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Taxation - Income Tax -Gross Income From Mining as the Basis for Computing Percentage Depletion Allowances

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TAXATION — INCOME TAX — GROSS INCOME FROM MINING AS THE BASIS FOR COMPUTING PERCENTAGE DEPLETION ALLOWANCES — Respondent, a miner of raw fire clay and a manufacturer of such clay into vitrified products, claimed a percentage depletion deduction based upon the gross income from the sale of its *finished* goods,[1] contending that because its crude minerals

[1] Int. Rev. Code of 1939, § 114 (b) (4), entitled respondent to a percentage depletion allowance based upon "gross income from mining." "Mining" was defined to include "not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners . . . to obtain the commercially marketable mineral product or products. . . ." Int. Rev. Code of 1939, § 114 (b) (4), as amended, ch. 63, § 124, 58 Stat. 45 (1944) [carried forward into INT. REV. CODE OF 1954, § 613 (c) (1), (2), which was, however, amended by 74 Stat. 292 (1960)]. It will be noted that the taxable year in question is 1951; hence, the case is governed by the 1939 code.

could not be sold profitably in a local market, these final products were the first to meet the statutory standard of "commercially marketable mineral product."[2] The district court[3] and the Court of Appeals for the Seventh Circuit[4] accepted respondent's contention. On certiorari to the United States Supeme Court, *held,* reversed, one Justice concurring. The fact that a taxpayer himself cannot sell his crude minerals at a profit does not make them commercially unmarketable within the meaning of the Code. *United States v. Cannelton Sewer Pipe Co.,* 364 U.S. 76 (1960).

One of the important questions in litigation seeking to define "commercially marketable mineral product"[5] has been whether a particular taxpayer's crude mineral is commercially marketable if he cannot sell it at a profit in a market which other producers use to make profitable sales of the same product. Lower federal courts have consistently held that it is not.[6] The effect of these decisions has been to allow depletion deductions to be computed by reference to the gross income from the sale of finished mineral products and thereby to increase the possibility of excessive depletion allowances. In overruling this line of decisions, the Supreme Court resolved the interpretative problem facing it by reference to the pre-enactment legislative materials.[7] On the basis of the implications of these congressional reports, it properly adopted an industry-wide test for determining commercial marketability: if a mineral is being sold on a profitable basis by other miners, it is commercially marketable, regardless of whether the particular taxpayer can market it at a profit.

Although the acknowledged basis for adopting such a test was a proper technical interpretation of legislative intent, the industry-wide standard has the additional merit of producing a result that is more consonant with an economically acceptable theory of percentage depletion than the individual taxpayer approach it replaces. Although the depletion rates are admittedly arbitrary and the actual deductions bear no relation to the cost basis of a taxpayer's mineral, the most compelling economic justification for permitting the depletion of non-strategic minerals is tax-free recovery for the

2 On the other hand, the Government argued that the raw clay was "commercially marketable" and that the depletion allowance should be computed by reference to the constructive gross income from the hypothetical sales of the crude minerals.

3 Cannelton Sewer Pipe Co. v. United States, 58-2 U.S. Tax Cas. 9676 (S.D. Ind. 1958).

4 Cannelton Sewer Pipe Co. v. United States, 268 F.2d 334 (7th Cir. 1959).

5 See generally White & Brainerd, *Percentage Depletion of Minerals—A Costly Study in Definitions,* 34 TAXES 97 (1956); Hobbet & Donaldson, *Percentage Depletion for Minerals,* 37 TAXES 477 (1959).

6 Riverton Lime & Stone Co., 28 T.C. 446 (1957); Sparta Ceramic Co. v. United States, 168 F. Supp. 401 (N.D. Ohio 1958); Standard Clay Mfg. Co. v. United States, 176 F. Supp. 590 (W.D. Pa. 1959); Cannelton Sewer Pipe Co. v. United States, 268 F.2d 334 (7th Cir. 1959). See also Commissioner v. Iowa Limestone Co., 269 F.2d 398 (8th Cir. 1959); Bookwalter v. Centropolis Crusher Co., 272 F.2d 391 (8th Cir. 1959).

7 See S. REP. No. 627, 78th Cong., 1st Sess. 23-24 (1944); *Hearings on H.R. 3687 Before Senate Committee on Finance,* 78th Cong., 1st Sess. 258 (1944); *Hearings Before the Committee on Ways and Means of the House of Representatives on Proposed Revisions of the Internal Revenue Code,* 80th Cong., 1st Sess., pt. 3, at 1857 (1947); S. REP. No. 2375, 81st Cong., 2d Sess. 53-54 (1951).

exhaustion of capital invested in mineral assets. Theoretically, then, the basis for computing the deduction should be related in some way to the mineral capital actually consumed. By precluding acceptance of the economics of the individual taxpayer as the principal factor in determining commercial marketability, the industry-wide test encourages a proper economic focus on the mineral consumed rather than on the product ultimately marketed.

A similar focus is achieved by a recent statutory amendment which makes fundamental changes in the definition of "mining."[8] The effect of the amendment is to require all miners to base their depletion deductions on the income (actual or constructive) from the sales (real or hypothetical) of the product (marketable or unmarketable) created by the processes specifically enumerated in the Code.[9] In framing this amendment Congress ignored completely the old standard which was interpreted by *Cannelton* and adopted a new approach to the problem of determining the bases for depletion allowances. Rather than be concerned with the time when a product is commercially marketable, Congress attempted to draw a specific line between the mining and manufacturing stages of production by listing the processes it thought to be a part of normal mining operations. In so doing, it eliminated the possibility of basing depletion deductions on gross income from the sale of finished products and, thus, embodied in the Code a more acceptable theoretical approach to the determination of the bases for the computation of depletion allowances.

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[8] Public Debt and Tax Rate Extension Act of 1960, § 302(b), 74 Stat. 292 (1960), amends INT. REV. CODE OF 1954, § 613(c)(2) [formerly Int. Rev. Code of 1939, § 114(b)(4), as amended, ch. 63, § 124, 58 Stat. 45 (1944)] to read: "(2) MINING — The term 'mining' includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto). . . ." Sec. 613(c)(4) of the amended Code contains a specific enumeration of those treatment processes which, within various contexts, are to be considered "mining." For example, § 613(c)(4)(G) provides that "in the case of clay . . . crushing, grinding, and separating the mineral from waste, but not including any subsequent process" are included within "mining."

[9] Although the amendment will eliminate litigation with regard to when a particular product becomes commercially marketable, the following new sources of litigation appear to be created: valuation of the constructive income from the fictional sales of non-marketable minerals; interpretation of "the treatment processes necessary or incidental thereto"; and inclusion of a particular process in "mining" even though not enumerated in the Code based on the fact that "the term 'mining' includes . . ." is used rather than "the term 'mining' means. . . ."