INVESTIGATION OF BUREAU OF INTERNAL REVENUE

HEARINGS

BEFORE THE

SELECT COMMITTEE ON INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE UNITED STATES SENATE

SIXTY-EIGHTH CONGRESS

SECOND SESSION

PURSUANT TO

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AUTHORIZING THE APPOINTMENT OF A SPECIAL COMMITTEE TO INVESTIGATE THE BUREAU OF INTERNAL REVENUE

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SELECT COMMITTEE ON INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

JAMES COUZENS, Michigan, *Chairman*

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WILLIAM H. KING, Utah.

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, FEBRUARY 10, 1925

UNITED STATES SENATE,
SELECT COMMITTEE TO INVESTIGATE THE
BUREAU OF INTERNAL REVENUE,
Washington, D. C.

The committee met at 10 o'clock a. m., pursuant to call of the chairman.

Present: Senators Couzens (presiding) and King.

Present also: Mr. L. C. Manson, of counsel for the committee; Mr. L. H. Parker, chief engineer for the committee; and Mr. A. H. Fay, consulting engineer for the committee.

Present on behalf of the bureau: Mr. A. W. Gregg, special assistant to the Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue: Mr. Nelson T. Hartson, solicitor, Bureau of Internal Revenue; Mr. James M. Williamson, attorney, office of solicitor, Bureau of Internal Revenue; and Mr. S. M. Greenidge, head, engineering division, Bureau of Internal Revenue.

The CHAIRMAN. Before we start in on the formal work of the committee this morning, Mr. Hartson, I want to draw your attention to a few statements which were made in the meeting that we had on February 7, at which time the committee had a meeting by itself, to discuss the future work of the committee. During this meeting Mr. Manson made this statement:

> We have been unavoidably delayed in our statistical work, for the reason that the bureau has delayed furnishing us the data that we called for in September. Now, I do not mean to imply that they have not done the best they could to get it out, but it has been quite a large job. They have furnished us about one-seventh of the individual returns that were called for, and about one-half of the corporate returns, up to the present time.

Is that your understanding, Mr. Nash, or Mr. Hartson?

Mr. NASH. Yes, sir. Senator Couzens, that work has been going forward just as fast as it is physically possible to get it out. We even had to buy new photostatic machines to perform this work. I think they have just installed some of the machines and there are more to be installed. We have also been working a night shift on the work to get it out.

The CHAIRMAN. When do you contemplate that you will be able to deliver all of that to the committee?

Mr. NASH. I hesitate to make a statement on it. We are putting it out just as fast as we can, with our equipment. It is a much bigger job than we anticipated.

The CHAIRMAN. Can you get it finished before the adjournment of Congress, do you think?

Mr. NASH. I doubt it. I doubt it very much.

The CHAIRMAN. Do you think that that work ought to be stopped after the adjournment of Congress, or that it ought to be finished up?

Mr. NASH. The statistics which are being prepared from the individual returns will be valuable at any time, and I believe that we ought to continue to gather those statistics and finish the work up, inasmuch as we have started on it, or what we have done will be wasted.

The CHAIRMAN. Does that apply to the corporation returns, or is that less important?

Mr. NASH. Senator, I do not know what use is being made of the corporation returns. We are merely furnishing photostatic copies of the returns themselves, and that does not involve any work in the bureau other than the withdrawing of the returns from the files and photostating them and forwarding the photostats to the committee. It is work that could be stopped and taken up again at any subsequent time.

The CHAIRMAN. Perhaps Mr. Manson can state at this time for the record what he is doing with the corporate returns.

Mr. MANSON. From the corporate returns we are tabulating the net income, both taxable and tax exempt, the distribution of that income as dividends, the amount undistributed and the tax. We are also tabulating a summary of the balance sheets for the purpose of showing the extent to which the undistributed earnings are being reinvested in the business or being invested in outside investments. Before making these tabulations all of these corporations are classified, first, on the basis of the distribution of their income as dividends; second, on the basis of the relationship of their net earnings to their combined capital, surplus, and undivided earnings; third, on the basis of proportion of total stock of the corporation controlled by the officers; and, fourth, on the basis of the nature of the business of the corporation.

The CHAIRMAN. What do you intend to use that information for after you get it?

Mr. MANSON. That will reflect the extent to which corporate net earnings are not subjected to individual income taxes: it will reflect the ability of the corporation to distribute; it will reflect the nature of the corporations, as to whether their stock is closely held or widely distributed, and it will reflect the percentage of earnings in the different corporate classes, from the standpoint of the extent to which they distribute their earnings. It all goes to the question of the extent to which corporate earnings are escaping individual income taxes.

The CHAIRMAN. That will show, as I understand it, also those corporations which were formed for the purpose of holding investments?

Mr. MANSON. Those are being disclosed, yes. The extent to which that is being done will be disclosed by these statistics.

The CHAIRMAN. Are you not classifying them in relation to the percentage of earnings which they distribute?

Mr. MANSON. They are being classified in relation to the percentage of earnings which they distribute.

The CHAIRMAN. Do you think, Mr. Nash, that that would be of any value to the bureau in making recommendations for legislation?

Mr. NASH. Mr. Chairman, I do not know that I would be qualified to answer that. I have never gone into the technical side of the income tax law.

The CHAIRMAN. Would you ask your associates or your superior, after having heard Mr. Manson's statement as to what their views would be as to the value of that information?

Mr. NASH. I will be glad to do that.

The CHAIRMAN. For legislative purposes.

Mr. NASH. Yes, sir.

The CHAIRMAN. Will you also ask Mr. Blair or your associates the probable time when you can complete the delivery of these returns?

Mr. NASH. Yes, sir.

The CHAIRMAN. Will you also ask your superior or your associates if they would approve of continuing this work to complete the statistical information?

Mr. NASH. Yes, sir.

The CHAIRMAN. I ask that because in these letters which I am going to hand to the reporter for the record, no mention is made of the statistical work. These letters, as I understand it, only deal with the investigation in a general way, and apparently have in mind—and if I am wrong, I hope you will correct me—the work that is being done by our engineers and auditors and does not have reference to the statistical work.

Mr. NASH. If you refer to my letter, Senator, that is correct.

The CHAIRMAN. Is that your understanding of your letter, Mr. Hartson?

Mr. HARTSON. Yes, Senator. The underlying thought that prompted my letter was not what good might be accomplished by well-directed efforts to get information for use in a constructive way, but had to do with the manner in which this investigation was being conducted.

The CHAIRMAN. Just explain what you mean by "the manner in which this investigation was being conducted."

Mr. HARTSON. I mean the hearings that the committee conducts on particular cases, which, I believe, are not typical cases, but are exceptional cases. The necessity to appear here day after day, and be taken away from what, to my mind, is most importnt work in the bureau. In my own personal case, I am at the head of a very large office, and have most responsible duties to perform. For the last three months I had nothing to do with those duties of the office. They have been performed by subordinates in my name, and I have felt keenly the disadvantage that I was laboring under. I am in a position where things of great importance and moment are issuing from my office every day, with my name attached, which may be subject to criticism by this committee, and personally I am in the dark, having had no opportunity to keep up with the affairs of my office. My time, as you know, has been spent almost entirely on this investigation. That is the thought that I have in mind. I think the Senator has always recognized that, in my personal judgment, Congress could well devote time toward securing information from

the Bureau of Internal Revenue which would be helpful to Congress in framing legislation, and while it is not for me to say, I think that information could be secured in another way.

The CHAIRMAN. Would you mind enumerating in what other ways it could be secured, because, so far as the chairman is concerned, he has no pride of conviction as to how this might be proceeded with.

Mr. HARTSON. I think it could be secured, Mr. Chairman, by this committee or any committee calling on the bureau for specific information in the form of such reports as are now being asked for of a statistical nature. That does not involve distributing throughout a very large organization, many agents of this committee who are there to criticise, who are there to talk with the employees of the bureau about their work in a way which causes those employees to be disconcerted and disturbed, many of them unnecessarily so. It is quite possible that the agents of the committee, in going over the work down there, are not purposely attempting to breed that sort of confusion that has resulted beyond a question of doubt.

The CHAIRMAN. I would like to say at this point that, so far as I can speak for the committee and its agents, we would have been perfectly willing to have had this work transferred to the offices here, but at the very beginning of these hearings the bureau took the position, if you will remember, that they could not let the records out of their possession, which necessitated our men going down there. I do not say that the bureau was not justified in that, but I do say that if confusion resulted, it was not because of the committee's desire that it be done that way, but because the bureau itself elected to retain control of the records. As I say, if confusion has resulted, it was not the program of the committee to create that confusion.

There is another matter that I wanted to speak about. In the meeting we had the other day, Mr. Manson, in stating to the committee the progress of the work and the probable length of time it would take to complete it, made this statement:

> Mr. Hartson told me that the facts that had been brought out before the committee in connection with amortization had been enlightening to the bureau as they have been to the committee.

Is that a correct statement, Mr. Hartson?

Mr. HARTSON. I do not recollect having made such a statement as that.

The CHAIRMAN. Is it correct?

Mr. HARTSON. It is correct, Senator, so far as an isolated case or so is concerned, I believe. I have had no knowledge that these cases were even in the bureau, much less settled one way or the other, and it is what the committee has heard here that has brought to my attention and to Mr. Nash's attention the adjustments in these cases. Now, if Mr. Manson was referring to a rather extensive conversation that he and I had on the whole subject of the conduct of this investigation in my office some two or three weeks ago, there was a great deal said at that meeting, both by Mr. Manson and me, which, if Mr. Manson thinks it wise to go into, I would be very glad to tell the committee just what occurred at that meeting. Yet, it was a discussion of counsel representing the committee and representing

the bureau—a very frank discussion. Just as counsel will do in discussing issues in law suits frankly, make statements which are not for the record, I quite frankly went over the matters with Mr. Manson at that time, and he with me, which we would not want to go into the record.

Mr. MANSON. I wish to say that I had no reference to that discussion; no.

Mr. HARTSON. If that is true, we can very properly, Mr. Manson, leave our conversation in my office out of this record.

Mr. MANSON. I understood that our conversation was to be strictly informal, between two lawyers interested in an investigation.

Mr. HARTSON. That is my understanding exactly, Mr. Manson, and I am perfectly willing to let it go at that.

Mr. MANSON. While there is nothing about it that I would care to conceal——

Mr. HARTSON. I know.

Mr. MANSON (continuing). At the same time, it is absolutely outside of the investigation.

The CHAIRMAN. I just want to say that I did not bring that matter up so as to get into any confidential or unofficial talks that counsel may have had. What I wanted to get at was this, whether the committee was correct in a conclusion that it has had for some little time that, in digging out these individual cases, we were helping to standardize the operations of the bureau. I have had that conviction right along for some time, and I was somewhat disturbed yesterday in receiving these letters, after inviting the members of the bureau to come down here and discuss the matter with us, to have them decline to come, but to send these letters, which was not in accordance with the procedure which we had been following. We had been talking rather frankly.

Mr. HARTSON. Yes.

The CHAIRMAN. And I thought we were getting somewhere. Therefore, the receipt of these letters somewhat disturbed me, and I thought that if there was any misunderstanding between the committee and the bureau, it had better be straightened out.

Mr. HARTSON. Senator, I would like to be put right on this matter.

Had it been the understanding of Mr. Nash and myself that we were invited to come, we would have been here, and have very gladly discussed orally the subject matter of those letters, and not have written any letters at all. I do not understand, and did not understand that we were invited to come. We were given the privilege to come if we wanted to, and, very frankly, I did not know whether we were wanted or not. It did seem to me that some members of the committee wanted us to come and others did not, and if the chairman of the committee had, over the telephone or in writing, suggested that he, as chairman of the committee, wanted to hear from Mr. Nash and me, we both would have been down here, and would have been very glad to come.

The CHAIRMAN. That may have been rather indefinite in the minds of the bureau, but the fact is that Senator Watson said in this meeting that he wanted to talk to members of the bureau, and I suggested that we have the members of the bureau come down here and talk to the members of the committee, as I thought that that would simplify

Senator Watson's task, because he said that at no time had he been in touch with the representatives of the bureau, and he wanted to get their reaction on the whole thing. Senator King was in a hurry to get to another meeting, and Senator Ernst was in a hurry to get to another meeting. Each of them went out to attend these other meetings, and left the chairman alone, without any resolution having been adopted or any objection having been raised to your coming down here. I then told the clerk of the committee to call up the representatives of the bureau and tell them that we would be glad to have them come down here if they desired to come. I frankly admit that I said "if they desire to come," because there was no resolution, and I had no authority to say that the committee had invited them. Yet, I knew unofficially that we would be glad to talk to the representatives of the bureau.

Senator KING. Mr. Chairman. Of course I do not know what prompted these letters. I have read them, and I do not agree at all with the conclusions therein stated. I think Mr. Nash's letter draws a very long bow, and at the proper time I want to cross-examine him on his letter.

The CHAIRMAN. So that the record may show what we are talking about, in this connection I wish to place in the record at this point two letters directed to the chairman, one from Mr. C. R. Nash, assistant commissioner, dated February 9, 1925, and another signed by Mr. Nelson T. Hartson, solicitor Bureau of Internal Revenue, dated February 9, addressed to the chairman, in response to the suggestion to them, over the telephone, that they might come before the committee and discuss the future work of the committee.

(The letters referred to are as follows:)

TREASURY DEPARTMENT,
Washington, February 9, 1925.

Hon. JAMES COUZENS,
Chairman Special Committee to Investigate the Bureau of Internal Revenue, United States Senate.

MY DEAR MR. CHAIRMAN: At the meeting of the Committee to Investigate the Bureau of Internal Revenue on Saturday, February 7, the question of the continuance of the activities of the committee through the recess of Congress was under discussion. Your invitation to present the views of the Internal Revenue Bureau as to the desirability of proceeding with the investigation after March 4 has been received.

The committee investigating the bureau has been in existence now for practically a year. Up to January 1, 1925, the direct cost to the bureau of this investigation, which cost is attributable principally to relieving employees of the bureau from their regular duties and assigning them to the work of the committee, was approximately $143,000. Since that time more accurate records have been kept which disclose that this direct cost to the bureau for the month of January was approximately $22,000, or at the rate of $260,000 a year. This direct cost, however, is relatively unimportant when the indirect harm to taxpayers and to the bureau of the activities of the committee is considered.

As a result of this investigation the employees of the bureau are badly demoralized and the work of the bureau in some sections is almost at a standstill. It is difficult for an organization to properly function if the agents of an outside critical body are scattered throughout that organization. These agents are interfering with and interrupting the work of the employees, taking from them casts which they are considering, watching for some slip which will justify adverse and hostile criticism. The fear on the part of the employees of the bureau that the exercise of their honest judgment in deciding and closing cases may make them the subject of attack by the committee has so permeated the bureau that the general tendency on the part of many of the technical employees is to protect their own responsibility by failing to

make decisions or if necessary to come to a conclusion the decision is adverse to the taxpayer, leaving the case to again be considered sometime in the future. The slowing up of the work of the bureau as a result of this investigation is postponing indefinitely not only the collection of a tremendous amount of taxes but the settlement of a great number of cases.

Not only the interests of the Bureau of Internal Revenue in the collection of its taxes are being adversely affected by this investigation, but in addition it is having a serious and detrimental effect upon the interests of the taxpayers. The taxpayers are entitled to have their tax liability settled and finally determined as soon as possible. The uncertainty which results from the delay in finally settling these cases upsets in a large measure the business organizations of the country. Reorganizations, refinancings, enlargements, expansions, and capital expenditures which, for the interests of the different business organizations and for the prosperity of the country should be put through, are necessarily postponed until the liability for taxes is finally determined. The activities of the investigating committee which result in the indefinite postponement of the closing of so many of these cases necessarily has an effect most detrimental to taxpayers and the business organizations of the country.

The activities of the committee are familiar to me. I have been able to judge quite definitely the effect of the investigation upon the bureau. It is my opinion that any good results which may have come from the activities of the committee are not to be compared with the injury and harm this investigation has had on the Internal Revenue Bureau.

Respectfully yours,

C. R. NASH,
Assistant to the Commissioner.

DEPARTMENT OF JUSTICE,
OFFICE OF THE SOLICITOR OF INTERNAL REVENUE,
Washington, February 9, 1925.

Hon. JAMES COUZENS,
Chairman Special Committee Investigating the
Bureau of Internal Revenue, United States Senate.

MY DEAR SENATOR: On Saturday afternoon Senator Watson called me on the telephone stating that at an executive session of your committee held that afternoon it was suggested that my views be obtained as to the possible good results that had come from the investigation of the Bureau of Internal Revenue. Senator Watson said he was offering me the opportunity of appearing and expressing myself on this subject if I so desired, but that the committee was not requesting that I do so.

From time to time during the past year at the hearings of your committee I have been questioned along the same line. I have on several occasions indicated that some beneficial purposes had been and could be served by a constructive inquiry into the bureau's activities. Isolated statements of this kind might no doubt be obtained from the record and if disassociated from the context would make it appear that I was in favor of the continuation of your investigation. If this were done, it would be obviously unfair because I am not, and never have been, in sympathy with the activities of your committee. In candor I have admitted that some of your criticisms of the bureau have been justified, but most, if not all, of the defects that are being pointed out, have been well known to all of us who are connected with the bureau.

Conscientious and intelligent efforts have been and are being made to improve conditions. Perfection has not yet been attained, but surprisingly good results have been accomplished when the tremendous task confronting the bureau is considered. Conceding that some good results might be brought about by a constructive investigation, I am convinced that the harmful effects of your committee's activities far outweigh any possible benefits that could be obtained.

If there has been a misunderstanding as to my attitude in this regard, I trust that what I have said will clear it away.

Sincerely yours,

NELSON T. HARTSON,
Solicitor.

The CHAIRMAN. Do you want to interrogate Mr. Nash now, Senator King?

Senator KING. No; I want to talk to Mr. Manson first, and then I want to cross-examine Mr. Nash on that letter, which I think is a very—well, I will not characterize it now.

The CHAIRMAN. Mr. Manson, this meeting was primarily called for the purpose of going into the question of the method of handling oil wells and oil discoveries by the Bureau of Internal Revenue. As I understand it, you want to present that matter this morning?

Mr. MANSON. Yes; but I would like to say, in order to have it at the proper place in the record, that it is not my understanding that the representatives of the committee, either those engaged in engineering work or auditing work, are wandering around the bureau talking with employees of the bureau. The engineers are quartered in either two or three rooms, located in the engineering section of the bureau. If they desire records, they ask the person designated by the bureau for the records that they want.

Those records are brought to those rooms and if the committee's engineers desire to ask any questions of the engineer who worked up the case, they send for such engineer and question him about the case. My information is that that practice is not indulged in to any great extent, and, furthermore, it was my definite instruction to everybody working in the bureau and representing the committee, that they are to engage in no criticism of the bureau's method or practice in the handling of any case or in the doing of anything. The purpose of those instructions was not to keep from the bureau such criticisms as we might have until we could present them to the committee. The purpose was that I felt that to permit the expression of views on the part our agents would have a tendency to impair discipline in the bureau, and that the proper procedure was for our agents to get the information they are asked to get, and to report that information to me and permit me to lay it before the committee, to express such views as we might have upon the subject before the committee, and let the committee determine whether or not they had any criticism to make. I have every reason to believe that those instructions have been carried out.

Senator KING. This letter of Mr. Nash's seems to be aimed at a chloroforming, or, rather, the presenting of such obstacles as to compel a cessation of any inquiry into the activities of the bureau. The letter is of such a nature as would lead me now to demand a rigorous investigation of the Bureau of Internal Revenue.

Mr. MANSON. If I am at all wrong about what I have just stated, I would like to be corrected.

Senator KING. I think we had better get a statement from those who have been associated with you and put it in the record to show the unfair inference, if it be unfair, of Mr. Nash's letter.

Mr. MANSON. I would like to ask Mr. Parker at this time to state on the record whether I have stated the conditions correctly under which we are working there.

Mr. PARKER. I think you are very accurate, Mr. Manson.

Mr. MANSON. We desire now to call the committee's attention to the oil situation, and more particularly to the discovery depletion.

Mr. Fay, who has been employed as consulting engineer for this committee, has prepared a report dealing with the general situation, and I wish to call Mr. Fay to discuss his report, but before calling him for that purpose I desire to call the committee's attention to some facts as to the history of this provision.

In 1918, when we were at war, it was represented to the Ways and Means Committee of the House of Representatives, and, if I am not mistaken, to the Finance Committee of the Senate, at the time that they were considering the 1918 revenue act, that the country was at that time consuming 60,000 barrels of oil a day in excess of the production, and that the production of the oil required to meet the needs of this country and its allies during the war depended very largely upon stimulating prospectors and stimulating wildcatting, and that the tax laws as then in force had the effect of discouraging the necessary prospecting.

I read from page 478 of the hearings before the Ways and Means Committee of the House on the revenue act of 1918, a portion of a brief by the Mid-Continent Oil and Gas Association and Texas Gulf Coast and Louisiana Oil and Gas Association, dated June 28, 1918.

The oil and gas supply of the world is kept up by new explorations and new developments. If the supply of this country is to be maintained and sufficient fuel oil, lubricant, and gasoline is to be furnished, these explorations and discoveries must go on and on, must be encouraged, and the entire reward must not be taken away from the wildcatter in case he is successful. In this connection it might be well to call the attention of your committee to the fact that vastly the greater portion of the crude oil in the United States is prospected for and discovered by individuals or small concerns. We wish further to call attention to the fact that the majority of the men engaged in the business are frequently having desperate struggles for existence, and are dependent very largely upon the luck of a strike for a success, and it is only the "hope of the pot of gold at the end of the rainbow" that furnishes this almost unlimited supply of people who are spending their money as prospectors, very few of whom realize such hope.

In view of the great hazard of the business and the necessity of extensive wildcatting necessary to keep the supply of crude oil up to the demands of the public, some method should be adopted to encourage the wildcatter and to permit him to be put in a class different from established industries. He should be guaranteed the return of the money risked and expended in discovering and developing new fields without diminishing the invested capital, and because of the great hazard and irregularity of the return from the oil business, and particularly that of prospecting and discovery, he should be permitted to retain a larger share of the profits of such business than is permitted to other industries.

On page 376 of the hearings before the Ways and Means Committee of the House, on September 13, 1918, the following is taken from a statement by Mr. John J. Shea, of Tulsa, Okla., representing the Mid-Continent Oil and Gas Association.

One of the things we ask relief on is this. Of course, all of you who are informed upon mining business will understand this: The prospector goes out and makes a strike. He may have had 10 years of failure before that. The only thing he can do with that is to sell it to somebody who is able to develop it and run it, and he can sell that at a good price, and he takes that money and goes out prospecting with it again. He can not sell now, because under the present law * * * all of the profits are held to have accrued during the year in which the sale is made, and as the result of that he must give up practically the whole body of his property in taxes.

In his brief, filed the same day, Mr. Shea includes under "Conclusions" the following paragraph, at page 392:

3. To encourage the prospecting vitally necessary to maintain the Nation's production, oil producers having discovered new deposits of petroleum unknown prior to January 1, 1918, should not be taxed on the income therefrom until all of the costs of discovering and developing such deposits has been returned.

4. In view of the importance and close relationship existing between sales of producing oil and gas properties and the continuance of drilling in search of new production so vitally necessary to the prosecution of the war, the net income derived from such sales, bona fide made, when not more than 50 per cent interest is retained by the seller, should not be subject to a greater tax than 20 per cent.

On page 497 of the proceedings, Mr. Orlandus West, Clarksburg, W. Va., representing the Oil and Gas Producers' Association of West Virginia, makes the following statement:

As it requires the investment of capital at great risk to determine the value of prospective oil or gas properties, such properties should be valued after oil or gas has been discovered thereon for the purpose of taxation. This would give the prospector an incentive by giving him some benefit or credit for the increased valuation which he might create at the risk of losing his investment.

I might go on indefinitely reading extracts from the record of hearings before the Ways and Means Committee at that time, but the purport of all of them is the same as that of those which I have read.

At that time the tax, which could run as high as 80 per cent, was claimed to fall too heavily upon the shoulders of the small prospector, who had, perhaps, prospected for oil for 5 or 6 or 8 or 10 years before he made his strike. He therefore had no income during those years during which he made no strikes against which he could offset the losses that he had suffered during those years, and when he did make a strike, 80 per cent of what he got out of it would go to the Government in the shape of taxes.

It is manifest that this oil-discovery provision was inserted in the statute to meet a situation existing in 1918, namely, we were at war, the country was not producing what it was consuming, and the representation was made that it was necessary to take care of the little fellow, the little prospector and wildcatter, in order that the prospecting and wildcatting might go on, that new wells be brought in and our oil supply kept up or increased.

The CHAIRMAN. Could you read into the record at this point the statute which resulted from those hearings to which you have just made reference?

Mr. MANSON. Yes; that will be read into the record at a little later time.

I call the committee's attention to the fact that that situation is entirely changed. We will supply the committee with data showing that instead of the country now producing less oil than it is consuming, the fact of the matter is that the trouble is just the other way. The country is producing more than it can consume; so that, instead of there being an emergency requiring the stimulation of wildcatting, the very necessity of conserving our resources at a time we are producing more than we require has exactly the opposite effect.

Senator KING. Mr. Manson, as a matter of fact, though, the necessity for stimulation was a little exaggerated. I had something to do with that and helped to draw the statute, together with Senator Gore and one or two others, and I am very familiar with the causes which were alleged as justification for the statute. I thought we went a little too far on the subject. I believed, as many Senators did, that the demand during the war would be so imperative, and the price, of course, would go up accordingly, that we did not need any stimulation. It was just like it was with many of the rare metals. There was a terememdous impetus in production, and there would have been here, because the natural increase in price would have stimulated wildcatting.

Mr. MANSON. I have a table here, which I will offer at this point as Exhibit No. 1. This table shows the percentage of discovery value which has gone to the wildcatter and the percentage of discovery value which has gone to others than wildcatters; in other words, which has gone to people who have discovered no new oil deposits. This table also shows the percentage of discovery value which has gone to small operators, and the percentage which has gone to large operators as distinguished from the small ones. This table does not attempt to cover all of the discovery values which have been allowed for depletion purposes. In the first place, 75 cases were examined at random by the oil section. Then, an additional 25 cases were examined.

Senator KING. You say they were examined by the oil section. Do you mean the oil section of your staff?

Mr. MANSON. No: this was information gotten out by the employees of the Income Tax Unit.

The CHAIRMAN. By the oil section of that unit?

Mr. MANSON. Yes, sir; by the oil section of that unit. Then 25 additional cases were examined.

The CHAIRMAN. By the same unit?

Mr. MANSON. By the same section of that unit. Then 100 additional cases were examined.

The results of those three sets of cases are set up here separately, as well as the general results, and they show that as to the total 37.5 per cent of the discovery value allowed has gone to the wildcatter and that 62.5 per cent of the discovery value allowed has gone to others than wildcatters.

Senator KING. To such companies as the Mid-Continent?

Mr. MANSON. Yes.

Senator KING. And the Gulf Refinery and other companies?

Mr. MANSON. That 36.3 per cent of the discovery value of oil allowed has gone to small operators and 63.7 per cent has gone to large operators.

Mr. Fay will discuss the reasons for that result, but I wish to point out the fact at this time, and to emphasize the fact, that but a small percentage of the relief afforded by the statute in the shape of taxes has gone to the fellow for whose benefit the statute was originally enacted into law.

Senator KING. Mr. Manson, if it is not taking you out of the chronological order of your discussion, has the statute been, in your opinion, properly interpreted, or has there been such interpretation

placed upon it as that greater advantages have been derived by the oil producer, whether the little fellow or the big fellow, than ought to have been granted to him?

Mr. MANSON. I will answer that question. It is right in the proper point in my discussion of this subject.

Senator KING. Because, may I say, if the department has properly interpreted it and has properly applied it, even though it has given inordinate profits to the big man or to the little man, there would be no use of our going into it very much, except for the purpose of framing recommendations, if we felt so disposed, to Congress to amend the statute. If we could not find any fault with the administration of it, I would not want to waste any time on it, so far as I am concerned.

Mr. MANSON. No; but what I want to do is to call attention at the outset to the fact that about two-thirds of all the loss in taxes to the Government has been suffered, to the advantage of someone who was never contemplated by the statute at the time it was written into the law.

The CHAIRMAN. We understand that, but that is not the bureau's fault, is it?

Mr. MANSON. I am now coming to that phase of the matter.

In interpreting this statute which applies to discoveries, the bureau determined that an area amounting to 160 acres, with a well in the center, became proven by a commercial well. The result of that interpretation is that a field discovered by a wildcatter may be blanketed with discovery values of operators who never discovered anything, and the result is what I have just called the committee's attention to. As to how that is brought about, and as to just what the details of that situation are, they will be brought out fully by Mr. Fay, whom I now desire to call as the committee's witness.

Senator KING. I would like to ask you or Mr. Fay, in the discussion, to state whether or not you have found cases of this character, that fields which had been proven absolutely, men have gone and acquired leases or the fee for a nominal amount, say $1,000 or $5,000, and they would bring in a well at a cost of $30,000 to $100,000, and sometimes $125,000, which would be worth all the way from $500,000 to $1,000,000 or $2,000,000, just as soon as it was brought in. They would claim a discovery value, or claim the worth of the property as not what they had paid for it a week or two weeks or a month before, but they would attribute to it a value of a million dollars, or just the value of the well after it was brought in, and would be allowed that in deductions and what not, and would pay no taxes?

Mr. MANSON. There are many such cases. In fact, that is the ordinary case. There are more cases where discovery value is allowed to the person who drills in territory which is known to contain oil than there are to wild-catters. For instance, I have another table here which I desire to submit, showing that out of a total of 13,671 cases of allowances of discovery value, only 35 of them were allowed to those who actually discovered new pools. I offer that as Exhibit No. 2.

(The statements submitted by Mr. Manson are as follows:)

EXHIBIT No. 1

DATA ON DISCOVERY VALUES PREPARED FOR THE SENATE INVESTIGATING COMMITTEE

Summary sheet—Detailed work sheet from which these figures were compiled, are on file in the oil and gas section.

	1	2	3	4
	Discovery value to original wildcatter [1]	Discovery value to others	Discovery value to small operators [2]	Discovery value to large operators
A. 75 cases submitted Apr. 4, 1923 (Midcontinent)	$6,755,000	$27,760,000	$12,420,000	$22,095,000
Per cent	19.6	80.4	36	64
B. 25 additional cases (Midcontinent)	$1,803,540	$7,947,760	$3,466,095	$6,285,210
Per cent	18.7	81.3	56.7	63.3
C. 100 different cases in addition to the 100 shown above (Midcontinent, Texas-Rocky Mountain, Appalachian	$39,559,552	$44,462,849	$30,688,167	$53,333,234
Per cent	47.1	52.9	56.5	63.5
D. Total of A and B	$8,558,540	$35,707,768	$15,836,098	$28,350,210
Per cent	19.3	80.7	35.9	64.1
E. Total of A and C	$46,313,552	$72,225,849	$43,108,167	$75,428,234
Per cent	39.1	60.9	36.4	63.6
F. Total of B and C	$41,362,092	$52,410,617	$34,154,265	$59,616,444
Per cent	44.11	55.9	36.4	63.6
G. Total of A, B, and C	$48,117,092	$80,170,006	$46,574,265	$81,713,444
Per cent	37.5	62.5	36.3	63.7

[1] There is no uniformity in the percentages of value allowed original wildcatter and others. In the Rocky Mountain region (Salt Creek and Cat Creek) the original wildcatter received 5 per cent of the total discovery value. In Texas (West Columbia and Burkburnett), the original wildcatters had protected their acreage by leasing in large blocks, and they received 54.9 per cent of the discovery value. (However, see note 3.)

[2] The very close uniformity in the percentages allowed small operators as compared with large operators, probably reflects consistent practice in the oil and gas valuation section, and also the unvarying operation of economic laws. (See note 3.)

NOTE 3.—The very close approximation of the percentages in columns 1 and 3 (line G) and columns 2 and 4 (line G) probably indicates nothing more than that taking a large number of cases the original wildcatter is generally the small operator.

EXHIBIT No. 2

Tax year	Cases in which discoveries were allowed	Unconsidered cases on hand Dec. 1, 1924	Total	Discoveries in fact same year
1918	2,386	103	2,489	10
1919	3,136	340	3,476	10
1920	2,448	1,108	3,556	7
1921	320	2,015	2,335	5
1922	160	1,655	1,815	3
1923	15			
Total, including 1922	8,450	5,221	13,671	35

NOTE.—In considering these results it should be borne in mind that a large number of discoveries have been allowed which are not shown by the memoranda in the files; that is, cases in which a discovery value is allowed are enumerated above while the number of discoveries allowed in each case is not stated.

STATEMENT OF MR. A. H. FAY, CONSULTING ENGINEER FOR THE COMMITTEE

The CHAIRMAN. Mr. Fay, will you give the reporter your full name and address?

Mr. FAY. A. H. Fay, 6204 Sixteenth Street, Washington, D. C.

Mr. MANSON. Mr. Fay, you are a mining engineer?

Mr. FAY. I am.

Mr. MANSON. From what school did you graduate?

Mr. FAY. Missouri School of Mines and Columbia University.

Mr. MANSON. State briefly your experience since leaving school.

Mr. FAY. I might start by saying that prior to entering college I was in the employ of the Copper Queen Mining Co. at Bisbee, Ariz., in 1897 or 1898, for a couple of years. After getting a little insight into the mining industry, I then left and went to the Missouri School of Mines and took a four-year course, graduating in 1902. After that I went to New York City, and was for a year and a half with Dr. R. W. Raymond, who was then secretary of the American Institute of Mining Engineers, and assisted him in the preparation of technical papers that were presented at the Institute for publication in the transactions. Immediately after that I went to Mexico, to Cananea, and for three years I was employed as mining engineer with the Green Con. Copper Co., engaged in survey work, map work, topographic work and other engineering work connected with the mining business. I resigned there and went to Columbia University and took a post graduate course in geology, and graduated there in 1906.

From there I went to Alaska and spent a year on Cape Prince of Wales, with the Bartells Tin Mining Co. They were prospecting for tin deposits up on the northwest coast of Alaska. From there I came back to New York, and then I spent a year and a half in Tennessee in the barite industry.

From there I went to New York again and was on the staff of the Engineering and Mining Journal for three years as editorial assistant. In that connection, I traveled all over the country, collecting technical data and news of various kinds relating to the mining industry. I handled that work for about three years, and then I was with the Bureau of Mines for about seven or eight years on statistical work connected with the coal and metal mining production figures, labor and accident statistics. In 1920, I resigned from the Bureau of Mines and went to Oklahoma. I spent three or four months in the oil fields of Oklahoma and Texas, on my own account, doing some geological work, here and there.

In June, 1920, I came back to Washington and went to the Bureau of Internal Revenue as valuation engineer in the oil and gas section, in which work I continued for about a year, and then was later head of the division of natural resources for two years.

Mr. MANSON. You have prepared a report to this committee on the question of the discovery value of oil and gas, have you?

Mr. FAY. Oil only.

Mr. MANSON. On the discovery value of oil?

Mr. FAY. Yes.

The CHAIRMAN. Before you go into that, let me ask you whether you left the bureau on your own account?

Mr. FAY. I did not.

The CHAIRMAN. You were asked to resign?

Mr. FAY. I was asked to resign.

The CHAIRMAN. By whom?

Mr. FAY. The commissioner.

Senator KING. Mr. Blair?

Mr. FAY. Mr. Blair.

Mr. MANSON. Will you refer to your report now?

Mr. FAY. What part of the report do you have reference to now, Mr. Manson, that you want me to discuss?

Mr. MANSON. Start at the beginning, and if there are such matters as I do not think—

Senator KING. I do not care to be inquisitive at all, or to elicit any information which would not be relevant, but was there a controversy between you and Mr. Blair over the construction of the revenue laws, or was it some personal disagreement?

Mr. FAY. It was in the administration of the law, so far as I know, the administration of the laws and regulations.

Senator KING. You took one view as to how they should be administered?

Mr. FAY. I did.

Senator KING. And he took another view?

Mr. FAY. He did.

Senator KING. You thought that his administration of the law was improper?

Mr. FAY. I considered that it was, from an engineering point of view, and I could not agree to it.

Senator KING. I see. And that disagreement led to your resignation?

Mr. FAY. Yes, sir.

Senator KING. Or to his asking for your resignation?

Mr. FAY. It did.

Senator KING. Have you any objection to stating just what function of the administration or activity of the bureau you did not agree with him on?

Mr. FAY. I did not agree with him. I might as well mention three cases, as long as you have asked the question.

Senator KING. Yes.

Mr. FAY. I do not know how else to explain it.

Senator KING. If the chairman does not object, I would be glad to have you do it.

Mr. FAY. If that is proper. It dates back probably to a year before I left the department. We had one case. Shall I give you the name of the case——

Senator KING. Give it.

Mr. FAY. The Texas-Pacific Coal & Oil Co. The case was presented by a former employee of the department, to begin with. They paid taxes to the extent of $2,500,000 without a protest, for 1917, 1918, and I think the year 1919. A year and a half or two years later, they filed a claim for a refund for the entire amount, setting up discovery valuations to the tune of $4.50 a barrel for oil which was selling at $2.50 and $2.75. We audited the case according to the oil section's methods of valuation, sent them their assessment letter, and told them that there was $33,000 refund due to them out of $2,500,000. They protested. The case went to the committee. The committee—I can not recall the ruling, but it was to the effect that we were to take the case back again and give very great weight to the taxpayer's method of valuing these oil leases, which, if followed, would have given them approximately the full amount as a refund.

Senator KING. Who comprised the committee?

Mr. FAY. It was the committee on appeals and review. N. T. Johnson was chairman, and I can not give you the names of the other members. I do not recall now who they were.

Senator KING. All right; proceed.

Mr. FAY. The committee's findings were sent to the commissioner's office for review. Mr. C. P. Smith was the commissioner's right-hand man at the time. The case came over his desk for the commissioner's signature. He was out and it went on through and the commissioner signed it. Mr. Smith came back to the office the next morning, and I said over the telephone, "Mr. Smith, that case that you were watching for went through yesterday." He said, "It did?" I said, "Yes." "Well," he says, "I will see what I can do about it."

So he called the commissioner's attention to it. The commissioner later considered it and rescinded and told us to take the claim back and have some more conferences on it. The taxpayer came in once or twice, and finally they refused to sit with us any more. They said they could not get anywhere. That continued along for eight or ten months, and finally they brought out a few little points that the bureau could concede, and we sent them another assessment letter, showing a refund of something between $50,000 and $60,000. The commissioner at that time wrote a letter to them stating that, so far as the department was concerned, the case was closed.

Now, for taking care of that case in that way the Government still has the money.

