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2012 Americas School of Mines

Basics of U.S. Mining Taxation

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Introduction

- This course introduces basic taxation knowledge for the mining industry.

- This course explains the tax treatment of the various phases of operations of a typical mining company and clarifies the key concepts of the taxation principles for the mining industry in the United States.

Agenda

Four phases of operations in the mining industry

Key tax principles within these phases of exploration, development, production, and reclamation

Depletion

IRC §199

Alternative Minimum Tax (AMT)

State and international tax issues in the mining industry

Phases of Operations

Phases of Operations

The phases of mining operations are:

- Exploration/Evaluation
- Development
- Production/Maintenance
- Reclamation/Remediation

- The basic taxation treatment of these phases will be discussed throughout the course

Exploration and Evaluation - Basic Taxation

Exploration and Evaluation - Basic Taxation

- Exploratory costs defined: The stage whereby the taxpayer is establishing the existence, location, extent or quality of a mineral deposit (IRC §617(a)).

- Note:
  - One could say that the exploratory phase is where the taxpayer investigates what it is that it has.
  - We can also refer to this stage as the "**discovery phase**".
  - Keep in mind, the exploration phase takes place before the development and ultimate production of the mineral deposit can ever take place.

Exploration and Evaluation - Basic Taxation

Basic taxation treatment:

- As a rule of thumb, exploration costs are incurred from the point of initial investigation of the deposit to the time facts and actions clearly identify a commercial mineralized deposit (e.g., a feasibility study supports the deposit and/or the board has approved development).
- Exploration costs can include the following:
  - Geological and geophysical investigation
  - Core drilling
  - Trenching
  - Driving of exploration tunnels
  - Feasibility and engineering studies

Exploration and Evaluation - Basic Taxation

3 Ways to Treat Exploration Costs for Income Tax Purposes:

(1) The general rule is that exploration costs are capitalized and recoverable through cost depletion (The cost depletion topic will be discussed later in the course); or

(2) At the election of a corporate taxpayer, exploration costs may be deducted 70% currently with the remaining 30% being amortized over five years beginning with the month in which the costs are incurred (IRC §617(a) & §291(b)); or

(3) Costs may be capitalized and amortized over 10 years for both Regular and AMT purposes (IRC §59(e)) beginning with the taxable year the costs are paid or incurred.

Exploration and Evaluation - Basic Taxation

- Note:
  - For alternative minimum tax ("AMT") purposes, exploration costs can be amortized over a 10-year period.
  - Alternatively, costs may be capitalized and recovered through cost depletion under method #1 above (i.e. method #2 only available for regular tax).
  - For earnings and profits purposes, exploration must be capitalized and amortized over a 10-year period beginning the later of the month production begins from the deposit or the month paid or incurred (IRC §312(n)(2)(B)).

Exploration and Evaluation - Basic Taxation

- Foreign Exploration Costs for Tax Purposes:
  - Capitalize 100% of costs and amortize over a 10-year period beginning with the taxable year in which the costs are paid or incurred; or
  - Make an election to add to adjusted cost basis of the property and recover through cost depletion (IRC §617(h)(2)(A)).
  - For earnings and profits purposes, exploration must be capitalized and amortized over a 10-year period beginning the later of the month production begins from the deposit or the month paid or incurred (IRC §312(n)(2)(B)).

Recapture of Exploration Costs - Basic Taxation

- The year in which a mine reaches the production stage, any exploration expenses previously deducted under the second method (i.e. 70% current, 30% amortized) must be recaptured under one of the following two methods (IRC §617 (b)):

  1. **Gross Income Method**- Included in gross income all exploration expenses previously deducted (elective); or
  2. **Reduction of Depletion**- Reduce current and future depletion allowance (cost or percentage) otherwise available to the extent of exploration expenses previously deducted.

- Note: Exploration expenses which are amortized over 10 years are not required to be recaptured, including for AMT.

Recapture of Exploration Costs - Basic Taxation

- If any unrecaptured exploration costs (deducted or amortized under IRC §617, §291(b) or §59(e) still exist upon sale of a mineral property, the lower of the following must be recaptured and treated as ordinary income (IRC §617 (d) & §1254 (a)) upon sale of the mineral deposit:

1. Exploration expenses deducted

or

2. Excess of amount realized over the basis of the mineral property (i.e., "the Gain")

Exploration Costs and Recapture - Basic Taxation

Election Considerations - Exploration Costs

- Election to Expense Mining Exploration Costs Under IRC §617(a)
  - #2 election is made each taxable year the exploration expenditures are paid or incurred by the taxpayer. The election is made by:
    1. Deducting the expenditures on the taxpayer's income tax return (Regs. § 1.617-1(c)(1)(i))
    2. Clearly stating on the income tax return the amount claimed as a deduction for each mining property, and
    3. Each property must be adequately described to permit application of the recapture rules of §617(b), (c), and (d)
- Election to Recapture Mining Explorations Expenditures Under IRC §617(b)
  - In order to elect to recapture exploration expenditures by method of including the amount previously deducted in gross income, the taxpayer must clearly indicate such election on the tax return for the tax year the mine reaches the producing stage (Regs. §1.617-3(b)).

