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

S. Res. 168

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

DECEMBER 17, 18, 20, 29, AND 30, 1924, AND JANUARY 6 AND 7, 1925

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SELECT COMMITTEE ON INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

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NEW JERSEY CALCITE CO. CASE

INVESTIGATION OF BUREAU OF INTERNAL REVENUE

WEDNESDAY, DECEMBER 17, 1924

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

The committee met, pursuant to adjournment, at 10 o'clock a. m., in room 410 Senate Office Building, Senator James Couzens, presiding.

Present: Senators Couzens (chairman) and Ernst. Present also: Earl J. Davis, Esq., of counsel for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, solicitor, Bureau of Internal Revenue; and Mr. S M. Greenidge, head, engineering division.

Mr. DAVIS. Mr. Chairman, from time to time, as we go along with our investigations, matters are called for and requests are made to furnish certain things. I have tried to keep track of the things that we have called for, so that we will keep in the record those matters when we come to them.

In the Berwind-White case there was something said in reference to settlements on commitments instead of actual expenditures, and I think there was something said to Mr. Hartson about furnishing other cases besides the Berwind-White case, if there were any, where the basis of settlement were commitments instead of actual expenditures. I believe there was something like that, Mr. Solicitor, and I am calling it to the attention of the committee now, so that we will have those matters in the record as we go along.

The CHAIRMAN. Have you got those yet, Mr. Hartson?

Mr. HARTSON. I am prepared to give something on that, Mr. Chairman. As we get into these cases, the tendency, although we have the information and have had it for a week, has been to be interested in the particular case that is presented, rather than to interrupt the presentation of that case by the introduction of this evidence on cases that have already been heard.

The CHAIRMAN. That is correct, but I think, now that we have suspended the Steel Corporation's case until your reply comes in, we might at this time go into that matter.

Mr. HARTSON. I feel this way about it, Mr. Chairman: The information which we have secured was secured by the representatives of the Income Tax Unit. I have had no opportunity to go over it and to talk with them about it, although, as I understand it, it is in final shape. I would like to look it over myself before presenting it to the committee, just for the purpose of familiarizing myself with what is going in. I have not had that opportunity, although Mr.

Greenidge has prepared a statement which contains the best information that we are able to get. If I may have that opportunity to look into it personally before it is put in, I should like to make a definite agreement to put it in the first thing to-morrow morning, if that is satisfactory.

The CHAIRMAN. That is satisfactory.

Mr. DAVIS. That will be satisfactory.

There was also something said concerning the individual returns on profit on the contract with the Northwest Steel Co. I wish to report to you on that that the individual returns have been furnished by the bureau to our men and they are now going over them to ascertain whether or not the bonus that was referred to in the case of the Northwest Steel Co. was reported by the individuals. The profit on that contract involved some figuring, but Mr. Thomas, our engineer, is working on that.

That covers the two things with reference to the Northwest Steel Co.

In the Standifer case, Senator Jones, I believe, said something about a check-up on amortization allowed by other contracting departments, with the Bureau of Internal Revenue records. I have asked the Navy Department, the War Department, and the United States Shipping Board to supply us with a list, so that we may take that list and check it up with the bureau officials with reference to the particular case mentioned and the amortization allowed.

I wanted to report to the committee that all of these things that we have spoken about here are being followed up, and the committee will have the benefit of everything that has been asked for.

The CHAIRMAN. You may proceed now, Mr. Davis, with the case that we are to take up this morning.

Mr. DAVIS. The case we are to take up this morning comes under the subject of depletion—nonmetals. The taxpayer is the New Jersey Calcite Co., of New York.

The total amount claimed as invested capital subject to depletion is $130,000. The total amount finally allowed as invested capital subject to depletion is $106,000, and the facts in this case, briefly, are as follows:

In 1903 Benjamin Nicoll leased a quarry from the Chester Securities Co. at a royalty of 3 cents per ton, no bonus; term of lease, 10 years.

In 1909 Benjamin Nicoll leased a quarry from the Franklin Mineral Co. at a royalty of 3 cents per ton, no bonus; term of lease, 10 years, with privilege of renewal for five years.

On March 1, 1913, Benjamin Nicoll executed a new lease with the Chester Securities Co. for the above-mentioned quarry, at a royalty of 3 cents per ton, no bonus; term of lease, from the 1st day of March, 1913, to the last day of August, 1919, with privilege of renewal for five years, at a royalty of 4 cents per ton.

In April, 1916, Benjamin Nicoll incorporated his business under the name of the New Jersey Calcite Co., with a capital stock of $150,000.

The taxpayer claims that the leases turned over to the New Jersey Calcite Co. by Benjamin Nicoll had a value of $130,000 as of April, 1916. This is substantiated only on a basis of net profit per ton.

Briefly, the action on that matter is as follows:

The claim of the taxpayer for seting up value of $130,000 on the basis of a retrospective apprisal, as of date of book transfer, was referred to the metals valuation section, and originally disallowed completely. This action was reconsidered, however. On March 4, 1922, the New Jersey Calcite Co. was notified that they would be allowed a valuation of $8,905.93 on their two leaseholds on the basis of market value. They were also advised that they would be allowed to deplete this lease at the rate of $1,118.87 per year.

The taxpayer protested this action, and finally carried his case before the special committee on appeals and review.

On January 4, 1923, this committee addressed the following memorandum to Mr. Griggs, chief of the nonmetals valuation section, as follows:

Memorandum for Mr. O. C. GRIGGS,
Chief Nonmetals Valuation Section, Room 5038:

I have gone over with the other members of the committee the case of the New Jersey Calcite Co. since the discussion I had with you concerning it, and we have come to the conclusion that the valuation heretofore fixed upon the leasehold of the taxpayer was based upon the only admissible evidence before us and consequently should be allowed to stand.

The finding in this case does not, in my opinion, necessitate or involve any change in procedure in the natural resources division, nor any modification of its rulings. The method used in arriving at a value in this case was resorted to because there was no other admissible evidence in the case, and for this reason the case should be considered as having been decided upon its own facts and should not be treated as a general precedent.

A. W. GREGG.
Chairman, Special Committee on Appeals and Review.

On the 6 day of January, 1923, the committee on appeals and review handed down a recommendation, No. 1517, which allowed the taxpayer the value of $106,000 for their two leases to be depleted in eight years.

This finding was approved by Mr. Fay, then head of the engineering division, under protest, as follows:

Approved for audit, January 8, 1923, only on basis of committee ruling, but not in accordance with the views of this division. It sets a bad precedent.

That is signed "Fay".

It appears from our engineer's report that there was other evidence before the bureau, and that the engineers, in their investigation of the case, found that other leases had been made in this same vicinity, covering property similar to this, and by a comparison of those leases with this lease, the most that could have been allowed would be around $9,000.

This is offered for the purpose of showing that rulings are made by the bureau and that these rulings are marked "Not to be used as a precedent in other cases." There appears to be no reason why a ruling, once made, should not be used as a precedent in any other like case that comes before the bureau.

We have also, in this case, the fact that the head of the engineering division, finding fault with the decision, approves of it only under protest, and states that "It sets a bad precedent." If this example were followed, and if this procedure is allowed to continue before the bureau, it seems to me that it will disrupt the handling of cases, and will result in a detriment to the service.

The amount of tax involved in that claim is $29,785.48.
I will ask Mr. Parker, our engineer, to take the stand.

TESTIMONY OF MR. L. H. PARKER—(Resumed)

Mr. DAVIS. Mr. Parker, you have been sworn as a witness heretofore in these proceedings?

Mr. PARKER. Yes, sir.

Mr. DAVIS. Will you refer to your report made in this case?

Mr. PARKER. Yes, sir.

Mr. DAVIS. On page 3 you set up a brief synopsis of the case. I wish you would give us that, beginning with the discussion of the case.

Mr. PARKER. Yes, sir.

As per Exhibit A attached, the engineers of the department gave careful consideration to the value of the two leases transferred from Nicoll to the New Jersey Calcite Co. in April, 1916. They were able to find authentic records of three other leases in this same vicinity at about the same time. These other leases were all on a royalty of 5 cents per ton, with no bonus. They firmly established, therefore, the fact that the market price of leases in this vicinity was 5 cents per ton. On this basis, the value of the taxpayer's leases would amount to about $9,000, as previously stated, figured on the difference between a royalty of 3 cents and 5 cents per ton. It would appear that this is very fair treatment, inasmuch as no value was originally assigned to the leases. A transfer from Nicoll to the New Jersey Calcite Co. was practically a book transfer and the value of the $150,000 worth of stock could only be determined by valuation.

Further, in the income tax report filed by Benjamin Nicoll in 1916, nothing was reported by him as income for the equivalent of the stock issued to him by the corporation. (See Exhibit B attached.)

Further, the principal lease of the New Jersey Calcite Co., covering the Fowler quarry of the Franklin Mineral Co. is valued, by the lessor, in its entirety, including land, at the amount of $24,599.29 as of March 1, 1913, and this value would be still lower as of April, 1916, on account of removal of stone. (See Exhibit C attached.)

The estimated amount of stone remaining in this quarry on December 1, 1919, was 1,500,000 tons. Inasmuch as this quantity of stone is much more than the taxpayer would remove according to his past records during the remaining years of the life of the lease, it would seem ridiculous that the taxpayer's value for his leases could be more than the value in fee for this property.

Mr. DAVIS. Let me interrupt you there, Mr. Parker. There is a provision in the regulations, is there not, that the valuation to the lessor and the lessee shall not exceed the valuation in fee of the property?

Mr. PARKER. Yes, sir.

Mr. DAVIS. All right; proceed.

Mr. PARKER. The study of the claims and briefs of the taxpayers show that he has tried to set up values due to extraordinary profits during the war years when the iron business was somewhat revived

in this locality. His principal customers for calcite were found among the iron and steel industries; and, naturally, his business fluctuates in the same manner as theirs, except that during the war, a number of old abandoned mines were opened up in this vicinity which were abandoned again shortly after the war period, but which causes a further increase in his business.

In face of the above evidence, we are at loss to understand the recommendation of the special committee on appeals and review which allowed a value of $106,000 for these two leases. (See Exhibit D attached.) They state that they had no other evidence on which to base a finding than the proposition of the 20 cents a ton profit made by the taxpayer. We know, however, that they must have had full evidence of market value of similar leases in that vicinity from the engineer's report.

Their own statement quoted in the body of this report expressing a desire that this decision should not be used as a precedent is clear indication of the fact that they were not acting in conformity with recognized procedure.

The CHAIRMAN. Let me ask you there, Mr. Parker, whether, in going through these records, you found any argument or any opinion to sustain this valuation?

Mr. PARKER. I found the opinion that ordered the valuation.

The CHAIRMAN. Why not put that into the record at this time, then?

Mr. DAVIS. I am going to offer the exhibits, Mr. Chairman, and that will be one of them. Will you refer to the opinion that the chairman speaks of?

Mr. PARKER. The formal recommendation, which has a number, is not among my papers. There is a copy of it in the engineer's report in the inorganic metals section.

Mr. DAVIS. Give us that, then, please.

Mr. PARKER. This is headed "Section of inorganic nonmetals." It is dated January 6, 1923, and bears the notation and symbols "IT : NR : NM, JHB :—New Jersey Calcite Co., New York, N. Y. Lease of calcite property."

Under date of March 4, 1922, the company was advised that this office would allow a value of $8,950.93 for two leases of calcite properties having a life of eight years, which were transferred to the corporation for capital stock. This value the company would be allowed to amortize over the life of the leases at the rate of $1,118.87 per year.

From the above action the company appealed to the committee on appeals and review. The finding of the committee on appeals and review follows:

After careful consideration of all facts presented, oral hearing having been had by the taxpayer, the committee concludes:

"(1) That the claim that certain mineral leases should be valued at $130,000 for purposes of invested capital should be disallowed.

"(2) That the leases had a substantial value, which is fixed at $106,000.

"Accordingly the committee recommends that the appeal of the New Jersey Calcite Co. be denied in part and sustained in part."

A. W. GREGG,
Chairman Special Committee on Appeals and Review.

Approved:

D. H. BLAIR,
Commissioner of Internal Revenue.

Mr. DAVIS. I will now ask you to refer to Exhibit B of your report, which is the engineer's report in reference to this matter, and I will ask you to read that into the record.

Mr. PARKER. This is also headed "Section of inorganic nonmetals," and bears the following notation and symbols: "IT:SA:NR:M—CCG New Jersey Calcite Co., 149 Broadway, New York, N. Y. (Successor to Benjamin Nicoll.) Quarrying limestone."

1. Individual returns for 1914, 1915, 1916 for Benjamin Nicoll accompanying to be kept with above case.

2. Taxpayer is operating quarry as lessee. Same quarry operated by Benjamin Nicoll until April, 1916, under name of B. Nicoll & Co., not incorporated. Quarry properties incorporated April, 1916, under name of New Jersey Calcite Co.

3. This case reviewed October 25, 1920, by this section, John Seward, valuation engineer. All claims for valuation and depletion disallowed. A-2 letter sent taxpayer January 31, 1921, resulted in conference and taxpayer submitting individual information substantiating valuation of property.

4. Taxpayer claims $150,000 paid for lease in capital stock of the company, of which, due to the lease having only eight years to run, they are entitled to amortization of the lease on one-eighth per year of the invested capital.

5. Inspection of 1916 individual returns filed by Benjamin Nicoll and revenue agent's report show that nothing was reported as income for the equivalent of the stock issued to him by the corporation; therefore, the incorporation simply resulted in change of name and the New Jersey Calcite Co. paid nothing for the quarry lease or development. Any development set up at that time had undoubtedly been paid for under operating expense while operated by Benjamin Nicoll.

For reasons stated above, action taken October 25, 1920, is herewith sustained as follows:

Valuation limestone quarry lease and development—claimed, $130,000; allowed, none; depletion allowed, none.

Case herewith returned for assessment.

Action taken: Foregoing comment only.

C. C. GRIGGS,
Valuation Engineer.

Approved.

ORR R. HAMILTON,
Chief, Metals Valuation Section.

Mr. DAVIS. What other leases similar to these were included in the engineers' investigation?

The CHAIRMAN. Do you mean leases of other companies?

Mr. DAVIS. Yes; of other companies similar to this, Mr. Chairman. I think that is shown in Exhibit A, Mr. Parker.

Mr. PARKER. Do you mean the leases that were compared with these leases as to the value?

Mr. DAVIS. Yes.

Mr. PARKER. The records of three lessees made in Sussex County, New Jersey, the same county in which the property of the New Jersey Calcite Co. is located, were set out as follows:

"November 9, 1916, Sussex Calcite Co. to Sussex Limestone Products Co., royalty no less than 4½ cents and not over 5 cents per ton book N-11, page 364, etc.

October 2, 1918, Lucy E. Lliff, etc., to Bernard Stener, royalty 5 cents per ton book R-11, 588, etc.

March 16, 1920, Franklin Mineral Co., to Wharton Steel Co., royalty 5 cents per ton X-5-11, page 56, etc.

Mr. DAVIS. You are reading there from a copy of a letter signed by E. H. Batson, deputy commissioner, are you not?

Mr. PARKER. That is correct.

Mr. DAVIS. I will ask you to continue on from where you just left off, to the end of the letter, with reference to these leases.

Mr. PARKER. (reading):

These leases for all practical purposes cost on the royalty basis 2 cents per ton more than the leases transferred to the New Jersey Calcite Co. In the case of one of the leases transferred to the Calcite Co., the advantage to the Calcite Co., is only 1 cent per ton for the renewal period of five years.

One of the leases as above was made in 1916, shortly after the Calcite Co. acquired its leases. Another was made in 1918, and a third was made in 1920.

The lease made in 1920 is particularly in point as it was made by the Franklin Mineral Co., the same company that made one of the leases which was transferred to the Calcite Co. The quarry property covered by this lease is on the same belt of limestone and is worked in the same manner as the quarry covered by the lease which was transferred to the Calcite Co.

From the above it is apparent that the only advantage in the leases transferred to the Calcite Co., over the leases referred to above is the difference in royalty rate of 2 cents per ton for one lease for the full period of eight years and for the other lease of 2 cents per ton for three years and 1 cent per ton for five years.

The value of these differentials may be capitalized to establish the value of the leases transferred to the Calcite Co. For the purpose of capitalization the Calcite Co. has assumed an annual output of 150,000 tons. This office holds that there is no authority for such an assumption. Inasmuch as there are no data in substantiation of the probability of a greater future output at the time the leases were transferred to the Calcite Co., the average annual output for the three prior years may be assumed to represent the probable annual output for the future which for all practical purposes may be placed at 100,000 tons.

Inasmuch as Form F (revised) does not show what tonnage should be allocated to each lease it is assumed that the output from each lease was equal. Upon that basis the lease advantage to the Calcite Co. would be for the full period of eight years as follows:

50,000 tons for 8 years at 2 cents per ton	$8,000.00
50,000 tons for 3 years at 2 cents per ton	3,000.00
50,000 tons for 5 years at 1 cent per ton	2,500.00
Total advantage	13,500.00

The capitalized value of this sum for an eight year period at 8 per cent, and 4 per cent, Hoskold's formula, would be $8,950.93. This sum $8,950.93 has been allowed as the value of the two leaseholds transferred to the New Jersey Calcite Co. in April, 1916, and may be amortized over the life of the lease at the rate of $1,118.87 per year.

This value and amortization rate will govern during the life of your lease, subjects to capital additions, deductions, or corrections (should error be discovered), which would require modification of these figures. The above results will be reflected in the audit of your case, which will begin 20 days from the date of this letter.

Respectfully,

E. H. BATSON,
Deputy Commissioner.
By ——— ———
Head of Division.

Mr. DAVIS. Mr. Chairman, the value of similar properties transferred is taken up in the regulations, and in article 206 of Regulation 62, among other things, we find the following:

The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any and all factors and evidence having bearing on the market value, such as cost, actual sales, and transfers of similar properties.

Mr. Parker, does it appear that the matter referred to with reference to other like leases in this vicinity had been finally disre-

garded in determining the amount this taxpayer should be allowed in depletion?

Mr. PARKER. The decision of the special committee on appeals and review would show that they had disregarded it.

Mr. DAVIS. On account of the remark therein that there was no other evidence except that presented by the taxpayer?

Mr. PARKER. That is the only light that they throw on it. They said that they had an oral hearing, but the mere statement that they had no other evidence does not seem to be borne out by the record, in view of the Engineer's report, which must have been before them, and which appears to me to be very clear.

Mr. DAVIS. That is all.

The CHAIRMAN. Mr. Hartson, do you want to inquire of the witness?

Mr. HARTSON. Mr. Parker, is it your understanding that objection to the result which is announced in that letter of Mr. Batson's to the taxpayer, from which an appeal was taken to the special committee on appeals and review, was made on the basis of similar transactions in that vicinity for the sale of like mineral deposits?

Mr. PARKER. Yes, sir; because if you take the differential of 2½ cents a ton, it shows just how it was figured.

Mr. HARTSON. They, however, by a computation of capitalizing earnings based on royalties received from other leases, arrived at a theoretical figure of some $8,000, as the value of this lease at that date, did they not?

Mr. PARKER. Yes, sir; but the 2 cents and 1 cent a ton show that they took into consideration those other leases, because that is where they got the differential of two and one cents per ton.

Mr. HARTSON. Do you know, Mr. Parker, the basis used by the special committee on appeals and review when it ascribed the value of approximately $106,000 to these leases, as of April, 1916?

Mr. PARKER. No, sir; there was nothing in the files that I could find about it, unless there are other files kept separate from the case.

Mr. HARTSON. Well, there must have been some method used by this special committee to reach the $106,000 value, and I wonder if you know what that is.

Mr. PARKER. I assume that they accepted practically the taxpayer's valuation of $130,000, but discounted it over the life of the lease, which would discount it back to $106,000. I did not carry those computations through, but it would appear to me that that was the way it was accomplished.

Mr. HARTSON. Then, you do not know, of your own knowledge, just what basis was used by this special committee in reaching this $106,000 valuation?

Mr. PARKER. I think it is stated in one of the papers, if you will give me a moment to refer to it. [After examination of papers] No; I do not know positively. That is my opinion of the way it was done.

Mr. HARTSON. It is a fact, is it not, that the bureau should have placed a value on those leases as of that date which represented the fair cash market value of the leases? Is not that true?

Mr. PARKER. I think that is a point of law that I should not be asked to discuss, as to whether the right valuation at all was firmly established, on account of whether this was a bona fide sale, as long

as this man Nicoll simply incorporated his business. That is a point of law.

Mr. HARTSON. You would not say that it was unlawful to do that?

Mr. PARKER. I do not know.

Mr. HARTSON. Assuming, then, Mr. Parker, that a man has a right to form a corporation and transfer certain property to that corporation, in exchange for its capital stock, and then having in mind the provisions of the law which authorize a valuation to be set up on the books of the corporation for the purpose of invested capital, and which also may form a basis for a depletion charge, such as might have been allowed in this case, then it becomes necessary, does it not, to fix a value for this property so transferred which represents its fair market worth as of the date of the transfer?

Mr. PARKER. That is my understanding, yes, sir.

Mr. HARTSON. I think that is right, and there is no question about it.

The CHAIRMAN. I would like to ask you, Mr. Hartson, whether it is your opinion that the bureau is not justified in going back of the mere transfer of property from the individual to the corporation, when the individual owns all of the stock?

Mr. HARTSON. I think the bureau is justified, if there is any irregularity or any fraud or corruption in the transaction of forming the corporation. However—

The CHAIRMAN. Is there any evidence in the records to show that the bureau did go back of the mere transfer of the property from the individual to the corporation?

Mr. HARTSON. No; I think the bureau took this transaction of creating this corporation as a bona fide transaction for business purposes which seemed advantageous to the taxpayer, and that was the policy that it followed.

The CHAIRMAN. In other words, if he had transferred it to himself—

Mr. HARTSON. He already had it, Senator.

The CHAIRMAN. I mean, if he had transferred it from himself to the corporation and had been given a million dollars' worth of the stock for the property, the bureau would have accepted that in the same manner as they have accepted $150,000?

