American Gilsonite Co. v. Commissioner, 28 T.C. 194 (1957)

The court determined that the scope of “ordinary treatment processes” in calculating percentage depletion for a mineral includes pulverizing and sacking the mineral but excludes the cost of transporting the mineral to a remote processing facility and the operation of a company town.

Summary

The U.S. Tax Court addressed whether certain activities of the American Gilsonite Company, related to mining gilsonite, were considered “ordinary treatment processes” for the purpose of calculating percentage depletion under the Internal Revenue Code of 1939. The court found that pulverizing and sacking gilsonite were part of the ordinary treatment process. However, it also ruled that the cost of transporting the mineral 113 miles to a processing facility and the expenses of operating a company town for employees were not part of the ordinary treatment processes and, thus, could not be included in the calculation of the depletion deduction. The case clarifies which costs are included in the calculation of percentage depletion.

Facts

American Gilsonite Company mined gilsonite in Bonanza, Utah. The mining process involved blasting, cleaning, crushing, and sorting the ore into different sizes. After this, some gilsonite was pulverized. The ore was then transported 113 miles by truck to Craig, Colorado, where it was sacked for shipment. The company also operated a townsite near the mine to house its employees and maintained a house in Vernal, Utah. The Commissioner of Internal Revenue disallowed certain deductions related to these activities for the purpose of calculating the company’s percentage depletion allowance.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies in the company’s income tax returns for the years 1948, 1950, and 1951. The company contested these assessments in the U.S. Tax Court, arguing that the disallowance of the deductions for pulverizing, sacking, the Craig office, and the operation of the Bonanza Townsite and the maintenance of the house at Vernal was incorrect. The Tax Court ruled on the merits of the dispute, resulting in this opinion.

Issue(s)

1. Whether pulverizing the gilsonite is part of the “ordinary treatment processes” and therefore a deductible expense in calculating the percentage depletion allowance.

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2. Whether sacking the gilsonite is part of the “ordinary treatment processes” and therefore a deductible expense in calculating the percentage depletion allowance.

3. Whether the cost of transporting the gilsonite 113 miles to the railhead in Craig, Colorado, is part of the “ordinary treatment processes” and therefore a deductible expense in calculating the percentage depletion allowance.

4. Whether the overhead expenses of maintaining the Craig office are part of the “ordinary treatment processes” and therefore a deductible expense in calculating the percentage depletion allowance.

5. Whether the loss incurred in operating the Bonanza Townsite is a direct cost of mining gilsonite and thus deductible in computing the percentage depletion allowance.

6. Whether the cost of maintaining the house at Vernal, Utah, is a direct cost of mining gilsonite and thus deductible in computing the percentage depletion allowance.

Holding

1. Yes, because the pulverization was part of the process of preparing a commercial marketable product.

2. Yes, because the packaging of the gilsonite into sacks was an ordinary treatment process.

3. No, because transporting the ore 113 miles exceeds the statutory limit for allowable transport distance.

4. No, because the company did not prove these expenses were directly related to the mining process.

5. No, because the costs of running the townsite were deemed an indirect increase in wages and salaries, and not directly related to the mining activity.

6. No, because there was insufficient evidence to show that the costs of maintaining the house were direct mining costs.

Court's Reasoning

The court examined sections 23(m) and 114(b)(4)(A)(iii) and (b)(4)(B) of the Internal Revenue Code of 1939 to determine what constituted “ordinary treatment processes.” The court found that pulverizing was a continuation of the sorting process, part of getting the product ready for market and therefore allowable. The court also found that sacking was a necessary step to get the product to customers in a marketable form and was an ordinary treatment process, and not related to the

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distance the processing occurred from the mine.

The court noted that crude gilsonite was not commercially marketable. The court cited that the packaging was essential for customers, as crude gilsonite could not be sold. The court referenced a 50-mile limitation on transportation costs from the 1939 Code, but because the ore was transported 113 miles, it was deemed an expense beyond the scope of allowable mining expenses. The court determined that the cost of maintaining the Craig office was not a direct cost of mining due to a lack of specific evidence presented by the company.

The court also determined that the losses associated with the Bonanza Townsite were not direct mining costs, as the low rental prices constituted an indirect increase in wages. The costs of maintaining the house in Vernal were also not allowed because the company did not adequately prove a direct connection to mining operations.

Practical Implications

This case provides a guide for determining what costs are included in calculating percentage depletion allowances. It suggests that activities directly related to preparing a marketable mineral product, such as pulverizing and packaging, are generally included as “ordinary treatment processes”. However, the case makes it clear that costs such as long-distance transportation and operating costs for services like housing, if not directly tied to the extraction or immediate preparation of the mineral, are not included. Attorneys advising mining companies should carefully analyze the specific steps in their client’s production process to determine which expenses qualify for the depletion allowance. Moreover, the case highlights the importance of documenting the direct connection between activities and mining operations to support claims for deduction.

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