Exploration Costs and Recapture - Basic Taxation

Election Considerations - Exploration Costs

- #3 Election to Amortize Mining Exploration Expenditures over 10 Years
  - A taxpayer makes the election to amortize mine exploration (or development) expenditures under §59(e) on Form 4562, Depreciation and Amortization.
  - The election under can only be made by attaching a statement to the taxpayer's income tax return (or amended return) for the taxable year in which the amortization of the qualified expenditures subject to the election begins (Regs. §1.59-1(b)). This statement should include:
    1. The taxpayer's name, address, and taxpayer identification number; and
    2. The type and amount of qualified expenditures identified that the taxpayer elects to deduct ratably over the applicable period described in §59(e)(1).
- Note: Elections #2 and #3 can be revoked only with the consent of the IRS.

Exploration Example

Facts:

- In June of 2011, Metal Corp. (a calendar year-end taxpayer) incurs $2,000 of exploration costs
- In January 2012, Metal Corp. incurs $1,000 of exploration costs
  - Calculate the 2011 and 2012 regular tax deduction and AMT adjustment for exploration costs if the taxpayer elected to deduct costs currently (i.e., under the 70/30 method) for regular tax and over 10 years for AMT.

Exploration Example

2011 Regular Tax Deduction:	
$2,000 x 70% =	$1,400
$2,000 x 30% x 7 months/60 months =	$70
Total Regular Tax Deduction	$1,470 **A**
2011 AMT Adjustment:	
$2,000 x 10% =	(200) **B**
AMT Adjustment (**A-B**)	$1,270
2012 Regular Tax Deduction:	
$1,000 x 70% =	$700
$1,000 x 30% x 12/60 =	$60
$2,000 x 30% x 12/60 =	$120
Total Regular Tax Deduction	$880 **A**
2012 AMT Adjustment:	
$3,000 ($2,000 + $1,000) x 10% =	(300) **B**
AMT Adjustment (**A-B**)	$580

Exploration Example

In the year 2013 when the mine reaches the production stage, any exploration expenses previously deducted under IRC §617(a) must be recaptured. The taxpayer can elect to include the amount into income during the 2013 tax year or reduce depletion allowance (cost or percentage) otherwise available for 2013 and subsequent years.

The amount subject to recapture would be $2,350 (Deducted $1,470 in 2011 + $880 in 2012) for regular tax and no recapture for AMT purposes.

Developmental Phase -Basic Taxation

Developmental Costs - Basic Taxation

Development Stage:

- Defined as the stage whereby the mineral deposit is proven to be commercially feasible to mine (i.e. in sufficient quantity and quality to justify commercial production).

- Management's decision to develop the mine can be an event that assists in determining when the development stage is reached.

- In other words, the purpose of incurring development costs is now to obtain accessibility to the mineral deposit rather than investigatory.

Developmental Costs - Basic Taxation

The following are examples of Development Costs:

- Mine design and engineering
- Temporary facilities
- Access roads and other surface improvements
- Certain dike development
- Construction of mine shafts, slope, vent holes
- Removal of overburden
- Also see Rev. Rul. 66-170, Rev. Rul. 67-35 and Rev. Rul. 69-540.

Developmental Costs - Basic Taxation

EITF 04-6:

- For books, the development costs are inventoriable costs once production begins
- There must be separate evaluation of what is development for tax:
  - Development is not well defined for tax
    - Expect review on IRS exam

Developmental Costs - Basic Taxation

Three Ways to Treat Development Costs for Income Tax Purposes:

1. The general rule is that for corporate taxpayers, development costs may be deducted 70% currently with the remaining 30% amortized over a five-year period beginning with the month in which the costs are incurred ((IRC §616(a) & 291(b)); or
2. Capitalized and deducted ratably as the ore or mineral is sold §616(b); or
3. Cost may be capitalized and amortized over 10 years for both Regular and alternative minimum tax purposes (IRC §59(e)) beginning with the taxable year the costs are paid or incurred.

Developmental Costs - Basic Taxation

Note:

- For alternative minimum tax ("AMT") purposes, development costs can be amortized over a 10-year period.
- Alternatively, costs may be capitalized and recovered through cost depletion under method #2 above (i.e. method #1 only available for regular tax).
- For earnings and profits purposes, development costs expensed under the 70%/30% rule must be capitalized and amortized over a 10-year period beginning with the later of the month production begins or the month paid or incurred (IRC §312 (n)(2)(B)).

Developmental Costs - Basic Taxation

Election Considerations – Development Costs

- #2 Election to Amortize Mine Development Costs Under IRC §616(b)
  - The taxpayer must make the election for each mine by:
    1) Making a clear indication on the tax return; *or*
    2) By a statement filed with the Submission Processing Center where the return is filed, not later than the due date for filing such return (including extensions) for the tax year to which such election applies (Regs. §1.616-2(e)(2)).
  - This is an irrevocable election (Regs. §1.616-2(e)(1)).
  - Note: The election to defer development expenditures applies only to expenditures for the taxable year for which made.