There was another case that came on in which there was involved more than there was in that one.

Senator KING. One moment. So far as you know, the case ended then?

Mr. FAY. It ended.

Senator KING. And they did not get any further refund?

Mr. FAY. They did not get any further refund. I understand they are going to take it to the Court of Claims.

Mr. HARTSON. Suit has already been started, Mr. Fay.

Mr. FAY. It has?

Mr. HARTSON. Yes. We have been working on it for about a year.

Mr. FAY. I did not know that.

Mr. HARTSON. Suit was started within the last year for a refund of the entire amount which Mr. Fay says the bureau rejected.

Senator KING. In that matter, so far as I can see now, the commissioner acted a little prematurely in passing it over his desk.

Mr. FAY. If you will allow me to tell you what the commissioner told me about that case afterwards——

Senator KING. Well, if he finally adhered to that decision, it seems to me it was all right.

The CHAIRMAN. I understood the witness was leading up to another case.

Mr. FAY. I was leading up to another case.

Senator KING. All right. Pardon me.

Mr. FAY. That established the bureau in a very strong position, the handling of this case, and taking care of it in that way.

Then came the Mexican petroleum case, which came through with an excess valuation of about three to four times the market value of

the stock, and also three to four times its value based on comparatives which were provided for in the statute, under section 210, I think. I was called down for calling the commissioner's attention to that. He said, "You are opening up too many cases." The commissioner did not like it because I called his attention to it.

The CHAIRMAN. Who called you down for drawing the commissioner's attention to it?

Mr. FAY. The deputy commissioner and the commissioner.

Senator KING. Both of them?

Mr. FAY. Yes.

Senator KING. Was that Mr. Smith?

Mr. FAY. No; Mr. Chatterton.

Senator KING. Chatterton?

Mr. FAY. Smith had been transferred to the committee, I think, at that time.

Senator KING. Is he still a member of that committee, Mr. Hartson?

Mr. HARTSON. Mr Smith is now a member of the Board of Tax Appeals.

Mr. FAY. That is the final committee, recently created.

This case of the Mexican petroleum was called to the commissioner's attention, and the deputy commissioner called at my office one day and said, "Your work over here is not very satisfactory—you are paying too much attention to some of these cases," and he named three or four cases.

Senator KING. These two were among the number, were they?

Mr. FAY. Yes.

Senator KING. Mexican petroleum?

Mr. FAY. Mexican petroleum was one of them, and Phelps-Dodge was another one.

The CHAIRMAN. What were the others?

Mr. FAY. He mentioned the Mexican petroleum, Phelps-Dodge, and those were the only two that the deputy commissioner mentioned at that time. Then, after he told me that my work was not satisfactory, that I was opening up too many cases, I said to him, "Mr. Chatterton, I am not opening up any cases. These had never been settled. I am trying to settle them."

The Mexican petroleum case was finally taken out of our division and taken over to the deputy commissioner, and was ordered closed over the deputy commissioner's signature.

Senator KING. Over Mr. Chatterton's signature?

Mr. FAY. Yes.

Senator KING. He took it away from you?

Mr. FAY. Yes, sir; I was then transferred to this committee on appeals and review, and I was sent to St. Paul. You remember that field division that went out there for experiment. I was up there for three months, and when our work was completed there, about the first of July, I was ordered to come back to Washington and report to the commissioner, which I did.

I called at the commissioner's office, and he interviewed me and said I was opening up too many cases, and that I did not earn my salt. He said, "I supported you in the Texas-Pacific case, because

I thought you were right there, and supporting you has gotten me in Dutch."

Senator KING. Did he say how you got him in Dutch?

Mr. FAY. No; he did not say how nor with whom.

That was the stand I had taken in these petroleum cases in favor of Uncle Sam, and I think there were some outside influences that were prevailing upon the commissioner to take care of me.

Senator KING. Do you know what the result was in the Mexican petroleum case or in the Phelps-Dodge case?

Mr. FAY. I do not know.

Senator KING. Have you, Mr. Manson, in your investigation, made any inquiry into those two cases?

Mr. PARKER. We are working on them, but have not arrived at any conclusion.

Senator KING. On both of those cases?

Mr. PARKER. Yes.

Senator KING. All right.

Mr. HARTSON. I think I can answer the Senator's question, of my own knowledge. They have both been opened up and the machinery is now in motion to assess an additional tax against both of them. That is my understanding of it.

Mr. FAY. There was another big petroleum case following right behind the Mexican Pete, and it was better for me to be out of the way than in the way.

Senator KING. What case was that?

Mr. FAY. Sinclair Oil & Gas.

Senator KING. Mr. Manson, have you investigated that Sinclair case?

Mr. MANSON. Yes.

Senator KING. All right.

Mr. MANSON. I think we have just recently received the papers in that case.

You may proceed, Mr. Fay. Begin at the beginning of your report, and if there is anything I do not think necessary I will call your attention to it.

Mr. FAY. In the discussion of the valuation and depletion of oil wells under the law and regulations there are at least three important features which stand out prominently:

1. Discovery clause in law: The application of the discovery clause to unlimited areas; in other words, the blanketing of entire oil fields or pools.

The depletion on discovery in the oil industry amounts to approximately $300,000,000 per year, this amount being a deduction from taxable income. A tax of 12½ per cent on this amount would be $37,500,000 per year. Had the discovery clause been confined to an original discovery well in a new pool, as the law contemplated, the depletion on "discovery" basis would not have exceeded $10,000,000 per year, as compared to $300,000,000 as permitted by the regulations as written. The discovery clause should be modified by definition in the law, so that it can apply to only one well in a new field or be eliminated altogether.

2. Market price of oil: The market price of oil at which valuations are made. By reason of the abrupt fluctuations in the market price, valuations at peak prices for depletion purposes carry excessive depletion units over into periods of low prices, eliminating all possible taxable income. When prices are high drilling operations are extensive and many wells brought in, resulting in many discovery wells and valuations. When prices are low but few wells are drilled,

and as a result not so many discovery valuations are made. There should be some modification or adjustment, possibly by combining the market price with an average over a period of years to obtain a reasonable price of oil at which valuation should be made.

3. Discount rate—hazard factor: The discount rate as applied to reduce operating profit to present worth. Factors used by the department range from 5 to 10 per cent, none of which are sufficiently large to take care of various operating hazards, as pointed out further on in this report. To be in keeping with the hazards encountered, this rate should be increased to at least 25 per cent.

Senator KING. You would not make it a fixed rate?

Mr. FAY. I would not. Some wells are better than others; some of the areas are better than others.

Senator KING. And some of the hazards are inconsequential?

Mr. FAY. Yes, sir; and some of them are 100 per cent.

By reason of factors 2 and 3 above, the depletion unit on oil is high, and the effect of 1 (discovery) spreads this high unit over large quantities of oil, so that discovery depletion represents approximately 27 to 40 per cent of the market price of oil each year, while for the mining industry the total amount of discovery depletion varies from 2 to 14 per cent of the market value of the product of the mines.

Part 1—law. Under the heading "Deductions allowed," 1916 law, March 1, 1923, valuations:

Section 5 (a) (4): *Provided*, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such loss sustained.

Section 5 (a)—Eighth (a): In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided*, That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made.

The 1917 law contains no change from the above, which was the 1916 law.

The 1918 law reads thus:

Section 234 (a) (9): In the case of mines, oil and gas well, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost, including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within 30 days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the commissioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

That last clause did not appear in the earlier laws, as you know. The 1921 law reads:

Section 234 (a) (9)——

Same as for 1918, with the following addition:

And provided further, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913.

The 1924 law contains the provisions of the 1918 and 1921 acts, modified as follows—and this has reference to the total amount of depletion which should be allowed:

Section 204 (10) (b): But such depletion allowance based on discovery value shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property upon which the discovery was made.

Now, with reference to oil wells, the discovery clause and the regulations "prescribed by the commissioner" permit many discovery valuations to be set up on any oil pool, each of which discoveries is only an extension of the original pool tapped by the real discovery well. The regulations provide that a "discovery well" is presumed to prove an area of 160 acres in the form of a square with the well as the center. When Jones makes his original discovery of oil in commercial quantities, and his neighbor Smith is at, or prior to, this date the owner, lessee, or lessor of adjoining land, he may immediately drill an offset well to protect his interests, and at the same time set up a "discovery" value that will greatly reduce his taxes when he has taken no undue risk in drilling. Smith's neighbors controlling land adjoining his at the time Smith brings in his well may also drill offset wells to save their oil, and at the same time extend the "discovery" area and be given a "discovery" valuation for taxation purposes. By a judicious handling of the various wells brought in, it is possible to blanket any pool or oil deposit with "discovery" valuations, to the extent that 90 per cent of a pool covering many square miles may be reported as "discovery" area for depletion deductions. For the entire oil industry this discovery depletion amounts to approximately $300,000,000 per year.

As an illustration of this blanketing process, the accompanying sketch has been prepared, with discovery wells in numerical order as shown.

Jones owns leases in wildcat territory to the extent of 19 quarter sections. Acquired January 1, 1919.

Senator KING. Is that the fee or the lease?

Mr. FAY. The leases.

Senator KING. From private individuals?

Mr. FAY. From farmers; from private individuals; yes.

Jones owns leases in wildcat territory to the extent of 19 quarter sections. Acquired January 1, 1919. His discovery well was brought in July 1, 1920, when mid-continent oil was selling at $3.50 per barrel. The first discovery well is Marked No. 1. The other wells (also discovery) were brought in in their numerical order, as shown on the accompanying sketch. In the meantime many intermediate wells have been drilled, possibly one well for each 10 acres.

The numbered wells show how the entire area may be blanketed with discovery valuations.

Smith acquired his lease in April, 1919, before any drilling was done on the Jones lease. Jones has drilled his No. 8 well, adjoining Smith, upon which a discovery value has been set up on that part which lies within Jones boundary limit. His discovery area overlaps into Smith's lease. Smith drills well C–1 just outside of Jones discovery area, and sets up discovery value on 160 acres. The wells C–2 and C–3 are then drilled, setting up discovery areas as shown.

Adams acquires his lease in November, 1920, about one month before Jones brings in well No. 9. Adams, as soon as No. 9 is brought in, drills well A–1 and sets up a discovery value on the area shown. He then drills well A–2 setting up discovery value on the remaining part of the 160 acres to his boundary line, with an overlap into Brown's lease.

Brown secures his lease only a few days before well A–2 is brought in, having paid a bonus of $50,000. This large payment would indicate that Brown considered this lease in proven territory. He begins drilling well B–1 ten days after A–2 is brought in, setting up a discovery value of perhaps $300,000 for approximately three-fourths of the 160 acres, part of which overlaps on A–2 discovery area. Since Adams can set up discovery to his boundary line only, Brown is entitled to set up his discovery area to the boundary between the leases.

DEPLETION BASED ON DISCOVERY

Depletion based on discovery: Referring to the "discovery clause" in the income tax laws of 1918, 1921, and 1924, the modifying provisions are compared in the following notes, the modifications of the 1918 act being in the 1921 and 1924 acts.

The 1918 act was effective February 24, 1919, and regulations 45 were prescribed for its administration later in the year.

Section 234 (a) (9) (Corporations) and section 214 (a) (10) (Individuals) act of 1918, reads as follows:

> That in the case of mines, oil and gas wells, discovery by the taxpayer, on or after March 1, 1913, * * * depletion allowances shall be based upon the fair market value of the property at the date of discovery, or within 30 days thereafter * * *.

The 1917 and previous acts did not contain any such provision, and it will be noted that the 1918 act makes this provision retroactive to March 1, 1913, covering the high tax years of 1917, 1918, and succeeding years. There was no provision in the law, or regulations, to prevent oil companies from blanketing the entire field with discovery valuations. While this was apparent in the original regulations 45, it was not corrected when regulations 45 (revised) were prescribed and approved by William M. Williams, commissioner, and David F. Houston, Secretary of the Treasury, January 28, 1921.

The act of 1918 placed no limit on the amount of depletion that might be claimed on discovery, so that it was possible to write off all profits as depletion, leaving little or no taxable income.

As an engineer in the bureau, I suggested when regulations 45 (revised) were being drafted, that a discovery well should be defined in such a way that it would be impossible to blanket an entire field.

This could be done by specifying a limit upon its nearness to a commercial well, say 2, 3, or 5 miles. Had this been done, the oil industry would have been placed upon the same basis as the mining industry. Both editions of regulations 45 as well as regulations 62 conform to the ideas of Congress regarding what a discovery should be so far as the mines are concerned, in that a mine can not be discovered in a known extension of an ore body. But with the oil industry, both editions of regulations 45 were too liberally prescribed, and unfortunately the same liberality was continued in regulations 62.

The act of 1921 reads (section 234 (a) (9) (Corporations) and section 214 (a) (10) (Individuals) contain the same provisions as the act of 1919, except):

That such depletion allowance based upon discovery value shall not exceed the net income, computed without allowance for depletion from the property upon which the discovery is made.

Congress, realizing the loop-hole thus established in regulations 45 (act of 1918) revised the law, act of 1921, effective November 23, 1921, limited the amount of depletion on discovery to "not exceeding the net income from the property," but at the same time it failed to correct the real cause of excessive depletion, in that there was no limit placed on the number of discovery wells that could be set up in any "new oil pool or field."

On the basis of the 1921 act, regulations 62 were prepared by the commissioner and approved by the Secretary of the Treasury, February 15, 1922. These regulations limited the amount of depletion in accordance with the act, but again failed to limit the number of discovery valuations that could be set up on a "new oil pool or field."

The act of 1924 contains the same provisions as the 1921 act, except that it provides a limit for depletion of 50 per cent of the net income.

Section 204 (10) (b) (2): But such depletion allowance based on discovery value shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property upon which the discovery was made * * *.

Here, again, no limit is placed on the number of wells that may be set up for discovery purposes. A discovery well should be defined, as a commercial well 3 to 5 miles from any other commercial well. This would prevent blanketing a pool. Unless a limiting definition can be drafted into the law, the discovery clause should be eliminated.

THE PROSPECTOR AND THE DISCOVERY CLAUSE

I now have some notes on the prospector and the discovery clause.

The intent of the law was undoubtedly to offer a bonus or subsidy to the real prospector who discovered oil in a new and unexplored field. It was not intended for operators who must drill offset wells to protect themselves, yet regulations 45, 62, and 65 permit it.

There are two classes of prospectors or pioneers in the oil industry.

Senator KING. Do you mean that offset wells are allowed discovery valuations?

Mr. FAY. Oh, yes; that is, to the extent that they are about a quarter of a mile from any other well. They are just outside of the 160 acre limit, and 160 acres are one half a mile square, so you can place another discovery well within a quarter of a mile.

Senator KING. Offset wells are often drilled without reference to the extent of the area?

Mr. FAY. Yes.

Senator KING. In a territory which is not only proven, but which is a certainty.

Mr. FAY. Well, there is the weakness of the law.

Senator KING. Or the regulations—which?

Mr. FAY. That is hard for me to say, Senator. They are interpreted both ways.

Senator KING. Well, it seems to me that should not be considered a discovery when you know that oil is there and you drive your well down.

Mr. FAY. I would not consider it so.

Senator KING. Not for the purpose of discovery, but for prospecting. Of course, you expect the oil and you take the oil out so that somebody else will not get it.

Mr. FAY. Yes.

Mr. MANSON. Go ahead, Mr. Fay.

Mr. FAY. There are two classes of prospectors or pioneers in the oil industry: (1) The individual or partnership with but small capital, perhaps hardly enough to sink one well. Years of time and some money are spent in search of oil lands that are sufficiently promising to test. A small amount of capital is assembled and a well drilled. In the event that this well is a failure, the prospector is out of the business for an indefinite time. He has no other capital or income against which he can charge his losses and thus secure some advantage in tax reduction. Of course he has no tax to pay—he has no income, and his capital is gone. If his well is a success he can charge off expenses incurred within the taxable year, but nothing in previous years. Under the present laws and regulations he can set up a discovery valuation on 160 acres and obtain a depletion unit sufficiently large to practically exempt him from income tax. Thus the Government, to that extent, subsidizes the real discoveror of a new oil pool. This is as it should be under the law, limiting this discovery to one well only, and to the man who ventured all that he might win.

(2) The second class of explorer is the large corporation, amply financed, so that the loss of a wildcat well is of little consequence. There is both capital and income against which this loss may be charged as well as any other exploration expenses each year as they occur.

Regulations 45 and 62, article 223, state that:

(*a*) Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling wells, building pipe lines, and the development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account, etc.

(*b*) The cost of drilling nonproductive wells may at the option of the operator, be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells.

An election once made under these options will control the taxpayer's returns for all subsequent years.

It will be noted that this loss may be charged off under either (*a*) or (*b*), and unless there is a very close analysis of accounts, especially "labor and supplies," it is possible to charge the entire amount off under (*a*) and at the same time charge off a lump sum per each dry well under (*b*). Whether oil is discovered or not, it is not a complete loss since under the regulations this is a proper deduction for tax purposes, and taxes therefore reduced. As a matter of fact, it would work to the corporation's advantage to spend a large part of its anticipated taxable income in development and exploration. If the anticipated profits are such that the income tax is to be $2,000,000, the operator can and in many cases did spend profits in an extensive drilling program to the extent that no taxable profit accrued. In this way, the Government would actually finance much of this exploration work, and at the same time give a discovery valuation to further reduce taxes. The small operator can not avail himself of this technicality by reason of lack of capital.

PROVEN OIL LAND

Discovery on proven (highly probable) oil lands is also permissible.

The regulations define a proven area as the 160 acres surrounding the discovery well as the center.

In the discussion of proved oil land by Beal, page 82, Bulletin 177, Bureau of Mines, he states that:

> Proved oil land includes those areas in which drilling involves practically no risk. Just what constitutes proved oil land depends, it is true, upon local conditions. All of some quarter sections on which only one well has been drilled may be called proved oil lands, even though it may not be surrounded by wells. Other tracts on the contrary, before they could be considered proved, would require many tests.

The following definition (modified from California State Mining Bureau) is given by Beal:

> Proved oil land is that which has been shown by finished wells, supplemented by geologic data to be such that other wells drilled thereon are practically certain to be commercial producers.

Senator KING. Under that definition—and I think it is a very fair one—a proved field might have an area of 4 or 5 or 8 or 10 square miles?

Mr. FAY. Certainly.

Senator KING. Take the Santa Fe Fields in California.

Mr. FAY. Certainly.

Senator KING. You are just as certain to get oil in all of that field as you are up around Bakersfield. In many of those fields it is so certain that it is simply a question of drilling, because you know you are going to get it, and in some sections there the area is very extensive; so I was wondering why so much emphasis is placed upon 160 acres.

The CHAIRMAN. That 160 acres was the limit set up by the Bureau itself, was it?

Mr. FAY. Set up by the Bureau's committee that was appointed to draft the regulations.

Senator KING. That seems to me to be most absurd, and I would like some explanation before we get through of why they selected that subdivision.

Mr. MANSON. Go ahead, Mr. Fay.

Mr. FAY. The above definition (by Beal) would seem to be as nearly correct as it is possible to give. The income tax regulations 45, 62, and 65 define a proven area as a 160-acre square surrounding a producing well, the well being at the center of the square with the boundary lines of the square running North, East, South, and West, or in accordance with the public land surveys. The Regulations also recognize other areas as proven, as follows:

Regulations 45 and 62, article 220, (a) 2:

* * * And even though a well is brought in on a tract or lease not included in a proven area as heretofore defined, nevertheless it may not entitle the owner of the tract or lease in which such well is located to revaluation for depletion purposes, if such tract or lease lies within a compact area which is immediately surrounded by proven land, and the geologic structural conditions on or under the land so inclosed may reasonably warrant the belief that the oil or gas of the proven area extends thereunder, unless the tract or lease had been acquired before it became so proven. Under such circumstances the entire area is to be regarded as proven land.

The "unless" inserted there nullifies the provisions above.

Senator KING. The Supreme Court has held repeatedly that you may indulge in geologic inferences, not only with respect to lode-mining territory but coal lands, and that geologic inference may comprise within its operations an area of coal lands of hundreds of square miles. I do not mean to say that it is so and that broad interpretation should be applied to oil lands, but I am interested to ascertain the reasons for selecting such a narrow field as 160 acres for the operation of that rule.

The CHAIRMAN. Does the witness know when those regulations were drawn up?

Mr. FAY. I have stated that. I will give it to you in a minute.

The CHAIRMAN. Well, that is not important. Do you know who drew them up?

Mr. FAY. I can not give you the names of the individuals. They were drawn up, I believe, in the solicitor's office. Do you know, Mr. Hartson?

Mr. HARTSON. I can not answer definitely, Mr. Fay, but I rather think that is correct. I think that was done in 1920. It seems to me it was done in either 1919 or 1920.

Mr. GREGG. It was done in October of 1920.

Mr. HARTSON. It was done in October of 1920?

Mr. GREGG. Yes.

Mr. HARTSON. Maybe Mr. Gregg can throw some light on that. He was in the bureau at that time, and, of course, I was not.

Mr. GREGG. The people who worked on it principally were Mr. George Davis, who was in the solicitor's office; Mr. Wayne Johnson, who, as I remember it, was then solicitor. They worked in conjunction with the representatives of the natural resources division of the bureau, in direct connection with the assistant commissioner and the commissioner. Mr. Callan, as I remember it, was assistant commissioner then, and Mr. Roper was commissioner. They worked in direct touch with it.

Mr. FAY. May I ask this question: Were there not some hearings on the proposed regulations at which representatives of the petroleum industry and the mining industry were present, prior to that?

Mr. GREGG. As I remember it, there were.

Mr. FAY. I am certain that there were.

Senator KING. Yes; I remember going down myself to attend some of those hearings.

Mr. GREGG. Mr. Chairman, do you contemplate the witness finishing up this discussion at this point?

Mr. HARTSON. Yes; I think he ought to finish, rather than to hear at this time any explanation by the bureau as to the adopting of the 160-acre area.

The CHAIRMAN. Yes; you may proceed, Mr. Fay.

Mr. MANSON. You had finished that quotation, Mr. Fay.

Mr. FAY. Yes.

The regulations recognize that a proven area may exist outside of the 160-acre square, but still permit a discovery valuation to be set up thereon if the lease was acquired prior to the time these conditions became known, although the expense of drilling may be withheld until it becomes necessary to drill offset wells for self-protection.

DISCOVERY NOT CONFINED TO ONE SAND

Discovery valuation is not confined to one sand. The acquisition of oil lands by lease, purchase, or gift guarantees the explorations and exploitation of any or all the tract to any depth attainable by any physical equipment. In many places there are two or more distinct and disconnected oil sands, each capable of producing oil in commercial quantities. It is possible to set up as many discovery values on the same 160 acres as there are producing oil sands. A discovery value is set up on the first big well, which is the first or shallow sand. The same well is sunk another 500 or 1,000 feet, and a second oil sand encountered. The regulations permit (by not prohibiting) a second discovery valuation. This may be repeated three or four times, thus giving the operator an opportunity to set up large values on each sand for depletion purposes, although the second and succeeding sands are within a proven area—160 acres surrounding the discovery well. The oil will be brought to the surface through the same drill hole and it will be an easy matter to credit the oil to the sand that has established the largest depletion unit, the discovery value being based on market price of oil at date of discovery or within 30 days thereafter.

Senator KING. Do you know of any allowances for discovery for penetrating the sands below the first sand?

Mr. FAY. I do not recall a specific case, but I know that there are cases. I can not recall any specific case, but I know it has been done.

Mr. MANSON. We will present a case of an 18-acre lease upon which two discovery values have been allowed.

Senator KING. I know, of course, there are many of those cases where the second and third sands have been penetrated, and perhaps each succeeding sand has given greater returns than the first sand.

The CHAIRMAN. Go ahead with your statement, Mr. Fay.

Mr. MANSON. Begin on page 5, Mr. Fay.

Mr. FAY. Thus $1.50 oil would give possibly a depletion unit of $0.97 for sand No. 1, while $3 oil would give a depletion unit of $1.76 for sand No. 2. The logical effect would be to charge all the production from sand No. 1 to sand No. 2 for purposes of tax reduction.

VALUATION FOR DEPLETION

Valuation for depletion: Depletion is the loss sustained through the progressive removal of natural resources, as mineral deposits.

It is not to be applied to offset profits, except to the extent that it is used to extinguish the capital sum representing the cost or market value of natural resources, as the 1916 law states, "not to exceed the market value in the mine."

Profits per unit of product can be estimated with a fair degree of accuracy in any industry by one familiar with the history, production costs, and past records. The basis of value for any property is its "income-producing ability" over a period of years. This being known or estimated, the buyer determines the rate of profit and return of capital with which he will be satisfied, and upon this decision determines what price he will pay for the mine or well.

For taxation purposes it is necessary to determine cost or value of ore, oil, or timber in place on an equitable basis, independent of what use is made of the commodity through manufacturing processes and independent of any personal element, good will, trade connections, etc. These are all reflected in any method using discounted profits as a basis. The question then is, What is ore or oil worth in the ground? They have a potential if not actual or market value. The value of a barrel of crude oil may be increased many times if this value is determined by reflecting the profits from its varied by-products, viz, kerosene, gasoline, paraffin, candles, dyes, medicated compounds, perfumes, etc.

The value of a ton of iron ore should not be predicated on the retail or wholesale price of needles and the profits arising therefrom. Nor should it be based on the price of steel rails. Rails may sell at $30 to $40 a ton, while 1 ton of needles or watch springs may be worth $10,000 to $50,000. Any increase in the value of ore or oil after they leave the ground is due to the various manufacturing processes through which they pass, advertising, selling agencies, etc. The profits arising from these latter processes are independent of the material in the ground.

The blast-furnace man not having ore of his own can go into the open market and by ore at $4 to $6 per ton, perhaps even cheaper than he can mine it from his own mine. The manufactured product from the purchased ore yields as much profit as though the ore came from his own mine. He would not expect to charge off depletion on the purchased ore. This charge would come under the head of cost of material and would be limited to cost or market price of ore. In the case of ore from his mine the cost of ore would be charged to mining costs, transportation, and original cost of ore deposit. However, if the present worth of the actual profits on the manufactured article are used as a basis for depletion of ore reserves, it may amount to many times the cost of the ore. Iron-ore royalties are about $1 per ton, thus fixing a basis for value in the mine. The discounted earnings may give $2 or even $5 per ton.

ANALYTICAL APPRAISALS

Analytical appraisal of oil lands: In the valuation of oil lands by the analytical appraisal method there are so many variables that a correct vluation is indeed difficult to obtain. Among the items to be considered are:

1. Quantity of oil in the ground (recoverable reserves): This is subject to varying conditions, as thickness of sand; porosity of sand; gas pressure; grade of oil, as light or heavy; chemical salts in the oil and water, etc., and due consideration should be given to the following:

(A) Number of wells: Many wells exhaust a property at an early date, but at a high development cost. Few wells usually prolong life, give slower returns with less development cost. The drilling program is, therefore, important.

(B) Discount for dry holes: This varies with locality and geologic conditions from 10 to 100 per cent. See Oil and Gas Manual (revised edition), pages 207–214, for actual percentages in various counties, based on United States Geological Survey data. This factor should be applied in connection with the estimation of reserves.

(C) Discount for offset wells on adjoining property: Often a very important factor by reason of drainage from property if drilling program does not keep pace with that on the adjacent properties. Applies more particularly to the small operator who can not finance a drilling program rather than the large operator who is able to protect his property by drilling offset wells.

(D) Reduction in flow:

(*a*) Reduction in flow of individual wells by reason of decreasing gas pressure and the clogging of interstices in oil sand adjacent to the drill hole with precipitated salts, tar, paraffin, sulphur, etc. By reason of this, an oil well is "shot" by exploding nitroglycerin in the oil sand. This shatters rock and temporarily increases the flow.

(*b*) The initial flow of succeeding wells is often not as great as that of the first well on account of reduced gas pressure in the pool due to the escape of gas through the first hole.

(*c*) Replacement of oil by salt water: In some fields this hazard may apply to 50 per cent of the producing wells.

2. Price of oil: Varies with supply and demand, grade of oil, location of wells as regards market, and market manipulation by large groups. The expected future price of oil should be given consideration in arriving at the market value of an oil property.

3. Cost of development: Varies with depth, location as regards transportation of supplies, character of rock through which drilling must be done, pipe-line construction, and number of wells. In arriving at the fair market value, allowance should be made for the cost of the maximum number of wells necessary to recover total reserves.

4. Cost of lifting or pumping: Varies with gas pressure, depth, and locality. Lessee to bear expense of pumping and storing lessor's share, i. e., royalty oil.

5. Economic life: The economic life of a well varies in different fields and depends upon gas pressure, porosity of sands, chemical

constituents of oil, rate of drilling, etc. It is fairly well established for each important producing field.

6. Operating hazards and expenses: Fire; wind; lightning; accident insurance for employees; tax; losses and leakage in pumping, piping, and storing of oil at or near wells; all to be considered in arriving at market value. These in addition to lifting costs.

7. Discount to present worth: The net income anticipated after considering the above factors should be discounted over the life of the property to determine its present worth, i. e., its real present market value. Such a factor should be used that will return a reasonable profit to the investor as well as the return of his capital. In oil-well speculation this capital should be returned in three to five years. The discount factor should give a value such that a willing buyer and a willing seller can agree upon, as a basis of transfer of property, when millions of dollars are involved.

If the factors 1 to 6, above, can be determined with a fair degree of accuracy, a lower discount rate may be used under this head. If they can not be determined, the discount rate should be increased. The final rate should be such that the investor can expect with a reasonable degree of assurance not less than 25 per cent profit on his investment. The coal and metal mining industries consider rates from 10 to 50 per cent, depending upon conditions.

Analytical appraisals: An analytical appraisal is of value in that it may be used for comparing one property with another of similar character; that it shows what a prospective purchaser may expect in the matter of costs under certain assumed conditions; what the possible profits may be; but its greatest value is to show the value of a going concern to the individual or corporation owning and operating it.

Any analytical appraisal based on operating profit over a period of years must of necessity include the influence of good or bad management, good will, established trade connections, processes of manufacture, advertising and selling agencies, personality of the management, etc. These and perhaps other varying factors may entirely disappear or change for the better or worse upon change of ownership, so that an analytical appraisal does not necessarily arrive at the true or market value as contemplated by the acts of 1917, 1918, 1921, and 1924. The *analytical appraisal gives the starting point* at which negotiations between a willing seller and a willing buyer begin, not the price at which the deal is made.

Value of undeveloped minerals: Vague ideas are often entertained regarding the value of a mine or oil well. It has been asserted that a mine or well is worth whatever it contains, that its full value is attained as soon as ore or oil is discovered, that this value is capital and that the extraction of the mineral values is like drawing money from a savings bank. Such ideas are ridiculously absurd. Of what value to you is a ton of gold on the moon, although it may be possible to discover it by means of a powerful telescope? Is that gold wealth?

J. R. Finlay, in his recent report on the valuation of mines for the State of New Mexico, says, "I find no warrant for putting a value upon the undeveloped coal of the State. Practically the entire value is in the plants in the case of the coal industry."

Nothing is valuable except to the extent that it has been brought by human efforts to that stage or station whereby it may be of benefit to mankind. Natural resources are practically worthless until an industry is started upon them. Ore or oil in the ground is no more capital than gold on the moon, and has little or no economic value until it is developed, taken out, and utilized. It is true the discovery of ore or oil often presents such favorable potential and speculative values through the possibilities of its utilization that its purchase and development is the proper object for the expenditure of capital; this expenditure absorbs capital instead of yielding it. The extraction of the minerals in excess of the amount expended may yield new capital in the form of profits. These profits, however, do not become capital unless reinvested.

At best the theory and method of the appraisal of mining or oil property involves many variables and the determination of the present worth of expected profits from potential values. A vague and indefinite basis from which to start! After estimating the probable quantity of ore or oil developed and prospective, forecasting the future production costs, and averaging fluctuating prices, as well as giving due consideration to the rate of mining or the life of the mine or well as possibly affected by market and other conditions, the ad valorem appraisal should be discounted liberally by applying a factor of safety as evidence of good faith, so that a prospective purchaser will at least have a fair chance to make a reasonable profit on what is at best a hazardous venture.

Annual dividend rate: The following table is taken from Hoover's Principles of Mining and shows annual rates of dividend that should be received to repay an investment in mining property and yield interest (5 to 10 per cent) profit during the life of the property. This table is based on the assumption that the annual receipts are based on a uniform tonnage per year.

TABLE I.

Number of years of life to yield — per cent interest, and in addition to furnish annual installment which, if reinvested at 4 per cent, will return original at the end of the period

Annual rate of dividend	Years					
	5 per cent	6 per cent	7 per cent	8 per cent	9 per cent	10 per cent
10 per cent	15.0	17.7	21.6	28.0	41.0	.....
15 per cent	8.6	9.4	10.3	11.5	13.0	15.0
20 per cent	6.0	6.4	6.8	7.3	7.9	8.6
25 per cent	4.7	4.9	5.1	5.4	5.7	6.0
30 per cent	3.8	3.9	4.1	4.3	4.5	4.7

To illustrate the use of this table, a mine has a life of six years and 10 per cent profit on the investment is desired. What should be the annual dividend? Find six years under column 10 per cent; in column 1 will then be found 25 per cent which is the annual dividend that must be paid, to return capital within six years and yield 10 per cent profit above the 4 per cent sinking fund.

This is not strictly applicable to the oil industry inasmuch as the production of any well decreases from year to year. Approximately

60 per cent will be recovered the first year, 15 per cent the second year, 8 per cent the third year, etc. However, the production from a large lease may be fairly constant as new wells are continually being brought in for perhaps two to four years. After the drilling program has been completed, there may remain 30 per cent of the ulti mate reserves to be recovered during a period of 5 to 15 years, the annual production steadily declining.

The table, however, does show the importance of large annual dividends in order that the investor may make a fair return on his investment. Since (as Beal shows, Bulletin 177, U. S. Bureau of Mines) oil wells should pay out in three to five years, the annual dividend rate to pay only 10 per cent should be in excess of 30 per cent. Compare this with the returns shown in table 7, wherein the total profit ranges from 9.49 to 44.98 per cent over a period of years in place of a like profit annually.

TABLE 1

Discount factors in the mining industry

	Per cent per annum
Hoskold, coal mines	14 to 20
J. R. Finlay, metal mines	10 to 50
Floyd Davis,[1] metal mines	20 to 30
J. H. Curle, gold mines	15+
J. H. Kendall,[1] ore blocked out	12 to 25
Robert S. Lewis:	
With large ore reserves known	12 to 15
Mine in foreign country	15 to 50
C. K. Leith, metal mines, depending upon reserves	6 to 20
W. B. Middleton:	
Under best possible conditions	7+
Other conditions	7 to 50
C. W. Purrington,[1] gold mines	10 to 20
R. A. S. Redmayne, unopened mines	15 to 20
T. A. Rickard, good reserves and good management	5 to 20
Average of the above	12 to 30

In the mining industry it is possible to determine ore or coal reserves (in most cases) with a fair degree of accuracy by actual measurements. Not so with oil. The mines produce a fairly uniform tonnage per year over life of property; oil returns 60 per cent the first year, with decreasing returns each year. The fact that the greater percentage of oil is recovered during the early life of the well is the only argument in favor of a low rate of discount.

The following are quotations from "Hearings on revenue act of 1918 before the Ways and Means Committee of the House of Representatives."

Memorandum by Manhattan Oil Co., page 525:

> It will be observed that these factors require the oil operator to face a much greater financial hazard than even the miner who is generally regarded as taking many chances of success or failure.

Vice president, Oil & Gas Producers' Association of West Virginia, page 484:

> Twenty per cent normal.
> Certainly a business so hazardous and irregular should be allowed an earning of at least 20 per cent.

[1] These rates are in addition to the legal interest rate.

Mid-Continent Oil & Gas Association and Texas and Gulf Oil & Gas Association, page 475:

We suggest that a reasonable deduction for earnings would be from 15 to 20 per cent in this business, and that such a deduction would not more than equalize the difference in hazard and risk between this and other business enterprises.

Mr. John J. Shea, attorney, Tulsa, Okla., representing Mid-Continent Oil & Gas Association, questioned by the House committee, page 439:

Mr. STERLING. Would you consider 8 per cent as a fair estimate of the earning power?

Mr. SHEA. Not in the oil business.

Mr. STERLING. Then how much?

Mr. SHEA. At least 15 per cent.

Mr. STERLING. Eight per cent is accounted a pretty fair income on capital, is it not?

Mr. SHEA. Not in the oil business. You could not get money into the oil business for that.

Discount rates and hazard factors in the mining industry:

H. D. HOSKOLD. It is customary, therefore, to allow a greater per cent upon the purchase of a colliery property, say 14 to 20 per cent per annum, depending upon the amount of risk estimated to be encountered with the redemption of the capital at some other practicable rate. (From Notes upon the Redemption of Capital Invested in Collieries. Trans. Fed. Inst. of Min. Engineers, volume 3, page 735; England, 1892. Author of Hoskold's formula, in "Engineers Valuing Assistant"; London, 1877.)

Hoskold is an English engineer, author and mining man. Many years ago he prepared a book on mine valuations, and prepared certain discount tables.

J. R. Finlay: The value of a mine must be traced to a commercial transaction and has to be figured from the amount that can be marketed, the cost of production and the time required to complete the operation. Management is often the sole factor in determining percentage of profit. The risk rate varies from 10 to 50 per cent. (From Costs of Mining, by Finlay, p. 44. Mr. Finlay made appraisal of iron mines for State of Michigan and coal mines for State of New Mexico.)

Floyd Davis: In metal mines where the prospects for probable and possible ore are good, a 20 per cent risk will often be sufficient, this being in addition to the legal rate of interest. Ordinarily, a mining risk should be above 30 per cent. (From The Mine Investor's Guide, by Floyd Davis, Western Correspondence School of Mining Engineers, Des Moines, Iowa, 1900.)

J. C. Dick: In any appraisal method, the closer the fair market value approaches the intrinsic value, the more accurate the appraisal. (From Methods and Problems of Federal Taxation of the Mining Industry, Proc. 23d Ann. Conv., Am. Min. Cong., Denver, Colo., 1920. Mr. Dick is a consulting mining engineer and formerly head of natural resources division, Income Tax Unit, Bureau Internal Revenue.)

J. H. Curle: Profit in sight must represent distinctly more than 50 per cent of the mine's market value. The shares must yield at least a clear 10 per cent. For a developed and operating gold mine, the net profit in sight in the ore reserves must be equal to 66 per cent of the market valuation, the yield on the investment must be 15 per cent, including the return of capital. (From Some Gold Mine Investments, Eng. and Min. Jour., vol. 75, p. 711. Mr. Curle is author of the Gold Mines of the World, a book much consulted on stock exchanges.)

