INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-109394-13

CC:LB&I:CTM:PNX

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Company A =
Date 1 =
a =
Mine A =
b =
Audit Period =
Date 2 =
Company B =
Site A =
Mine B =
Mine C =
Mine D =
Mine E =

Mine F =
Mine G =
Year 1 =
Year 2 =
Years =
$c =
$d =
Year 3 =
$e =
$f =
$g =
Year 5 =

ISSUES:

(1) Is Taxpayer required to recapture mining exploration expenditures that Taxpayer failed to recapture in years that are closed by the statute of limitations?

(2) Is the recapture of mining exploration expenses a method of accounting, and if so, does Taxpayer's practice of deducting exploration costs as incurred without recapture provide a clear reflection of income?

CONCLUSIONS:

(1) Taxpayer is required to recapture mining exploration expenditures that Taxpayer failed to recapture in years that are closed by the statute of limitations.

(2) The recapture of mining exploration expenditures is a method of accounting. Taxpayer's practice of deducting exploration costs as incurred without recapture fails to provide a clear reflection of income. Therefore, Exam is authorized by § 446(b) to place Taxpayer on a method of accounting that clearly reflects income. The alternative methods of recapture described in §§ 617(b)(1)(A) and 617(b)(1)(B) both are authorized by statute, and thus both should be considered to provide a clear reflection of income. It lies within Exam's broad discretion to place Taxpayer on either the § 617(b)(1)(A) or § 617(b)(1)(B) method of recapture. The new method generally should be imposed in the earliest taxable year under examination. Once the accounting method change is imposed by Exam, the computation and recognition of an appropriate adjustment under § 481(a) becomes mandatory to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change. The taxable income for the year of change and the following taxable years is determined under the new method of accounting as if the new method had always been used.

FACTS:

Taxpayer, an international mining company, acquired Company A as part of a stock acquisition on Date 1. Prior to its acquisition by Taxpayer, Company A purchased an a% interest in Mine A. Company A subsequently, purchased additional interests in Mine A, and owned a b% interest during the Audit Period. The owners of Mine A treated this as a joint venture and elected out of being treated as a partnership under Subchapter K. Therefore, each owner includes on its own return the operating income and expenses with respect to its ownership interest. On Date 2, Company A transferred its b% interest in Mine A to Company B and retained two royalty interests, a production royalty and a bonus royalty.

There are several mines for which exploration costs were incurred at Site A: Mine B, Mine C, Mine D, Mine E, Mine F, Mine G, and Mine H. On its Year 1 corporate tax return, Taxpayer elected under § 614(c)(1) and § 1.614-3(a) of the Income Tax Regulations to aggregate all operating interests in Mine D as it reached the development phase in Year 1. In Year 2, Taxpayer elected to include Mine B and Mine E in the Mine D aggregation. Taxpayer represents that it aggregated Mines B, C, D, and E as one mine.

During Years, Taxpayer deducted under § 617(a) $c of mining exploration expenditures for all its operating interests. Taxpayer's adjusted exploration expenditures (AEE) were $h. Taxpayer elected to recapture its AEE by foregoing depletion deductions pursuant to § 617(b)(1)(B). Mine C was in production when Taxpayer purchased Mine B. In Year 3, Taxpayer commenced production on Mine B. Taxpayer had deducted $e of exploration costs for Mine B. Taxpayer recaptured $f of those costs. For years prior to Year 5, Taxpayer failed to recapture $g of its $h of AEE. Those years are closed by the statute of limitations.

LAW AND ANALYSIS:

Section 611(a) provides in part that in the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary.

Section 1.611-0 of the Income Tax Regulations provides that §§ 1.611–1 through 1.614–8, inclusive, are prescribed under the authority granted the Secretary or his delegate by § 611(a) to prescribe regulations under which a reasonable allowance for depletion and depreciation of improvements shall be allowed, according to the peculiar conditions in each case, in the case of mines, oil and gas wells, other natural deposits and timber.

Section 1.611-1 provides in part that in the case of exhaustible natural resources other than standing timber, the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see § 612, relating to cost depletion) or upon a percentage of gross income from the property (see § 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year.