Developmental Costs - Basic Taxation

Two Ways to Treat Foreign Development Costs for Tax:

1. Capitalize 100% of costs and amortize over a 10-year period; or

2. Make election to add to adjusted basis of the mineral property recoverable through cost depletion (IRC §616 (d)(2)(A))

Development Example

Facts:

- In January 2011, Mining Corp. incurs $10,000 of development costs
- In January 2012, Mining Corp. incurs $5,000 of development costs

Calculate the 2011 and 2012 regular tax deduction and AMT adjustment for exploration costs using the election to deduct costs for regular tax purposes over 10 years in 2011 and currently in 2012 (i.e., under the 70/30 method). Assume the taxpayer elected to amortize over 10 years for AMT purposes.

Development Example

2011 Regular Tax Deduction:	
$10,000/10 years =	$1,000 **A**
2011 AMT Adjustment:	
$10,000/10 years =	(1,000) **B**
AMT Adjustment (**A-B**)	NIL
2012 Regular Tax Deduction:	
$5,000 x 70% =	$3,500
$5,000 x 30% x 12/60 =	$300
$10,000/10 years =	$1,000
Total Regular Tax Deduction	$4,800 **A**
2012 AMT Adjustment:	
$15,000 ($10,000 + $5,000)/10 years =	(1,500) **B**
AMT Adjustment (**A-B**)	$3,300

Developmental Costs - Basic Taxation

Recapture of Development Costs:

- There is no recapture of development costs previously deducted in the year a mine reaches the production stage.
- However there is recapture upon disposition of a mine for previously deducted development costs:
  - For property placed into service after 1986, any development expenses which have been deducted by a taxpayer (under IRC §616, §291(b)(2), or §59(e)) are subject to recapture upon the disposition of the property involved to the extent there is a gain upon the sale (IRC §1254(a) &§ 291(b)(3))

Production Stage - Basic Taxation

Production Stage - Basic Taxation

- The production stage is reached when the principal activity of the mine is the production and extraction of developed ores or minerals rather than investigating or developing the mineral resource for mining.

- Keep in mind that when a taxpayer reaches the production stage, the method for recapture of previously deducted exploration expenses must be evaluated.

Production Stage - Basic Taxation

Accounting for Production Costs 1:

- In order to achieve the matching of income to expenses, the IRS requires a taxpayer to maintain inventory on the balance sheet for any product extracted from the mining operations (IRC §471(a)).

- Direct and indirect production costs must be taken into account when determining the inventoriable costs in accordance with the prescribed inventory method.

Production Stage - Basic Taxation

Accounting for Production Costs 2:

- The uniform capitalization rules under IRC §263A require certain costs to be capitalized into inventory when producing either real property or tangible property.
- Direct costs and allocable indirect costs benefiting or incurred by reason of the production of the mineral property must be capitalized.
- Treas. Reg. §1.263A-1(e)(3) provides a list of the indirect costs for capitalization and a list of indirect costs not requiring capitalization.
- Selling and distribution costs and income taxes are not capitalized into inventory.

Maintenance Activities - Basic Taxation

- Expense costs of routine maintenance and repairs as incurred rather than accruing in advance
  - Repairs for maintenance of a certain level of output are not required to be capitalized.

- Major cyclical maintenance projects (smaller turnaround)
  - Capitalize costs that replace a major aspect of the asset
    - Major improvements to mine output should be capitalized
    - Expenses associated with betterment of an asset may be required to be capitalized
    - Rebuilds of engines may not be required to be capitalized

Reclamation and Closing Costs - Basic Taxation

Reclamation and Closing Costs - Basic Taxation

Reclamation and Closing Costs 1:

- In general, reclamation and closing costs are incurred by a taxpayer throughout the mining process.
- A considerable amount of the expenses are usually incurred following the exhaustion of the mineral resource.
- Reclamation activities are planned from the beginning of the mine.
- The “economic performance requirements” would require reclamation costs to be deductible at the time the expense has been incurred and the services performed.
- In situations where a taxpayer incurs reclamation costs at the end of the mine life and only has (or will have) one mine, all reclamation cost may not be benefited (i.e., assuming no further taxable income is generated) because there will not be sufficient future taxable income to absorb the net operating loss (NOL).

Reclamation and Closing Costs - Basic Taxation

Reclamation and Closing Costs 2:

- IRC §468 allows each mining operation to accrue (upon election) its reclamation costs estimated during the production period, in advance of satisfying the economic performance requirements.
- Upon election, the taxpayer establishes a reserve account for the reclamation and closing costs. In each year, the taxpayer may deduct the current year reclamation costs. In addition, the balance of the reserve is increased by an amount of "federal" interest computed under IRC §1274.
- The "interest" portion is a permanent increase to the company's effective income tax rate under ASC 740.

Reclamation and Closing Costs - Basic Taxation

10 Year Carryback:

- IRC §172(b)(1)(C) provides that a taxpayer with specified liability losses may carry such losses back 10 years, instead of the generally allowed 2 years.
  - Specified liability loss includes costs associated with reclamation and remediation of land
- The 10 year carryback is mandatory unless the taxpayer elects out on an originally filed tax return.