J. D. Kendall: There remains to be noticed the interest to be allowed to a purchaser, and the amount to be set aside for redemption. Even for ore blocked out, the rate should never be less than 12 per cent, and might have to be made 25 per cent or more, depending on the mining and commercial risks. A rate of interest to a purchaser that is commensurate with the greater

risk must be allowed. (From The Valuation of Mines, Trans. Canadian Min. Inst., vol. 17, p. 142, 1914.)

Robert S. Lewis: At best a mining investment has a large element of risk attached to it, and therefore the rates should be proportionately great. Having a proved mine that is well managed and has large ore reserves, the rate may be comparatively low, say 8 to 10 per cent. Since this is not all income, as part must be used to replace the investment, 12 to 15 per cent would compare favorably with say 7 to 10 per cent in manufacturing or other industrial enterprises. For a mine in a foreign country, the rate should be much higher, as high as 50 per cent has been asked on investments or mines in foreign countries where the mines were not fully developed, though they were of great promise. (From Some Principles of Finance, Min. & Sci. Press, vol. 121, p. 457, 1920.)

C. K. Leith: In actual practice, interest rates used in making valuations vary from 6 to 20 per cent. (From Economic Aspects of Geology, p. 331, by C. K. Leith. Mr. Leith collaborated with Finlay in valuing Michigan iron mines.)

C. W. Purrington: It is generally and fully considered that a gold mine must pay from 10 to 20 per cent per annum on the investment, besides redeeming the whole capital required, the difference in the amount of interest depending on the situation and life of the mine considered; but to assume that anything above ordinary bank interest can be obtained on that proportion of the annual returns which is set aside to redeem capital is undoubtedly wrong. (From Valuation of Mining Shares, Min. & Sci. Press., vol. 96, p. 771, 1908. The late Mr. Purrington had made a specialty of placer mining for about 20 years in Alaska, California, and Russia.)

R. A. S. Redmayne: It is not uncommon practice in the case of unopened mines, to allow in deducing the value deferred, from 15 to 20 per cent in the place of about 8 per cent, as in the case of properties already being worked, but there must of necessity be a considerable variation in the value of undeveloped property. (From The Ownership and Valuation of Mineral Property, by Redmayne and Stone, London, 1920. Mr. Redmayne was for many years connected with the mines department of Great Britain.)

T. A. Rickard: A mine may be said to be worth a certain sum when it can return that sum as profit from operations covering a term of years, plus the interest on the investment during the period consumed in the return of the stated price. It is hard to purchase mines at a fair valuation. If a mine is worth a certain sum, as near as fact can be determined by skilled and trained specialists, one group, chiefly the mine operators, will pay only that much for a mine, another group will pay more, according to the popularity of the locality and the attractiveness of the mine in the expectation of selling or promoting the property at a profit, and the third group of innocents will be deluded into parting with a price which, humanly speaking, promises a loss with deadly certainty. (From The Valuation of Mines, an editorial by Rickard in Eng. & Min. Journal, Jan. 31, 1903.)

T. A. Rickard: Mines are very rarely bought merely for the ore proved up by complete evidence; the attractive feature is as a risk, a speculative enhancement of value likely to arise from further discovery. (From The Sampling and Estimation of Ore in a Mine, 1907.)

T. A. Rickard: The investor who expects to cut out all risk in mining is like a man who wants to learn to swim without getting wet. Risk is the essence of mining, as it is of any business that yields high returns. All you should expect is a reasonable security for your money. To be a sound venture, a mine during its life must return the price paid for it, plus interest, the rate of which depends upon the risk, from 5 to 20 per cent. (From The Valuation of Mines, Min. & Sci. Press, May, 1913, p. 770. Mr. Rickard was for many years editor of Mining Magazine, London; Engineering and Mining Journal, New York; and Mining and Scientific Press, San Francisco, Calif. Also a consulting engineer of note.)

F. W. Sperr: Hoskold's method of mine valuation was undoubtedly old among mining financiers long before it found its way into literature, and I have never known any fault to be found with it as a fundamental proposition; but as to details of its application, there are sometimes greatly diversed opinions. Smock used the method in New Jersey many years ago. Finlay used it in Michigan more recently, and it is still being used in Michigan for there is nothing else to be used. You can not get away from it any more than you can get away from the method in use for finding

the value of a perpetual annuity, but there should be uniformity in the application of the details to each class of property. (From Federal Taxation of Mines, Trans. Am. Inst. Min. Engrs., Bull. 155. Mr. Sperr is professor of mining engineering, Michigan College of Mines.)

Wm. Young Westervelt: There should be assured mineral reserves, at least sufficient to produce profits that will more than return the capital required to put the property into successful operation. The cost of securing capital under favorable conditions often does not exceed 10 per cent and may not be more than 5 per cent. In the absence of assured mineral reserves, the whole question of value is one of inference, and amortization tables have little application. (From Mine examinations, valuations, and reports, p. 1515. Peele's Mining Engineer's Handbook. Mr. Westervelt is a consulting engineer in New York.)

Pope Yeatman: On account of risk inherent in mining, the dividend rate should be higher than the usual for railway or high class utilities and industries. (From Risks and security in mining investments, Eng. & Min. Journal, Vol. 112, p. 837. Mr. Yeatman directed the development of the Chile Copper Co., and has been connected with other large mining companies.)

Mr. Yeatman uses an 8 and 5 per cent valuation factor (Hoskold formula) in reducing operating profit to present value, in order to show the relative values of the mine with plants varying in capacity from 10,000 to 50,000 tons per day. This computation could refer only to Utah Copper Co. or Chile Copper Co., as no other mining company in existence has either ore reserves or prospective plant capacity in any way approaching those used in Yeatman's example.

George J. Young: The rate of interest on mortgages ranges from 6 to 8 per cent and the security given is from 50 to 100 per cent greater than the sum loaned. Mining investments are assumed to involve a greater risk, and as a consequence, a higher rate of return is expected. (From Elements of Mining, 1916, by G. J. Young. Mr. Young is western correspondent for Engineering & Mining Journal-Press, New York.)

Mr. MANSON. That concludes the portion of this report that I desire Mr. Fay to read into the record. I desire to offer the balance of the report, beginning with page 21, as an exhibit to Mr. Fay's testimony.

The CHAIRMAN. How many pages are there?

Mr. MANSON. All told, there are about 40 pages.

Mr. FAY. There are about 40 pages all together. There are 20 additional pages.

The CHAIRMAN. I would like to ask the representatives of the bureau if they wish to have that done, or whether they want to cross-examine the witness?

Mr. MANSON. I will furnish the representatives of the bureau with a copy of this.

Mr. HARTSON. I think it should go in as Mr. Manson suggests, and then, if possible, we could question Mr. Fay at the next session, if that is satisfactory.

(The balance of Mr. Fay's report, as submitted by Mr. Manson, is as follows:)

VALUATION OF HYPOTHETICAL LEASE

In order to bring out some of the important features of the law and regulations to show its working, abuses, inequalities, and inconsistencies, the following typical example of an oil lease is studied from various angles for purpose of discussion.

Assume the following:
Lease to contain 160 acres.
Life of property 19 years.
Area to be drained by each well, 8 acres.
Depth, 2,500 feet.
Cost of drilling, $20,000 per well.
Price of oil per barrel at date of discovery, $3.06.
Factor representing possible dry holes, 20 per cent.

The estimated wells to yield as follows:

	Barrels
1 "discovery well"	100,000
3 wells, at 100,000	300,000
4 wells, at 75,000	300,000
4 wells, at 50,000	200,000
4 wells, at 25,000	100,000
4 wells dry	
Total yield, first year	1,000,000
Ultimate yield	1,547,290
Lessor's interest, one-eighth	193,410
Lessee's interest	1,354,880

This gives total estimated reserves of 1,547,290 barrels, which is only 50 per cent of what 20 wells of the magnitude of the discovery well would yield.

Cost of lease, $10,000.

Cost of drilling 20 wells, $400,000.

Lifting cost per barrel, 50 cents.

Lifting costs of the lessor's share prorated to the lessees production, 10 cents per barrel,

Other costs, wastes, shrinkage, tax, and miscellaneous, 30 cents.

Total costs per barrel, 90 cents.

TABLE 2

Estimated reserves

Year	Per cent recoverable each year	Discovery well, Jan. 1, 100,000 barrels	Estimated reserves—16 producing wells, 4 dry wells	Royalty, one-eighth	Lessee's reserves
1921	64.65	100,000	1,000,000	125,000	875,000
1922	17.91	27,700	277,000	34,625	242,375
1923	7.27	11,250	112,500	14,062	98,438
1924	3.62	5,600	56,600	7,075	49,525
1925	2.07	3,200	32,000	4,000	28,000
1926	1.29	2,000	20,000	2,500	17,500
1927	.84	1,300	13,000	1,625	12,375
1928	.58	900	9,000	1,125	7,875
1929	.42	650	6,500	812	5,688
1930	.31	480	4,800	600	4,200
1931	.23	360	3,600	450	3,150
1932	.18	285	2,850	356	2,494
1933	.15	225	2,250	281	1,969
1934	.12	180	1,800	225	1,575
1935	.10	150	1,500	187	1,313
1936	.08	123	1,230	154	1,076
1937	.07	104	1,040	130	910
1938	.06	87	870	109	761
1939	.05	75	750	94	656
		154,669	1,547,290	193,410	1,354,880

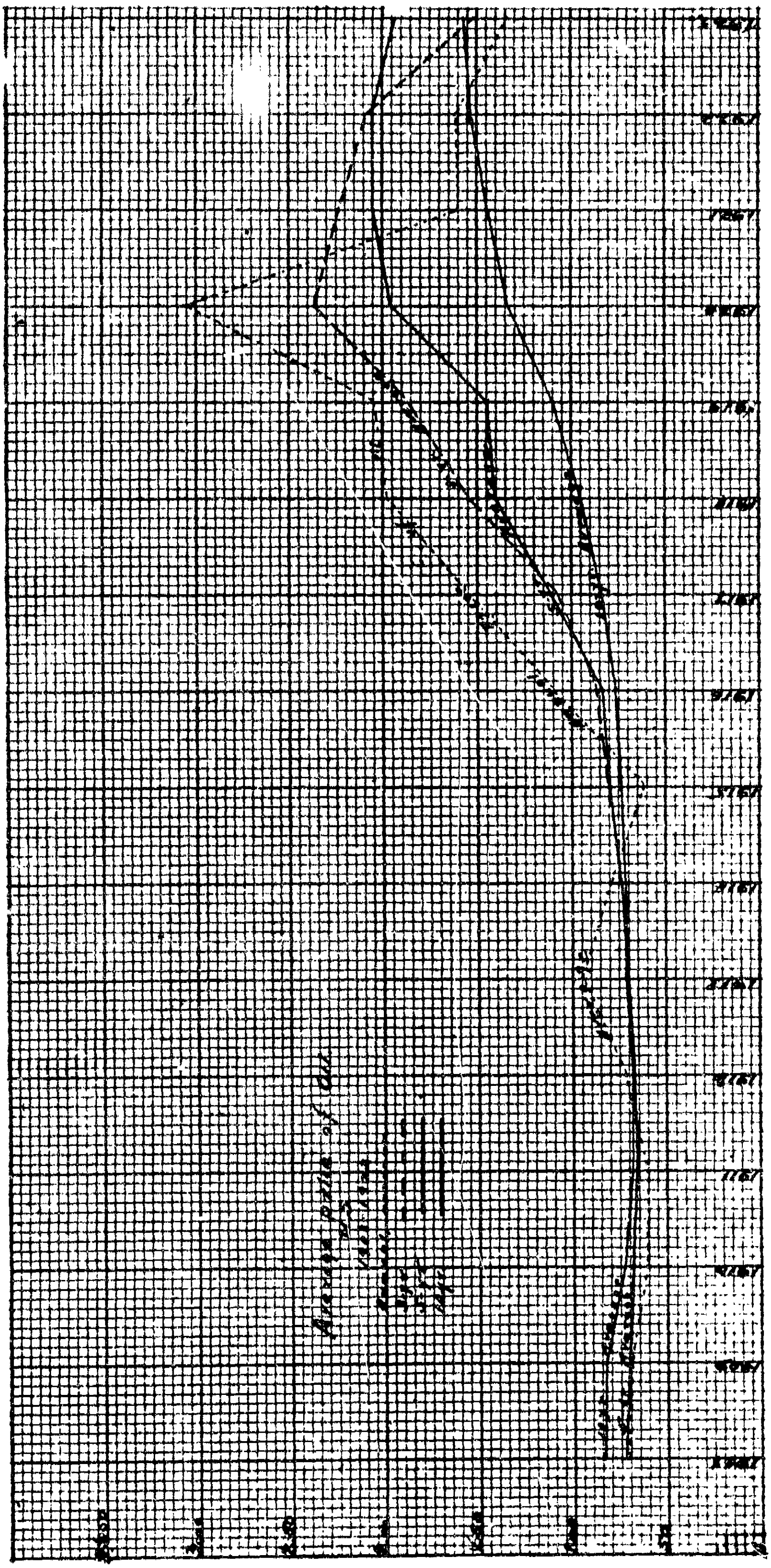

Average price of Oil

TABLE 3

Price of oil, 1908-1923

Year	10-year average price	5-year average price	Average yearly price	3-year average price
1908	$0.8421	$0.733	$0.722	
1909	.7923	.701	.704	
1910	.7338	.698	.610	
1911	.6989	.613	.608	
1912	.6924	.676	.737	
1913	.7273	.722	.954	
1914	.7220	.743	.806	
1915	.7433	.809	.638	$0.7993
1916	.7602	.847	1.100	.8513
1917	.8438	1.210	1.559	1.0990
1918	.9694	1.416	1.978	1.5456
1919	1.1042	1.465	2.052	1.8630
1920	1.3490	1.951	3.067	2.3656
1921	1.4495	2.052	1.604	2.2410
1922	1.5368	2.062	1.610	2.0936
1923	1.5754	1.934	1.340	1.5246

Valuations have been made on the basis of $3.06 oil, minus 90 cents, or $2.16 per barrel which is in accordance with the practice in the department in 1921 to 1923. This net price of $2.16 multiplied by the number of barrels or reserves or estimated production during the life of the lease gives the total anticipated operating profit as shown in Table 4. This operating profit is then discounted over the life of the well at 10 per cent compound interest. Other rates have been used for comparative purposes. (Table 8.)

TABLE 4

Discovery value at $2.16 per barrel

Year	Reserves Jan. 1, barrels	Value at $2.16 per barrel	Discount 10 per cent compound interest Hoskold	Present value	Depletion at $1.5284	Depletion on cost, at $0.30261
1921	875,000	$1,890,000	$0.9090	$1,718,010	$1,337,504	$264,784
1922	242,375	523,530	.8264	432,645	370,489	73,345
1923	98,438	212,626	.7513	159,746	150,470	29,788
1924	49,525	106,974	.6830	73,063	75,702	14,987
1925	28,000	60,480	.6209	37,552	42,800	8,473
1926	17,500	37,800	.5644	21,334	26,750	5,296
1927	12,375	26,730	.5131	13,715	18,916	3,745
1928	7,875	17,010	.4665	7,935	12,038	2,383
1929	5,688	12,286	.4241	5,210	8,695	1,721
1930	4,200	9,072	.3855	3,497	6,420	1,271
1931	3,150	6,804	.3504	2,384	4,815	953
1932	2,494	5,387	.3186	1,716	3,812	755
1933	1,969	4,253	.2896	1,232	3,010	596
1934	1,575	3,402	.2633	896	2,407	477
1935	1,313	2,836	.2394	679	2,007	397
1936	1,076	2,324	.2176	506	1,645	326
1937	910	1,966	.1978	389	1,391	275
1938	761	1,644	.1798	296	1,163	230
1939	656	1,417	.1635	232	1,003	198
	1,354,880	2,926,541		[1] 2,481,037	2,071,037	410,000

[1] Cost and development charges, $410,000. Present value of oil, $2,071,037.

A second basis for valuation, not used by the department at any time, takes into consideration the average price of oil for a period of five years. This is combined with the posted price of oil as follows:

The average price for the five-year period at date of discovery was $1.85. The anticipated price at the end of the first year's operation is $2. Inasmuch as 65 per cent of the oil is recoverable the first year, the first year's production

is valued by taking the average of $3.06 (the posted price) and $2, the anticipated future price on five-year average. This gives $2.53 as the basic price from which 90-cent operating costs are taken, leaving a net operating profit per barrel for the first year, $1.63. This then is applied to the first years estimated production and gives a value for 65 per cent of the total oil. The remaining oil (35 per cent) is then valued at the expected price of oil based on five-year average ($2) less the operating costs of 90 cents, making a net operating profit of $1.10.

$$\frac{\$3.06+\$2.00}{2}-90c=\$1.63$$

This figure ($1.10) is then applied to the estimated annual yield for 18 years, which gives the expected operating profit from 35 per cent of the oil. The sum of these two sets of figures gives the total value of the oil which is discounted 10 per cent throughout the life of the well, yielding a depletion barrel for the first year, $1.63. This is then applied to the first year's estimated price of oil over the entire life of the well.

TABLE 5

Value compared on basis of posted price and expected price determined from a five-year average (10 per cent discount in each case)

[Reserves, 1,354,880 barrels. Operating cost, 90 cents]

	Total net proceeds	Present worth	Depletion unit	Less $0.3026, depletion on cost
Market price of oil, $3.06, at date of discovery				(1)
Value at $3.06−$0.90=$2.16	$2,926,541	$2,481,037	$1.831	$1.5284
Value of 64.65 per cent, at $\frac{\$3.06+\$2}{2}-\$0.90=\$1.63$	$1,426,250	$1,296,461	$1.481	$1.1784
Value of 35.25 per cent at expected future price of $2−$0.90=$1.10	527,871	388,580	.809	.4964
Total	1,954,121	1,685,041	1.24	.9374

[1] Appreciated depletion due to discovery.

TABLE 6

VARYING DISCOUNT FACTORS

Values compared on basis of varying discount factors

[Reserves, 1,354,880 barrels]

	Total net proceeds (from Table 5)	Present worth	Per cent yield on investment	Depletion unit	Less $0.3026 depletion on cost (appreciated depletion)
Discount at—					
10 per cent compound interest	$1,954,121	$1,685,041	15.37	$1.24	$0.9374
20 per cent compound interest	1,954,121	1,490,522	30.43	1.10	0.7974
25 per cent compound interest	1,954,121	1,410,982	38.49	1.041	0.7384
10 per cent and 4 per cent	1,954,121	1,710,421	14.25	1.264	0.9574
20 per cent and 4 per cent	1,954,121	1,525,286	28.11	1.125	0.8224

The value of these same reserves set up at market price ($3.06—$0.90), $2.16 and discounted at 10 per cent is $2,481,037, as compared with $1,685,041 above. The per cent yield on investment is the total, not annual earnings.

In all of the foregoing calculations it is assumed that the lease cost $10,000 and development $400,000, making the actual cash invested as $410,000 which is cost of oil. The depletion unit on this basis is $0.3026 per barrel.

Each of the depletion units above is, therefore, decreased by this amount to show appreciated depletion rate by reason of the discovery clause. This is shown in the last column, and is tax free under the discovery clause of the law.

In this example, 35 per cent of the oil or 527,871 barrels will be recovered after the first year. The depletion unit of $1.831 arrived at in the usual way will, according to regulations, maintain during the life of the well, 18 years. The expected price of oil can hardly exceed $2 based on five-year average, making the net expected price $2—$0.90 or $1.10 per barrel—yet the $1.831 depletion unit applies subject to limitation prescribed in the 1924 act. Thus it will be seen that the use of the market price of oil (without proper discount) at date of discovery, or 30 days thereafter, as a basis for valuation is questionable. It defeats the purpose for which the tax law was enacted—i. e., wipes out taxable profit.

The average price of oil in 1920 for all grades was $3.06, while for 1921 it was $1.60 and in 1922, $1.61. Discovery is assumed to have been made as of December 31, 1920, and oil is assumed as selling at $3.06 the average for the year. Discovery value is set up on this basis as of January 1, 1921, and a depletion unit of $1.831 established. This then applied to the 1921 production (875,000×$1.831) gives $1,602,125 as a depletion deduction. The actual price received for the oil was $1.604 per barrel, from which must be deducted the 90 cents as cost of production, leaving a net income from oil sold of (875,000× $0.704) $616,000 which is approximately $1,000,000 less than the depletion allowance. Had depletion been allowed on cost of $0.3026 per barrel, the depletion deduction would have been (875,000×$0.3026) $264,775, leaving a taxable income ($616,000—$264,775) of $351,225.

The cash receipts from the above hypothetical case, based on *actual average* price of oil for three years succeeding discovery and 89.83 per cent of total reserves, are shown in the following table:

TABLE 6 (a)

Year	Per cent recovery each year	Production, barrels	Net price per barrel	Net returns per year	Discount factor 10 per cent	Present worth
1921	64.65	875,000	$0.704	$616,000	0.9090	$559,944
1922	17.91	242,375	.710	172,086	.8264	142,212
1923	7.27	98,438	.440	43,313	.7513	32,541
	10.17	139,067	.684	95,122	.5131	48,807
Average		1,354,880		926,529		783,504

The present worth of the property, based on *actual prices* obtained for oil is $783,504, which includes $410,000 as cost of lease and development. This allows the purchaser 10 per cent compound interest on his investment, with no factor of safety beyond what this interest rate exceeds gilt edge securities. The value thus determined is only 32.8 per cent of that obtained by using the price of oil at its peak, viz, $3.06 per barrel. The depletion unit arrived at on actual selling price basis is 58.64 cents, of which 30.26 cents is applicable to actual cost (of lease and development), leaving 28.38 cents as the "appreciated depletion" by reason of discovery, as compared with $1.5284 when based on market price ($3.06) of oil on date of discovery. The actual result obtained emphasizes the need of carefully considering the future price of oil, as well as pointing out the fallacy of using (without modification) the posted price prevailing at date of discovery or within 30 days thereafter. The actual results show that a value determined by discounting the profits at a peak price (followed by a series of years at low prices) may, as in this case, be 300 per cent or more above what it should be. This well, whose value for discovery depletion is $2,481,037, had an earning capacity of only 10 per cent on the basis of $785,504, so that its market value as between a willing buyer and willing seller would not exceed $500,000.

VALUE BASED ON 10-YEAR AVERAGE PRICE

The 10-year average price at date of discovery was $1.35. At the end of the year the anticipated price could have been $1.40 (net 59 cents), and the price beyond that for the major portion of the remaining oil would have been approximately $1.50 (net 60 cents). The following table gives—

TABLE 6 (b)

Value based on 10-year average price of oil

Year	Per cent	Reserves	Average price	Expected returns	Discount factor 10 per cent	Discount returns
1921	64.65	875,000	$0.50	$437,500	.9090	$395,144
1922	17.91	242,375	.60	145,425	.8264	120,179
1923	7.27	98,438	.60	59,063	.7513	44,374
1924 to 1940	10.17	139,067	.60	83,440	.5131	42,813
	100.00	1,354,880		724,428		602,510

VALUATIONS AT MARKET PRICE EQUAL SALES AT AVERAGE MARKET PRICE

A series of valuations of this hypothetical property as of January 1, each year from 1916 to 1922, inclusive, based on the average price of oil as of the preceeding year, gives aggregate valuations of $7,479,559 (seven valuations), as compared with sales of production of $8,034,730 (receipts discounted at the same rate, 10 per cent), giving a margin of only 7.4 per cent as between the discovery value and of total income. A margin entirely too narrow to be considered a safe investment. During the five years 1916–1920 there is a margin of 58.8 per cent in favor of the Government for taxation purposes; but during the last two years (1921–22) of declining prices, this is practically wiped out with an operating loss of 51.8 per cent.

TABLE 6 (c)

Valuations for depletion

Year	Net receipts at actual sales price less operating costs	Valuation at market price less operating costs	Valuation at three-year average less operating costs	Valuation at five-year average less operating costs
1916	$672,110.00	$157,456.00	$341,498.00	$352,564.00
1917	965,747.00	540,493.00	285,474.00	281,824.00
1918	1,332,693.00	866,009.00	341,154.00	467,804.00
1919	1,496,431.00	1,229,982.00	736,621.00	588,750.00
1920	2,042,468.00	1,314,415.00	1,098,769.00	644,657.00
1921	783,504.00	2,422,517.00	1,672,230.00	1,199,175.00
1922	741,777.00	898,687.00	1,530,061.00	1,314,415.00
Total	8,034,730.00	7,479,559.00	6,065,807.00	4,849,189.00
Average per barrel, cents	76.65	71.36	57.21	46.27

While the margin of profit is apparently greater when using the three-year and five-year average prices, yet it must not be overlooked that in using these long-period averages it will be three years and five years, respectively, before the influence of the peak price of 1920 is eliminated. Using the three-year average price as a basis, discoveries could be allowed for 1923 at $1.524 per barrel, while the market price is only $1.34; using the five-year price average the discovery valuations in 1923 would be based on $2.06 oil when the market is

$1.34, which, of course, does not set up the correct value as between a willing seller and a willing buyer. It will be noted that the valuations are more erratic when the market price is used as a basis. The three or five year bases show more uniformity, but in the long run the result will be approximately the same as when market price is used. The average of a large number of valuations over a long series of years at market price will equal the actual receipts at market price during a long series of years. This, of course, assumes that the actual production equals estimated reserves.

Carrying these valuations back another seven years, making 14 valuations in all (one for each January 1), gives the following result:

Aggregate of 14 valuations	$10,264,606
Aggregate of sales from same	10,597,254
Difference	332,548
Per cent, margin of safety over a period of 14 years	3.24

This shows, as set forth elsewhere in this report, that in the long run, when many valuations are considered at actual market price over a period of years, the discovery values approach the value of actual sales, leaving no margin of profit for a prospective purchaser and no taxable income for the Government.

Valuations based on a rising market will result in a taxable gain only so long as the price continues to rise. When the market enters a declining-price period the depletion established during the rising market will extend to and be applicable in the years of declining prices, thus wiping out any taxable gain.

Valuations made on a declining market result in no taxable gain, inasmuch as the market price is less than the discovery price.

Taxable income will accrue only during rising prices. Deficits will accrue (by reason of depletion) during declining prices, and in the long run will offset the other.

In view of these conditions it is apparent that the discount rates and production hazards should be scrutinized. The application of a 10 per cent compound discount to determine present worth is not sufficient unless a liberal hazard factor has been applied previously. Even then it is questionable whether 10 per cent is enough. Wells at the best are short-lived, usually 60 per cent of the ultimate oil being recovered during the first year. The total invested capital should be returned within three to five years, which means a dividend on capital of 20 to 33 per cent per year, to say nothing of interest (profit), on the investment in a hazardous industry.

EARNING CAPACITY—INVESTMENT HAZARDS

The accompanying tables, 5 and 7, show the earning capacity of a lease wherein different discount factors have been applied to the estimated value of reserves when the market price of oil is $3.06 or a net price of $2.16 after 90 cents has been allowed for pumping and production costs. The discount rates range from 5 per cent, which has been applied in some instances, to 25 per cent, which to my knowledge has never been applied. The discount rate often used by the oil and gas section is 10 per cent applied to the middle of the year. The present worth column in this table represents the net proceeds of the oil which in each case of necessity includes the drilling and equipment of wells required to produce the oil. On the lease in question this is estimated at $400,000 to cover the drilling of 20 wells. This amount, plus $10,000 (cost of lease) would represent therefore, the actual cost of the oil reserves, or $0.3026 per barrel. Deducting this amount from present worth represents amount of depletion resulting by reason of the discovery clause.

TABLE 7

Comparison of earning capacity based on different discount factors

[Reserves, 1,354,880 barrels]

	Net value at $2.16 per barrel	Present worth	Total yield on investment [1]	Depletion unit	Less depletion on cost $0.3026 (appreciated depletion)
Discount at—			*Per cent*		
5 per cent	$2,926,541	$2,671,808	9.49	$1.972	$1.6694
10 per cent middle of year	2,926,541	2,584,938	12.82	1.908	1.6054
10 per cent end of year	2,926,541	2,464,529	18.74	1.819	1.5164
10 per cent and 4 per cent	2,926,541	2,519,656	16.15	1.860	1.5574
15 per cent	2,926,541	2,291,913	27.68	1.692	1.3894
20 per cent	2,926,541	2,145,360	36.36	1.583	1.2804
20 per cent and 4 per cent	2,926,541	2,271,757	31.72	1.640	1.3374
25 per cent	2,926,541	2,048,915	44.98	1.490	1.1874

[1] This does not represent annual earnings but the total earning over the 10-year life of property. About 65 per cent of total income will be received at end of first year, 17.9 per cent second year, 7 per cent third year, and 10 per cent during the remaining 16 years. The present worth includes $400,000 estimated cost of 20 wells.

Assuming that the oil reserves are definitely known and that no additional dry holes will be drilled on the lease, there remain certain hazards in the industry for which adequate provision must be made in order that a prospective purchaser shall be able to receive on this investment an ample return to justify the expenditure of large sums of money. This same money may be invested in real estate mortgages which yield a net annual return of 5 to 7 per cent. Railroad bonds and utility corporation bonds are considered safe and sound investments yielding 5 to 7 per cent. What then should an investment in hazardous oil ventures yield in order that the investor may be amply repaid for the risks involved? What discount rate should be applied to obtain the present worth of an oil valuation based upon the posted market price of oil? If the reserves are definitely known, the following hazards are of such importance that they must be given due consideration before making an investment:

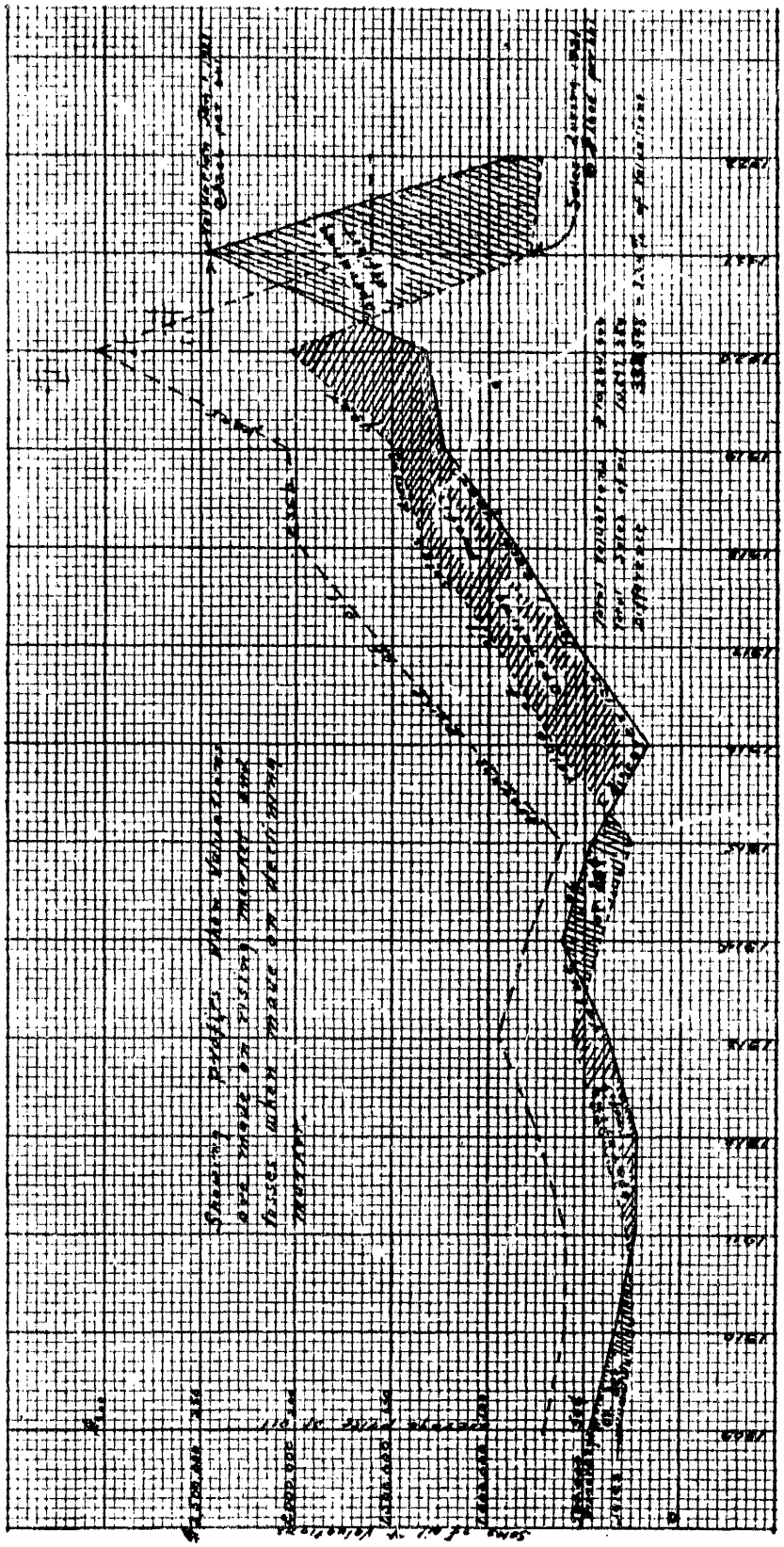
1. **The uncertainty of the price of oil. A drop of 10 per cent may wipe out all possible profits on the basis of a 5 per cent discount rate.**
2. **Losses by fire, wind, etc. A single 55,000 barrel tank may be the only margin between a profit or a loss on the investment.**
3. **The encroachment of salt water. The loss of a single well may turn anticipated profit into an actual loss.**
4. **Loss of casing by reason of corrosion. This may mean the possible total loss of a well.**
5. **Drainage into neighboring offset wells. This has a decided affect upon the total reserves, especially when the operator or investor is not financially able to drill wells sufficiently fast to keep pace with the drilling program of his neighbor.**
6. **Local taxes.**
7. **Leakage in storage and transportation.**

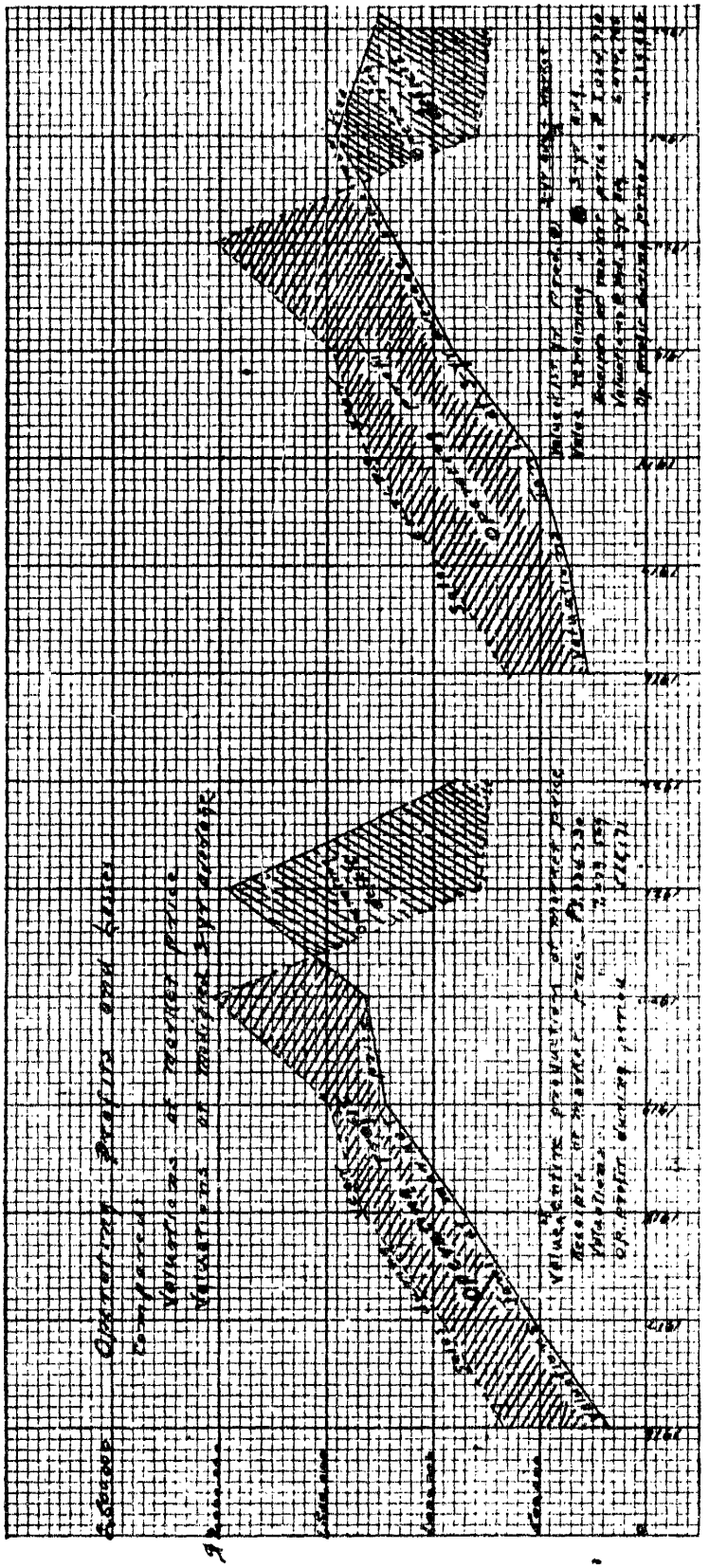
The following table shows the result of applying some of these losses:

TABLE 8

Losses which may occur in the operation of any lease

10 per cent shrinkage in reserves	$292,654	$292,654	$292,654	$292,654	$292,654
15 per cent drop in price of oil		438,981	438,981	438,981	438,981
Loss of one 55,000 barrel tank (fire)			118,000	118,000	118,000
Loss of one well by salt water encroachment				145,000	145,000
Bleeding by offset wells, 5 per cent					145,000
	292,654	731,635	849,635	994,635	1,139,585





A 10 per cent shrinkage in estimated reserves in the case in question, with no variation in price, means a loss of $292,654. The margin resulting from a 5 per cent discount is only $254,739, not enough to provide for this single item.

A 15 per cent drop in price of oil (a 47 per cent drop occurred in 1921) represents a loss of $438,981, which practically wipes out the margin of 10 per cent discount, $462,012. Should both these factors operate at the same time the resulting loss would be $731,635, which practically absorbs the $781,181, provided by a 20 per cent discount. Add to these two losses the loss ($118,000) of one 55,000-barrel tank destroyed by fire or lightning. We have a loss of $849,635, which is barely covered by the $907,626, due to the use of a 25 per cent discount to determine the present worth.

