) was not incurred solely due to the recession of the working face.

Thus, based on the language contained in Reg. §1.612-2(a), Scenario B emphasizes the point that an allocation of a single expenditure between qualifying and nonqualifying costs (e.g. a “dual purpose expenditure”) is not appropriate.

The facts are the same in Scenario C, except the miner upgrades the entire mainline belt and extension from 48 inch belting to 60 inch belting. That change increased belt capacity and allowed the miner to increase its production rate by 20 percent and to reduce the overall cost per ton to produce the mineral by 10 percent. These expenditures, as determined by the Coordinated Issue Paper, do not qualify as a deduction under Reg. §1.612-2(a) because although they were incurred due to the recession of the working face, they result in an overall reduction in the cost per ton to produce the mineral. Accordingly, this expenditure must be capitalized.

In Scenario D, the miner uses a conveyor system to transport excavated overburden to its waste rock disposal site. Because of capacity constraints and environmental concerns, it can no longer use the current waste disposal site. To maintain its current production rate from the mine, it constructs a new conveyor system to a newly approved disposal site. The working face was contemporaneously receding. Based on these facts, the Coordinated Issue Paper concluded that the costs were not deductible under Reg. §1.612-2(a) because although the mining face receded, the expenditures were not solely related to the recession of the working face but rather enabled the transport of overburden to another storage site.

Legal Analysis

As a general rule, the cost of mine improvements and equipment are ordinarily treated as capital expenditures and recoverable through depreciation over their useful lives. One exception to this general rule is found in Reg. §1.612-2(a). This section provides that certain expenditures, which would ordinarily be capitalized, are currently deductible when they are incurred to maintain the normal output of the mine solely because of the recession of the working face.¹ Thus, for expenses to be currently deductible, the regulations provide that they cannot (1) increase the value of the mine, (2) decrease the cost of production of mineral units, or (3) represent amounts spent in restoring property for which a prior allowance is or has been made.

¹ The working face represents the place in the mine where the mineral is being extracted from its deposit. Generally, as the mining operation progresses, the mine’s working face gets further away from the processing plant or from the delivery point of the mineral product. Due to the progressively increasing distance between the working face and the processing plant and/or the delivery point, additional machinery and equipment are required in order to maintain the normal output of the mine.

The origin of the receding face doctrine dates back to the decision rendered by the Fourth Circuit in Marsh Fork Coal Co. v. Lucas, 42 F.2d 83, 2 USTC ¶550 (4th Cir. 1930), reversing 11 B.T.A. 685 (1928). The three-part test enumerated in Reg. §1.612-2(a) was taken directly from section 39.23(m)-15 of Treasury Regulations 118, originally promulgated in art. 242(b) of Regulations 77 (1933 ed.) under the Revenue Act of 1932.² Since 1933, the receding face doctrine, as reflected in the current regulations, has not been substantially changed.

The Fourth Circuit in Marsh Fork Coal Co. v. Lucas, supra, reviewed a Board of Tax Appeals decision that disallowed a taxpayer's deduction for electric locomotives, steel rails and mine cars on the basis that the expenditures were capital. At the time the expenditures were made, the taxpayer's mine was fully developed and had been operating for a number of years. The working face of the mine had reached a considerable distance from the head-house³ and additional cars, locomotives and tracks were necessary to maintain the normal output. The taxpayer had contended that the expenditures were properly treated as deductible maintenance items because they did not increase output, decrease the cost of production, or add to the value of the mine. Rather, they were made solely to maintain normal production.

In reversing the Board of Tax Appeals, the Fourth Circuit agreed with the taxpayer's position. Finding that the expenditures involved were not made to either increase production or decrease the cost of operation, and did not add to the value of the property, the Court concluded that the expenditures were made solely for the purpose of maintaining the capacity of the mine as the working face receded.

Thus, taking into consideration accounting methods and principles, the Fourth Circuit concluded that it is much more reasonable to allow mine operators to charge the expense of equipment for maintaining production due to lengthening tunnels against the coal mined rather than against coal not yet removed. The Court also determined that the fact that the locomotives, cars and tracks would last for a number of years was immaterial.

Thus, the receding face doctrine is based on the reasoning that if the expenditures required to maintain the normal output of a mine were capitalized, then the removal costs would be pyramided against the mineral further back in the mine. This could effectively result in abnormal profits being earned on the mineral extracted at the beginning of the mine with potential losses on the mineral extracted further back in the mine.