Section 1.611-2 provides that after the amount of basis applicable to the mineral property under § 612 has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year.

Section 612 provides that except as otherwise provided in Subchapter I, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in § 1011 for the purpose of determining the gain upon the sale or other disposition of such property.

Section 1.612-1(a) provides that the basis upon which the deduction for cost depletion under § 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in § 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in § 1.612-1(b). The adjusted basis of such property is the cost or other basis determined under § 1012, relating to the basis of property, adjusted as provided in § 1016, relating to adjustments to basis, and the regulations under such sections.

Section 1.611-2(b) provides that every taxpayer claiming and making a deduction for depletion of mineral property shall keep a separate account in which shall be accurately recorded the cost or other basis provided by § 1012, of such property together with subsequent allowable capital additions to each account and all the other adjustments required by § 1016. Mineral property accounts shall thereafter be credited annually with the amounts of the depletion so computed in accordance with § 611 or § 613 and the regulations thereunder; or the amounts of the depletion computed in shall be credited to depletion reserve accounts. No further deductions for cost depletion shall be allowed when the sum of the credits for depletion equals the cost or other basis of the property, plus allowable capital additions. However, depletion deductions may be allowable thereafter computed upon a percentage of gross income from the property.

Section 1.613-1(a) provides that in the case of a taxpayer computing the deduction for depletion under § 611 with respect to minerals on the basis of a percentage of gross income from the property, as defined in § 613(c) and §§ 1.613–3 and 1.613–4, the deduction shall generally be the percentage of the gross income as specified in § 613(b) and § 1.613–2.

Section 617(a)(1) provides that at the election of the taxpayer, otherwise deductible 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, shall be allowed as a deduction in computing taxable income. For provisions relating to elections under § 617(a), see § 617-1(c). For provisions relating to expenditures to which section 617 applies ("exploration expenditures"), see § 1.617(a) and (b).

Section 617(b)(1)(A) provides that if, in any taxable year, any mine with respect to which expenditures were deducted pursuant to § 617(a) reaches the producing stage, then, if the taxpayer so elects with respect to all such mines reaching the producing stage during the taxable year, he shall include in gross income for the taxable year an amount equal to the adjusted exploration expenditures with respect to such mines, and the amount so included in income shall be treated for purposes of this subtitle as expenditures which (i) are paid or incurred on the respective dates on which the mines reach the producing stage, and (ii) are properly chargeable to capital account. For provisions relating to elections under § 617(a), see § 1.617-3(b).

Section 617(b)(1)(B) provides that if, in any taxable year, any mine with respect to which expenditures were deducted pursuant to § 617(a) reaches the producing stage, then, if § 617(b)(1)(A) does not apply with respect to any such mine, the deduction for depletion under § 611 with respect to the property shall be disallowed until the amount of depletion which would be allowable but for this subparagraph equals the amount of the adjusted exploration expenditures with respect to such mine.

Section 617(e) provides that the basis of any property shall not be reduced by the amount of any depletion which would be allowable but for the application of this section.

Section 617(f)(1) provides that adjusted exploration expenditures means, with respect to any property or mine, (A) the amount of the expenditures allowed for the taxable year and all preceding taxable years as deductions under subsection (a) to the taxpayer or any other person which are properly chargeable to such property or mine and which (but for the election under subsection (a)) would be reflected in the adjusted basis of such property or mine, reduced by (B) for the taxable year and for each preceding taxable year, the amount (if any) by which (i) the amount which would have been allowable for percentage depletion under § 613 but for the deduction of such expenditures, exceeds (ii) the amount allowable for depletion under § 611, properly adjusted for any amounts included in gross income under subsection (b) or (c) and for any amounts of gain to which subsection (d) applied.

ISSUE (1): Is Taxpayer required to recapture mining exploration expenditures that Taxpayer failed to recapture in years that are closed by the statute of limitations?

Taxpayer deducted mining exploration expenditures under § 617(a), which it elected to recapture by foregoing depletion deductions pursuant to § 617(b)(1)(B). Taxpayer recaptured a portion of its exploration expenditures, but failed to recapture the full amount of those expenses. Some of the years in which Taxpayer was required to recapture by foregoing depletion deductions are now closed by the statute of limitations.

