

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-162413-03, CC:ITA:B07

District Director  
LMSB, Natural Resources & Construction

Taxpayer's Name:  
Taxpayer's Address:

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

LEGEND:

Taxpayer =  
Metal 1 =  
Country =  
Year 1 =  
Year 2 =  
Year 3 =  
Year 4 =  
Year 5 =  
Year 6 =

ISSUE(S):

1. Is Taxpayer required under § 263A to capitalize drilling, blasting, loading, and hauling costs related to Metal 1 to be produced from the leach piles?
2. If Taxpayer is required to capitalize drilling, blasting, loading, and hauling costs related to Metal 1 to be produced from the leach piles, is it required to allocate such costs to the Metal 1 that will be produced from leach piles?

3. Is a § 481(a) adjustment required if the examining agent changes Taxpayer's method of allocating drilling, blasting, loading, and hauling costs?
4. Is Taxpayer entitled to relief from a § 481(a) adjustment under § 7805(b)?

#### CONCLUSION(S):

1. Taxpayer is required under § 263A to capitalize drilling, blasting, loading, and hauling costs related to Metal 1 to be produced from the leach piles.
2. Taxpayer is required to allocate capitalized drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from the leach piles. The drilling, blasting, loading, and hauling costs are recovered through cost of goods sold as the related Metal 1 is sold.
3. A §481(a) adjustment is required if the examining agent changes Taxpayer's method of allocating drilling, blasting, loading, and hauling costs.
4. Taxpayer is not entitled to relief from a § 481(a) adjustment under § 7805(b).

#### FACTS:

Taxpayer operates an open pit Metal 1 mine in Country. Through its drilling and blasting operations at the mine it obtains rock bearing both high-grade and low-grade Metal 1 ore.

Taxpayer's mining activity is conducted in accordance with both short-term and long-term mining plans. The mining plans are based on core samples that ascertain the grade and type of materials that will be found in different parts of the mine. All of the material in the mine – whether high-grade ore, low-grade ore, or barren rock – must be removed as part of the open pit mining process. Taxpayer uses the mining plans to determine the time frames for mining different parts of the mine to meet its production needs.

Prior to blasting an area of the mine, Taxpayer drills blast holes and shavings are sampled to ensure that the ore found is the grade and type the mining plans show. After blasting, a final sample is taken to ensure that the ore to be mined is loaded and transported to the correct area for processing. Taxpayer uses two separate methods to process ore. Taxpayer generally uses a concentration method to process high-grade ore and a leaching method to process low-grade ore. In order to make the determination as to whether ore should be processed using the concentration method or the leaching method, Taxpayer divides the ore by grade. Ore with less than .1% Metal 1 is considered waste. Ore with Metal 1 above .1% and below a prescribed cut-off grade are placed on leach piles. Ore with Metal 1 above the prescribed cut-off point is transported to the concentrators. All diabase rock is considered waste.

At any given time, Taxpayer operates several electric shovels in the mine. These shovels load materials into haulage trucks that carry payloads in excess of 200 tons. At the mine, shovels load materials that will be hauled to the concentrators; while other shovels simultaneously load materials that will be hauled to leach piles.

Historically, Metal 1 at Taxpayer's mine has been produced primarily using a concentration process. In the concentration process, high grade Metal 1 bearing ore is hauled from the mine and dumped in a crusher where it is crushed to the size of 8 inches or less. Next, the material is milled to a size of 3/8 of an inch and fed as slurry into ball mills, where the materials are reduced to the size of sand or fine powder. The powder slurry from the ball mills are then fed to a flotation plant where a re-agent is added that separates a compound containing Metal 1 from the slurry to form a concentrate. The concentrate is then dried and sent to the smelter. Next, dried concentrate, along with other materials, is introduced into a hot furnace. In the furnace, Metal 1 that contains some impurities floats to the bottom of the furnace. The Metal 1 laden material is then sent to another furnace called a converter to remove some of the impurities. The Metal 1 is then sent to an anode furnace to remove more impurities. The Metal 1 is then cast into 98% to 99% pure anodes that are sent to a refinery. At the refinery, the anodes are suspended along with cathodes in tanks containing Solution 1 where an electrical current is introduced to the anodes. As a result, electrical current flows from the anodes through the solution dissolving the anodes into the solution. The Metal 1 from the anodes is electroplated on the cathode starter sheets. The material that remains is sludge that sinks to the bottom of the tank.