DISCOUNT FACTOR APPLICABLE AT MIDYEAR

Prior to 1923 the Income Tax Unit used the discount tables as published by Hoskold, selecting such rates as were considered applicable to the case in question. Seldom, however, did the discount factor ever exceed 10 per cent. Since 1923 a new discount table embodying the 10 per cent factor has been prepared and is in use. This table is entitled "Present worth of $1 realized at the middle of the first fractional year and at the middle of each calendar year thereafter."

The present worth of $1 due in one year at 10 per cent is $0.90909, while the present worth of $1 due in six months, according to the new table prepared for use in the department, is $0.95346. No doubt the theory for the introduction of this factor is that oil companies receive their returns monthly from the pipe lines, and therefore the average deferred period for the year's receipts is six months. While this is largely true, this method might be further extended to discounting quarterly, or even monthly.

As an example of the difference between this midyear 10 per cent factor and the Hoskold end-of-the-year 10 per cent factor, the data given in Table 9 is self-explanatory. It will be noted that the depletion unit applicable to oil on the basis of the Hoskold 10 per cent factor is $1.5164 per barrel, while the factor used by the unit gives $1.6054, a difference of 9 cents per barrel. This, therefore, has the effect of increasing the depletion unit and giving a much larger depletion during the first or flush period of the oil well's life. This additional 9 cents per barrel gives $78,750 additional depletion for the year 1921 on yield of 875,000 barrels. This is also reflected in the total yield on the investment as it gives a much higher present worth. Should a purchaser buy the property at the value (present worth) determined by either of these two factors, the earning power based on the midyear 10 per cent factor would be 12.82 per cent, while on the 10 per cent end-of-the-year factor it would be 18.74 per cent.

As will be noted in Table 7, this factor which would make a possible yield of 12.82 per cent on the investment, is but slightly better than a straight 5 per cent discount, which would yield 9.49 per cent. Either of these factors is entirely too small to offer a safe margin for anyone to purchase oil-producing lands. This midyear 10 per cent discount factor had its origin outside the Income Tax Unit. It works admirably to the advantage of the taxpayer in the reduction of income, and by increasing the present worth places excess valuation on property in case of sale or reorganization. It does not come anywhere near placing a value as between a willing buyer and a willing seller.

TABLE 9

Discovery value compared on basis of 10 per cent discount applied at mid-year and at end of year

Year	Per cent	Reserves	Value at $2.16 per barrel	10 per cent factor (Hoskold)	Present worth [1]	10 per cent factor (mid-year)	Present worth [2]
1921	64.65	875,000	$1,890,000	$0.9090	$1,718,010	$0.9534	$1,801,926
1922	17.91	242,375	523,530	.8264	432,645	.8668	453,796
1923	7.27	98,438	212,626	.7513	159,746	.7880	167,549
1924 to 1940	10.17	139,067	300,385	.5131	154,128	.5382	161,667
	100.00	1,354,880	2,926,541	.8421	2,464,529	.8833	2,584,938
Cost of lease, wells and equipment					$410,000		$410,000
Discovery value of oil in ground					2,054,599		2,174,938
Depletion on total value					1.819		1.908
Depletion on cost					0.3026		0.3026
Depletion applicable to oil on discovery					1.5164		1.6054
Yield on investment, per cent					18.74		12.82

[1] Compounded yearly from end of first year.
[2] Compounded from end of first six months, and yearly thereafter.

NOTE.—The $400,000 cost of wells may be capitalized and depleted over life of the wells, or it may be charged off as incurred as a development expense. Since depletion would be allowed on discovery, the $10,000 bonus for lease would be absorbed in the discovery valuations.

LESSOR'S EQUITY

The income-tax laws of 1918–1921 and 1924 provide for the equitable apportionment as between lessor and lessee as follows:

"SEC. 214. (a) (10) * * * In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

Regulations 45, 62, and 65, article 204, define the lessor's interest on basic date and give him depletion and depreciation on values as of March 1, 1913, cost if acquired subsequent thereto, and the value of the lessor's equity in a discovery on or after March 1, 1913. This latter value is the fair market value at the date of discovery or 30 days thereafter of his equity in the mineral deposit. The lessor's equity and the lessee's equity shall be determined separately, but when determined shall never exceed the value at that date of the property in fee simple.

In the majority of cases the original lessors are the farmers or cattlemen who acquired their land for farming or grazing purposes from the Government at a nominal cost. The early land grants and sales conveyed not only the surface rights but all that the land contained beneath the surface. The purchaser usually bought the land for what he could make by utilizing the surface with no thought of mineral contents. In this way, the oil reserves can not be considered as costing the farmer or cattleman any appreciable sum. The great majority of these lands which are leased to oil operators are usually leased at a nominal cost plus a royalty of usually one-eighth so that the principal cost to the operator is the expense of the development. It is true that occasionally large bonuses are paid for proven oil land leases. The excess of these bonuses over the value of the lessor's interests as owned on March 1, 1923, is taxable income to the lessor.

LESSOR'S EQUITY ON DISCOVERY BASIS

The lessor has no operating costs or other expenses in connection with the recovery of his share of oil. These expenses according to the terms of the lease are borne by the lessee. The law and regulations allow the lessor depletion based on cost, value as of March 1, 1913, or on date of discovery, or 30 days thereafter. In the case of the lessor the valuation for depletion purposes resolves itself into the simple form of determining the present value

of a barrel of oil in the ground, returnable through a period of years, the discounted value being based on the posted market price of oil at discovery period. His reserves are as definitely known as are the reserves of the lessee, his share being stated in the lease.

In the following tabulation the lessor's equity in a lease is represented by one-eighth of the total reserves which amount to 193,410 barrels. The basis for valuation is the market price for oil at $3.06 per barrel which gives a total net income of $591,838 returnable over a period of 19 years. The annual production has been estimated on the basis of lessee's operations and market price of oil ($3.06) applied to every year's production.

TABLE 10

Value of lessor's equity (on discovery) discounted over 19-year life of well

Reserves one-eighth of total	Value at $3.06 per barrel	Present worth, 10 per cent discount	Present worth, 10 per cent middle year	Present worth, 25 per cent discount
Barrels				
125,000	$382,500	$347,693	$304,676	$306,000
34,625	105,953	87,560	91,829	67,810
14,062	43,030	32,328	33,903	22,027
7,075	21,650	14,765	15,508	8,866
4,000	12,240	7,600	7,971	4,010
2,500	7,650	4,318	4,529	2,005
1,625	4,973	2,552	2,676	1,043
1,125	3,443	1,606	1,684	577
812	2,485	1,054	1,105	333
600	1,836	708	742	197
450	1,377	483	506	118
356	1,089	346	364	75
281	860	249	261	47
225	689	181	187	30
187	573	137	144	20
154	471	102	107	13
130	398	79	83	10
109	333	60	63	6
94	288	47	49	4
193,410	591,838	501,868	526,387	413,191

Depletion unit:
Present worth, 10 per cent discount $2.595
Present worth, 10 per middle year 2.721
Present worth, 25 per cent discount 2.136

In this example it will be noted that three different discount rates have been used. In column three the present worth has been determined by using straight 10 per cent compound discount, which reduces the net income to a present worth of $501,868, giving a depletion unit at $2.595. Column 4 shows the present worth at 10 per cent compound-interest discount applied to the middle of the first year and to the middle of each succeeding year. The factors for this determination being obtained from a table now in use by the Income Tax Unit. Column 5 shows the present worth of the same earnings (column 2) discounted by 25 per cent which still gives the lessor a depletion unit of $2.136 per barrel, which after all is in excess of the average price of oil.

It would seem that in the case of the lessor as well as in the case of the lessee, a higher discount rate than that used by the department should be used. It does not seem within reason nor within ordinary business practice to conceive that any investor would put up as much as $500,000 for an oil well and expect to receive only $591,838 in return for the investment. The margin is entirely too narrow for the risk involved. It can be assumed that the lessor's interest in this piece of property has cost him nothing more than the price of his agricultural or grazing land and that he would be well repaid if he were able to sell his interests at even one-half the value as indicated in column 2, and it is believed that in order to make a sale at all as between a willing buyer and a willing seller it would be necessary to discount the anticipated net income approximately 50 per cent before an investor could be interested.

The valuation is based on the market price of oil at $3.06 per barrel, the actual average price of oil for the following year was $1.60, which goes to

show that the valuation at a peak price does not establish a value that will appeal to an investor

INVESTED CAPITAL

The acts of 1917, 1918, and 1921 recognize that invested capital may include a "paid-in surplus."

In the case of a corporation or partnership: (1) Actual cash paid in; (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to Jan. 1, 1914, the actual cash value of such property as of Jan. 1, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor); and (3) paid-in or earned surplus and undivided profits earned during the taxable year. (Act of 1917, sec. 207 (a).)

In the case of an individual: (1) Actual cash paid into the trade or business; (2) the actual cash value of tangible property paid into the trade or business, other than cash, at the time of such payment (but in case such tangible property was paid in prior to Jan. 1, 1914, the actual cash value of such property as of Jan. 1, 1914); and (3) the actual cash value of patents, copyrights, good will, trade-marks, trade brands, franchises, or other intangible property, paid into the trade or business, at the time of such payment, if payment was made therefor specifically as such in cash or tangible property, not to exceed the actual cash or actual cash value of the tangible property bona fide paid therefor at the time of such payment. (Act of 1917, sec. 207 (b).)

Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided*, That the commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257. (Act of 1918, sec. 326 (a)(2).)

Tangible property paid in—value in excess of par value of stock: Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment, and may consist, among other things, of (*a*) an appraisal of the property by disinterested authorities made on or about the date of the transaction; (*b*) certification of the assessed value in the case of real estates; and (*c*) proof of a market price in excess of the par value of the stock or shares. The additional value allowed in any case is confined to the value definitely known or accurately ascertainable at the time of the payment. (Act of 1918, regulations 45 and 62, art. 836.)

Surplus and undivided profits—paid-in surplus: Where it is shown by evidence satisfactory to the commissioner that tangible property has been paid in by a stockholder to a corporation as a gift or at a value definitely known or accurately ascertainable as of the date of such payment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess shall be deemed to be paid-in surplus. Substantially the same kind of evidence shall be required under the article as under article 836. (Act of 1918, regulations 45 and 62, art. 837.)

ANALYTICAL APPRAISALS FOR INVESTED CAPITAL

Since the regulations recognize the analytical appraisal method for determining invested capital, including paid-in surplus, it is evident from the foregoing example worked out in detail for depletion purposes, that unduly large invested capital may result. One of the important contentions of many oil company tax cases was that the paid-in surplus should be recognized. The law allows the inclusion of a paid-in surplus in invested capital.

The amount that is allowable is a question of fact. This fact, in accordance with the regulations, is determinable by the analytical appraisal method. If the proper hazard and discount factors are not used, excessive paid-in surplus will be allowed as well as excessive depletion rates. While the value based on a discovery may not be included in invested capital, yet the principles involved and used in making valuations for discovery are employed in determining a value for tangible property (oil lands, wells, etc.) turned in for stock upon change of ownership or reorganization. Paid-in surplus was an important factor in tax reduction under the 1917, 1918, and 1921 laws.

The CHAIRMAN. Do you want to continue on this oil situation to-morrow, Mr. Manson, or do you wish to present something now, Mr. Gregg?

Mr. GREGG. Mr. Chairman, I may not be able to be here to-morrow morning, and there are just a few points that I wish to bring out in connection with Mr. Fay's testimony.

The CHAIRMAN. All right.

Mr. GREGG. Mr. Fay, your criticism, as I gather it, of the action of the bureau in treating the depletion of natural resources, is divided into three heads. The first was the criticism of the regulation defining a proven area. You stated in your testimony that this regulation was first issued in October, 1920, defining the proven area as 160 acres square, with the well in the center. As I gather it, that regulation is an interpretation of the statutory language, which says, "a proven tract or lease."

Mr. FAY. Yes.

Mr. GREGG. Since that time there have been two new revenue acts passed by Congress—the 1921 and the 1924 acts—both of which use exactly the same language, do they not?

Mr. FAY. They do.

Mr. GREGG. In other words, Congress, with the regulations defining that that language before them, reenacted the same identical language twice?

Mr. MANSON. That is a legal conclusion. I doubt very much whether Mr. Fay, who is an engineer, is qualified to express an opinion on that subject.

The CHAIRMAN. I should say if they did not have it, they ought to have had it.

Mr. GREGG. All right, sir. There is one other point that I want to bring out. I am not attempting to justify the 160 acres definition, but I want to bring out a couple of points in connection with it. Mr. Fay gave an example showing how that definition worked to an absurdity. I will attempt to restate it. Suppose A and B own adjoining 160-acre tracts. There has been no oil discovered anywhere around. A brings in a well in the center of his tract. B then drills an offset well on his adjoining tract, and, as Mr. Fay brings out, he is allowed discovery value.

That sounded as if it were a criticism of the regulations. As a matter of fact, it is a criticism of the law, which says that in the case of oil mines, gas wells, and so forth, "not acquired as the result of the purchase of a proven tract or lease"; in other words, no matter if the well were on the adjoining acre, the law would have given discovery on the second well brought in by the owner of that adjoining acre, since he had held the property prior to the time that the well was brought in on the adjoining acre.

Mr. MANSON. That all depends on what the regulations say.

Mr. GREGG. No, sir.

Mr. MANSON. A discovery area of 160 acres or otherwise.

Mr. GREGG. No, Mr. Manson; that is just the point that I was trying to bring out, that the definition of a proven area in such a case as the example given by Mr. Fay is immaterial, because, in the law, the "proven" provision only applies to property acquired as a result of the purchase of a proven tract or lease. In other words, if it were not proven at the time it was acquired, then he can get discovery if he drills a well on an adjoining acre to a proven well.

Do I make myself clear, Mr. Chairman?

The CHAIRMAN. It is very involved, but I think I understand it. Let me see if I do.

A buys or owns 160 acres. B, two weeks afterwards, buys the next 160 acres. At the time B buys his 160 acres, A has not discovered any oil on his land. In that event both A and B are entitled to discovery value?

Mr. GREGG. Yes, sir; regardless of the definition of a proven area contained in the regulations.

The CHAIRMAN. And that is your interpretation of the law?

Mr. GREGG. Yes. Let me read the section:

***Provided*, That in the case of mines, oil and gas wells discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease.**

In other words, the proven tract or lease comes in only in connection with the word acquisition.

The CHAIRMAN. Let me get this straight. The successive revenue laws reenacted that clause in the law?

Mr. GREGG. Yes, sir; verbatim.

The CHAIRMAN. And the bureau raised no objection to it?

Mr. GREGG. No, sir; neither did Congress.

The CHAIRMAN. I understand. I am coming to the Congress.

The bureau must have known that this was resulting in an absurdity, it seems to me. They should have drawn the attention of Congress to the fact that it was working to an absurdity. Congress should have had this before them when they reenacted that part of the statute year after year, and I confess that Congress was negligent. I also think the Treasury was negligent in not drawing the attention of Congress to the absurb way in which the law works.

Mr. MANSON. I would like to call the attention of the chairman to the fact that this is the first time that Congress has attempted to investigate this subject.

The CHAIRMAN. I understand that. I am not talking about that, but I am talking about the fact that the bureau during all of this time had that experience, and I think the records show, so far as I have looked into them, which have been presented to me, that it has resulted in an absurd situation, and certainly it was up to the bureau, in their good judgment, and it was their responsibility and initiative, to draw to the attention of Congress the fact that the law was working in an absurb way.

Mr. GREGG. The two points that I wanted to bring out were these: In the first place, that the criticism of the regulation in connection with the example Mr. Fay gave, should be directed, not at the regulation, but at the law; and, in the second place, that the regulation which has been criticised has been in effect since 1920, and that the

same language in that respect has been reenacted twice subsequently by Congress.

There is one other point that I want to make in that connection.

The second criticism by Mr. Fay was that at the date of discovery there is a boom value of the well, and that allowing depletion on that value gave the taxpayer a much greater advantage than he is entitled to.

Mr. MANSON. That was not Mr. Fay's suggestion at all.

The CHAIRMAN. That is what I understood, anyway, and that is what I understand the criticism to be, because it does create an unreasonable depletion, as I gather it from statements that have been made to me both formally and informally a number of times.

Mr. MANSON. But the objection is this, that it is not at the time of the discovery of the well, but it is at times of high oil prices.

The CHAIRMAN. Yes; I understand that.

Mr. GREGG. It comes right back to the same point.

The CHAIRMAN. Yes; and I still think the attention of Congress ought to be directed to the absurdity of that feature of the law, and it ought to be corrected in the next statute.

Mr. MANSON. On that point, I maintain that the law does not justify any such thing at all. The law says that the value of the well shall be determined as of that date. I submit that in the case of a well which is not to be exhausted for a period of 5, or 10, or 15 years, no one would assume, in purchasing that well, that the price of the oil as of the date of discovery was going to continue.

The CHAIRMAN. I would like to ask counsel, then, how he would arrive at the discovery value, in the light of the statute?

Mr. MANSON. In reply, I might say this, Mr. Chairman; the particular provision quoted by the gentleman is exactly the same provision that applies to mines. It is not only a similar provision; it is exactly the same provision that applies to mines. In the case of mines, they have taken a ten-year average as the basis. Mr. Fay has suggested here, by reason of the fact that a very high percentage of the oil is recovered the first year, that they should take a combination of the market price as of date of discovery and of the average price over a period of time; but the figure that the law fixes to be determined within 30 days is the value of the oil in the ground, not the price of that oil as though it were all on top of the ground and ready to be delivered into the pipe line. The basis of value taken here assumes the oil has all been recovered from the ground and is ready to be delivered into a pipe line as of the date of discovery, or within 30 days thereafter. The thing to be determined is the value of the oil in the ground, and anyone buying it on the date of discovery, or buying it at any time during the 30-day period fixed by law, would necessarily take into consideration the fact that the price of oil is liable to be reduced before that oil is recovered.

The CHAIRMAN. I would like to ask Mr. Gregg, then, to tell us why they applied this rule that counsel has just complained of to oil and not to other natural resources?

Mr. GREGG. I am not familiar with the valuation side of it, but there is one rather obvious answer. The copper mines were not being valued under this section, which provides for valuation at date of discovery or within 30 days thereafter. They are being valued as of March 1, 1913.

The CHAIRMAN. Yes: I understand that, but counsel has referred to this provision as applied to oil and gas as being exactly the same provision as applied to other natural resources.

Mr. GREGG. Yes, sir; that is the point I was bringing out, that it was not exactly the same one.

Mr. MANSON. There is only one provision in the law which is identical in the case of both corporations and individuals, that provides for discovery value, and that provision provides for discovery value of mines, oil wells, and gas wells.

Mr. GREGG. That is perfectly true.

Mr. MANSON. And it is the only provision under which any discovery value would be allowed to anybody for any purpose.

Mr. GREGG. That is perfectly true, Mr. Chairman. The valuations which are under consideration now are discovery values of oil wells. That is the only place in the statute, the discovery value section, where the valuation must be at the date of discovery or within 30 days thereafter. However, I am not qualified to pass on the determination of the future price or to give you the future price of oil. I merely want to bring out that the valuation as of date of discovery was in accordance with the provision of the statute.

The CHAIRMAN. I know, but it seems to me that it is not a question of th exact language of the law. What has been impressed upon me is that the application of the law is what is being criticised, and not the fact that the law reads that way.

Now, I would like to ask Mr. Gregg if he can tell me why, in certain oil cases, they used the price of oil averaged on the 30-day period, and in other cases they spread it over the ten-year average?

Mr. GREGG. I not only can not tell you, but I did not know that they did. I have no idea of how the value is determined, the average price of oil.

The CHAIRMAN. I saw an editorial in one of the mining journals recently. That editorial was drawn to my attention, and it criticis d this committee, of course, and I might say that all public criticism as carried in the press is directed at this committee, some of which is undoubtedly inspired; but in this editorial mention was made of the tax simplification board. The committee was charged with doing some duplication, or at least for assuming some responsibility which properly b longed to the tax simplification board.

Do you know that board, Mr. Gregg?

Mr. GREGG. Yes, sir.

The CHAIRMAN. Is it in existence now?

Mr. GREGG. No; it was disbanded, I think, about six months ago.

The CHAIRMAN. Was it created by statute law or by Executive order?

Mr. GREGG. Under the revenue act of 1921.

The CHAIRMAN. The statute provided for the organization of that board?

Mr. GREGG. Yes, sir.

The CHAIRMAN. And did the statute provide for its abolishment?

Mr. GREGG. It said they should continue longer than they did, but the Appropriations Committee cut out the appropriation.

The CHAIRMAN. Did that board present any r commendations to Congress as to how the law might be amended so as to eliminate the ridiculous application of the discovery feature or other features,

which you have just referred to, in fixing the value of oil for 30-day period?

Mr. GREGG. The tax simplification board devoted itself practically exclusively to recommendations for administrative changes within the bureau. It did not consider the law to any appreciable extent. It made two reports to Congress. The only recommendation as to legislation was in reference to capital gains and capital losses.

The CHAIRMAN. Now, this mining journal's criticism of infringing upon the work of the tax simplification board was not exactly correct, was it?

Mr. GREGG. The tax simplification board's work, as I say, was confined exclusively to questions of administration.

There is just one other point that I would like to bring out.

The criticism of this definition contained in the regulations of the proven area does not arise in a case where both properties were acquired before discovery was made on either, but it does arise where discovery is made on one, and then an adjoining property is acquired. Then the criticism is applicable.

I should like to point out this fact, that the regulation as quoted does not lay down the ironclad rule that the only area which is proven by a discovery was this 160-acre tract. The regulation says that at least the 160-acre tract is proven by the discovery. Then, if I can find it——

Mr. MANSON. Mr. Fay read the other regulation.

Mr. GREGG. It then says, in article 220, that in specific cases more may be proven by discovery than the 160 acres. I just wanted to make it clear that it did not say arbitrarily that only 160 acres were proven by discovery.

The CHAIRMAN. You think it is justifiable criticism, then, to allow discovery value if the oil is already known to exist in the 160 acres?

Mr. GREGG. It depends entirely, Mr. Chairman, upon the question of policy, in the first place, whether you are going to allow discovery value.

The CHAIRMAN. You contend, then, that the bureau has a right to determine whether it shall allow discovery value?

Mr. GREGG. No, sir; I think it is a question of policy that Congress has determined one way.

The CHAIRMAN. Yes; that is my interpretation of it, that you are following the act of Congress.

Mr. GREGG. Yes, sir.

The CHAIRMAN. Do you construe it that Congress intended that you should allow B discovery value when he purchased his land after A had purchased his and discovered oil?

Mr. GREGG. Not if B's property were proven by A's discovery, and I think the regulations so provide.

The CHAIRMAN. Would you not think that B's land had been pretty well proven if A had discovered a well previously?

Mr. GREGG. It depends on the relation between A's and B's land.

The CHAIRMAN. Of course, I mean if they are contiguous to each other?

Mr. GREGG. Well, it would depend upon how far from A's land B's well was. I think those matters are matters that have to be decided in individual cases. I do not think you can lay down a

hard and fast rule. I think that is all the regulation says, that the discovery at least proves the 160-acre tract, and may prove more, depending upon the facts in the case.

Mr. MANSON. Do you know of any cases where the department has ruled that discovery proves more than 160 acres?

Mr. GREGG. No, sir; I have not gone through the cases which the department has closed, searching for this information.

The CHAIRMAN. Do you want to make any further statement, Mr. Gregg?

Mr. GREGG. That is all, sir. I just wanted to bring out those three points.

The CHAIRMAN. You covered three items?

Mr. GREGG. Yes, sir.

The CHAIRMAN. Is there any criticism on your part of the third criticism of Mr. Fay?

Mr. GREGG. On the matter of the discount rate I noticed this point, that several of Mr. Fay's quotations applied only to gold mines. I am not qualified to say whether the discount rate applied in the case of oil wells should be used in the case of gold mines. I noticed in one of these quotations that he made the statement that the discount factor was different in the case of a mine than in the case of a manufacturing concern because in the case of mines the payment they received did not represent entirely profits, but represented, in part, a return of capital. Now, of course, by deducting depletion in our estimates, we take care of that in whatever discount rate we use: so that quotation has no real application to the cases under consideration. But, as I say, I have no real knowledge of this subject of discount.

The CHAIRMAN. You have had a good deal to do with financial matters and rates of return, have you not?

Mr. GREGG. No, sir; but I have studied it somewhat.

The CHAIRMAN. Would you consider a 5 per cent rate to be all right on an oil well?

Mr. GREGG. I would say frankly that from what little I know of the matter it appears to be too low.

The CHAIRMAN. Would you consider 10 per cent too low?

Mr. GREGG. I would not like to go any further than that. I do not know where I would draw the line.

The CHAIRMAN. As I understand it, you have a national reputation as a financier and treasury expert, and I was wondering if you would personally invest your money, or the money of your heirs, if you had any heirs, in an oil well on a 5 per cent or a 6 per cent basis.

Mr. GREGG. I do not think I would on a 5 per cent basis. Above 5 per cent I would say it would depend upon the reports of people who had greater knowledge than I as to the risk involved.

The CHAIRMAN. You would take some risk, then, at 7 per cent, when you could get a gold bond at 6 per cent?

Mr. GREGG. I would take a risk proportionate to the 1 per cent difference; yes, sir.

The CHAIRMAN. We will adjourn until 10 o'clock to-morrow morning.

(Whereupon, at 12.30 o'clock p. m., the committee adjourned until to-morrow, Wednesday, February 11, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, FEBRUARY 11, 1925

UNITED STATES SENATE,
SELECT COMMITTEE TO INVESTIGATE THE
BUREAU OF INTERNAL REVENUE.
Washington, D. C.

The committee met at 10 o'clock a. m., pursuant to adjournment of yesterday.

Present: Senator Couzens, presiding.

Present also: Mr. L. C. Manson, of counsel for the committee; Mr. L. H. Parker, chief engineer for the committee; and Mr. A. H. Fay, consulting engineer for the committee.

Present on behalf of the bureau: Mr. A. W. Gregg, special assistant to the Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, solicitor, Bureau of Internal Revenue; Mr. James M. Williamson, attorney, office of solicitor, Bureau of Internal Revenue; Mr. S. M. Greenidge, head, engineering division, Bureau of Internal Revenue; and Mr. W. N. Thayer, chief, oil and gas section, Bureau of Internal Revenue.

The CHAIRMAN. Are you going to continue this morning, Mr. Mason?

Mr. MANSON. Yes.

The CHAIRMAN. If you are ready, you may proceed.

Mr. MANSON. Some time ago I received a communication from a local lawyer, by the name of Walter Holland. This communication followed a verbal conference which was had between Mr. Holland and myself, at Mr. Holland's invitation. I do not think it is necessary to read this letter into the record.

The CHAIRMAN. Is that the letter that deals with the percentage on foreign moneys?

Mr. MANSON. Yes, sir.

The CHAIRMAN. Suppose you hold that until some of the other members of the committee are present, and let them pass upon it. I would like to have them hear it. I do not think it is a matter that concerns this committee, though.

Mr. MANSON. I do not, either.

The CHAIRMAN. But we will let the committee decide that.

Mr. MANSON. I am frank to say that I had expected at some day to submit this, when I reached that point, to the department and ask them to reply to this letter. I have been engrossed with other things and have neglected to do that. There was an interview published in the paper with Mr. Holland the other day in reference

to the matter, and I feel it is proper to submit it to the committee without any recommendation at all.

The CHAIRMAN. I met some newspaper men and I told them I did not think it was a matter the committee had anything to do with. It did not concern the investigation of the Bureau of Internal Revenue, as I understood it, and I would ask the committee to pass upon it, as I did not care to pass upon it myself.

You may proceed, Mr. Manson, with the matter that you are to present.

Mr. MANSON. I desire at this time to read into the record the written instructions issued by Mr. L. H. Parker, chief engineer for the committee, to the engineers employed under his supervision by the committee, and who are working in the Income Tax Unit. These instructions are in writing, dated October 25, 1924, and are initialed as having been noted by all of the employees who have from time to time been employed under Mr. Parker's directions. It is entitled "Memorandum to engineers."

The CHAIRMAN. Is this done for the purpose of answering the criticism by Mr. Nash as to the interference of our engineers down there?

Mr. MANSON. Yes.

The CHAIRMAN. The point that occurs to me is whether the instructions have been adhered to—not whether they have been issued, but whether they have been adhered to.

Mr. MANSON. We received no complaint from Mr. Greenidge or anyone else up to the time that Mr. Nash's letter was sent to the committee, to the effect that it had not been adhered to.

Mr. NASH. Mr. Chairman, if I may make a statement right here as to what called this matter to my attention, it is as follows:

Mr. McCloskey, who is the head of one of the audit sections in consolidated audit division, reported to me that he has a large room in which 50 or 60 auditors are working and that Mr. Thomas and Mr. Johnson, agents for the committee, came into his room and were interviewing one or more auditors with reference to cases that are under consideration by the committee. He went to Mr. Thomas and Mr. Johnson and called their attention to the fact that there was not a single auditor in that room working while these men were in the room. It is human nature; I can not explain it, nor do I offer any apology for it; but when one of these men comes into a room that is filled with workmen, the natural tendency is for everybody to stop work, to look around to see what is going on and what is likely to happen.

When Mr. McCloskey spoke to Mr. Thomas about it, Mr. Thomas rather resented it, and Mr. Parker came up to Mr. McCloskey's office afterwards and straightened it out.

I think he called their attention to the fact that if they wanted anything in Mr. McCloskey's division they should go to Mr. McCloskey and ask for it, and not step out into the audit division where people were working. That is the procedure that we asked to have followed down there. If an agent of the committee wants a case he should go to the head of the division and ask for the case, or call the individual auditor to his room and interview him there. There is certainly no objection to that, but I think the chairman can understand how it affects the workmen, if the representatives of the com-

mittee go into a large room where these men are working. They feel that somebody is under suspicion and that something is going to happen, and as soon as the representative of the committee steps in the room work practically stops.

The CHAIRMAN. I will say that if I were in charge of the bureau down there I would insist on the practice that you have just mentioned of confining inquiries to the proper heads.

Mr. NASH. I think that has been what has been desired down there, and I am not criticizing Mr. Parker or Mr. Manson, nor the men that have this work in charge for the committee, but I do think that some of the men that have been working for Mr. Parker have been indiscreet in this respect.

The CHAIRMAN. Then, there is no use of wasting time in discussing it. We will see that it is stopped. Will you see that that practice is stopped, Mr. Manson?

Mr. MANSON. Yes; but the thing I desire to answer is the necessary inference drawn from his letter that it has been the general practice of our engineers and others to go around the department and create a disturbance. There has been no such practice. In this isolated case, if it had been called to my attention, I am sure it would have been straightened out at once.

Mr. PARKER. And immediate action was taken on it.

Mr. MANSON. Yes; and it is very evident that Mr. Parker took immediate action on it when it was called to his attention.

The CHAIRMAN. I think, so far as I may speak for the committee, the committee understands the circumstances, and I do not think it is necessary to put all of those instructions into the record. Are they lengthy?

Mr. MANSON. They cover about a half a page.

The CHAIRMAN. If that is all, you may put them in. You need not stop to read them in. Hand them to the reporter and let him incorporate them in the record.

(The instructions referred to are as follows:)

OCTOBER 25, 1924.

Memorandum to engineers, Senate Committee for Investigation of Bureau of Internal Revenue

Kindly be governed by the following rules, the necessity for which is obvious:

1. No original papers of any kind are to be removed from the files you are examining and taken out of the building, even for overnight.

2. Copies of pertinent papers may be taken, but it should be remembered that they are confidential and must be handed in with your reports.

3. Conversations with persons outside the department and not connected the Senate committe reflecting on the department or giving any details of your work are prohibited.

4. The least possible annoyance should be given the employees of the Income Tax Unit, in that their work may not be disturbed or their production interfered with.

L. H. PARKER,
Chief Engineer.

Mr. MANSON. I also have a statement from Mr. Parker, regarding the entire situation, in reply to the letter of Mr. Nash.

The CHAIRMAN. As to just how this work has been conducted?

Mr. MANSON. Yes.

The CHAIRMAN. Do you desire to put that in?

Mr. MANSON. I do.

The CHAIRMAN. You may put that in the record also as long as Mr. Nash's letter is in.

(The letter referred to is as follows:)

"SENATE COMMITTEE FOR INVESTIGATION OF
BUREAU OF INTERNAL REVENUE,
February 11, 1925.

To: Mr. L. C. Manson, General Counsel.
From: L. H. Parker, Chief Engineer.
Subject: Morale of engineering division.

In view of charges of bureau that your engineers are disturbing the morale of the bureau's engineers, and in view of our general statement of our policy, which the writer corroborated in yesterday's hearing, it is desired to make a full statement on this subject.

First. Statement of counsel as to policy of committee's engineers is correct as a general principle, and has been followed as rigidly as possible.

Second. Exceptions to the policy have been made only when it seemed to be more advantageous to the unit to vary the above slightly, as follows:

(*a*) Your chief engineer has thought best to consult with head of division, assistant chief of division, and chiefs of section in their own private offices rather than in his own office. All these conferences were relatively short and avoided the necessity of taking administrative officers away from their desks.

(*b*) Your investigating engineer, Mr. Wright, has done a considerable amount of work at a desk assigned to him in the metals section. This action was at the suggestion of chief of the metals section, Mr. Grimes. It avoided much confusion in transmittal of papers and data. The amount of statistical data in Mr. Grimes's section was large and very valuable, and it was preferable from all angles not to take this matter out of the section.

(*c*) Mr. Thomas, on account of supervising the contractual amortization features of the work, as called for by Senator Jones, has been obliged in some instances to deal directly with the unit's engineers outside of his office.

(*d*) Papers, records, etc., have, of course, in the nature of the work been called for from the production committee or those in charge of same by your chief engineer and his assistants, in person.

Third. On October 25, 1924, five days after employing additional engineers on this work, your chief engineer addressed the attached communication to his force. (See Exhibit A attached.) This memorandum has been initialed by each member of the force on or shortly after date of employment. A copy of this memorandum was personally handed to Mr. Greenidge, head of engineering division.

Your engineers are very much surprised at this date with being charged with having unnecessarily disturbed the morale of the bureau. The fact that orders were given to cause the least possible annoyance to the bureau is evident from the written order herewith submitted. Your chief engineer, prior to yesterday's hearing, never heard one word of complaint on this subject from the head of the engineering division. In view of his having been furnished with a copy of your memorandum, he would certainly have felt privileged to complain if unnecessary annoyance was being caused. The only complaints received from the head of division were relative to proper arrangement of leaving papers on desks at night, covering typewriters, etc. All such requests we have tried to comply with in spite of the very voluminous files we have had to handle and the pressure under which we necessarily have to work in order to get production.

Further, your chief engineer has been assured by the chief of the metals section, the chief of the nonmentals section, the chief of the coal section, and the chief of the timber section that our investigation was not disturbing the morale of the force and that the investigation was welcomed.

In regard to the amortization section, it must be stated that its demoralization is evident to all. We contend that this is unavoidable and would of necessity have happened in any event, even if the investigation had been made by the Commissioner of Internal Revenue. It appears to your engineers that a lack of policy and a proper engineering basis in this section and the revelations made before the committee are responsible for this condition. We feel certain, however, that the ultimate effect will be a very great benefit not only to

the Government but also to the 15 or 20 engineers in this section who have had to do the best they could in their own way without a sufficient policy laid down to enable them to handle cases in a uniform manner.

Respectfully submitted.

I. H. PARKER, *Chief Engineer.*

Mr. NASH. I just want to state to the chairman that the complaint that Mr. McCloskey made to me is not the only one that I received. I have received others that are similar to that.

The CHAIRMAN. I think that Mr. Nash and Mr. Manson had better get together and have Mr. Nash tell Mr. Manson what those other cases are, and if the situation requires any action on his part, I am sure he will take it. This is a matter that the committee wants straightened out.

Mr. MANSON. Do you desire to ask Mr. Fay any questions with reference to his statement of yesterday in the record?

Mr. HARTSON. Mr. Manson, I am going over, very carefully, the written report of Mr. Fay's testimony, and I think it would be wasting time until I have fully covered it, to question him now at random. I would rather wait until I have finished with his report.

The CHAIRMAN. I want to refer to at least an inference that Mr. Gregg made yesterday, in reference to the rulings in the oil cases, with respect to discovery values, namely, that this whole statement was directed to a criticism of the bureau. I want to draw Mr. Gregg's attention to the fact that the resolution authorizing the organization of this committee was directed to investigating the Bureau of Internal Revenue, and was not confined to criticizing the bureau, but specifically stated that we should recommend corrective legislation for anything that we found wrong during the course of our investigation. Neither Mr. Gregg nor the other members of the bureau must conclude that everything that this committee or its agents says is exclusively a criticism of the bureau, but is brought to the attention of the committee for the purpose of corrective legislation. It is not only a criticism of the bureau; it is a criticism of the law in many cases.

Mr. GREGG. I realize that, Mr. Chairman, and I did not mean to leave the inference that I was just defending the bureau. I thought that was sufficiently stated. The thing I did want to bring out, which was not brought out, I thought, Senator, in Mr. Fay's statement, was that some of his criticisms, while apparently directed at the regulations of the bureau, were, in fact, criticisms of the law. I just wanted to bring that out so that the record would show that. That was my sole thought.

The CHAIRMAN. All right, Mr. Manson.

Mr. MANSON. In connection with the general subject of discussion of discovery value of oil, I desire to call the committee's attention——

The CHAIRMAN. Before you proceed with that, Mr. Manson, I am not clear in my mind whether there are two credits allowed, one for discovery value and one for depletion.

Mr. MANSON. No.

The CHAIRMAN. In other words, why, in this case, do you call it discovery value, and in the case of gravel or lime deposits, you call it depletion value?

Mr. MANSON. I will explain that. There are three things which, under different circumstances, may be depleted. If the owner of an oil well buys that well after 1913, and after it has been brought in—we will say that an operating oil well changes hands—the owner of that well would be entitled to a depletion allowance which, during the estimated life of the well, would return to him what he pays for the well.

The CHAIRMAN. Yes; I understand that.

Mr. MANSON. That is where an operating oil well changes hands after 1913.

The CHAIRMAN. That is what you call depletion?

Mr. MANSON. That is depletion. These are all cases of depletion, that is, depletion on cost.

The CHAIRMAN. I understand that.

Mr. MANSON. In the case of an oil well which was an operating property prior to the 1st of March, 1913, instead of the cost being depleted, it is the March 1, 1913, value that is depleted.

Mr. HARTSON. When it does not change hands in the meantime?