Taxpayer takes the position that because § 1.617-3(a)(1)(i) provides that depletion is to be disallowed for the taxable year in which the mine reaches the producing stage and each subsequent year, recapture must occur in the earliest year to which it can apply, and then must be applied to the next earliest year and years until the full amount of the AEE has been recaptured. A portion of the AEE equal to the amount of the depletion deduction that otherwise would have been allowable for each year is attributable to that year, and cannot be recaptured in another year. Thus, if Taxpayer fails to recapture exploration expenses in a year in which recapture is required, and that year is closed by the statute of limitations, then those expenses are not subject to recapture.

We agree that under § 1.617-3(a)(1)(i), recapture should occur in the earliest year to which it can apply, and then be applied to the next earliest year and years until the full amount of the AEE has been recaptured. However, Taxpayer's position that exploration expenses that were not recaptured in a year that is closed by the statute of limitations are not subject to recapture is inconsistent with § 617, § 1.617-3(a)(1)(i), and the legislative history underlying § 617.

Section 617(b)(1)(B) provides that if § 617(b)(1)(A) does not apply to a mine, no depletion deduction is allowed with respect to the property until the amount of depletion deductions otherwise allowable equals the amount of the AEE with respect to that mine. Similarly, § 1.617-3(a)(1)(i) disallows depletion deductions until the aggregate amount of depletion that would be allowable but for § 617(b)(1)(B) equals the amount of the AEE. The Senate Finance Committee Report underlying § 617 states that:

> "Under the election to forego depletion deductions from a property until this equals the exploration expenditures, the amount of the depletion allowance disallowed is limited to the amount of the "adjusted exploration expenditures" with respect to a mine. "

S. Report No. 1377, 89th Cong., 2nd Sess.(1966), 1966-2 C.B. 778,

Thus, the statute, the regulations, and the legislative history make clear that a taxpayer that recaptures exploration expenses under § 617(b)(1)(B) must forgo depletion deductions that in the aggregate equal the amount of the AEE with respect to the mine. Nothing in the statute, the regulations, or the legislative history indicates that a portion of the AEE equal to the amount of the depletion deduction that otherwise would have been allowable for a given year is attributable to that year and is not subject to recapture if the year is closed. Under Taxpayer's position, the amount of depletion deductions Taxpayer's foregoes would not equal the AEE. Thus, Taxpayer's position is inconsistent with § 617, § 1.617-3(a)(1)(i), and the legislative history underlying § 617.

ISSUE (2): Is the recapture of mining exploration expenses a method of accounting, and if so, does Taxpayer's practice of deducting exploration costs as incurred without recapture provide a clear reflection of income?

Involuntary accounting method changes

Section 446(b) provides that if no method of accounting has been regularly used by the 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 reflect income. See also § 1.446-1(b)(1).

Section 1.446-1(c)(1)(ii)(C) provides in part that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer determining when income is to be accounted for generally will be acceptable if it accords with generally accepted accounting principles, is used consistently by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-3 (1979); RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981), cert. denied 457 U.S. 1133 (1982).

Once the Commissioner has determined that the taxpayer's method of accounting does not clearly reflect income, the Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer. The Commissioner's selection may be challenged only upon showing an abuse of discretion by the Commissioner. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970); Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970); Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (10th Cir.), cert. denied, 342 U.S. 860 (1951).

An examining agent who determines that a taxpayer's method of accounting is impermissible may propose an adjustment with respect to that method only by changing the taxpayer's method of accounting. Except as provided in section 2.06 of Rev. Proc. 2002-18, 2002-1 C.B. 678 (relating to previous accounting method changes made by a taxpayer without obtaining the requisite consent under § 446(e)), an examining agent changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts determined by the agent. The method selected must be a proper method of accounting and will not be a method contrived to reflect the hazards of litigation. See Rev. Proc. 2002-18, sections 3.01, 5.01 to 5.03.