Mr. HARTSON. No, Senator; that is not the case. The bureau does look through a transaction when it is perfectly legal on its face, such as this transaction appears to me to have been, to determine, however, not what the par value of the stock was in exchange for the property but what the real value of the property was in exchange for the stock.

The CHAIRMAN. I think that is a perfectly correct basis, but I wondered if there was any evidence here, so that I can carry this clearly in my mind, to prove that this property was worth $150,000.

Mr. HARTSON. $106,000.

The CHAIRMAN. I know; but he got $150,000 worth of stock, and it was evidently worked back from that to $106,000.

Mr. HARTSON. No; I do not so understand it.

The CHAIRMAN. As I understand it, he got $150,000 worth of stock.

Mr. HARTSON. We are not very far apart, but I think the taxpayer represented that the value of those leases was $130,000.

The CHAIRMAN. Yes; that is true, but I mean he got $150,000 worth of stock.

Mr. PARKER. I can account for that difference.

Mr. HARTSON. There is no disputing the $150,000 worth of stock,

The CHAIRMAN. No.

Mr. HARTSON. The bureau would ignore the par value of that stock in attempting to find out what the real value of the leases was that were exchanged for the stock.

The CHAIRMAN. In other words, then, the bureau accepted the valuation of $130,000?

Mr. HARTSON. The value was $106,000 as allowed by this special committee on appeals and review. That may have been an acceptance of the $130,000, with certain adjustments.

The CHAIRMAN. Yes.

Mr. HARTSON. But I am not prepared to say that, although I think I can bring that out here before the hearing is over, as to just what the fact is.

Mr. PARKER. The difference between the $130,000 and the $150,000 is, I believe, represented by the value of the machinery and operating equipment of the property which, of course, is not a part of the lease.

The CHAIRMAN. Do you want to ask any further questions, Mr. Hartson?

Mr. HARTSON. No; I think that is all I care to ask.

Mr. DAVIS. With reference to their having before them any evidence about this transfer from the individual to the corporation, I find this statement contained in the engineer's report:

> The inspection of 1916 individual returns filed by Benjamin Nicoll and revenue agent's report, show that nothing was reported as income for the equivalent of the stock issued to him by the corporation, therefore, the incorporation simply resulted in change of name, and the New Jersey Calcite Co. paid nothing for the quarry lease or development. Any development set-up that time had been undoubtedly paid for under operating expense while operated by Benjamin Nicoll.

The CHAIRMAN. As I understand it, your reference to that indicates that you believe that the individual owner, in the first intsance, having received $150,000 worth of stock for the property should have returned an income of $150,000; is that right?

Mr. DAVIS. That seems to be the intimation of the engineers here in making up that report.

The CHAIRMAN. Mr. Hartson, would that sort of a transaction require a return by the taxpayer of a $150,000 income?

Mr. HARTSON. I rather think not, Senator. That would be my impression of it, but I do not want to say definitely, because I am not thoroughly familiar with it.

The CHAIRMAN. I would like to inquire of Mr. Nash if he knew whether, in general cases of that character, that is so.

Mr. NASH. I do not think so, Senator. If there were income there, we would have to show that the value of the assets were transferred by the individual to the corporation was less than the value of the stock that he received in exchange for it. At this time the fixing of value on that $150,000 worth of stock that he received would be a difficult thing to do; and unless we could show that there was a

margin between the value of the assets and the value of the stock he received, we could not charge him with having recieved any income.

The CHAIRMAN. Mr. Nash, under the law and under the rules of the department—and I just ask for information—would a transfer of that character have to be reported to the department?

Mr. NASH. Not necessarily; not unless the taxpayer was satisfied that he had received income.

The CHAIRMAN. I see.

Mr. NASH. Or unless a subsequent investigation would lead us to believe that he had recieved an income.

The CHAIRMAN. I get the point.

Mr. HARTSON. Of course, Senator, the law is changed somewhat from year to year, since this transaction occurred. An exchange of property for property is what we term a realization of profit, just like you exchange it for money, if a property so exchanged has a readily ascertainable value, so it can be reported on in terms of money. It would occur to me—and I have not considered this feature of it at all before it came up this morning—that whether or not he did make a profit in exchanging his lease for stock in the corporation would depend on the very thing that had to be settled in the bureau as to the value of the leases, because, if these $130,000 represented the true value of those leases, then the stock was worth approximately par, was it not? That would be my impression.

The CHAIRMAN. Less $20,000.

Mr. HARTSON. Yes.

The CHAIRMAN. I would like to bring out, if possible, how the bureau arrived at this value of $130,000, or whether it is admitted that you took the taxpayer's statement on that.

Mr. HARTSON. Assuming that we took the taxpayer's statement—and it will develop later just what was done—there is nothing unlawful in that providing the taxpayer's statement was the correct method of computing the value of that property.

The CHAIRMAN. I am not claiming that it is unlawful, I was just asking for information.

Mr. HARTSON. Yes.

The CHAIRMAN. So as to see what weight the department placed upon the value of the other leases enumerated by the engineers, in arriving at the value of this particular property involved in this transaction. It appears from the records that you ignored these other leases as comparable with his particular case, and I was wondering if there was anything in the records to indicate why you ignored this information when finally disposing of the case, because, at one time, it was placed by the department at a valuation of some $9,000, and nothing has been introduced here to show why the bureau jumped from a $9,000 valuation to a $130,000 valuation.

Mr. HARTSON. The files show the memoranda prepared by the special committee on appeals and review, of which Mr. A. W. Gregg was chairman, and they briefly state the basis for this value of $130,000 that was allowed. A reference to the briefs of the taxpayer, sworn to and properly submitted in conformity with the regulations, I believe, would show more fully the reasons why that value was accepted, as matter of law.

The taxpayer makes the contention and submits it in his brief, and the facts are really not in dispute; so much so, I think, that in these other transactions involving the disposition of leases, the records of those transactions, if I am not misinformed, are submitted by the taxpayer's engineers. There was never any field investigation or examination by the bureau engineers of these properties at all. The taxpayer, however, came down and filed these briefs, supporting a contention that this value should be arrived at in some way other than the use of these figures which he himself has submitted involving the transfers of other leases in that vicinity. Now, the method that was followed or argued for by the taxpayer, and which, from the record, as I find it here, was a method of capitalizing the future prospective earnings of the corporation, was based on an engineer's report that the product of the quarries would net them a certain profit.

The CHAIRMAN. Have you that part of the taxpayer's brief there which sets up this claim in that connection?

Mr. HARTSON. Yes.

The CHAIRMAN. If it is not too long, I would like to have you read it here, but before we proceed with that, I would like to ask Mr. Parker if he saw the taxpayer's brief in this case?

Mr. PARKER. I saw one of his briefs. I do not know whether I saw that one or not.

The CHAIRMAN. In making your criticism of this case, then, have you given full consideration to the taxpayer's brief?

Mr. PARKER. Yes, sir; to the one that I saw.

The CHAIRMAN. Yes.

Mr. PARKER. I do not know whether it is that same one.

Mr. HARTSON. Well, there is no question in your mind in this case that any of the files had been withheld from you, is there?

Mr. PARKER. No, but if you have two briefs there, I have not seen one of them. I may have skipped it or something, but I saw but one brief.

Mr. HARTSON. Mr. Chairman, if I may interrupt at this point, I personally would like to clear up any impression, if it can be done, that exists in the minds of the representatives of the committee that anything down there in the bureau that is available, that is there, is being withheld or concealed, or that you are being delayed in getting access to it. Mr. Nash and Mr. Greenidge and I can not control the actions of every individual in the bureau. No one can do that. But I want this definite assurance to be given the committee, that if Mr. Parker or any of his associates fail to get something that they think they are entitled to, by reason of making the inquiry from those who have immediate supervision over the records, if they will come to us, we will see that they get it just as quickly as it physically can be done. There is not a thing in the bureau—and I am just as certain of this as I can be—there is not a thing in the bureau, whether it is good or bad, that is not ready to be produced to this committee—not a thing.

The CHAIRMAN. So far as I am concerned, I am satisfied with that, and I hope our staff will follow your suggestion and go direct to either Mr. Nash or Mr. Hartson, in case they do not get proper service in the future.

Mr. NASH. Mr. Chairman, I would also like to say that Mr. Parker, when he first began to work in the bureau, was told by me that if he did not get proper cooperation and did not get what he needed in any place where he was going to work, that he should come to me and I would see that he did get it. I have not had a complaint of any sort from Mr. Parker, and assumed that he was getting 100 per cent cooperation.

The CHAIRMAN. I think Mr. Parker ought to carry his complaints to you, then, before carrying them to us.

Mr. PARKER. The time was pretty limited this morning.

Mr. HARTSON. Mr. Chairman, I have the brief submitted by the taxpayer. It is a statement of his appeal from the letter which bears Mr. Batson's signature, and which Mr. Parker has read into the record which allows him a value of, roughly, $8,000 on these leases. This brief reads:

IN THE MATTER OF THE ADDITIONAL INCOME TAX ASSESSMENT ON THE N. J. CALCITE CO. FOR THE YEARS 1917 AND 1918

The Treasury Department, in a letter addressed to the N. J. Calcite Co., dated January 31, 1921, has assessed an additional income and excess profits tax for the years 1917 and 1918, amounting to $38,813.69.

This is an appeal by the N. J. Calcite Co. from the ruling of the Treasury Department.

FACTS

The imposition of this additional tax arises from the two disallowances by the Treasury Department:

(*a*) The Department excludes from the corporation's invested capital the value of certain leases of a quarry which the corporation acquired in 1916, on its incorporation;

(*b*) The department refuses to permit the corporation to deduct an annual depletion charge based upon the life of the leases.

In order that a clear understanding of the points at issue may be had, the following facts are given:

In 1902 Benjamin Nicoll took from Miss Clarinda Fowler a lease of some property at Franklin N. J., which it was believed contained valuable limestone deposits. The property consisted of a hill.

Mr. Nicoll proceeded to open up the hill and to quarry the limestone.

In 1909, the Fowler heirs, having incorporated under the name of the Franklin Mineral Co., Mr. Nicoll made a new lease of the property expiring July 18, 1924.

In 1903 Mr. Nicoll made a lease with the Chester Securities Co., for some adjacent land, which lease expires August 1, 1924. The quarry covers a part of each of the two properties.

After opening up the quarry, Mr. Nicoll found that the hill was almost entirely of limestone, with a very shallow covering of earth.

We submit herewith photographs showing the condition of the hill at various times of operation.

The quarrying operations proceeded at an excellent rate, the shipments of limestone running as high as 174,553 tons in 1906. The production in 1911 and 1912 was low on account of labor troubles, strikes, etc. In April, 1916, Mr. Nicoll organized the N. J. Calcite Co., a New Jersey corporation, with a capital stock of $150,000, and transferred to that corporation the aforesaid leases and all his quarrying machinery and buildings, for the capital stock of the company, to wit, $150,000 par value. At that time, the leases still had eight years to run.

The corporation entered upon its book the valuation of the quarries, machinery, etc., at $150,000, invested capital, and proceeded each year to deduct an amount for depletion, so that the capital stock of the company would be repaid by the time the leases expired in 1924.

There are, therefore, three questions before the department:

(*a*) Where an individual owning leases covering a quarry, mine, oil wells or similar property, transfers same to a corporation in exchange for the capital stock of the corporation, may the corporation enter the leases upon its books at a proper valuation as invested capital?

(*b*) Under the above circumstances, may a corporation, having acquired the leases or the stock, take off from its income an amount to cover an annual depletion charge based on the life of the leases?

(*c*) Assuming either or both of the above questions to be answered affirmatively, how is the value of the leases to be fixed?

ARGUMENT

(*a*) We respectfully submit that a lease may be a thing of value the same as any other kind of property, and that when it is acquired by a corporation, it may be entered as invested capital the same as any other property acquired. It is true that Mr. Nicoll paid nothing for the leases in 1902, but that doesn't alter the fact that they may have been of great value in 1916, due to the development thereof. If Mr. Nicoll had acquired the fee of the property in 1902 for, say, $5,000, the value thereof at the time that he might sell it to the corporation would not be its cost to him, but its actual value at time of sale. The same principle applies to a lease. This principle has been recognized by the department in a number of its rulings as follows:

In Treasury Department Bulletin No. 21–20, at page 25, is a clear-cut case exactly the same as that of the N. J. Calcite Co. The case is summarized as follows:

"Where certain commercial leases to oil lands are informally transferred to a corporation formed by the lessees for the purpose of taking over such leases, no consideration being paid for such transfer, it will be deemed that the transfer was made at the time of taking possession, and the addition to invested capital of the corporation upon such transfer is the fair market price or value of the leases at the time possession is so taken by the coporation."

Another case very much in point is that cited by the Treasury Department in Bulletin No. 20–20, at page 17. There a mining lease was acquired without bonus in 1915 by individuals who drilled the ground at a cost of x, locating an ore body. In June, 1916, they transfered it to a corporation for the entire capital stock of the corporation. At that time, the actual value of the lease was $14x$ dollars. The question was whether the corporation was entitled to a deduction of the leases in its invested capital at $14x$ dollars or only at x dollars.

The department clearly holds (p. 19) that:

"If the owners of the leases had organized a corporation jointly subscribing for its stock at $14x$ dollars in cash and the corporation had then purchased from them the very lease here in question, there would be no question that the cost of the lease to the corporation would have been $14x$ dollars. The result is not changed by the fact that they adopted the more direct method. The cost of the lease to the corporation was the value of the stock issued in exchange for it."

Another interesting case in this point is that of Doyle *v.* Mitchell Bros. Co. (247 U. S. 179). There, Mitchell Bros. Co. was a lumber corporation. In 1903, it acquired certain timber lands, paying therefor $20 per acre. When the corporation excise tax of 1909 took effect, the corporation deducted a certain percentage of depletion due to its cutting down of timber. For the purposes of estimating the depletion, the corporation placed the value of its timber lands at $40 per acre, claiming that that was its value in December, 1908. This contention was upheld by the Supreme Court in the case above cited, the court stating as follows:

"When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and a subsequent change of form by conversion into money did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the act was in force. Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case are not in dispute."

B. Assuming now that the corporation has acquired the leases at a valuation of 150x dollars, and that these leases have eight years to run, what is the proper depletion or amortization allowance to the corporation to be deducted from its income?

We respectfully call attention to article 109 of Regulation 45, amended as shown in Treasury Department Bulletin No. 37–20, at page 9, as follows:

"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 true that there is a difference between a business property and a mining property, which is depleted by the lessee and in some instances, it is proper for the depletion allowance to be equitably apportioned between the lessor and the lessee. (See opinion from the Attorney General, October 29, 1920, reported in Treasury Department Bulletin No. 47–20, at p. 13.)

In this case, however, we feel that the royalty paid by the N. J. Calcite Co. to the lessors of the quarry is to be taken by them in lieu of any depletion of the mineral deposits, and that the Calcite Co. is entitled to amortize the value which it paid for the leases by an aliquote depreciation allowance for each year of the lease still to run.

Here also the United States Supreme Court has expressed itself in favor of the position taken by the taxpayer in this case. We call attention to the case of United States *v.* Biwabik Mining Co. (247 U. S. 116). In that case the mining company paid $612,000 for a lease of certain ore property having 50 years and 3 months to run. The company offset this income by two depletion items. One was the depletion item based upon the amortization of the $612,000 over the period of 50 years, and was worked out in terms of a valuation per ton, and figured 0.03885 per ton. In addition to that, they took off for depletion an allowance of 0.44865 per ton, based upon the amount of ore taken out of the property, as if the lessee were the owner of the property itself. The Supreme Court in the above case allowed the depletion or amortization item of 0.03885 per ton, and disallowed the depletion item of 0.44865 additional per ton. In other words, the Supreme Court in that case held that the lessee of mining property did not become the owner of the property, and therefore could not charge off the annual decrease in the value of the property due to the excavation of ores; but as lessee of the property, he could charge off a depletion or amortization charge based upon the value of the lease as spread over the period of the lease.

C. The third question involved is the one of fact, namely, What was the value of the leases in April, 1916——

Now, that is the real point of the dispute here, Mr. Chairman——

when same were transferred to the N. J. Calcite Co. for $150,000, par value of the stock?

In April, 1916, the value of the machinery, buildings, and other physical equipment at the quarry was $22,000——

That $22,000 is in typewriting and there has been a pencil line drawn through it.

We contend that the difference between that and $150,000, to-wit, $128,000——

There is a pencil line also drawn through $128,000.

was a fair valuation of the leases.

It may be that they have in some other paper here taken the position that the physical property was worth $20,000 instead of $22,000, and that the contention would then be that the difference between the $150,000 and the $20,000 was a fair valuation of the leases: to-wit, $130,000 would be a fair valuation of the leases.

In assuming the value of the leases, we refer to Principles of Mining, by Herbert C. Hoover. In chapter 5, on "Mine valuation," he points out how the value of a mine is determined by its annual dividend yield for a period of years, and replacing the invested capital by reinvestment. At page 46 he gives a condensation from Inwood's Tables. According to these tables, in order to ascertain the value of a mine, the annual income is multiplied

by a given number which is based upon an annual dividend yield and the amortization of the capital investment within a period of years.

The same principles that apply to the valuation of a mine would apply to the valuation of a quarry with even greater definiteness—especially in the quarry such as the one operated by the N. J. Calcite Co. The reason is that a mine requires sinking of shafts and the following of a vein of ore, both of which involve speculative elements, whereas the quarry was almost entirely pure limestone in which the annual yield of limestone and cost of operation could be calculated to a nicety. In the Calcite Co.'s quarry, the speculative element was eliminated.

In assuming, therefore, the value of this quarry, you must take into consideration the following elements:

(*a*) The life of the lease.

(*b*) The estimated tonnage of limestone that was in the quarry on its acquisition by the corporation in 1916.

(*c*) The amount of limestone that could reasonably be quarried per annum.

(*d*) The rate of profit that could reasonably be calculated upon the limestone shipped, plus determining the annual income from the quarry.

We will take these up in detail.

(*a*) The life of the leases when taken over by the corporation in 1916 was eight years.

(*b*) The amount of limestone that remained in the quarry at that time can be determined as follows: In December, 1918, Mr. Nicoll had a report on the limestone quarries made by H. P. Henderson, mining engineer; a copy of this report is submitted herewith, marked "Exhibit A." Mr. Henderson figures that the amount of limestone at the floor level then operated by the quarry was 3,410,000 tons, and that if the quarry were lowered 30 feet, 2,300,000 tons would be added.

(*c*) It is very obvious that the Calcite Co. might remove 200,000 to 300,000 tons annually from the quarry for the remaining eight years of the lease, without completely exhausting the quarry. This report was made in December, 1918. During the year 1918, 152,000 tons were excavated and shipped; in 1917, 153,000 tons; in 1916, 133,000 tons, all of which would be added to the available limestone in the quarry as of April, 1916. We append hereto, marked "Exhibit B," a schedule of the limestone shipped from the Nicoll quarries from 1902 to 1920, as certified to by Mr. Tonking, the quarry superintendent.

(*d*) The rate of profit per ton on the limestone is estimated at 20 cents per ton. This estimate is made by Mr. Mullen, auditor of Mr. Nicoll, and is based upon his recollection of the figures of the quarry shipments, etc., all of which, however, were destroyed when the N. J. Calcite Co. took over the operation of the quarry in 1916. Mr. Mullen states that the rate of profit was always figured at at least 20 cents per ton. He submits herewith schedules for the years 1917 and 1918 showing the tonnage shipped, the price received and the cost of operation, which shows that in 1917, the average profit was 23 cents per ton and in 1918, it was 31 cents per ton. (Schedules marked "Exhibit C".)

For purposes of estimating the valuation of the leases, we are submitting herewith (marked "Exhibit D") a schedule based upon the tables heretofore referred to in Mr. Hoover's book. We start with an estimated shipment of 150,000 tons per year at a profit of 20 cents per ton, yielding an annual income of $30,000, and we show the valuation of the quarry at different dividend yields ranging from 6 per cent to 10 per cent. At a 6 per cent yield, the valuation would be $177,900; at a 10 per cent yield, the valuation would be $143,700.

The greater the tonnage the greater would be the annual income, and consequently the greater would be the value of the leases.

There remains only one question to be considered, and that is, whether the Calcite Co. is entitled to deplete or amortize its entire invested capital within the period of the lease.

It can readily be seen that the value of the quarry was so great in 1916 that even apportioning the depletion between the lessor and the lessee, the amount of the depletion alone allotted to the lessee would be at least equal to the amortization of the lease per annum.

The CHAIRMAN. In this case, did the lessor take credit for depletion, as well as the lessee?

Mr. HARTSON. I can not answer that, Senator, offhand.

The CHAIRMAN. Would it be customary?

Mr. HARTSON. It would be customary, if the lessee took any depletion, to apportion it between the two.

Mr. DAVIS. In reference to the brief that has just been read by the solicitor, Deputy Commissioner Batson had the brief in mind and referred to the same when he speaks of it in a letter of March 4, 1922, as follows:

> In a brief submitted by the company is a statement of the tonnage content of the quarry based upon a report made by a mining engineer. The statement was then made that "it is very obvious that the Calcite Co. might remove 200,000 to 300,000 tons annually from the quarry for the remaining eight years of the lease, without completely exhausting the quarry."
>
> From Form F (revised) filed by the company it appears that the average annual output for the three years previous to 1916, was 97,951 tons. The actual average output for five years, 1916 to 1920, inclusive, is 109,952 tons. This falls considerably short of the assumed annual output of 150,000 tons.
>
> This office holds that for income-tax purposes it is unsound to value a mining property or lease by capitalizing the earnings of the company upon the basis of an annual output and profit per ton. For income-tax purposes value is based on cash cost, or if the property is acquired with stock, its value or cost should be based on an amount that would obtain between a "willing seller and a willing buyer."

So that in spite of the brief that has just been read, and the allegations therein made, Deputy Commissioner Batson did not take the taxpayer's view with reference to that?

Mr. HARTSON. Just one further word, Mr. Chairman, so that we will have the whole picture before you. It is true that the brief that I have read was submitted before the case was referred to the committee on appeals and review, and was before the Income Tax Unit and Deputy Commissioner Batson when the letter rejecting the taxpayer's claim was transmitted to the taxpayer. After the case was appealed to the committee on appeals and review there was a subsequent brief filed, which was received on May 19, 1922, and is identified as being an additional brief filed with the committee on appeals and review in connection with its letter to the attorneys for the taxpayer, dated March 9, 1922.