At the mine, this concentration process has historically been supplemented with some precipitation of Metal 1 cement. In Year 1, Taxpayer began dump leach pilot test work to evaluate the main process variables such as Metal 1 recovery, irrigation rates, rest periods, and curing acid concentrations. Taxpayer had its first feasibility study on leaching done during Year 1. Taxpayer resumed testing in Year 2 and had another feasibility study in Year 3. The metallurgical results showed that the mine was amenable to dump leaching and the feasibility studies concluded that the solvent-extraction/electro-winning (SX/EW) operations would be technically and economically viable. In Year 4, Taxpayer built an SX/EW plant at the mine.

Generally, the SX/EW plant is used to produce Metal 1 from lower grade sulfide ore<sup>1</sup> and oxide ore that is susceptible to leaching. The SX/EW process begins with the accumulation of heap leach and dump leach grade ores in leach piles. Both heap leach and dump leach piles are carefully constructed so as to maximize the Metal 1 that will be recovered. First, the depth of each layer (called a "lift") added to a heap leach or dump leach pile is determined by engineering studies that take into account the leaching qualities of the material being added to the pile. Trucks dump the leaching ore on the pile. Next, a team of bulldozers push the ore into place and the surface of the lift is ripped and roughed up so that the acidic solution that will be poured through the lift

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<sup>1</sup> The sulfide ore that is transported to leach piles is a lower grade ore because, on a tonnage basis, it contains less recoverable Metal 1 than the sulfide ore transported to the concentrators.

better soaks it. After the initial ground work is completed, a pipe system, consisting of several miles of pipe, is constructed atop the lift. Once a lift is completed a berm is constructed around the edge so that the acidic solution will pool and soak into the pile rather than run over the edge. Then an acidic solution that engineers determine will maximize the recovery from the pile is poured over the pile. After the leaching process is complete, the surface of the pile is again roughed up to enhance leaching when the next lift is constructed.

The leaching process requires the leach piles to be placed so that the solution containing Metal 1 (called pregnant leach solution or PLS) can be collected and treated. To accomplish this, leach piles must be constructed on areas that are overlain with relatively impervious rock so that the PLS does not soak into the ground. Additionally, dams along with accompanying solution pumping systems are constructed at the base of natural drainages. Accordingly, Taxpayer's engineers have carefully designed and circumscribed areas where leach piles are constructed as compared to waste areas that cannot be leached.

The process for leaching heap leach and dump leach grade ores are different. Heap leach piles are constructed using the highest quality of the oxide ore. The leaching quality of the heap leach material is very good and the amount of copper that will be recovered from the heap leach is very predictable. On the other hand, a dump leach pile is constructed using the remaining oxide and low-grade Metal 1 ore. Accordingly, the leaching quality of the dump leach ore is less than that of the heap leaching grade ore and the amount of Metal 1 that will be recovered from the dump leach is less predictable. Below is a description of both processes.

Heap leach grade ore is hauled and dumped in a crusher. Once the heap leach ore is crushed it is placed on a heap leach pile where it is sprinkled with a slightly acidic solution for a predetermined amount of time. As the solution percolates through the heap leach pile, Metal 1 ions attach themselves to the solution to form PLS. Next, the heap leach pile is allowed to rest (dry out) while another heap leach lift is started on the top of the one that was just leached. The PLS from the heap leach pile is then pumped to a holding pond where it may be commingled with PLS from dump leach piles.

Dump leach grade ore, unlike heap leach grade ore, is not crushed or processed in any way prior to it being placed on a leach pile. Instead, dump leach grade ore piles are constructed in 30 foot lifts and the surface of the lift is ripped by a bulldozer and a sprinkling system is installed. The lift is then sprinkled with a slightly acidic solution for a predetermined length of time. As with a heap leach pile, the solution percolates through the dump lift where Metal 1 ions attach themselves to the solution to form PLS. The PLS from the dump pile is then collected and pumped to a holding pond where it may be commingled with PLS from heap leach piles.

The collected commingled PLS then is mixed with re-agents (SX) that turn the PLS into an electrolyte with a high Metal 1 content. The electrolyte is then pumped into

EW tanks where starter sheets (cathodes) are suspended. An electric current is then introduced into the electrolyte that causes the Metal 1 ions to be stripped from the electrolyte and deposited on cathodes. The resulting cathodes, which are then 99.99% pure Metal 1, are removed and ready for sale.