An examining agent changing a taxpayer's method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible, although an examining agent may defer the year of change to a later taxable year in appropriate circumstances. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change. See Rev. Proc. 2002-18, section 5.04(1).

An examining agent changing a taxpayer's method of accounting ordinarily will impose a § 481(a) adjustment, subject to a computation of tax under § 481(b) (if applicable). The § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change. See § 1.448-1(c)(3); Rev. Proc. 2002-18, section 5.04(2), (3).

What constitutes a change in method of accounting?

Section 1.446-1(e)(2)(ii)(*a*) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. See Rev. Proc. 97-27, 1997-1 C.B. 680, section 2.01(1); Rev. Proc. 2002-9, 2002-1 C.B. 327, section 2.01(1); Rev. Proc. 91-31, 1991-1 C.B. 566; Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11^{th} Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered a method of accounting. General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts, Inc. v. Commissioner, T.C.Memo. 2003-95.

Although a method of accounting may exist under the definition in § 1.446-1(e)(2)(ii)(*a*) without the necessity of a pattern of consistent treatment, in most instances a method of accounting is not established for an item without such consistent treatment. See § 1.446-1(e)(2)(ii)(*a*). The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(*a*). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57.

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, a change from treating an item as a personal expense to treating it as a business expense is not a change in method of accounting because it does not involve the proper timing of an item of income or deduction. See § 1.446-1(e)(2)(ii)(*b*).

Where the correction of an error results in a change in accounting method, the requirements of § 446(e) are applicable. Huffman v. Commissioner, 126 T.C. 322, 354 (2006); First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987); Diebold, Inc. v. United States, 16 Cl. Ct. 193, 203-205 (1989), 891 F.2d 1579 (Fed. Cir. 1989), cert. denied 498 U.S. 823 (1990).

Under the foregoing principles, a consistent practice for determining when a taxpayer recognizes deductions for a type of expense generally constitutes a method of accounting, and a change from one such practice to another generally constitutes a change in method of accounting. Thus, a change from deducting officers' bonuses in the year they are declared to deducting the bonuses in the year following the declaration year constitutes a change in method of accounting [Summit Sheet Metal Co. v, Commissioner, T.C.Memo 1996-563], and a change from deducting real estate taxes when paid to deducting these taxes when incurred is also a change in method of accounting [§ 1.446-1(e)(2)(iii), Example (2)]. Courts have found accounting method changes in similar circumstances involving a variety of different types of expenses, including vacation pay [American Can Co. v. Commissioner, 317 F.2d 604 (2nd Cir. 1963)], interest [Peoples Bank and Trust Co. v. Commissioner, 50 T.C. 750 (1968), aff'd 415 F.2d 1341 (7th Cir. 1969); Mulholland v. U.S., 28 Fed.Cl. 320 (1993); Prabel v. Commissioner, 882 F.2d 820 (3rd Cir. 1989)], customer rebates [Knight-Ridder Newspapers, Inc. v. U.S., 743 F.2d 781 (11th Cir. 1984)], and related party payables [Bosamia v. Commissioner, 661 F.2d 250 (5th Cir. 2011)].

Similarly, a change from deducting an expense when paid or incurred to capitalizing such expense, or vice versa, generally constitutes a change in method of accounting. Expensing and capitalization generally result in the same cumulative taxable income over the lifetime of the taxpayer. For example, an expenditure of $1,000 that is deducted in full when it is paid or incurred reduces a taxpayer's lifetime taxable income by $1,000. If the same expenditure is capitalized, taxpayer's lifetime taxable income will also be reduced by $1,000 through deductions for depreciation or amortization, recognition of basis resulting in a reduction of gain (or an increase of loss) on sale or disposition of the asset, or a combination of the foregoing.