The CHAIRMAN. Is the one that you read, Mr. Parker, the one that the solicitor is talking about now, or the one he read before?

Mr. PARKER. I am familiar with the one he read before. I do not recall this other brief.

Mr. HARTSON. This is a two-page brief. I might read it, in order to have the record complete, although I think there is nothing in it that is departure from what their contentions had been before.

The CHAIRMAN. If that is substantially correct, there is no use of putting it in the record.

Mr. HARTSON. The issue here, Mr. Chairman, is a very clear one. The issue is whether the value of those leases which had to be determined was arrived at properly by capitalizing the earnings of the corporation, or whether that should be totally disregarded and some other method used.

Now, the method that was followed by those in the unit, as has been pointed out by Mr. Davis and Mr. Parker, was a computation based upon certain royalties received by the other lessees in that vicinity. It, in a sense, was a capitalization of past earnings of other people in that vicinity, in order to determine what the leases

were worth. It reaches an entirely different result. This method that was followed by the special committee on appeals and review took an arbitrary figure of future production and then estimated a profit which would be made per ton on that production, and capitalized that and reached this figure.

The CHAIRMAN. Is that the usual way of capitalizing those quarries?

Mr. HARTSON. That is not the usual way.

The CHAIRMAN. Can you tell us why, or do you know any reason or have you any suspicion, if that is the proper word, as to why it was done in this case, and not in other cases?

Mr. HARTSON. I have not. The bureau does, in some instances, resort to the capitalization of earnings to determine value. It has to do so in certain instances.

The CHAIRMAN. Will you give us the kind of case, for instance?

Mr. HARTSON. Yes; for instance, in determining the value of an intangible, such as a good will, we will say the bureau does customarily resort, in order to determine a fair value for good will—and good will is an extremely difficult thing to determine the value of, and yet it is a very real thing, as the Senator knows, in certain lines of business—the bureau has capitalized earnings in an attempt to figure out and ascribe some figure for good will. If there is any other way to determine it, if there is any better method, this process of capitalizing earnings is not resorted to and should not be resorted to, I believe.

Now, the way that the bureau should approach the decision in this case is just as a court would do it: What is the evidence that can be considered lawfully, and what is the best evidence to determine the value of these leases? Certainly transactions in the same vicinity and under substantially the same circumstances are very persuasive—very persuasive, and if that showing is sufficiently definite, this method of resorting to any theoretical computation ought to be abandoned, and is, I think, in most cases not availed of.

I do not know whether the file is going to show just the reason why the special committee accepted the theory of capitalizing earnings that was advanced by the taxpayer in this case. The statement is made by Mr. Gregg in his memorandum announcing his decision that the only lawful evidence—I think that is the word——

Mr. PARKER. Admissible.

Mr. HARTSON. That the only admissible evidence before him was this evidence submitted by the taxpayer in the form of what might be termed retrospective appraisal.

The CHAIRMAN. Is Mr. Gregg still in the service of the department?

Mr. HARTSON. He is still in the Treasury Department, Senator. He is the Mr. Gregg who was the tax adviser to the Secretary during the course of the last revenue bill's progress through Congress.

The CHAIRMAN. Who is the deputy commissioner who signed or approved the final disposition of this case, do you know?

Mr. HARTSON. The final disposition of the case was not approved by the deputy commissioner. It was approved by Mr. Blair, the commissioner.

The CHAIRMAN. Is Mr. Batson still in the service?

Mr. HARTSON. No, sir; Mr. Batson is not now in the service, and has not been for two years, nearly.

The CHAIRMAN. So that the settlement of this claim was finally disposed of in absolute disagreement with the conclusions reached by Mr. Batson; is not that correct?

Mr. HARTSON. That is correct, and the record shows that not only did Mr. Batson disapprove of it, but Mr. Fay, who sits here, disapproved of it, he being at that time the head of the natural resources division. Mr. Briggs, assistant chief of the section, also disapproved of it. I think the record is very clear on the sharp disagreement that occurred in this case in the bureau—very clear.

The CHAIRMAN. The memorandum on one of the papers saying that this case should not be used as a precedent was placed there by some individual, I do not recall who it was?

Mr. HARTSON. By Mr. Gregg, the chairman of the special committee on appeals and review.

The CHAIRMAN. But he evidently had no influence or authority which would prevent the using of that basis again, had he?

Mr. HARTSON. Well, yes, I think he had, because his decision in the case was approved by the commissioner, and, no doubt, as a part of the approval, it was suggested by Mr. Gregg that the facts in this case seemed peculiar and the admissible evidence, in his view, being very limited, it was not likely that they would find another case where the facts were on all fours with this case, and therefore they were not to decide a case where the facts were not just the same as these in the same way that this case was decided.

I do not understand Mr. Gregg to mean in that memorandum, where he says it would create a bad precedent, that in a case where the facts were exactly similar it should be decided in a different way, but I think his statement was to the effect that this is unique, and that his statement, fairly read, would carry this understanding, that he thinks the facts are so unique here that it should not be used as a precedent in settling other cases, but that certainly if any other case presented the facts which were identically the same as these, Mr. Gregg, would doubtless be in favor of settling it on the same basis as this case.

The CHAIRMAN. Does the record show who the counsel were in this case?

Mr. HARTSON. Yes, it does, Senator. The counsel are Kaye, McDavitt & Scholer, attorneys, 145 Broadway, New York. I have no acquaintance with any of those gentlemen; I do not know who they are.

Mr. DAVIS. I have Mr. Fay here, Mr. Chairman. He will testify in reference to this matter.

The CHAIRMAN. There is no objection to putting him on now.

TESTIMONY OF MR. ALBERT H. FAY, MINING ENGINEER, WASHINGTON, D. C.

(The witness was duly sworn by the chairman.)

Mr. DAVIS. Your full name, Mr. Fay, is——

Mr. FAY. Albert H. Fay.

Mr. DAVIS. Where do you live?

Mr. FAY. Washington.
Mr. DAVIS. What is your occupation?
Mr. FAY. Mining engineer.
Mr. DAVIS. Are you practicing that profession now?
Mr. FAY. To some extent.
Mr. DAVIS. Were you formerly with the Internal Revenue Bureau?
Mr. FAY. For three years.
Mr. DAVIS. And when did you go there?
Mr. FAY. June, 1920.
Mr. DAVIS. When did you sever your connection with the bureau?
Mr. FAY. July 1, 1923.
Mr. DAVIS. Did you resign?
Mr. FAY. I did.
Mr. DAVIS. During the time that you were there did the New Jersey Calcite case come before you?
Mr. FAY. It did.
Mr. DAVIS. I will refresh your recollection on that matter by showing you a memorandum attached to a letter from A. W. Gregg, chairman of the special committee on appeals and review, to Mr. C. C. Griggs, chief of nonmetals section, which reads as follows:

Approved for audit, January 8, 1923, only on basis of committee ruling, but not in accordance with the views of this division. It sets a bad precedent. (Signed.) Fay.

You signed that, did you?
Mr. FAY. To the best of my recollection, I did.
Mr. DAVIS. And what was it with reference to this case that was not in accordance with the views of your division?
Mr. FAY. The ignoring of the royalty value of leases in the immediate vicinity, and, secondly, the establishment of a precedent whereby royalties in other minerals, coal, and other mineral property might also be ignored and set up undue values.
Mr. DAVIS. So that the Government, in other cases, might lose large sums of money.
Mr. FAY. It would.
Mr. DAVIS. Is this case an isolated case by itself with reference to the facts?
Mr. FAY. I can not see that it is.
Mr. DAVIS. Are the comparisons with other leases in this same vicinity very good comparisons and those that could be used under the regulations?
Mr. FAY. I should say that they were A No. 1.
Mr. DAVIS. Is it your opinion as the head of that division that like leases in that vicinity should be practically the controlling feature in getting at the valuation of this lease?
Mr. FAY. It was, in my opinion. It is in the regulations that a similar practice should govern. I can not cite those regulations now.
The CHAIRMAN. If I remember correctly, you answered the question of Mr. Davis as to whether this case was settled in line with other cases, in the affirmative; is that correct?
Mr. FAY. No; that was not the question he asked, Mr. Senator. He asked me if this did not contain sufficient information that it could have been settled in line with other cases. That was my understanding. Is that correct, Mr. Davis?

Mr. DAVIS. Yes.

Mr. HARTSON. I think Mr. Davis had this in mind: Was this case, on the facts, different from the average case where the committee had settled it on a unique basis. Is that right, Mr. Davis?

Mr. DAVIS. That is right.

The CHAIRMAN. I stand corrected.

Mr. DAVIS. The regulations provide as follows:

The commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as costs, actual sales, and transfers of similar property, etc.

Is that the regulation that you have reference to?

Mr. FAY. That is the regulation that I have reference to.

Mr. HARTSON. Mr. Davis, would you mind reading all of it?

Mr. DAVIS. I was just going to call his attention to a further provision of the regulations.

Mr. HARTSON. All right.

Mr. DAVIS. We find this further:

Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight: (1) If the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer, or to extrinsic causes other than the possession of the mineral itself. Where the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

Is that what you had in mind?

Mr. FAY. Yes; that is what I had in mind.

Mr. DAVIS. When you answered my question?

Mr. FAY. Yes.

Mr. DAVIS. With reference to the appraisal here?

Mr. FAY. I did.

Mr. DAVIS. Did you go over fully the taxpayer's claims with reference to the value of the lease?

Mr. FAY. I can not recall that I did. The matter was brought to me by Mr. Briggs, I believe, as assistant head of the section at the time.

Mr. DAVIS. Did you, however, have in mind the taxpayer's claims with reference to what he based value on?

Mr. FAY. I undoubtedly did.

Mr. DAVIS. Was there any reason for marking the ruling in this case to indicate that it should not be used as a precedent?

Mr. FAY. I think, the way it was rendered, it probably was wise to mark it.

Mr. DAVIS. Did you have any discussion with anyone concerning that?

Mr. FAY. I can not recall that I did.

Mr. DAVIS. You do say that that ruling would be a bad precedent, and is a bad precedent in the bureau?

Mr. FAY. I think so.

Mr. DAVIS. And, if followed out, it might work to the prejudice of the Government, in that the Government might lose vast sums of money?

Mr. FAY. It would.

The CHAIRMAN. I would like to ask you there, Mr. Fay, if you can tell us anything which would be a guiding factor in fixing the amount or profit per ton over years in the future when no one knew what the price or demand might be for the product?

Mr. FAY. In the brief that is submitted, and which has just been read by Mr. Hartson, this value of 20 cents per ton was set up from the memory of an ex-bookkeeper, as I understand it, and at the time the property was transferred to the new corporation, all the old records were destroyed. Now, why they were destroyed I do not know.

The CHAIRMAN. I do not think that is important. What I am trying to get at is if you know, as an engineer, of any way that the Government might be assured that the taxpayer could secure a profit of 20 cents per ton until the end of the lease.

Mr. FAY. I can not see that you could be sure of it at that time.

The CHAIRMAN. Well, could you be sure of it at any time?

Mr. FAY. No; you can not.

Mr. DAVIS. Particularly so at this time.

Mr. FAY. This was war time: it might have been more than 20 cents; it might have been much less.

The CHAIRMAN. Of course, if you accept that theory that you are going to take the taxpayer's estimated profit per ton for six, seven, or eight years in advance, and figure a valuation based on that, then you ought to apply that rule to all the coal mines and every other——

Mr. FAY. I am not accepting that.

The CHAIRMAN. Just wait until I get through with the question. Will you read the question as far as it has gone?

(The reporter read the question as above recorded.)

The CHAIRMAN (continuing). Mineral product where the tonnage would be used as the basis for fixing the valuation. As I understand it, you do not take that view?

Mr. FAY. I do not take that view, but that is the settlement that was made in this particular case.

The CHAIRMAN. Do you know of any other case where this view was taken?

Mr. FAY. I can not recall any other now, Senator.

The CHAIRMAN. Do you think this was an exceptional case?

Mr. FAY. It apparently was.

The CHAIRMAN. You do not now recall any other case that was settled on such a basis?

Mr. FAY. Not by name; no.

The CHAIRMAN. Well, do you have any recollection that such methods were pursued in other cases, even though you do not remember the particular names of the cases?

Mr. FAY. I think they have been pursued to a very slight extent in accordance with the regulations just read there, where retrospective appraisal may be used, in the absence of anything else, and it was not our custom to use the retrospective appraisal where there was anything else to tie to.

The CHAIRMAN. Can you recall any unusual circumstances which have not been developed in this hearing, which led to the conclusion in this case?

Mr. FAY. I can not.

The CHAIRMAN. Then, you think it went through in the ordinary process, and that the persuasiveness of the taxpayer was convincing in this case, and it therefore was settled in that manner?

Mr. FAY. It seems that the taxpayer had the last say.

The CHAIRMAN. That is all I wish to ask.

Mr. DAVIS. That is all.

The CHAIRMAN. Do you want to ask him any questions, Mr. Hartson?

Mr. HARTSON. I want to ask Mr. Fay about the regulations that were read to him by Mr. Davis.

Were those regulations in effect in April, 1916?

Mr. FAY. In 1916?

Mr. HARTSON. Yes.

Mr. FAY. They were not.

Mr. HARTSON. Are those regulations applicable to this situation; regulations promulgated pursuant to the revenue act which was in effect in 1916?

Mr. FAY. I do not know whether there is anything in that particular regulation that would prevent it from being retroactive. It is the only guidance that we had to work by.

Mr. HARTSON. Yes: I agree with you, Mr. Fay.

The situation, Mr. Chairman, you undoubtedly have very clearly before you now. Such a thing as retrospective appraisal is not actually prohibited by our regulations, and in a few isolated cases—and my recollection and understanding is much the same as Mr. Fay's—in the absence of anything else they have used it, and, as I say, we do capitalize earnings customarily in connection with the determining of value of an intangible, such as good will.

The CHAIRMAN. Why do you say in the absence of any other information?

Mr. HARTSON. I am not speaking of this case now.

The CHAIRMAN. Oh, I see.

Mr. HARTSON. I am not saying that this case presented no facts which warranted a valuation in some other way than by the use of this method, and I have been very careful not to do so; but I am merely summarizing the situation that is now before the committee. I think we can have no very great dispute about the regulations, and we can have no very great dispute about what has happened. The chairman of the special committee on appeals and review and the membership of that committee, from the record here, believed that there was no other evidence before it which would warrant them in determining value in the usual way; so they accepted the unusual way, in the absence of facts to warrant following the regulations, which provide for such a situation.

The CHAIRMAN. In reading one of the reports here reference was made to other leases, by name and location, as a guidance for determining this case. I would like to know whether there was any case before the bureau which involved this particular lease to which reference is made.

Mr. DAVIS. Could you answer that, Mr. Parker?

Mr. PARKER. I called for some of the files in those cases mentioned, to see if I could find out what depletion had been allowed these

outside companies. I will have to testify from memory. I found either no amount of depletion, or a very small amount of depletion, fixing a rather low value, if any, on such a list. In the case of the Franklin Mineral Co., as already stated, I found that they set up a definite value for this very property which I have already identified as twenty-four thousand and some odd dollars.

The CHAIRMAN. There were other cases mentioned, but I am not going to ask counsel to give them now. I am going to ask them to look up those cases which were referred to in one of the papers read this morning, and ascertain what their income tax statements show and whether there was any depletion or amortization allowed in those cases, and what the ruling of the department was in connection with those cases?

Mr. DAVIS. These leases were all in Sussex County, N. J.

The CHAIRMAN. I think that is correct, as I remember it.

Mr. DAVIS. Yes.

Mr. HARTSON. I would like to ask Mr. Fay another question. Mr. Fay, at that time you were chief of the natural resources division?

Mr. FAY. I was.

Mr. HARTSON. In that position, you came frequently in contact with the commissioner, did you not?

Mr. FAY. I did.

Mr. HARTSON. Did you call this contention in this case to his attention as in your judgment being a settlement out of line with the usual procedure?

Mr. FAY. I do not recall that I did.

Mr. HARTSON. That is all.

Mr. FAY. It came to me with the commissioner's signature on it.

Mr. DAVIS. And you thought when it came to you from your superior, that that was all there was to it, so far as you were concerned?

Mr. FAY. Yes.

The CHAIRMAN. Was it customary in a case of that kind to discuss it with the commissioner?

Mr. FAY. There had been cases where we would have it up with the commissioner.

The CHAIRMAN. This decision did not do violence to your conscience to such an extent that you felt justified in taking it up with the commissioner?

Mr. FAY. I do not know that I thought of taking it up with the commissioner at all. The committee's report came through approved, and I simply passed it on.

The CHAIRMAN. Then, your answer is that the decision did not do sufficient violence to your conscience to justify your taking it up with your superior officer?

Mr. FAY. I do not think it worried me very much.

Mr. DAVIS. I would think that that signed memorandum was protest enough, Mr. Chairman.

The CHAIRMAN. I doubt that. The signed memorandum does not necessarily go before the commissioner or his chief officers.

Is that all, Mr. Davis?

Mr. DAVIS. I have Mr. Briggs here.

TESTIMONY OF MR. JOHN H. BRIGGS, NONMETALS SECTION, BUREAU OF INTERNAL REVENUE

(The witness was duly sworn by the chairman.)

Mr. DAVIS. Mr. Briggs, your full name, please.

Mr. BRIGGS. John H. Briggs.

Mr. DAVIS. You are employed by the Bureau of Internal Revenue?

Mr. BRIGGS. I am.

Mr. DAVIS. In what capacity?

Mr. BRIGGS. Enginner.

Mr. DAVIS. In what section?

Mr. BRIGGS. Nonmetals.

Mr. DAVIS. How long have you been so employed?

Mr. BRIGGS. A little over three years.

Mr. DAVIS. While you were there acting in that capacity or in any other capacity, did the New Jersey Calcite Co.'s case come to your attention?

Mr. BRIGGS. It did.

Mr. DAVIS. In what respect?

Mr. BRIGGS. It came to me for valuation.

Mr. DAVIS. And did you review the case?

Mr. BRIGGS. I did.

Mr. DAVIS. Did you make a finding concerning valuation?

Mr. BRIGGS. I did.

Mr. DAVIS. Just give us your ideas with respect to this valuation,

Mr. BRIGGS. I made the valuation which has been read here, allowing the taxpayer between $8,000 and $9,000, based on the comparison with the leases in the same county.

The CHAIRMAN. At this point, I would like to ask the witness if he does not practically confirm what has already been testified to?

Mr. BRIGGS. I do, and I might add just a little bit more to it, and explain a point which you have tried to bring out.

The CHAIRMAN. Well, if you explain that, I think it will be sufficient.

Mr. BRIGGS. You have been trying to find out why Mr. Fay did not complain to the commissioner. The protest was made to the Committee on Appeals and Review on their finding, and as a result of that protest this memorandum is in there, which says this should not be taken as a precedent, and they refused to take it up.

The CHAIRMAN. I understand that.

Mr. BRIGGS. Yes.

The CHAIRMAN. That does not answer my question particularly. I asked you why, if it did violence to the conscience of the men who disagreed, they did not take it up with the commissioner who signed the final findings. I do not disagree with the evidence, mind you, if objection was made on the record, but I raised the point as to whether or not you were satisfied with it as a sufficient protest, or whether you were not sufficiently outraged to take the question up direct with the commissioner.

Mr. BRIGGS. Well, it is a question of just how far we go when we make our protest. We generally make our protest to the man over us, Senator.

Mr. DAVIS. Did you do that in this case?

Mr. BRIGGS. I think Mr. Griggs, in my absence, took the matter up with the Board of Appeals and Review.

The CHAIRMAN. I think that is all.

Mr. DAVIS. Just one further question. Does this set a bad example in the bureau with reference to the handling of depletion matters?

Mr. BRIGGS. I think so. As a matter of fact, our ordinary method of determining depletion is that if we have the sale or purchase of similar properties in the same neighborhood, we use that as a comparison.

The CHAIRMAN. I think that is a matter that can be made a subject of proof, as to whether it was a bad example or not. That can be done by finding out whether the bureau has followed it in other cases.

Mr. DAVIS. That is all.

Mr. HARTSON. If it is a bad example, Mr. Briggs, it has not been followed in subsequent cases, has it?

Mr. BRIGGS. Very rarely, but that has been used. It has been used in different cases, where they did not have anything else before them at all.

Mr. HARTSON. That was my understanding.

Mr. DAVIS. Was that decision ever published?

Mr. BRIGGS. This one here?

Mr. DAVIS. Yes.

Mr. BRIGGS. I could not say.

Mr. HARTSON. Oh, I think not. If there is any dispute about that——

Mr. BRIGGS. No; I do not think so.

Mr. HARTSON. I do not believe it was.

Mr. BRIGGS. But I will say this: As a result of this protest, in the next case that came up, the Board of Appeals and Review said that they would have an engineer present at the hearing, and I was called down shortly afterwards on a hearing where practically the same line of valuation was brought out and contested before the Board of Appeals and Review, and it has come up the second time before the commissioner.

The CHAIRMAN. You might give us the name of that case.

Mr. BRIGGS. It was the Texas clay cases. There were ten of them.

The CHAIRMAN. Ten of the Texas clay cases?

Mr. BRIGGS. Yes, sir.

Mr. HARTSON. Was the precedent established in this case followed in the settlement of those?

Mr. BRIGGS. No.

Mr. HARTSON. It was not?

Mr. BRIGGS. No.

The CHAIRMAN. Have those cases been finally disposed of?

Mr. BRIGGS. They have.

The CHAIRMAN. The solicitor then ruled in accordance with the views expressed in this New Jersey case?

Mr. BRIGGS. No; they followed——

The CHAIRMAN. Although not following the conclusion reached in the New Jersey case?

Mr. BRIGGS. No; they followed the valuation based on cost of similar properties.

The CHAIRMAN. In other words, along the same line you recommended in the case under discussion?

Mr. BRIGGS. Yes.

Mr. HARTSON. The solicitor had nothing to do with either one.

