Office of Chief Counsel
Internal Revenue Service

memorandum

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WRDavis

date: **December 4, 2001**

to: Engineering, LMSB Division, Albuquerque, NM
Ken Howell, Engineer

from: Area Counsel
(Natural Resources:Houston)

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subject: **[redacted]: percentage depletion issue - Does [redacted] Constitute the "First Marketable Product"?**

We respond to your request for assistance concerning two issues integral to determining the gross income from mining. **This memorandum incorporates changes recommended in the review of our prior advice dated November 21, 2001, and supercedes that advice.** The first question relates to whether the [redacted] are sold in "significant quantities by the taxpayer or by others in the taxpayer's marketing area" so as to constitute the "first marketable product" under Treas. Reg. § 1.613-4(d)(4)(iv). The second issue -- potentially important in establishing the quantities of [redacted] that are sold -- involves interpretation of the refining contracts between [redacted] producers ("miners") and refiners. Specifically, the second issue concerns whether contracts offering cash settlements at various times in the refining process based on the [redacted] content of the [redacted] and the spot price of refined [redacted] constitute sales of [redacted]. Our recitation of the facts and analysis follow.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Facts

The taxpayer, [redacted], is the U.S. common parent of a consolidated group of subsidiaries whose principal activity is the mining of [redacted] ore. After severing the ore from the ground, the taxpayer begins the process of extracting [redacted] from the ore by using both mining and nonmining processes. The end product of these processes performed at the mine site is known as a [redacted]. In the [redacted] mining industry, these [redacted] contain varying

percentages of [redacted], smaller amounts of [redacted], and some metal impurities. You indicate that the [redacted] from the [redacted] property in [redacted] contain approximately [redacted]% pure [redacted] a few percent of [redacted], and small amounts of metal impurities. The taxpayer mines the [redacted] property. The taxpayer contends that the [redacted] content in [redacted] varies from [redacted] percent to more than [redacted] percent.

During the tax years at issue, the taxpayer transported the [redacted] produced at [redacted] to the refining facilities of [redacted], an unaffiliated third-party, in [redacted]. There, [redacted] refined the [redacted] in the [redacted] into refined [redacted] of [redacted] weighing [redacted] ounces, containing [redacted]% [redacted]. Thereafter, the [redacted] was shipped to [redacted] [redacted] storage facilities in [redacted].

Throughout the taxable years at issue, a refining agreement was in place between the taxpayer and [redacted]. At the beginning of this period, the taxpayer was required to provide [redacted] with a minimum of [redacted]% of its [redacted] production for refining. On [redacted], this agreement was amended to reduce the minimum amount to be supplied to [redacted] to [redacted]% of [redacted] production. Among the other terms, the contract required the [redacted] supplied by the taxpayer to contain a minimum of [redacted]% [redacted].

[redacted] was compensated for its refining of the [redacted] in two ways: first, it received $[redacted] per [redacted] of [redacted] refined. Next, it retained [redacted]% of the assayed [redacted] content and [redacted]% of the assayed [redacted] content of each [redacted] refined. On [redacted], the agreement was adjusted to provide for compensation of $[redacted] per [redacted] of [redacted] refined.

Under the contract, risk of loss passed to [redacted] upon delivery of the [redacted], but title was retained by the taxpayer. Final settlement occurred [redacted] business days after delivery of the [redacted] to [redacted]. At that time, [redacted] invoiced the taxpayer for the "per [redacted]" charge. If the taxpayer opted for an advanced delivery of refined [redacted] prior to settlement, [redacted] also charged the taxpayer interest for the advanced delivery at settlement. We note that the sample [redacted] contract provided in the taxpayer's response makes clear that representative samples are taken from each lot of [redacted], for the purpose of assaying the product to determine the actual [redacted] and [redacted] content.

Other representative contracts

The taxpayer provided several other pro forma copies of refinery agreements for refining [redacted]. Of them, you point to the [redacted] one as evidence that, in determining mining income under the proportionate profit method,

[redacted] is the "first marketable product," i.e., the "product . . . produced by the taxpayer as a result of the application of nonmining processes . . . in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area." Treas. Reg. § 1.613-4(d)(4)(iv).

That contract stated that the refiner, a wholly-owned subsidiary of the [redacted], "will purchase the [redacted] and will pay the purchase price as follows: xx.x % of the weight of the [redacted] [[redacted] refined to [redacted]% purity] content of each delivery" as set forth in the miner's assay certificate accompanying the shipment. It further stated that an amount will be credited to the miner's account within a specified number of business days following the day of pick-up of the [redacted] by the refiner, based on price per [redacted] of the [redacted] Market quoted on the date of pick-up (the "provisional credit"). A similar provision applied to the [redacted] content of the [redacted].