Reclamation and Closing Costs - Basic Taxation

IRC §198 Qualified Remediation Costs:

- Certain qualified environmental remediation expenses which occurred on a qualified contaminated site may be expensed, under §198 rather than capitalized
- The §198 costs are deducted in the year paid
- Generally applies in an asset acquisition setting whereby assumed liabilities for remediation would otherwise be a purchase price adjustment upon payment
- Treatment will apply for AMT as well
- The §198 deduction is subject to recapture upon a disposition.
- Expired 12/31/2011
  - House bill in early stages to extend provision to 12/31/13

Reclamation and Closing Costs - Basic Taxation

IRC §198 Requirements for a Qualified Contaminated Site:

- Any area that is held by a taxpayer for use in trade or business or for the production and at which a release or disposal of hazard substance has occurred
- Does not include any site that is currently on or proposed for the Superfund list (i.e., CERCLA site)
- Must receive a statement from the state environmental agency claiming that the taxpayer is responsible for the release or disposal of any hazardous substance

Reclamation and Closing Costs - Basic Taxation

IRC §198 - Revenue Ruling 2005-42:

- Environmental remediation costs that are not qualified expenditures under §198(b) should be capitalized to inventory (Section 263A under Revenue Ruling 2005-42)
  - These expenses were previously currently deductible as a period cost
  - Could result in a mismatch since the remediation could be related to inventory produced many years prior
  - Impact on 10 year carryback computation

Reclamation and Closing Costs - Basic Taxation

Other Mining Tax Issues 1:

- Under IRC §631(c), when coal that has been held for more than one year is disposed of under a contract that provides for the owner to retain an "economic interest" in the materials disposed, the amount realized from the disposal is treated as a gain or loss under which IRC §1231 would apply.
- This statute applies even if the coal has been held as property used in a trade or business during the year.
- Also, coal royalties received following an IRC §631(c) transaction will also qualify for capital gains treatment under IRC §1231 and not be treated as ordinary income.

Reclamation and Closing Costs - Basic Taxation

Other Mining Tax Issues 2:

- After production has begun, most mining operations will require additional equipment to maintain production as the mineralized deposit moves further from current processing facilities. These costs incurred may be deducted currently under the "receding face doctrine" (Treas. Reg. § 1.612-2(a) & *Marsh Fork Coal CO. v. Lucas*, 42F.2d 83 (4th Cir. 1930)).
- Expenditures of tangible equipment solely necessitated by the recession of the working face and to maintain production are currently deductible under the "receding face doctrine". Expenditures that would otherwise have been treated as capital costs can be currently deducted so long as they do not increase the value of the mine or decrease the cost of production.

Tax Depletion - Basic Taxation

Tax Depletion - Basic Taxation

Depletion 1:

- Depletion, like depreciation, is a form of cost recovery.
- Just as the owner of a business asset is allowed to recover the cost of an asset over its useful life, a mining industry taxpayer is allowed to recover the cost of its mineral property over the mine life.
- With production from the mine, a piece of the mineral property's selling price is treated as a capital recovery of the wasting mineral asset.

Tax Depletion - Basic Taxation

Depletion 2:

- Depletion is available only to the persons having an "economic interest" in the producing property (IRC §611(a) and related Treasury Regulations).
- For a taxpayer to have an "economic interest", it must have the following:
  - Acquired by investment, an interest in the mineral in place, and
  - Secured, by any form of legal relationship, income derived from extraction of the mineral to which it looks solely for its return of capital investment.

Tax Depletion - Basic Taxation

Depletion 3:

- The first requirement (i.e., acquisition by investment of the minerals in place) was designed to weed-out contract miners from those taxpayers that solely relied upon the full mineral enterprise for an economic return on their investment.
- Whether a taxpayer has an investment in the mineral in place will depend upon the taxpayers' rights and duties under the contract.
- Possessing legal title to a mineral property is not a primary requisite to holding of an economic interest.

Tax Depletion - Basic Taxation

Depletion 4:

- Depletion is a form of capital cost recovery of a wasting (or exhaustible) asset.
- Minerals derived from an inexhaustible source are not eligible for the depletion deduction.
- At times, a taxpayer may be required to demonstrate that the normal deposit is a closed finite system and not being replenished (Treas. Reg. §1.611-1(d)(5)). For example, certain water deposits are eligible for cost depletion, provided the water is form an exhaustible resource (e.g., a finite well) (see U.S. v. Shubert, 347 F.2d 193 (5th Cir. 1965).)

Tax Depletion - Basic Taxation

Depletion 5:

- There are 2 forms of depletion for tax purposes:
  1. **Cost depletion** - Based on the cost recovery concept
  2. **Percentage depletion** - Statutory concept base upon "gross income from the property" rather than upon any particular item of basis
- Taxpayers are required to use the method which results in the greatest depletion deduction amount in a given year.
- Note that depletion is calculated on a "mine-by-mine basis" (i.e., depletion must be calculated for each mine/property owned). However, there is an election available to aggregate mines (IRC §614(a) and §614(c)).

