INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
August 25, 2000

Number: **200102007**
Release Date: 1/12/2001
Index (UIL) No.: 616.00-00
CASE MIS No.: TAM-107740-00/CC:PSI:B7

District Director:

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

a =
b =
c =
d =
e =

ISSUE(S):

Whether, under the circumstances described below, the taxpayer has properly determined amounts to be treated as mine development expenditures under section 616 of the Internal Revenue Code.

CONCLUSION:

The taxpayer has not properly determined amounts to be treated as mine development expenditures.

FACTS:

The taxpayer acquired the economic interest in a disseminated deposit of a containing approximately c of a. Through further exploration and acquisition the taxpayer's reserves were increased to d.

The taxpayer mines the deposit using an open pit with hydraulic shovels and trucks. The equipment is capable of removing approximately b tons per year. There is a barren zone above the ore body (overburden) which must be removed to reach the ore body. There are also barren zones within the body (interburden) which also must be removed during mining. To maximize efficient use of its equipment, taxpayer tries to remove a fixed total quantity of material (overburden, interburden, and ore) each year.

However, because of the configuration of the ore bodies and other factors the production of a is not uniform but fluctuates as much as 38% in the years in issue.

The pit is expanded incrementally using laybacks. A layback is an incremental expansion of the pit both vertically and horizontally. Each layback consists of a series of many benches. Each bench in a layback can be several hundred feet wide (while being mined) and e feet in height. Each layback takes several years to develop to total depth. Initially almost all of the material removed in a layback is overburden. Typically, by the second or third year of activity in a layback there will be interburden and ore removed as well as overburden. For most laybacks, by the fourth or fifth year practically all the material removed is interburden and ore. During the years in issue, operations occurred simultaneously in areas excavating almost entirely overburden and areas excavating almost entirely ore and interburden. For example, during the earliest year in issue, a comparison of three active laybacks indicates that the taxpayer was removing mostly ore and no overburden on one layback while in a second, 75% of material removed was overburden. In a third layback only overburden was removed.

The removal of both the overburden and the interburden involves similar activities and both types of waste must be removed in order to gain access to all parts of the ore body. The removal of interburden differs from the removal of the overburden in that it is intimately associated with removal of ore in the day to day operation of the mine. Ore cannot be removed without also removing interburden, whereas the removal of overburden serves to expand the pit limits and to gain access to ore that is scheduled to be mined in the future. The timing of the removal of overburden is an engineering/operational decision that is made after taking into consideration factors such as equipment and manpower availability, future production requirements, and the overall economic plan for the mine.

In order to determine how much, if any, of the waste removal costs should be classified as development, the taxpayer has determined a ratio, the numerator of which is the amount of waste that must be removed over the life of the mine and the denominator of which is the total ore to be removed. If the ratio of waste to ore removed during the year exceeds the ratio for the life of the mine, the removal cost of excess waste is classified as a development expenditure. In the years in issue, the taxpayer claimed no development expenditures.

Although the taxpayer and the District Director are not in agreement regarding the facts in this case, the District Director has determined, in light of all the facts and circumstances peculiar to the taxpayer's operation, that the removal of overburden in the years in question benefitted a substantial portion of the ore body and made such portion of ore accessible for future mining including the mining of layers below those being mined during the years in question. The District Director has also determined that the removal of the interburden in these tax years was primarily related to the day to day removal of ore in the ordinary course of mining. Accordingly, the District Director believes that the costs of removal of overburden are appropriately treated as mining development expenditures that are currently deductible under section 616(a) of the

Code or, at the election of the taxpayer, deferred and deducted ratably under section 616(b). The District Director also believes that the costs of removal of interburden are appropriately treated as costs of goods sold. We understand that this request for Technical Advice involves only the dispute as to the proper characterization of certain costs of removal of material that is considered waste as opposed to material that is considered to be ore.

LAW AND ANALYSIS:

Section 616(a) of the Code provides a deduction in computing taxable income for all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (excluding oil and gas wells). The deduction only applies to expenditures made after the existence of minerals in commercial quantities has been determined. Deductions under section 616 do not include expenditures for the acquisition or improvement of depreciable property.

Section 1.616-1(a) of the Income Tax Regulations provides that development expenditures are deductible under section 616(a) whether incurred in the development or production stage of a mine.

Section 616(b) of the Code provides, in part, that a taxpayer may, under regulations, elect to defer the deduction provided in section 616(a), such deduction to be made on a ratable basis as the units of minerals benefitted by the development expenditures are produced and sold.