Generally, the entire recoverable mineral content contained in ore transported to the leach piles is not fully processed and ready for sale within a year from the time of being placed on the leach pile because more than one leaching cycle is ordinarily required to recover the mineral content. Moreover, a dump or heap leach pile cannot be leached while it is being constructed. However, once leaching has commenced most of the recoverable Metal 1 in the ore is recovered within 8 months. Taxpayer has a significant backlog of low grade ore awaiting the leaching process. Taxpayer claims that it will not be able to process the ore placed on leach piles currently until 10 to 15 years in the future.

Taxpayer produces Metal 1 primarily using the concentration process. According to Taxpayer, Metal 1 produced from the leach piles using the SX/EW process comprises only 1% of the total Metal 1 that will be recovered from the mine over its productive life. During the three year period ending Year 5, however, SX/EW production at the mine constituted 311.4 million pounds of Metal 1, which was approximately 15% of Taxpayer's sales.

Under its present method of accounting, Taxpayer capitalizes all drilling, blasting, loading, and hauling costs to Metal 1 produced using the concentration process and does not capitalize any drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from the leach piles. However, Taxpayer capitalizes the leaching costs as well as all other costs associated with the SX/EW process to the Metal 1 that will be produced from the leach piles.

The examining agent has proposed to change Taxpayer's accounting method so that some drilling, blasting, loading, and hauling costs are allocated to Metal 1 that will be produced from leach piles using a facts and circumstances allocation method. The method proposed by the examining agent allocates costs between the Metal 1 that will be produced using the concentration process and Metal 1 that will be produced from the leach piles based on tons of material transported to each process.

With its Federal income tax return (Form 1120), Taxpayer filed an Application for Change in Accounting Method (Form 3115) to capitalize additional § 263A costs to the ore transported to the concentration process.

#### LAW AND ANALYSIS:

Issue 1: Is Taxpayer required under § 263A to capitalize drilling, blasting, loading, and hauling costs related to Metal 1 to be produced from the leach piles?

Under its present method, Taxpayer capitalizes all of its drilling, blasting, loading, and hauling costs. However, Taxpayer allocates all of those costs to Metal 1 that is produced from the high grade ore that is transported to the concentration process. The examining agent has proposed to allocate some of the drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from the leach piles. Taxpayer argues that drilling, blasting, loading, and hauling costs incurred with respect to ore transported to leach piles are excluded from capitalization under § 263A(c). Section 263A(c)(3) provides that costs that are allowable as a deduction under § 616 are not capitalized under §263A.

Section 263A generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of the real or tangible personal property that it produces. See § 263A(a). A taxpayer “produces” property when it constructs, builds, installs, manufactures, develops, or improves property. See § 263A(g). The direct costs of property produced by a taxpayer include direct materials and direct labor costs. See § 1.263A-1(e)(2)(i). The indirect costs of produced property are all costs other than direct material costs and direct labor costs. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. See § 1.263A-1(e)(3).

Taxpayer does not dispute that its drilling, blasting, loading, and hauling costs are either direct or indirect costs of producing Metal 1. Instead, Taxpayer has argued that these costs should not be allocated to the Metal 1 that will be produced from the leach piles because drilling, blasting, loading, and hauling costs incurred with respect to leach piles are excluded from capitalization under § 263A(c). Section 263A(c)(3) provides that costs that are allowable as a deduction under § 616 are not capitalized under §263A.

For the following reasons, drilling, blasting, loading, and hauling costs associated with ore transported to the leach piles are not deductible as mine development costs under § 616. Accordingly, such costs are not excluded from capitalization under § 263A(c)(3).

Section 616 provides a deduction for all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed.

Neither the code nor the regulations defines the term “development expenditures.” The Service has, through revenue rulings, attempted to provide some guidance as to what the term means. Development expenditures are described in Rev. Rul. 67-169, 1967-1 C.B. 159, as expenditures paid or incurred to make the ore accessible for sustained extraction over a relatively long period. “Development expenditures described in section 616 of the Code are those expenditures paid or incurred in carrying out the excavation of material and related activities in the driving of

shafts, tunnels, galleries, and other mining excavation for the purpose of making the ore or mineral in place accessible for sustained extraction methods by either underground or strip-mining methods. These expenditures benefit an area of a mineral deposit, recoverable over a relatively long period in the ordinary course of mining and selling of the valuable mineral extracted from the deposit. Such expenditures would be chargeable to capital expenditures except for the provisions of section 616 of the Code.” Id.; see also Rev. Rul. 86-83, 1986-1 C.B. 251.

