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REPORT
No. 1137

LIMITATION ON DEDUCTION OF EXPLORATION EXPENDITURES

FEBRUARY 24 (legislative day, FEBRUARY 15), 1960.—Ordered to be printed

Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 4251]

The Committee on Finance, to whom was referred the bill (H.R. 4251) to amend the Internal Revenue Code of 1954 with respect to the limitation on the deduction of exploration expenditures, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. SUMMARY OF BILL

Under present law an annual exploration expenditure deduction of up to $100,000 is allowed for no more than 4 years. This bill removes the 4-year limitation and substitutes an overall limitation of $400,000. However, the limitation of $100,000 per year remains.

Exploration expenditure deductions may be taken (currently or deferred and taken when the product is sold) for expenditures made in exploring for ore or mineral deposits (but not for oil or gas) prior to the development stage of the mineral deposit.

This change is to be effective for taxable years beginning after the date of enactment of this act.

II. GENERAL STATEMENT

Under present law a deduction may be taken for exploration expenditures made to determine the presence, location, quantity, or quality of any deposit of ore or other mineral. (This is not available in the case of oil and gas wells for which a separate expenditure deduction is allowed in the case of intangible drilling and development costs.) This deduction is only for those expenditures occurring before the development stage of the mine or the deposit and in any

case does not apply to expenditures for depreciable property. This exploration expenditure deduction is a substitute for adding these expenses to the basis of the mining property (if cost depletion is used, where these expenditures are capitalized this addition to basis is reflected in the depletion allowance).

Under present law the maximum exploration expenditure deduction which may be taken for any year is $100,000. This may be taken in the year the expenditures are paid or incurred, or, if the taxpayer so elects, may be deferred and deducted ratably as the units of ore or minerals are sold. This exploration expenditure deduction is available for 4 taxable years (whether or not consecutive) with respect to all property held by a taxpayer. In determining whether such expenditures have been made in prior years, deductions made by certain prior holders of mineral property are taken into account. The cases where a transfer is covered in general are cases either where substantially all of the property held by a transferee was transferred in a tax-free exchange or where the transferee has a substantial interest in the transferor.

This exploration expenditure deduction was added by the Revenue Act of 1951 during the consideration of that act by the Senate Finance Committee. The Finance Committee report indicates that the limitation (then $75,000 but subsequently raised to the present $100,000) was provided because of the desire to provide a "special incentive for increased exploration for mineral deposits * * *, especially in the case of taxpayers with limited financial resources."

In actual operation, however, this provision has tended to discriminate against the smallest producers. This results from the fact that although a taxpayer may claim deductions of up to $100,000 in any 1 year, he may not take such deductions for more than 4 years. Thus, a relatively large producer may obtain the full benefit of these deductions by claiming $100,000 in each of 4 years, namely, $400,000 in all. However, a smaller producer whose annual exploration expenditures do not amount to as much as $100,000, will have deductions available to him under this section reduced below the $400,000 ceiling applicable to his larger competitor.

In view of these considerations, your committee has agreed with the House Committee on Ways and Means in rewriting the limitation applicable in the case of exploration expenditures to provide that the ceiling is to be $400,000. A taxpayer still will not be able to claim exploration expenditure deductions with respect to any year in excess of $100,000, but if this exploration expenditures on a yearly basis are less than $100,000, he will be able to claim exploration expenditure deductions over more than a 4-year period so long as the total deductions claimed by him are not in excess of $400,000.

Under this bill since the 4-year limitation is removed it no longer matters whether exploration expenditures have already been deducted in 4 prior years. Under the bill, taxpayers will determine what excess amounts they may still deduct (or defer) by adding all amounts deducted or deferred in taxable years beginning after December 31, 1950, when this provision first became applicable. The $400,000, reduced by this amount, represents the remaining exploration expenditure deductions which may be taken. In determining expenditures which will be taken into account in arriving at the $400,000 ceiling, there is to be taken into account amounts which are deferred at the election

of the taxpayer under subsection (b) even though the property was sold before such deferred amount was actually deducted. In such a case, the deferred amount, although treated as a part of the basis of the property in determining gain from the sale, will reduce the exploration expenditure deductions which may subsequently be taken.

Other technical revisions have been made in the bill including the deletion of references to the partnership provisions. These in effect already were inapplicable since in the case of partnerships, exploration expenditure deductions are determined at the level of the partner rather than the partnership.

This bill is to apply to taxable years beginning after the date of enactment of the bill.