Treating changes between expensing and capitalization as changes in method of accounting is supported by § 1.446-1(e)(2)(ii)(d)(2), which provides that "a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting." See also Exxon Mobil v. Commissioner, 114 T.C. 293, 321-323 (2000) (change in treatment of 'dismantlement, removal and restoration costs' from deduction when work is performed to capitalization constituted accounting method change); Pelaez and Sons, Inc. v. Commissioner, 114 T.C. 473, 487-489 (2000), aff'd 253 F.3d 711 (11th Cir. 2001) (change in treatment of preproductive citrus growing costs from deduction to capitalization); FPL Group, Inc. v. Commissioner, 115 T.C. 554 (2000) (change in treatment of asset costs from capitalizing and depreciating to deducting when incurred constituted accounting method change); Sunoco, Inc. v. Commissioner, T.C.Memo. 2004-29 (change in treatment of miner's 'overburden removal costs' from developmental costs (spread as deductions) to production costs (included in cost of goods sold) constituted a change in method of accounting); and Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 680-687 (1980), supplemented by 82 T.C. 122 (1984) (change in treatment of certain railway maintenance expenses from capitalization into embankments to deduction as work is performed constitutes a change in method of accounting).

Section 481(a) adjustments

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year (year of change), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken 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, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. See also § 1.448-1(a).

A change in method of accounting to which § 481(a) applies includes a change in treatment of a single material item. See § 1.481-1(a)(1); Graf Chevrolet v. Campbell, 343 F.2d 568, 570-571 (5th Cir. 1965); Knight-Ridder v. United States, 743 F.2d at 798; Peoples Bank & Trust v. Commissioner, 415 F.2d at 1344; Ryan v. Commissioner, 42 T.C. 386, 392 (1964).

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used. Rev. Proc. 97-27, section 2.05(1).

Once the Commissioner has imposed a change in method of accounting, the application of § 481(a) to such change is patent and mandatory. Primo Pants Co. v. Commissioner, 78 T.C. 705, 720 (1982); Emert v. Commissioner, T.C.Memo. 1999-175; Hitachi Sales Corp. of America v. Commissioner, T.C.Memo. 1994-159, supp. T.C.Memo. 1995-84.

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the statute of limitations. Suzy's Zoo v. Commissioner, 114 T.C. 1, 12-13 (2000), aff'd 273 F.3d 875, 884 (9th Cir. 2001); Huffman v. Commissioner, 126 T.C. 322, 341-2 (2006), aff'd 518 F.2d 357, 363-4 (6th Cir. 2008); Graff Chevrolet Co. v. Campbell, 343 F.2d at 571-572; Rankin v. Commissioner, 138 F.3d 1286, 1288 (9th Cir. 1998); Superior Coach of Florida v. Commissioner, 80 T.C. 895, 912 (1983); Weiss v. Commissioner, 395 F.2d 500 (10th Cir. 1968); Spang Industries, Inc. v. United States, 6 Cl. Ct. 38, 46 (1984), rev'd on other grounds 791 F.2d 906 (Fed. Cir. 1986).

Exploration cost recapture

Although mining exploration expenditures are capital by nature, § 617(a) allows a taxpayer to elect to deduct these expenditures in the year paid or incurred. If a taxpayer deducts its mining exploration expenditures as paid or incurred, the taxpayer must "recapture" these expenses under § 617(b) when the mine reaches the producing stage. Speaking in broad terms, this recapture is accomplished in either of two ways. Under the first alternative in § 617(b)(1)(A), the taxpayer must include the already deducted mining expenditures in gross income, while increasing the recoverable cost basis (non-exploration cost of the mine) of the mine by the amount recognized as income. Under the second alternative in § 617(b)(1)(B), the taxpayer does not include the already deducted mining expenditures in the basis of the recoverable cost of the mine. Rather, the taxpayer refrains from taking depletion deductions until the amount of foregone deductions equals the amount of exploration expenses previously deducted. However, the denied depletion deductions do not reduce the amounts of non-exploration cost basis of the mine; it merely defers the onset of recovering such basis.

The function of recapture under § 617(b) is to limit the time value of money benefit that taxpayer acquired by deducting exploration expenditures when paid or incurred instead of treating them as capital expenditures not eligible for cost recovery until the mine begins production or thereafter. Under § 617(b)(1)(A), the limitation is accomplished by requiring taxpayer to recognize as gross income the exploration expenditures previously deducted once the mine reaches production; this effectively limits the time value benefit of the early deduction of exploration costs to the period before production is achieved. Under § 617(b)(1)(B), the limitation is accomplished by denying taxpayer depletion deductions until the denied deductions equal the amount of exploration expenditures;

the time value benefit from early deduction is effectively reduced by the delay in recovering the non-exploration cost basis of the mine.

