



EARTHWORKS

## EARTHWORKS FACT SHEET

# HR 2262 GROSS VALUE ROYALTY: A NET SMELTER ROYALTY

### HR2262 provides that, subject to certain exemptions:

"All locatable minerals from any mining claim [...] shall be subject to a royalty of 8 [or 4] percent of the *gross income from mining*."<sup>1</sup> [emphasis added]

### HR2262's royalty is net smelter, not gross.

The use of the phrase "gross income from mining" has caused some to think that the HR2262 royalty is a gross proceeds royalty. It is not. It is a net smelter royalty – although there is no such thing as a "standard" net smelter royalty.<sup>2</sup> A net smelter royalty allows for the deduction of smelting costs, and frequently other costs as well.<sup>3</sup>

A pure gross royalty allow no deductions from the final mineral sale price. Some argue that there is no such thing as a true gross royalty for hardrock mining – at least as is applied to oil and gas.<sup>4</sup>

### Gross income from mining defined

HR 2262 defines "gross income from mining" as

"[T]he same meaning as the term 'gross income' in section 613(c) of the Internal Revenue Code of 1986."<sup>5</sup>

Section 613(c) defines gross income from mining fairly inclusively:<sup>6</sup>

"The term 'mining' includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills."

### Gross income from mining excludes smelting, and other related costs

Section 613(c) also fairly specifically defines what is NOT included in "gross income from mining":<sup>7</sup>

"[T]he following treatment processes shall not be considered as 'mining':"

- electrolytic deposition,
- roasting,
- calcining,
- thermal or electric smelting,
- refining,
- polishing,
- fine pulverization,
- blending with other materials,
- treatment effecting a chemical change,
- thermal action,
- and molding or shaping."

### What this means in practice.

For example, a mine produces pre-smelted (impure) gold worth \$800,000. It sells that gold (for 800K) to a smelter. After purifying the gold, the smelter sells the finished product for \$1,000,000. In this case, the royalty would be 8% x \$800,000.



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In cases where the smelting – or commonly, roasting – occurs as part of an integrated mine operation (i.e. there is no sale before the non-mining process occurs), then those costs from non-mining processes are deducted from the final sale price before the royalty is applied.

## **HR 2262 royalty is superior to a net proceeds royalty**

### **HR 2262 royalty preserves comparative advantage because it doesn't subsidize inefficiency**

A net proceeds royalty allows for a mine operator to deduct its costs of extraction.

This rewards inefficiency. If one mine operator efficiently extracts a target mineral, where another must spend more money to extract an equivalent amount, the inefficient operator should not be able to deduct the costs of its inefficiency.

In effect, net proceeds royalties hurt taxpayers and the mining industry:

- Taxpayers, by reducing the amount paid to the minerals' owners;
- Industry, by reducing or removing comparative advantage for efficient mine operators.

Because the HR 2262 net smelter royalty applies to the value of the product, regardless of extraction cost, it rewards relatively efficient operators with comparative advantage over their less efficient competitors.

### **HR 2262 royalty would be more easily administered**

There is institutional knowledge within the mining industry and within the federal government as to how the HR 2262 would be calculated.

Because the HR 2262 royalty uses the same Internal Revenue Service definition of “gross income from mining” as does the percentage depletion allowance, mining operators already calculate gross income from mining for their corporate income tax returns.

### **HR 2262 royalty would be less subject to fraud**

Net proceeds royalties allow for so many different types of deductions that aggressive enforcement of the public interest would likely result in policy set by litigation.