The contract required the refiner to, along with the weighing of the [redacted], melt and sample it within two days of delivery for the purpose of obtaining an assay of the metal percentages of the melting lots. Within a set amount of time after the completion of the exchange of assay results, the contract called on a reconciliation of the assay results with the provisional crediting based upon the miner's assay certificate that accompanied the shipment. Further, the contract provided that risk of loss passed from the miner to the refiner upon delivery of the [redacted], with a reversion of that risk occurring when the [redacted] delivered contained "deleterious elements which unreasonably impair the Refiner's ability to refine the [redacted] or which constitute health or safety hazard." In case of loss for any cause while that risk was with the refiner, the refiner was required to replace the equivalent [redacted] and [redacted] [[redacted]% pure] content of the [redacted] bars, based on the miner's assay certificate or the final agreed assay, whichever was more recent.

The contract additionally included a "refining and transportation charge" of $0.xx per ounce gross weight, including the assay samples. Further, if the weight of the [redacted] fell outside of the 10 kg to 30 kg range, if the [redacted] content was less than [redacted]%, or if the [redacted] content exceeded [redacted]%, the contract gave the refiner the right to adjust these charges and the timing of the final crediting.

Finally, the contract specified that title passed to the refiner with its payment of the provisional credit to the miner's account.

We note that several other contracts or sample contracts were contained within the taxpayer's response. None of these presented as strong a position for treating the transfer of [redacted] to the refiner as a "sale" of [redacted] as the [redacted] agreement.

[redacted] mining companies produced [redacted] in the United States and Canada in [redacted], the last taxable year at issue. Information was presented by the taxpayer concerning [redacted] of these companies, whose production amounted to approximately [redacted]% of the North American [redacted] production for that year. Of these mining companies, around [redacted]% of the [redacted] produced was sold through refiner-facilitated [redacted] sales agreements.

Of the [redacted] North American [redacted] producers that were responsible for [redacted]% of the North American production, only [redacted]% of the [redacted] refined in [redacted] was purchased by the refiners. You indicate that the [redacted] smallest producers comprise around [redacted]% of the total North American production, and that these producers are most likely to sell the [redacted] to the refiners.

Analysis

Section 611 of the Code provides taxpayers with the allowance of a deduction for depletion in the case of mines and other natural deposits, among other things. Section 613(a) specifies that, with regard to certain enumerated mines, wells, and other natural deposits, including deposits of [redacted] ore, the allowance for depletion shall be a specified percentage of the "gross income from the property," subject to certain limitations not relevant to this analysis.

Section 613(c) defines "gross income from the property" as, in the case of a property other than an oil or gas well or a geothermal deposit, the gross income from mining. "Mining" is defined to include not only the extraction of the ores or minerals from the ground, but also the treatment processes considered as mining that are described in section 613(c)(4). "Mining" also is defined to include certain transportation of the ores or minerals. Section 613(c)(2).

In the case of [redacted] and [redacted], minerals that the Code recognizes as "ores or minerals which are not customarily sold in the form of the crude mineral product," certain processes are specifically enumerated as being mining, and others are excepted

from the definition of mining.[1] The parties do not dispute that some of the processes that occur to transform [redacted] ore prior to its sale constitute "non-mining" processes, under section 613(c)(4) and 613(c)(5).

Treas. Reg. § 1.613-4 sets out the rules applicable to determining gross income from the property for minerals other than oil and gas. For cases where a "representative market or field price" for the taxpayer's ore or mineral cannot be ascertained, the regulation calls for the use of the "proportionate profits method," set forth therein at Treas. Reg. § 1.613-4(d)(4).[2]

This method of computing gross income from mining is applied by multiplying the taxpayer's gross sales (actual or constructive) of its first marketable product or group of products by the ratio of the costs allocated to all mining activities to the total of all mining and nonmining costs. More simply put, "The purpose of the proportionate-profits formula is to separate the sales price of a product into its mining and nonmining components." North Carolina Granite Corp. v. Commissioner, 56 T.C. 1281, 1291 (1971). In equation form, this can be represented as follows:

$$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining}$$

Therein, the regulations define the term, "first marketable product or group of products" as "the product (or group of

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[1] The Code identifies the mining and non-mining processes for gold as "crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit." Section 613(c)(4)(D).

[2] It should be noted that, pursuant to Treas. Reg. § 1.613-4(d)(1)(ii), the successor to the Office of the Assistant Commissioner (Technical) may determine that a method of computation of gross income from mining is more appropriate than the proportionate profits method or another method being used by the taxpayer. This memorandum does not otherwise consider this option than to point out its existence.

essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area." Treas. Reg. § 1.613-4(d)(4)(iv) (emphasis added). The interpretation of the highlighted phrase is the crux of the issue.

The Supreme Court has addressed the issue of what constitutes the "first marketable product" in two cases. In United States v. Cannelton Sewer Pipe Co., 364 U.S. 76 (1960), the Court held that an integrated miner-manufacturer of burnt clay products from fire clay and shale must determine its depletion based upon the first marketable product, even if, for that particular taxpayer, the product would not be profitable because of high extraction costs. There, however, the Court did not address the question of the level of sales at which a product becomes marketable. A summary of the Court's decision is found in the following: "From this legislative history, we conclude that Congress intended to grant miners a depletion allowance based on the constructive income from the raw mineral product, if marketable in that form, and not on the value of the finished articles. Id., 364 U.S. at 86 (emphasis added). In that case, however, the finding that three-fifths of the fire clay produced in the same state as the taxpayer was sold in its raw state, and that a producer close to the taxpayer made "large sales" of raw clay and shale supported the Court's finding that the raw clay and shale were the cut-off point where "gross income from mining" stopped, i.e., where the ordinary miner shipped the product of his mine. Id., 364 U.S. at 87.