Mr. MANSON. Yes; when it does not change hands in the meantime. In the case of a well, or in the case of a property which is developed subsequent to March 1, 1913, under the conditions described here by Mr. Fay, a value is set up as of the date of the discovery, which is depleted. In other words, if an owner of a property brings in an oil well under the conditions under which discovery depletion is allowed, all of which we have gone into in a general way, and which we expect to go into further in a particular way, that discovery value, instead of the cost of the property, or instead of its March 1, 1913, value, is the basis of the depletion allowance.

The CHAIRMAN. In other words, in that case it is fixed at the price of oil within that 30-day period. That is what the fact is, is it not?

Mr. MANSON. No; that is not exactly the fact.

The CHAIRMAN. Well, is it not a fact that it is fixed during the 30-day period after discovery; that is, the depletion value?

Mr. MANSON. The depletion value is fixed.

The CHAIRMAN. Well, that is what I mean.

Mr. MANSON. Yes.

The CHAIRMAN. And in that respect it differs from the March 1, 1913, cost?

Mr. MANSON. Oh, yes.

The CHAIRMAN. And it also differs with respect to the value of the oil in the ground for an operating company which may be acquired after March 1, 1913?

Mr. MANSON. Yes; in the case of the sale of a going property, or in case of the acquisition of property which is not subject to discovery value. For instance, suppose that after this 160-acre tract is brought in——

The CHAIRMAN. When you say "brought in," you mean when oil is discovered?

Mr. MANSON. Oil is brought in in commercial quantities.

The CHAIRMAN. Yes.

Mr. MANSON (continuing). I buy a part of this 160-acre tract upon which oil has been discovered in commercial quantities. My

depletion allowance, if I bring in a well on the part which I buy, is based upon what I paid for that property.

We will say that Mr. Fay owns 160 acres of land. He has brought in a well in the center of that 160 acres. He sells me a piece off at one corner of it. The fact that Mr. Fay brought in a commercial well proves that area of 160 acres. If I buy 10 acres out of one corner of it, after he brought in that well, I am not entitled to discovery depletion because I have bought a proven tract or leased within the meaning of both the law and regulations. In that event the amount that I am entitled to deplete is what I pay for that property as distinguished from the discovery value

The CHAIRMAN. Let me see if I understand you so far. Assuming that hypothetical case that you have just referred to, and which I understand, but assuming further, for instance, that a wildcatter discovers oil and the price of oil is away down under a dollar a barrel, he would lose money if the contents of that well on that price basis did not equal what it had cost him to wildcat it?

Mr. MANSON. That is true.

The CHAIRMAN. I think I understand. You may proceed.

Mr. MANSON. To carry this illustration that I mentioned a little bit further, suppose that instead of buying a corner of Mr. Fay's 160 acres, I own a tract across the fence from this piece that I just mentioned, or I had a lease on it at the time that Mr. Fay brought in his well. Under the regulations I am entitled to discovery value upon any well that I bring in across the fence here, even though the fact that Mr. Fay has brought in a well establishes the fact that oil is under my property.

The CHAIRMAN. You say "under the regulations." You mean also under the law, do you not?

Mr. MANSON. Well, I do not give this same construction to the law that is given to it by Mr. Gregg.

The CHAIRMAN. We can discuss that later. You may proceed with your case.

Mr. MANSON. I might say very briefly that I believe that the law meant what it said when it referred to discovery. That means you discover something, and there is no logical relationship between 160 acres and a pool of oil.

The CHAIRMAN. Do you not think that the bureau had to put some definition on the word "discovery"?

Mr. MANSON. I believe this: I believe the definition that Mr. Fay quoted from the California regulations——

Mr. FAY. The California Bureau of Mines——

Mr. MANSON. Yes; from the California Bureau of Mines—is an intelligent definition, because it recognizes the fact that when you have oil in a certain place there are certain geological standards from which you determine the extent of that oil body, rather than by any arbitrary definition or arbitrary number of acres.

The CHAIRMAN. As I understand it, then, the view of counsel is that the bureau, instead of adopting this 160 acre measurement, should have used the Geological Survey?

Mr. MANSON. I take the position that they should have used, or recognized at least, the common geological experience.

The CHAIRMAN. Which would have meant resorting to the Geological Survey?

Mr. MANSON. Which would have meant resorting to the standards generally accepted by geologists in the oil business as the means of determining the extent of an oil body.

The CHAIRMAN. The difference between these two contentions is that in adopting the bureau's interpretation and plan, the taxpayer was relieved of an unreasonable amount of tax?

Mr. MANSON. Yes; not only is the taxpayer relieved—well, that depends upon who the taxpayer is, of course——

The CHAIRMAN. Just explain what you mean by the statement "who the taxpayer is."

Mr. MANSON. Suppose a wildcatter has a lease on 10 acres. If he brings in a well on his 10 acres, under the bureau regulations, the fact that he brings in the well on his 10 acres only proves a 10-acre area. If he had a tract of 160 acres, it would prove a 160-acre area.

The CHAIRMAN. Then, if counsel——

Mr. MANSON. I take the position that there is no relationship.

The CHAIRMAN. Just a minute, please. If counsel's contention is correct, why does not the wildcatter use the geological survey and avoid the necessity of wildcatting?

Mr. MANSON. There are two factors in the determination whether there is oil. In the first place, you have certain geological conditions to deal with, which are generally recognized by everyone in the oil business. In the second place, to prove that oil is there, you have to find it; but when you get a combination of an actual commercial well and certain geological conditions—now, I am not enough of a geologist to describe what those conditions are, but I do know that when you get a combination of a well and certain geological conditions, you can define with a reasonable degree of certainty the extent of that oil body, and there is no relationship between an arbitrary 160 acres following lines running due north and due south and due east and due west, and the extent of an oil body.

The CHAIRMAN. I understand, I think.

Mr. GREGG. Mr. Chairman, I do not know whether you want any discussion of this at this time, but in view of some of these statements, I should like to ask Mr. Fay what definition of a proven area he and counsel for the committee think should have been adopted by the bureau, or would you rather I postpone that?

The CHAIRMAN. I think it should go in here chronologically.

Mr. GREGG. All right, sir.

Mr. FAY. My definition of a discovery well would be a well of commercial importance and a specified distance from another commercially producing well.

Mr. GREGG. What specified distance?

Mr. FAY. Two or 3 or 4 miles.

Mr. GREGG. Why 2 or 3 or 4 miles?

Mr. FAY. Any distance which might be sufficiently large to possibly touch or open up a new oil pool. Oil pools, as they ordinarily go, cover comparitively small areas. They might cover an area of 3 or 4 miles square, or they might cover a township.

Mr. GREGG. All right, sir. Would it not be possible that if we adopted the suggestion that you make, that one well proves everything within 2 miles of it——

Mr. FAY. It does not prove it.

Mr. GREGG. All right. Then no discovery could be brought in and discovery value allowed on a well within 2 miles of a discovery well. Would there not be cases where that would be too great and other cases where that would be too little?

Mr. FAY. I think not. The intent of the law——

Mr. GREGG. Let me interrupt you there. You said 2 or 3 or 4——

Mr. MANSON. Let him finish what he started to say. Go ahead, Mr. Fay.

Mr. FAY. As I understand it, the intent of the law is to benefit, to subsidize, to some extent, the man who gambles, who spends his money to drill and discover a new oil well or a new ore body, and to my mind there is no reason to believe the man who follows along after the wildcatter and drills a well adjoining the well that the wildcatter has brought in, is entitled to discovery, because he already knew, both from the actual production and the geologic conditions, that he was 95 per cent sure of bringing in oil. Now, if the well is at a distance of 3 or 4 miles from this first discovery well, then it gives the possibility of discovery of a new oil pool, as I believe the law intended that it should be.

The CHAIRMAN. Let me see if I get that straight.

Suppose, for instance, you discover an oil well, and that it is a very small pool, and suppose a thousand feet away there is another pool discovered, or at least drilled. How would you determine whether that was a new discovery, or whether it was a part of the field that you had drilled?

Mr. FAY. There would be no way, Mr. Chairman, of actually telling.

The CHAIRMAN. In other words somebody has to do some guessing?

Mr. FAY. You would have to do some guessing.

The CHAIRMAN. In that connection, I would like to ask Mr. Gregg if, in formulating these regulations to determine discovery value, the Geological Survey was consulted?

Mr. GREGG. May I say this: What I was bringing out—and this is not in answer to your question, and may not touch it at all—was that Mr. Fay's proposal was arbitrary, as the regulations are. You have got to be arbitrary in the definition of a proven area. Any arbitrary definition is wrong in some cases, and right in some cases. The point that was not brought out by Mr. Manson is this, and this is where we consult the records of the Geological Survey: The regulations say 160 acres, at least, is proven by a given well. They then continue and say that it may prove more, depending on the circumstances of the case. Now, in saying whether a given well proves more than the 160 acres, that is where we should go to the records of the Geological Survey or any other records which are available, to determine the extent of the pool which was tapped by the first well.

The CHAIRMAN. And did the bureau do that? Did they go to the Geological Survey?

Mr. GREGG. Can you answer that question, Mr. Greenidge? I am really not familiar with it?

Mr. GREENIDGE. That definition of 160 acres, Mr. Chairman, was made, I think, in the year 1919. At least, it was made before I came here, and I understand that a great deal of investigation was done at that time to determine what would probably be the best area to specify. Consulation was had at that time, I have heard, with the United States Geological Survey, some of the Supreme Court's decisions dealing with discovery of ore deposits were also consulted, some of the best minds were gotten together on that particular subject, and it was found that 160 acres was just as near a correct area as could be determined upon arbitrarily. At best, it must be an arbitrary figure.

The CHAIRMAN. I would like to know whether there are any publications, or whether any opinions have been rendered by the Geological Survey covering that question.

Mr. GREENIDGE. I think there are. I could not say definitely, but I do know, from my past experience, that I have come across a definition of discovery by the Supreme Court in connection with solid deposits, metal mines, and, of course, I have known of the definition that was read into the record yesterday; but at the time the decision was made to use 160 acres as the discovery area, I feel sure that a great deal of attention was given to this definition before it was made. If you were to ask me right now what criticism I have to make of it, you would put me in a position where it would be very difficult for me to answer.

The CHAIRMAN. I would like to say that I think the controversy, if there is a controversy, between counsel for the committee and the bureau, is on the question of whether the arbitrary regulation was too liberal to the taxpayer and too harsh upon the Government, or vice versa. In that connection I might say that if the bureau desires to introduce any testimony to sustain their 160-acre regulation, they may do so, because Mr. Fay has put in testimony showing why he believes that the ruling of the bureau is too arbitrary in favor of the taxpayer.

Mr. GREGG. May I say just a word, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. GREGG. The point I was trying to bring out there was that the regulation is not as arbitrary, quite, as it sounds, because it may prove more than the 160 acres.

The CHAIRMAN. Yes; I understood that yesterday.

Mr. MANSON. I will say that I understand that this practice of the bureau is to accept the 160 acres arbitrarily.

The CHAIRMAN. Is that a correct assumption?

Mr. GREENIDGE. Yes, sir. With your permission, I would like to ask one question, Mr. Chairman.

The CHAIRMAN. Yes.

Mr. GREENIDGE. Mr. Fay, as I remember it, in yesterday's testimony, stated that he had made recommendations to the solicitor's office or to the office charged with the preparation of the last regulations, or with regulations 45, relative to a change in the application of the discovery section of the law.

Could you tell us, Mr. Fay, to whom that recommendation was made, so that we may be able to refer to it at some future time, if we wish?

Mr. FAY. I made the recommendation to E. H. Batson, deputy commissioner, through C. F. Powell, chief of the division at the time.

Mr. GREENIDGE. Then it is a matter that is in the files?

Mr. FAY. Whether it is in the files or not, I do not know. I do not know whether it ever got past the messenger boy, so far as I know.

The CHAIRMAN. Was that put in writing?

Mr. FAY. I had a written statement defining what I believed a discovery well should be.

The CHAIRMAN. And you handed it to a messenger boy, as I understand it?

Mr. FAY. No; I think it went to Mr. Powell's desk. As far as I can recall, it went through the ordinary procedure in handling the mail in the division, but I did write that recommendation.

The CHAIRMAN. Have you got a copy of it?

Mr. FAY. I have not.

The CHAIRMAN. You have no copy, and you have not the date?

Mr. FAY. Well, the date was, I presume, probably early in 1921. It was in the preparation of Regulation 45, revised, whenever that was.

Mr. GREGG. Mr. Chairman, do you want counsel for the committee to continue, or do you want discussion? There are some points in counsel's statement that seem to me to be questionable. Do you want that brought out at this time or would you rather have us wait on that?

The CHAIRMAN. What do you say about that, Mr. Manson?

Mr. MANSON. It makes no difference to me.

The CHAIRMAN. You may do that now, Mr. Gregg, if you desire?

Mr. GREGG. The first point in connection with counsel's statement is that a discovery under the regulation of the bureau proves the property on which the discovery is made to the extent of 160 acres. In other words, if discovery is made on a 10-acre tract, it would prove only 10 acres; and if discovery was made on a 160-acre tract it would prove 160 acres. I would like to read one part of the regulations on that, article 222. [Reading:]

In other words, a producing well shall be presumed to prove that portion of a given sand, zone, or reservoir, which is included in an area of 160 acres of land—

And the next language is in italics.

* * * regardless of private boundaries.

Mr. MANSON. I want to correct my statement. I recognize that I was inaccurate there.

The CHAIRMAN. Is that all, Mr. Gregg?

Mr. GREGG. Yes, sir.

Mr. MANSON. I now desire to call the committee's attention to several phases of the allowances made to the Gulf Oil Co. for depletion for 1917, 1918, and 1919.

The depletion on cost—I have called the committee's attention to the fact that there are two classes of depletion—the depletion on cost amounts to $6,570,100.30. The depletion on March 1, 1913, value for those years amounts to $4,947,327.12.

The CHAIRMAN. Is that in addition to the other amount?

Mr. MANSON. Yes. The depletion on discovery value for 1918 and 1919 amounts to $20,996,496.33.

The CHAIRMAN. Why did you use different years there than you did in the first instance?

Mr. MANSON. We have not the discovery depletion for the year 1917. It was not allowed, but the purpose of these figures is to show, as illustrating what we were talking about yesterday, that the amount of discovery depletion for the years 1918 and 1919 is twice as much as the amount of the cost depletion, and March 1, 1913, depletion for the three years. That discovery depletion is approximately evenly divided between the years 1918 and 1919.

The CHAIRMAN. Have you looked at any years beyond those years that you have just enumerated?

Mr. MANSON. No; we have not acted beyond 1919.

The discovery depletion in this case was the agency which removed this taxpayer from the 30 per cent bracket in 1918 to a normal 12 per cent in 1919.

I want to call the attention of the committee to the way this case was handled in the bureau.

The amended returns on the Gulf Oil Corporation and its subsidiaries was filed on February 19, 1921. The field auditors completed their report on February 20, 1921, and the letter fixing the amount of tax was dated February 26, 1921. In the preparation of this claim, the entire books of the taxpayer were rewritten by Ernst & Ernst, and no change was made in this taxpayer's claim by the bureau.

The CHAIRMAN. It was testified at the beginning of the hearings, if I remember correctly, that this case was hurried up because of Mr. Mellon's interest in it, and they decided to have it out of the bureau before he took office as Secretary of the Treasury. Is that correct, Mr. Hartson, do you remember?

Mr. HARTSON. That is correct. I think the testimony last spring showed that the then commissioner, Mr. Williams, had given appropriate instructions to close the case as quickly as possible, in order that it be out of the way before Mr. Mellon became Secretary of the Treasury.

The CHAIRMAN. I would like to ask Mr. Manson at this point this question: You referred to the fact that the engineers' report or investigation was completed upon February 20?

Mr. MANSON. I said the auditor's investigation was completed on February 20.

The CHAIRMAN. 1921?

Mr. MANSON. Yes. It is very apparent to me from the numerous errors all the way through this case, that no adequate check was ever made by the engineers of the taxpayer's claim for depletion allowance.

The CHAIRMAN. As I recall it, you said that the taxpayer's amended claim or amended return—which?

Mr. MANSON. The amended returns.

The CHAIRMAN. Was dated February 21. I got the impression that that was filed one day after the auditors had completed their work?

Mr. MANSON. February 19, and the auditors' report was dated February 20.

The CHAIRMAN. I understood the testimony to show that it was filed February 20, 1921, one day before the claim.

Mr. MANSON. And that tax was finally determined on February 26.

The CHAIRMAN. What was the tax that was determined upon at that time?

Mr. MANSON. It amounted to a net refund of approximately $4,000,000.

The CHAIRMAN. A net refund?

Mr. MANSON. Yes.

The CHAIRMAN. Have you found out, when that refund was made, whether it applied to other taxes?

Mr. MANSON. I can not answer that question, Mr. Chairman.

Mr. PARKER. That was not wholly in cash. I can say that this $4,000,000 was the net over-assessment, and I suppose a portion of it was a refund in cash and a part of it credited against other taxes. That is my impression about it.

The CHAIRMAN. Have the auditors looked up the records in that case?

Mr. MANSON. That is being investigated at the present time to see just what the status of it is.

The CHAIRMAN. Does anyone here know what is delaying the settlement of this oil case for those years? Do you know, Mr. Nash?

Mr. NASH. Do you mean——

The CHAIRMAN. For the subsequent years——

Mr. NASH. The years subsequent to 1919?

The CHAIRMAN. Yes.

Mr. NASH. Only generally, Mr. Chairman, that we have been trying to get all cases for 1919 and prior years out of the way, and on the more difficult cases for 1920 and subsequent years very little work has been done, and I presume the Gulf Oil Co. case is piled up with hundreds of others for 1920 and subsequent years.

The CHAIRMAN. Does that mean that the taxpayer is being penalized because of that delay, or that the Government is being penalized in not securing the taxes?

In other words, it seems to me that delay must penalize somebody somewhere.

Mr. NASH. Under the present statutes, Mr. Chairman, if the refund is determined in the settlement, the taxpayer gets interest from the date of payment up to the date of the approval of the refund, and I believe conversely, if there is an additional assessment made, we assess interest from the date that the tax should have been paid up until the date that it is paid.

The CHAIRMAN. That is not exactly in answer to my question. What I was interested in particularly was the principal and not the interest, because, in any case, either the taxpayer is out a large amount of money, or the Government is out a large amount of money, and I was asking Mr. Nash if he knew which was the case?

Mr. NASH. I think it works both ways. In some cases, probably, the taxpayer is deprived of the use of money that he has overpaid during those years, and in other cases the Government is deprived

of the use of money that would have been collected a few years ago if we had had those cases settled.

The CHAIRMAN. So, there is a necessity, in any case, it appears to me, for speeding up the conclusion of these cases.

Mr. NASH. That is the very big problem that confronts us. The thing that we are trying our utmost to accomplish is to get these old cases closed up and behind us.

The CHAIRMAN. Has the committee delayed your work in that oil case at all?

Mr. NASH. I have not had any complaint from the oil section. I do not know definitely.

Mr. GREENIDGE. I think I should say, Mr. Chairman, with your permission, that I would not say that there was complaint. There has been delay, of course.

The CHAIRMAN. By the work of the committee?

Mr. GREENIDGE. Yes, sir; and on those particular cases as to which you have just asked why there has been apparent delay, I should say that some months ago, probably six or more, I requested the chief of the oil and gas section to take up a number of big cases and start work on them, particularly those cases in which the taxpayers had supplied all the information up to the end of the year 1921, or 1922, so that I might be able to measure the amount of work the division would have to do to bring up to date all of the larger cases by the end of this year. I think at that time I suggested that they take four or six—I do not remember—but to take a certain number of the large cases, which involved from a thousand to several thousand leases, and to work those through, so that we would have something definite to base our estimates of time on. This case is one of those on which the taxpayers have supplied information, and which were being worked on, and which I got for the committee some weeks ago.

The CHAIRMAN. I am asking if the committee's agents have delayed closing it up?

Mr. GREENIDGE. Well, it has delayed progress. I do not know that they would have been closed up by this time. While it has delayed progress on this case, we have shifted the men to other work. The delay incident to taking the men off of it and starting them on something else means that they will just have to start back where they were and take up a lot of loose ends, and keep on.

Mr. PARKER. I can not quite understand why we are delaying the Gulf Oil case, because the whole matter was simply taken up through the year 1919, and the only papers available are the taxpayers' papers. There were no papers in the unit dealing with the engineering questions. Volumes and the Form O of the taxpayer for the years succeeding 1919, we have not touched, except in one instance, where I looked at the book to see if, in those following years, the same method had been pursued, and my belief is, from looking at that book, that in the Gulf Oil case they used the same method as they used in former years, or the unit would probably have to make up that whole form over again.

The CHAIRMAN. The Chairman does not understand how reviewing the settlement for 1919 and previous years could interfere with the investigation of cases for the years succeeding 1919.

You may proceed, Mr. Manson.

Mr. MANSON. I stated that I asked Mr. Thayer, the chief of the oil and gas section, who was in the room, whether our men had interfered in his section, and he stated a few moments ago to me in this room that they never had been in there except upon his invitation.

In arriving at the discovery values in the Gulf Oil case, no hazard factor is used in reducing the total expected profits to the present value, and the profits factor is 5 per cent. In other words, the total expected profits are only discounted at 5 per cent to arrive at the values as of date of discovery.

I desire to call the committee's attention to some of the results that are thus obtained.

The total estimated net receipts in the case of the Leana Fife lease, 6, volume 1061; that is, the total estimated net receipts less drilling, development and operating costs, are estimated at $793,252. The valuation set up amounts to $730,109. The life of the well is estimated to be 16 years. In other words, a person buying that well at that valuation would be expected to pay $730,000 for a well out of which they would expect to get $63,143, of profit, and wait 16 years before they got the whole of the profit.

In the case of the Leana Fife lease, page 7, the net receipts are estimated at $270,704. The valuation is $249,156. The life is 16 years. The total profit that the purchaser of that property at that valuation of nearly $250,000 would expect to get in 16 years is $21,548.

The CHAIRMAN. They could earn almost that much as lawyers, could they not?

Mr. MANSON. Almost. In the Leana Fife lease, page 7, the net receipts, $48,772; the valuation, $47,426; the life of the property, six years; and the total profit upon that valuation would be $1,346. In other words, it would require an investment of nearly $50,000, all of which would not be recovered back until the end of six years, in order to earn $1,346.

The CHAIRMAN. Has Mr. Gregg any comment to make on that result?

Mr. GREGG. I am not prepared to pass, from the curbstone, on these cases.

Mr. MANSON. The same lease, on page 8, the net receipts are $30,572; valuation, $29,728; and the life six years. The total expected profit, $844. That is the total expected net profit on an investment of nearly $30,000 for six years.

The Leana Fife lease, page 8, net receipts, $22,486; the valuation, $20,696; the life 16 years, and the total profit is $1,790.

The CHAIRMAN. When you mention profit, you mean estimated profit in all of these cases?

Mr. MANSON. I mean that if the amount of reserves is estimated correctly, and there is no fall in the price of oil, and all of the reserve that is estimated is recovered, if a man paid the value fixed upon these properties, he could not get a net return on his money in excess of the amount that I am stating as the profits, and it is manifest that a very small drop in the price of oil would wipe out all of these profits, that is, in the price below the price used as the basis of the estimate.

The CHAIRMAN. Do your records there show what price was fixed in arriving at those estimated values?

Mr. MANSON. I have not that before me. I am just giving these summary statements. We will furnish that information.

The CHAIRMAN. Has Mr. Parker any record of that there?

Mr. PARKER. Not of these particular ones, Senator. Of course, they all vary. In this case they may be anywhere from $1 to $2.50. They may all be different, according to the date that they have come in.

The CHAIRMAN. In view of the fact that counsel mentioned the variation in the price, it seemed to me appropriate to have in the record here something concerning that price, because it is equall true that if there was a rise in price there would be a larger profit.

Mr. MANSON. Yes; that is true.

The CHAIRMAN. Just the same as there would be a less profit if there was a drop in price.

Mr. MANSON. We will supply that information.

The Eliza Lowe lease, page 3, the net receipts are $71,702; the valuation, $65,995; the life, 16 years; the total profit would be $5,707.

The Eliza Lowe lease, page 4, the net receipts are estimated to be $19,206; the valuation, $18,570; the life, 9 years; and the total expected profit is $636.

The CHAIRMAN. In that connection, have you examined the leases in all the cases?

Mr. PARKER. No; these particular cases were picked out last night in about twenty minutes, by taking out a certain book and going through it at random. For this corporation for those years there were probably thirty to forty very large volumes that you would have to search through, and we did not attempt to look at all of these. We could not do it in the time that would be available and be able to present it to the committee at all.

The CHAIRMAN. Then, you could not say whether these were typical cases, whether they were the general run of cases, or whether they were exceptional cases?

Mr. PARKER. I can say that they are typical cases; yes, Senator. I looked at enough of them to see that that was generally typical of the way it was handled.

The CHAIRMAN. How could you determine that if you only looked over a few cases?

Mr. PARKER. I looked over a few, picking these out, but I have looked through quite a few volumes, and in making that statement, I rest it also on the statements made to me by my engineers, who have looked over many more cases than I have looked at, and they tell me that that is the method generally pursued.

Mr. GREENIDGE. May I ask a question, Senator?

The CHAIRMAN. Yes.

Mr. GREENIDGE. Are those valuations March 1, 1913, values, cost, or discovery values?

Mr. MANSON. These are discovery values.

Mr. GREENIDGE. They are discovery values?

Mr. MANSON. All of them.

I would like to have Mr. Fay call the committee's attention to some omissions and inaccuracies in connection with these valuations.

The CHAIRMAN. Are you now talking about the ones that are closed, or the ones subsequent to 1919?

Mr. MANSON. No; these are the 1919 and prior.

Mr. FAY. I have only had a chance to look over two that were handed to me yesterday.

The CHAIRMAN. Two what?

Mr. FAY. Two leases.

Mr. HARTSON. Mr. Fay, were you chief of the natural resources division at the time the Gulf case was closed, in February, 1921?

Mr. FAY. I was not.

Mr. HARTSON. So that you are thoroughly familiar with this adjustment yourself?

Mr. FAY. I am not thoroughly familiar with all the details of it, but I was in the oil and gas section when the case was put through, in February, 1921.

The CHAIRMAN. Did you approve of that settlement in 1921?

Mr. FAY. I do not approve of it.

The CHAIRMAN. How is that?

Mr. FAY. I say I do not approve of it.

The CHAIRMAN. But when this passed through your hands in 1921, did you approve of its settlement?

Mr. FAY. In 1921 I did not touch it. I was in the oil and gas section as a valuation engineer at the time, and I did not do any work on the case. The case was approved, I believe, by Mr. Powell, chief of section, at the time.

Mr. MANSON. You were not chief of the natural resources division at that time?

Mr. FAY. No; I was not.

Mr. HARTSON. Then, you misunderstood my question, Mr. Fay, because that was the exact question I asked you, whether you were chief of the natural resources division of the income tax unit in February, 1921, when that case was before the division?

Mr. FAY. No; I was valuation engineer under Mr. Powell, who was chief of the oil and gas section at the time.

The CHAIRMAN. And, as I understand it, you had nothing to do with this case at all in 1921?

Mr. FAY. No connection whatever, only I knew the history of the case.

The CHAIRMAN. That is not what we are talking about. We are talking about whether you knew of the case.

Mr. FAY. No; I had nothing to do with it.

The CHAIRMAN. Proceed, then.

Mr. FAY. Yesterday I brought up the point of discovery of an oil well on a second sand or zone, and Senator King asked the question: Can you point out any case where there were two discoveries in the same area. This case was handed to me last night, and I find that it has that question in it.

In this connection, I wish to file these statements as Exhibit C to my testimony.

This is a lease in the Burkburnett district, Wichita County, Tex. The lease was given to the Gulf Production Co. on February 26, 1912. It was to remain in force so long as oil and gas were produced in paying quantities. The royalty oil rate is one-eighth, and

the rate on gas $100 per year for each well where used or marketed. The cost of the property was cash $400 at date of acquisition, February 24, 1912.

The CHAIRMAN. Was that a lease, or was it purchased in fee?

Mr. FAY. It is a lease, because it mentions the royalty as one-eighth.

The CHAIRMAN. But you referred to the purchase price.

Mr. FAY. He paid a little bonus of $400.

The CHAIRMAN. For the lease?

Mr. FAY. For the lease. That is often done in the oil fields.

On November 20, 1912, he began drilling well No. 1. This well was completed on April 18, 1913, with initial daily production of an average of 27 barrels per day for the first month.

Well No. 2 was drilled and completed on August 9, 1917, with a production of 60 barrels per day for the month.

Well No. 3, which is claimed as a discovery well, was drilled and completed on July 12, 1918, 35 barrels per day.

Mr. MANSON. How large is the area covered by that lease?

Mr. FAY. This lease covers approximately 18 acres, as I recall—18.41 acres.

The first two wells were drilled, I infer from this map, into a sand 1,295 feet deep, and were producing oil over a period of years up to the time this discovery well was brought in.

This is a typical example of a case where the taxpayer has established a discovery on a deeper sand, namely, 1,873 feet, which is approximately 600 feet below the other wells, when he only had two producing wells from a sand which, according to the chart, was 1,295 feet deep. The taxpayer's first well, as of April, 1913, set up total reserves of 24,200 barrels. This was a 27-barrel well, and the reserves set up by the taxpayer for this particular well check fairly close with the estimate taken from a production chart in the Oil and Gas Manual. It checks within a thousand barrels.

Well No. 2, August, 1917, was brought in at 60 barrels per day, and should, according to the chart in the Oil and Gas Manual, produce approximately 30,000 barrels, which amount should have been added to the remaining reserves of well No. 1, and a new depletion unit obtained on cost. This, however, was not done. At the end of 1918, the estimated reserves for the 18-acre lease had been reduced to about 1,243 barrels, while the actual production from these two wells for 1919 was 6,035 barrels.

In establishing discovery value for the 1,873-foot sand—

First, the taxpayer assumes two wells of 21,800 barrels each, or 43,600 for the two wells. This estimate checks fairly closely with the chart in the Oil and Gas Manual.

Second, the taxpayer deducts from anticipated net receipts the cost of one well only, $21,470, in the place of two wells. Apparently, the first well has been charged to general operating or development expenses. This, then, has the effect of giving a higher depletion unit on the so-called discovery well.

Third, he does not deduct from his anticipated net receipts the cost of pumping and storing the royalty oil, which is 5,450 barrels, at 25 cents a barrel, which amounts to $1,362.50.

Fourth, the taxpayer's net value to be discontinued is set up as $54,830.

Fifth, from this amount, $54,830, there should be the additional deduction of one well, $21,470, and cost of pumping royalty oil, $1,362, with a total of $22,832, leaving the net receipts to be discounted as $31,938.

Mr. MANSON. Instead of how much?

Mr. FAY. Instead of $54,830.

Sixth, the taxpayer should have discounted this amount ($31,938) at 5 per cent, or a composite of 11.34 per cent, $3,628, which leaves a value of $28,370 as the present worth of the oil in the ground. This, divided by the taxpayer's reserves for these two wells, namely, 38,150 barrels, equals 74.3 cents.

Seventh, the taxpayer, in determining his depletion unit, uses the gross reserves, namely, 43,600 barrels, plus the remaining reserves of wells Nos. 1 and 2, which gives 44,843 barrels, which amount he has divided into $54,830 and obtained a depletion unit of $1.08 per barrel.

Eighth, this depletion unit of $1.08 is then applied to the total production from all wells on the lease, which is an erroneous application of the depletion unit, and not in conformity with law and regulations.

Mr. HARTSON. Let me see if I get that correctly in my mind.

Mr. FAY. Yes.

Mr. HARTSON. On this lease there were three wells?

Mr. FAY. Yes.

Mr. HARTSON. Two that went down to a 1,200-foot level, approximately?

Mr. FAY. Yes.

Mr. HARTSON. The discovery well, however, went down to 1,800 feet?

Mr. FAY. Yes.

Mr. HARTSON. The discovery value was placed on that well for purpose of depletion?

Mr. FAY. Correct.

Mr. HARTSON. After the depletion unit was arrived at, they applied it to the production of the three wells?

Mr. FAY. They did.

Mr. HARTSON. On the tract?

Mr. FAY. Yes.

Mr. HARTSON. And it is your contention that they should have applied it to the production from the discovery well only?

Mr. FAY. To only the production of the discovery well.

Mr. HARTSON. In other words, if they are entitled to discovery at all, it was upon the theory that they were striking into a new sand, and they have no business to apply the depletion unit based upon discovery in a new sand to the product of two wells that were in existence before the discovery well was drilled.

Mr. FAY. I might say in that connection that on the basis of estimated reserves as of April, 1913, they depleted the cost at the rate of 1.6 cents per barrel up to the time they brought in this discovery well on the lower sand, and from that date on the unit of $1.08 was applied to put this 1-cent oil that was remaining in the original wells and any production that came from those in excess of the reserves.

Ninth, the difference between the depletion unit established above for the discovery well and that set up by the taxpayer for the discovery well is 34.1 cents per barrel. On the taxpayer's reserves for well No. 3, for only 38,150 barrels, this amounts to $13,009.

Tenth, the application of the $1.08 depletion unit to the actual production of wells 1 and 2 from an upper sand for the years 1918 and 1919 amounts to 16,216 barrels, at $1.084 per barrel, or $17,878.

Mr. MANSON. Let me ask you a question right there. If those first two wells had produced more than their estimated reserves, or had nearly produced their estimated reserves, that would have returned the purchase price of the lease which was being depleted, would it not?

Mr. FAY. It would.

Mr. MANSON. And if they produced more than that, the taxpayer, under the regulations, would not be entitled to any depletion?

Mr. FAY. None whatever.

Mr. MANSON. By this method, if there is a surplus of oil over the estimated reserves, the taxpayer gets depletion upon that surplus at the new discovery rate?

Mr. FAY. He does, the way the set-up reads.

Mr. MANSON. Yes.

The CHAIRMAN. Is that applicable to all oil companies, do you know?

Mr. MANSON. That I can not say. In the case of this particular lease, the way this was handled is in violation of the regulations and the practice of the department, as well as the law.

The CHAIRMAN. I understand; but do you know whether this rule is applied to all cases under the rule which you have just criticized?

Mr. MANSON. I am not criticizing the rule in that respect.

The CHAIRMAN. I understand; but do you know whether the application of the rule that was applied to the settlement of this particular case was extended beyond the Gulf Oil case?

Mr. MANSON. I do not know about that.

Mr. FAY. I do not know myself, but that method is possibly applicable to many others.

The CHAIRMAN. Does Mr. Greenidge or anybody else know whether that particular oversight or practice has been continued in all the oil cases?

Mr. GREENIDGE. No, sir: it has not been continued. I am not quite sure that it is an oversight. I would have to have the particular lease in the record, so that I would be able to examine it.

The CHAIRMAN. Well, if Mr. Fay's contentions are correct, that the depletion was allowed after the estimated production had been exhausted, would that be a correct principle?

Mr. GREENIDGE. No, sir.

The CHAIRMAN. All right.

Mr. FAY. That is all I have on this particular case.

(The exhibits introduced by Mr. Fay are as follows:)

EXHIBIT 3

SCHEDULE 4. FOR PROOF OF DISCOVERY

1. Description of the property:

(a) Give a legal description of the property, including its location in section (or farm), township, range, county, and State: Staley-Ramming, 18.41

acres of land in block 35, Red River Valley, Wichita County, Tex. (Burkburnett district).

(*b*) Are you the sole owner? Yes. If not, give your ownership, interest therein, and the names and addresses and ownership interest of each of the other joint owners — — —.

(*c*) Is the property a leasehold? Yes. If so, give the name and address of the lessor and the lessee: J. I. Staley, Della Staley, and R. W. Ramming, Wichita Falls, Tex.; Gulf Production Co., Fort Worth, Tex.

(*d*) Give date lease was effective: February 26, 1912.

(*e*) Give date of expiration: Lease remains in force so long as oil or gas is produced in paying quantities.

(*f*) Give royalty rate: Oil, one-eighth; gas, $100 per year for each well where used or marketed.

(*g*) State whether bonus was in cash or property: Cash, $400.

(*h*) Give any unusual terms of lease: None.

2. Date of acquisition: February 29, 1912.

Table of well data

Number or letter	Date— Began drilling	Date— Began producing	Initial daily production (barrels)
1	Nov. 20, 1912	Apr. 18, 1913	27
2	July 1, 1917	Aug. 9, 1917	60
3	Feb. 20, 1918	July 12, 1918	35

Used electric drive

VALUATION OF PROPERTY

(*a*) What was the fair market value of the property as of date of valuation? (See schedule below.)

(*b*) How was this value ascertained?

(1) By comparison with values established by actual sales of similar properties? No.

(2) By appraisal? Yes.

(3) By assessed value? No.

(4) By other method? No.

If by comparison with values of other properties established by actual sales of these properties, give the details regarding each transaction so used and your basis of comparison.

Revaluation No. 1.

Sand horizon 1,800 feet.

Lease discovery well No. 3. Date, July 12, 1918.

Depth, 1,873 feet. Initial production, 35 barrels.

Estimated recoverable oil from discovery and wells to be drilled

Year	Average first 30 days production	Ultimate production	Number of wells to be drilled	Total recoverable oil
1918	35	21,800	(1)	21,800
1919	35	21,800	1	21,800

[1] Discovery well.

Total recoverable oil	barrels	43,600
Royalty 12.5 per cent		5,450
Net recoverable oil		38,150
Value of 38,150 barrels oil at $2.25 per barrel		$85,837.50

LESS—

Cost of 1 well at $21,470 per well	$21,470.00	
Cost of producing 38,150 barrels oil at 25 cents per barrel	9,537.50	
		31,007.50
		54,830.00
Less 11.3401 per cent for discount to present worth		6,217.78
Net value		48,612.22
Gulf 100 per cent working interest		48,612.22

Record of individual well production, by years, Staley Ramming lease, Burkburnett field

Well No. 1:	
1913	4,363
1914	4,601
1915	2,484
1916	1,971
1917	2,682
1918	3,585
1919	1,864
Well No. 2:	
1917	5,450
1918	6,586
1919	4,171
Well No. 3:	
1918	4,913
1919	3,913

EXHIBIT 4

Depletion schedule—Gulf Production Co., Pittsburg, Pa.

