84-SBE-129

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HUNTINGTON ALLOYS, INC.)

Appearances:

For Appellant: Dean M. Weiner
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Huntington Alloys, Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Appeal of Huntington Alloys, Inc.

Income Years	Amount
1963	$ 25,970.44
1964	34,896.52
1965	41,486.59
1966	31,232.75
1967	37,613.45
1968	35,083.90
1969	31,506.43
1970	63,074.55
1971	18,877.19
1972	37,133.53
1973	108,681.97

The issues presented for decision are: (1) whether the Ontario and Manitoba mining taxes paid by appellant's affiliates were properly disallowed as nondeductible income taxes within the meaning of section 24345 of the Revenue and Taxation Code; and (2) whether the application of the Uniform Division of Income for Tax Purposes Act, set forth in sections 25120 through 25139 of the Revenue and Taxation Code, is violative of the federal or state Constitutions.

Appellant is a Delaware corporation qualified to do business in California. Its business during the years in question was the sale of primary nickel and the manufacture and sale of nickel alloy products exclusively within the United States. Appellant is controlled by Inco Limited, a corporation organized under the laws of Canada. Inco Limited's business is the operation of mines, smelters and refineries in Canada to produce nickel and other mineral products which it sells in a worldwide market and to certain of its affiliates, including appellant. During the years in question, it operated 15 nickel mines in Ontario Province and 4 nickel mines in Manitoba Province. Both provinces imposed a mining tax on the mining operations.

The Ontario mining tax is administered by ministries concerned with mining and natural resource regulation. It is imposed at three graduated rates on profits. Profits are determined by deducting specified mining expenses from the gross revenue from production. The gross revenue is determined by one of three methods: (1) if the ore is sold, gross revenue is the gross receipts from the sale of ore; (2) if the ore is processed at the mine, gross revenue is the amount of the actual market value of the output at the pit's mouth; (3) if the ore is processed at the mine and there is no means of

ascertaining the actual market value of the output at the pit's mouth, gross revenue is the amount at which the mine assessor appraises such output.

Expenses which are deductible from gross revenue include cost of transportation, working expenses of the mine, power costs, costs of food for employees, explosives, safeguards, insurance, not less than 5 percent or more than 15 percent for depreciation on mining equipment and structures, and up to 15 percent per year of exploration and development expenses incurred after commencement of production. The nondeductible expenses include all development expenses paid or incurred prior to commencing production, exploration expenses paid or incurred prior to the development state of the mine, all expenses incurred for exploration and development work that did not result in a producing mine, all dominion, municipal, and province taxes (except for a minor surface property provincial tax and for sales and excise taxes on purchase of goods and equipment), any loss on the sale of the mine property, cost or other depletion, any expense incurred in acquiring the mine property, the right to mine, or an option on the right to mine, royalties, interest, and most expenses for annual shareholder meetings.

The provisions of the Manitoba mining tax are substantially the same as the provisions of the Ontario mining tax. It is imposed at a flat 8 percent of income over $10,000 derived from the operation of a mine. Income is statutorily defined as net profit derived, or deemed derived, from mining operations without an allowance for depletion. If the ore is sold, the profit is calculated by subtracting the allowable expenses from the gross revenue. If the ore is not sold, the market value or the appraised value of the output is substituted for gross revenue. Allowable expenses are the operating expenses similar to those allowed under the Ontario law, plus up to 15 percent per year for depreciation of preproduction development costs. Specifically disallowed as deductions are interest, dividends, any expense incurred in acquiring the mine property or the right to mine, and depreciation in the value of the mine, mining land or mining property, by reason of exhaustion or partial exhaustion of the ore or mineral. In addition to their respective mining taxes, both provinces impose a separate income tax.

Upon audit, respondent determined that appellant was a part of Inco Limited's worldwide unitary

business and issued proposed assessments. Appellant contests the proposed assessments on the ground that application of the unitary concept in this manner is unconstitutional. Appellant also contends that respondent erroneously treated the Ontario and Manitoba mining taxes as nondeductible income taxes.