Litigation and other negative consequences of a net proceeds royalty would likely be minimized, if not completely avoided, with the HR 2262 royalty. *This is true for a simple reason: it is often in the mining operator's financial interest to fairly calculate the HR 2262 royalty.*

Because the HR 2262 royalty is calculated using the same data with which the percentage depletion allowance subsidy is calculated, it will usually be in the operator's financial interest to accurately calculate the royalty. Revenues accruing to mining operators as a result of the percentage depletion allowance on public lands exceed the revenue that would be lost by operators as a result of the HR 2262 royalty.<sup>8</sup>

### **Governments more commonly use HR 2262 type royalty than net proceeds**

Value based royalties, like net smelter royalties, or much more commonly used by governments than the net proceeds royalties.<sup>9</sup> Of the thirteen western U.S. states governing hardrock mining, only two mandate net proceeds royalties.<sup>10</sup>



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<sup>1</sup> HR2262, Hardrock Mining and Reclamation Act of 2007, as passed by the House of Representatives, section 102(a)(1)

<sup>2</sup> “Although mention is often made in the industry of a “standard” form of royalty, there is, in reality, no such animal. At most, it can be said that there are a number of generic types of royalties with each generic type having the same general characteristics. A sure way to invite costly litigation is to sign an agreement agreeing to pay or receive a “standard net smelter return royalty” or “net profits interest”, or to retain a “carried interest” without further elaboration and definition.” -- “Royalty Provisions: Issues for the ‘90’s” in *The Mining Industry: Meeting the Challenges of the Decade* (Mississauga, Ontario: Insight Press, 1992)

<sup>3</sup> “A royalty calculated on the net smelter return is essentially calculated on the amount received by the mine or mill owner from the sale of the mineral product to the treatment plant that converts the output of the mill to marketable metal. From the gross proceeds received there may be deductions for costs incurred by the owner after the product leaves the mine property and before sale, such as the costs of: transportation, insurance or security, penalties, sampling and assaying, refining and smelting, and marketing. No deductions are made for the operating costs of the mine-mill complex.” -- B.J. Barton, *Canadian Law of Mining* (Calgary: Institute of Resources Law, 1993) at 461.)

<sup>4</sup> “A gross overriding royalty loses its defining character and becomes something else, if created in relation to a mine whose product must undergo significant alteration before it is saleable. As illustration, a royalty on a gold mine is going to be based not on the value of the gold-bearing ore but rather on the value of the gold itself. The costs of smelting and refining the gold will reduce the proceeds to the mine owner, a percentage of which will be paid as royalty. However the deduction of these expenses alters the basic character of the royalty to such an extent that it requires a different name, which in this case is the net smelter returns royalty.” – *Understanding Royalty Structures*, Christopher Baldwin, 2003, p.2. Written for the Conference Board of Canada, “Structuring More Effective Mining Ventures”, Feb 17-18, 2003.

<sup>5</sup> HR2262 Section 102(i)

6 Internal Revenue Code 613(c)(1) Gross income from the property

The term 'gross income from the property' means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

(c)(2) Mining

The term 'mining' includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(c)(3) Extraction of the ores or minerals from the ground

The term 'extraction of the ores or minerals from the ground' includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

(c)(4) Treatment processes considered as mining

The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

(A) In the case of coal - cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(B) In the case of sulfur recovered by the Frasch process - cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(C) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product - sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment;

(D) In the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product - crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore



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or the mineral or minerals from other material from the mine or other natural deposit;

(E) the pulverization of talc, the burning of magnesite, the sintering and nodulizing of phosphate rock, the decarbonation of trona, and the furnacing of quicksilver ores;

(F) in the case of calcium carbonates and other minerals when used in making cement - all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(G) in the case of clay to which paragraph (5) or (6)(B) of subsection (b) applies - crushing, grinding, and separating the mineral from waste, but not including any subsequent process;

(H) in the case of oil shale - extraction from the ground, crushing, loading into the retort, and retorting, but not hydrogenation, refining, or any other process subsequent to retorting; and

(I) any other treatment process provided for by regulations prescribed by the Secretary which, with respect to the particular ore or mineral, is not inconsistent with the preceding provisions of this paragraph.

<sup>7</sup> Internal Revenue Code Section 613(c)(5)

<sup>8</sup> FY 2000 Clinton administration budget, Analytical Perspectives, p.88, estimates of the value of repealing the percentage depletion allowance on public lands at \$478 million over 5 years (in 2000 dollars). The Congressional Budget Office (10/29/2007) estimates that the HR 2262 royalty would generate \$160 million the first 5 years after enactment.