The other case, Commissioner v. Portland Cement Co., 450 U.S. 156 (1981), addressed the issue of what product constituted the "first marketable product or group of products" of a taxpayer using the proportionate profits method of determining the gross income from mining. That taxpayer, which mined a type of limestone known as cement rock and manufactured Portland cement from it, sold the Portland cement both in bulk and in bags. The taxpayer asserted that the first marketable product was cement sold in bulk, and excluded both the cost of bagging the cement that it sold and the receipts from the bagged cement that it sold from the fraction used to determine the taxpayer's gross income from mining. The Court rejected the taxpayer's approach, relying on Treas. Reg. § 1.613-4(d)(4)(iv). There, the regulation defines "first marketable product" as "the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the

taxpayer's marketing area." Id. Unfortunately, neither of these cases specifically addressed the questions raised here.

Past cases considering what constitutes the marketing of a "significant" quantity of product are scarce. Moreover, the courts have been inconsistent in determining a fixed percentage as being "significant." In Gray Knox Marble Co. v. United States, 257 F. Supp. 632, 642-643 (E.D. Tenn. 1966), the court found that 3.18 to 9.3% of the material being sold as dimension stone was insignificant and therefore insufficient to establish a representative market or field price. However, in Warner Co. v. United States, 504 F.2d 689 (3rd Cir. 1974), the court found in examining the same issue, that sales representing 7.3% of the limestone produced in that taxpayer's market area was significant enough to establish a representative market or field price. This problem in quantifying the meaning of "significant" was recognized in Pointer v. Commissioner, 48 T.C. 906 (1967), by the court which stated that:

> "Substantial" is an illusive word. It refers to that which is large, valuable, or noteworthy, or in a negative sense, to that which is not trivial, nominal, or incomplete. Any general definition is necessarily vague because the concept is relative to the circumstances in which it is used.

Id., 48 T.C. at 915.

In North Carolina Granite Corp. v. Commissioner, 56 T.C. 1281 (1971), the Tax Court addressed which of several alternative products should be used to determine, for depletion purposes, the "gross sales price" of the granite quarried by the taxpayer. That taxpayer was required to use the proportionate profits method. In finding the curbing product to be the "first marketable product," the court cited the fact that over seventy-five percent of the cubic feet of granite sold by the taxpayer was curbing as a significant factor. Importantly, although a small amount of "rough cut" granite was marketed by the taxpayer, the parties did not dispute that these mining costs were not indicative of the price it would charge if the taxpayer regularly sold rough granite blocks. Id., 56 T.C. at 1288. Thus, the Service there recognized that small amounts of sales of minerals that undergo no nonmining processes do not always stand as the "representative" market or field price that Treas. Reg. § 1.613-4(c)(1) contemplates.

Here, the proposed position of treating [redacted] as the "first marketable product" can be attacked because the evidence available to the Service is insufficient to show that [redacted] is marketed in significant enough quantities to stand as the first

marketed product of the [redacted] mining process. While the contracts under which title to the [redacted] is transferred to the refiners may represent sales of [redacted], the record does not provide evidence of the amounts sold under any of the particular contracts. Only the taxpayer's assertions placing the [redacted] sales in the range of [redacted] to [redacted] percent[3] -- standing as admissions -- provide any evidence of the amount of [redacted] that is sold.

The references contained in the write-up of this issue reflect a considerable effort in discovering evidence of sales of [redacted]; nonetheless, we do not view this as proving that [redacted] stands as the "first marketable product or group of products" for purposes of applying the proportionate profits method of Treas. Reg. § 1.613-4(d)(4). For one, case law has generally treated poorly those attempts to equate small percentages (i.e., less than ten percent) of processed minerals to "significant quantities."

In the case of [redacted] production, the fact that the quantities of the finished product resulting from these refiner-facilitated sales amount to only so many [redacted] per year worldwide does not make such a position more tenable. In our view, the fact that the Service proposes to treat a quantity measured in the [redacted] as a "significant quantity" will likely prove a difficult perception to overcome before any trier of fact.

We understand that, due to the taxpayer's forward sales contracts of the [redacted] that is refined for it, the gross sales figure includes a significant amount that relates to what is, in effect, a cost for the use or forbearance of money during the time between sale of the contract and delivery of the [redacted]. We agree with your assessment that, in the absence of our ability to show that [redacted] is the "first marketable product," an alternative method of determining the gross income from mining, as contemplated by Treas. Reg. § 1.613-4(d)(1)(ii)(c) may be appropriate for this taxpayer.

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[3] In actuality, the taxpayer characterizes these transactions as sales of refined [redacted], not [redacted]. We disagree with the taxpayer's characterization.

Please call the undersigned to discuss this memorandum at (303) 844-2214, ext. 259.

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By:_____
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