With regard to the distinction between expenditures for development, and expenditures for the day-to-day operations of the mine, courts have long stated that “if an expenditure is made to attain an intended output, it is properly chargeable to capital as a cost of development; if the expenditure is made to maintain an output, it is properly chargeable to operating expense.” See, e.g., Clear Fork Coal Co. v. Commissioner, 229 F.2d 638, 642 (6th Cir. 1956).

In this case, the expenditures at issue are the costs of removing low grade ore from the mine, and piling it for later extraction by a leaching process. Taxpayer argues that, because the low grade ore cannot be leached in the mine, the cost of moving and piling the ore should be considered development because it prepares the ore for long term sustained extraction.

Taxpayer uses the leaching process because the quantities of copper in the low grade ore are small enough that the use of the concentrator process is not economically practical. However, Taxpayer has gained access to the mineral, and is removing mineral as part of the day-to-day mining cycle. The fact that Taxpayer is able to remove the ore from the mine illustrates that it has gained access to the ore. That further processing (in this case leaching) of the ore takes place to remove the mineral from the rock does not change the result. Each of the processes treated as mining under § 613 are designed to separate the mineral from the rock, and the need to use one mining process rather than another will not convert operations into development.

Issue 2: If Taxpayer is required to capitalize drilling, blasting, loading, and hauling costs related to Metal 1 to be produced from the leach piles, is it required to allocate such costs to the Metal 1 that will be produced from the leach piles?

Taxpayer argues that it is not required to allocate drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from leach piles for three different, but related, reasons. First, Taxpayer argues that the Metal 1 bearing ore transported to leach piles is waste or scrap from mining the high grade ore for use in the concentration process. Therefore, Taxpayer concludes that the related costs should be allocated to the high grade ore pursuant to § 1.263A-1(e)(3)(ii)(Q). Second, Taxpayer argues that Metal 1 bearing ore transported to leach piles has no value. Therefore, Taxpayer concludes that under § 1.471-7 none of the drilling, blasting, loading, and hauling costs should be allocated to the Metal 1 that will be produced from the leach piles. Finally, Taxpayer argues that allocating all of the drilling, blasting, loading, and hauling costs to

the high grade ore is consistent with generally accepted accounting principles. Therefore, Taxpayer concludes that its present allocation method is permissible for federal income tax purposes. As explained below, we disagree with Taxpayer's arguments.

A. Waste or Scrap under § 1.263A-1(e)(3)(ii)(Q)

Taxpayer argues that the ore transported to leach piles is waste or scrap from mining the ore that is transported to concentrators. Taxpayer believes that property that is intentionally produced is inventory, but that property that is produced as an unavoidable part of the intentional process of producing a related product is scrap. Taxpayer essentially argues that the ore that is sent to be leached and processed using the SX/EW method should be considered scrap or waste of mining ore that is transported to the concentration process because Taxpayer's mining operations are primarily focused on the high grade ore and that ore is the only ore that can be mined profitably by Taxpayer. Taxpayer further argues that pursuant to § 1.263A-1(e)(3)(ii)(Q) the drilling, blasting, loading, and hauling costs associated with such scrap should be allocated to high-grade ore that is sent to the primary production process (i.e., the concentration process), rather than the Metal 1 that will be produced from the leach piles.

We disagree with Taxpayer's definition of what constitutes scrap or waste. Section 1.263A-1(e)(3)(ii)(Q) provides that the cost of goods produced by a taxpayer must include the costs of rework labor, scrap, and spoilage. The term scrap is not defined in the regulations. However, the term "scrap" is generally defined in cost accounting literature as material that is left over from the making of a product and that either has no recovery value or a relatively minor recovery value as compared to the value of the product. See Charles T. Horngren Et. Al., Cost Accounting, A Managerial Emphasis, 648 (Prentice Hall 10th ed. 2000).

Many cases deal with the classification of property as inventory. However, none deal with the distinction between scrap and inventory. Generally, where property is held for sale or for further processing so that the property can ultimately be sold to customers in the ordinary course of business, the property is classified as inventory. See, e.g., Wilkinson-Bean, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970); Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781 (11th Cir. 1987); Nemetschek North America, Inc. v. Commissioner, T.C. Memo. 2001-288. Thus, goods that are regularly produced and sold by the taxpayer ordinarily must be treated as inventory rather than scrap or waste.