Tax Depletion - Basic Taxation

Cost Depletion 1:

- Cost depletion is based on the cost recovery concept. The costs of the mineral property are deducted ratably as the mineral is produced and sold.
- Once the capitalized basis in the property has been recovered through depletion (either cost or percentage), no additional cost depletion is allowed.
- However, in cases where a taxpayer is not eligible for cost depletion (i.e., due to lack of basis in the property), it may likely be eligible for percentage depletion.

Tax Depletion - Basic Taxation

Cost Depletion 2:

- The allowable cost depletion for a taxable year is generally calculated by multiplying the basis of the mining property at the end of the taxable year (adjusted, except for the current year's depletion) by a fraction,
  - The numerator of which is the units of minerals or ore sold within the taxable year
  - The denominator of which is the units of minerals or ore estimated to be remaining at the beginning of the year

Tax Depletion - Basic Taxation

Other Cost Depletion Issues 1:

- The estimated recoverable reserves for the denominator of the cost depletion computation includes proven, probable and prospective mineral reserves (Treas. Reg. §1.611-2(c)).
- To maximize cost depletion in any given year a taxpayer may attempt to minimize its estimated reserves contained in the denominator.
- However, the regulations limit a taxpayer's manipulation since it defines probable/prospective as those mineral reserves believed to exist based on good evidence, irrespective of whether actually known based on existing development of the resource property.

Tax Depletion - Basic Taxation

Other Cost Depletion Issues 2:

- The effect of this requirement (i.e., of including probable and prospective reserves in the denominator) becomes evident in years where commodity prices fluctuate significantly or economics of the industry change.
- Resources of probable and prospective reserves at times of high prices may never be exploited in a low price environment.
- The IRS has questioned revisions to original estimated reserves based solely on changes in economic factors. Changes may only be in circumstances where the geological facts were incorrect.

Cost Depletion Example

Facts:

- Adjusted Basis in the Property = $10,000
- Units of Mineral Sold during 2011 = 100 units
- Units of Mineral Available at 1/1/2011 = 1,000 Units

What is the amount of Allowable Cost Depletion for 2011?

Cost Depletion Example

2011 Cost Depletion Deduction

- 100 Units Sold in the Year/1,000 Units of Mineral Available at 1/1/2011 = 10% Depletion Rate
- $10,000 Cost Basis x 10% = $1,000 cost depletion for 2011

Tax Depletion - Basic Taxation

Percentage Depletion 1:

- Percentage depletion is a statutory concept based upon “gross income from the property” rather than upon any particular item of basis (like under cost depletion).
- Percentage depletion deducted will reduce any capitalized basis but is not limited to such basis for regular tax purposes.
- In practice, percentage depletion in a sufficiently productive mine can greatly exceed the capitalized basis over the life of a mine.

Tax Depletion - Basic Taxation

Percentage Depletion 2:

- In a basic application, the amount of percentage depletion is calculated by applying a rate (which can vary from 5% to 22% depending upon the mineral) to the “gross income from mining”.
- In addition, the amount of percentage depletion deducted may not exceed 50% of the “net income from property” in the year (a.k.a. the “net income limitation”) (IRC §613 (a)).

Tax Depletion - Basic Taxation

Percentage Depletion 3:

- In general, “gross income from mining” should simply be the amount an independent party would pay for the mineral product at the mouth of the mine.
- However, sales do not often occur at the mine mouth but, rather, could occur at any point in the process.

Tax Depletion - Basic Taxation

Percentage Depletion 4:

- Further, complications arise where there are non-mining processes or transportation.
- In general, "gross income from mining" is equal to the amount of income derived from sale of minerals (IRC §613(c)):
  - After the minerals are extracted from the ground; and
  - After certain treatment processes are performed (e.g., crushing, grinding, cleaning, flotation, leaching, pulverizing, etc.); and
  - Also includes transportation of the mineral to facilities or mills for processing not in excess of 50 miles.

Tax Depletion - Basic Taxation

Percentage Depletion 4 (Continued):

- Where there are non-mining processes or transportation, other methods may be used to determine "gross income from mining":
  - **Representative Market or Field Price ("RMFP"):**
    - May be used when non-mining processes or transportation are applied and a market price for the product can be determined.
    - Under this method, the market price (determined by arm's length transactions) of the first commercially marketable product is multiplied by the amount of mineral product produced.

Tax Depletion - Basic Taxation

Percentage Depletion 4 (Continued):

- **Proportionate Profits:**
  - This method is used in cases where there are non-mining processes or transportation and the taxpayer does not have a representative market or field price for the product.
  - Used almost exclusively in the gold mining industry because unrefined gold (i.e., not pure) is not a commercially marketable product.
  - The amount of gross income from mining is determined by multiplying total gross income by a ratio of mining costs over total mining and non-mining costs.
- **Alternative Method:**
  - Permitted by IRS when any other methods fail to clearly reflect gross income.