III. DEPARTMENTAL REPORT

OFFICE OF THE SECRETARY OF THE TREASURY,
Washington, January 12, 1960.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance, U.S. Senate,
New Senate Office Building, Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in response to a request for the views of this Department on H.R. 4251, introduced by Mr. Baker and passed by the House of Representatives September 9, 1959, to amend the Internal Revenue Code of 1954 with respect to the limitation on the deduction of exploration expenses.

1. SIMILAR BILLS

We know of no similar bills introduced in the 86th Congress.

2. POSITION OF THE TREASURY

The Treasury is opposed to H.R. 4251.

The Bureau of the Budget has advised the Treasury Department that there is no objection to the presentation of this report.

3. EXPLANATION OF THE BILL

Section 615 of the code permits a taxpayer to deduct in the current year expenditures for mine exploration not in excess of $100,000, or he may elect to defer any part of these expenditures and deduct them ratably as the ores or minerals are sold. The deduction or election is limited to any 4 years. H.R. 4251 would eliminate the 4-year limitation on the deduction of exploration expenditures in mining. The overall limitation of $400,000 with a $100,000 limit per year would remain. The proposed legislation would be effective for taxable years beginning after the date of its enactment.

4. LEGISLATIVE HISTORY

Prior to 1951, exploration and development expenditures were not treated separately, but both were considered to be costs of development. All expenditures on a mine in excess of net receipts while the mine was in the development stage were capitalized and were to be recoverable through depletion allowances.

The Revenue Act of 1951 distinguished between expenditures prior to the development stage of a mine and expenditures during the development stage. Exploration expenditures were defined as expenses "paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral prior to the beginning of the development stage." Under the 1951 act, taxpayers were permitted to elect to deduct exploration costs currently or to treat them as a deferred expense recoverable ratably over the period during which the resulting ores or minerals were sold. A deduction could be taken with respect to any portion of such costs and the balance treated as a deferral. However, the amount of exploration expenditures which the taxpayer could expense was limited to $75,000 in each of 4 taxable years. This permitted each taxpayer to expense a maximum of $300,000 of such costs. All outlays in excess of this amount were capitalized and recoverable through the depletion allowance.

The Internal Revenue Code of 1954 increased the annual limit on the amount of exploration expenditures which may be expensed from $75,000 to $100,000. Since the 4-year limitation remains, this permits the taxpayer to expense a maximum of $400,000 of exploration costs.

5. COMMENTS

At the time of the passage of the 1951 Revenue Act, the expensing of some mine exploration costs was urged in order to develop strategic mineral deposits for the Korean war effort. The report of the Committee on Finance explained that "It is generally recognized that the presently available mineral resources of this country are in many respects deficient in view of the ever-increasing demands of our economy, especially in an emergency period such as the present."

The provision which was enacted, however, was a limited measure which restricted the tax benefit to a specified number of years and a maximum amount. The provision was not intended as a means whereby each mine operator would be assured of the maximum deduction of $400,000 or of expensing exploration costs over an indefinite number of years. While the annual limit of the exploration deduction was liberalized in 1954 from $75,000 to $100,000, there was no suggestion for a change in the 4-year limitation.

It is notable that the Government has provided considerable assistance outside the tax laws for mineral exploration. For example, the Government provides procurement contracts for mining firms to encourage the mining of high-cost, strategic minerals. Amounts paid to mineral taxpayers by any Federal agency for the encouragement of exploration, development, or the mining of strategic minerals are exempt from income tax. The Office of Minerals Exploration provides direct financial aid to firms and individuals to facilitate the search for new ores. The Government's contribution and interest are repayable from royalties on production, but if no production results, there is no obligation to repay.

Under present tax law, mineral taxpayers may be entitled to expense all of their exploration costs for 4 years. In this sense, the miner who spends less than the $100,000 annual limit can expense proportionately more of his exploration costs than the large miner whose annual outlays exceed $100,000. The proposal, however, would provide further tax relief for those who have already enjoyed 4 years of expensing of exploration costs but who have not reached the maximum of $400,000. The revenue loss of this proposal would be substantial and the benefit would accrue largely to established miners who more or less routinely make outlays which may be classified as exploration expenditures. This would be contrary to the effect of Congress' original provision which chiefly confined relief to the new operator in the exploration stage and obtained the maximum benefits of new mine developments at minimum revenue costs.