Moreover, Taxpayer's argument is belied by the facts. Since at least Year 3, Taxpayer has understood from metallurgical tests that it that the mines were amenable to dump leaching and that the SX/EW operations would be technically and economically viable. Moreover, in Year 4, Taxpayer built a SX/EW plant at the mine to process the

PLS derived from the low grade ore. Accordingly, from at least Year 4 and as early as Year 3, the ore transported to the leach piles as well as the ore transported to concentrators has been considered by Taxpayer as property that will be used to produce the same finished product – 99.99% pure Metal 1.

Taxpayer's argument that ore transported to the leach piles is scrap or waste of producing higher grade ore only views the production process at an intermediate point of production. Taxpayer's argument rests on the mistaken notion that the product being produced is high-grade ore. This is incorrect. Taxpayer is a producer of Metal 1 and the Metal 1 it produces is derived from two different grades of material using two separate production processes. Moreover, the finished product derived from each process has the same sales price regardless of the process that is used to produce it. Thus, with the issue now properly refocused on the product produced, it is readily apparent that the Metal 1 Taxpayer produces from the leach pile is not scrap of Metal 1 produced using a concentration process.

Taxpayer has further argued that the low-grade ore should be considered waste from producing high-grade ore because the low-grade ore is of relatively modest value as compared to the value of high-grade ore. Again, Taxpayer's argument misses the point. As stated above, Taxpayer is not a producer of high- and low-grade ores. Taxpayer does not produce high- and low-grade ore for sale, but produces Metal 1. The Metal 1 Taxpayer produces using the concentration process and the SX/EW process have the same value. Accordingly, it can not be said that the Metal 1 produced through the SX/EW process is waste from producing Metal 1 through the concentration process.

Furthermore, Taxpayer derived approximately 15% of its sales of Metal 1 during the three year period ending Year 5 from the SX/EW process. This lends further support to our conclusion that the Metal 1 produced through the SX/EW process is not of relatively minor value as compared to the Metal 1 that is produced through the concentration process.

#### B. Applicability of § 1.471-7

Taxpayer argues that its current method of allocating drilling, blasting, loading, hauling costs is required by § 1.471-7. According to Taxpayer, its drilling, blasting, loading, and hauling costs are joint costs under § 1.471-7 because it can not mine high-grade ore without extracting low-grade ore. Taxpayer argues that § 1.471-7 requires joint costs to be allocated on the basis of respective selling values of the products produced (i.e., the high and low-grade ores). Taxpayer further argues that the ore transported to leach piles has no value and therefore, none of the drilling, blasting, loading, and hauling costs are allocable to Metal 1 that will be produced from the leach piles.

Section 1.471-7 of the regulations provides as follows:

A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product.

We disagree with Taxpayer's arguments concerning the applicability of, as well as the application of, § 1.471-7.

First, we are not convinced that Taxpayer's drilling, blasting, loading, and hauling costs are the type of costs that are allocable under § 1.471-7. Taxpayer's drilling, blasting, loading, and hauling costs are more in the nature of common costs than joint costs. Section 1.471-7 permits a taxpayer, with the Commissioner's prior consent, to use a "relative sales value" method, to allocate joint costs. Joint costs have been defined as the costs of a single production process that yields multiple products simultaneously. See Horngren Et. Al., supra at 536-537; Adolph Matz & Milton F. Usry, Cost Accounting, Planning and Control, 176-177 (South Western Publishing Co. 7th ed. 1980). This definition indicates that the process that creates the products must do so in a definite quantitative relationship. In other words, an increase in one product's output will bring about an increase in the quantity of the other products. For example, a poultry farmer cannot simply slaughter a turkey wing. Instead, the poultry farmer to obtain a wing must slaughter the whole turkey, which yields breasts, thighs, drumsticks, and other turkey parts. See Horngren, Et Al., supra at 537. Joint costs are not directly traceable to the various products resulting from the process because it is impossible to determine the amount necessary to produce only one of the joint products.

Common costs, unlike joint costs, are divisible. Common costs are allocated among products or services because each of the products or services could have been obtained separately. With common costs the obtaining of one product or service does not have a quantitative relationship with the other product or service. For example, a poultry farmer may incur slaughtering costs with respect to both chickens and turkeys but there is no quantitative relationship between the slaughtering of chickens and turkeys. The cost of slaughtering a chicken or a turkey can be determined separately; there is no need to allocate the total slaughtering costs on the basis of relative selling values of chickens and turkeys. See Matz & Usry, supra at 176-177.