With, respect to the issue of the constitutionality of worldwide combination, this board has a well established policy of abstention from deciding constitutional questions in an appeal involving proposed assessments of additional tax. This policy is based upon the absence of any specific statutory authority which would allow the Franchise Tax Board to obtain judicial review of a decision in a case of this type, and our belief that such review should be available for questions of constitutional importance. (Appeal of Shachihata, Inc., U.S.A., Cal. St. Bd. of Equal., Jan. 9, 1979.) Accordingly, we will not consider appellant's constitutional arguments.

We now turn to the issue of the deductibility of the Ontario and Manitoba mining taxes. Revenue and Taxation Code section 24345 provides, in pertinent part:

> There shall be allowed as a deduction--
>
> (a) Taxes or licenses paid or accrued during the income year except:
>
> * * *
>
> (2) Taxes on or according to or measured by income or profits paid or accrued within the income year imposed by the authority of
>
> (A) The Government of the United States or any foreign country; ...

Thus we must determine whether the Ontario and Manitoba mining taxes are taxes levied "on or according to or measured by income or profits." The term "income" in this statutory phrase has been construed by the courts to mean gross income as defined "under general tax law as currently operating." (Beamer v. Franchise Tax Board, 19 Cal.3d 467, 479 [138 Cal.Rptr. 199] (1977); MCA, Inc. v. Franchise Tax Board, 115 Cal.App.3d 185, 193 [171 Cal. Rptr. 242] (1981).)

When tax liability was incurred, the "general tax law as currently operating" included former regulation 24271(b)(1) from title 18 of the California Administrative Code, in effect for the years at issue. Regulation 24271(b)(1) provided:

> In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based [on] a percentage of income and without subtraction of selling expenses, losses, or other items not ordinarily used in computing cost of goods sold. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

(Former Cal. Admin. Code, tit. 18, reg. 24271(b), repealer filed Sept. 3, 1982 (Register 82, No. 37).)

The California Supreme Court interpreted the meaning of "total sales less cost of goods sold" with respect to the mining business in Beamer v. Franchise Tax Board, supra. In Beamer, the taxpayer paid a Texas tax on the production of crude oil and natural gas. The tax was measured by the market value of the oil and gas at the mouth of the well. If the minerals were sold for cash, the tax was computed on the producer's gross cash receipts. The court held that the Texas tax was not a tax "on or according to or measured by income" because the tax was measured by gross receipts instead of gross income. Because the taxpayer was in the business of mining, the court looked to state and federal tax regulations which define gross income from the mining business as total sales less cost of goods sold. It characterized these regulations as recognizing that gross receipts would include receipts which may constitute a return of capital as well as income, and returns of capital may not be taxed. The court found that with respect to the mining business, operating costs, denominated "lifting costs," must be subtracted from the gross receipts in order to determine the gross income. Since such costs were not deducted from the gross receipts to compute the Texas tax, the court concluded that the tax was not measured by income.

Appellant contends that because the Canadian provincial mining taxes do not allow a deduction for cost depletion, the taxes are measured by gross receipts rather than gross income. Appellant argues that regulation 24271(b)(1) specifically excludes from the calculation of the cost of goods sold only percentage depletion. Therefore, appellant argues, regulation 24271(b)(1) recognizes that cost depletion is a component of the cost of goods sold in the mining industry.

Regulation 24271(b)(1) does provide that gross income is determined without subtraction of percentage depletion. However, this does not mean that the regulation recognizes that cost depletion is a necessary component of the cost of goods sold. The regulation provides in pertinent part:

> Gross income is determined without subtraction of depletion allowances based [on] a percentage of income and without subtraction of selling expenses, losses, or other items not ordinarily used in computing cost of goods sold. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. (Emphasis added.)

Regulation 24271(b)(1) makes it clear that in the mining business, items not ordinarily used in computing cost of goods sold cannot be subtracted in determining gross income. (MCA, Inc. v. Franchise Tax Board, supra, 115 Cal.App.3d at 198.) Thus, if cost depletion is not ordinarily used in appellant's computation of cost of goods sold, it is not necessary that the mining taxes allow for its deduction in order to be termed taxes measured by gross income. Appellant has made no showing that its accounting method normally includes cost depletion in the computation of its cost of goods sold. Consequently, it has failed to carry the burden of showing that the mining taxes are measured by appellant's gross receipts which include, as did the Texas tax in Beamer, a direct return of capital invested as cost of goods sold.