Tax Depletion - Basic Taxation

Percentage Depletion 5:

- As mentioned earlier, the percentage depletion deducted in a particular year is limited to the lesser of the following:
  1. The depletion rate determined multiplied by the gross income from mining; or
  2. 50 percent of the "net income from property"

The net income from property is calculated as follows:

Gross income from mining

Less: Directly attributable expenses

Less: Allocated indirect costs

=Taxable Income from Property

X50%

=Net Income from Property Limit

Percentage Depletion Example

Facts:

- Saleable pounds of copper in 2011 = 1,000,000 lbs.
- Copper percentage depletion rate = 15%
- RMFP price = 0.80 cents/lb. and saleable price = $1/lb.
- Total mining costs in 2011 = $500,000
- Total non-mining costs in 2011 = $200,000
- Taxable income from property = $300,000

Determine the allowable percentage depletion deduction amount in 2011 for regular tax purposes using:

a. The RMFP method

b. The proportionate profits method

Percentage Depletion Example

a) RMFP method:	
• saleable pounds of copper	1,000,000
RMFP price (cents/lb.)	$0.80
Gross income from mining	$ 800,000 **A**
Total mining costs	$500,000
Net Income from property	$300,000
	50%
Net Income Limitation	$150,000
Copper percentage depletion rate	15% **B**
Allowable Percentage Depletion (**A x B**)	$120,000
b) Proportionate profits method:	
• saleable pounds of copper	1,000,000
• saleable price (cents/lb.)	$1
Gross income from mining	$1 ,000,000 **A**
Total mining costs	500,000 **D**
Total costs	700,000 **F**
Mining Percentage (**D/F**)	71 .43% **B**
Mining Income (AxB)	714,3000 **C**
Net Income Limitation (**C - D** x 50%)	107,150
Copper percentage depletion rate	15%
Allowable Percentage Depletion (limited)	107,150

Tax Depletion - Basic Taxation

Other Percentage Depletion Issues 1:

- In general, percentage depletion will reduce any capitalized basis but is not limited to such basis for regular tax purposes.
- In addition, for coal and iron ore mining, percentage depletion is reduced by 20% of the excess of the deduction over the adjusted basis of the property (IRC §291(a)(2)).

Tax Depletion - Basic Taxation

Other Percentage Depletion Issues 2:

- The "Black Hole" Concept:
  - The taxpayer's basis must be reduced by allowable depletion (i.e., the greater of cost or percentage depletion in each year the property was held) whether or not that amount was actually deducted.
  - Note: For purposes of computing capital G/L on the sale of a mineral property, the adjusted basis can never be less than zero.
  - If the black hole concept applies and the taxpayer acquires additional mineral that is part of an existing mine, then the taxpayer must apply the cost of that acquisition against its black hole account and restore the account to zero before it can increase mineral property's basis. (Rev. Rul. 75-451)
  - Is there a Black Hole for AMT purposes?

Tax Depletion - Basic Taxation

Other Percentage Depletion Issues 3:

- 2008 Tax Court case – Santa Fe Pacific Gold Co. v. Commissioner

  Held that ACE adjustment required for any item not deductible for any year for purposes of computing E&P. Thus, ACE addition for excess of percentage depletion over mine basis (IRC §56(g)(4)(c)(i)).

  - Special ACE rule required addition for excess of percentage depletion over cost depletion for post-1989 mines.
  - Santa Fe case held the unamortized development costs may not be added to basis for purposes of determining E&P adjustment for percentage depletion.
  - Question whether unamortized development and exploration costs (IRC §56(a)(2)costs) treated as basis for AMT adjustment (i.e., depletion over excess of property basis at year end but before depletion deduction (IRC §57 (a)(1)).

Tax Depletion - Basic Taxation

- ACE percentage depletion:
  - For properties placed in service after 1989 (per Santa Fe 2008 case also applies for pre-1989 properties), percentage depletion in excess of cost depletion is an ACE adjustment (i.e., 75% is added back for AMT purposes)

Tax Depletion - Basic Taxation

Recapture of Depletion 1:

- As discussed earlier, depletion, depreciation and the deduction of exploration and development expenses are a form of cost recovery of wasting assets. The recapture rules attempt to re-characterize capital gain as ordinary income to the extent of these prior year deductions (IRC §1254(a)).

Tax Depletion - Basic Taxation

Recapture of Depletion 2:

- There is recapture of previously deducted depletion upon disposition of a mineral property:
  - For property placed in service after 1986, any depletion (cost and percentage) previously deducted by a taxpayer is subject to ordinary income recapture upon disposition if:
    1. There is a capital gain upon sale; and
    2. To the extent depletion reduced basis
  - Percentage depletion does not reduce basis less than zero, and, accordingly, percentage depletion in excess of basis is not subject to recapture.