[Name of property, Staley Ramming lease; district, Burkburnett; State, Texas]

	Purchase								
1. Data pertaining to oil:									
(a) Date of purchase or revaluation	Feb. 29, 1912						July 12, 1918		
(b) Period for which depletion is figured	Mar. 1, 1913 Dec. 31, 1913	1914	1915	1916	1917	Jan. 1, 1918 July 12, 1918	July 12, 1918 Dec. 31, 1918	1918	1919
(c) Estimated recovery oil at date of purchase (barrels)	24,200.00								
(d) Estimated recovery oil at beginning of period (barrels)		20,636.66	16,105.68	13,548.65	11,571.29	6,259.61	1,243.94	6,259.61	36,703.91
(e) Estimated recovery oil; additions due to discovery, etc. (barrels)							43,600.00	43,600.00	
(f) Estimated recovery oil; total (barrels)	24,200.00	20,636.66	16,105.68	13,548.65	11,571.29	6,259.61	44,843.94	49,859.61	36,703.91
(g) Gross oil produced during period (barrels)	3,563.34	4,530.98	2,557.03	1,977.26	5,311.68	5,015.67	8,140.03	13,155.70	10,010.46
(h) Estimated recoverable oil at end of period (barrels)	20,636.66	16,105.68	13,548.65	11,571.29	6,259.61	1,243.94	36,703.91	36,703.91	26,693.45
2. Revaluation:									
(a) Value at end of last period	$400.00	$341.10	$266.21	$223.94	$191.26	$103.46	$20.56		$39,805.01
(b) Value of additions due to discovery, etc							48,612.22		
(c) Total value returnable	$400.00	341.10	266.21	223.94	191.26	103.46	48,632.78		39,805.
3. Sustained depletion:									
(a) Depletion unit value per barrel (II (c)÷I (f))	$0.016529	0.016529	0.016529	0.016529	0.016529	0.016529	$1.084439		1.084489
(b) Depletion sustained (III (a)×I (g))	58.90	74.89	42.27	32.68	87.80	82.90	8,827.77	$8,910.67	10,856.23
(c) Capital sum returnable at end of period (II (c)−III (b))	$341.10	266.21	223.94	191.26	103.46	20.56	39,805.01		28,948.78
4. Depletion applicable to cost:									
(a) Cost or unamortized balance of cost	$400.00								
(b) Undepleted balance at end of last period		341.10	266.21	223.94	191.26	103.46	20.56		16.83
(c) Additions to cost during period									
(d) Total cost returnable	400.00	341.10	266.21	223.94	191.26	103.46	20.56		16.83
(e) Unit cost per barrel (IV (d)÷I (f))	$0.016529	0.016529	0.016529	0.016529	0.016529	0.016529	0.016529		0.000458
(f) Depletion sustained on cost (IV (e)×I (g))	58.90	74.89	42.27	32.68	87.80	82.90	3.73	86.63	4.58
(g) Balance returnable at end of period (IV (d)−IV (f))	$341.10	266.21	223.94	191.26	103.46	20.56	16.83		12.25

Mr. HARTSON. Mr. Fay, may I ask you again the name of that lease?

Mr. FAY. Did I not give it in the record?

Mr. HARTSON. I think you did, but I did not get it in my notes.

Mr. FAY. The Staley-Ramming, 18.41 acres of land, in block 35, Red River Valley, Wichita County, Tex., Burkburnett district.

Mr. HARTSON. Do I understand that lease was purchased in 1912 for cash by a subsidiary of the Gulf Oil Co.?

Mr. FAY. The Gulf Production Co.

Mr. HARTSON. Yes.

Mr. FAY. Which is a subsidiary.

Mr. MANSON. I wish to say that the 5 per cent discount rate, the effect of which has been stated by me in connection with a limited number of leases, applied to all of the discovery valuations in connection with the Gulf Oil Co.

The CHAIRMAN. Was that percentage applied to other wells, where the other base of vaduation was fixed, such as the March 1, 1913, value, and the value of oil that was drilled on proven land?

Mr. PARKER. Five per cent is the one in use; yes, sir.

The CHAIRMAN. Is all of these leases?

Mr. PARKER. Of course, when you have cost, that is the value. You do not have to discount it.

The CHAIRMAN. Yes; I understand that; but I mean where you have to arrive at a discount value, is 5 per cent applied all through these cases?

Mr. MANSON. All through the Gulf Oil.

The CHAIRMAN. That is what I mean.

Mr. GREGG. Mr. Chairman, may I ask a question of Mr. Fay? In his discussion of the 5 per cent rate he immediately changed to 11 and a fraction per cent, and I do not understand exactly what he meant.

Mr. FAY. I can explain that.

The CHAIRMAN. As I understand that, he meant that a money value was added to it.

Mr. MANSON. No; what that means is this: It is discounted at the rate of 5 per cent a year. Instead of using Hoskold's tables, which assume a uniform depletion throughout the estimated life, the depletion is assumed to take place at so many barrels per year, and the investment is discounted at the rate of 5 per cent, compounded over that period.

Mr. GREGG. May I interrupt? Five per cent a year?

Mr. MANSON. Five per cent a year. By applying 5 per cent a year, by reason of the differences in the amount recovered each year, it results in a total composite percentage for the entire period of 11 and a fraction per cent.

Mr. GREGG. In other words, let me state it this way, to see if it is correct, Mr. Chairman. Your computations assume that the taxpayer would purchase on the basis of a 5 per cent return on his investment, and that is not correct, because he would get over 11 per cent return on his investment, when you consider that his investment each year was being decreased.

Mr. MANSON. Oh, no.

The CHAIRMAN. We have all of that before the committee.

Mr. FAY. It is 11 per cent for the whole period.

Mr. MANSON. It is 11 per cent for the whole period. In other words, the gross return that he will get during the entire period on the money that he has invested in that well is 11 per cent, plus—not a year, but 11 per cent for the whole period.

That is all we have to offer this morning. We will have further reports to make on this case.

The CHAIRMAN. Have you examined any other cases, or do you contemplate examining any outside of the Gulf Oil case?

Mr. MANSON. Oh, yes.

The CHAIRMAN. When will you be prepared with those cases?

Mr. MANSON. We have two cases of coal depletion which will be brought on next. We will have nothing further ready on oil until next Monday.

The CHAIRMAN. When do you want to bring on those coal cases?

Mr. MANSON. Tomorrow.

The CHAIRMAN. Are those anthracite or bituminous?

Mr. PARKER. I think they are both bituminous.

Mr. HARTSON. May we have the names, Mr. Manson?

Mr. MANSON. Yes; certainly. What are they, Mr. Parker?

Mr. PARKER. One is the Pond Creek Coal Co. and the other is the Houston Colliery Co.

Mr. MANSON. As my recollection is now refreshed, they are the two cases.

The CHAIRMAN. Where are they located—in Ohio, or West Virginia, or what district are they in?

Mr. MANSON. Do you know the fields that they are in?

Mr. PARKER. This was prepared entirely by Mr. Wright's force, and I have just read a part of one case casually.

The CHAIRMAN. Have you done anything with respect to the anthracite field?

Mr. PARKER. Yes; we are working on that now.

The CHAIRMAN. Do you want to ask any questions now, Mr. Hartson?

Mr. HARTSON. Not about this oil matter at this time, Mr. Chairman. I have a word that I would like to say with regard to the Saginaw Shipbuilding case, which was reported to the committee by Mr. Manson some days ago. That case involved the bureau's allowance for amortization to that company. At the time Mr. Manson called that case to the committee's attention I made a brief statement as to the difference between the Regulations 45 and Regulations 62, in the manner in which the allowance of contractual amortization by another Government department should be treated.

Under Regulations 45 there was no provision that such an allowance be computed to reduce the cost of the plant investment in figuring the income-tax amortization. Regulations 62, promulgated under the 1921 act, were the first regulations that made such a provision.

The CHAIRMAN. If I may interrupt you, do I understand that when Regulations 45 were issued there was no reference to contractual amortization?

Mr. HARTSON. That is right. There was no specific reference to it, so far as my knowledge goes, and I am positive of this, that there

was not a similar provision in Regulations 45 which required that such an allowance, if any be made by another Government department, be considered to reduce the cost of the company's investment.

The CHAIRMAN. Regardless of whether it was in the regulations or not, would the bureau allow amortization if the Shipping Board or the War Department had allowed amortization?

Mr. HARTSON. The bureau would treat it this way, Senator; if the War Department or some other agency made an allowance to a taxpayer for contractual amortization, that sum, so allowed, would be considered as income for the year in which it was received, for income-tax purposes.

The CHAIRMAN. And were they so considered?

Mr. HARTSON. They were so considered, and that is the case of the Saginaw Shipbuilding Co. The allowance was made by the Shipping Board in 1920. The allowance by the Shipping Board to this shipbuilding company did not specifically say that any amount of it was for contractual amortization, but assuming that some portion of the award was for contractual amortization, it was all taken up in the taxpayer's return in 1920 as income, and he was taxed at the 1920 rates.

The CHAIRMAN. What difference would it make in the tax whether that principle was followed, or whether the principle of deducting the amortization was followed?

Mr. HARTSON. Your engineers have had some computations made on that, Mr. Chairman, and I have them here before me. I do not know whether the chairman wants all of these figures to go in or not. I can make the statement from these figures, that——

The CHAIRMAN. Are they hypothetical cases?

Mr. HARTSON. They are hypothetical to this extent, Mr. Chairman, that there are different computations based on different assumptions in these cases.

For instance, the first one that was computed here was amortization computed by the unit of $1,104,363.40, spread over 1918, 1919, and 1920. The total contractual amortization was $685,171.34, given in effect in 1920. On that theory the tax would be $85,423.47.

Under another computation the contractual amortization of $685,171.34, spread as income for three years on the basis of vessels completed, and a total amortization computed by the unit of $1,104,363.40, spread over three years on the basis of income. That produced a tax of $110,397.46. The third computation is total amortization computed by the unit of $1,104,363.40, reduced by contractual amortization of $685,171.34, and the balance, $419,192.06, spread over the three years on the basis of income, producing a tax of $114,790.94.

The CHAIRMAN. It is the third computation, as I understand counsel for the committee, that should have been followed.

Mr. HARTSON. The last plan is the plan that counsel took the position should have been followed.

Mr. MANSON. I think, if I made any estimate of the tax, though, it was away off, because at that time I know that I did not fully appreciate the fact that the method which will produce the most tax depends entirely on the taxpayer's net taxable income in 1918 and 1919.

Mr. HARTSON. That depends upon the rate that his excess profits tax is computed at.

Mr. MANSON. Yes. If the taxpayer, as is the case with the most of the war manufacturers, has a high tax in 1918, the amortization allowance by the Government department, if deducted from the amortization allowed by the bureau, will produce more tax to the Government than if treated as income in some subsequent year.

Mr. HARTSON. That is true; but under some circumstances, as I conceded at the time I made the statement before, the inclusion in income of the total amount allowed by another government department may result in the taxpayer paying a lower tax than he would have paid had that amount allowed by another Government department gone to reduce his mortization claim. Now, it works the other way as well. In this case, Mr. Chairman, if I may continue, the tax assessed by the unit against this company, spreading the entire amount received from the Shipping Board as income, produced a total tax of $137,911.06. In other words, the tax that was actually paid is in excess of any of the computations that have been made on this. They paid more money than they would have paid had they been assessed on the theory that counsel suggests should have been followed in this case.

The CHAIRMAN. Yes. Now, do you not think that the third method there is the correct method?

Mr. HARTSON. I am not prepared to say that it is, Mr. Chairman, for this reason——

The CHAIRMAN. I mean regardless of the amount. I do not mean where you would get the most tax.

Mr. HARTSON. Yes; I agree with the chairman that this matter should be without regard to the results in tax that might be reached.

The CHAIRMAN. Yes.

Mr. HARTSON. We should attempt to administer the law as the law provides and the regulations that are promulgated thereunder.

The CHAIRMAN. Did not the law require the third principle there?

Mr. HARTSON. This is the situation, in direct answer to the chairman's question. The final amortization report in the case was made almost immediately after the new regulations were put into effect, and when I refer to the new regulations, I mean Regulations 62. This case was one that was in the mill, and was practically closed, so far as the amortization allowance was concerned, before any change in regulations was brought about. The final report, however, bears date subsequent to the promulgation of the new Regulations 62; it having been settled after Regulations 62 came into effect, in my judgment it should have been settled on the basis of Regulations 62. That would have required an upsetting and changing of what had been done, and a reauditing of the case, and I assume those who had it in charge thought that if the taxpayer was satisfied, paying an amount in excess of what they should have to pay by reason of the new regulations, the bureau could well be relieved of going back and changing it. That is the situation. Technically, I think it should have been settled under Regulations 62, as Mr. Manson suggests.

The CHAIRMAN. Regulations 62 contain a correct interpretation of the law, as I understand it.

Mr. HARTSON. It may be correct or may not. It is what the regulations now provide, and before Regulations 62 came into effect it was different.

Mr. MANSON. I think, theoretically, there can be no dispute but that Regulations 62 as to contractual amortization correctly interpret the law. The purpose of the amortization provision of the income tax law is to permit the offsetting——

The CHAIRMAN. Oh, yes; we have gone through all of that a number of times in the record, as to what the purpose of the amortization law was.

Do you want to make any further statement concerning that, Mr. Hartson?

Mr. HARTSON. Nothing else, Mr. Chairman.

The CHAIRMAN. You are not prepared to go ahead with anything further until to-morrow, Mr. Manson?

Mr. MANSON. No.

The CHAIRMAN. I would like to take up a matter now that I did not intend to take up this morning particularly, but because we have a few moments before the Senate convenes, I would like to refer to Mr. Nash's letter addressed to the chairman on February 9. In that letter Mr. Nash says:

> The committee investigating the bureau has been in existence now for practically a year.

That is substantially correct, but the committee has not been active, other than for a very small portion of a year. Is not that correct?

Mr. NASH. That is true, Mr. Chairman.

The CHAIRMAN. Do I understand that the fact that the committee was in existence, though not working, interfered with the efficiency of the bureau?

Mr. NASH. There was a little upset last March when the committee started its operations, Mr. Chairman. I do not think I intended to convey in that letter that our bureau had been upset all during this year, but I was mentioning the fact that the committee had been in existence for a year. There was a flurry last March when the committee was working. Conditions bettered somewhat during the summer, and then they have become worse again since we opened up last fall.

The CHAIRMAN. The fact is that the committee did not put anyone into your bureau, if I remember correctly, until the last part of September or October, 1924. Is that correct?

Mr. NASH. That is correct.

The CHAIRMAN. So that when you wrote this letter the committee had had investigators in your bureau practically for between four and five months?

Mr. NASH. Yes, sir.

The CHAIRMAN. Out of the entire year?

Mr. NASH. Yes, sir.

The CHAIRMAN. I think the bureau recognizes that, although Senator Watson was chairman of this committe at the time of its appointment, and from that time up until September, 1924, after I took sick and went to the hospital there was nothing done until the middle of September. In making that statement, I do not charge that Senator Watson is at all responsible, because I think he relied

upon the Senator who introduced the resolution to initiate the investigation rather than to expect him to do it; but whatever delay there has been since this committee was organized, is substantially up to the present chairman, I think. I bring that out because I want it understood tha' the commitee has not been dilatory, as I see it, in prosecuting the investigation, since the committee once got started, and the failure to get started earlier was due to the illness of the present chairman.

Now, there is another question raised by the following statement:

As a result of this investigation the employees of the bureau are badly demoralized, and the work of the bureau in some sections is almost at a standstill.

Tell us just what sections are almost at a standstill.

Mr. NASH. I refer there specifically to the amortization section.

The CHAIRMAN. By "at a standstill" do you mean the decisions are at a standstill, or the actual work?

Mr. NASH. The output is practically nothing from the amortization section. That is my information.

The CHAIRMAN. Do you mean by that that the decisions are at a standstill, or do you mean that no work is being done in making the investigations by the bureau?

Mr. NASH. The flow of cases through that section has practically stopped. Cases are not coming out. The cases involving amortization allowances are not being audited, because the cases in which this feature is involved are not coming from the amortization section of the engineering division.

The CHAIRMAN. But the employees are not remaining idle, are they?

Mr. NASH. No; the employees are there, and some of them are working after a fashion, but the organization itself is not functioning as it should.

The CHAIRMAN. I understand there is a difference of opinion existing between counsel for the committee and the bureau as to the method of arriving at amortization, but I do not understand that because of that difference all of the employees of the amortization section are idle, waiting for this decision to be reached.

Mr. NASH. Oh, no; that is not true, that they are sitting there; but in looking at it as a machine, it is not functioning, and there is no output of cases.

The CHAIRMAN. Have you reached any conclusion about this method of amortization, as to whether the contentions of the committee are correct or whether the contentions of the bureau are correct?

Mr. NASH. I do not know what you refer to specifically as the contentions of the committee and the contentions of the bureau.

The CHAIRMAN. Well, it is because of the contentions of the committee that the work has stopped; is not that correct?

Mr. NASH. It is because of the fact that the engineers in the amortization section have been taken off of their regular work and are working on other work, and because there has been more work done, I believe, by the committee engineers in the amortization section. More cases have been questioned from that section. We have settled something over 4,000 cases in the amortization section.

There remain to be closed just around three or four hundred cases. What the bureau had in mind was to close up those three or four hundred remaining cases and wind up the amortization section.

The CHAIRMAN. Why are you not closing up those cases?

Mr. NASH. I am unable to say definitely why they are not being closed. I do know that the cases are not coming through.

The CHAIRMAN. Well, as long as you made that——

Mr. NASH. There are 18 engineers in that section, and I think 10 or 11 of them have been diverted to other work. I know it has been brought up in the committee here that we have had to assign, I think, 10 of them to check up on contracts in various other Government departments to see if there are some items of contractual amortization that might have been overlooked. I have been informed that they have not found anything up to date, although they have been working on that for several weeks.

The CHAIRMAN. You have not found any what?

Mr. NASH. That these men who are investigating these contracts in other Government departments have found any items of contractual amortization that have been overlooked in the settlement of these cases.

The CHAIRMAN. Does Mr. Manson know whether they have found any?

Mr. MANSON. I do not think they have reported any.

Mr. NASH. I will be frank. It looks to me like wasted effort. That is something that is over the dam, as far as we are concerned, and half of our engineers are now working at the request of this committee on something that is not producing anything, when we have cases here that ought to be closed.

The CHAIRMAN. How do you reach a conclusion like that when the job is not completed, as to whether they will find anything? In other words, what suggested this inquiry largely was the Standifer case, and, as I understand it, when the committee suggested a checking of the contractual amortization allowances in the other Government departments, it was entirely agreeable to the bureau, particularly because of the Standifer case, which, itself, did seem to justify a complete checking of that question.

Mr. NASH. I do not recall that the bureau ever admitted that the Standifer case justified a checking of contracts in the other departments any more carefully than we had been checking them.

The CHAIRMAN. I do not contend that the bureau admitted it, because I know the bureau has been very careful all through the hearings not to admit anything. But what I do point out is that no objection was raised by the bureau to doing that, and the bureau did think sufficient of the Standifer case to reopen it, and the letters which were exchanged between the committee and Mr. Blair indicated that it was a case well worth looking into. Prima facie, anyway, the counsel for the committee did make a case which justified looking into it, and enough was brought in in that case to indicate to the committee that it might be quite possible to find other such cases. Anyway, there is a moral issue always, and it was well argued on the floor of the Senate yesterday, that in the appropriations for the war fraud cases to be used by the Department of Justice to investigate war frauds, they ought to be gone into anyway,

whether the investigation resulted in dollars and cents to the Government. If all moral issues and auditing questions are to be decided on the question of cost, then I think most of the corporations might abandon their audit departments, and they might dispense with the certified public accountants, on the theory that these certified public accountants do not find anything wrong, and because they do not find anything wrong, you must not do anything that, in other words, it is a waste of time and energy and money to put certified public accountants into a concern, because you discover nothing wrong.

Mr. NASH. Mr. Chairman, the bureau has checked all of these contracts in other Government departments to a certain extent, to the extent that they thought was justified. I think the evidence before the committee shows that the bureau did check the Standifer case in the Shipping Board, and the Standifer case was settled on the judgment of the men that went over to the Shipping Board.

Any other cases that may come up will depend upon the judgment of the men to find something additional in these contracts.

The CHAIRMAN. Do you think there is any justification for or any warrant against questioning the judgment of the bureau?

Mr. NASH. In the Standifer case?

The CHAIRMAN. In any case?

Mr. NASH. There are thousands of questions that come before the bureau every week that are so close that they can be decided one way or the other, and the decision will be the honest judgment of the man who has the question before him.

The CHAIRMAN. I have admitted that all the way down the line. I have discussed it with our own counsel, and I have discussed it with our own experts, and I have asserted up to date that the bureau has, in my opinion, at least, been justified in reaching some of their conclusions, and perhaps most of their conclusions, from facts which they had before them, and the opportunities presented, but do I understand that the bureau is above criticism?

Mr. NASH. No, indeed.

The CHAIRMAN. Or that the bureau must not be questioned by the Congress?

Mr. NASH. No, indeed.

The CHAIRMAN. Then, how is Congress to know whether they agree with the judgment of the bureau in settling these close questions, and how is Congress to know whether they should make the law more explicit, so as to aid the bureau in the administration of the law, unless it may inquire. The whole thing is preposterous to me, to think that because somebody is interfered with, because some taxpayer is interfered with, the Congress of the United States must not find out what kind of judgment the bureau is exercising in the carrying out of the will of Congress. In other words, you send auditors all over the country time after time, and I have had dozens of cases brought to my attention where you have required the taxpayer to go to great expense, to go through all of his books and examine his records and check up his returns, and you have returned again. I have not criticised that because I believe the bureau should be thorough, but in all of those cases the taxpayer has been greatly inconvenienced, the taxpayer has been required to spend

large sums of money in audits, the salaries of accountants, and lawyers' fees, because of the conduct of the bureau, but the Congress itself must not cause any inconvenience to the taxpayer. Congress itself is not justified in doing anything which would inconvenience the employees of the Government or the taxpayers who have dealings with them.

In other words, the situation is so peculiar that I do not understand it.

Mr. NASH. I think this may explain my position a little more clearly, Mr. Chairman: Probably less than an hour ago you asked me if the Gulf case had not been settled for 1920 and subsequent years.

The CHAIRMAN. Yes.

Mr. NASH. Now, the thing that permeates our whole organization, the thing that I preach every time I get a chance to talk to our administrative officers, is to get these cases closed, and to get the cases behind us for those past years. I am not satisfied to sit here today and say that we have not closed up the 1920 cases. I would like to have the 1920 cases closed and the 1921 cases and the 1922 cases. I would like to see the bureau working on current cases. When I made that statement in my letter, what I had in mind was this: The men were working on something that is apparently not productive; they could be working on cases that should be closed up and put behind us, so that we might become more current in our work.

The CHAIRMAN. The assistant to the Commissioner further states in this letter:

> Reorganizations, refinancings, enlargements, expansion and capital expenditures which, for the interests of the different business organizations, and for the prosperity of the country should be put through, are necessarily postponed until the liability for taxes is finally determined.

Does Mr. Nash think that the bureau itself, in investigating to determine these taxes in specific cases, has accomplished that same result at all?

Mr. NASH. Again it goes back to the closing of the old cases; there is not a day that people from various lines of industry do not come into our office and tell us that they want to get their cases closed up forever, that they are contemplating reorganizations, expansions, or additions of some kind, and that they can not get credit. The banks will not loan them money until their tax liability is settled. The banks also frequently write letters to our department and state that a certain firm is asking for a line of credit, or for a big loan, and that before they take action on that loan they want to know where the applicant stands as to his taxes.

The CHAIRMAN. That may be true; I do not doubt that, but is not that largely due to the delay in the bureau in settling these cases.

Mr. NASH. That is the very thing we are trying to overcome.

The CHAIRMAN. Yes; but this has been going on since 1919, and you have delayed for five or six years, and we have delayed them for four or five months, and we are adversely criticized for a four or five months' delay, when the bureau itself has delayed them for five or six years. I would like to ask if, at the meeting to-morrow, the bureau can state how many cases are being held up by the activities of this committee, and if that is not a practical question

or is of great difficulty to answer, I would like to ask in how many cases the bureau has notified the taxpayers or their agents that the committee is preventing the closing of their cases, because letters have been sent to the chairman, signed by Mr. Bright—at least I have seen them—saying that it was impossible to close these cases because of the activities of the Special Committee of the Senate investigating the Bureau of Internal Revenue. I think we ought to have our responsibility in this matter exactly defined, so, if the committee reaches a conclusion, we can arrange our plans so as not to have that happen.

Mr. NASH. Senator, may I just add one sentence here? I think the effect would come down to specific cases, but rather to a general condition, and I would just like to call your attention to these figures:

For the quarter ended December 31, 1923, we closed in the bureau, 554,000 cases. For the quarter ended December 31, 1924, we closed 414,000 cases. There is a drop of 140,000 cases.

The CHAIRMAN. Oh, of course, that——

Mr. NASH. I do not say that that may all be attributed to the fact that the bureau was under investigation, but——

The CHAIRMAN. The statement itself, Mr. Nash, is perfectly asinine. There is no way to determine the size of the cases, nor the amount of time involved in the settling of the cases, and you know that that kind of a statement in the record is absolutely misleading and misguiding. I can not interpret the intent of it; but you know that you, yourself, have pointed out that the small cases are settled first, and that after you had finished the small cases you would take up and speed up the big ones, and naturally the tail end of the work will show the slightest progress with regard to getting out numbers of cases, and they have no relation at all.

Mr. NASH. That is not the point I am trying to bring out, Senator, at all. The same program was followed in 1923 as was followed in 1924, as to the run of cases through the mill.

The CHAIRMAN. Yes; but you, yourself, have stated, and the record will show it, that some cases will take more time to work out than others.

Mr. NASH. That is true.

The CHAIRMAN. And that the easier cases were settled first where there was the least controversy.

Mr. NASH. That is also true.

The CHAIRMAN. So the number of these cases can not mean anything.

Mr. NASH. I can not agree with you on that.

The CHAIRMAN. That is the basis on which you figure your efficiency, and to me that is ridiculous, to rate a man's efficiency in the bureau by the number of cases he turns out, regardless of the kind of cases he handles.

We will adjourn until 10 o'clock to-morrow morning.

(Whereupon, at 12.05 o'clock p. m., the committee adjourned until to-morrow, Thursday, February 12, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

THURSDAY, FEBRUARY 12, 1925

UNITED STATES SENATE,
SELECT COMMITTEE TO INVESTIGATE
THE BUREAU OF INTERNAL REVENUE,
Washington, D. C.

The committee met at 10 o'clock a. m., pursuant to adjourment of yesterday.

Present: Senators Couzens (chairman) presiding, Jones of New Mexico, and King.

Present also: Mr. L. C. Manson, of counsel for the committee; Mr. L. H. Parker, chief engineer for the committee; Mr. Edward T. Wright, investigating engineer for the committee; and Mr. Hugh Archbald, investigating engineer for the committee.

Present on behalf of the bureau: Mr. A. W. Gregg, special assistant to the Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, solicitor, Bureau of Internal Revenue; Mr. James M. Williamson, attorney, office of solicitor, Bureau of Internal Revenue; Mr. S. M. Greenidge, head engineering division, Bureau of Internal Revenue; and Mr. R. C. Davis, chief, coal valuation section, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. The first case which I desire to call to the attention of the committee this morning is that of the allowance made to the Houston Collieries Co., a subsidiary of the Houston Coal & Coke Co., for the amortization of three leases on mining property.

This taxpayer owned three leases. The total values of these three leases were determined to be $477,711.44. It was determined by the Coal Valuations Section that the values of these leases should be depleted in accordance with the general practice and in accordance with the depletion section of the law and the regulations pertinent thereto.

The CHAIRMAN. Mr. Manson, in your statement there you used the expression "amortization."

Mr. MANSON. I used the term "amortization," because they made an amortization allowance—not an allowance of amortization on the war facility, but, as I will explain to the chairman, instead of depleting the value of these leases in accordance with the depletion provision of the law, the committee on appeals and review determined that the value of these leases should be amortized over the respective lives of the leases by allowing a deduction of the sum of $20,743.43 a year, regardless of the coal taken out under the

leases. In using the term "amortization" here, I use it in its broad general sense. They permitted the taxpayer to deduct the value of the leases, as though they were a lease upon a building for which a bonus had been paid.

These leases were typical coal mining leases. Two of them were for periods of 30 years, and one of them for a period of 21 years. All of the leases contain provisions providing for a renewal at the expiration of the period specified, without any increase in royalty.

The matter of the value of the leases is not a question at issue. We are not questioning the valuation placed upon the leases.

The issue which we present to the committee is whether these coal leases—these leases of coal lands for the purpose of permitting coal to be taken therefrom—should be amortized as you would amortize the value of a lease upon real estate, for agricultural purposes, or upon which the rent had been prepaid over a period of years, or a lease upon a building which had a value independent of the rental, by reason of the fact that the rental was below the market value of the rentals of such buildings.

In this case, the coal valuation section determined that the value of these leases arising out of the rights they conferred upon the lessee to mine coal was a value that was to be depleted in the ordinary way, which has been described before this committee, namely, by making a deduction which would be in proportion to the tonnage removed from the property each year.

Upon appeal to the committee on appeals and review, that committee determined that the proper method by which to make this deduction was by deducting an aliquot part; for instance, in the 30-year leases, one-thirtieth of the value of those leases each year, regardless of whether or not any coal was removed under them.

The CHAIRMAN. Of course, if there was no coal removed, then there would not be anything to deduct amortization from, would there?

Mr. MANSON. That is exactly the point I make in this case.

The CHAIRMAN. Then, there would not be any loss to the Government on this theory, if there was not anything to deduct from?

Mr. MANSON. Oh, yes; there would be, because, under the method provided in this case, by the committee on appeals and review, the taxpayer could make a deduction of one-thirtieth of the value of the 30-year lease, and one-twenty-first of the value of the 21-year lease, each year, regardless of whether he mined coal or not, and that is the very thing we object to.

The CHAIRMAN. I understand that, but I do not get clearly what he could deduct it from, he not having made any profits, if he did not remove any coal.

Mr. MANSON. He might mine on other preperty, or he might have a profit that would just be equal to the amount of this deduction.

The CHAIRMAN. In that case, of course, he would have removed some coal, but what I was trying to straighten out in my own mind was that if he mined no coal, then there would not be any opportunity to deduct it from any profits; but I understood you to say that he could make that one-thirtieth deduction on those particular leases from the operation of other mines he may be operating.

Mr. MANSON. He can deduct it from his income.

The CHAIRMAN. I understand that, of course, but I mean——

Mr. MANSON. Now, if that income arises out of another mine, he could deduct it from that. The point I desire to make is that there is no relationship——

The CHAIRMAN. I understand that, but what I am trying to get at is whether he, owning a number of leases, and failing to operate under some of them, could deduct amortization or depletion from the mines he does not operate from the profits made on the mines that he does operate?

Mr. MANSON. Yes; under this method of allowing amortization of these leases.

Section 214(a) of the statute, which provides for deductions, provides, in part, as follows:

That in computing net income there shall be allowed as deductions:
* * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Under article 109, which is the regulation pertinent to that provision of the statute that I have just read——

Mr. HARTSON. Is that regulations 62, Mr. Manson?

Mr. MANSON. Yes; regulations 62.

Article 109 provides:

Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return, an aliquot part of such sum each year, based on the number of years the lease has to run.

It is manifest that the amortization of the value of these coal leases was made under the provision of the statute that I have just read, and under the regulation that I have just read. It is the contention of committee's counsel that that provision has no application to the case of a mining lease, but that recovery of the value of a mining lease is a proper subject of depletion.

The depletion statute is one that has been frequently called to the attention of the committee, and I will now call the committee's attention specifically to the second paragraph of article 201, which says:

The essence of the provisions of the statute—

That is, the provisions referring to depletion——

is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure an aggregate of annual depletion and depreciation deductions, the return of either (a) the cost of this property if acquired subsequent to March 1, 1913, or (b) the value of his property on the basic date, plus subsequent allowable capital additions, including land values, for purposes other than the extraction of minerals.

I also wish to call the committee's attention to subdivision (b) of article 210 of regulations 62, which reads as follows, referring to mining property:

When the value of the property at the basic date has been determined, depletion sustained for the taxable year shall be computed by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion so determined by the number of units sold or produced within the taxable year.

It is very clear that the depletion allowances upon mineral properties, upon mines, must be predicated upon the number of units removed during the year.

The CHAIRMAN. Did you make any comparison between the method adopted and what would have been the result if figured on the basis of tonnage removed?

Mr. MANSON. On the basis of tonnage removed, the depletion for the year 1917 would be $3,953.60, as against the allowance deducted by the Committee on Appeals and Review, of $20,743.43.

It is obvious that the committee, in considering this case, ignored the essential difference between a lease of property which confers upon the lessee merely the right to use the property, and leaves the property intact at the expiration of the lease, as is the case of the lease of lands for grazing purposes, for agricultural purposes, the lease of buildings for manufacturing, office, or residential purposes.

In the case of a lease of coal lands, carrying with it the right to take coal, the lease is, in fact, the sale of coal. The right to enter upon the property and remove the coal is an incident to the real purpose of the lease, which is to convey title to that portion of the coal removed during the period covered by the lease. The same thing is true of a lease of timber property, carrying with it stumpage rights.

The CHAIRMAN. Do you know whether that principle has been used generally in coal leases?

Mr. MANSON. It is my information that it has not been used at all by the Coal Valuation Section of the Engineering Division. Am I not right about that, that it is not the practice of the coal valuation section?

Mr. DAVIS. They occasionally use it where the mine is exhausted, and then it resolves itself into the same answer as to the depletion, but it is not customary to close——

Mr. MANSON. I understand that Mr. Davis is chief of the coal valuation section.

The CHAIRMAN. As I got Mr. Davis' answer, it was that the valuation section did not use this method which you complain of.

Mr. MANSON. No.

The CHAIRMAN. They were reversed by the committee on appeals and review.

Mr. MANSON. They were reversed by the committee on appeals and review.

The CHAIRMAN. And after having been reversed in that way by the committee on appeals and review, is that generally used by the department now?

Mr. DAVIS. No, sir.

The CHAIRMAN. Is it only in a few cases or in a large number of cases?

Mr. DAVIS. It was never used by the Department, except where the taxpayer made a demand that it be used, citing this decision of the committee on appeals and review as his authority.

The CHAIRMAN. And after the taxpayer has cited that as his authority, does the bureau then accede to the taxpayer's viewpoint on that question?

Mr. DAVIS. Not if we can help it; no, sir.

The CHAIRMAN. But are you successful in helping it?

Mr. DAVIS. We have been quite successful.

The CHAIRMAN. So that we may reach the conclusion that this practice has been fairly well defeated by the coal valuation section?

Mr. DAVIS. It is always hanging over our heads, and causes more or less trouble.

The CHAIRMAN. Then, you have never been convinced, even in spite of the decision of the committee on appeals and review, that you should follow the practice adopted by them?

Mr. DAVIS. We have never considered that the decision handed down by the committee on appeals and review on that one case bound us irrevocably in all other cases. However, that is a disputed point, whether it does or not.

The CHAIRMAN. In other words, the point disputed is whether that decision handed down by the committee on appeals and review is binding in other cases?

Mr. DAVIS. That is the point which gives us a great deal of trouble, because a taxpayer who can claim that point to his great advantage, will claim it, and we have to combat it.

The CHAIRMAN. Can you tell us, Mr. Davis, any other cases where this matter has been dealt with in that manner?

Mr. DAVIS. Where it has been claimed on account of this decision of the committee?

The CHAIRMAN. Yes, sir.

Mr. DAVIS. I can not, offhand.

The CHAIRMAN. Has any attempt been made to get a uniform policy in that connection?

Mr. DAVIS. Oh, yes. We are making attempts all the time to hold our uniform policy in the department of not following this decision of the committee on appeals and review.

The CHAIRMAN. Do you know whether the solicitor's office has ever been called upon to pass upon it?

Mr. DAVIS. They have not, to my knowledge.

The CHAIRMAN. Do you know whether the commissioner has ever been called upon to pass upon it?

Mr. DAVIS. He has in an indirect way, recently. It was not the commissioner, directly, but it was brought to the attention of Mr. Allen.

The CHAIRMAN. What is Mr. Allen's position?

Mr. DAVIS. Mr. Allen's position is assistant deputy commissioner, next under Mr. Bright, assistant deputy commissioner. This was brought to his attention recently, at a meeting held in his office between the Coal Operators' Association, and the unit, represented by Mr. Greenidge and myself.

The CHAIRMAN. Was any decision reached at that time?

Mr. DAVIS. No, sir.

The CHAIRMAN. When this case was brought to Mr. Allen's attention, was it brought to his attention in the form of writing, or in the form of a brief?

Mr. DAVIS. No, sir; it was just general talk at this meeting.

The CHAIRMAN. In this meeting, you presented the views of the coal valuation section; is that correct?

Mr. DAVIS. Yes.

The CHAIRMAN. Who presented the other views at this meeting?

Mr. DAVIS. No one. That is the only time that this thing has been brought up, and it was brought up then casually, and more or less as a side issue, with other things. It has never been brought up officially, in writing.

The CHAIRMAN. The representatives of the Coal Operators' Association were at this meeting. What were they there to secure?

Mr. DAVIS. They were at a conference of their own. It was a convention of coal operators here in Washington, and while they were here there was a committee of them that waited on Mr. Allen, concerning some decision—I can not give you the number of it—that had been passed by the Solicitor's office recently, and this decision pertained to article 222, on depreciation. They were protesting against that decision to the office of the commissioner. That was the object of this meeting.

The CHAIRMAN. And during that meeting this question of amortization or depletion was discussed?

Mr. DAVIS. Yes, sir. This decision that was handed down in the Houston Colliery case was brought up and talked over. It was brought to their attention.

The CHAIRMAN. And did the coal operators contend for this viewpoint as established in the Houston Collieries case?

Mr. DAVIS. The operators did not have anything to say about this. As I say, this was brought up as a side issue. I brought this up at that time, just to get it to the attention of the department.

The CHAIRMAN. Has anyhing been done about it since then, do you know?

Mr. DAVIS. No, sir.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. HARTSON. Just one further word of possible explanation, in order to make clear Mr. Davis's statement as to who were present at this meeting, at the time he called attention to the Houston Coal Co. case. Were the coal operators present in the room at the time you mentioned this case to Mr. Allen?

Mr. DAVIS. Yes, sir.

Mr. HARTSON. They were?

Mr. DAVIS. Yes, sir.

Mr. HARTSON. So that the representatives of the coal companies were thoroughly familiar with the holding in the Houston Coal Co. case?

Mr. DAVIS. I can not say that.

Mr. HARTSON. Well, they were certainly after you called it to their attention, were they not?

Mr. DAVIS. Well, some of them, but I doubt if all of them were, or whether the majority of those coal operators knew what we were talking about. They were there on another object.

Mr. HARTSON. When was this conference?

Mr. DAVIS. I can not give you the date. It was a few weeks ago.

Mr. HARTSON. How long ago?

Mr. DAVIS. A month or six weeks.

Mr. HARTSON. Just recently?

Mr. DAVIS. Yes, sir.