Mr. BRIGGS. No.

Mr. HARTSON. Was the committee on appeals and review a separate entity at that time?

Mr. BRIGGS. A memorandum was prepared for Mr. Greenidge's signature, to the commissioner, and he finally said that that was settled, so far as he was concerned.

The CHAIRMAN. I would like to ask, in view of the elaborate discussion of this subject, whether the solicitor does not think that this is an unusual decision, in view of the fact that later cases have not been settled along this line, involving the same class of testimony before the special committee on appeals and review?

Mr. HARTSON. I consider it a case, Mr. Chairman, that is not in exact conformity to what the bureau had done and has since done in similar cases. I think the regulations do not prohibit such a valuation as was made here, in the sense that they do not make it specifically unlawful or in violation of the regulations to determine a value by this retrospective appraisal method, or any theoretical computation showing the value; but if there is better evidence, the regulations say that such a method should not be used.

The CHAIRMAN. Was there not better evidence in this case?

Mr. HARTSON. Well, the evidence seems to be pretty strong here on which a value could be based, by reference to transactions in that community of a similar nature, and if the evidence is strong, it would be my opinion that adjustment ought to have been made on that basis.

The CHAIRMAN. Then you will agree, I think, in view of your answer, to the wisdom of the counsel for the committee in having drawn attention to that particular case.

Mr. HARTSON. I have absolutely no criticism of counsel for the committee in drawing attention to this case, Mr. Chairman, nor to any other case.

The CHAIRMAN. Well, I do not mean to ask you to confirm what counsel has said, but I do mean to say that this case was so unusual that it was perfectly good judgment to have drawn the committee's attention to it?

Mr. HARTSON. I do not know what the circumstances are, but it is quite possible that the individuals who composed this committee, Mr. Chairman, may have had some reasons in their own minds which were sufficient to them, and which, upon presentation to this committee, might be satisfactory to the committee. One of the members of that committee is now chairman of the board of tax appeals, Mr. Hamhill; another member is out engaged in the practice of law in Chicago, and a third member of this special committee on appeals and review has been the tax adviser to the secretary, and is a very able man.

The CHAIRMAN. Would you think it would be wise or desirable to have Mr. Gregg come before us here?

Mr. HARTSON. Mr. Gregg is not in the city at the present time, but it might be enlightening to have him discuss it. On the other hand,

I would want to defer the judgment of the committee on that. I do not know; I have not discussed it with him, and I will not be able to do so, as it will probably be several weeks before he returns. He is on a special mission at the present time to England to study the English tax system for the Secretary, as the public press has already announced.

The CHAIRMAN. Have you anything further on this case?

Mr. DAVIS. Not anything more this morning.

The CHAIRMAN. What are the probabilities for to-morrow?

Mr. DAVIS. Mr. Hartson said something about submitting some data with reference to the Berwind-White case. I will have Mr. Parker take up with Mr. Thomas some of the tag ends with reference to the matters that I spoke of when we convened this morning. It is doubtful whether we will have another specific case ready for to-morrow.

The CHAIRMAN. When will you have your answer to the query that I made yesterday, Mr. Hartson?

Mr. HARTSON. Mr. Chairman, we have designated two individuals, who have worked on that case, and who have followed it through for the last year or so, to write out roughly the answers to the questions which have been raised by counsel for the committee in the United States Steel case. It may take several days to put that in proper form. It is difficult to estimate the time until we see it in rough draft form, because, as I indicated the other day, after these individuals prepare what to them seems a sufficient answer, those who are going to have to speak for the bureau may want to discuss it and consider it at greater length; so it is almost impossible to say right now when we can have that ready. I asked for not less than three days on yesterday.

The CHAIRMAN. Yes.

Mr. HARTSON. I did not put a maximum limit on it. I think we ought to have it in a week or possibly less.

The CHAIRMAN. I think we had better adjourn subject to the call of the Chair. There is no use of bringing the committee together for this Berwind-White matter and those other tag ends to-morrow.

Mr. HARTSON. I wish to make the definite statement that when we do convene again we will have this Berwind-White information in shape so that it can go into the record in advance of taking up any other business.

Mr. DAVIS. May I ask how long that will take, Mr. Hartson?

Mr. HARTSON. Not very long. I think maybe ten or fifteen minutes discussion of it will be all that will be necessary.

The CHAIRMAN. We would also like to know if, at the same time, you can clean up the income tax matters of the three individuals who purchased the Northwest Steel Co.

Mr. HARTSON. We have this information from our own people, and the information for the committee is being developed by Mr. Thomas. Our people have gone through the returns of those individuals, and from the returns and the associated papers with the returns it is impossible to say definitely that there was or was not included in the income of these individuals this unpaid but credited bonus arising out of the transaction of the sale to the partnership in the Northwest Steel Co. case.

Mr. DAVIS. Yes. Having gone into the matter very fully Mr. Thomas reports something of the same nature to me, that it is very difficult to get at that, but he is trying to run it down for us and get it in shape, if he can.

Mr. HARTSON. Our auditor tells us that the only way that it can be obtained, in his opinion, is by an examination of the books of the taxpayer. The chairman will remember that on the returns there are gross amounts entered, under income, of salaries and bonuses, wages, and things of that sort. As an element in their returns, although unsegregated, it is possible that this unpaid but credited bonus from the Northwest Steel Co. to these individuals appears.

The CHAIRMAN. It seems to me that these items are so large, running up into $75,000 to $100,000 or more that——

Mr. HARTSON. It is quite possible that these individual returns of income are quite large during those years. I do not know, but I think it is quite possible that by figuring out the amounts, you can say whether the amounts returned as a gross amount were less than the total amount that was received in bonus, and therefore it could not be there?

The CHAIRMAN. That is what I meant to infer, because the question was raised by the engineers and the auditors and others as to where these men got such large amounts of money, to pay for this property, and if they heretofore had had such large incomes that you could not notice an item of $75,000 or $100,000, then the question as to where they got the money from was not well raised.

Mr. HARTSON. We may be able to develop something further in that connection, without any additional search in the field.

The CHAIRMAN. At any event, I think the department ought to assure this committee that the Government got the income tax from this bonus in some way. If it has not, the Government has been defrauded, and I think the taxpayer has made a fraudulent return, if he did not include it.

We will adjourn here, subject to call.

(Whereupon, at 12.15 o'clock p. m., the committee adjourned, subject to the call of the chairman.)

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INVESTIGATION OF BUREAU OF INTERNAL REVENUE

TUESDAY, DECEMBER 30, 1924

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: Senators Couzens (presiding), Watson, Jones of New Mexico, and Ernst. Present also: Earl J. Davis, Esq., and L. C. Manson Esq., of counsel for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Nelson T. Hartson, Solicitor, Bureau of Internal Revenue; and S. M. Greenidge, head, Engineering Division, Bureau of Internal Revenue.

The CHAIRMAN. What else do you have for this morning, Mr. Manson?

Mr. MANSON. Those are the two things that we wanted to clean up. I believe the bureau has some matters that they want to clean up.

Mr. HARTSON. Mr. Chairman, Mr. Nash has that statement of costs which the chairman asked for.

The CHAIRMAN. What is that?

Mr. HARTSON. I say, Mr. Nash has that statement of costs that the chairman asked him to submit here.

The CHAIRMAN. All right.

Mr. NASH. Mr. Chairman, at the hearing of December 20, you called attention to a statement appearing in the press, in which I was quoted as having given information to the appropriations committee of the House to the effect that the expense incurred by the Internal Revenue Bureau as a result of the investigations of the Special Senate committee totaled approximately $100,000, and that approximately 200 employes had been assigned to such work. You then asked for information as to where these employes were assigned. You will probably recall that in the hearing of September 15, the committee passed a resolution asking for quite an exhaustive analysis of individual returns showing over $100,000 income, from 1916 up through 1923, and also for corporation returns showing income in excess of $50,000 for 1923. The resolution is incorporated in this statement. I do not think it necessary to read it, but we have 136 employed that worked on the individual returns.

Mr. MANSON. For how long?

Mr. NASH. Commencing as soon as we could after September 15. The cost of that has been $32,029.91.

An analysis of all corporation returns reporting a net income amounting to $50,000 or more, with much detailed information, has been requested. In this connection, we have had a total of 171 employes working on that, and it has cost us $11,734.74. That work is as yet incomplete.

Senator WATSON. When you say it has cost you, Mr. Nash, just what do you mean by that?

Mr. NASH. That is the equivalent of salaries paid employees assigned to this work.

Senator WATSON. You say you figure their salaries?

Mr. NASH. On an annual basis.

Senator WATSON. Because they were diverted from their regular work to this special work?

Mr. NASH. Yes, sir.

Senator WATSON. And they worked on this work during this time?

Mr. NASH. Yes, sir. We have a cost sheet on these jobs showing the number of clerks, hours employed, and the annual salary rates.

The inventory of amortization cases, and furnishing data on the question of amortization took the entire time for one day of all employees on the consolidated returns division, corporation returns division, and engineering division. There were 1,922 employees involved, and cost us $5,382.55.

I put in this item for the purpose of indicating to the committee what it sometimes costs to get an answer to an apparently simple question. This is a question that was asked about two weeks ago—information was requested as to the number of amortization cases that we have handled, the amounts involved, etc. We had to take all of our auditors and clerks in three divisions and put them on the files to get that information, and it took a little over a day to get it out. The salary cost on this job alone was in excess of $5,000.

The CHAIRMAN. Has that been turned into the committee yet?

Mr. NASH. It is prepared, and is ready to be turned in this morning, Senator.

The statement showing the status of claims pending as of March 1, 1924, for refund, credit and abatement, for years 1917 and 1918. $60,836. That is a statement which was prepared and submitted to the committee last spring.

The engineering division has a total cost of $31,288.15. That includes costs for the hearings of last spring, as well as from September 15 up to the time I was before the Appropriations Committee sometime in December. The photostatic work—that is, just the materials—has cost us $1,949.75. That makes a total of $143 161.10.

The above figures represent the cost to the Internal Revenue Bureau of the investigation being conducted by the special committee of the Senate, only in so far as actual cost records have been kept. No estimate is here given of any work performed in the solicitor's office, the accounts and collections unit, the miscellaneous tax unit, or the immediate office of the commissioner, nor can complete figures be given for the income-tax unit.

It is difficult to give any accurate statement as to the number of employees and clerks assigned to work called for by the committee,

there being employees assigned to the analysis of cases now pending before the committee, etc. The great bulk of the employees, however, are assigned as follows:

In the Statistical Division, 100 employees engaged in an analysis of individual and corporation returns, as called for in the resolution of the committee.

In the Personal Audit Division, there are 54 auditors on this same work.

In the Service Division there are 9 clerks, who are drawing these returns from the files.

In the Engineering Division there are 20 engineers on all phases of the work.

In the Consolidated Division there are 10 employees on the analysis of returns.

In the Records Division there are 17 employees, making a total of 210 employees, who are engaged practically all the time on this work, besides those who are on it from time to time incidentally.

Mr. MANSON. How many did you state are employed in getting out the statistical information?

Mr. NASH. There are 154.

The CHAIRMAN. Those are regular employees in the bureau who have just been diverted from their regular work to this work?

Mr. NASH. Yes sir. We did have some temporary typists on for a while this fall whom we used on this work, but we have had to let them go, because we were overdrawn on our appropriation, and we could not afford to carry them.

The CHAIRMAN. This means, then, not so much additional expenditure by the bureau as it does actual delay in the performance of some of its ordinary functions; is that correct?

Mr. NASH. I think that is true.

I want to make this explanation: In appearing before the Appropriations Committee, it was necessary for me to show the status of the work in the bureau, how we are spending our money, why we need more money, and what we are doing. This was mentioned as an incident in the work of the bureau, along with a great many other things. This cost that I spoke of here is indicated as one of the elements of the total cost in the operation of the bureau.

The CHAIRMAN. Would you say, after making that analysis, that the work of this committee is justified?

Mr. NASH. I do not believe that I can honestly say that I think it is at all justified, Senator?

The CHAIRMAN. At all or all?

Mr. NASH. I mean that not all of the work is justified.

The CHAIRMAN. Would you say that any of it is justified?

Mr. NASH. Well, I would not say that none of it is justified either. I think a part of it is going to be very beneficial to us.

The CHAIRMAN. And part of it is not.

Mr. NASH. May not.

The CHAIRMAN. But you have not reached a definite conclusion yet?

Mr. NASH. No sir.

The CHAIRMAN. Do you want to say anything further, Mr. Manson?

Mr. MANSON. I do. In the first place, I want to make an analysis of this statement, but it is not necessary for me to go very deeply into it. However, I do want to call a few facts to the attention of the committee.

The returns on individual income taxes are taken directly; that is, the transcript we make, is taken directly from the face of the return.

The CHAIRMAN. Is it recopied, or is it just a photostat?

Mr. MANSON. In the case of individuals, it is copied from the face of the return. I do not know what work is involved in finding the returns, but I have been compelled to verify every transcript I have received, back to the original returns, because of errors that have been found in so many of them, and the work of verification involves as much work as the work of originally copying them from the returns. All of that work has been done by two men, who, in addition to doing that, have made a complete analysis of the profits as a source of income and loss deduction, and even analyzing that down to the character of the stock, as to whether it was railroad stock or industrial stock. They have carried that work on in addition to doing as much work as was involved in making those transcripts in the first place, and I have had all of that done by two men, and we have received up to date something less than 200 individual returns.

As to the corporations, there is no clerical work involved at all. The return itself is photostated. There have probably been half a dozen cases where the return, as we have received it, did not contain all the information desired, and we have called for additional information.

There have been some 4,000 returns, and I have had all of them put through four different classifications, and in every one of those classifications calculations were involved. I have had every bit of information taken off from those returns and tabulated. I have had them put through at least four distinct recapitulations. I have done that entire job with a maximum of 17 people, working on an average of 46 days.

To save my soul, I can not see where 154 people can be involved in digging out those returns, if we can take those returns, examine them, and put them through all of those classifications, some of which require computations, tabulate every bit of information on them, and recapitulate them with 17 people working 46 days!

As to 20 engineers being employed, our engineers are required to take the returns that their engineers dig up for us. They advise with our engineers, they answer questions; but we have had a maximum of five engineers employed, who have made an exhaustive examination, as is manifest from the work that we have presented here. With 20 men, possibly, having been employed to assist us, and with four men who have made this careful examination and this exhaustive examination, I can not see it.

Mr. NASH. Mr. Chairman, this statement is prepared from records that have been kept in the income tax division. I understand that the 54 auditors who are mentioned here and auditors that have been taken from the personal audit division, and are used to dig out these elements of the personal returns that go on to the schedules

which Mr. Manson has mentioned. We did try to use clerks on that work when it was first started, but we found, as Mr. Manson has stated, that errors were being made, and it was not satisfactory. That is why we put on auditors, who are people of a higher class and who are more familiar with the elements of the returns.

I presume that Mr. Bright can show where these people are working, and if the committee wants to check up on it I will be glad to have it done.

The CHAIRMAN. You have the criticisms of Mr. Manson, and you might go back and discuss them with Mr. Bright, to see how he justifies so many employees, and then, if you have anything further that you wish to say to the committee the committee will be very glad to hear you, I am sure.

Mr. MANSON. There may be a lot of this data that has been prepared—I do not want to be unjust here—there may be a lot of this data that has been prepared that has not yet been submitted to us, in the case of the individual returns. When I come to think of it, I believe that is true.

Mr. NASH. I believe that is true. As the committee knows, our files are scattered all over town. We have the 1917 and 1918 returns in one building, the 1919 returns in another building, and so on. The taxpayer, for instance, might have a big income for 1918 and 1919, and may be in 1920 he would have a poor year and would make his return on a 1040–A form, out in San Francisco, or Tacoma, or somewhere, and we have to send for that to complete the schedule.

There are hundreds of these sheets that are complete with the exception of one or two returns, and we are trying to find the missing returns. As I recall it, I was told the other day, that there are 3,000 cases which are pretty well worked out, but which are not quite complete as yet.

Mr. MANSON. I do want to say this at this time—and I think this affords a good opportunity—I believe the filing system of the Income Tax Bureau, taken from top to bottom, in all of its features, is almost as good as no filing system at all. I do not hold the administration of the bureau responsible for it in any way. I think it is entirely due to lack of room, and I believe that if the bureau were equipped, or if it were provided the room in which it could maintain a modern up-to-date filing system, so that it could file, in the case of individuals with high incomes, as it now does in the cases of corporations, data that is accumulating from time to time, all in one file, it would save at least 10 to 15 per cent of the total expense of administering the income tax, if not more than that. The difference between the amount of space necessary for maintaining a proper filing system and the kind of one they have, is this, that they must of necessity have accessible at the place where they are working the current returns. That means that the old returns are filed everywhere and anywhere, and it is impossible to maintain a proper filing system. I believe that 85 per cent of the expense, even if it was all justified, is due to trying to find things.

Mr. NASH. That is true. These special employees from the statistical division are searching the files for these individual returns.

Mr. MANSON. I want to say also, in connection with that statement of the expense, that I believe, for instance, in the engineering division, if this were in a private institution, some statistics of their

work would be kept and it would not be necessary, whenever Congress calls upon them for answers to very simple questions, and questions that are very pertinent, such as have been put by the members of this committee from time to time, to go and search through stacks of papers, some of which would be 8 or 10 inches high, and some of which would fill a good-sized trunk.

Senator WATSON. There is no way of changing that until they get new facilities. They have to have new buildings. This whole business is scattered all over town.

Mr. MANSON. Yes, sir; and that accounts, in very large part, in my opinion, for the confusion, the lack of housing, the lack of proper office facilities, and I believe the expense of administering the Income Tax Bureau, if it were properly housed, would be cut down 25 per cent. I do not think I am at all rash in making that statement.

The CHAIRMAN. Then we ought to help Senator Smoot to get his appropriation bill through.

Senator WATSON. Yes; I think so.

Mr. MANSON. I have delayed making this statement, waiting for an opportunity when it would be pertinent, and that opportunity never presented itself before.

The CHAIRMAN. Is that all on that matter?

Mr. NASH. That is all, Senator.

(The statement submitted by Mr. Nash is as follows:)

Character of work	Number of employees	Cost to date based on total number of hours assigned	Condition of work
SEC. 1. The personal income tax returns with reference to which the Secretary of the Treasury is called upon to furnish information to said committee are as follows: (*a*) The returns showing personal net income exceeding $300,000 for 1916. (*b*) The returns, for the year 1920, of the individuals who reported personal net income exceeding $300,000 for 1916. (*c*) The returns showing personal net income between $150,000 and $300,000 for 1916. (*d*) The returns, for the year 1920, of the individuals who reported personal net incomes between $150,000 and $300,000 in 1916. (*e*) The returns showing personal net incomes between $100,000 and $150,000 in 1916. (*f*) The returns, for the year 1920, of the individuals who reported personal net income between $100,000 and $150,000 for 1916. (*g*) The returns for the years 1917, 1918, 1919, 1921, 1922, and 1923, of the individuals who reported personal net income exceeding $100,000 in 1916. (*h*) The returns of individuals who did not report personal net incomes exceeding $100,000 in 1916, but who have reported personal net incomes exceeding $100,000 in any subsequent year, for the first year, subsequent to 1916, in which such individuals reported net personal incomes exceeding $100,000. (*i*) The returns of the individuals mentioned in the next preceding paragraph for each year subsequent to the first year (after 1916) in which they reported personal net incomes exceeding $100,000.			
(NOTE.—The bureau was called upon to analyze the above data in considerable detail).	136	$32,029.91	Incomplete.
SEC. 4. An analysis of all corporations reporting net income amounting to $50,000 or more. Much detailed information has been requested in this connection.	171	11,734.74	Incomplete.
Inventory of amortization cases and furnishing data on question of amortization. (Entire time for one day of all employees of consolidated returns division, corporation returns division, and engineering division devoted to this task).	1,292	5,382.55	Completed.

Character of work	Number of employees	Cost to date based on total number of hours assigned	Condition of work
Statement showing status of claims pending as of Mar. 1, 1924, for refund, credit, and abatement for years 1917 and 1918.		$60,836.90	Completed.
Engineering division		31,228.15	
Photostats		1,949.75	Completed.
Total		143,161.10	

NOTE.—The above figures represent the cost to the Internal Revenue Bureau of the investigation being conducted by the special committee only in so far as actual cost records have been kept. No estimate is here given of any work performed in the solicitor's office, accounts and collections unit, the miscellaneous tax unit, or the immediate office of the commissioner, nor can complete figures be given for the Income Tax Unit.

It is difficult to give any accurate statement as to the number of employees at present assigned to work called for by the committee, there being employees assigned to the analysis of cases now pending before the committee, etc. The great bulk of the employees, however, are assigned as follows:

	Number of employees	Character of work
Statistical division	100	Analysis of individual and corporation returns, as called for in resolution of committee.
Personal audit	54	Do.
Service division	9	Do.
Engineering division	20	All phases.
Consolidated	10	Analysis of returns.
Records division	17	All phases.
Total	210	

Mr. HARTSON. I have a matter, Mr. Chairman, in connection with the New Jersey Calite Co. case. That was a case where counsel for the committee questioned an allowance for depletion which had been made to this company.

The CHAIRMAN. And also discovery, was it not?

Mr. HARTSON. And discovery, yes. It developed in the evidence that was presented to the committee that in the engineering division of the Income Tax Unit there was a decision, or an opinion which was contrary to the taxpayer's views as to the allowance that it should have, and the case was appealed from the Income Tax Unit to the committee on appeals and reviews in the bureau, and after appeal to that body it was referred to a special committee of appeals and review, of which Mr. A. W. Gregg was then chairman. Mr. Gregg's name was mentioned at the time this case was discussed before the committee, and the chairman of the committee, at that time, if I remember correctly, asked me if I thought it wise to ask Mr. Gregg to appear before the committee. I replied that Mr. Gregg at that time was out of the city. Mr. Gregg has now returned to the city, and is here, and I believe he ought to be given an opportunity, if the request is not specifically made, to explain the decision which was reached in that case, and also to state the manner in which the case reached his committee, and what gave rise to the special committee on appeals and review which was then in existence.

