



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224  
January 27, 2000

OFFICE OF  
CHIEF COUNSEL

Number: **200021006**  
Release Date: 5/26/2000  
TL-N-4976-99  
CC:DOM:FS:IT&A  
UILC: 56.15-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, BROOKLYN  
CC:NER:BRK

FROM: Deborah Butler  
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Potential ACE Adjustment for Depletion

This Field Service Advice responds to your memorandum, dated October 27, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corp A	=
Corp B	=
Corp C	=
Location D	=
Mine X	=
State E	=
Taxable Year 1	=
Taxable Year 2	=
\$f	=
\$g	=
\$h	=

ISSUE:

Whether in computing alternative minimum tax (AMT), Corp C has an adjusted current earnings (ACE) adjustment under I.R.C. § 56(g)(4)(C)(i) for the use of percentage depletion for mining property placed in service in a tax year beginning prior to January 1, 1990, when its AMT basis in the mining property is adjusted basis for the purposes of section 612.

### CONCLUSION:

In computing AMT, Corp C does not have an ACE adjustment under section 56(g)(4)(C)(i) for the use of percentage depletion for mining property placed in service in a tax year beginning prior to January 1, 1990, when its AMT basis in the mining property is adjusted basis for the purposes of section 612.

### FACTS:

Corp A is a wholly-owned United States subsidiary of Corp B, a company located in Location D. Corp C, a wholly owned subsidiary of Corp A, owns and operates Mine X located in State E. The mine is an open-pit copper mine.

Corp C placed the mining property at issue in service prior to January 1, 1990, and uses the percentage depletion method described in section 613 for computing its allowable section 611 depletion deduction. For regular tax purposes, Corp C claimed depletion deductions for Taxable Year 1 of \$f and for Taxable Year 2 of \$g. For AMT purposes, the taxpayer claimed depletion deductions for Taxable Year 1 of \$f and for Taxable Year 2 of \$h, which is less than \$g. Corp C's AMT basis for the mine only included amounts that would be basis for purposes of 612.

For Taxable Year 1, the depletion deduction was determined by using section 613 percentage depletion, which amount was less than the adjusted basis for purposes of section 612. Therefore, the depletion deduction was the same for regular tax and AMT purposes.

For Taxable Year 2, the depletion deduction was also determined by using section 613 percentage depletion. The depletion deduction for AMT purposes, however, was limited to the taxpayer's remaining section 612 basis in the property, which, after adjustments, was \$h

### LAW AND ANALYSIS:

Section 55(a) imposes, in addition to the other taxes imposed by Subtitle A, AMT equal to the excess (if any) of the tentative minimum tax (TMT) for the taxable year, over the regular tax for the taxable year.

Under section 55(b)(1), TMT equals the AMT rate applied to the excess of alternative minimum taxable income (AMTI) for the taxable year over an exemption amount, reduced by the AMT foreign tax credit for the taxable year.

AMTI is defined in section 55(b)(2) as the taxable income of the taxpayer for the taxable year determined with the adjustments provided in sections 56 and 58, and increased by the amount of the items of tax preference described in section 57.

Under section 57(a)(1), depletion is an item of tax preference, which, with respect to each subject property, is the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction of the taxable year.)

Section 611(a) provides that in the case of mines, there shall be allowed in computing taxable income a reasonable allowance for depletion. The two methods of computing depletion are "cost depletion" under section 612 and "percentage depletion" under section 613. While the basis for "cost depletion" is the adjusted basis of the property, percentage depletion is computed by applying the specified rate for the mineral produced to gross income from the property. I.R.C. § 612 and § 613(a).

Section 56(g)(1) requires an increase to AMTI based on ACE of a corporate taxpayer. The ACE adjustment is equal to 75% of the corporation's ACE for the taxable year over its AMTI (determined without regard to the ACE adjustment and the AMT net operating loss deduction (AMT NOLD).)

Section 56(g)(3), defines "ACE" to mean AMTI for the taxable year determined with the with the adjustments provided in section 56(g)(4), but without regard to the ACE adjustment and the AMT NOLD.<sup>1</sup>

Section 56(g)(4)(C)(i) provides that, in computing ACE, a deduction shall not be allowed for any item if the item would not be deductible for any taxable year for purposes of computing the corporation's earnings and profits.

Section 56(g)(5) defines the term "earnings and profits" for purposes of section 56(g)(4) as earnings and profits computed for purposes of subchapter C.

Treas. Reg. § 1.312-6(c)(1) provides that in the case of a corporation in which depletion is a factor in the determination of income, the only depletion deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to the March 1, 1913, value. In computing earnings and profits for any period beginning after February 28, 1913, the only depletion deductions that are to be considered are those based upon (1) cost or other basis, if the depletable asset was acquired after February 28, 1913, or (2) adjusted cost or March 1, 1913, value, whichever is higher, if acquired before

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<sup>1</sup> In computing ACE, section 56(g)(4)(F) provides specifically with regard to depletion that the allowance with respect to any property placed in service in a taxable year beginning after 1989 shall be cost depletion determined under section 611. No ACE adjustment is necessary under section 56(g)(4)(F) here, because the depletion at issue is on property placed in service in a taxable year beginning before 1990.

March 1, 1913. Percentage depletion under all revenue acts for mines is not to be taken into consideration in computing earnings and profits.

Instead, under section 1.312-6(c)(1), only depletion based upon adjusted basis, like cost depletion, can reduce earnings and profits. Section 56(g)(4)(C)(i) requires that deductions which reduce AMTI, but which do not reduce a corporation's earnings and profits, must be added back in for purposes of calculating ACE. Here, the amount that would not reduce earnings and profits is excess of percentage depletion over cost depletion. But the AMT depletion deduction does not ultimately exceed cost depletion under section 612 in this case, because the preference item under section 57(a)(1) has effectively limited the AMT depletion deduction to the amount of the adjusted basis for cost depletion. In other words, the percentage depletion deduction in excess of cost depletion does not reduce AMTI because the excess is completely offset by the preference item for depletion provided by section 57(a)(1). Thus, for AMT purposes, there is ultimately no reduction to AMTI that does not also reduce earnings and profits. As a result, there is no ACE adjustment under section 56(g)(4)(C)(i) attributable to depletion under these facts.

The current case is distinguishable from a case where a taxpayer has a percentage depletion deduction that is in excess of cost depletion and the excess is not completely offset by the preference item provided under section 57(a)(1) in computing AMTI. For example, basis under section 57(a)(1) may be increased by mine exploration and development costs that must be capitalized for AMT purposes under section 56(a)(2). In such a case, the excess of percentage depletion over cost depletion would not necessarily be eliminated by the preference item under section 57(a)(1). Because the excess would never decrease earnings and profits, the excess that was not eliminated would be added back to increase ACE under section 56(g)(4)(C)(i).

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