The courts have considered the receding face asset doctrine in numerous cases since Marsh Fork Coal Co. and the enactment of Reg. §1.612-2(a).

² See United States Gypsum Company v. U.S., 62-1 USTC ¶9367.

³ This term is sometimes applied to the structure containing the hoisting engine, boilers and other machinery, in addition to the actual hoisting cage.

SETTLEMENT GUIDELINES

The settlement guidelines are limited to the four specific fact patterns described in the Coordinated Issue Paper.

On first impression, the application of the three-prong test set forth in Reg. §1.612-2(a) to a particular set of circumstances appears simple. However, this issue requires an extensive analysis of the facts and circumstances as to whether the expenditures are required solely because of the recession of the working face of the mine.

Each of the scenarios in the Coordinated Issue Paper contains various factual assumptions (e.g. whether production at the mine increased, whether production costs decreased, whether normal output was maintained, etc.). However, it should be emphasized that arriving at those assumptions is not an easy task as it requires a careful evaluation of both historical and current mining data and reports.

Various conclusions can result due to different interpretations of the underlying data and reports. For example, assume that Compliance determined the expenditures at issue caused a 30% increase in production and a 15% decrease in production costs. How are these percentages computed? What data/reports should be utilized in calculating these percentages and for what periods of time? Similar questions may also arise with respect to determining the normal output of the mine.

As another example, assume Compliance determined the expenditures under consideration enhanced the value of the mine. How does one measure there has been an increase in the value of the mine? How does a geological change such as the location of a new vein of ore relate to and affect a receding face issue?

Resolution of this issue will normally be on a factual basis. Accordingly, sufficient documentation⁴ should be included in the administrative file in order to establish whether the expenditures at issue maintained the normal output of the mine, increased the value of the mine as a producing unit, decreased the cost of production or were made to upgrade or replace worn out or obsolete equipment. Undeveloped cases may have to be returned to Compliance for further analysis.

The area of potential disagreement focuses on the definition of the phrase “solely because of the recession of the working face of the mine”. As previously stated, it has

⁴ Some examples include: (a) mining cost studies, (b) production reports, (c) development and mining plans before and after the expenditure(s) at issue, (d) mining plan detailing the layout of the new conveyor system, (e) mine maps (e.g. an area location map, property map with boundaries, deposit/reserve map, quarry and plant processing site map), (f) Authorization for Expenditures, (g) Capital Preparation Requests, etc. In some instances, the administrative file may contain an engineering appraisal. Additionally, Compliance may have inspected the project site and/or interviewed site engineers.

been alleged by industry members that Compliance has defined this phrase too narrowly and too literally thereby substantially limiting a taxpayer's ability to qualify for a receding face deduction. On the other hand, Compliance contends that taxpayers generally take an overly expansive position with respect to the definition of the word solely. Therefore, the question arises as to whether the expenditures need to be "exclusively" related to the recession of the working face (e.g. a direct and exclusive casual relationship) or just somehow related to the recession of the working face.

Although the word "solely" means "exclusively" (see Webster's II New Riverside University Dictionary), the phrase "solely because of the recession of the working face of the mine" has not been given a precise definition under the regulations or in the numerous court cases which address receding face issues.⁵

Despite the lack of a precise definition of this phrase, based on the literal interpretation of Reg. §1.612-2(a), it appears that Compliance's narrow application of this phrase would be supported in the event of litigation.

The determination as to whether the expenditure was incurred "*solely*" because of the recession of the working face is a factual matter. Since each receding face issue presents its own unique set of facts and circumstances, it is difficult to provide a settlement range that can be applied to each particular situation.

Accordingly, this issue will be settled on a case-to-case-basis in consultation with the ISP coordinator.

⁵ The Fourth Circuit in Commissioner v. H.E. Harman Coal Corporation, 52-2 USTC ¶19487 (CA 4th Cir.), held that the cost of mine equipment, such as conveyors, loaders, cutting machines and electric jeeps, was a capital expenditure and not a current business expense, when the equipment was necessitated by the thin seam of coal encountered, the change in the seam being mined and the increasing difficulty of obtaining manpower. Thus, these costs were determined to have been made in the interest of economy and efficiency and not "solely because of the recession of the working faces of the mine". In requiring these costs to be capitalized, the Court ruled that it was immaterial that they were required to maintain production after full capacity had been reached. Also see United States Gypsum Co. v. U.S., 62-1 USTC ¶9367 (DC) (new air and escape hatches were not necessitated merely because of the recession of the working faces but due to a safety requirement under the state mining law).