Mr. MANSON. The real value in a mining lease, consisting, as it does, of the right to remove the metal or remove the coal, as in this

case, is not directly affected by the lapse of time, as in the case of the rental of a building. If I rent a building and do not use the building during a part of the time, I have lost forever the value which was covered by that period of time.

The CHAIRMAN. To the extent, at least, of the rental paid.

Mr. MANSON. To the extent of the rental paid.

In the case of a lease which has a value independent of the rental, suppose I pay a $10,000 bonus for a 10-year lease, and if, during a year or two years of that period, I do not use the property, that portion of my bonus which represents the share of it covered by the used period is a loss. In the case of a lease where the right to enter upon the property is a mere incident to the right to take from the property, something of value, which, when taken from that property, decreases the value of that property, the mere lapse of time has nothing to do with the decrease in value. I may, by speeding up my operations in a subsequent year, make up for that loss.

In this case two of these leases were 30-year leases, and one of the leases was a 21-year lease. Each of these leases contained a right to renew. This value was distributed over 30-year periods, and a 21-year period, to be deducted in equal proportions.

It is manifest that what actually gave those leases their value was the right to remove coal for a period of 60 years in the case of the two 30-year leases, and for 42 years in the case of the other lease. The renewal privilege in such cases gave to those leases a part of their value, but even if such a basis as was adopted by the committee on appeals and review were to be recognized as sound, the distribution of that value for purposes of deduction over the mere first half of the period resulted in allotting to that half twice as much of that value as really attached to that half.

Mr. CHAIRMAN. Mr. Davis, were you in the bureau when this case was before the bureau?

Mr. DAVIS. I can not say whether I was or not, Senator. I did not handle the case personally, and without knowing the time I could not say whether I was there or not.

The CHAIRMAN. Do you know, Mr. Manson, who comprised the committee on appeals and review at that time?

Mr. MANSON. I do not.

Mr. HARTSON. Have you a copy of the committee's recommendation there, Mr. Manson?

Mr. MANSON: No; I have not. I have just the substance of it.

Mr. HARTSON. Have you the date of it?

Mr. MANSON. It is somewhere in this document. I can furnish it to you.

The CHAIRMAN. Has anybody here got it? If so, this is a good place to put it into the record.

Mr. MANSON. This decision was published as recommendation No. 6459 in C. B.——

Mr. HARTSON. Cumulative Bulletin.

Mr. MANSON. Cumulative Bulletin, volume 3, No. 14, page 3, April 7, 1924.

The CHAIRMAN. This case is important, of course, in view of the fact that as long as there is a tax this question will be involved.

Mr. MANSON. Oh, yes; and it is important for another reason.

As Mr. Davis has intimated, I am of the opinion that the rulings of the committee on appeals and review are at least presumed to constitute precedents which are supposed to be followed, and the maintenance of the present method of distributing these values by the Coal Valuation Section depends upon the resistence of the chief of that section to the effect of this ruling. It really presents a situation where it is at least extremely difficult to maintain any uniformity of policy with respect to the distribution of these values for depletion purposes.

Am I right about that, Mr. Davis?

Mr. DAVIS. You are, sir.

Mr. MANSON. I have just a few more sentences to conclude what I have to say on this subject.

It is manifest that the value here attaching to the coal in the ground is depleted as that coal is removed. It is conceivable that one of these leases could have its entire value depleted and could then be sold to another operator for the full value which has been attached to it.

The CHAIRMAN. And then he may continue to deplete it.

Mr. MANSON. And then he may continue to deplete it.

The point is, that the entire value, attaching not to the use, as in the case of real estate, which is what is provided for by the first provision of the statute, and the first regulation which I read, but attaching, as it does, to an article which is to be consumed and the consumption of which is to reduce the value of the property, there is nothing to deplete and nothing to amortize, except as that value is reduced and except as this property is removed from the premises.

The CHAIRMAN. Do you know the price of coal to be used in arriving at this depletion?

Mr. MANSON. No: I do not. I have made no further investigation of this case than was necessary to develop the principle that was involved.

The CHAIRMAN. Does any of the engineers here have any paper showing the price of coal that was used?

Mr. WRIGHT. I think, Mr. Chairman, it was practically the depletion rate—practically 2 cents.

Mr. MANSON. A ton?

Mr. WRIGHT. A ton; yes. That is, the valuation section used a depletion rate of practically 2 cents. I have not the exact figures.

The CHAIRMAN. Where were those coal mines?

Mr. MANSON. There are located in West Virginia, in McDowell County. Is not that right?

Mr. WRIGHT. Yes.

Mr. MANSON. Bituminous coal?

The CHAIRMAN. Did you say that you want to present another case now, Mr. Manson?

Mr. MANSON. Yes.

Mr. HARTSON. Mr. Chairman, at this point, may I ask Mr. Davis a question or two?

The CHAIRMAN. Yes.

Mr. HARTSON. I understand, Mr. Davis, that you are the chief of the coal valuation section.

Mr. DAVIS. Yes, sir.

Mr. HARTSON. This recommendation of the committee on appeals and review was in the case of a coal-mining property, was it not?

Mr. DAVIS. Yes, sir.

Mr. HARTSON. And it had direct application to the work of your section, had it not?

Mr. DAVIS. It had.

Mr. HARTSON. You know of your knowledge, do you not, that the committee on appeals and review's recommendations are approved by the commissioner?

Mr. DAVIS. Yes.

Mr. HARTSON. When approved by the commissioner, they constitute, at least in cases of like kind and character, authority for the decision of subsequent cases?

Mr. DAVIS. Yes, sir.

Mr. HARTSON. Now, if I understand you correctly, this recommendation in the Houston coal case was embarrassing to you as chief of the coal valuation section, because it was a departure from your practice in that section of settling other cases?

Mr. DAVIS. Yes, sir.

Mr. HARTSON. How long have you known of this decision in the Houston coal case?

Mr. DAVIS. Oh; it seems to me I have known of it for a year.

Mr. HARTSON. Is it a correct way to put it that it has been a thorn in your side for about a year?

Mr. DAVIS. Yes, sir.

Mr. HARTSON. To whom have you complained?

Mr. DAVIS. Nobody.

Mr. HARTSON. Did you bring it to the attention of Mr. Greenidge?

Mr. DAVIS. I might have mentioned it casually. Such things as that are mentioned from time to time. I do not recall, but I have probably mentioned it at some time, just as we are here saying that it was causing us trouble.

Mr. HARTSON. The first time that you called it to the deputy commissioner's attention was at the time that you referred to, in Mr. Allen's conference.

Mr. DAVIS. And that was only casually, as I say, a side issue to the stuff that was being talked about.

Mr. HARTSON. So far as you know, it was never called to the commissioner's personal attention, to the attention of Mr. Blair?

Mr. DAVIS. Not officially and in writing.

Mr. HARTSON. Well, do you know of its having been called to his attention unofficially or orally?

Mr. DAVIS. No; I do not.

Mr. HARTSON. Do you not think, Mr. Davis, that a case of the importance of this case, which, to your mind, was wrong and an improper interpretation of the statute and the regulations, warranted your protesting in some formal way to the commissioner or his assistants, particularly when, in the settlement of subsequent cases, you say it proved of constant embarrassment?

Mr. DAVIS. Just what is your question? You say did I not think——

Mr. HARTSON. Just read him my question.

(The reporter read the question as above recorded.)

Mr. DAVIS. No. If you understood the way the work was going at that time and the business we had on hand and the way we were rushing to get the work done and get things current, you would not think that it was strange that we did not stop to make official and written protests to a decision of that kind handed down by the committee on appeals and review, when we were getting decisions from time to time that gave us more or less embarrassment. You would just figure on making the best of it for the time being, like I said we had done in this case, and fight it out on our own hook until such time as we could get things in the department in shape where we could probably have time to take these matters up officially, through official channels. That takes a great deal of time, as you know.

The CHAIRMAN. This discussion has reminded the chairman that the engineers or chiefs of sections who had the temerity to oppose these decisions were threatened with reprisals by Mr. Greenidge. I do not know whether this witness was threatened with any reprisals, but certainly some of the section heads were. The communication read into the record under the signature of Mr. Greenidge would tend to scare off any timid soul against protesting.

Mr. HARTSON. Mr. Davis has had no such experience as that with Mr. Greenidge. Have you, Mr. Davis?

Mr. DAVIS. No, sir; and I am not a timid soul, either.

The CHAIRMAN. I gathered that from your statements.

Mr. DAVIS. No, sir; I had no such intimidation.

The CHAIRMAN. Have you any efficiency records in the bureau?

Mr. DAVIS. Yes, sir.

The CHAIRMAN. How do they rate you?

Mr. DAVIS. As a valuation engineer.

The CHAIRMAN. Yes; but valuation engineers, of course, have different ratings as to efficiency, do they not?

Mr. DAVIS. Well, as my rating goes now, as chief of section, which position I have held for the last two years, I do not know how it stands. I would not see it. I could see it if I would ask, I guess.

The CHAIRMAN. Before you became chief of section, what were you then?

Mr. DAVIS. Valuation engineer.

The CHAIRMAN. Did you have a rating as valuation engineer?

Mr. DAVIS. Yes, sir.

The CHAIRMAN. Do you know what that rating was?

Mr. DAVIS. I do not.

The CHAIRMAN. Do you know how it was arrived at?

Mr. DAVIS. I do not.

The CHAIRMAN. Is there anyone here who can enlighten the Chairman on that question?

Mr. HARTSON. Mr. Chairman, the efficiency ratings of employees of the bureau are standardized now, under the regulations of the Personnel Classification Board, which is an organization independent of the bureau.

The CHAIRMAN. When did that organization start that?

Mr. HARTSON. Possibly Mr. Nash can answer that. I do not know when it was begun.

Mr. NASH. We have been working on the efficiency ratings, I think, since about the 1st of July. They were completed somewhere around the first of the year. They are on the forms prescribed by the Personnel Classification Board, and are made up according to the directions and rules of the Personnel Classification Board.

The CHAIRMAN. Prior to that time, however, you maintained an efficiency record, did you not?

Mr. NASH. Yes, sir. Efficiency records were maintained to a certain extent in the income-tax unit.

The CHAIRMAN. Yes. Do you know how they were arrived at?

Mr. NASH. Partially.

The CHAIRMAN. Will you tell us?

Mr. NASH. There were a number of elements taken into consideration—the employee's adaptability for his work, his education and training, his previous business experience, the quantity of work he turned out, the quality of work he turned out, his attendance, and elements of that sort.

The CHAIRMAN. It is quite evident from the fact that Mr. Davis was promoted that he had an efficient record. Is not that true?

Mr. NASH. I think that is probably true.

The CHAIRMAN. Do you keep any record of the efficiency of the chiefs of these bureaus?

Mr. NASH. Personally, I do not. Now, whether any such record is kept in Mr. Bright's office, I do not know.

The CHAIRMAN. When you fill out these forms of the Personnal Classification Board, you have to have some records in your office to enable you to fill them out, do you not?

Mr. NASH. Those forms are filled out by the immediate supervisory officer of the employee, and they go to a review board in that section, or in the division, and finally through the review board of the bureau. The procedure is entirely mapped by the Personnel Classification Board?

The CHAIRMAN. But the record that you send to the Personnel Classification Board is established, of course, in your office, is it not?

Mr. NASH. The primary rating is made by the immediate supervisory officer of the employee, subject to review.

The CHAIRMAN. I do not want to embarrass anyone, but if convenient, and if it will not be embarrassing to anyone, I would like to have you bring down to me a copy of Mr. Davis's efficiency record in the bureau.

Mr. NASH. I might say also, Mr. Chairman, that, under the rules that have been prescribed by the Personnel Classification Board as to efficiency ratings, they are subject to inspection by the employee for whom they are made, or by any of his associates.

The CHAIRMAN. Then there is no objection to bringing it down to me?

Mr. NASH. I do not think there is any objection to bringing it down to you, and I do not think there is any objection to anybody calling at the department and looking at it.

The CHAIRMAN. If convenient, then, I would like to have you bring that down and let me see it, please.

Mr. MANSON. Mr. Davis, you were chief of the coal valuation section at the time this case was being considered by the committee on appeals and review, were you?

Mr. DAVIS. The date of that was about a year ago, was it not?

Mr. MANSON. January, 1924, if I remember right.

Mr. DAVIS. Yes, sir.

Mr. MANSON. Did you receive any notice of the hearings on this case before the committee on appeals and review?

Mr. DAVIS. I would say no.

Mr. MANSON. Did you ever receive notices of hearings in cases coming from your section that were appealed to any higher authority?

Mr. DAVIS. Yes, sir.

Mr. MANSON. What?

Mr. DAVIS. We sometimes receive notices to send an engineer over to the committee on appeals and review to sit in at the hearing, and sometimes we do not.

Mr. MANSON. There is no uniform practice in that respect, then?

Mr. DAVIS. No.

The CHAIRMAN. Is there a record in any specific case showing whether an engineer was called in or not?

Mr. DAVIS. There would be a record in the case if there had been an engineer called in; yes, sir.

The CHAIRMAN. I would like to inquire of counsel or the engineers as to whether there is any record in this case of an engineer having been called in?

Mr. MANSON. In this case there is no record of any engineer from the coal valuation section having been brought in.

Mr. ARCHBALD. In the case of the Houston Collieries Co., I think no engineer was brought in, but I only saw the record of the decision. The decision speaks of oral arguments, of having heard oral arguments of the taxpayer, and that no engineer appeared from the unit.

The CHAIRMAN. Have you any record there, Mr. Archbald, showing who were at the hearing?

Mr. ARCHBALD. I beg your pardon; I did not hear you.

The CHAIRMAN. I say, have you any record as to who participated in this particular hearing?

Mr. ARCHBALD. Before the committee on appeals and review?

The CHAIRMAN. Yes, sir.

Mr. ARCHBALD. It speaks only of the taxpayer and the committee. I do not know who the people were.

The CHAIRMAN. You do not know who were on the committee either?

Mr. ARCHBALD. I could not tell you now.

The CHAIRMAN. You have not the record here?

Mr. ARCHBALD. No, sir.

The CHAIRMAN. I think counsel ought to bring all of those records in here, so that when these questions arise we may get an answer to them.

Mr. HARRISON. Mr. Chairman, if the recommendation of the committee on appeals and review was signed in January, 1924, it must have been signed by Mr. Charles D. Hamel, who was then chairman of the committee on appeals and review, and approved by the commissioner. Mr. Hamel is now chairman of the Board of Tax Appeals.

The CHAIRMAN. Will you look that up and bring it down to the next hearing, Mr. Hartson?

Mr. HARTSON. Yes, sir; I will be glad to bring you a copy of the recommendation, together with such other data as may be in the files of the case in the committee on appeals and review.

The CHAIRMAN. Yes.

Mr. GREGG. Mr. Chairman, may I bring out a couple of points in reference to the last statement made by counsel?

It was pointed out that this taxpayer could have taken depletion equal to the cost of the value of the leases, and then have sold the leases for the amount they cost him, and then that the purchaser could have continued having depreciation on the basis of the cost to him of the leases. I just want to point out this fact: Assuming that the lease cost the taxpayer in this case $100,000 - -

The CHAIRMAN. Let us say at this point that there is no record in the hearings that it did cost the lessee anything, is there?

Mr. WRIGHT. $177,000; yes, sir. That was the cost of the three leases.

The CHAIRMAN. Before the lessee entered the property at all?

Mr. WRIGHT. Yes, sir.

The CHAIRMAN. I see. I did not understand that.

Mr. GREGG. It was brought out that depreciation could be determined to the extent of the total cost of the lease and the lease could then be sold or an amount equal to the full cost and the purchaser continue to take depreciation, making it appear that there would be two depreciation allowances. As a matter of fact, if this taxpayer sold the lease for the full amount that he had paid for it, after having taken deductions for depreciation equal to the cost of the lease, the entire amount for which he sold would be on his income return; so it would be a wash transaction. He would have gotten depletion, and then have returned the same amount as his income. It would not have been a double deduction. That is what I am trying to bring out. It would not have been a double deduction, as indicated.

The CHAIRMAN. Of course, that would depend somewhat upon what the bracket was under the particular revenue law that was in effect at the time the transaction took place. It is conceivable that at the end of the first 30 years we may not have anywhere near such taxes as we have now at least, we hope not and at the end of 30 years he may have gotten all of his money back, and the purchaser, at the end of 30 years, for another 30 years, might have depleted it.

Mr. GREGG. That is perfectly true; but the point I am trying to bring out is that the depreciation on this lease is just the same as depreciation on any other property. In the case of the sale of property the profit from the sale is increased by the amount of depreciation taken on the property. It is the same here as in other cases.

The CHAIRMAN. The adoption of any such conclusion as that in extenuation of the policy adopted in this case indicates that it is a wise thing for taxpayers to gamble, to get all there is to get while the getting is good, and to trust to death and taxes hereafter as to what they may hope for in the future.

Mr. GREGG. I did not make myself clear.

The statement of counsel indicated to me that in this case the taxpayer could have gotten a full return of capital, and then have sold the lease to somebody else, and the purchaser would have gotten a full return to the same amount. I was not bringing out what I thought would justify it in some of the cases, but I was trying to show that if such a thing happened, the taxpayer himself would not have gotten the return. He would have paid the tax on the same amount if he had previously gotten his deduction for depreciation. Of course, that might put him in a worse or better position, so far as the tax liability is concerned, but I do not think that is important, as to whether he paid more or less taxes.

The CHAIRMAN. No; but I think it is an important point as to whether you adopt this theory of settlement, and while I appreciate Mr. Gregg's statement as being of value, assuming that the lease was sold now; but in his statement counsel did not confine himself to the fact that the lease may be sold now, but that it may be sold in 30 years or 30 years from the date of the lease, and then what he claims might have happened would occur to the great advantage of the taxpayer and to the loss of the Government because of this method of settling these cases. I just mention that because I do not think that Mr. Gregg's position is well taken in view of the statement of counsel.

Mr. MANSON. There is another thing on that same point.

This whole law is designed to arrive at the net income for each year, and the very purpose of the depletion allowance, the very purpose of the provision allowing amortization of the value of a lease or business property, is to arrive at the net income of each year. There is no contention made that ultimately some income tax would not be paid upon this provision, but it ignores those provisions of the law and the very purpose of the law, which contemplates the taxation each year of the net income for that year.

The CHAIRMAN. Do you want to go ahead with your other case now, Mr. Manson?

Mr. MANSON. Yes. This is the case of the Pond Creek Coal Co., a bituminous coal mining company.

The question involved is the valuation of coal-bearing lands for the purpose of determining invested capital for the year 1917.

The promoters of this company acquired the lands in question for $30 an acre.

The CHAIRMAN. When?

Mr. MANSON. In 1911, or immediately prior to 1911.

The company was organized, and the lands exchanged for $1,500,000 of the capital stock of the company.

The CHAIRMAN. I would like to get a picture of this, if I can, as we go along. How many acres were involved and what was the amount paid?

Mr. MANSON. The amount paid for the property by the promoters was $937,780.28. There is involved, all told, about 28,000 acres—I will come to the specific amount here—about 28,000 acres of coal lands.

The value fixed on this land by the coal valuation section was $1,925,629.55.

The CHAIRMAN. As of March 1, 1913?

Mr. MANSON. As of the date of acquisition.

The CHAIRMAN. That was prior to March 1, 1913?

Mr. MANSON. Yes. You see, the purpose of this valuation is to determine invested capital.

The CHAIRMAN. Yes.

Mr. MANSON. The committee on appeals and review fixed a value of $3,756,930.48, which gave the taxpayer a paid-in surplus allowance of $2,256,930.48.

Our first objection, before going any further with the consideration of this matter, is based upon that provision of the excess profits tax law, section 207, which provides that—

(a) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in or other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January 1, 1914, the actual cash value of such property as of January 1, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor).

Our first objection is that the allowance of paid-in surplus to the extent of $2,256,930.48 is in direct violation of that provision of the statute.

In substance, the issue here turns upon this question. There was approximately enough coal land to provide this company with raw material for a hundred years. In other words, with their equipment and at their rate of progress in the depletion of these lands, it would take them about a hundred years to work the land.

The valuation engineers divided the lands into two parts—those which were accessible and which could be worked in 50 years, and valued those lands separately from the balance of the lands.

The lands which they determined could be used within the 50-year period were valued at $137 an acre, while the lands upon which operations would not be begun until after the expiration of 50 years, were valued at $35 an acre.

This gave an average value on all of the lands of $70 per acre, and, as I have stated, the land was purchased at an average value of $30 per acre.

This case was appealed to the committee on appeals and review from the valuation of the coal lands as calculated by the coal valuation section and as approved by the head of the natural resources subdivision. The question was the value of the lands owned by the company on the basic date in order to determine the paid-in surplus and the invested capital.

The company owned enough coal acreage to give an operating life of close to 100 years. In making their valuation the coal valuation section had divided the lands into those which could be mined within 50 years and those which would be mined in a later period. A valuation had been made for each part, that which was available in the first 50 years being given a higher value than the lands which would be mined later.

In making their decision the committee on appeals ignored this point and applied a value for the full acreage as if it were to be mined within a near future period. The result was that the paid-in surplus was nearly tripled in amount.

Moreover, it apears from the record that only the arguments of the taxpayer were heard and no opportunity was given to the natural resources subdivision to present the reasons for the conclusions which they had made.

The Pond Creek Coal Co. was organized in the year 1911 under the laws of the State of Maine. Prior to the date of its organization the original incorporaters and owners, through themselves or their agents and employees, acquired contracts of sale and deeds of conveyance for approximately 28,000 acres of coal lands lying on Blackberry and Pond Creeks in Pike County, Ky. At the time said property was acquired under said contracts and deeds it consisted of numerous tracts belonging to various owners. Practically all of the property was underlaid with valuable seams of merchantable coal, but as none of the property was situated on a railroad and as there were no transportation facilities available, the property was not at that time susceptible of development. The coal seams on said property before the date of conveyance to this company were fully opened and prospected, the thickness of seam and mining conditions were known to the owners and organizers of this company. Extensive and thorough investigation of the property had been made and at the date the property was acquired it was known to the owners that there was approximately 400,000,000 tons of minable and merchantable coal on said property.

A large percentage of the property was owned by the Blackberry Coal Co. and the Big Sandy Co. Neither of these companies was organized for the purpose of operating or developing coal properties, but for the purpose of holding same for sale or for lease. The properties of these companies were so situated in relation to each other and in relation to the properties owned by other persons that they could not have been economically developed without acquiring numerous tracts from resident owners.

The organizers of this company, after obtaining options or contracts for the purchase of these two properties through their agent and trustee, Donald Clark, obtained contracts upon 52 tracts of coal and mineral land for the purpose of consolidating the two properties mentioned above and the various inside and contiguous tracts into the boundary which could be operated in an economical manner after transportation facilities were obtained. Thereafter and prior to date said properties were conveyed to this company, Mr. T. B. Davis, one of the organizers and now president of said company, obtained from Mr. L. D. Johnson, the then president of the Norfolk & Western Railroad Co., an agreement providing the said railroad company would build lines of railroad into said property from their main line of railroad to Williamson, W. Va., and such other points as might be necessary, sufficient to allow the company to develop its properties when same were obtained and would provide adequate and necessary transportation for the coal mined by said company; that said railroad would be completed during the year 1912 and that transportation would be furnished by the time said company could install its mining operations. This agreement was made on October 26, 1911, and was carried out by said railroad through a subsidiary corporation known as the Williamson & Pond Creek Railroad Co. at a cost of approximately one and one-half million dollars.

Thereafter the organizers of this company authorized and directed their trustee, Henry W. Beale, to convey the properties, which were under contract or had been conveyed to him by their direction, to the Pond Creek Coal Co.

Hayden, Stone & Co., of New York, N. Y., brokers and bankers, took over the entire issue of the stock of the corporation and deposited to the credit of the corporation $1,500,000. The individuals who acquired the property, and who were later stockholders, were obliged to acquire their stock through Hayden, Stone & Co. Mr. Francis contends that these individuals purchased lands for $30 per acre, cash, and turned the lands over to Hayden, Stone & Co. receiving stock therefor in the amount that they had expended for the property.

In filing the returns for the Pond Creek Coal Co. for the year 1917, the company claimed an addition to their invested capital of $3,160,689.22 under the provisions of article 63, Regulations No. 41.

Under date of June 11, 1919, they filed Form B, setting forth that they had arrived at this figure by valuing 27,323.13 acres owned in fee at $150 per acre. This was sent to the natural resources subdivision for examination.

There is reference in the files of this case to the recommendations made by Department Engineer Hudson, but this particular paper was not found in the files. Apparently, the claim of the Pond Creek Coal Co. was first referred to this engineer. Under date of January 7, 1922, there is a memorandum from the valuation section giving the figures which Engineer Hudson recommended. As given in the memorandum, the recommendations were:

In September, 1919, Department Valuation Engineer Hudson recommended the value of this land as of date of acquisition as follows:

9,448 acres of available accessible land, at $137.60 per acre	$1,300,000.00
17,875.13 acres, not immediately available land, at $35 per acre	625,629.55
Total (27,323.13 acres)	1,925,629.55

And that $1,925,629.55, less the cost of $937,780.28, or $987,849.27, be allowed as paid-in surplus.

This valuation was approved September 9, 1919, by Mr. Talbert, acting assistant to the commissioner, by an explicit written memorandum, and Mr. Pearman noted thereon, "Close case on basis of value herein shown," and also O. K'd by Mr. Darnell, chief of the coal valuation section.

The rate of depletion which was calculated amounted to 2.3 cents per ton. As far as the records of the files show, this rate of depletion was satisfactory to the company, but the amount of paid-in surplus was not. Appeal was therefore made, first in consultation with the natural resources subdivision, and then to the committee on appeals and review, which rendered a decision, signed by N. T. Johnson, chairman, on May 26, 1922.

In rendering their written decision the committee quotes from a memorandum of the commissioner which referred the case to them. In this memorandum it is stated that the taxpayers—

Claim that the valuation of $137.50 per acre allowed by Mr. Talbert was not only for depletion purposes but also for invested capital. The papers in the case raise a doubt as to whether the decision of Mr. Talbert was intended to cover invested capital, and it is on that point that I desire your decision.

In other words, this case was not referred to the committee on appeals and review for the purpose of making a new valuation, but was referred to them upon one question only, namely, as to whether the valuation engineer had intended the valuation of $137.60 per acre to be solely for the purpose of depletion, or whether it had been intended to be also applied for use in determining invested capital.

The CHAIRMAN. Why should that question be raised? Would not the valuation be applicable in both cases, or should it not be applicable in both cases?

Mr. MANSON. I take it that in this case they only determined the depletion of that portion of the property; they divided the property into two parts, and only determined the depletion on that portion of it which they anticipated would be worked within the succeeding 50 years.

The CHAIRMAN. Yes; I understand that, but perhaps I should have said theoretically should not the value be the same, assuming that there was no unusual situation, as exists in this case, where one part of the property was being worked?

Mr. MANSON. It might not be; no. The invested capital would depend upon the cost as of date of acquisition, while depletion would depend upon the value of the property on March 1, 1913.

The CHAIRMAN. Or what was paid for it if it was purchased subsequently?

Mr. MANSON. Or what was paid for it if it was purchased subsequent to that time.

At the time the case first arose there was no coal valuation section in the Income Tax Unit. By the time the case came up for decision the original engineers had left the unit and could not be called upon to tell what actually had been the original intention. However, during the intervening time, the case had been reviewed by the coal valuation section, and in consultation with the taxpayer. The committee heard only the arguments of the taxpayer and rendered a decision stating "that the total acreage had a value equal to that claimed of $137.50 per acre at the time such property was paid into the corporation in November, 1911."

The result of this decision by the committee was that the Pond Creek Coal Co. was allowed to increase their capital through a paid-in surplus of $2,819,150.20. The depletion rate which resulted from including the whole acreage and all the coal which it contained, and which was later calculated so as to be in conformity with the decision of the committee in regard to paid-in surplus, happened to bring a rate three-tenths of a mill less than was originally allowed by the coal valuation section, but the taxpayer had gained so much by being allowed to increase his capital that no objection was raised to the lower depletion rate.

In other words, by bringing in all of this coal to be mined, even over a 100-year period, it did not particularly affect the depletion rate which, I take it, had been based upon the coal to be mined within the 50 years.

The case of the Pond Creek Coal Co. can be divided into two questions: the more important of the two is more a question of manner of arriving at a decision than the actual decision. The second is the setting up of a bad precedent. The second probably would not have occurred if the first had been different.

The committee on appeals heard only the argument of the taxpayer and did not call upon the natural resources subdivision or the coal valuation section for any explanation of the written record which was before them. This is shown by the language of the decision. In arriving at their decision the committee allowed land which would not be mined until a period commencing 40 or 50 years hence, to be valued at the same figure as land which would be mined in the near future. Had the committee called upon the coal valuation section for argument in support of the amounts which had already been allowed, this feature, which probably was not pointed out in the arguments of the taxpayer, would have been brought out.

An important point to note is that the commissioner, in submitting the case to the committee, stated that "the papers and memorandum in the case raise a doubt as to whether the decision of Mr. Talbert was intended to cover invested capital purposes, and it is on that point that I desire your decision." In consequence the committee was going beyond the request made of it, if it rendered any decision beyond the question of whether the memorandum of Mr. Talbert (who had been acting deputy commissioner) "was intended to cover invested capital purposes." The calculations for the rate of depletion which Mr. Talbert had approved were not in question nor was there any request upon the committee to make a revaluation. They, nevertheless, made a revaluation without consultation and slipped into error.

As has been noted already, the memorandum of Mr. Talbert is not in the files, but essential quotations are scattered through various papers. Mr. Talbert in approving the original valuation of Mr. Hudson had concurred in the separation of the holdings of the Pond Creek Coal Co. into "available accessible lands" and "not immediately available." Each had been valued separately. The available land had been allowed the value of $137.50 an acre and the not immediately available, a value of $35. That there was this separation is supported by the words of the decision of the committee, who had this paper before it, wherein is found the statement "that the decision of the former chairman of the committee fixed a value of a part of the acreage," and in the statement that "the informal memorandum from the committee addressed to the Income Tax Unit, under date of September 9, 1919, which reads as follows:

> I think the one signed by Mr. Hudson valuing 9,448 acres at $1,300,000 and 17,875.13 acres at $35 per acre, giving to the corporation a paid-in surplus item of $987,849.27, is consistent with the facts and equities of the case, and I therefore approve the settlement of the case on that basis.

As the date of the quotation is the same as the Talbert memorandum referred to, this is probably a question from the original document. Moreover, another previous paragraph is quoted in the decision which throws light upon the question which was really submitted to the committee for decision:

> I have considered these two memoranda submitting different views as to the proper valuation for invested capital purposes of the properties turned over to the corporation upon the organization of the Pond Creek Coal Co., of Boston, Mass.

The original Hudson valuation was made in September, 1919. The company protested and on December 10, 1921, and on January 6,

1922, A. H. Fay, head natural resources subdivision, by written opinion stated that although the Talbert-Hudson allowance was believed liberal it was acquiesced in.

In making its decision, the committee refers to a pencil memorandum. There is a pencil memorandum in the file. It is signed "Tait" in the handwriting of Godfrey M. S. Tait, who about that time was chief of the coal valuation section and subordinate to the head of the natural resources subdivision. It is dated January 29, 1921, three weeks later than the recommendation of the head of the natural resources subdivision.

The committee does not specify the exact pencil memorandum to which it refers but it lays weight upon some pencil memorandum.

The committee also finds that the pencil memoranda in the file indicate that it was the intent of the coal valuation section to allow $137.50 per acre as the cash value of the property at the time paid in to the corporation.

The pencil memorandum of taxpayer's conference which was signed "Tait," reads:

Conclusion: That $137.50 per acre for the entire property would be acceptable by the taxpayer and that the valuation section would revise the case seeking to reconcile the estimate with the amount.

It is a question whether the committee in making its decision should have been so guided by a single memorandum of a taxpayer's conference which ran counter to all the recommendations of superior officials, without attempting to reconcile the differences between the recommendations and without seeking information from the natural resources subdivision, particularly as that pencil memorandum concerned something which they had not been called upon to decide.

This stands out upon the examination of the facts of the decision. The Pond Creek Coal Co. was seeking to have the Income Tax Bureau allow it to place upon its return for 1917 a paid-in surplus of $3,160,689.22. It sought this allowance under article 63, regulations 41, which provides that—

Where it can be shown * * * that the tangible property has been conveyed to a corporation * * * by gift or at a value accurately ascertainable * * * clearly * * * in excess of the cash or par value of the stock * * * paid therefor, then the amount of excess shall be deemed to be paid-in surplus. * * * Evidence * * * may consist of the market price in excess of the par value of the stock or shares.

But I take the position that this case comes clearly under the provisions of the 1917 law, which prohibits the allowance of value upon property exchanged for shares of stock of a corporation in excess of the par value of the stock.

There was some confusion of thought within the Income Tax Bureau in this case as to what constituted paid-in surplus. A memorandum submitted by the audit section December 1, 1921, referred to section 207 (a) 1 and 2, regulations 41, but as this case falls under the next subdivision, namely, No. 3 (invested capital * * * means * * * actual cash paid in * * * and (3) paid-in or earned surplus), reference is also made in this memorandum by audit to T. D. 3181 C. B. 4, page 373. This reference is to a decision by the Supreme Court that—

The provisions of clause 3 of section 207 (a) that includes "paid-in" or earned surplus * * * recognizes that in some cases contributions are received from stockholders in money or its equivalent for the specific purpose

of creating an actual excess capital over and above the par value of the stock; and in view of the context, surplus * * * "paid-in" excludes * * * a mere appreciation of values over cost.

The audit section denied the paid-in surplus because of lack of tangible property.

In the case of the Pond Creek Coal Co., there had not been a mere appreciation without work. The people behind the promotion had done work which added to the value of the company and which was above the value written on the books and the money expended. In a brief submitted by the taxpayer, there is the pleading:

At the time said properties were acquired, said contracts made and said properties conveyed to Pond Creek Coal Co., it was not known to the public generally or to the persons conveying said properties, that they were being purchased for immediate development or that a railroad would be immediately built into the properties or that capital had been arranged for and plans made to open and develop large and extensive coal mines on said property. At the date of said conveyance, however, all the foregoing facts were known to the organizers and the present management of this company and the value of the property as based on these facts was known, but notwithstanding this fact the organizers of this company, on account of the fact that they were largely becoming owners of the stock thereof, had their trustee or trustees convey and transfer all of said properties to this company at approximately the cost thereof, including the expense incident to acquiring same. Said company now states that at the date of said conveyances said property was worth and had a value accurately ascertainable and definitely known of $150 per acre. Said facts were known to the owners of said property at the time they caused it to be conveyed to said company; the property had been thoroughly prospected; the quality and quantity of coal had been fully explored and reported, the transportation facilities for development of property provided for, the necessary capital for development and operation of said property has been obtained and at the date of the various conveyances referred to said property was worth and had a value actually ascertainable of $4,098,469.50.

The fact is that while they paid something over $900,000 for the property, which was exchanged for stock of the par value of $1,500,000, we recognize that the organization of this property into a solid whole and the securing of transportation facilities did bring about an increase which would warrant an increase in value from something less than a million dollars to $1,500,000; but we do maintain that there was nothing to justify the violation of this statute by the allowance of a value as a paid-in surplus in excess of the par value of that stock.

We further maintain that the committee erred in allowing as the value of the whole twenty-seven or twenty-eight thousand acres which could not be worked for a period of 100 years, a value of $137.50 an acre, which had been fixed as the value of that portion of the property that could be worked within the period of 40 or 50 years.

There was no attempt upon the part of the committee to make an independent valuation.

The real fundamental purpose of counsel in bringing this case to the attention of the committee is to show the weakness in a system which permits of a decision of this sort being arrived at by the committee without consulting the engineers who knew upon what basis this valuation had been made, and without giving them any notice or opportunity to appear and explain the basis of the valuation before reaching their decision.

Had that been done, I am confident that this result would never have been arrived at. They fell into the error of assuming that because the engineers had valued one tract, which was accessible to the railroad, and could be worked within 40 or 50 years at $137.50 an acre, that therefore the whole tract, two-thirds of which was inaccessible, and which could not be worked, or upon two-thirds of which work would not start until after 40 or 50 years, would have the same value.

The CHAIRMAN. I do not understand how the committee, even though it did not call in an engineer, could overlook the valuation, which must have been before them, showing that some 17,000 acres were valued at only $35 an acre. Is there anything in the record showing why they ignored that feature?

Mr. MANSON. We find nothing, but it is a moral certainty, in my opinion, that if they had notified the engineers, or notified Mr. Davis, or whoever was in his position at that time, and a valuation engineer had appeared before the committee, they would see that the value of the property which was accessible and could be worked, and was being worked at that time, and would be worked in the 40 or 50 year period was entirely different from the value of the property upon which work would not commence until 50 years hence.

The CHAIRMAN. Yes; I understand that, but what I do not understand is why an engineer would be any more impressive before the committee than the valuation which they must have had, showing a valuation of $35 for 17,000 acres. I do not understand why the committee was not impressed with that value just as much as if an engineer had been there and told them about it. What I would like to know is whether you have anything in the record there to show what this would amount to in taxes. I think it is important, in questioning these decisions here, to know what it means in dollars and cents.

Mr. MANSON. That tax, Mr. Chairman, for 1917, has not been computed.

Senator KING. Mr. Manson, is this a type of other cases, or are there other cases that come in the same category that are subject to the same criticism?

Mr. MANSON. In answer to the Senator's question, I have presented two cases this morning which involve appeals from the coal valuation section to the committee on appeals and review. While we have taken exceptions to the decisions of the committee, the real thing I want to call the committee's attention to is the fact that these cases are passed upon by men who do not know anything about them, hearing the taxpayer's side only, and not notifying the engineers of the bureau who have either made the valuations or are at least familiar with the subject matter, and that, in my opinion, neither case would have been decided as it has been had there been a uniform practice of notifying the technical men familiar with the subject matter, and giving them an opportunity to appear before that committee.

Mr. HARTSON. Mr. Manson, if it were shown that the membership of this committee included engineers equally capable and equally competent, from an engineering standpoint, with those in the income tax unit, then you could not say that these cases were being passed

upon by people who knew nothing about the subject matter, could you?

Mr. MANSON. The mere fact that a man may be a trained engineer, sitting on this committee, and hearing one case after another, does not show that he is familiar with the subject matter that is involved in the case to the same extent as the engineer who made the valuation, or the engineer, as in this second case, who reviewed the valuation.

The CHAIRMAN. Is any significance to be attached to the fact that these records are missing, or the expression of these views is missing, or is that just an accident?

Mr. MANSON. I am merely stating the facts as they have been stated to me by the engineer. I attach no significance to it, other than it may be a reflection on the filing system.

