§ 1.631–3 Gain or loss upon the disposal of coal or domestic iron ore with a retained economic interest.

(a) In general. (1) The provisions of section 631(c) apply to an owner who disposes of coal (including lignite), or iron ore mined in the United States, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal under any form or type of contract whereby he retains an economic interest in such coal or iron ore. The difference between the amount realized from disposal of the coal or iron ore in any taxable year, and the adjusted depletion basis therefor plus the deductions disallowed for the taxable year under section 272, shall be gain or loss upon the sale of the coal or iron ore. See paragraph (b)(4) of this section for the definition of owner. See paragraph (e) of this section for special rules relating to iron ore.

(2) In the case of such a disposal, the provisions of section 1231 apply, and the coal or iron ore shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether the coal or iron ore is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the coal or iron ore which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend on the application of section 1231 to the taxpayer for the taxable year; i.e., if the gains do not exceed the losses, they shall not be considered as gains and losses from sales or exchanges of capital assets but shall be treated as ordinary gains and losses.

(b) Rules for application of section. (1) For purposes of section 631(c) and this section, the date of disposal of the coal or iron ore shall be deemed to be the date the coal or iron ore is mined. If the coal or iron ore has been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date it is mined, it is immaterial that it had not been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date of the contract. There shall be no allowance for percentage depletion provided in section 613 with respect to amounts which are considered to be realized from the sale of coal or iron ore under section 631(c).

(2) The term adjusted depletion basis as used in section 631(c) and this section means the basis for allowance of cost depletion provided in section 612 and the regulations thereunder. Such adjusted depletion basis shall include exploration or development expenditures treated as deferred expenses under section 615(b) or 616(b), or corresponding provisions of prior income tax laws, and be reduced by adjustments under section 1016(a) (9) and (10), or corresponding provisions of prior income tax laws, relating to deductions of deferred expenses for exploration or development expenditures in the taxable year or any prior taxable years. The depletion unit of the coal or iron ore disposed of shall be determined under the rules provided in the regulations under section 611, relating to cost depletion.
Example. A owns a tract of coal land in fee. A leases to B the right to mine all the coal in this tract in return for a royalty of 30 cents per ton. B subleases his right to mine coal in this tract to C, who agrees to pay A 30 cents per ton and to pay to B an additional royalty of 10 cents per ton. Section 631(c) applies to the royalties of both A and B, if the other requisites of the section have been met.

Example 2. Assume the same facts as in example 1, except that A dies leaving his royalty interest to D. D has an economic interest in the coal in place and qualifies for section 631(c) treatment with respect to his share of the royalties since he is a successor in title to A.

Assume the same facts as in example 1, except that E agrees to pay a sum of money to C in return for 10 cents per ton on the coal mined by C. E has an economic interest, since he must look solely to the extraction of the coal for the return of his investment. However, E has not made a disposal of coal under a contract wherein he retains an economic interest, and, therefore does not qualify under section 631(c). E is entitled to depletion on his royalties.

(c) Payments received in advance of mining. (1)(i) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to mining shall be treated under section 631(c) as received from the sale of coal or iron ore if the contract of disposal provides that such amounts are to be applied as payment for coal or iron ore subsequently mined. For example, advance royalty payments or minimum royalty payments received by an owner of coal or iron ore qualify under section 631(c) where the contract of disposal grants the lessee the right to apply such royalties in payment of coal or iron ore mined at a later time.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. A acquires coal rights on January 1. On January 30, A enters into a contract of disposal providing that mining shall begin...
July 2, and mining actually begins no ear-
lier. Any advance payments which A receives
qualify under section 631(c).

(2) However, if the right to mine coal
or iron ore under the contract expires,
terminates, or is abandoned before the
coa or iron ore which had been paid for
is mined, the taxpayer shall treat pay-
ments attributable to the unmined coal
or iron ore as ordinary income and not
as received from the sale of coal or iron
ore under section 631(c). Accordingly,
the taxpayer shall recompute his tax
liability for the taxable year in which
such payments were received. The re-
computation shall be made in the form
of an amended return where necessary.

(3) Bonuses received or accrued by an
owner in connection with the grant of
a contract of disposal shall be treated
under section 631(c) as received from
the sale of coal or iron ore to the ex-
tent attributable to coal or iron ore
held for more than 1 year (6 months for
taxable years beginning before 1977; 9
months for taxable years beginning in
1977). The rules contained in paragraph
(d) of §1.631–2 relating to bonuses in the
case of contracts for the disposal of
timber shall be equally applicable in
the case of bonuses received for the
grant of a contract of disposal of coal
or iron ore under this section.

(d) Nonapplication of section. Section
631(c) shall not affect the application of
the provisions of subchapter G, chapter
1 of the Code, relating to corporations
used to avoid income tax on share-
holders. For example, for the purposes
of applying section 543 (relating to per-
sonal holding companies), the amounts
received from a disposal of coal or iron
ore subject to section 631(c) shall be
considered as mineral royalties. The
determination of whether an amount
received under a contract to which sec-
tion 631(c) applies is personal holding
company income shall be made in ac-
cordance with section 543 and the regu-
lations thereunder, without regard to
section 631(c) of this section. See also
paragraph (e) of §1.272–1.

(e) Special rules with regard to iron ore.
(1) With regard to iron ore, section
631(c) and this section apply only to
amounts received or accrued in taxable
years beginning after December 31,
1963, attributable to iron ore mined in
such taxable years.

(2) Section 631(c) and this section
apply only to disposals of iron ore
mined in the United States.

(3) For the purpose of section 631(c)
and this section, iron ore is any ore
which is used as a source of iron, in-
cluding but not limited to taconite and
jaspilite.

(4) Section 631(c) shall not apply to
any disposal of iron ore to a person
whose relationship to the person dis-
posing of such iron ore would result in
the disallowance of losses under sec-
section 267 or 707(b).

(5) Section 631(c)(2) results in the de-
nial of section 631(c) treatment in the
case of a contract for disposal of iron
ore entered into with a person owned
or controlled, directly or indirectly, by
the same interests which own or con-
trol the person disposing of the iron
ore, even though section 631(c) treat-
ment would not be denied under the
provisions of section 631(c)(1). For ex-
ample, section 631(c) treatment is de-
nied in the case of a contract for dis-
posal of iron ore entered into between
two brother and sister corporations, or a
parent corporation and its subsidiary.
The presence or absence of control
shall be determined by applying the
same standards as are applied under
section 482 (relating to the allocation
of income and deductions between tax-
PAYERS).

[T.D. 6841, 30 FR 9307, July 27, 1965, as amend-
ed by T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§ 1.632–1 — Tax on sale of oil or gas prop-
properties.

(a) If the taxpayer, by prospecting
and locating claims or by exploring or
discovering undeveloped claims, has
demonstrated the principal value of oil
or gas property, which prior to his ef-
forts had a relatively minor value, the
portion of the tax (or, in the case of
taxable years beginning before Jan. 1,
1971, the surtax) imposed by section 1
attributable to a sale of such property,
or of any interest of the taxpayer
therein, shall not exceed 33 percent (or,
in the case of taxable years beginning
before Jan. 1, 1971, 30 percent) of the
selling price of such property or such
interest. Shares of stock in a corpora-
tion owning oil or gas property do not
constitute an interest in such property.
To determine the application of section