Section 1.616-2(a) provides that section 616(b) is applicable to development expenditures paid or incurred both in the development and producing stage of the mine or other natural deposit.

Section 1.616-2(b) provides that a mine or other natural deposit will be considered to be in a producing stage when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or other natural deposit is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

Section 1.616-2(f) provides for the computation of the amount of the deduction allowed under the election of section 616(b). The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred development expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefitted by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefitted by such expenditures remaining as of the taxable year). For the purposes of this proportion, the “number of units of ore or mineral remaining as of the taxable year” is the number of units of ore or mineral benefitted by the deferred development expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefitted by such expenditures recovered but not sold) plus the number of units benefitted by such expenditures sold within the taxable year.

The predecessor to section 616 of the Code was enacted by Section 309(a) of the Revenue Act of 1951 (1951 Act), c. 521, 65 Stat. 452, 486. Prior to 1951, development expenses incurred during a "production" stage of a mine's operation were allowed to be deducted ratably as the ores or minerals benefitted were produced and sold. Any such expenses incurred after the discovery of minerals, but during the preliminary "development" stage of operation, were required to be capitalized and recovered only through deductions for depletion over the entire productive life of the mine (except to the extent that those costs were offset by production of ore incidental to development). Treasury Regulations 111 (1939 Code), Sec. 29.23 (m) - 15. Neither the statute nor the regulations provided a definition of the term "development" but, under the law as it existed prior to 1951 the courts had determined that a development expenditure was one made to **attain** an intended output of a mine while an expenditure made to **maintain** an output was a cost of "production" or operation (see Guanacevi Mining Company v. Commissioner, 127 F.2d 49 (6th Cir. 1942) and Clear Fork Coal Company v. Commissioner, 229 F.2d 638 (6th Cir. 1956). We see significance in the fact that this formulation of the term "development" does not depend on the timing of the expenditure relative to the phases of mining exploration, development, and production.

In discussing the law prior to 1951, the legislative history of section 616 states:

> After a mine reaches this production stage continued expenditures must be made to extend tunnels, galleries, etc., as the working face of the ore or other mineral recedes. Such expenditures are deductible currently, unless extraordinary in scope, in which case they are treated as prepaid expenses to be deducted ratably as the ore benefited by the expenditure is produced and sold. Report of the Committee on Finance, Revenue Act of 1951, S. Rept. 781, 82d Cong. 1st Sess. 44 (1951).

We believe that this language reflects Congress' recognition that the activities of development and production were similar in that both involved the removal of waste material, but that costs of waste removal associated with concurrent removal of ore ("as the working face of the ore...recedes") constituted ordinary operating expenses. We believe that Congress understood that when a waste removal activity related to ore or minerals to be mined in the future, the cost of that activity represented a premature payment of the costs to extract that mineral in the future. Such costs are extraordinary in the sense that they do not relate to the concurrent removal of ore as the working face of the mine recedes, and, as such, their recovery was appropriately deferred under prior law until such time as the ore was extracted and sold. This interpretation is wholly consistent with the courts' characterization of a development activity as one that relates to **attaining** a level of production in the future as contrasted with a production activity that **maintains** a current level of production.

The cited language in the Finance Committee's report makes clear that, under the law prior to 1951, the determination of whether a cost incurred in the production stage was a development or a production cost required a "benefit analysis," that is, an analysis of which specific portion of the taxpayer's ores or other minerals was benefitted by the activity giving rise to the cost. If concurrently mined ore was benefitted the cost was a production cost recovered currently but if ore to be mined in the future was benefitted, the cost was a prepaid one whose recovery was deferred.

Congress considered the required capitalization of development costs to be a serious obstacle to expansion of the mining industry and intended to address the problem in a manner similar to the manner in which the same problem was addressed with respect to the oil and gas industry, namely enacting the intangible drilling and development costs provision of section 263(c). As a result, in the 1951 Act, Congress provided for the current deduction of all expenditures for the development of mines provided only that they be incurred after the exploration phase and do not relate to the acquisition or improvement of depreciable property.

The legislative history further indicates that Congress (in what is now section 616(b)) intended that taxpayers could, by election, treat all development expenditures under the rules that under prior law were reserved for those development expenditures incurred after a production stage was reached. The overall effect on the treatment of development costs of the 1951 Act was to eliminate the recovery of such costs through depletion deductions and to annually give taxpayers the flexibility to recover all development costs currently or ratably as the developed reserves were mined and sold. The distinction in treatment of development expenditures between the so-called "development stage" and "the production stage" ceased to exist with the enactment of the 1951 Act.

.