The drilling, blasting, loading, and hauling costs incurred by Taxpayer are common costs, not joint costs. Taxpayer's argument that it can not mine high-grade ore without extracting low-grade ore ignores the question that is asked in determining whether the costs at issue are joint or common costs. The critical question is whether the costs incurred to extract low-grade ore are separable from the costs incurred to

extract high-grade ore. Taxpayer incurs drilling, blasting, loading, and hauling costs with respect to both types of ore, but the different types of ore are extracted simultaneously from separate locations within the mine. Thus, Taxpayer is able to separately determine the amount of drilling, blasting, loading, and hauling costs it incurs with respect to Metal 1 that will be produced from the leach piles. Joint costs are indivisible and can not be tracked separately with regard to any single product that is produced through a single process. Accordingly, since Taxpayer's drilling, blasting, loading, and hauling costs at issue are separately traceable they are not the types of costs allocable under § 1.471-7.

Second, even if we were to assume, arguendo, that drilling, blasting, loading, and hauling costs are joint costs that could be allocated based on the relative sales values of Metal 1 produced through the concentration process and through the SX/EW process, Taxpayer does not allocate those costs based on relative sales values. We do not accept Taxpayer's assertion that ore transported to the leach piles has no value. As discussed above, Metal 1 produced through the SX/EW is not scrap or waste of producing Metal 1 through the concentration process. Metal 1 produced from the leach piles constitutes approximately 15% of Taxpayer's sales during the years at issue. Metal 1 produced from the leach piles has the same exact value as Metal 1 produced through the concentration process.

Third, Taxpayer's argument also incorrectly assumes that it produces two products, high-grade ore and low-grade ore. The regulation section provides that a taxpayer may use a recognized trade practice to allocate joint costs when a single process or uniform series of processes produce multiple products. As is discussed above, Taxpayer's argument that ore transported to the leach piles and ore transported to the concentrators are different products is incorrect and only views the production process at an intermediate stage of production. Taxpayer's SX/EW and concentration processes do not produce products of different kinds, sizes, or grade. Instead, Taxpayer is a producer of Metal 1 and the Metal 1 it produces is derived from two different grades of material using two separate production processes.

Lastly, Taxpayer's argument also ignores that § 1.471-7 does not impose a requirement, but only permits with the Commissioner's consent, the use a relative sales value method to allocate joint costs. Accordingly, contrary to Taxpayer's position, the regulations do not require the use of a market value method to allocate joint costs. Moreover, Taxpayer has failed to demonstrate that it received the Commissioner's consent to use such a method to allocate drilling, blasting, loading, and hauling costs.

### C. Generally Accepted Accounting Principles (GAAP)

Taxpayer has argued that its method of allocating drilling, blasting, loading, and hauling costs exclusively to Metal 1 produced using the concentration process conforms to GAAP and is therefore, allowable for federal income tax purposes. At first glance, this argument seems to find support in §§ 446 and 471. Section 446 provides that

taxable income shall be computed under the method of accounting regularly used by a taxpayer in computing his income and keeping his books. Section 471 provides that whenever in the opinion of the Secretary the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income. However, in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 540 (1979), the Supreme Court held that any presumption that a taxpayer's book method is permissible for tax purposes is overcome when a specific section of the Code or regulations provides otherwise. In so holding, the Supreme Court recognized the vastly different objectives of financial and tax accounting. Specifically, the Supreme Court noted that "generally accepted accounting principles ... tolerate a range of reasonable treatments leaving the choice among alternatives to management ... [and if management's choice] were dispositive for tax purposes, a firm could decide unilaterally – within limits dictated only by its accountants – the tax it wished to pay." See Thor Power Tool Co. v. Commissioner, supra at 544. Likewise, Taxpayer's decision to allocate no drilling, blasting, loading, and hauling costs to metal that will be produced from leach piles for financial accounting purposes is not dispositive for federal income tax purposes.<sup>2</sup> Instead, the allocation method used must be judged in light of the capitalization requirements provided by § 263A and the regulations thereunder.

