Revenue Ruling 90-65

July 1990

Depreciable versus non-depreciable; precious metals. Economically recoverable precious metal fabricated into items used in a taxpayer's trade or business are not depreciable if their cost is more than half the total cost of the item into which they are fabricated. *Rev. Rul. 69-55* revoked; *Rev. Rul. 75-491* amplified.

ISSUE

If economically recoverable precious metals are physically or chemically fabricated into an item of property used in a taxpayer's trade or business and the cost of those metals represents more than half of the cost of the item, are the metals accounted for separately or as part of the item into which they are fabricated?

FACTS

Situation 1-Individual *A* is a contract jeweler who fabricates jewelry to customers' specifications, using gold supplied by the customers. *A* does not maintain an inventory of gold or completed jewelry, but to assist customers *A* fabricates and maintains gold sample jewelry showing currently available styles. *A*'s samples are not held for sale. The cost of the gold used in each item of sample jewelry represents more than 50 percent of the total [*2] cost of the item. Every 3 years, *A* melts down the sample jewelry, recovering 100 percent of the gold content of the jewelry. For *A*'s purposes, the recovered gold is indistinguishable from gold that has not previously been used in sample jewelry, and *A* reuses it in fabricating new sample jewelry.

For federal income tax purposes, *A* sought to depreciate over three years the full cost of the sample jewelry, including the cost of the gold and the costs allocable to fabrication.

Situation 2-Corporation Z is a petroleum refiner. As part of its refining operation, Z uses a catalyst called prills, made by fabricating platinum salt solutions and other chemicals onto the surfaces of small alumina pellets. Z purchases the platinum in elemental form and then delivers it to a contractor for fabricating in accordance with Z's specifications. The prills are placed in reactor vessels, where they perform as a catalyst for the production of high-octane gasoline. The cost of the platinum fabricated into the prills represents more than half of the cost of the prills.

During the production of high-octane gasoline, the prills are contaminated through the build up of coke and other chemicals on their surfaces. [*3] The prills, therefore, must be periodically regenerated by burning off the coke. Some of the chemicals cannot be removed by the regenerating process, and after several years the prills are considered spent and must be replaced. Approximately 15 to 20 percent of the platinum is lost during use as a catalyst. The spent catalyst is sent to a reclaimer, where approximately 80 to 85 percent of the platinum initially contained in the prills is recovered and refabricated into prills. For federal income tax purposes, Z sought to depreciate the cost of the platinum over the life of the reactor vessel.

LAW AND ANALYSIS

Section 162 (a) of the Internal Revenue Code allows a deduction for the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. *Section 1.162-1 (a) of the Income Tax Regulations* defines business expenses deductible from gross income to include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items that are used as the basis for a deduction or a credit under provisions of law other than *section 162*. No such item shall be included in business expenses, however, [*4] to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property.

Section 1.162-3 of the regulations requires taxpayers carrying materials and supplies on hand to include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operations during the tax year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year.

Section 263A of the Code sets forth the general rules for the capitalization and inclusion in inventory costs of certain expenditures. *Section 263A* applies to property produced for sale or for use in the taxpayer's trade or business and to property acquired for resale. *Section 1.263A-1T (b) (2) (ii)* of the temporary regulations provides for the capitalization of indirect costs. Certain examples of indirect materials and supplies are identified by *section 1.263A-1T (b) (2) (iii)* as indirect costs that must be capitalized.

Section 167 of the Code sets forth the general, [*5] rules for depreciation. Depreciation is designed to compensate a taxpayer for the loss of utility of property. Section 1.167 (a)-2 of the regulations limits the depreciation allowance in the case of tangible property to that part of the property subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. Thus, if an identifiable part of property used in a trade or business is recoverable-and is reasonably expected to be recovered-without loss of utility, the cost of that part is economically recoverable and does not enter into the depreciation allowance. In such a case, the nonwasting part is accounted for separately from the wasting part.

Section 446 (b) of the Code requires that computation of income be made under a method of accounting that clearly reflects income. *Section 1.446-1 (a) (1) of the regulations* explains that the taxpayer's method of accounting includes the accounting treatment of any item.

In *Rev. Rul. 69-55, 1969-1 C.B. 26*, a glass manufacturer used platinum in its fabricated furnace linings, electrodes, and other equipment necessary for manufacturing glass products. These fabricated items had useful lives that varied from 6 [*6] months to 3 years, after which time the items were refined and the platinum was recovered and reused in fabricating new items. The ruling states that platinum in its sponge (raw) form did not depreciate by reason of exhaustion, wear and tear, or obsolescence. It further states, however, that fabricated items containing platinum with a useful life of over 1 year take on the characteristics of depreciable property. The ruling concludes that because none of the fabricated platinum items had a useful life to the taxpayer of 4 years or more, the taxpayer was not entitled to investment tax credit under *section 38 of the Code*.

