

The 13th Annual Americas School of Mines US Mining Tax Issues*

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Agenda/Contents

- Hedging gains and losses and percentage depletion
- Deductibility of fee for terminating a merger
- ACE depletion update
- Separating coal v. lignite in calculating taxes
- Mining Law of 1872

Effect of Hedging on percentage depletion

IRS ruling asserts mining companies enter into “hedging” transactions to “ensure a certain level of stability for the selling price of their inventory of mine products”

- Calls it a type of ‘insurance’

IRS defines “futures contract” as a contract to sell or purchase a commodity at a future date at a fixed price

- Ruling asserts futures contract could be settled in a variety of ways
- “Only a small percentage of futures contracts are closed by delivery or purchase of the property itself.”

Effect of Hedging on percentage depletion

Ruling concludes gains and losses from hedging contracts are not “gross income from mining” for percentage depletion purposes, nor are they income for the 50% net income from the property test

- Theory appears to be that hedging transactions do not close by delivery of the mineral, they are essentially financial instruments (my words, not the ruling’s words)

Effect of Hedging on percentage depletion

Ruling mentions futures contracts, equates them to hedging and says 'only a small percentage are closed by the delivery of the product'

- Implication is that futures contracts are the same as hedging

Ruling itself only refers to hedging transactions

Equating a futures contract to hedging, especially where the mineral is mined and actually delivered by the taxpayer, seems wrong

Generic advice from one group to another within IRS

Deduction of \$65 million merger termination fee

Santa Fe Pacific Gold was being pursued by Newmont

Santa Fe didn't want to merge with Newmont & sought a 'white knight'

- Homestake stepped in as that 'white knight'
- Deal: Homestake would get a \$65 million fee from Santa Fe if the deal was not consummated

Newmont sweetened offer

- Santa Fe board accepted the Newmont deal
- Santa Fe paid the \$65 m fee to Homestake

Deduction of \$65 million merger termination fee

Santa Fe claimed a \$65 million deduction for the fee paid to Homestake

IRS denied the deduction

- Claimed the payment was part of the ultimate Newmont deal

Held: Deductible

- Section 162 loss – payment to stop a deal; didn't work or
- Section 165 loss from capital transaction

Either way - deductible

Separating lignite from coal in calculating the coal excise tax

Black Lung excise tax is imposed by IRC section 4121 on the sale of coal

Lignite is exempt from the excise tax

Taxpayer mines coal and lignite simultaneously

- Tests amount of coal v. lignite using American Society for Testing and Materials (ASTM) procedures
- Keeps adequate records

Taxpayer entitled to exclude percentage of lignite from excise tax calculation

Separating lignite from coal in calculating the coal excise tax

Rules require testing *in situ*

Coal and lignite sold together

Taxpayer can rely on properly performed testing to exclude the percentage of lignite from the tax calculation

Other cases support the idea that where taxable and nontaxable minerals are sold, but adequate testing is performed and adequate records are maintained, the taxpayer can exclude the nontaxable material from the tax calculation

Percentage depletion in excess of E&P depletion is an ACE adjustment, even for a pre-1990 mine

ACE adjustment for percentage depletion in excess of E&P depletion (essentially, cost depletion) if the taxpayer is out of basis

- Taxpayer will never get that excess depletion for E&P because E&P depletion is based on cost

Different section of the code says only cost depletion for ACE for mines placed in service after 12/31/89

- Taxpayers took this 'after 12/31/89' rule to mean that percentage depletion in excess of E&P depletion did not apply to pre-1990 mines

Santa Fe Pacific Gold co. v. Commissioner, T.C., No. 22956-06, 130 T.C. No. 17, 6/25/08

Percentage depletion in excess of E&P depletion is an ACE adjustment, even for a pre-1990 mine

This Court disagreed and said the pre-1990 limitation did not apply to the 'no percentage depletion in excess of E&P depletion' rule

Court further ruled that unamortized development costs under Section 56(a)(2) do not give additional basis when calculating percentage depletion in excess of E&P depletion

Percentage depletion in excess of E&P depletion is an ACE adjustment, even for a pre-1990 mine

Dicta: Court said it would have decided unamortized development costs do not give additional basis even for the basic section 57(a)(1) preference (percentage depletion in excess of basis)

- Issue was stipulated by the parties (IRS agreed with the position)

We have spoken with the IRS and know of no plans on the part of the IRS to change its position on the section 57(a)(1) issue

Proposed amendments to the Mining Law of 1872

Charge a royalty for mining on unpatented Federal lands

Proposal that has been around for many years

Took on new life a couple of years ago

Early proposals were for 8% on gross income

- “We know 8% is too high; its just a starting point.”

Most recent proposals were for a lower amount on net income

Many environmental and other matters in the proposed legislation

Do you know if you are mining on unpatented federal lands?

Total Taxes should be part of the analysis

Questions or comments?

Thank you!