Recapture under § 617(b) has no permanent impact on the amount of exploration costs recovered against taxable income over the lifetime of the taxpayer. Thus, under § 617(b)(1)(A), a taxpayer incurring $1,000 of exploration costs would deduct $1,000 as paid or incurred during the pre-production phase, recognize $1,000 of gross income when production begins, and recognize $1,000 thereafter in depletion deductions or adjusted basis. Under § 617(b)(1)(B), a taxpayer would recognize $1,000 as paid or incurred during the pre-production phase, with no further consequences related to the exploration expenditures. Under either alternative, taxpayer would ultimately reduce its taxable income by $1,000 of exploration costs, albeit in different amounts and different taxable years. Similarly, the amount of non-exploration cost basis recovered against taxable income is the same for both forms of recapture; only the amounts and taxable years differ.

The choice of recapture provision can affect the cumulative lifetime amount of depletion deductions in excess of cost basis. The amount of percentage depletion, and whether it exceeds cost depletion, depends upon numerous factors that differ among taxable years. Thus, the difference between § 617(b)(1)(A) and § 617(b)(1)(B) recapture with respect to the taxable years in which a depletion deduction may be taken can produce different amounts of depletion deduction (if any) claimed in excess of cost basis. For purposes of analysis under § 446, however, it is appropriate to disaggregate the depletion deduction into cost depletion (and the recovery of actual or out-of-pocket costs) and percentage depletion (a deduction not reflecting cost recovery). As discussed above, the purpose of recapture is to impact the timing of cost recovery, and thus any collateral consequence that different cost recovery timing methods would have upon the cumulative amount of depletion deductions not reflecting cost recovery is irrelevant to the determination of whether recapture constitutes a method of accounting for purposes of §§ 446 and 481.

Taxpayer's practice (deducting exploration costs as incurred without recapture) and the statutorily prescribed practice of deducting exploration costs with recapture under § 617(b) result in the same amount of exploration costs being recognized over the lifetime of Taxpayer; only the timing (taxable years and amounts) are different. Accordingly, Exam's adjustments constitute a change in method of accounting under §§ 446 and 481.

In the present case, Taxpayer deducted exploration costs as paid or incurred, but failed to recapture these exploration costs as required by § 617(b). Accordingly, Taxpayer’s method of accounting for exploration costs failed to provide a clear reflection of income, and Exam is authorized by § 446(b) to place Taxpayer on a method of accounting that clearly reflects income. The alternative methods of recapture described in §§ 617(b)(1)(A) and 617(b)(1)(B) are both authorized by statute, and thus should both be considered to provide a clear reflection of income. Thus, it lies within Exam's broad discretion to place Taxpayer on either the § 617(b)(1)(A) or § 617(b)(1)(B) method of recapture.

Should § 481(a) adjustments be recognized for the accounting method changes imposed by Exam? May such adjustments reflect amounts attributable to closed taxable years?

As concluded above, the Exam adjustments requiring Taxpayer to recapture its exploration expenditures constitute a change in method of accounting. The new method should generally be imposed in the earliest taxable year under examination, and be made with an adjustment under § 481(a). Rev. Proc. 2002-18, section 5. The taxable income for the year of change and the following taxable years is determined under the new method of accounting as if the new method had always been used.

Once the accounting method change is imposed by Exam, the computation and recognition of an appropriate adjustment under § 481(a) becomes mandatory to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change. The § 481(a) adjustment reflects relevant amounts from any taxable years preceding the year of change, even if such years are closed by the statute of limitations. Compare Earthquake Sound Corp. v. Commissioner, T.C.Memo. 2000-112 (§ 481(a) adjustment to eliminate duplicated deductions resulting from accounting method change could be imposed even though related years in which duplicate deductions were taken have been closed by the statute of limitations).

CAVEAT(S):

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