In *Rev. Rul. 75-491, 1975-2 C.B. 19*, a manufacturer of flat glass used molten tin as a frictionless surface on which glass moved through the float process of glass manufacturing. The ruling concludes that the tin was not depreciable property because it retained its identity as tin in

its elemental state rather than serving as a material of construction that became part of a depreciable property. The ruling states that, although a portion of the tin (approximately 9 percent) was consumed and used in the manufacturing operation, the portion that remained had not diminished [*7] in value to the taxpayer by reason of its use. The ruling concludes that the cost of tin consumed is deductible under *section 162 of the Code* as an expense of operation, subject to being included as a production cost in the inventoriable cost of producing the glass.

In *Arkla, Inc. v. United States, 765 F.2d 487 (5th Cir. 1985), cert. denied, 475 U.S. 1064, 89 L. Ed. 2d 601, 106 S. Ct. 1374 (1986)*, the taxpayer owned a gas reservoir and maintained "cushion gas" in the reservoir to regulate the pressure. The cushion gas was indistinguishable from the gas the taxpayer sold to its customers. At the end of the reservoir's useful life, the taxpayer could recover some, but not all, of the cushion gas. The recoverable cushion gas was indistinguishable from the nonrecoverable cushion gas. The taxpayer was allowed investment credit and depreciation only for the nonrecoverable cushion gas. Similarly, in *Rev. Rul. 75-233, 1975-1 C.B. 95*, natural gas was injected into a reservoir for storage and later withdrawal and sale. For federal income tax purposes, that ruling divides the injected gas into the portion that is recoverable and the portion that remains in the reservoir and is unrecoverable. The cost of the unrecoverable portion [*8] is a capital expenditure subject to depreciation. *See also Rev. Rul. 70-354, 1970-2 C.B. 50*, as modified by *Rev. Rul. 73-469, 1973-2 C.B. 84*, in which liquified petroleum gas injected into a well to improve production is divided for tax purposes into a recoverable and an unrecoverable portion. The cost of the unrecoverable portion is a capital expenditure subject to depreciation in contrast to the cost of the recoverable portion, which is an offset against proceeds arising in future sales.

If a part of an item of property represents more than half of the total cost of the item and that part is economically recoverable for reuse without a loss of utility, separate accounting treatment is, in the Commissioner's opinion, necessary to clearly reflect income even though the recoverable part may have been "fabricated" (either by itself or with other materials) into an item of property with a determinable service life. Notwithstanding the fabrication, the taxpayer's ability to recover the part economically and reuse it without a loss in its utility indicates that the part is not subject to wear and tear. Moreover, allowing depreciation deductions in such a case would fail to clearly reflect [*9] income. Accordingly, the cost of the recoverable part is not depreciable. Section 1.167 (a)-2 of the regulations. (By contrast, the platinum in a car's catalytic converter is not accounted for separately because its cost does not represent more than half of the total cost of the car.)

Situation 1-*A*'s costs associated with acquiring the gold and the fabrication of the jewelry are required to be capitalized under *section 263A of the Code*. The capitalized cost of the gold represents more than half of the total cost of the sample jewelry. It is economically feasible to recover the gold from the sample jewelry, and, once recovered, the gold is usable in *A*'s business in a manner that is indistinguishable from the use of gold that had never been fabricated, used, and recovered. The utility of the gold does not diminish as a result of its fabrication into sample jewelry. Accordingly, it is not subject to exhaustion, wear and tear, or obsolescence, and is not depreciable.

A may depreciate other capitalized costs allocable to fabricating the sample jewelry. Because the sample jewelry has a limited period of utility in *A*'s business, the asset represented by its fabrication cost is subject to obsolescence [*10] and may be depreciated. Similarly, the capitalized costs of any physical portions of the jewelry that are reasonably expected either not to be economically recoverable or to be recoverable only with diminished utility for *A* may be depreciated. In such cases, the utility of that portion ends with the utility of the item of property

into which it has been incorporated, and the capitalized costs allocable to that portion are depreciable as part of the cost of the item.

Situation 2-As costs of producing an asset used in Z's trade or business, the costs of acquiring the platinum and the costs incurred by Z in having the catalyst (the prills) fabricated under contract for use in Z's trade or business are required to be capitalized under *section 263A of the Code*.

The capitalized costs of the platinum contained in the catalyst are to be accounted for separately from the capitalized costs of the remainder of the catalyst. The cost of the platinum represents more than half of the total cost of the prills, and the platinum, like the gold in *Situation 1,* is economically recoverable for reuse in the taxpayer's business with no loss of utility. The fact that a portion of the platinum is lost during [*11] its use as a catalyst does not affect this conclusion.

It makes no difference that, on the one hand, *A*'s gold is used in its elemental state and is subject only to physical fabrication while, on the other hand, Z's platinum undergoes a chemical change when it is fabricated into prills and a second, reverse chemical change when it is recovered. The critical fact is not the physical or chemical nature of the fabrication process but whether the platinum can be economically recovered without loss of utility.