<sup>9</sup> *Mining Royalties: a global study of their impact on investors, government, and civil society.* James Otto, et al, World Bank publication, 2006.

<sup>10</sup>

state	royalty type (value or proceeds)	cite
Alaska	proceeds	AK Statute 38.05.212 <a href="http://touchngo.com/lglcntr/akstats/Statutes/Title38/Chapter05/Section212.htm">http://touchngo.com/lglcntr/akstats/Statutes/Title38/Chapter05/Section212.htm</a>
Arizona	value	Ariz. Rev. Stat 27-234, <a href="http://www.azleg.state.az.us/FormatDocument.asp?inDoc=/ars/27/00234.htm&amp;Title=27&amp;DocType=ARS">http://www.azleg.state.az.us/FormatDocument.asp?inDoc=/ars/27/00234.htm&amp;Title=27&amp;DocType=ARS</a>
California	value	CAL. PUB. RES. CODE § 6895, <a href="http://www.legaltips.org/california/california_public_resources_code/6890-6900.aspx">http://www.legaltips.org/california/california_public_resources_code/6890-6900.aspx</a>
Colorado	varies	Colorado Revised Statutes 36-1-113, <a href="http://www2.michie.com/colorado/lpext.dll/Infobase4/1/59285/59298/5929a/5929c/59364?f=templates&amp;fn=fs-main-doc.htm&amp;q=36-1-113&amp;x=Advanced&amp;2.0#LPHit1">http://www2.michie.com/colorado/lpext.dll/Infobase4/1/59285/59298/5929a/5929c/59364?f=templates&amp;fn=fs-main-doc.htm&amp;q=36-1-113&amp;x=Advanced&amp;2.0#LPHit1</a>
Idaho	varies	Idaho Code 47-404, <a href="http://www3.state.id.us/cgi-bin/newidst?sctid=470070004.K">http://www3.state.id.us/cgi-bin/newidst?sctid=470070004.K</a>
Montana	value	Montana Code Annotated, 77-3-116 and 77-3-101, <a href="http://data.opi.state.mt.us/BILLS/mca_toc/77_3_1.htm">http://data.opi.state.mt.us/BILLS/mca_toc/77_3_1.htm</a>
Nevada	proceeds	NRS Chapter 362, <a href="http://law.justia.com/nevada/codes/NRS-362.html">http://law.justia.com/nevada/codes/NRS-362.html</a>
New Mexico	value	NM Statute Annotated 19-8-22, <a href="http://www.conwaygreene.com/nmsu/lpext.dll?f=FileLink&amp;t=document-frame.htm&amp;l=query&amp;iid=17417b2f.4546cb5b.0.0&amp;q=%5BGroup%20%2719-8-22%27%5D">http://www.conwaygreene.com/nmsu/lpext.dll?f=FileLink&amp;t=document-frame.htm&amp;l=query&amp;iid=17417b2f.4546cb5b.0.0&amp;q=%5BGroup%20%2719-8-22%27%5D</a>
Oregon	value	GAO-RCED-93-109
South Dakota	value	S.D. Codified laws 5-7-55, <a href="http://legis.state.sd.us/statutes/DisplayStatute.aspx?Type=Statute&amp;Statute=5-7-55">http://legis.state.sd.us/statutes/DisplayStatute.aspx?Type=Statute&amp;Statute=5-7-55</a>
Utah	value	personal communication with Will Stokes, Utah School Trust Lands Administration, 9/2007
Washington	value	WAC 332-16-035, <a href="http://apps.leg.wa.gov/WAC/default.aspx?cite=332-16-035">http://apps.leg.wa.gov/WAC/default.aspx?cite=332-16-035</a>
Wyoming	case by case	personal communication with Diana Wolvin, Office of State Lands and Investment