Mr. MANSON. Mr. Chairman, that case was presented by Mr. Davis, and I think, if Mr. Gregg is to go into it, we ought to send for Mr. Davis.

The CHAIRMAN. I would like to ask Mr. Gregg if he has the circumstances of this case in mind?

Mr. GREGG. Only vaguely. I just want to give you a brief statement of the case, and I do not want to argue the merits of it at all. I have not had an opportunity to go into it fully enough. I can give you the reasons that I think justify the conclusion reached in the case, and I would like to do so, if that is agreeable to the committee, at this time, because I am very short of time.

The CHAIRMAN. You may proceed, then.

Mr. GREGG. I would like to give you the background of the decision in that case.

In December of 1922 we started looking at the conditions in the bureau, and found that the committee on appeals and review was away behind in its work and had been getting more so all the time. That committee started as a body of three men. At this time in 1920, it was composed of 12 men and it was still falling behind all the time.

The statute gives the taxpayer a right to appeal to the commissioner prior to the assessment of a deficiency. He had that as a matter of right. In all these cases therefore, a decision had to be made prior to the running of the statute.

In December, when we took stock of the conditions in the committee, we found that they were about 600 cases behind.

The CHAIRMAN. That was December of 1922?

Mr. GREGG. December, 1922. The 1917 cases which had to be decided were to be sent back to the Unit, in accordance with the decision, and assessment had to be made prior to March 1; so that we were in rather serious circumstances as the result.

To dispose of just these accumulated cases, a special committee was created, just a temporary affair, to take over these 600 cases. As soon as we disposed of them, that committee dissolved. I was made chairman of the committee, and I was really given my pick of the bureau for the other men. I picked those that I considered the most able men in the bureau. I had Mr. B. M. Price, who handled the case in question, and Mr. Hamel, who is now chairman of the Board of Tax Appeals, created by the 1924 Act, and two other gentlemen. The cases were all disposed of about the first of February, which gave the unit just about a month to make the audit in accordance with our decision, and dispose of the cases.

With reference to the case in question Mr. Price handled the case originally, and the question involved was the valuation of a clay deposit. The taxpayer claimed a valuation of about $130,000, representing the par value of the stock issued for the property. The unit allowed him about $9,000, as I remember it.

He appealed to us, and Mr. Price, who handled the case singly—we could not sit in groups—wrote a decision, allowing a valuation of $106,000, which was based on the following facts:

The taxpayer could show his earnings for the years prior to incorporation. He had incorporated, let me say, in 1916, and it was a question of valuing the property as of that date. He could show his earnings from the operation of the property for years prior to incorporation. Of course, the contents of the deposit were known, and the costs of production and transportation were known, because he had been operating the property.

On the basis of those known facts, we set a value of $106,000, based on a capitalization of the future earnings of the property, derived from the knowledge gained from past experience prior to incorporation.

The CHAIRMAN. What return did you show on the capitalization?

Mr. GREGG. We discounted back. I think we probably followed your regular formula on that, Mr. Greenidge. What is your recollection of that?

Mr. GREENIDGE. Eight per cent and 4 per cent, as I remember it.

Mr. GREGG. Yes; I think it was 8 and 4 per cent. I think that is probably a fair rate. There was nothing problematical about the contents of the deposit, so the valuation was based on known facts.

The unit then protested against our decision, and it came up to me. They said it would necessitate reversing their rulings and overruling prior decisions. They wanted to base the valuation on the following factors:

Three leases which were made in adjoining territory. Of those three leases, one was made in 1918, and one in 1920. I think we can let those two out immediately We were valuing as of 1916, and something that happened either in 1918 or 1920 as to similar property was certainly not admissible evidence, legally. The 1916 lease, Mr. Price contended to me, was not comparable to the one in question, for several reasons: first, the transportation cost was different; second, the costs of production of this property that we were valuing were exceptional, in that it was located on a hill and accessible for surface quarrying, and he said that, in his opinion, that other lease was not admissible evidence.

We left out all but the two single factors—capitalization of earnings and the par value of the stock issued for it. The par value was not entitled to a great deal of weight, but it certainly is legal evidence. On the basis of those facts, I discussed the case with Mr. Hamel and with Mr. Price, and wrote a memorandum to Mr. Briggs, the head of the section, telling him that we adhered to the decision previously given, and I stated in it that the decision was based on those facts and the peculiar conditions of the case, and I did not think it necessitated the reopening of any other cases in the bureau; that on that basis I thought it should remain settled as it was.

I would like to say this one other thing to the committee in connection with that case. We decided about 500 cases and I think if the committee went into the 500 cases they would probably find some of them—not a great many, but a few—where they would disagree with our conclusions. I think that if Mr. Hartson went into them or Captain Rogers went into them, they would find cases in which they would disagree with us. There were cases, a few, unquestionably, where we disagreed among ourselves. But the fact was that we had to decide the case. We could not say it was a difficult question and that we did not know what the answer was. We had to decide it one way or the other. Unquestionably, we made errors in the decision of some of the cases, but we did decide them, and we decided them before the statute ran. That was the matter of primary importance, and it was done.

The CHAIRMAN. Did it not seem to demonstrate in this case that the conclusion arrived at did an injustice as between taxpayers?

Mr. GREGG. No, sir; I do not think so. If any other taxpayers were under the same conditions as ths particular taxpayer was, he was certainly entitled to and there was no reason in the world why he should not receive exactly the same treatment. It was a matter of proof. Senator, why should we decide that case on evidence which, if we got into court, we could not even get admitted?

Mr. MANSON. Right on that point, I do not know anything about the facts in this case, as I stated before, but I submit to the lawyers who are members of this committee that—in the first place, this was not a clay deposit; it was limestone—a transfer of a quarry within two years, in the same neighborhood, is the best evidence possible. The price received on a transfer within two years in the same neighborhood is the best evidence of market value, provided it can not be shown that something has occurred in the meantime which has changed the market values in that locality.

I have tried several cases in my own experience in which evidence has been admitted, and has been sustained by appellate courts, where transfers within a period of as long as six years had been made, and that evidence has been accepted. That would not be true of city real estate where a city is growing. It would not be true of farm property where it can be shown that values have changed; but even in the case of farm property, in the absence of a showing that values have changed, evidence of transfers within the two-year period is always accepted. In the case, for instance, of natural deposits, it certainly is accepted.

Mr. GREGG. I do not remember, Mr. Chairman, whether it was limestone or clay deposit, but that is not material. As I say, it all comes back to the question of judgment. I do not think the leasse made subsequently without a showing, and there was none, that the values were the same, without a showing that properties similarly situated——

Senator JONES of New Mexico. Mr. Gregg, the question that is troubling me is the question of arriving at these things. There seems to be a general method in the bureau. I can not reconcile myself to the proposition that what is made out of the finished product ought to have any kind of material bearing as to the value of the mine or the deposit itself.

Mr. GREGG. Well, Senator, if I may answer that, I think that is a much more important question than this particular case.

Senator JONES of New Mexico. Yes.

Mr. GREGG. You can not have offers and sales around the date in every case, and you have to consider other factors, and you are determining the market value by the statute. In determining market value, is not the best way to look at the factors which a purchaser would consider in determining the purchase price that he was willing to pay for the property, which are the same factors which a seller would look at in determining the amount for which he would sell? Are not both of them primarily interested in arriving at such an amount?

Senator JONES of New Mexico. That has been argued here time and again, but is not that real value there given through the development of the process of manufacturing the article and putting it on the market? Is not that where the value is? Here is your natural

product in the ground, and we may say that it has no value unless you can use it. Now, some one patents a process or discovers a process for handling it and making something out of it. Are you going to attribute all of those discoveries to the value of the ore in the ground?

Mr. GREGG. Does not that tend directly to the value of the ore?

Senator JONES of New Mexico. It seems to me not. Take a man that discovers a process of reducing zinc ores, and that has been a very difficult job in the metallurgical world. We will say that man discoveres a means for reducing zinc ore. Are you at once going to give the value of the finished product, in large measure, or in greatest measure, to the ore in the ground, or to the discovery of the process whereby the ore can be used?

Mr. GREGG. May I answer that in this way, Senator: You will concede, I think, as a starting point, the definition of market value; the statute prescribes market value.

Senator JONES of New Mexico. Yes.

Mr. GREGG. And if we will agree on the definition of market value as the price at which a willing buyer will buy and a willing seller will sell, neither under any compulsion——

Senator JONES of New Mexico. Yes.

Mr. GREGG. Suppose then you owned a zinc deposit, its value before this new process would have been comparatively small. As a matter of fact, it might not have paid to work it at all. After this process has been developed, does not the market value of that property increase materially? In other words, can you not go out and sell it for a great deal more than you could have sold it for before the process was developed? Does not that show that this process, by increasing the amount of money that can be made from the operation of the property, is in itself the primary factor in determining the market value of the property?

Mr. MANSON. Does not that depend on the amount of such natural resources as are otherwise available? In other words, if I have a process that can be applied to zinc ore, wherever it may be found, the fact that my process has reduced the cost of production ce.tainly does not increase the value of a particular mine I happen to own, as distinguished from, perhaps, hundreds of other mines, the product of which can be reduced through that process.

Mr. GREGG. May I ask you a question there? Suppose you had a mine from which you knew from past experience that you could make a hundred thousand dollars a year profit, through operation by paid employees, and that it would last for the next five years. Assume that those factors could be determined accurately. Suppose a new invention is made that reduces the cost of operation of that mine to such an extent that you can make $200,000 a year for the next five years under that process, taking into consideration the additional cost, if any. Now, would you, the day after you get that information, sell that property for the same price as you would have the day before you received the information?

Mr. MANSON. Why, certainly, for this reason, that what you are arriving at is the utility value of the property to you, and not the market value of it, and not the value which somebody else would pay

for it. In other words, you assume here that a man is going to pay all of the profit that he will expect to make——

Mr. GREGG. Oh, no.

Mr. MANSON. And certainly if a man is going to pay the profit that he expects to make, there is no inducement to buy.

The CHAIRMAN. Just a minute. I think, in answer to Mr. Gregg's question, I certainly would sell the property if I could go out and buy another piece of property that belonged to somebody who did not have the process and who, in all probability, would sell it to me willingly at a less price than what I had sold the other one for.

Mr. GREGG. That is perfectly true, Senator; but suppose this process has been known for years, that everybody is using it, and that it has jumped the value of the other man's property just as much as yours.

The CHAIRMAN. Not at all, because in that one instance, a farmer or a laborer may own the mine, a man with no ability or competence to organize a production plant, with overhead and a selling system, and therefore, to him it is not as valuable as it is to you.

Mr. GREGG. No, sir; but——

The CHAIRMAN. And yet his ownership of this product has a bearing upon the market value of your particular property, which, through your ingenuity and ability to develop, you have.

Mr. MANSON. There is also the question of the ownership of capital.

The CHAIRMAN. That is another element.

Mr. MANSON. Yes, the mere fact that you have the capital together to operate a property. This method of valuing, of giving the material in the ground the value which is added to it by the collection of the capital or the ownership of the capital, by the organization, by the selling ability, by the good will, by everything that distinguishes a successful business man from an unsuccessful one.

The CHAIRMAN. I think the bureau admits it, and yet I have not come across a specific case where they have given going concerns value. The difference between going concern value to the particular property that you are using and the lack of going concern value to a property not yet developed, the two values are not comparable.

Mr. GREGG. I am afraid, Senator, I did not express myself well. Let me give you a specific case.

Suppose I am the owner of this ore in the ground, and you wish to purchase it. We both know all the facts and neither of us is under any peculiar conditions with respect to the property. You have the property examined to determine the mineral content. You have it analyzed. All the facts are known to both of us. Is not what you will pay me for that property determined to a large extent by the cost to you of marketing the product, the estimated cost? In other words, the method of refining the ore—I do not know enough about the industry to discuss it—the method of refining the ore, and the cost of refining it, are not they factors which you are going to take into consideration in determining the price that you are willing to pay me for the property?

The CHAIRMAN. Yes; to some degree. But here is a mine that has not been developed. Here is a mine that is owned by some man without capital, and without ability to organize, and here you are over here with this other mine.

Mr. GREGG. Yes.

The CHAIRMAN. With the ability and the organization you have for developing it. In all probability, I could not buy your mine after you had it organized at the same price that I could buy this other man's mine, and yet this other man's mine would be just as valuable to me, because I am going to organize it and develop it and produce, anyway; so that this man is a factor in fixing the value of the product in the ground.

Mr. GREGG. I want to get away from the comparison of a going concern with a new property. Of course, a going concern has a value in itself. It may have an organization, and it may be a very efficient one. It may have good will or something of that sort; but let us come back to two undeveloped properties.

The CHAIRMAN. Go right to that case that you have just been discussing.

Mr. GREGG. That is what I was going to do.

The CHAIRMAN. You show the capitalized earnings on that, and yet if it had not been a developed mine, you would not have known what the earnings would be; so the method of capitalizing earnings and fixing the value of the product in the ground does not seem to me to be a justifiable method.

Mr. GREGG. Coming to that specific case, I think, in going in there myself to purchase the property at the time, I would be primarily interested, without knowing anything about it, in how long the property would last, the amount of money that I would make out of it, what discount I would have at a fair rate to take care of the risk, and I would figure whether I would want to invest so much money and receive out of it so much money to take care of my risk, and the discount for the use of the money. Those are the factors which we take into consideration, and I think they are the accepted factors in valuing mineral properties. Mr. Greenidge, the engineer, is here, and he is more familiar with that than I am.

The CHAIRMAN. Is that the generally accepted method, Mr. Greenidge?

Mr. GREENIDGE. That is the adopted method in the Minerals Valuation section. In the absence of anything better, it is the method for determining the value.

The CHAIRMAN. I would like to ask in that connection, whether any attempt has been made to get a better method of valuation, rather than the mere capitalization of the earnings?

Mr. GREENIDGE. Yes, sir.

The CHAIRMAN. Have you ever discovered any other method?

Mr. GREENIDGE. Where we can find sales of similar properties, or the sale of an interest in the same property, those are considered by the Engineering Division as the very best evidence of value. Going back to your proposition of a while ago, occasionally a man owns a piece of property which he has not the money to develop, and has not the ability, perhaps, if he did have the money. He says to some one, "I will sell you a half interest in this property for $100,000, and then you can get your friends to come in and supply the money and brains and energy necessary to develop it." The payment of that $100,000 for a half interest is taken by the department as correctly demonstrating $200,000 to be the value of the property as of the date of that sale.

The CHAIRMAN. Well, that is probably correct, because you could probably go out and raise the money from some of the others.

Mr. GREENIDGE. Yes.

Senator JONES of New Mexico. I have in mind a very large number of mines which were too low grade to work by any known process. Finally, a process was discovered by which those properties could be worked to advantage. Now, would you increase the value of those ores in the ground by reason of the discovery of the process?

Mr. GREGG. If it were, of course you would not give a higher valuation than if the process had been discovered at the date of valuation.

Mr. GREENIDGE. I do not want to presume to know what the Senator is talking about, but I think he is referring to the flotation process for the treatment of low grade ores.

Senator JONES of New Mexico. Yes, I am.

Mr. GREENIDGE. Where the properties have been transferred subsequent to the discovery of that process, of course a much greater value must be given to those properties than would have been given to the same properties prior to the date of the demonstration of the commercialability of the process. We could not give increased value to this property prior to the date of the demonstration.

Mr. GREGG. That is just the point I was trying to make.

Mr. GREENIDGE. And it is why many concerns come before the department and say we are pretty hard boiled and pretty arbitrary, because we do not permit them to apply to the March 1, 1913, value of the property processes which become known at a later date. It may have been definitely known that their properties were not workable by the processes known at the date of valuation; we are therefore estopped from allowing value, and are subject to a great deal of criticism because of this.

Senator JONES of New Mexico. After the process is discovered, then, in order to arrive at the value of the ore in the ground, you take the going business, with the process in use, and allow what I think is a very modest return for profits on the business, and that is carried back, and the ore in the ground, it seems to me, is given an extraordinary valuation by this process here, which seems to be in general vogue.

Senator WATSON. Is all of this discussion germane to the proposition of getting stone out of the quarry? Was there any new process discovered?

Mr. GREGG. It is germane to the question that Senator Jones asked, in criticising our general theory of looking at it.

Senator JONES of New Mexico. It is the general proposition. That is very important, and it is giving me a great deal of concern.

Mr. MANSON. In this particular case, I would like to call attention to the fact that the product of this quarry was used very largely for flux in reducing iron ore. I would call attention to the fact that in 1918, during the war, there was just as great a demand for limestone for flux as there was during 1916, and it was practically under the same conditions.

Mr. GREGG. May I interrupt?

Mr. MANSON. And the value of the product of a quarry similarly situated in 1918 would be almost identical——

Mr. GREGG. May I interrupt?

Mr. MANSON (continuing). Just a minute. With the value of the product of this quarry in 1916, with practically no change in conditions at all. That brings the quarry that was leased in 1918 directly in line as competent, legal evidence, and the best evidence of the value of this quarry in 1916.

Mr. GREGG. May I ask, do you know whether there was any newly developed limestone quarry between 1916 and 1918? That, of course, would affect the value. Do you know whether the demand was the same in 1918 as it was in 1916?

Mr. MANSON. Yes; I do. I know that the demand for everything connected with the iron industry was as great in 1918 as it was in 1916.

The CHAIRMAN. I do not think that question is competent, anyway, because nothing has been introduced here to the effect that you had any such information before you when you decided this case, Mr. Gregg.

Mr. GREGG. As to what?

The CHAIRMAN. As to whether the demand in 1918 was equal to the demand in 1916, or whether there were any new discoveries, or whether the conditions were typical, so that you are introducing a subject here which has not been presented to this committee as a basis for deciding this particular case apparently at wide variance with the decision in all other like cases.

Mr. GREGG. I do not think it was decided at variance with the decision in all like cases. It is the practice, where we are not satisfied with the other evidence, to use the capitalization of earnings.

Senator JONES of New Mexico. I think one of the criticisms that the committee has is that each individual group of engineers or conferees, as made up of the different classes of men or different members of the bureau arrive at different conclusions, such as you have in this case, and in so doing they have done great injustice as between taxpayers. I mean by that that in your case you seem to have been overliberal with the taxpayer, and the decision was certainly greatly in his favor. In other cases engineers and conferees have been more strict and not so liberal, and the taxpayer therefore has been penalized more than the taxpayer in your particular case, and as a result, there has not been any uniformity of policy in connection with these review cases.

Mr. GREGG. I do not think we were too liberal in this case, but, leaving that aside, on the question of uniformity you are perfectly right. There has been a decided, and necessarily so, lack of uniformity in the disposition of cases. I do not think anyone in the bureau will deny that. When you have to have as many men passing on cases as we have to have, you can not get absolute uniformity. We have tried for it; we have at least attempted it.

Senator JONES of New Mexico. Can you not get more uniformity—I do no want to interrupt, but if these things were held in the open, where interested parties in like cases could hear the testimony, could you not get more uniformity?

Mr. GREGG. Of course, we have gone very far toward that in the creation of the board of tax appeals on appeal cases. In a great many of those cases the taxpayers appear really in a body to argue a general principle.

Senator JONES of New Mexico. Yes; but if the conferees in these private conferences satisfy the taxpayers, there is then no board of appeals to go to, and there is no publicity of the decision.

Mr. GREGG. That is very true.

Senator JONES of New Mexico. In other words, you may have a group of conferees in one case, another group in another case, and another group in another case, and all the groups may decide almost identical cases in three different ways, and in perfect harmony with the ideas of the taxpayers. Those cases do not go to the board of tax appeals, and therefore there is no publicity as to the rulings; there is no publicity as to how you arrive at your conclusions, and there is, therefore, no uniformity of decision, and the board of tax appeals does not correct that situation at all.

Mr. GREGG. I did not say it corrected the entire situation. It takes care of a limited class of cases, and only a limited class; but I will agree with you entirely as to the desirability of absolute uniformity. I think that is important, but I do not think it can be achieved with as big a job as we have. That was one thing that was most interesting in the English system. They do not even attempt uniformity.

Senator JONES of New Mexico. They do not even attempt uniformity?

Mr. GREGG. No. We have tried at it, at least, but we have not succeeded in the attempt. We have tried at it, but they do not attempt it. There is a provision in the statute allowing claims for refunds for 1920. Before that they were not allowed. It says in that provision of the statute, after saying they may be allowed within three years, that, however, no claim for the refund of taxes will be allowed if, at the time the tax was assessed, it was assessed in accordance with the then practice of the department.

The CHAIRMAN. That is substantially what you do now?

Mr. GREGG. No; if we have to change——

The CHAIRMAN. If you change your ruling, you do not go back and change it in all of the other cases?

Mr. GREGG. Possibly we do, theoretically; practically we do not. The taxpayer can always come in, however——

The CHAIRMAN. Yes; but he has no means of knowing, because of your method of adjusting these cases.

Mr. GREGG. That is true, but there is this provision right in the law.

The CHAIRMAN. Are the taxpayers entirely satisfied to have this lack of uniformity of decisions in England?

Mr. GREGG. They are much more satisfied than our taxpayers are, because they do not attempt to collect 100 per cent of the tax.

The CHAIRMAN. What do you mean by that, that they do not attempt to collect 100 per cent of the tax?

Mr. GREGG. They compromise; they bargain on the tax.

The CHAIRMAN. Do you not do likewise here?

Mr. GREGG. Not to any great extent. We decide a case, and it may work a hardship on an individual, and we say, "That is unfortunate, but it is the law." In England, they knock off a portion of it.

The CHAIRMAN. I think you will find that there has been a lot of compromise in the prohibition unit.

Mr. GREGG. Well, that is a little out of my jurisdiction.

Senator JONES of New Mexico. I think we have a great deal of evidence here of this compromising system in these cases that have come before us. That has come up time and again. Take the Berwind-White case. One engineer thinks this, and the other that, and finally they get to the point where the taxpayer is satisfied. He keeps on amending his claim. Some factor comes in that he does not like, and he will increase his claim here and somewhere else, and finally he will get all he wants. That seems to be the result.

The CHAIRMAN. The evidence verifies that absolutely.