Because Z's platinum is economically recoverable for reuse in Z's business with no loss of utility, the capitalized platinum is not depreciable. The cost of any platinum not recovered is a material or supply expense under *section 162 of the Code* during the periods the prills are in use and is further capitalized under *section 263A* as an indirect material or supply cost of producing the gasoline. *See section 1.263A-1T (b) (2) (iii)* of the temporary regulations.

Also, as in Situation 1, the fabrication process creates a wasting asset. Thus, given the multi-year useful life of the prills, the capitalized cost of fabricating the prills and the non-platinum materials of the prills are depreciable. [*12] The depreciation allowance, however, is itself further capitalized under *section 263A of the Code* as a cost of the gasoline.

In neither of the two situations can the, taxpayer avoid a separate accounting for precious metals by including the cost of the precious metals and the fabrication costs in a single depreciation account. In these cases, such a single-account method does not, in the opinion of the Commissioner, clearly reflect income. In each case, the cost of the precious metal represents more than half of the cost of the item into which it is fabricated. Thus, if a single precious metal account were to include the cost of the precious metal along with the costs of fabrication and all such costs were treated as subject to a depreciation allowance, the majority of the costs in that account would receive treatment that is fundamentally different from the more precise treatment that they receive if accounted for separately. A taxpayer must therefore use a multiple-account method because, in the Commissioner's opinion, only such a method clearly reflects income. *See section 446 (b) of the Code*.

The same result obtains if the taxpayer does not fabricate the items containing precious [*13] metals, but buys them already fabricated and, at the end of the items' useful lives, resells them to the fabricator or some other party. So long as recovery with undiminished utility is economically feasible, the fact that the taxpayer benefits from the recovery by resale rather than refabrication is irrelevant. The taxpayer must use a multiple-account method to account separately for the precious metal content of the items.

HOLDING

If economically recoverable precious metals are physically or chemically fabricated into an item of property used in a taxpayer's trade or business and the cost of those metals represents more than half of the cost of the object, the costs of the precious metals are nondepreciable and are accounted for separately from the item into which they are fabricated.

APPLICATION

Any change in the taxpayer's method of accounting to conform with the holding of this revenue ruling is a change in method of accounting to which the provisions of *sections 446* and *481 of the Code* and the regulations thereunder apply. *Section 446 (e)* requires a taxpayer who changes a method of accounting to secure the prior consent of the Commissioner. *Section 1.446-1 (e) (3) (i) of the regulations* [*14] provides, in part, that a taxpayer may secure the Commissioner's consent by filing with the Commissioner a Form 3115, *Application for Change in Accounting Method,* within 180 days after the beginning of the tax year in which the change is to occur. See section 5.02 of *Rev. Proc. 84-74, 1984-2 C.B. 736*, for late applications. *Section 481 (a)* requires that those adjustments necessary to prevent amounts from being duplicated or omitted be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding tax year. *See Rev. Proc. 84-74.*

This ruling is identified as a designated "B" ruling pursuant to section 5.12 (2) of *Rev. Proc. 84-74*. Accordingly, if a taxpayer files a Form 3115 requesting a change from an accounting method that capitalizes and depreciates precious metals, then the *section 481 (a)* adjustment period determined under section 5.06 (1) (e) of *Rev. Proc. 84-74* shall not exceed 6 tax years. If, however, the use of the method is raised as an issue during an examination and the taxpayer thereafter files a Form 3115 more than 2 years after the date of publication of this revenue [*15] ruling in the Internal Revenue Bulletin, then the *section 481 (a)* adjustment period shall not exceed 3 tax years pursuant to section 5.12 (2) of *Rev. Proc. 84-74*.

Any change in the taxpayer's method of accounting to conform with the holding of this revenue ruling shall be made as specified above. If the taxpayer has been capitalizing and depreciating precious metals used in its trade or business, any change in the taxpayer's method shall be made without regard to the change in method of accounting procedures set out in *section 1.263A-1T (e)* of the temporary regulations and in *Notice 88-78, 1988-2 C.B. 394*.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 69-55 is revoked.

Rev. Rul. 75-491 is amplified. The principles stated in that ruling apply not only when a recoverable element is used in its elemental state, but also when an economically recoverable precious metal is fabricated physically or chemically into items of property used in the taxpayer's trade or business and it is necessary, in order to clearly reflect income, to account for the precious metals separately.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in *section 7805 (b) of the Code*, relief will be extended to any taxpayer [*16] covered by the implication in *Rev. Rul. 69-55* that the cost of precious metals fabricated into an item of property with a useful life of more than one year is depreciable. For such a taxpayer, this revenue ruling will not

be applied adversely for tax years beginning before August 13, 1990, the date of publication of this revenue ruling.