#### D. Proper Allocation Method under § 263A

The results obtained by Taxpayer's allocation method are inconsistent with the § 263A regulations. The § 263A regulations permit taxpayers to allocate § 263A costs using either a specific identification method, a burden rate method, or a standard cost method (collectively, these methods are referred to as facts-and-circumstance methods). See § 1.263A-1(f). The § 263A regulations also permit taxpayers to allocate additional § 263A costs using certain simplified methods, the simplified production method and the simplified resale method. See §§ 1.263A-2(b) and 1.263A-3(d).<sup>3</sup>

Under a specific identification method costs are traced to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the cost and the cost objective. See § 1.263A-1(f)(2). Likewise, both the burden rate and standard cost methods require a causal relationship between the cost objective and the cost being allocated. In other words, the base chosen to allocate costs must have a causal relationship with the

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<sup>2</sup> Taxpayer has failed to establish that its method of accounting for drilling, blasting, loading, and hauling costs is the best accounting practice in its trade or business. Instead, an accounting guide directed at the mining industry indicates that capitalizing costs to leach piles is appropriate under GAAP. See PricewaterhouseCoopers, Financial Reporting in the Mining Industry for the 21st Century (1999).

<sup>3</sup> Generally, a taxpayer's § 471 costs are the costs, other than interest, capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A. See § 1.263A-1(d)(2). Whereas, a taxpayer's additional § 263A costs are generally defined as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A, but that are required to be capitalized under § 263A. See § 1.263A-1(d)(3).

cost being allocated. Moreover, § 1.263A-1(f)(4) requires a taxpayer's facts-and-circumstances method to be a reasonable allocation method within the meaning of the regulations. For this purpose, § 1.263A-1(f)(4) provides that an allocation method is reasonable if, with respect to a taxpayer's production or resale activities taken as a whole –

- (i) The total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in the regulations, with appropriate considerations given to the volume and value of a taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;
- (ii) The allocation method is applied consistently by a taxpayer; and
- (iii) The allocation method is not used to circumvent the requirements of the simplified production method contained in § 1.263A-2 or the simplified resale method contained in § 1.263A-3 or the principles of § 263A.

Taxpayer's method does not capitalize any drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from leach piles. Taxpayer incurs drilling, blasting, loading, and hauling costs with respect to Metal 1 bearing ore that is placed on leach piles as well as the ore transported to the concentration process. Taxpayer could allocate drilling, blasting, loading, and hauling costs using a burden rate method developed with an appropriate base. The use of a burden rate method developed with an appropriate base would have resulted in the allocation of a significant amount of drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from the leach piles.

The costs capitalized under Taxpayer's method differ significantly from the results of other allocation methods permitted under § 263A regulations. Taxpayer's SX/EW production represents 15% of the total Metal 1 sales by it and the costing information necessary to use a proper and accurate allocation method is readily available. Therefore, even after considering the factors in § 1.263A-1(f)(4)(i), Taxpayer's method is not a reasonable method for purposes of § 1.263A-1(f)(4).

Since Taxpayer's method for allocating drilling, blasting, loading, and hauling costs is not permissible under § 263A, the Commissioner may compute Taxpayer's taxable income using any method for allocating drilling, blasting, loading, and hauling costs that in his opinion clearly reflects income. Section 446(b) provides that if no method of accounting has been regularly used by a taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method, as in the opinion of the Secretary, does clearly reflects income. The

Commissioner's authority under § 446(b) permits him to select the method of accounting a taxpayer must use once he has determined that a taxpayer's method does not clearly reflect income. See Thor Power Tool Co. v. Commissioner, *supra* at 522. Accordingly, the Commissioner may change Taxpayer's method of allocating drilling, blasting, loading, and hauling costs so that drilling, blasting, loading, and hauling costs are not only allocated to ore transported to concentrators, but also Metal 1 that will be produced from leach piles.

The most appropriate method to allocate the drilling, blasting, loading, and hauling costs between the concentration and the leaching process would be to separately track the actual cost of each process. The cost per ton of drilling, blasting, loading, and hauling ore that is used in the leach process is approximately the same as the cost per ton of drilling, blasting, loading, and hauling ore that is used in the concentration process. Accordingly, absent separately tracking these costs, an allocation based on tonnage reasonably reflects the allocation a taxpayer would have made if the costs of each process were separately tracked. Therefore an allocation of costs based on tonnage is a reasonable method. The drilling, blasting, loading, and hauling costs allocated to Metal 1 that will be produced from leach piles is recovered through cost of goods sold as the related Metal 1 is sold.