Mr. GREGG. I do not agree with that statement. Are you not judging from a comparatively few cases?

Mr. MANSON. Pardon me. Then, the taxpayer assesses his own tax.

The CHAIRMAN. I think the evidence sustains that.

Mr. GREGG. I was discussing it in that respect.

Senator JONES of New Mexico. I am not satisfied yet as to that formula for estimating natural resource value. I declare it does seem to me that that sort of a formula can not be fair in any case. I can see how the fact that the property can be used at a profit might become a factor in a case, but nevertheless it seems to me, and it must be universally so, that you can not, by any absolute formula, based upon profit, get at the market value of a body of ore or any other natural resource. You have to take into consideration the quantity of it. That may be discovered, and the demand for it has something to do with it; but simply to take a formula and say the operating end of this thing shall make only a 10 per cent profit, or any uniform rate of profit, can not possibly be a correct basis of reaching the value of the ore in the ground.

Mr. MANSON. I would like to call the Senators' attention to this situation. You might have two natural deposits, both of them of exactly the same quality of ore, and both of them similarly situated. One of them would be financed by people who would have plenty of capital, people who would have the most modern machinery, the best methods of reducing the ore, and who would have business ability to build up a market for their product. The other company would be financed by people who had insufficient capital, who had no business ability, and who did not look after their business. In that case, the unsuccessful company would receive a much lower valuation under this formula for identically the same ore deposit than the successful company would receive.

Senator JONES of New Mexico. I think that presents in a very clear way the thought that has been running through my mind, that you can not adopt a formula depending on the business prosperity, which will give you a correct view or notion of the value of the ore in the ground.

The CHAIRMAN. From the taxpayer's standpoint, for instance, if you trace these properties back to their local political subdivision, you will find that they do not stand for any local assessment based on the theory you adopt for valuing the mine, and let some other mine which is not worked get off at a lower tax. In other words, they would not permit or stand for their local assessors assessing the value of the property on any such basis of earnings as you have used, would they?

Mr. GREGG. Just one word on that, Senator. I have not advocated the use of capitalization of earnings, expected future earnings, where you have other evidence. It is a matter of using it as a last resort. I think those factors all enter into market value.

Assume, for example, two mines identically alike, and neither one opened. One has a railroad running right by it; the other is 30 miles from a railroad. Now, that factor certainly influences the cost of developing the property or selling or marketing its products, and that certainly influences the market value of the mine. You would pay more for the one than you would for the other. All we do is to take those factors into consideration.

I do not think—and Mr. Greenidge will correct me if I am wrong—that in the case given we would give different values. Take a copper mine. We are trying to draw a picture of the way I understand valuation is fixed. Take a copper mine. We estimate the cost of the shaft, the cost of the machinery to raise the ore. I do not know about the cost of the refinery; I do not know enough——

Mr. GREENIDGE. Not unless it is necessary.

Mr. GREGG. Not unless it is necessary, Mr. Greenidge says. We take into consideration all of those things. Then we estimate the cost of production and make a reasonable allowance for depreciation of these investments necessary to develop the property, the cost of transporting the property to market, and the making of an allowance for the profit they would make. It is a theoretical profit and would be the same in the two cases. We discount that property back to make up for the use of the money in the meantime, and the discount made is high enough, and ought to be high enough to take care of any risk involved.

Senator JONES of New Mexico. May I inquire if you know of any mining concern that, in buying a piece of property in the ground, has ever been willing to pay for a mine on any such basis as is fixed here for valuation?

Mr. GREGG. I can not give you an example of that at all.

Senator JONES of New Mexico. I say you can not do it. If you go into a mining venture you expect a great deal more profit than has ever been figured on here. If you can not get a hundred per cent or a thousand per cent, or something like that, on what you put into it, you do not do it.

Mr. GREGG. That is not true of known ore bodies, where the extent of the ore body is possible to be determined, and the cost of producing it is definitely determined.

Senator JONES of New Mexico. Well, my dear brother, I think it is. Of course, there is not so much chance in one case as there is in the other, but on any kind of an ore body or mining venture that is so, unless it is possibly in the case of coal, where there is a stable value

for it, or a controlled value, or something of that sort. I imagine that in the anthracite field that does have a whole lot to do with it, but that is a controlled product there. Take any sort of an ordinary mining venure, or an ordinary gravel pit, selling sand and gravel, even there you are not willing to undertake it on a 10 or 20 per cent basis.

The CHAIRMAN. Certainly not. when you can lend the Belgians money at 7 or 8 per cent.

Mr. GREGG. Of course, there has to be something there to take care of the element of risk. That is perfectly true.

Senator JONES of New Mexico. As I understand it, the highest formula they have here involves a 20 per cent profit only.

The CHAIRMAN. Have you anything further you want to present, Mr. Hartson, on these tag ends?

Senator JONES of New Mexico. I would like to invite the honest and sincere effort on the part of you gentlemen engaged in that work to devise some plan for handling this thing other than that which is adopted, because I declare this will not stand the light of day, it seems to me, in reasonable minds; and I do not say that to criticise m ves, or anything of that sort. I have nothing of that kind in mind, but it must be apparent that this thing will not do, and if it were published to the country to-day that that is the way this thing is being handled, I am satisfied that there would be a protest from all over the country on the part of the other income taxpayers and from other lines of industry. I have heard it said time and again that these natural resources are not paying any tax—I mean by that anything like the rate of tax that is being paid by other industries of the country.

The CHAIRMAN. I think that will be found to be almost absolutely correct, so far as the oil well business is concerned.

Mr. GREGG. Oil, of course, stands on a little different footing. That is peculiar. There is a provision in the statute with reference to discovery, Senator.

Senator JONES of New Mexico. On the question of the discovery value of the oil, I understand the difficulty in the way. You have to take into consideration not the profit you make out of it, but what other similar properties are being sold for. There is also a large chance being taken there, but I will venture the assertion that there is not an oil concern in existence that would pay for a well or a property on any such basis as is fixed here as a formula for ascertaining discovery or depletion value.

Mr. GREGG. I do not know the basis used in valuing oil properties. Of course, in one project they make a very large allowance for the element of risk, but as to the method of valuing the properties, Senator, the only other cases that I have ever investigated were in Wisconsin. Doctor Adams valued the properties in Wisconsin from time to time, and he and I discussed it, and they were forced to use this system. They were pretty harsh in knocking off a good bit for the element of risk, but they were forced to use the system of capitalization and the so-called analytical appraisal.

Mr. MANSON. Take the zinc mines in Wisconsin. The zinc mines are very close to the surface of the ground in southwestern Wisconsin, and the man that discovers the zinc, notwithstanding the

fact that it takes very little capital to develop it, generally recognizes that he has not very much until he can find a promoter. The promoter of zinc mines in Wisconsin used to expect to get at least 50 per cent of the stock, and was then paid big commissions to sell the balance of the stock. I do know that in the zinc mining industry in southwestern Wisconsin the cost of raising the capital was the big element in getting the zinc mine into operation. If you were to consider buying stock in an operating zinc mine you would probably resort to a method similar to the one used here, but that is where the capital has already been raised, and the mine is in operation. But to just take a mine that has been discovered and the extent ascertained, and compare it with a mine that is already financed is entirely out of the question, because the big thing in southwestern Wisconsin is to get the money.

Senator JONES of New Mexico. Any individual financing a gold mine or a zinc mine or a copper mine will figure on at least a thousand per cent profit in the final development and the marketing of the product. In the financial statements in the papers you see the prices at which the stock is quoted on the market, and it is at a very small fraction, in many cases, of its par value, even, and the number of shares issued in proportion to anything that they pay for the mine is away beyond anything like a 20 per cent basis on what they expect to make out of the mining and the marketing of the product. I tell you the system will not do.

Senator WATSON. Will you formulate a statute that will correct it and make it an absolute rule of law?

Senator JONES of New Mexico. As you have probably observed, I have just invited these gentlemen to put their heads to work in order to devise some other method.

Senator WATSON. That is administration, though.

Senator JONES of New Mexico. Yes.

Senator WATSON. That is true.

Senator JONES of New Mexico. I do not know that we will need any change in the law on this subject, but it must be developed by some other process, because it must be apparent that this thing can not be accepted by the public, and we have to devise something else.

Mr. GREGG. I am sure we are all as anxious as the Senator to do things better.

Senator JONES of New Mexico. I think you are. But something must be done. I think that it is quite clear that this thing will not stand the light now. People will not be satisfied with it if they find out what is going on, and, as I stated before, I want to assure you that I am not criticising the motives of anybody.

Mr. GREENIDGE. I would like to make two comments.

First, I wish to state, as head of the engineering division, that I fully agree with what Mr. Manson has had to say about the necessity and importance of more statistical information being compiled and kept in that division. I think that was your statement, was it not?

Mr. MANSON. Yes.

Mr. GREENIDGE. But to do that we will have to have an increased pay roll, and, if I am correctly informed, there is a great deal of opposition to that.

Mr. MANSON. Is it not true, Mr. Greenidge, that at every session of Congress you are called upon to furnish more or less information, and that every time you are called upon for information you have to go back and go over every file in your division relating to that particular subject, and that the cost of doing that work under those conditions is far greater than the cost of keeping such statistics as you, as head of that division, must be able to anticipate being called upon to furnish?

Mr. GREENIDGE. I could not agree with that in its entirely, Mr. Manson. What you state is partly correct, but to carry it to the degree of nicety which is necessary to make such statistics of any value whatever, a more permanent and expensive organization would be necessary for that purpose.

Senator JONES of New Mexico. Mr. Greenidge, I have been on the finance Committee now for eight years, and the legislation which we have had to deal with has been framed more or less in the dark, at every step we have taken, and if Congress is going to legislate intelligently, we must have this information.

Mr. GREENIDGE. I agree with you, sir.

Senator JONES of New Mexico. And I think one of the great big things that have come out of this investigation is to devise the kind of statistics that ought to be available to the Congress, and promptly available, when we are dealing with matters of legislation. It seems to me that, regardless of what it may cost, it is the sine qua non: we must have it in order to legislate intelligently. It will not do to get these things out a year or two years or three years after they are needed. Mr. Gregg realizes the darkness in which we were groping during the passage of the last revenue bill. We did not have any of these statistics. We had all sorts of impractical statements made, and we could not assess the value of such statements, because we did not know just how to do it.

The CHAIRMAN. I should like to ask Mr. Gregg if there is not some way of reorganizing the department so that you could get at the statistics as they seem to be necessary in the work that we are doing here?

Mr. GREGG. Mr. Nash can answer that better than I can. He has already told you of the difficulty that we have labored under in the way of improving the organization and in getting such statistics. How many men have we in our statistical division now, Mr. Nash?

Mr. NASH. In our present statistical organization, about 100.

Mr. GREGG. They prepare these statistics, covering income.

Senator JONES of New Mexico. The trouble is that we get them about eighteen months after the year is over.

Mr. GREGG. Yes; they are not prepared in time to be really helpful because the conditions have changed so in the meantime that they mean nothing, practically. To have an organization capable of giving us those statistics as we want them and as the Treasury Department wants them, and the Treasury Department wants them just as much as Congress, in determining our recommendations on legislation, it would require a much bigger organization than we have, and much bigger than we can afford. Is not that correct, Mr. Nash?

Mr. NASH. Yes, sir.

Senator JONES of New Mexico. Last year, in framing the law, the latest statistics that we had were for the year 1921.

Mr. NASH. The reason that they are always a year behind is because of the fact that some of the returns are filed on a fiscal basis. They can not get their statistics together until 12 months after the close of the tax year. We have in the Printing Office now our statistics for 1923.

The CHAIRMAN. Would it not be better if we had one method, namely, that of the calendar year?

Mr. NASH. Yes, sir. The fact some of the returns are filed on a fiscal basis delays the statistics 12 months.

The CHAIRMAN. What is the objection to correcting that and making them file them on the calendar year basis?

Mr. NASH. There is no objection if it is worth while, just for that reason.

Mr. GREGG. That question was very much alive several years ago, and the big opposition came from those corporations, manufacturing concerns, etc., that took their inventory at the end of the fiscal year and kept their books on the fiscal year basis. They objected very strongly to changing their accounting period to a calendar year basis.

The CHAIRMAN. As a matter of fact, many of them, since the income-tax law has become effective, have changed over to the calendar year basis, have they not?

Mr. GREGG. Yes; a great many of them, but a great many of the others object very strenuously to doing it.

The CHAIRMAN. It seems to me, in view of the fact that so many of them have changed over to the calendar year basis, there can not be so many of them left to object, and if it was made mandatory to change to the calendar year basis, it would certainly simplify the work of the bureau in preparing the statistics; is not that true?

Mr. GREGG. Certainly; but, as you know, there are provisions in the act relating to the fiscal year basis.

Senator JONES of New Mexico. Of what value are your statistics if you have a fiscal year return, the statistics coming in at such a late period? For instance, the statistics of income taxes for the year 1921, on the face of them, all relate to the calendar year 1921, but, as a matter of fact, they include partial returns based on the fiscal year, and, really, with such a system, we do not now just how much relates to the calendar year and how much involves the fiscal year. The statistics really do not mean very much in the way they come out; I mean with respect to accuracy.

Mr. NASH. Senator Jones, for the fiscal year 1922, let us assume that you had the returns that ended October 31. You would begin on November 1, 1921. The two months part of that return that refers to 1921 would be in the 1921 statistics, and the 10 months that refer to 1922 would be in the 1922 statistics.

The CHAIRMAN. You could not get the 1921 statistics until the last return was filed in November of 1922?

Mr. NASH. Yes, sir; that is just the trouble, Senator Couzens.

The CHAIRMAN. Is the bureau prepared to recommend that the calendar year basis be made mandatory?

Mr. HARTSON. Of course, the objection to that, as Mr. Gregg has pointed out, is this: There has been a disposition on the part of

Congress to impose the income tax law on the various taxpayers with as little inconvenience as is possible. Now, a great many companies have kept their books on a fiscal year basis for years and have never changed. Others have kept their books on the calendar year basis, and have since changed to a fiscal year basis, all for reasons which to the company or to the individual were sufficient. I think it would add greatly to the administrative ease of putting these revenue acts into operation if there were a mandatory requirement that all people keep their books on a calendar year basis and make their returns in a consistent way. That would simplify the problem tremendously.

Senator JONES of New Mexico. For statistical purposes, why should we not take all of the returns that come in to a given year and use those without allocating the two months or whatever it may be, because, in the end, after the first year, you would be getting into that calendar year just the same things that you did in the previous year. Why not just take the returns as they are, without undertaking to allocate the amount of revenue out of the fiscal year and putting it into the calendar year?

Mr. MANSON. It would only create an abnormal condition for one year.

Senator JONES of New Mexico. That is all; and the chances are that that would not be abnormal, that there are about as many that would be hit one way as the other, even in the first year.

Mr. MANSON. What I had reference to in referring to statistics in the engineering division was this: Take the amortization. That is a temporary deduction. It is a deduction that can be made for the years 1917, 1918, 1919, 1920, and 1921, I believe.

Mr. HARTSON. Not for 1917.

Mr. MANSON. Not for 1917?

Mr. HARTSON. No.

Mr. MANSON. For 1918, 1919, 1920, and 1921?

Mr. HARTSON. Yes.

Mr. MANSON. I endeavored to find out to what extent amortization affected the net income for those years. Being purely temporary, it is an influence which does not affect subsequent years, and it would certainly be important to Congress to know the effect of that upon net income, in order that they might be able to estimate the future net income in which amortization was not a factor. I concluded that to gather statistics on that point would involve a prohibitive cost; but it strikes me that any factor which affects income is just as important from a statistical standpoint as the amount of net income.

Take the case of discovery value in oil. I have endeavored, and I know that Mr. Greenidge has cooperated with us in this respect, to arrive at some estimate of the effect upon the income derived from oil producers within some one particular year or several particular years; but we have not even been able to figure out a formula whereby we can estimate it, to say nothing of getting figures upon it. However, it strikes me that it is a highly important thing—it runs into hundreds of millions of dollars—it is a highly important thing for Congress to know how much revenue is being lost each year, for instance, because of the allowance of discovery value to a man who discovered nothing. The law permits discovery value for wells that are put down, when the property is proven, directly at the time

the well is sunk. I deemed it important to try to at least make some intelligent estimate of how much revenue was being lost on that feature alone, and I have given up the idea. With the heartiest cooperation on the part of the bureau, it is impossible for us to figure out a formula whereby we can even estimate that, and the cost of doing it would be absolutely out of the question.

Is not that right, Mr. Greenidge?

Mr. GREENIDGE. Yes: the cost in time and money both would be very large.

The CHAIRMAN. It seems to me that you could keep some sort of running statistical bureau, where these statistics could be put in abstract form as you go along.

Mr. GREENIDGE. It would be the only one that would be of any value to us, Senator.

The CHAIRMAN. Why can you not get at that and have some sort of a running statistical bureau where these returns could be abstracted into these statistics as you go along from day to day, and then, when the year is completed, you will have the job done?

Mr. MANSON. That is what I had in mind. In other words, the job that I have in mind does not strike me as being one of large proportions. I believe the cost of maintaining a statistical organization in the engineering division, to do the kind of work that I have in mind—I have not mapped it out completely: my ideas about it are developing every day as we go along, but up to the present time the cost would not amount to anywhere near as much as the cost of ascertaining the gross amount of amortization allowed, for instance.

Senator JONES of New Mexico. Is it not absolutely essential that the Congress should have before it this information, in order to legislate intelligently?

Mr. NASH. Senator, these cases have been grinding through the mill for the last six years. Many statistics have been kept. The great majority of cases have been closed and put away in the files. Now, to gather any additional statistics means dragging all of these cases out of the files, and going through them again to find the other elements in them that we may want statistics on.

Senator JONES of New Mexico. Why can you not take a fresh start there?

Mr. NASH. We can take a fresh start on the cases that are now before the bureau.

Senator JONES of New Mexico. The discovery question is a thing that we hope will not go on indefinitely.

Mr. GREENIDGE. By starting now, Senator Jones, if I may be permitted to suggest it, an equation may be worked out from information collected in the future which could be made to reflect what has happened in the past without going to the extreme cost, both in money and time, to collect it from all of the prior closed cases.

Senator JONES of New Mexico. We are not so much concerned about what has happened as we are about what is happening and what will probably happen in the future.

Mr. MANSON. I want it to be understood here that what I said was said out of no spirit of criticism at all.

Mr. GREENIDGE. Oh, no; and I agreed with it.

Mr. MANSON. It is a suggestion on my part, and I realize that the men in the bureau have been so busy in taking care of to-day's job, all the time, that there is every reason in the world why they had no opportunity.

Senator JONES of New Mexico. This question of amortization is important even yet, because amortization really amounts to a reduction in taxation, and it might be looked upon as a part of the war debt. It is important for us to know how much of the war debt we are paying. We have many extraordinary expenses growing out of the war which we are still paying, and amortization is one of them. In order to know how much revenue we ought to raise for next year, we ought to know how much less this amortization is going to affect the revenue than it has in the last two or three years.

Mr. MANSON. That is exactly what I had in mind.

Senator JONES of New Mexico. Yes.

Mr. MANSON. It was necessary, in order to use existing figures as a basis for estimating future revenue.

Senator JONES of New Mexico. It is just as important to know that as it is to know the amount that we had to pay in the period after the war, in order to square up our war obligations, the hospitalization expenses, the rehabilitation expenses, and the pensions and everything else. We have to know how much they are likely to vary. It evidently has amounted to hundreds of millions of dollars.

The CHAIRMAN. I think it would have been very interesting to Congress if we had known what this loss to the Government meant, by giving credit for capital losses.

Senator JONES of New Mexico. Yes.

The CHAIRMAN. That is the greatest element in the reduction of our revenue, of any one thing and we evidently have no statistics up to date as to what the capital losses meant to the country.

Senator JONES of New Mexico. In looking over the very meager statistics which Mr. Manson has gotten up for us, I have been somewhat astonished. It is an enormous amount that is involved, and we want to know something about it and try to plan for the future.

The CHAIRMAN. I would like to ask Mr. Gregg this question: What would be your idea after March 4, if this work has not been completed by that time, of having a joint committee of the House and Senate carry on this work until the next meeting of Congress?

Mr. GREGG. If I may answer that from a personal standpoint, I do not think that in going into individual cases anything in particular would be accomplished. I think if the committee would consider such things as what should be done with capital gains and capital losses, present methods, a study of the legal phases, the matter of getting the bureau current through a study of administration and the systems used in other countries, I think it would be of wonderful service to the bureau and to the country.

The CHAIRMAN. Of course, to get at the capital losses and so on, we would have to study the individual tax returns.

Mr. GREGG. To this extent: As a matter of curiosity to myself, I took 1921, which was the last year available then, and I took the returns of fifty of the largest taxpayers, and went through them for capital gains and capital losses. I found that the capital losses reported by those fifty largest taxpayers were $11,000,000, and the

capital gains reported were $1,000,000. That is indicative of what happened to us on the capital gains.

The CHAIRMAN. Then, as a matter of fact, you did have to study the individual cases?

Mr. GREGG. Not individual cases, but compilations taken from individual cases.

The CHAIRMAN. That is exactly what we are doing. We are not studying income tax returns for the purpose of discovering crookedness or dishonesty, but we are trying to find out the methods adopted for reporting the taxes.

Mr. GREGG. I think questions like the matter of legal evasion certainly need more study than they have ever received. The matter of capital loss and gain is one phase of it. The matter of reorganization may be studied quite thoroughly. It can certainly stand a great deal more study, as well as the division of property between husband and wife and the creation of trusts. Great Britain has some very interesting legislation on that. All of those things could be studied, I think, and a great deal of benefit derived from it, as a matter of administration.

The CHAIRMAN. I judge from your answer, then, you think there is enough benefit to be derived from it to justify the continuation of this work?

Mr. GREGG. I am not speaking for the Treasury now.

The CHAIRMAN. No, sir: I am only asking you to speak for yourself.