The Supplemental Report of the Committee on Finance, Revenue Act of 1951, S. Rept. 781, Part 2, 82d Cong. 1st Sess. 21 (1951) provides a concise statement of the effects of the 1951 Act on the treatment of mining development expenditures:

> During the development stage, this new subsection is applicable to all expenditures of the taxpayer, unless otherwise excluded herein. However, after the producing status is reached, it is only those extra-ordinary expenditures which under existing law must be deferred and deducted ratably as the produced ores or minerals benefited thereby are sold which are affected by this subsection. The determination of when a mine or deposit passes from one stage into another shall be made under existing law.

Here, Congress clearly states what expenditures, if incurred in a production stage of the mine, are considered to be "extraordinary" to the extent that those costs would be subject to the treatment allowed under section 616. They are the costs that under prior law were required to be ratably deducted as the benefitted ore was mined and sold. Thus, under the law subsequent to 1950, a determination of the relationship between a mining activity and the ore benefitted by that activity remains the basis for recognition of a mining development expense as opposed to an operating cost. In addition, by making reference to a determination regarding the development stage under existing law, the final sentence of the above-cited material indicates that Congress intended to change the treatment of development costs but did not intend to change the meaning of the term.

The legislative history further indicates that Congress intended that taxpayers could, by election, treat all development expenditures (regardless of whether incurred during a development or production stage) under the rules that under prior law were reserved for those development expenditures incurred after a production stage was reached. The overall effect on the treatment of development costs of the 1951 Act was to eliminate the recovery of such costs through depletion deductions and to annually give taxpayers the flexibility to recover all development costs currently or ratably as the developed reserves were mined and sold. The distinction in treatment of development expenditures between the so-called "development stage" and "the production stage" ceased to exist with the enactment of the 1951 Act. Congress preserved the prior law treatment of development costs in the form of the election provided in what is now section 616(b) of the Code. Both in the statute and in the regulations (section 1.616-2(f)) implementing section 616(b), the "benefit analysis" is retained in determining which expenditures are properly deferred under the election and when those costs are to be recovered.

Following the enactment of the 1951 Act, both the Internal Revenue Service and the courts have opined regarding the meaning of the term "development" (see Rev. Rul. 77-308, 1977-2 C.B. 209-10, Rev. Rul. 66-170, 1966-1 C.B. 159, Rev. Rul. 75-122, 1975-1 C.B. 87, Rev. Rul. 86-83, 1986-1 C.B. 251, Hughes v. Commissioner, T.C. Memo 1989-528, Sante Fe Pacific Railroad Co. v. United States, 378 F.2d 72 (7^{th} Cir. 1967)). In each case, the term "development" is understood to refer to the activities by which ores or minerals are made accessible to sustained mining. Central to this understanding of the term is the relationship between the activity and the portion of the ore that is made accessible.

Taxpayer places great emphasis upon Congress' use of the word "extraordinary" in the above-cited language of the Finance Committee's report arguing that use of such term indicates that only those expenditures that go "far beyond" the normal year to year costs of operating a mine be treated as "development." Taxpayer suggests that "development" be limited to expenditures similar to the one-time expenditures incurred in a "very major" expansion of the production level of the mine.

As the discussion above indicates, we find no support for interpreting the word “extraordinary” in the manner advocated by the taxpayer. We believe that a cost or activity is not required to go “far beyond” the normal costs of operating a mine in order to constitute a development cost or activity. We read the Finance Committee’s language to require that development activities be merely those “extra” activities that relate to ore or minerals to be mined in the future rather than to the activities related to maintaining the present level of production. The taxpayer’s interpretation seemingly substitutes a requirement that an activity be “extraordinary” for the benefit analysis found in the statute and the contemporaneous regulations promulgated thereunder. Indeed, given the fact that production and development comprise very similar activities, differing only with respect to the exact ore benefitted, no activity or associated cost would in all likelihood be considered extraordinary if that word was interpreted in the manner advocated by the taxpayer.

Although to what extent an activity and its associated costs relate to particular portions of a body of ore or other mineral is a factual matter, we believe that the law requires that an analysis of this relationship be made in order to properly identify those activities and costs that constitute development of a mine. Because the taxpayer identifies development activities by reference to a formula that does not take into account the relationship between each activity and the portion of the ore benefitted by that activity, the taxpayer’s method is not a reasonable method for determining which expenditures are properly treated under section 616 of the Code. Because the method employed by the District Director takes into account an analysis of the ore benefitted by the taxpayer’s activity, that method is consistent with the requirements under the law for identifying costs subject to section 616.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.