IRC §199 - Basic Taxation

Tax Depletion - Basic Taxation

IRC §199 and Percentage Depletion:

- IRC §199 and percentage depletion are similar because they are both based on sales, not costs.
- The §199 deduction is determined after the depletion deduction
- Taxable income from mining for percentage depletion is determined before taking into consideration the §199 deduction

Tax Depletion - Basic Taxation

IRC §199 - Qualified Production Activities Deduction Defined:

- A deduction is allowed for companies with qualifying production activity income (QPAI). These include property that was manufactured, produced, grown, or extracted by the taxpayer in or in significant part within the United States.
  - Mining qualifies when minerals are extracted
  - Examples of additional manufacturing occurrences:
    - Turning copper cathode into rod or wire
    - Manufacturing imported mineral together with domestic mineral

Tax Depletion - Basic Taxation

IRC §199 - Qualified Production Activities Deduction:

- Deduction is allowed for 9% of the lesser of the following:
  1. Qualified Production Activity Income (QPAI), or
  2. Taxable income (after NOLs)
- Deduction may not exceed taxable income for the year or 50% of wages paid to employees.
- The §199 deduction is allowed for both regular tax and AMT purposes

Tax Depletion - Basic Taxation

IRC §199 – Computation:

- Domestic Production Gross Receipts (DPGR)
- Less the sum of:
  - Cost of goods sold allocable to DPGR receipts
  - Other deductions directly allocable to DPGR receipts
  - A rateable portion of other deductions not directly allocable to such receipts or another class of income
  - Equals: Qualified Production Activity Income
  - Multiply by 9%
  - Equals: Qualified Production Activity Deduction (before any limitations)

Tax Depletion - Basic Taxation

IRC §199 - Contract Mining:

- Contract mining - Generally only one taxpayer may claim the §199 deduction. This is typically the entity with the "benefits & burdens" of ownership of the tangible personal property under the Federal Income Tax Principles.
  - The owner of the mineral property, the one with the "economic interest," will be the one eligible for the §199 deduction
  - The 50% of wages limitation may come into play if the mineral owners use a contract miner and have no W-2 wages of their own
  - The owner of a mining royalty is not eligible for the §199 deduction

Alternative Minimum Tax - Basic Taxation

Alternative Minimum Tax - Basic Taxation

Alternative Minimum Tax 1:

- Alternative minimum tax ("AMT") is a separate and parallel tax system to the regular tax (IRC §55(a)).
- Alternative minimum taxable income less net operating losses ("NOL") is multiplied by a tax rate of 20%
- AMT paid in a given year generates minimum tax credits ("MTC's) that may be used to offset future regular tax when regular tax exceeds AMT (IRC §53(a)).
- Most mining companies are subject to AMT due to the capital intensive nature of mining and percentage depletion in excess of basis
- A taxpayer may be able to use its MTCs.
  - For example, if a taxpayer has significant non-mining income or if the taxpayer operates only foreign mines, earning interest, dividends and technical assistance fees in the US.

Alternative Minimum Tax - Basic Taxation

Alternative Minimum Tax 2:

- In general, AMT is calculated as follows:

  +/- Regular taxable income (before NOL)

  +/- Adjustments

  +/- Preferences

  +/- ACE adjustments

  - 90% AMT NOL carrying forward

  - AMT foreign tax credits carry forward

  = AMT

Alternative Minimum Tax - Basic Taxation

Alternative Minimum Tax 3:

- The specific adjustments/preferences items to AMT related to mining activities include the following:
  - Exploration and development costs are amortized over a 10-year period for AMT (IRC §56(a)(2)). Any excess deduction for regular tax purposes is a preference items
  - Exploration expenses are not required to be recaptured for AMT purposes
  - Percentage depletion in excess of AMT adjusted basis is a preference item (IRC §57(a)(1)).

Alternative Minimum Tax Example

Facts:

AMT before any adjustments	=$20,000
AMT depletable basis before depletion	=$5,000
AMT development adjustment	=$200
AMT exploration adjustment	=$100
Regular tax percentage depletion deduction amount	=$8,000
AMT cost depletion amount	=$1,000

What is the alternative minimum taxable income for the year (assuming no other adjustment /preference items)?

Alternative Minimum Tax Example

AMT income before preference items	= $20,000
Add: AMT development preference item	= $200*
Add: AMT exploration preference items	= $100*
Add: Regular tax percentage depletion	= $8,000
Less: Greater of cost or percentage depletion not in excess of AMT basis	= ($5,000)
AMT taxable income	= $23,300

* Amounts represent the differences between the regular tax deduction (i.e., at 70% current and 30% amortized) and the AMT amount allowable (i.e., amortized over 10 years).

State Tax - Basic Taxation

State Tax - Basic Taxation

- To this point, we have discussed the Federal taxes unique to the mining industry; however there are a number of State taxes that should also be considered. Those state taxes include the following:
  - Severance taxes (think of this as royalty paid to State or local governments)
  - Sales and use taxes (on purchases)
  - Property taxes (tax on real and personal property)
  - State income taxes

State Tax - Basic Taxation

Severance Taxes:

- To date, no royalties are charged by the federal government for mining on federal public land (other than coal mining).
  - Bureau of Land Management charges 12.5% royalty for surfaced mined coal and 8% for underground coal.
- Most state and local governments charge severance tax for mining operations in their jurisdictions.
  - The severance tax rates can vary from 2% to 10%.
  - Most calculations of taxable income subject to severance taxes are based on a "net proceeds" approach: in other words, gross sales revenues less production costs less certain depreciable costs

State Tax - Basic Taxation

Sales and Use Taxes:

- Sales and use taxes are taxes applying to the purchase of real property or tangible personal property
- The rate of tax can vary from zero to 9%
- Many states have certain exemptions for the purchase of equipment used in mining, manufacturing and processing operations
- Furthermore, many States exempt sale and use taxes applying to certain chemicals and reagents used in the mining process

State Tax - Basic Taxation

State Property Taxes :

- In general, there are 2 ways in which property taxes are applied:
  1. A rate is applied to the fair market value of real property and tangible personal property
  2. Or a rate is applied to the estimated discounted cash flows that will be derived from the mining operations
- Again, the rates can vary significantly between states
- Many times, opportunities can arise in times of low commodity prices to reduce the projected discounted cash flows in an assessor's model. This can result in significant property tax savings.