Mr. GREGG. May I state one more word on that particular case, to change the subject abruptly? I would like to impress on the committee that the work of this special committee lasted about three or four months. I have been in the bureau for five years and have decided a great many cases. Even in those cases that we decided in the four or five months, as I said, there are a great many where you would probably disagree with me, and where Mr. Hartson would probably disagree with me. There are probably some wherein I was wrong; but the point I want to make is this: The computation of the tax, particularly under the excess profit tax, is not a matter that can be worked out with mathematical 100 per cent accuracy. There are questions of judgment involved in every case. The judgment of almost any two men will differ on it. The only way to handle it in the bureau is to leave the matter of final judgment up to the person in whom you have the most confidence, and then take what he says. There are too many matters of judgment to get accuracy. Someone has to decide it, and some are going to disagree with him one way or the other. I do not see how, under a system like our excess profits tax, it could possibly be avoided, or the inconsistency which there always is in such a system.

Mr. MANSON. Mr. Gregg, how would you arrive at the practice in the bureau with respect to, for instance, a matter like amortization, to determine whether or not congressional action might be necessary to more clearly set forth in the law the intent of Congress, unless you examine individual cases?

Mr. GREGG. I was not going into the amortization section. I should say it was a crime to ask the department to administer a section as indefinite and as vague as that.

Mr. MANSON. I agree with you absolutely.

Mr. GREGG. I think the same thing is true of the consolidated returns section.

Mr. MANSON. I agree with you there also.

Mr. GREGG. Nobody can administer it accurately. It still seems to me that in the absence of actual corruption, it is better to close the cases and close them finally than it is to attempt to again get more mathematical accuracy.

Mr. MANSON. Even though that might result in the loss of several hundred million dollars to the Government?

Mr. GREGG. Of course, you are drawing a very fine line there to determine when you are justified in reopening a case. Personally, I think the country would be benefitted more by closing out cases up through 1921 in almost any manner than by going into them and attempting to get more mathematical accuracy.

The CHAIRMAN. If we did that, Mr. Gregg, the man who would delay paying his tax would always get the benefit, while the man who paid his tax promptly would be penalized.

Mr. GREGG. Senator, he is getting it. I remember, in 1919, I think it was, or possibly before that, we had quite an argument in the department as to whether we would ignore matters of tax one cent or less. Now, I understand there is a disagreement about ignoring $15 or less. We tried first for more mathematical accuracy than we do now. We saw we could not get it. We have been relaxing a little bit since then. If we can ever get the excess profits tax out of the way and get to the income tax with a more accurately drafted law, as we have now, I think the department can keep current, and can do it with reasonable consistency in the treatment of individual cases; but it is that terrible burden of the excess profits tax that is breaking down the administration of the department.

Mr. MANSON. You spoke of the matter of ignoring a cent, and coming up to the point of $15. You do not think that that is a fair illustration of what we are driving at here, where one case may involve $20,000,000?

Mr. GREGG. No, sir; I was not giving that as an illustration of that. I was giving it just to show this, that the longer you go with the excess profits tax law the more liberal the treatment—not more liberal, but the more careless—that it not a good word—but the more lax the examination of a return must be to get them out of the way. That is all I was trying to illustrate there.

The CHAIRMAN. Mr. Davis, Senator Jones was not here when I talked to Senator Ernst about it, but it was agreed before Senator Jones came in, if it would be agreeable to him, to hold a meeting to-morrow morning on the prohibition matter. Senator Ernst talked with Commissioner Haynes, and I think with some people connected with the prohibition unit. They have a man here from Pittsburgh who can discuss this matter with us, if agreeable to Senator Jones, and we will take up that question of prohibition to-morrow morning, to consider how to proceed and what we ought to do, and also to consider what we have developed so far.

Mr. DAVIS. That can be done all right, Senator, but there is another little matter that is going to interfere with that. I would have liked to have had a little more notice, so that I could get

together and compile some matters and bring them up to date, from one man that I have working on it. The only man I have on it is in New York. Could you put that over for a few days?

The CHAIRMAN. Are you going to be here, or do you want to get away?

Mr. DAVIS. I would like to go to-morrow if I could, but I will come back in a few days. I can be back the first of the week.

Senator JONES of New Mexico. I think it is essential to have that man here to get a summary of what has been done.

Mr. DAVIS. I have the man here, Senator Jones.

The CHAIRMAN. I think that these reports from Mr. Storck, many of which I have been through, and doubtless you are familiar with them, can be summarized between now and ten o'clock to-morrow morning, so that you can make a statement and talk to Commissioner Haynes, and Mr. Storck could be gotten here by 10 o'clock in the morning.

Mr. DAVIS. I will try to reach him at his house. He is around interviewing some parties, but I think I can reach him. I do not know that I can promise that.

The CHAIRMAN. Well, we will proceed, anyway, and take a chance on your getting him here.

Mr. DAVIS. I will do the best I can.

The CHAIRMAN. And get as much ready as you can by that time.

Mr. DAVIS. All right, by 10 o'clock to-morrow morning.

The CHAIRMAN. We will not take up anything more concerning the Income Tax Unit until the 2d of January. I understand, Mr. Manson, that you will be ready to go ahead with the Steel company case at that time?

Mr. MANSON. Yes.

The CHAIRMAN. Will you, Mr. Hartson?

Mr. HARTSON. Yes; we will be ready.

The CHAIRMAN. We will take up the case of the United States Steel Corporation, then, on January 2.

Mr. HARTSON. Mr. Greenidge has had some figures to present to-day. He might put them into the record without taking the time of the committee to listen to them. I do not know just what they are, but they cover information which he submitted pursuant to a request having been made by one of the members of the committee.

The CHAIRMAN. What is that, Mr. Greenidge?

Mr. GREENIDGE. You asked, Senator, for the number of amortization cases now in the department. There are 233 in the Engineering Division, on which there has been claimed $152,190,136.

Mr. HARTSON. Mr. Greenidge, let me interrupt you there. Does that include all the cases that there are in the bureau?

Mr. GREENIDGE. No.

Mr. HARTSON. Or only those in the Engineering Division?

Mr. GREENIDGE. In the Engineering Division only. In Audit Divisions there are 650 case years.

The CHAIRMAN. What is that?

Mr. GREENIDGE. Six hundred and fifty case years. That means about 200 cases.

The CHAIRMAN. Of three years apiece?

Mr. GREENIDGE. Yes. A case will sometimes have 1917, 1918, and 1919 tax returns involved: 650 case years are in the Consolidated and Corporation Audit Divisions of the Income Tax Unit, on which $480,751,074 have been claimed, $153,979,909 have been allowed, and on which $326,771,166 have been disallowed.

There are a few claims not included in the foregoing, which are in such places as the solicitor's office and the Records Division. They probably will not amount to as much as 3 per cent of the above figures.

Senator JONES of New Mexico. That represents a total amount involved of how much?

Mr. GREENIDGE. $152,190,136, sir, not yet acted on, and $153,979,909 acted on, but in process of audit.

The CHAIRMAN. I understood Mr. Manson to state yesterday that up to date there has been between five and six hundred million dollars allowed for amortization. That is correct, is it not?

Mr. GREENIDGE. That is correct, sir. I can give you the exact figures if you wish them.

Senator JONES of New Mexico. Yes; we would like to have them.

Mr. GREENIDGE. $562,741,259.

The CHAIRMAN. That really represents, then, what the American people have invested in private business here in America, and on which we get no returns?

Mr. GREENIDGE. As I understand it, Senator—and I do not attempt to take issue with you—the Government promised to help out such industries as would make a consistent effort to speed up production during the war.

The CHAIRMAN. Yes; I do not take issue with that. I think we are justified in having some investment of that kind, and I do not think it is in the committee's province to go to the extent of it rather than the principle.

Senator JONES of New Mexico. Then, you have allowed $562,000,000, and, roughly speaking, $300,000,000 still claimed.

Mr. GREENIDGE. Yes, sir. You may have a copy of this, Mr. Manson.

Mr. MANSON. I would like to have a copy of it.

Mr. GREENIDGE. There is nothing confidential about it.

Mr. Nash, do you wish to take up the other request?

Senator JONES of New Mexico. I think we might as well put that statement in the record.

The CHAIRMAN. I think, in view of the fact that he has given us the figures, that will be sufficient.

Mr. GREENIDGE. The figures may be useful to Mr. Manson and the statement shows how they were compiled.

Senator JONES of New Mexico. Yes.

Mr. GREENIDGE. Do you wish to take up the other request, Mr. Nash?

Mr. NASH. No; not now.

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

(Whereupon, at 12.20 o'clock p. m., the committee adjourned until to-morrow, Wednesday, December 31, 1924, at 10 o'clock a. m.)

EXHIBIT A

MARCH 4, 1922.

NEW JERSEY CALCITE CO.,
149 Broadway, New York, N. Y.

SIRS: Receipt is acknowledged of letter dated February 21, 1922, from Kaye, McDavitt & Scholer, attorneys, New York, N. Y., in which exception is taken to action of this office in allowing no value to certain quarry leases which were transferred in April, 1916, by Benjamin Nicoli to the New Jersey Calcite Co. Request is also made that all papers in the case be submitted to the committee on appeals and review and that you be advised of a time when an additional brief may be submitted by you.

In reply, you are advised that the action of allowing no value to the leases in question has been reconsidered and the value of the leases has been fixed at $8,950.93, based upon the advantage in royalty rate attaching to the leases conveyed to the New Jersey Calcite Co. over the royalty rate upon which leases were made at about that time and shortly thereafter.

Two leases with privilege of removal for five years were transferred to the corporation in April, 1916, the remaining lease period being eight years. The leases called for a royalty of 3 cents per ton, the renewal on one being at the same rate, the renewal on the other being 4 cents per ton.

Claim has been made for a value of the leases based on an output of 150,000 tons per year, at a profit of 20 cents per ton. Affidavits have been submitted to the effect that the profits for many years prior to 1916 averaged 20 cents per ton. An annual output of 150,000 tons appears to be purely an assumption. In a brief submitted by the company is a statement of the tonnage content of the quarry based upon a report made by a mining engineer. The statement was then made that "it is very obvious that the Calcite Co. might remove 200,000 to 300,000 tons annually from the quarry for the remaining eight years of the lease, without completely exhausting the quarry."

From Form F (revised) filed by the company it appears that the average annual output for the three years previous to 1916 was 97,951 tons. The actual average output for five years, 1916 to 1920, inclusive, is 109,952 tons. This falls considerably short of the assumed annual output of 150,000 tons.

This office holds that for income-tax purposes it is unsound to value a mining property or lease by capitalizing the earnings of the company upon the basis of an annual output and profit per ton. For income-tax purposes value is based on cash cost, or if the property is acquired with stock, its value or cost should be based on an amount that would obtain between a "willing seller and a willing buyer."

In the brief submitted by the company the records of three leases made in Sussex County, N. J., the same county in which the property of the New Jersey Calcite Co. is located, are set out as follows:

"November 9, 1916, Sussex Calcite Co. to Sussex Limestone Products Co., royalty no less than 4½ cents and not over 5 cents per ton. Book X-11, page 364, etc.

"October 2, 1918, Lucy E. Lliff, etc., to Bernard Stener, royalty 5 cents per ton. Book R-11, page 588, etc.

"March 16, 1920, Franklin Mineral Co. to Wharton Steel Co., royalty 5 cents per ton. X-5-11, page 56, etc."

These leases for all practical purposes cost on the royalty basis 2 cents per ton more than the leases transferred to the New Jersey Calcite Co. In the case of one of the leases transferred to the Calcite Co., the advantage to the Calcite Co. is only 1 cent per ton for the renewal period of five years.

One of the leases as above was made in 1916, shortly after the Calcite Co acquired its leases. Another was made in 1918, and a third was made in 1920.

The lease made in 1920 is particularly in point as it was made by the Franklin Mineral Co., the same company that made one of the leases which was transferred to the Calcite Co. The quarry property covered by this lease is on the same belt of limestone and is worked in the same manner as the quarry covered by the lease which was transferred to the Calcite Co.

From the above it is apparent that the only advantage in the leases transferred to the Calcite Co. over the leases referred to above is the difference in royalty rate of 2 cents per ton for one lease for the full period of eight years and for the other lease of 2 cents per ton for three years and 1 cent per ton for five years.

The value of these differentials may be capitalized to establish the value of the leases transferred to the Calcite Co. For the purpose of capitalization the Calcite Co. has assumed an annual output of 150,000 tons. This office holds that there is no authority for such an assumption. Inasmuch as there are no data in substantion of the probability of a greater future output at the time the leases were transferred to the Calcite Co., the average annual output for the three prior years may be assumed to represent the probable annual output for the future which for all practical purposes may be placed at 100,000 tons.

Inasmuch as Form F (revised) does not show what tonnage should be allocated to each lease it is assumed that the output from each lease was equal. Upon that basis the lease advantage to the Calcite Co. would be for the full period of eight years as follows:

50,000 tons for 8 years at 2 cens per ton	$8,000
50,000 tons for 3 years at 2 cents per ton	3,000
50,000 tons for 5 years at 1 cent per ton	2,500
Total advantage	13,500

The capitalized value of this sum for an eight year period at 8 per cent and 4 per cent, Hoskold's formula, would be $8,950.93. This sum $8,950.93 has been allowed as the value of the two leaseholds transferred to the New Jersey Calcite Co. in April, 1916, and may be amortized over the life of the lease at the rate of $1,118.87 per year.

This value and amortization rate will govern during the life of your lease, subject to capital additions, deductions, or corrections (should error be discovered), which would require modification of these figures. The above results will be reflected in the audit of your case, which will begin 20 days from the date of this letter.

Respectfully,

E. H. BATSON, *Deputy Commissioner.*
By ——, *Head of Division.*

EXHIBIT B

SECTION OF INORGANIC NONMETALS

New Jersey Calcite Co. (Successor to Benjamin Nicoll)

QUARRYING LIMESTONE

1. Individual returns for 1914, 1915, 1916 for Benjamin Nicoll accompanying to be kept with above case.

2. Taxpayer is operating quarry as lessee. Same quarry operated by Benjamin Nicoll until April, 1916, under name of B. Nicoll & Company, not incorporated; quarry properties incorporated April, 1916, under name of New Jersey Calcite Co.

3. This case reviewed October 25, 1920, by this section, John Seward, valuation engineer: All claims for valuation and depletion disallowed. A–2 letter sent taxpayer January 31, 1921, resulted in conference and taxpayer submitting individual information substantiating valuation of property.

4. Taxpayer claims $150,000 paid for lease in capital stock of the company, of which, due to the lease having only eight years to run, they are entitled to amortization of the lease of one-eighth per year of the invested capital.

5. Inspection of 1916 individual returns filed by Benjamin Nicoll and revenue agent's report show that nothing was reported as income for the equivalent of the stock issued to him by the corporation; therefore, the incorporation simply resulted in change of name and the New Jersey Calcite Co. paid nothing for the quarry lease or development. Any development set up at that time had undoubtedly been paid for under operating expense while operated by Benjamin Nicoll.

For reasons stated above, action taken October 25, 1920, is herewith sustained as follows:

Valuation limestone quarry lease and development: Claimed, $130,000; allowed, none.

Depletion allowed, none.

Case herewith returned for assessment.

Action taken: Foregoing comment only.

C. C. GRIGGS,
Valuation Engineer.

Approved:

ORR R. HAMILTON,
Chief, Metals Valuation Section.

EXHIBIT C

EXTRACT FROM BRIEF DATED DECEMBER 13, 1921

In the matter of the income and excess profits tax of the Franklin Mineral Co.
Statement of facts

PART I

* * * * * * *

QUARRY PROPERTIES

In order to estimate the value of these properties in 1905, it is necessary to recall the conditions then prevailing. The three chief uses for stone of this character were (1) cement making, (2) furnace flux, (3) ballast and road work.

The great cement plants near the Delaware River, in New Jersey and Pennsylvania, used thousands of tons of limestone daily. Their stone came principally from the Lebanon Valley region of Pennsylvania. These quarries were deep, requiring constant pumping and lifting of the stone, and hence were expensive to operate.

The only other stone with competitive freight rates, it was believed, was in the Wallkill Valley of New Jersey, beginning a little south of the company's Ogdensburg property and extending north to the New York line. Only so much of this vein was commercially available as was convenient to the existing railroads and was not overlaid with great masses of earth. The company's two quarry properties, on the Ketchem farm and the Ogdensburg property, exactly fulfilled these requirements.

It therefore appeared at the time of the transfer of the property to the company that there was a great demand by the cement manufacturers for its stone and that its stone could be produced much cheaper than the stone of competitors.

However, in 1906 and 1907, it proved that the company's stone was too irregular in quality for the cement trade. Some of the stone was excellent; but other stone of the same appearance and from the same quarry ran as high as 10 or 15 per cent in magnesia and was unfit for cement.

EXTRACT FROM BRIEF DATED DECEMBER 13, 1921, IN RE THE FRANKLIN MINERAL CO.

The second great use for this limestone, as it appears in 1905, was flux in iron furnaces. There were such furnaces in many parts of northern New Jersey using a very large tonnage of stone, so located that the freight rates from the company's property gave the company's lessees almost a monopoly. In the latter part of 1907, however, a number of these customers shut down and have not, it is understood, ever reopened. Some others which closed in 1907 reopened during the war, but only temporarily.

The third use mentioned was for ballast and road work, as a substitute for trap rock. The Erie Railroad used large quantities of this stone in 1911 and 1912 and found it too brittle. Since then there has been no market for such use.

For the reasons mentioned these quarries have decreased in value (excluding the item of depreciation) since the company acquired them.

At the time of the conveyance to the company negotiations were under way for leasing the right to quarry on the Ogdensburg property for a period of years. A lease was finally executed in 1906, whereby the tenant agreed to open and develop the property at his expense, to pay all taxes on the property, to pay a royalty of 5 cents per ton of stone shiped, and agreed that the royalty the first year would be at least $1,000, the second year $2,000, and so on until $5,000 a year should be reached. The company believed that the royalty would be much greater and did not regard the lease as a very good bargain on its part.

If the average royalty per year had been $5,666, of which 2 cents per ton, or $2,266, had been set aside for depletion, the net income would have been $3,400, or 10 per cent (free of taxes) on $34,000. We submit that under the circumstances existing at the time of the conveyance of the property to the company $34,000 was the fair value of the Strong quarry.

Turning now to the Fowler quarry; this property at the time of the conveyance to the company was well developed; it was under lease for a term expiring in August, 1909, with a privilege of five years more, at a royalty of 3 cents per ton and a guaranteed minimum of $1,000 per year.

The same general conditions affecting the value of the Strong quarry also affected the value of the Fowler quarry. The company, of course, considered the existing lease as a detriment to its value, and fully expected that upon the expiration of the privilege of renewal it would be able to lease the property upon terms fully as favorable as the lease soon made for the Strong quarry as above stated.

While the lease reduced the value of the property, the fact that it was developed increased its value.

We submit that, under all the circumstances, $35,000 was the fair value of the property in 1905.

Recapitulation of values

Fowler homestead	$10,000
Ketchem farm	8,800
Ogdensburg farms	16,000
East Mountain woodlot	200
Tallman woodlot	400
Strong quarry	34,000
Fowler quarry	35,000
Total invested capital	104,400

* * * * * * *

(For extract form Part II, see attached.)

EXTRACT FROM BRIEF DATED DECEMBER 13, 1921

In the matter of the income and excess profits tax of the Franklin Mineral Co. Statement of facts.

PART II

DEPLETION

The company niether at the time of acquiring its quarry properties shall be governed by the railroad weights and has required the lessees to send to the company monthly a detailed statement of the amount of stone shipped as shown bp such weights. The company has also accepted without question the figures so furnished by the lessees, and such figures are the basis of the calculations below:

FOWLER QUARRY

The New Jersey Calcite Co., the lessee of the Fowler Quarry, has advised the company that early in 1920 it had a survey made of this quarry and a calculation by a competent engineer of the amount of stone removable. A picture of this quarry is inclosed herewith which shows the method of working it.

The floor of the quarry is about 10 feet above the level of the railroad over which the stone is shipped. We submit that stone below that level is not commercially available because of the floor of the quarry was lowered the expense of operation would be increased beyond the market value of the stone, especially by necessitating pumping water from the quarry and necessitating raising the stone to the level of the railroad cars and increasing the expense of removing snow—a large item.

The hill in which the quarrying is conducted is about 300 feet wide and the limestone extends back about 1,000 feet from the railroad. The further in the hill the quarry is pushed the longer the haul to the railroad and the greater the expense of quarrying. We submit that it is doubtful whether, commercially speaking, the stone more than 800 feet from the railroad is recoverable.

A similar quarry, located about 300 yards north of the Fowler quarry, was abandoned many years ago because a worthless product known locally as black rock, was found under the limestone but near the surface. The expense of removing this black rock was prohibitive and the quarry was abandoned. In about 1910, a similar dike of black stone was encountered in the Fowler quarry and was removed by the lessee at great expense. There is always a possibility that such dikes may be found as the development of the quarry progresses.

The calculation obtained by the New Jersey Calcite Co. early in 1920, covered the entire deposit of stone extending back to the end of the limestone but above the present quarry floor. It made no allowance for the possible presence of black rock or for the increase of expense of removing that part of the stone more than 800 feet from the railroad.

	Tons
New Jersey calcite estimate	1,500,000
Removed from Sept. 1, 1905, to Dec. 1, 1919	869,247
Total estimated tonnage as of Sept. 1, 1905	2,369,247

For the reasons above stated, namely, that the possible presence of black rock and the doubt as to the commercial value of stone most distant from the railroad are not taken into consideration in said estimate, we submit that the estimate should be reduced by about 619,247 tons, making the estimate removable stone, September 1, 1905, to be 1,750,000 tons.

The fair value of this quarry March 1, 1913, is stated as follows:

Value, Sept. 1, 1905 (see Part I)	$35,000.00
Depletion recovered for stone removed at 2 cents per ton	10,400.71
Fair value Mar. 1, 1913	24,599.29

	Tons
Estimated tonnage, Sept. 1, 1905	1,750,000
Stone removed	520,035
Estimated tonnage, Mar. 1, 1913	1,299,965
Value at 2 cents per ton	$24,599.29

On March 1, 1913, this quarry was under lease for a term expiring August 19, 1919, at a royalty of 3 cents per ton and a guaranteed minimum of $1,000, the lessees to pay all taxes. The average royalties obtained prior to that date since the organization of the company, under the same and a similar lease was $2,104.30 per year. On the basis of past records the company could expect on March 1, 1913, that it would receive during the balance of the lease royalties totaling $13,675.

