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, contending that because its crude minerals

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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." The district court and the Court of Appeals for the Seventh Circuit accepted respondent's contention. On certiorari to the United States Supreme 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" 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. 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. 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

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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, 36-2 U.S. Tax Cas. 9676 (S.D. Ind. 1958).
4 Cannelton Sewer Pipe Co. v. United States, 269 F.2d 334 (7th Cir. 1959).
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 eco­
nomics of the individual taxpayer as the principal factor in determining
commercial marketability, the industry-wide test encourages a proper eco­
nomic 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.” 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. 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 subse­
quent 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-market­
able 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. . . .”