State Tax - Basic Taxation

State Income Taxes 1:

- For companies operating in more than a single State, double taxation could result without the rules on allocating income to each respective state.
- To alleviate the possibility of double taxation, the concept of "Nexus" evolved. Nexus is based upon the idea of how much contact (and what type of contact) a taxpayer has within a state.
- Public law 86-272 prohibits a State from imposing income tax upon a taxpayer whose only activity within the State is "solicitation" of orders of tangible personal property.

State Tax - Basic Taxation

State Income Taxes 2:

- If a taxpayer is found to have nexus within a number of States, the sourcing of income and expense between States is based on a weighted average formula of the following apportionment factors:
  - **Payroll Factor:** the amount of employee's salaries within a particular State.
  - **Property Factor:** the amount of land, buildings, inventory and rents paid within a particular state
  - **Sales Factor:** the amount of Sales within a particular state

State Tax - Basic Taxation

State Income Taxes 3:

- In addition, there are different types of state income tax returns that may be filed within States:
  1. **Separate return:** Some States require companies to file a separate return for each company within the State.
  2. **Combined return:** Some States require the unitary business group to file a combined return that includes generally all the business income of the related "unitary group".
  3. **Consolidated return:** Finally, some States file by the common parent of an affiliated group of corporations and begin with federal consolidated income.

International Tax Issues - Basic Taxation

International Tax Issues - Basic Taxation

Earnings and Profits (E&P):

- What is Earnings and Profits (E&P)? E&P represents the earnings and profits of a foreign subsidiary using the U.S. tax principles.
- Why is it important? E&P is used to determine whether or not a distribution (including Subpart F) or the sale of shares of a Controlled Foreign Corporation ("CFC") is taxable as a dividend, capital gain or a non-taxable return of capital.

International Tax Issues - Basic Taxation

Foreign Tax Credit:

- In general, the U.S. taxes domestic companies on their worldwide income, including income earned in foreign countries and by foreign branches. Therefore, it is possible to pay twice (once to a foreign company and once to the U.S.) on the same income.
- The potential for double taxation is reduced primarily through two mechanisms:

  1. *Tax treaties:* Generally, providing reduced rates of withholding tax
  2. *U.S. statutory law:* The foreign tax credit system

- The U.S. foreign tax credit ("FTC") system permits a U.S. entity to credit foreign taxes paid against U.S. taxes due (IRC 901(a)). Accordingly, a U.S. taxpayer may use the FTC system to reduce its U.S. tax liability.

International Tax Issues - Basic Taxation

Foreign Tax Credit Limitations 1:

- Several limitations apply to the FTC.
- Limitations cause some of the credit to be disallowed.
- Primary limitation is that the credit cannot exceed the U.S. tax actually due on the foreign income (IRC §904(a)). The limitation is computed as follows:

(Net Foreign Source Taxable Income/Total Taxable Income) X Total U.S. Tax= FTC Limitation

International Tax Issues - Basic Taxation

Foreign Tax Credit Limitations 2:

- In calculating the net foreign source taxable income, certain expenses must be allocated to the income from foreign sources.
- The following expenses reduce a taxpayer's foreign source taxable income:
  - U.S. Interest Expense (IRC 864 (e))
  - G&A and Stewardship Expenses (Treas. Reg. 1.861-8(e)(4))
  - Research and Development Expenses (IRC 864(f))

International Tax Issues - Basic Taxation

Foreign Source Income:

- We saw from the previous screen that the sourcing of income between foreign and domestic is critical in the determination of the foreign tax credit that may be taken in a particular year.
- **Examples of source rules:**
  - Interest income sourced to the payor's place of residence/incorporation
  - Dividend income sourced to the payor's place of residence/incorporation
  - Rentals and royalties sourced to the geographic location of the property or the place where the property is used
  - Income from the sale of inventory generally sourced to the place where the title passes

International Tax Issues - Basic Taxation

Subpart F Income:

- Generally, earnings of a foreign subsidiary are not subject to U.S. tax until those earnings are actually distributed to the U.S. parent.
- However, the Subpart F provisions of the U.S. Tax Code (for CFC's (Controlled Foreign Corporation)) do not follow this basic premise.
- Any Subpart F income of a CFC must be currently included in the U.S. gross income of the U.S. parent (i.e., even though the income has not been distributed back to the U.S.).
- Example: interest income earned in a CFC of a U.S. parent may need to be included into income currently

PwC Publication Website

Dig for more information at: http://www.pwc.com/mining

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