The law continues to operate as Congress intended for new or prospective miners exploring for mineral deposits. Their exploration expenditures for any 4 years may be deferred until production is established. Any exploration costs which do not result in productive properties can be fully deducted as losses in the year in which the efforts are abandoned without regard to the 4-year limit. The operator who is successful in finding ore deposits which result in mining income is entitled to percentage depletion based on gross income from the property.

The deduction of exploration costs in addition to percentage depletion has frequently been criticized by some tax experts as commonly permitting a double deduction, once when the costs are incurred and again through percentage depletion. This point was made again before the House Ways and Means Committee in the recent tax hearings which included discussion of the tax treatment of the costs of exploration and development for mines, the intangible drilling costs for oil and gas wells, and the depletion allowances accorded the various mineral industries. The numerous issues raised indicate the desirability of a thorough and comprehensive review of the tax problems in these areas. A proposal for change calls for careful consideration of all its consequences. It should be appraised, not only in the context of our overall tax structure, but in the light of our national policies relating to the development of natural resources. The Treasury Department believes that special tax relief at this time for certain mining expenses would be inappropriate and inconsistent with the objective of a general review and integrated approach to any tax changes in this area.

For these reasons, the Department is opposed to the type of tax relief proposed by the bill.

Sincerely yours,

JAY W. GLASMANN,
Assistant to the Secretary.

CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italic; existing law in which no change is proposed is shown in roman):

SECTION 615 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 615. EXPLORATION EXPENDITURES.

(a) IN GENERAL.—In the case of expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine or deposit, there shall be allowed as a deduction in computing taxable income so much of such expenditures as does not exceed $100,000. This section shall apply only with respect to the amount of such expenditures which, but for this section, would not be allowable as a deduction for the taxable year. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures paid or incurred. In no case shall this section apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas.

(b) ELECTION OF TAXPAYER.—If the taxpayer elects, in accordance with regulations prescribed by the Secretary of his delegate, to treat as deferred expenses any portion of the amount deductible for the taxable year under subsection (a), such portion shall not be deductible in the manner provided in subsection (a) but shall be deductible on a ratable basis as the units of produced ores of minerals discovered or explored by reason of such expenditures are sold. An election made under this subsection for any taxable year shall be binding for such year.

[(c) LIMITATION.—This section shall not apply to any amount paid or incurred in any taxable year if in any 4 preceding years a deduction or election under this section, or the corresponding provision of prior laws, has been allowed to, or exercised by—

[(1) the taxpayer, or

[(2) the individual or corporation who has transferred to the taxpayer any mineral property.

Paragraph (2) shall apply only if (A) the taxpayer was required to take into account under section 23(ff)(3) of the Internal Revenue Code of 1939 the deduction allowed to or election exercised by such individual or corporation; (B) the taxpayer would be entitled under section 381(c)(10) to deduct expenses deferred under this section had the distributor or transferor corporation elected to defer such expenses; or (C) the taxpayer acquired any mineral property under circumstances which make section 334(b), 362 (a) and (b), 372(a), 373(b)(1), 723, 732, 1051, or 1082 apply to such transfer.]

(c) LIMITATION.—

(1) In general.—This section shall not apply to any amount paid or incurred to the extent that it would, when added to the amounts which have been deducted under subsection (a) and the amounts which have been treated as deferred expenses under subsection (b), or the corresponding provisions of prior law, exceed $400,000.

(2) Amounts taken into account.—For purposes of paragraph (1), there shall be taken into account amounts deducted and amounts treated as deferred expenses by—

(A) the taxpayer, and

(B) any individual or corporation who has transferred to the taxpayer any mineral property.

(3) Application of paragraph (2)(B).—Paragraph (2)(B) shall apply with respect to all amounts deducted and all amounts treated as deferred expenses which were paid or incurred before the latest such transfer from the individual or corporation to the taxpayer. Paragraph (2)(B) shall apply only if—

(A) the taxpayer acquired any mineral property from the individual or corporation under circumstances which make paragraph (7), (8), (11), (15), (17), (20), or (22) of section 113(a) of the Internal Revenue Code of 1939 apply to such transfer;

(B) the taxpayer would be entitled under section 381(c)(10) to deduct expenses deferred under this section had the distributor or transferor corporation elected to defer such expenses; or

(C) the taxpayer acquired any mineral property from the individual or corporation under circumstances which make section 334(b), 362 (a) and (b), 372(a), 373(b)(1), 1051, or 1082 apply to such transfer.