Appellant points to the case of Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982), in which the U.S. Court of Claims decided that the Ontario mining tax was not an income tax. The issue before the court was whether the Ontario mining tax qualified as an income tax so as to be creditable under section 901 of

the Internal Revenue Code. **Section** 901 provides for a credit to United States income taxpayers for the amount of any income taxes paid to a foreign country.

The finding of the U.S. Court of Claims that the Ontario Mining Tax is not an income tax creditable under section 901 is not decisive for the purposes of Revenue and Taxation Code section 24345. In order to **be** creditable under section 901, a foreign tax must reach net gain as that term is understood in the United States. (Bank of America National T. & S. Ass'n. v. United States, **459 F.2d 513 (Ct. Cl.), cert. den., 409 U.S.** 949 **[34 L.Ed.2d 220] (1972).) The court in Inland** Steel reached its decision on the basis of what it termed "the large-scale omission from the OMT of significant costs of the mining **business"** such as deductions for interest, depletion, and royalties. While the **absence** of these deductions was significant to the court in determining that the OMT is not a tax on net income, it is not determinative in deciding whether the tax is a tax on gross income.

A more troubling point which appellant raises is the provision within both mining taxes for the taxation of unsold inventory. There is no realized income at this point. Instead, the tax is imposed on the value of the ore rather than on income generated from its sale.

In Robinson v. Franchise Tax Board, 120 **Cal.App.3d** 72 **[174 Cal.Rptr. 437] (1981),** the taxpayers were beneficiaries of a Hawaii trust. **The** trust was involved in agricultural, industrial, and residential development. In connection with its operations in Hawaii, the trust paid a 'Hawaii General Excise Tax" which imposed annual "privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income, whichever is specified." (Robinson v. Franchise Tax Board, supra, 120 **Cal.App.3d** at 79 (emphasis omitted), quoting 3a Hawaii Rev. Stats. (1976) ch. 237, **§** 237-13.) Gross income was defined as gross receipts without any deductions for the cost of the property sold, materials, labor, taxes, royalties, interest, or any other expenses. The court found that the Hawaii statute had multifaceted applications. Applied to retail sales, it was a sales tax not measured by gross income. Applied to mining, it was a gross receipts tax. A business could be subject to two or more tax rates depending upon which section of the

tax applied to an activity. The taxpayers contended that, judged as a whole, the Hawaii statute was a gross receipts tax. They argued that the issue should be resolved by a general analysis of the law without regard to its specific applications to the income of the trust. The court ruled that the Hawaii tax must be judged by its application to different forms of income, and that while some of its applications constituted a tax "measured by income," others did not. The income of the trust was primarily derived from interest and real property rents. Since the definition of rent excludes a return of capital or cost of goods sold, the tax paid on such income was a gross income tax. Because the taxpayers failed to carry their burden of proving which portions of the taxes paid, if any, were not measured by income, the court decided in favor of the Franchise Tax Board.

Like the Hawaii statute in Robinson, the Ontario and Manitoba mining taxes are multifaceted. Instead of using different methods to tax different businesses, the provincial mining taxes provide three alternative ways to tax one business. "The tax is a hybrid type of tax, with both income tax and property tax features." (Inland Steel Co. v. United States, supra, 667 F.2d at 82.) Our purpose is to determine whether the mining taxes nevertheless have the effect of being "on or according to or measured by" gross income. The taxes allow deduction of the operating costs equivalent to the lifting costs in Beamer. As we stated earlier, appellant has failed to show that the taxes fall on receipts which include a return of capital. Therefore, as applied to receipts from the sale of ore, we must conclude that the taxes are measured by income. However, to the extent the taxes are imposed on unsold ore, they are not measured by income. Appellant has not shown which portion of the taxes paid, if any, were imposed on unsold ore. Therefore, absent such a showing, we must rule in favor of respondent.

Appeal of Huntington Alloys, Inc.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Huntington Alloys, Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Income Years	Amount
1963	$ 25,970.44
1964	34,896.52
1965	41,486.59
1966	31,232.75
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1968	35,083.90
1969	31,506.43
1970	63,074.55
1971	18,877.19
1972	37,133.53
1973	108,681.97

be and the same is hereby sustained.

Done at Sacramento, California, this 12th day of September , 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

________________, Member