Issue 3: Is a § 481(a) adjustment required if the examining agent changes Taxpayer's method of allocating drilling, blasting, loading, and hauling costs?

Taxpayer contends that a § 481(a) adjustment is not appropriate in this case because its requirement to capitalize drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from leach piles is not due to a change in accounting method, but instead is due to a change in facts and circumstances. A taxpayer that changes its method of accounting, either voluntarily or involuntarily, must take into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. See § 481(a). By its terms, § 481 applies only when there is a change in method of accounting. Section 1.446-1(e)(2)(ii)(a) describes a change in method of accounting as follows: "a change in the treatment of any material item. \* \* \* A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." In other words, a change in method of accounting does not involve *whether or not* an item of income is included, but *when*. See Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir.1984). The regulations also provide that a change in method of accounting does not include a change in treatment resulting from a change in underlying facts. See § 1.446-1(e)(2)(ii)(b).

Taxpayer's argument is not sustainable because the required change in method of allocating drilling, blasting, loading, and hauling costs is not due to a change in facts. In Year 3, Taxpayer conducted feasibility studies that concluded that SX/EW operations would be technically and economically viable. In Year 4, Taxpayer built a SX/EW plant. Accordingly, since at least Year 4 and perhaps as early as Year 3, Taxpayer should not

have been treating Metal 1 produced through the SX/EW process as waste of producing Metal 1 through the concentration process. Accordingly, Taxpayer has been using an impermissible method to allocate its drilling, blasting, loading, and hauling costs since at least Year 4. Requiring Taxpayer to now change its method of allocating drilling, blasting, loading, and hauling costs, so that drilling, blasting, loading, and hauling costs are not only allocated to Metal 1 that will be produced from concentrated ore, but also to Metal 1 that will be produced from leach piles, is a change in accounting method that requires a § 481(a) adjustment. See § 1.263A-7.

Issue 4: Is Taxpayer entitled to relief from a § 481(a) adjustment under § 7805(b)?

Taxpayer argues that it is entitled to relief under § 7805(b) from a retroactive application of this technical advice memorandum. Taxpayer argues that it should be afforded such relief under § 7805(b) because the Service has not published rules and regulations that specifically requires miners to capitalize drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from leach piles. With its Year 6 Form 1120, Taxpayer filed a Form 3115 to change its method of accounting for certain costs that were required to be capitalized pursuant to § 263A. Taxpayer contends that the Service implicitly accepted its present method of accounting for drilling, blasting, loading, and hauling costs when the Service accepted the form 3115.

A letter ruling granting consent to a change in accounting method is a letter ruling. A letter ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. See section 601.204(c) of the Procedural and Administrative Regulations; see also section 11.04 of Rev. Proc. 2004-1, 2004-1 I.R.B. 1, 46. When a letter ruling is revoked, the revocation applies to all years open under the statute of limitations unless the Service exercises its discretionary authority under § 7805(b) to limit the retroactive effect of the revocation. See id. However, section 601.201(l)(5) of the Procedural and Administrative Regulations provides, in part, that except in rare and unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to a taxpayer to whom the ruling originally was issued or to a taxpayer whose tax liability directly was involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling originally was issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment. See also section 11.05 of Rev. Proc. 2004-1, supra at 46. Failure to satisfy any one of the conditions contained in that section justifies the denial of relief.

Taxpayer is not entitled to relief under § 7805(b). Taxpayer's argument that the Service has not published guidance that requires the capitalization of drilling, blasting, loading, and hauling costs to Metal 1 that will be produced from leach piles is inaccurate. Taxpayer's argument ignores the existence of the regulations underlying

§ 263A. These regulations specifically provide that a taxpayer is required to capitalize the direct and indirect costs of producing property and those costs must be allocated to the items that gave rise to the costs. As is discussed above, the existing regulations require Taxpayer to not only allocate drilling, blasting, loading, and hauling costs to ore transported to its concentrators, but also to Metal 1 that will be produced from leach piles.

Taxpayer has not asserted that the Service is retroactively revoking a ruling letter. With its Year 2 Form 1120, Taxpayer filed a Form 3115 to change its method of accounting for certain costs that were required to be capitalized pursuant to § 263A. Taxpayer has not asserted that that Form 3115 addressed its method of allocating drilling, blasting, loading, and hauling costs. Accordingly, consent to the accounting method change requested in that Form 3115 can not serve as a basis for claiming relief under § 7805(b).

CAVEAT(S):

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