Mr. HARTSON. Mr. Manson, may I ask another question?

Have your engineers attempted to value the property transferred to the corporation in 1911 in exchange for its stock?

Mr. MANSON. No, indeed.

Mr. HARTSON. It might be that, except for the position that you take that the law prohibited the taking into invested capital this property in excess of the par value of the stock issued therefor, that the property, in fact, was worth in 1911 more than the $1,500,000 in stock?

Mr. MANSON. I do not think the circumstances in this case would warrant the conclusion that it was. The value of this property, for the purpose of determining invested capital, was as of the date of acquisition. The property had been purchased as wild land at $30 an acre. The engineers, in making their valuation of approximately——

The CHAIRMAN. January 1, 1914, was it not?

Mr. MANSON. Yes. The engineers, in making their valuation, had given it a value of about $70 an acre, an average value of about $70 an acre, assuming that it more than doubled in value, due to the fact that it has been organized into a solid mass and into a going concern.

Furthermore, I think it is necessary, as the chairman has pointed out, for anyone, in making a valuation of this property, to recognize the distinction between the value of property which is adjacent to a railroad, which is at the point of mining operations, and which can be worked within the next fifty years, and the property upon which operations will not begin until 50 years hence. It does not seem to me that it requires an engineer to say that there is a vast difference in the value of those two groups of property.

Mr. GREGG. May I ask just one question?

Is there any evidence in the case to show why only one-third of this land was immediately available for operation, other than the fact that there was so much of it that this taxpayer could, within the next forty years operate only one-third of it? Is there any other evidence? Was the remainder of it inaccessible and far from the railroads?

Mr. MANSON. That was the determination of the engineers. There is nothing in the decision that rebuts that.

Mr. GREGG. I did not get that from what you read of the engineers' report. As I got it the sole point that the engineers made was that only a portion of it could be worked in the next forty years, because there was so much of it, and that this one-third would occupy all of the time of this particular taxpayer.

Mr. MANSON. No; the engineers determined that two-thirds of it was not accessible.

Mr. GREGG. For what reason—lack of transportation?

Mr. MANSON. I assume so.

Mr. PARKER. This property is situated between two valleys, as I understand it, with a high ridge in the middle. The railroad went up one of the valleys, and it is obvious that on the farther side of the ridge it is not as accessible as it is on the side near the railroad.

Mr. GREGG. That is the point I wanted to bring out.

Mr. HARTSON. Mr. Chairman, counsel has again brought to the attention of the committee the apparent inconsistency between article 63 of regulations 41 and section 207 (a-2) of the revenue act of 1917, which involves the definition of invested capital. The law, as counsel has read, on its face, says that the property issued in exchange for the capital stock of a corporation may not be included in invested capital at a figure in excess of the par value of the stock issued therefor. The regulations which counsel has cited, article 63 of regulations 41, which are applicable to the 1917 law, say that when it can be ascertained clearly and definitely that the value of property exchanged for capital stock is clearly in excess of the par value of the stock, in such excess amount it shall be included as paid-in surplus. That, as the membership of the committee will remember, was in issue here some weeks ago in another case.

The CHAIRMAN. Yes; but in this case they did allow in excess of the capital stock in fixing the value at some $1,900,000.

Mr. HARTSON. That is correct, Mr. Chairman, and assuming that that property actually did have a value at the time it was taken in exchange for the stock, a value in excess of the par value of the stock, then the regulations permit that excess value to be included as paid-in surplus.

Mr. MANSON. But the law did not.

Mr. HARTSON. That is just exactly what I am coming to. At the time the regulations were adopted, it was well known that there was an apparent inconsistency. Now, Mr. Gregg is thoroughly familiar with the reasons for the——

The CHAIRMAN. For the violation of the law.

Mr. HARTSON. No, Mr. Chairman; not for the violation of the law—thoroughly familiar with the circumstances surrounding the adoption of article 62 of regulations 41, and I think he should be heard on that. He was not here at the time it came up before, and the committee would, I think, be interested in hearing him.

Mr. GREGG. I would like to give the committee, not with particular reference to this particular case, the history of that.

As you probably know, when the 1917 act was passed, it was rewritten in conference, probably Senator Jones was in that conference, and the last rewrite of the invested capital provisions, I have been told many times, was done in two hours. It was very incomplete, and it was recognized at the time that the act was passed

that it was very doubtful whether the Treasury Department would be able to administer it, because it was so incomplete. As a matter of fact, in section 210, some words were actually omitted from the law, just through a clerical error, because it was so hastily done at the last minute.

After the act was passed Congress knew and the department knew that some strong-arm methods were going to be necessary to make the act work at all, so they formed a committee to advise the department on these matters.

The CHAIRMAN. You say "they formed a committee." Who formed a committee?

Mr. GREGG. That is just what I was coming to, Mr. Chairman. I remember Doctor Adams was on it, and Mr. Sterrett, who is a partner in Price, Waterhouse & Co., one of the leading accountants in the country, together with several other prominent tax men, in addition to representations of both the Ways and Means Committee and the Finance Committee. I have forgotten now what representatives were on the committee, except Mr. Cordell Hull. I remember distinctly that he was one of them. This body was to advise the Treasury Department, and assist it in administering the act. It was admitted that it was practically impossible to administer it. They did, in regulations 41, at several places, absolutely strong-arm the act. There is no need of my denying that. I think they will admit it themselves; in fact, I know they will. They have told me several times about this trouble, and the way this question has come up to them.

The section which counsel read very clearly indicates that property paid in for stock prior to January 1, 1914, should not be given a greater value for invested capital purposes than the par value of the stock. I think it is the following paragraph that includes in invested capital paid-in surplus. Of course, "paid-in surplus" is a very indefinite term, and no one knew just exactly what it meant.

One of these cases, I remember, very distinctly was a case where, in 1901, a corporation was organized by a family corporation, with property, the known value of which, as I remember it, was in excess of $10,000,000, and that was paid in for stock of the par value of $1,600, the purpose in issuing any stock being to determine the respective interests of the members of the family in the property. It made no difference to them, of course, what the par value was.

That was one of the cases that came to the attention of this committee, on which there were representatives of both the Finance Committee and the Ways and Means Committee.

As I remember it, there were five cases that were brought to their attention, and they made such an impression on this committee that they issued article 63 of regulations 41 to take care of that type of cases, which said that if the value of the property paid in for the stock is clearly in excess of the par value of the stock issued for it, the excess may be allowed as paid-in surplus, basing that decision, if there were any statutory justification for it, on the provision of the statute allowing inclusion in invested capital of paid-in surplus.

Several times since that time the question has arisen as to the validity of that regulation, and naturally it would. We have always taken the position, and it seems to me properly so, that con-

sidering all the conditions at the time when the regulation was promulgated and the fact that it was sanctioned by both the committees of Congress charged with the framing of revenue legislation, and that a great many of the cases have been settled on the basis of the regulations, we would not be justified in upsetting it.

Mr. HARTSON. And the 1918 law came around immediately and corrected the apparent defect.

Mr. GREGG. The 1918 law and all subsequent excess profits tax laws, as Mr. Hartson says, recognized the omission in the 1917 law, and they have taken care of it in express terms.

That is the history of that regulation, and there are several other regulations with the same history, which, as a technical matter, it is hard to defend.

The CHAIRMAN. But you do believe that it has been corrected by statute since?

Mr. GREGG. Yes; and I can furnish you a citation, if you wish.

The CHAIRMAN. Have you completed that case, Mr. Manson?

Mr. MANSON. I have concluded it.

The CHAIRMAN. I do not know whether I referred to this yesterday or not, but the members of the committee now present were not present at that time. There was a little discussion toward the close of yesterday's session concerning the effect that this work was having upon the work of the bureau; I mean the effect that the work of the committee was having upon the work of the bureau.

It appears that—and I think other Senators can verify this—the bureau is sending out letters, and I do not think they deny it, to taxpayers who have claims, stating that their claims are being held up by this committee. In fact, I got a telegram from an oil man down in Oklahoma City to-day, saying something to this effect, that his father's case had been settled and refund made on the basis of the present depletion policy, and that his refund had been denied on the same basis.

Now, I do not recall—and if I am wrong about this, I hope some member of the bureau will correct me—that we asked that any cases of oil depletion be held up.

Mr. HARTSON. Mr. Chairman, if I may state my recollection of what occurred, and what brought about this situation that the Chairman comments on, it first arose through Senator King's suggestion that the pending deficiency appropriation bill might well be held up; that is, the deficiency appropriation bill to make refunds to taxpayers——

The CHAIRMAN. Yes.

Mr. HARTSON (continuing). Until the investigation was completed. It was then that the assurance was given by the representatives of the bureau that refunds and adjustments in cases which involved principles which were being criticized here would be held up until we had reached some final conclusion.

Mr. MANSON. I might add to that, that subsequent to that Mr. Nash called me up and asked me whether, in my opinion, if they held up all cases involving depletion allowances arrived at on an analytical appraisal basis and amortization allowances, that would cover the class of cases that they had agreed not to make refunds in, and I told him that I thought it would.

The CHAIRMAN. Did that include oil cases, too, Mr. Manson?

Mr. MANSON. Yes: the same principles that had been discussed in connection with the other depreciations are as applicable to the oil situation as they are to any other mine.

Mr. HARTSON. Of course, Mr. Chairman, taxpayers have known that their cases were settled, except for the machinery of finally closing either the refund or the credit which might be made to them as the result of the adjustment. In order to explain to them the reason why their check was not forthcoming, or that their credit was not actually made, the department has sent out letters—how many I am unable to say, but I think Mr. Nash has that information in response to the Chairman's question of yesterday—in which they were advised that the Senate Investigating Committee had requested the department to withhold action pending a further agreement between the representatives of the bureau and the committee.

I think that possibly Mr. Nash has a copy of the form letter which was prepared. I will only read that portion of the letter which refers to the point I am making, although I will be glad to put the whole letter in evidence:

> However, the Senate committee investigating the Bureau of Internal Revenue has requested that no amount of overassessment based upon a natural resource valuation or allowance for amortization be refunded or credited pending its inquiry into the bureau's practice in administering the provisions of the various revenue laws dealing with these subjects.
>
> Accordingly the item has been deleted from the refund schedule and final adjustment will be withheld pending a further understanding between the bureau and the Senate committee.

That is the form letter which is being filled in in the various blanks (The letter referred to is as follows:)

> TREASURY DEPARTMENT,
> *Washington.*
>
> SIR: Advice has already been furnished that you were overassessed by the Bureau of Internal Revenue for income taxes in the amount of $——— for the years ———, and that the overassessment had been scheduled to the collector for your district to be applied in the adjustment of your account.
>
> You are now informed that the collector has returned to this office the schedule upon which your item of overassessment was listed, indicating the following adjustment: .
>
> * * * * * * *
>
> However, the Senate committee investigating the Bureau of Internal Revenue has requested that no amount of overassessment based upon a natural resource valuation or allowance for amortization be refunded or credited pending its inquiry into the bureau's practice in administering the provisions of the various revenue laws dealing with these subjects.
>
> Accordingly, the item has been deleted from the refund schedule and final adjustment will be withheld pending a further understanding between the bureau and the Senate committee.
>
> Respectfully,
>
> J. G. BRIGHT,
> *Deputy Commissioner.*
> By ———,
> *Head of Division.*

The CHAIRMAN. How many of such claims are there?

Mr. HARTSON. I should say, Senator, that there are a great many. I do not know exactly. Mr. Nash may have the exact figures.

Mr. NASH. Mr. Chairman, to date, there are 2,205 such schedules.

Senator KING. "Schedules." Does that mean claims?

Mr. NASH. Claims; yes, sir.

The CHAIRMAN. And that is because of the campaign or drive that is being made on the Senators in this matter, because of this recent request of Senator King's to hold up this refund list for which an appropriation has just been passed. Is that right?

Mr. NASH. Yes, sir. At the time that this was under discussion, we had a great many schedules that had already gone through and had been approved.

The CHAIRMAN. When you say "schedules" do you mean schedules or claims?

Mr. NASH. Well, schedules or claims, either. They are synonymous.

Mr. HARTSON. The explanation of that is that the schedule is the formal action of the commissioner on a claim.

The CHAIRMAN. I thought you put a great number of claims on one schedule.

Mr. NASH. That is true.

The CHAIRMAN. Then, you may have ten schedules and yet have a thousand claims.

Mr. NASH. I think one schedule to-day will carry anywhere up to about 50 claims or 50 items.

Senator KING. Then, when you said you had 2,000 schedules, it might mean 10,000 claims?

Mr. NASH. We have, as stated in this memorandum, 2,205 certificates of overassessment, which means individual claims. At the time this matter was under discussion, a great many claims had already been approved and scheduled and were awaiting payment in the accounting division, and we withdrew from those schedules all claims that involved any element of amortization or natural resources valuation. We also had in our scheduling division a great many claims waiting to be scheduled, on which the advice had already been sent to the taxpayer that his claim had been settled. We withdrew from scheduling in the claims division all claims that involved the items under discussion. Then, we have since withheld from scheduling all claims that involved those points; that is, we settled the cases up to the point of bringing them into the claims division, and then we stopped.

In the first two classes that I have enumerated, the taxpayer has been advised that his case been settled. The first notification had already gone out to the collector's offices, and some of the credits applied to outstanding assessments in the collectors' offices; so all of those credits had to be withdrawn, and a great many inquiries came in for an explanation as to why we were taking this action.

We took the position that we should make a uniform reply to everybody and tell them, as nearly as we could, why it was being done.

I do not think our letter was ever intended to be critical of this committee, but to inform the taxpayer why action was being withheld temporarily on his claim. The letter which went out was brought to my attention; it was brought to Mr. Hartson's attention, and it was brought to the commissioner's attention.

There are two letters, which are going out, one where the taxpayer has already been advised that his claim has been settled and brought up to a certain point, and the other is a letter we are using

where we have determined that a taxpayer is entitled to a refund, but the statute of limitations is running against him on March 15th. In those cases we are writing a letter telling the taxpayer to file a formal claim for a refund to protect his interests, in the event that, subsequent to March 15, we still hold that he is entitled to that refund. If he does not file a claim the statute will toll on March 15, and the taxpayer would be deprived of the refund to which he is entitled.

The CHAIRMAN. I would like to ask at this point whether the committee thinks that we have gone far enough into the amortization question to arrive at a conclusion as a result of this investigation, and that a decision may be reached either by a statement from the committee, or, having gone into it and having drawn the bureau's attention to it, we will leave it to the bureau to reach a decision?

Senator KING. I am not ready to express an opinion on that, Mr. Chairman. I want to talk the matter over a little with the committee and with Mr. Manson and the engineers before I am able to express an opinion. Of course, I am very anxious that we shall be able to consider those questions that involve principles within which a large number of cases may be brought as a class, and reach our conclusions, and then advise the department. Of course, they may not accept our views, but the matter will be closed as far as we are concerned, except to make a report. I should be glad, as I say, if we could cover that class of cases at as early a date as possible.

The CHAIRMAN. If agreeable to the committee, I would like to go into executive session now.

Mr. NASH. Mr. Chairman, before we adjourn, I think I should call to the attention of the committee the interest losses that have accrued on these payments that are being held up.

The claims will aggregate something over $9,000,000, and up to date there is interest accrued to the extent of something over $10,000. That interest is growing daily as the claims accumulate, and it now averages something over $800 a day.

We have had complaints because of the fact that claims that were already approved by the commissioner and were held awaiting payment had interest stopped on thim. The taxpayers are demanding payment, because they say they are not getting any interest, and they should have their money immediately.

Senator KING. I would like to ask Mr. Nash or Mr. Hartson whether, in view of any suggestions or criticisms made by the committee as to methods or principles adopted, the department has taken steps to change any of its policies or to revalue or reassess any of the matters which came before us.

Mr. HARTSON. Is that question directed to me?

Senator KING. Yes; either of you or both.

Mr. HARTSON. Then, I will be glad to answer it.

Senator KING. Yes; all right.

Mr. HARTSON. I think the department has. There have been particular cases which have been called to the department's attention, in which adjustments and changes have been made, but as a general proposition, as a general plan, as a general policy the department has made no change so far.

Now, the committee has not made up its mind, and has not made a report. The bureau is trying to go ahead and do its job in the in-

terim. That does not mean that after the report is made by this committee substantial changes will not be made by the department. It does mean that up to the present time we have changed results in particular cases as a consequence of this investigation, but there has been no general, widespread change of policy in settling these cases, or in any of these principles that have been criticized by the committee.

Senator KING. That is to say that you, as legal adviser, and the department are so satisfied with the perfection and the infallibility of the positions that you have taken, not only in most cases, but with the general underlying principles, that you are going to persist in them?

Mr. HARTSON. Senator King, the department has never taken the position that it has been infallible. It has never said that it was perfect, and everybody who has intelligence in the department recognizes that it is imperfect and that it is not infallible. We have made mistakes. It may be that on matters of general application the department has been wrong.

Senator KING. Mr. Hartson, may I say this: I do not see how it would be possible, with these statutes, many of which are rather ambiguous, even if you had the wisest and best men in the world, for you not to have made mistakes, or to have adopted policies which would, perhaps, be disadvantageous to the Government, and oftentimes disadvantageous and unfair to the taxpayer, in these years, and with the changes which have taken place in the personnel. I do not think it would be possible, and any statement which I might make would be rather in the nature of suggestions instead of criticisms, because I have no doubt that if I had been there, or the wisest men in the world had been there, lots of mistakes would have been made in general policies, as well as in individual cases; but I do not think you or the officials of the department ought to take a dogmatic position here and simply set your teeth and say, "We have pursued this policy, and we are going to continue to pursue it."

Mr. HARTSON. Did the Senator gather from my answer to his question that we take such a position? My answer is this——

Senator KING. I rather got that view from the position that you have taken, Mr. Hartson, since I have been here, that you were going to defend yourselves to the last ditch against any suggestion we might make, if you possibly could.

Mr. HARTSON. Well, Senator King, we are on trial——

Senator KING. Well, I do not agree with you.

Mr. HARTSON. And it is rather a human tendency, a human characteristic, to stand up under fire, isn't it? I think the Senator would do the same thing were he in our position, and yet I never have said, and I would be most unhappy if any member of this committee thought that I was justifying everything that the bureau has done, because I do not. Many things have occurred that I have not been satisfied with, and there are many things that I have done that I have been satisfied with but that somebody else might take exception to.

In answer to the Senator's question as to what the policy of the department was to be with regard to the general criticisms of this committee as to its practice or procedure in settling some of these

cases, this, I believe, should be said, and it is an attempt to repeat what I have said before, so that there will be no misunderstanding about it, namely, that up to this time the department has made no widespread or general change in its policy or practice concerning the settlement of these cases.

The CHAIRMAN. Senator King, I did not understand Mr. Hartson to say that they would not do it.

Mr. HARTSON. No; and I further said, just as the chairman points out, what will be done is quite another matter, and I do not attempt to forecast that, because I am unable to say; but we have already made changes in particular cases.

Senator KING. You will understand, Mr. Hartson, that this is purely a nonpartisan investigation. So far as I have reached a conclusion now, it would be that the criticisms should perhaps fall, if any criticisms at all are to be made, upon the former administration and those who were in office then, rather than upon you or some of those who are immediately connected with the department at this time, so that the question of the personnel does not cut any figure at all.

Mr. HARTSON. I have not any personal feeling about it. I have been heatedly emphatic sometimes, but that is no indication of any personal feeling that I have.

Senator KING. To show the position that I take, Mr. Gregg has criticized the act of 1917, and in doing so he is criticizing the Senators, and we deserve it. Many of our statutes, as I have stated here, are ambiguous, and I should think this investigation would rather be for the purpose of clarifying the law and making suggestions in order to improve the statutes. I had hoped that you gentlemen would make suggestions as to imperfections in the existing revenue laws, that you would criticize them, and that would mean a criticism of Congress. I have no pride of opinion about those matters, because I know that much of our legislation is horribly defective. In the administration of it, I had hoped that you would point out to us in these hearings where the defects lie, so that we might take steps to correct them. I do not think we are on trial at all. I know that much of our legislation is hodgepodge, and I do not want you to feel that because we think a statute has not been interpreted rightly, or that some policy has not been right throughout, that you are on trial. I thought this was a sort of a mutual meeting to exchange views and to see how we could improve the service, and if mistakes were made in legislation, how we could correct them.

The CHAIRMAN. That is why this committee has had four members of the finance committee on it. It was for the very purpose of getting correct legislation.

Senator KING. That is it.

The CHAIRMAN. In other words, the President of the Senate chose four members of the Senate Finance Committee, so that they would have the benefit of this investigation for legislative purposes, and that makes it all the more difficult for me to understand why there should be such resistance on the part of Mr. Nash to the continuing of this investigation. He makes such a mountain out of the damage and injury that this committee has done to the bureau, and, as I

said yesterday, I thought we were getting along in a cooperative way, and then to be confronted with the letter of Mr. Nash the other day, practically charging that the work of the committee is unwarranted and unjustified, was more than the chairman could understand.

Senator KING. And I wish to say that when the question was up in the Senate, aside from Senator Couzens's resolution, there was quite a serious question of whether we ought not to have some sort of a standing subcommittee to confer with your department as to what legislation was needed to correct legislation, and so, when this resolution came along, we thought this was a good idea. This committee has not been organized so much for the purpose of criticizing your department, as it is to find out the defects in the law and to enable us to make recommendations back to the Finance Committee, so that we can correct any imperfections that there are in existing legislation. We had hoped that you gentlemen, with your long experience, could point out to us the imperfections in the existing law, would criticize the law, and then we would report your criticisms back to the Congress.

Senator JONES of New Mexico. Let me make this statement:

I have been on the Finance Committee since the beginning of the war, and during that time all of this important legislation has been enacted. We have framed different bills, and the members of the Finance Committee have been lacking in information with respect to what was going on at the time of the enactment of each one of the revenue bills. There are many technical terms used in the revenue law, and the application of a language in a practical way has been very difficult to forecast. Even during the preparation of the last revenue law, the bureau itself presented a great many suggestions for modification of the law. The great majority of these suggestions were adopted by the committee, and subsequently became embodied in the law. Some of them were not; but all of them came from the bureau itself.

I think this committee has a very important responsibility—to ascertain, as separate and apart from the bureau workers, the way in which the law is being applied, the effect upon industry, and how it operates with respect to different classes of industry.

I think it is quite unreasonable to assume that the people in the department themselves are able to get a perspective of the operation of the revenue law, and it is that thing which it appears to me this committee ought to be able to do in an independent way—get a perspective of what is going on, and to be thus enabled to make suggestions—intelligent suggestions—for modifications of the law.

Now, it has appeared to me that Mr. Hartson, the solicitor of the bureau—and I think I might add at this point, in my judgment, a most competent solicitor for the bureau—it has appeared that many cases have been going on there on which he has had no information, and I think it has been, in the very nature of things, impossible for him to keep in touch with everything that is going on. I think we have brought out many things here that have not been in accordance with the views of any responsible party in the bureau, not because of any design willfully to disregard the law or to bring about unfair or unjust settlements; but I think that out of this there are going to

develop many points which the bureau itself will want to know about and will take cognizance of in the future. Some of them, I think, involve the administration of existing law, where the law itself need not be changed, but where more exact justice will be done by reason of these investigations and the things that have been brought out here, and in some respects, at least, I think we have already shown that the law ought to be changed.

The law ought to be changed, in my opinion, so as to develop some different system of handling some of these matters in the bureau. My judgment is that there should be greater concentration on general principles and constant attention given to the question as to whether the regulations are being applied, not only in accordance with the regulations, but are being applied in a way that does not bring about a fair adjustment of the cases which are being brought up for disposition.

I think much could be said in favor of having a standing committee, because there is nobody in the bureau itself who is charged with the distinct duty of general supervision of the bureau, with the idea in mind of ascertaining where mistakes are being made. Your routine work is going on, and every individual, I am sure, is fully engaged in that routine work; the mill starts, and everybody must perform a share and go ahead and do that work; but there ought to be somebody in the bureau, or somebody on the Finance Committee, or connected with Congress who should get a view of things as the mill rolls around.

I see that difficulty not only here, but in the various governmental departments.

As an illustration, I am a member of the Subcommittee on Appropriations which has in charge the work of the Interior Department. The only view that we get in making those appropriations is the opinion of some one in the bureau itself as to the necessity of the work and as to the cost of the work. It is a mere partial view.

Senator KING. And the effects of the operations of the department.

Senator JONES of New Mexico. The kind of work that is going on, the necessity for it, and the way that it is being handled, whether in an economical way or not. I think that Congress ought to be in close touch, through some of its agencies, with these various activities of the departments. I think in that way, not because I believe the people in the departments are not doing honest and sincere work, but that they need some outside point of view, not only in this bureau but in every agency of the Government. I know how natural it is for a division or a bureau to want to expand its activities and to take on additional work. It is a perfectly natural thing when a man is in charge of a division or a bureau to try to draw activities under his supervision, because it is a much greater thing, in a way, and it adds to prestige somewhat, if a man has 200 men working under him rather than 100. As I say, there is that natural inclination to expand activities and to draw in additional activities.

It is in that spirit that I think the work of this committee ought to go on. Let the bureau have the benefit of independent thought as to whether the law is right, and as to whether it is being administered in a proper way. It is just like a corporation having a good business manager, somebody whose duty it is to get a perspective of things, and which I am sure you people down there do not get.

As the result of this, it may well be worthy of consideration that we do establish some agency of the Government to get this general perspective of the workings of the departments. I had hoped that the Budget Bureau might perform that function in the administration of the Government, and it may be that that is the best way to work it out; let the Budget Bureau get this bird's eye view of things; but it must be quite apparent that thus far, in the framing of every revenue law we have had the benefit only of such suggestions as have been picked up from time to time by people in the bureau. As to the last law which was framed, I understood that there was a committee in the department which undertook that job. They did a great work; I am quite sure of that. But the question is whether they did a complete job or not, whether something more should not have been done, and the question of policy ought to be one which the Congress itself should at least to be able to justify through its own information.

Without any intention of criticizing anybody as to individual acts, I think there is a great work to be performed by some such committee as this, not only with regard to this bureau, but with respect to the other activities of the Government.

I think this bureau is the most important branch of the Government when it comes to a question of the financial affairs of the Government. The other agencies are all engaged in spending money. Here is the great agency engaged in collecting the money, and we have it all concentrated in this one bureau, so far as the collection end of the Government is concerned; and you can readily see how important it is that this one great side of the financial affairs of the Government, being concentrated in one bureau, ought to function as nearly correctly as it is possible to have it done.

Senator KING. May I add just a word?

The CHAIRMAN. Yes, Senator.

Senator KING. I should think you gentlemen would be most anxious to have your attention called to certain matters which must of necessity come up for consideration in the next tax bill. I recall that I attempted to make some amendments to the last tax bill on the question of depletion of these oil wells, etc., and on the question of obsolescence, and all that sort of thing. I could not do it; I did not have enough facts. I did not know how the present law was operating. I would go into the oil fields and I would learn of men paying no taxes at all, although they had made a great deal of money. I would go over in New York, and I would see some of those fine buildings there, which had increased in value enormously, but on account of depreciation I would find that the taxes have been decreased far below what I thought was just. Yet I did not know how the present law operated, and I favored the creation of a joint committee of the House and Senate to keep in touch with the Treasury Department, so as to have their reactions and their recommendations, and so that we would be ready when the tax bill was framed to present the studies of those in the department who were administering the law, and the views of the members of the legislative branch of the Government.

Take this question of oil wells. I do not know whether we ought to amend the law, but I think we should, and yet, if I were compelled now to draw the law, I would not know how to draw it. I

would want to get the views of you gentlemen who are administering it, and you gentlemen certainly ought to have the views of others on the outside.

My idea of the purpose of this committee was to find out just how the law did operate, how you interpreted it, and, as interpreted, how it operated, whether disadvantageously or fairly or justly, so that we could make recommendations to the Congress.

Mr. Gregg came before the finance committee and gave us most valuable suggestions. I do not know what we would have done if it had not been for him and others who came from the Treasury Department, and what I had hoped to see was that in a nice, friendly way, we could sit down and go into the various features of this work to see whether injustices have resulted to the Government or to the taxpayers from the way you have interpreted the law, or whether the law was ambiguous. I had hoped that you gentlemen would make your recommendations and suggestions to us, and if we approved of them, we would carry them to the Senate and try to rectify the law, and we will doubtless pass a new tax bill when we meet in December.

I want you gentlemen to get my point of view. You are not on trial at all, any more than Congress is on trial, for I know that much of our legislation is horribly bad. You can criticise me as a member of the finance committee as much as you please. I know I deserve it, because I have not known enough about the intricacies of the tax bills to draw an entirely just tax law. You ought to tell us wherein it is unwise or where it does not operate justly to the taxpayer or where it is unfair to the Government; and if in the investigation here we think that you have not interpreted the law quite right, you ought to develop anything that will show that.

I am a fraid we have been a little at cross purposes.

Senator JONES, of New Mexico. May I call attention to the fact that when I first came into the Senate, and for some years afterwards, there was a committee on expenditures in each of the departments of the Government. There was a committee on expenditures in the Interior Department, and a committee on expenditures in each of the other departments.

Senator KING. And may I say that I was chairman of the committee on expenditures in the Post Office Department.

Senator JONES, of New Mexico. For some reason those committees have never functioned since I have been in the Senate, and they are now abolished. At the time when those committees were formed, they were formed entirely for the purpose of doing some such work with respect to each of the departments as this committee is now doing with respect to the Bureau of Internal Revenue.

The CHAIRMAN. The original resolution that I introduced, authorizing the creation of this committee, particularly provided that we should report our recommendations to the Congress for improving legislation.

Senator KING. That is the primary purpose of it.

The CHAIRMAN. I think someone in the bureau—I do not know who—has a wrong conception of what this committee is trying to do. I think it was properly inspired at the beginning because it was alleged that there was some animus in it, but I thought that had all disappeared during the course of the hearings.

Mr. GREGG. Mr. Chairman, I can not agree with all that. Some time ago, when I returned from London, I came before the committee. I had worked with the Finance Committee and the Ways and Means Committee on constructive legislation for about a year, on the 1924 act. I had worked over a year on the act before it ever got to either committee. I had done the best I could. I had worked with both committees, and I gave them everything I had to help improve the act. I think Senator Jones and Senator King, who were on the Finance Committee, will say that the Treasury Department officials did everything we could to help the committee on the 1924 act.

Senator JONES of New Mexico. There is no question about that at all.

Mr. GREGG. When I came back, as I started to say, I was handed the record relating to one case which I had decided. I suppose I have decided a thousand of them since I have been in the department; but this particular case was taken up by the committee, and a memorandum which I wrote in the case, saying that I did not set up a general precedent for the bureau, was read into the record, and the inference was very strong, "Why was this particular case settled by Mr. Gregg on a basis different from the basis of settlement of other cases?" Naturally, I was rather hurt and quite indignant. Suppose I had decided it wrong. Suppose you all differed with my judgment. What good, in a constructive way, can come from that?

The CHAIRMAN. Did Mr. Gregg reach his conclusion as to the whole work of the committee based on that one case?

Mr. GREGG. No, sir: I have gone into every other case that the committee has taken up. The committee has spent a great deal of its time on amortization cases, which comes down to a difference in a matter of principle between the counsel for the committee and counsel for the bureau. It is so close that the committee has not yet made up its mind as to which way is right. Does it make a great deal of difference? We did the best we could. If you go back and try our cases, what are you going to do? Reopen them? Is the committee going to take it up, in the way it has, individual cases of that sort and reopen them and resettle them? I do not envy the committee its job if it anticipates doing that.

So far as constructive legislation is concerned, amortization is out of the statute. It expired in 1919, which was about the last year for which the deduction was allowed.

The CHAIRMAN. But let me ask you at this point whether the handling of the question of amortization might not be a factor in determining the efficiency of the bureau as constituted?

Mr. GREGG. I think on the question of the efficiency of the bureau, you can get plenty of experts familiar with the work of the bureau from the inside and the outside. Mr. Hartson and Mr. Nash will tell you the same thing, I think, that not only do we not contend that it is perfect, but we have criticized it to each other, criticized things that have been done; but this is not going to get us anywhere. We are doing everything we can to improve it. Bringing up the errors of the past is not going to help us, that I can see. We are trying to correct everything that we know is wrong.

We have brought in people from the outside for that purpose. For example, last year we got a very high paid efficiency expert from the Federal Reserve Bank of New York. We got him to study the bureau, our administrative machine, in order that he might help us. We have studied it; we have studied the law, and we have done our best.

Now, it seems to me that on the question of the law there is plenty of room for further study, but I still can not see how any good can come from retrying cases which we have already decided, possibly incorrectly, but, at the same time, with some degree of intelligence, and with honesty.

Senator JONES of New Mexico. But how can we know what changes should be made in the law unless we go into the individual cases and see how it is operating?

Mr. GREGG. I think it can be brought out, Senator.

As to the question of discovery depletion, we recognized that discovery depletion was unsatisfactory in the 1921 law, even, and we recommended, the Treasury Department, that it be modified. I tried to take that up with both the Ways and Means Committee and the Finance Committee and to go into it in more or less detail, but neither committee seemed to be particularly interested in the technical side of it. We modified it in a very arbitrary manner, cutting it in half, down to 50 per cent; but the Congress had decided that they wanted to give some indirect subsidy to the wildcatter. Continuing that policy, we left discovery depletion in and limited it by cutting it in half.

That was the direct Treasury recommendation, and if the committees wanted to take that up, we would have been glad to give them all the data we had. For example, on the estimates as to the loss of revenue from discovery depletion, I had those prepared three years ago. They did not quite agree with those used here, but they were close enough. I do not think any one will be more willing to help in a constructive way in a revision of the revenue laws, than I.

The CHAIRMAN. Do you find fault with the committee in endeavoring to have the amortization claims corrected and put on a proper basis, such, for instance, as in the case of the United States Steel Corporation, which seems at least to me—and I have sat through all of the hearings—to have been settled on a very incorrect principle?

Mr. GREGG. I admit that there are some points in the original allowance by the engineers in the amortization of the Steel Corporation case that ought to be corrected. I do not know, but I think that is also the view of Mr. Hartson and Mr. Nash. But that case had never been closed, and, as I understand it, those points have been picked up by a review officer in our department. Of course, those points will be corrected before the case is finally closed.

The CHAIRMAN. Nothing has been developed here to indicate that those matters were brought up before our investigating staff brought them up.

Mr. GREGG. I may possibly be wrong on that, but I understood that the reviewer—I do not remember the name—in the consolidated returns section, had caught those points.

The CHAIRMAN. Oh, no; that has not been developed here.

Mr. HARTSON. That is not exactly accurate. Mr. Gregg was not here at the time you held those hearings. The fact is this, that there was still to be a review in the bureau of that case, which might have developed the very criticisms which Mr. Manson called attention to, but which, up to the time that the committee did have the case before it, had not yet been revealed by the bureau.

Senator KING. I do not quite follow all of your decisions. Assume now that your decisions have been sincere, as they doubtless have been, and generally accurate, if there have been decisions which laid down policies and interpretations of the statute which we think, and which Congress might think, were policies that ought not to be adhered to in the future, and that you have interpreted the law in a certain way, I see no reason why we should not call your attention to those decisions, or to get your interpretation, so that whether your interpretation is right or wrong, and if your interpretation is right, let us assume, and we think it is not just, that it to say, it relieves the taxpayer from the payment of money to the Government, or vice versa, we ought to get the interpretation which is placed upon it by you, so that we can make a recommendation to the Congress to change the law.

Mr. GREGG. That is perfectly true. I do not think it is necessary to retry the cases to do that. We can give you any data covering our rulings, and as to our decisions as to policy, general decisions, that the committee desires.

Now, as to errors in individual cases, that is a different matter, and if you want to take that matter up, you must go into specific cases, and I can not see that any good is going to follow from it.

Senator KING. The trouble is that errors in individual cases may, in some cases, be due to the general policy which is pursued in all cases of like character.

The CHAIRMAN. I think, if you will look through the record, you will find that in nearly every case that has been presented to the committee—and I think Mr. Hartson will agree with this—I have asked the question whether these cases that have been reported were typical of all cases. Is not that correct?

Mr. HARTSON. Yes; and I think Mr. Manson answered in the affirmative. I do not concur in that answer.

The CHAIRMAN. But it was my effort to find out, not for the purpose of trying to find exceptions, but for the purpose of trying to find the rule, and every question that I have asked has been directed to finding the rule and not to finding flyspecks.

Mr. HARTSON. Yes; I agree with the Senator in that. That is a fair statement.

The CHAIRMAN. For Mr. Gregg to feel hurt because some decision of his has been criticized just exemplifies the fact that he is a very young man, although a very brilliant one, and is not accustomed, perhaps, to the hard knocks of the world, as are some of us who have reached more mature years.

Mr. GREGG. May I insert right there, Senator——

The CHAIRMAN. At the same time, if some of our staff, all of whom we do not vouch for, any more than we vouch for all of your employees, either as to the accuracy or their motives, but we have to adopt the same method in securing a staff as you do, and

therefore I do not believe that either side would be justified in being unduly critical, because the employees of the committee and the employees of the bureau do not agree with each other.

Mr. GREGG. May I answer your reference to me? I have no objection in the world to having my decisions criticized. I admitted myself that there are many of them that have been wrong; but I do object to the memoranda which I have written being read into the records of the committee when I was not here to answer. There was a very clear inference there, "Why did Mr. Gregg settle this case on a different basis from the basis used in settling the other cases?" I object to that, and I think I am perfectly right in doing it.

The CHAIRMAN. No; I do not think so, because the bureau was represented. I have not been chagrined, nor did my lip quiver with disappointment because, in my discussion of taxes with Mr. Mellon, he felt disposed to publish that I had tax-exempt securities. That did not worry me, and it did not hurt my feelings a bit. I knew I was right and honest about it. You undoubtedly felt that way, too. I have always contended that we should feel worried and get excited about things that are wrong, but when we are right we do not have to get excited, or to even feel hurt.

Mr. GREGG. I was not excited. I was just indignant.

The CHAIRMAN. Well, I understood you to say that you felt hurt.

Mr. GREGG. I was both hurt and indignant; yes.

The CHAIRMAN. Will you have a case ready for to-morrow, Mr. Manson?

Mr. MANSON. No; I will not.

The CHAIRMAN. We will let you gentlemen of the bureau know when we will be ready for you next.

The committee will adjourn now to meet to-morrow morning at 10.30 o'clock, at which time we will proceed with the matters pertaining to the Prohibition Unit.

(Whereupon, at 12.45 o'clock p. m., the committee adjourned until to-morrow, Friday, February 13, 1925, at 10.30 o'clock a. m.)

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