EXTRACT, ETC., FROM BRIEF IN RE: THE FRANKLIN MINERAL COMPANY

The then present value of such royalties at five per cent simple interest was $11,766.00.

	Tons
Estimated tonnage in quarry Mar. 1, 1913	1,229,965
To be removed under lease in order to earn royalties of $13,675	455,833
Balance to remain after lease	774,132

Prior to March 1, 1913, stone had been removed at the rate of 70,144 tons per year. Assuming that it was removed at the same rate until the quarry were exhausted it would take eleven years, after the expiration of the lease, to exhaust the quarry. The company might reasonably expect in 1913 that upon the expiration of the existing lease it would be able to lease the quarry at a royalty of five cents per ton, instead of three cents per ton. The royalty on the 774,132 tons at five cents a ton would be $38,706.60. The average due date of the same would be eight years nine months after March 1, 1913. The value of the royalty March 1, 1913, at five per cent simple interest would be $26,500.

Value as of Mar. 1, 1913, of expected royalties under existing lease	$11,766
Value as of Mar. 1, 1913, of stone remaining after expiration of lease	26,500
Total value of company's equity	$38,266

The company admits, however, that such value is excessive and that the true value was $24,599.29.

This property was formerly of some value as farm property or it was of value as quarry property but if it is used for farming, it can not be used as a quarry and conversely, if it be used as a quarry, it has no value as a farm. As the stone is removed the property becomes absolutely worthless, as can be seen by the picture. The floor of the quarry has no earth on it. It follows that the value of the land for other purposes than mineral production should not be deducted in determining depletion.

We submit that depletion at two cents per ton is reasonable and should be allowed.

EXHIBIT D

JANUARY 6, 1923.

New Jersey Calcite Company, New York, N. Y.

LEASE OF CALCITE PROPERTY

Under date of March 4, 1922, the company was advised that this office would allow a value of $8,950.93 for two leases of calcite properties having a life of eight years which were transferred to the corporation for capital stock. This value the company would be allowed to amortize over the life of the leases at the rate of $1,118.87 per year.

From the above action the company appealed to the committee on appeals and review. The finding of the committee on appeals and review follows:

"After careful consideration of all facts presented, oral hearing having been had by the taxpayer, the committee concludes—

"(1) That the claim that certain mineral leases should be valued at $130,000 for the purposes of invested capital should be disallowed.

"(2) That the leases had a substantial value, which is fixed at $106,000.

"Accordingly the committee recommends that the appeal of the New Jersey Calcite Company be denied in part and sustained in part."

A. W. GREGG,
Chairman Special Committee on Appeals and Reviews.

Approved:

L. H. BLAIR,
Commissioner of Internal Revenue.

Based upon the above opinion the leases in question should be valued for invested capital purposes at $106,000; the company should be allowed to

amortize this value over the life of the leases, eight years, at the rate of $13,250 per year.

J. H. BRIGGS,
Assistant Chief of Section.

Approved:

C. C. GRIGGS,
Chief, Nonmetals Valuation Section.

Approved for audit January 8, 1923.

"Only on basis of committee ruling but not in accordance with the views of the division. It sets a bad precedent.

"FAY."

Routing and correction sheet, Natural Resources Division Audit Section F-1

SEPTEMBER 28, 1923.

To: Review section:

The following cases are forwarded for your action: Name, New Jersey Calcite Co. Address, 149 Broadway, New York City.

Prepared for review of the following years:

1916, overassessment	$198.7
1917, overassessment	13,145.47
1918, overassessment	15,659.30
1919, overassessment	781.94
	29,785.48

UNITED STATES GRAPHITE CO. CASE

INVESTIGATION OF BUREAU OF INTERNAL REVENUE

SATURDAY, DECEMBER 20, 1924

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

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

Present Senators Couzens (presiding), Watson, Jones of New Mexico and Ernst.

Present also L. C. Manson, Esq., of counsel for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, solicitor, Bureau of Internal Revenue; and Mr. S. M. Greenidge, head engineering division Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson, if you are ready?

Mr. MANSON. The case to which we desire to call your attention today is the claim of the United States Graphite Co., of Saginaw, Mich.

Your engineers and counsel take exception to the allowance for invested capital, which we claim to be excessive in the sum of $237,107.90, and which makes a difference in the tax of $32,070.51 for 1917 and 1918.

In addition to that we take exception to the allowance of depletion for all of 1918, subsequent to the month of April, and for all of 1919.

In view of the fact that we have not the data of the computation of this allowance, and its effect upon the tax, we are unable to state the exact effect upon the tax, except that the allowance of depletion for 1919 is $404,616.44, and for 1918 it is $64,766.12. How much of the latter amount accrued subsequent to the month of April, 1918, we are unable to ascertain.

We take exception to the basis upon which value for depletion purposes is figured, and for lack of sufficient information in the records, we are unable to determine what the depletion allowance would be if figured upon a proper basis.

This taxpayer is engaged in the manufacture of graphite products, such as foundry facings, paints, lubricants of all sorts, motor and generator brushes, electrical supplies, stove polish, boiler graphite and graphite for electrotyping, powder glazing, pencil making etc. The taxpayer manufactures practically all of the refined ground graphite used by lead-pencil manufacturers in the United

States, in addition to which it exports large quantities of ground graphite to England, France, Germany, and Japan.

Senator WATSON. Do you say that at the present time they manufacture practically all of the graphite for lead pencils used in this country?

Mr. MANSON. Yes, it is sold to lead pencil manufacturers, as I understand it, in the very finely ground, refined state, and by them it is pressed into lead pencil leads.

The mines are the property elements which are involved in the issues which we raise.

These mines are located in Mexico. The raw material is mined and shipped in crude form to Saginaw, Mich., where the factory is located. The company disposes of no raw material; that is, it does not dispose of what we would call crude ore. I do not know what the technical term for that is in the graphite industry, but what would be called crude ore in the case of iron is not disposed of. In other words, all of the product that it disposes of and all of the product that it mines is converted into a finished, marketable product, either ready for consumption by the ultimate consumer or for use by lead pencil manufacturers.

We raise no question and, in fact, there is no question raised in the record as to the value of any of the company's property outside of these Mexican mines.

There are two mines in the State of Sonora, Mexico. One was purchased in 1893, and there was given in payment of the purchase price $35,000 of the capital stock of this company. The other mine was purchased in 1918 for a cash consideration of $37,000. The second mine appears to be the more valuable mine. It is on a piece of property adjoining the first mine. From the fact that the working of the first mine has been practically suspended and all operations are carried on in the second mine, it would appear the quality of the ore in the second mine is better and that mining operations can be carried on there more economically.

Both for the purpose of determining invested capital and for the purpose of determining depletion, the purchase price of the first mine was ignored. The value for both depletion and invested capital purposes was determined by what is known as the analytical method. This method involves a rather intricate formula. I will try to state it in as understandable way as I can.

In the first place, the amount of ore in the ground is estimated. In this case, the estimated amount of ore in the ground was multiplied by the sale price of the finished product. By that, I mean the average price they received for paint, the raw material for lead pencils, for lubricants, and all of the other finished products which they sold.

I have gotten a little ahead of my story here.

The quantity of ore in the ground is multiplied by the price of the finished product, less the cost of the mining, the freight, and the cost of manufacture. In other words, the ore is valued by giving to the value of the unmined ore in the ground the total profit per ton made by the company in all of its operations.

Senator WATSON. You are speaking now of the basis used by the department, are you?

Mr. MANSON. Yes, sir; I am speaking of the basis used by the department.

That is the first step. In arriving at this value, they take the difference per ton between what they got for their merchantable products as they left the factory at Saginaw, Mich., and what it cost them to mine the ore, ship it to Saginaw and convert it into that finished product, including the overhead and sales expenses. In that manner, they arrive at the aggregate recoverable value of the ore in the ground, or at least their estimate of the aggregate recoverable value.

It is recognized in this formula that the value as of a particular date—in the case of invested capital, the value as of the date of the acquisition of the property; in the case of depletion, the value as of March 1, 1913—is necessarily less than the aggregate of this recoverable value, for the reason that they have to wait until they recover that ore and convert it into a finished product before they can secure this money.

They, therefore, reduce the total recoverable value, or the aggregate recoverable value, at the end of the period, by the application of two factors.

The first factor is what they estimate a purchaser of that property would accept by way of profit on his investment during the period from the basis date until the ore has been recovered. In this case, they estimate that profit as being 10 per cent.

The CHAIRMAN. In how many years?

Mr. MANSON. In 28 years. We take the position that 10 per cent is no more than the manufacturer engaged in a nonspeculative enterprise, with all of his property located in the United States would expect to make upon his investment.

In 1913 the basic date for the purpose of determining depletion allowance, Mexico was in a state of revolution. It had been in a state of revolution since some time in the year 1910, when Diaz was overthrown. In the year 1913, Madero had been overthrown: Huerta was about coming into power. One of the basic causes of the revolution in Mexico, at least one of the things upon which most of the revolutionary leaders based their propaganda, was their objection to the exploitation of the resources of the Mexican nation by foreigners. It is a well known fact that in the constitution adopted in 1918, all of these grants of mineral rights made prior to that time were denounced, and it was necessary for those who continued to hold property in Mexico to organize Mexican corporations and take it under the Mexican law.

I mention this fact to show that no person with any sense at all would think of investing a million dollars, the value they placed on this graphite mine, in 1913, or as of March 1, 1913, expecting to make no more than 10 per cent on his investment, under the sort of conditions which prevailed in Mexico at that time, particularly in view of the fact that 10 per cent is considered a conservative return upon a nonspeculative manufacturing business.

That is the first exception that we take to the application of this formula.

The CHAIRMAN. May I interrupt you there, Mr. Manson, to ask you if it is some such analytical formula as this that they use in the case of depletion of oil wells?

Mr. MANSON. It is a similar formula.

I desire to call the committee's attention to the fact that in determining depletion which took place before March 1, 1913, namely, from 1893, when this company first acquired this mine, up to March 1, 1913, they applied a 20 per cent profit factor. In other words, at a time when Mexico was under the Diaz rule, where property rights were respected, when there was no agitation and no revolution, when an investor was assuming practically no risk from the standpoint of the threatened overthrow of government, they took the position that an investor would expect a 20 per cent return. The result is that the depletion rate that they have applied to the ore that was taken out of the ground from the acquisition of the property up to March 1, 1913, is about $2.40 per ton, while the depletion rate that they have applied to the ore taken out subsequent to March 1, 1913, is eleven dollars and something a ton, the difference being the difference as the result of the application of 20 per cent and the 10 per cent rate.

Now, I got as far as——

The CHAIRMAN. Let us see about that. The result of that was to make a much larger depletion credit?

Mr. MANSON. Yes; subsequent to March 1, 1913, which depletion credit, of course, applied in the years 1917, 1918, and 1919.

The CHAIRMAN. Yes.

Mr. MANSON. To which we take exception.

My first exception, therefore, is to the use of the 10 per cent factor under the conditions which prevail in this case.

In this formula they also deduct 4 per cent as the sinking fund interest which would be earned upon the annual depletion allowances; so that at the end of the period they would equal the amount which they determined to be the value of the property.

To that factor we take no exception.

When they have thus reduced the aggregate of the recoverable values to a present value as of the basic date, whether it is the date of acquisition or the March 1, 1913, date, they then divide the reduced aggregate of recoverable values by the estimated tonnage in the ground. That gives them the depletion factor. The depletion factor is then only applied to the amount of ore mined, and the result is the depletion allowance for that year.

Senator WATSON. Have you the figures for any one year, Mr. Manson, to illustrate what you say?

Mr. MANSON. You mean to go all the way through and show the result?

Senator WATSON. Yes.

Mr. MANSON. Well, the depletion allowed for 1917 is $55,766.84. The depletion allowed for 1918 is $64,766.12.

The CHAIRMAN. The Senator wants to know what is the difference between your method and the method adopted by the bureau.

Senator WATSON. Yes; that is what I want to get at.

Mr. MANSON. I wish to say this, that we have not the data from which we could figure what a proper allowance would be, assuming that they are entitled to depletion.

For other reasons, I take exception to the depletion allowance made in 1918 and 1919, and I take exception to the entire allowance.

Senator WATSON. That is to say, for that year you would have allowed no depletion?

Mr. MANSON. No depletion, for the reason that they did not own the property in those years. I am coming to that.

Senator WATSON. All right. I did not mean to interrupt the trend of your argument.

Mr. MANSON. When we come to the matter of silver and copper mines which we expect to call the committee's attention to, I expect to go into this formula with a good deal more care than I have attempted to go into it with at this time, in order to show how the formula itself operates. At this time, I am merely taking exception to that factor.

Senator WATSON. Do I understand from that that this formula is applied in coming to a conclusion or reaching a basis for the assessment of taxes, in connection with the matter of depletion as related to all mines?

Mr. MANSON. To all mines and to oil. They also apply it to discovery value in the case of oil.

The factors used in this case are as follows:

The average selling price from 1907 to 1916 of the finished product is $113.86 per ton. The cost of mining and of converting the product into the finished product, including the selling cost and overhead, is $55.21. The freight during the years 1914, 1915, and 1916 was $10 a ton, and that was accepted as the basis.

The average profit upon those figures would be $48.65. By reason of some adjustments in those figures, which do not appear, the actual amount accepted as the value of the ore in the ground, was $46.42, but it was determined upon the basis of the figures that I have just mentioned, with some adjustments, which makes a difference of about $2.20 per ton.

Right at that point, in connection with the freight, I want to call the attention of the committee to the inadequacy of this factor of 10 per cent. One of the things that any purchaser of such a property would consider would be the cost of freight to get his product to market. They have accepted here $10 a ton, which was the freight in 1914, 1915, and 1916. The present freight rate is something like $16. That is one of the hazards assumed by a prospective purchaser, the hazard of an increase in freight rates, as well as the hazard of the confiscation of your property, and that is another reason why a 10 per cent factor is wholly inadequate.

I now call the committee's attention to article 206 of Regulations 62, as follows:

> The determination of fair market value of mineral property, other than oil and gas.
>
> * * * The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date.

And down at the foot of page 87, which I am reading from, appears the following language:

> Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight: * * * if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer, or to extrinsic causes.

I would call the committee's attention to the fact that in using the profit per ton made by the taxpayer and the value of the ore in the mine, the bureau has given to the material mined in Mexico all of the value which arises out of the use of the plant in Saginaw, Mich., which arises out of their organizing, their manufacturing and their selling ability; they have given to that raw material which has not yet been mined all of the value which arises out of the good will of this company; they have given it all the value which arises out of the business genius of the management of this company.

This regulation provides that the value of the ore is to be determined by the price that would be paid by a willing buyer to a willing seller of the mine down in Mexico, and I submit that it is a long ways through a route of business hazard, traveled by business judgment, business management, and business genius, as well as contributed to by the invetment in the plant at Saginaw, and contributed by such value as is attached to that concern in the shape of good will, between the raw material in the mine and the place where it finally leaves the consumer in the market in the shape of paints, lubricants, and the other products which I have mentioned.

It was to call the committee's attention to that fact that at the opening of my remarks I stated as fully as I did the nature of the products of this concern.

With the exception of the raw material, the refined, ground, raw material used by lead pencil manufacturers, practically all of this ore that goes on the market at a price which has been made the basis of this valuation, goes onto the market in condition to be used by the ultimate consumer.

Senator JONES of New Mexico. If it will not interfere with the trend of your thought, how did they handle the question of the fluctuations in the market value of the finished product?

Mr. MANSON. In the first place, there is practically no fluctuation. This company has a practical monopoly of this business. There is, of course, some fluctuation, but that fluctuation is taken into consideration by averaging. They average the market value; that is, they average the actual prices received per ton by the company for its finished product between 1907 and 1916. They average the cost of converting that ore in the ground into this finished product. They deducted the average cost of this conversion from the average price received, and got a figure of about $46 a ton.

The CHAIRMAN. Over how long a period did they average it?

Mr. MANSON. They averaged it from 1907 to 1916, inclusive.

Senator JONES of New Mexico. What about the fluctuation in labor costs and other costs?

Mr. MANSON. Of course, they do not make any allowance for the fact that labor is liable to increase. That is one of the elements that will have to be stood out of the 10 per cent profit, and I would call the attention of the committee to the fact that, for instance, in the year 1916, the cost is $67.33 a ton, and the profit per ton is $63. In other words, the cost is over 50 per cent of the total selling price, and a very marked increase in that cost would soon wipe out that 10 per cent profit.

Senator JONES. Let me understand you. Does it show there that the actual profit was about 100 per cent?

Mr. MANSON. Just about 100 per cent—a little less than 100 per cent. It will average about that.

Senator JONES. And yet they figure a profit of 10 per cent in arriving at it?

Mr. MANSON. Yes, sir.

Senator JONES. On the ore in the ground?

Mr. MANSON. Yes. I would call the committee's attention to this fact, that if you will go back and take into consideration what actually happened in this business, you will get some fair idea of the margin of profit that was expected, and that was actually received.

This company owns two graphite mines located on adjoining property in Mexico. These two mines produce the finest grade of graphite porduced anywhere in the world.

This company owned and operated what I will call mine No. 1, from 1893 to 1918, before it acquired mine No. 2. It was making a tremendous profit upon a $35,000 investment in that mine. It made enough profit on a $35,000 investment in the first mine so that the bureau gives that first mine a value of a $1,000,000 and over in 1913; yet, in 1918, five years after the first mine is valued at one million and some odd thousand dollars, the company acquired the second mine for $37,000 cash.

Now, that is not due to development costs. This ore lays practically on top of the ground; it is near the surface and outcrops all along the surface. The mining operations are carried on from the surface. There are no shafts, and all cost of development is charged to operating expense. The company itself does not capitalize any development costs.

The CHAIRMAN. What value did they put on the 1918 mine, when they purchased mine No. 2?

Mr. MANSON. Of course, that having been purchased subsequent to March 1, 1913, they had to carry that at what they actually paid for it.

Mine No. 2 is the one that is at present the principal source of supply of the company, the operations in mine No. 1 having been either entirely, or to a large degree, suspended. The only assumption that I can draw from that—the fact does not appear from the record, but I feel justified in assuming that it is because they can mine the product of mine No. 2 more economically, or that it is of a better grade. They must have some reason for having gone over to their mine No. 2 instead of mine No. 1.

Mine No. 2 is carried, for purposes of calculation, at $37,000, while mine No. 1 is carried at over a million dollars.

Senator JONES. Although they actually cost about the same amount?

Mr. MANSON. Although they actually cost about the same amount.

I take the position that under these regulations, where the market value of this property can be determined by actual sales which took place in the neighborhood of similar property, the analytical method can not be used.

In this instance, we have the second mine on an adjoining property, located in Mexico, and the same or a better grade of ore similarly situated in the ground, mined under similar conditions, with an estimated quantity of ore greater than the first, and an actual sale of that mine, in 1918, for $37,000, and, as far as governmental conditions

were concerned, there was a very little difference between the revolutionary state of Mexico in 1918 and the revolutionary state of that country in 1913. So that those conditions were about the same.

As to the use, as I have stated before, this first mine was acquired for $35,000 par value of the capital stock of the taxpayer. Subsequently, the taxpayer paid in the neighborhood of $35,000 for the purpose of defending title. Assuming that this defense of title is a properly capitalized item as against the cost of property, it would make an aggregate of about $70,000.

For purposes of invested capital, this property is estimated to be worth as of the date of acquisitions, $307,149.08; in other words, $237,137.90 more than the aggregate of the par value of the capital stock and the cash expended for the defense of title.

I now read from section 207, subdivisions (a), of the revenue act of 1917, which covers this condition:

> In 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 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)—

That is the provision of the act which covers this situation. In other words, they fix the value on this property nearly $300,000 in excess of the par value of the stock paid in in direct defiance of that provision of the statute.

In 1918, the Mexican Government denounced this property and laid it open to claim. At that time, the Mexican corporation was organized, of which the taxpayer is the sole stockholder. That Mexican corporation has owned these mines from sometime in April, 1918, to the present time.

I take the position, therefore, that this taxpayer is not a mine owner; it is a stockholder in a company which does own a mine, and comes directly under the provisions of article 201 of Regulations 62, which provides:

> Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a stockholder in a mining or oil or gas corporation is not allowed such deductions.

It seems that depletion was allowed for the whole of 1918 and 1919, in the amounts which I have already stated, upon the theory that the taxpayer had in its possession at Saginaw, Mich., or en route to Saginaw, Mich., at the time these mines changed hands, enough raw material to carry it through 1919. I submit that it was in no different situation than a coal dealer in the city of Washington who may have enough material on hand to meet his trade for two years. That does not make him a coal miner nor the owner of any coal mine, who is entitled to depletion under the provisions of this act.

I will call Mr. Parker.

Senator JONES of New Mexico. I am just wondering whether it is necessary to go further. Mr. Manson has made this statement, and why should not that statement be accepted, unless there is some objection to it on the part of the bureau?

The CHAIRMAN. If agreeable to Mr. Hartson, I think it should be handled in the same manner as we handled the case of the United

States Steel Corporation. Here is the statement of counsel, not yet controverted, and if the bureau wants to controvert it, they will have an opportunity. But, in the meantime, there is no necessity for taking any further evidence on it.

Senator JONES of New Mexico. That is the way it strikes me.

Mr. HARTSON. The chairman will recollect that during one of the sessions, when Senator Jones was absent, I made the very suggestion that, upon counsel's statement, the bureau would then put on its proof rather than to go through the form of calling the committee's engineers and their agents to, in a sense, sustain the opening statement of counsel. I think that would save time and we will make better progress that way. That is thoroughly satisfactory, then, to the bureau, to have the bureau now put on its proof on Mr. Manson's statement in this case.

Senator JONES of New Mexico. Yes.

The CHAIRMAN. I assume you are not ready to do that this morning?

Mr. HARTSON. The files, Mr. Chairman, have been in the possession of the agents of the committee for the last two or three days, and I have had no opportunity to go through them. I knew, in a general way, and anticipated that this case was coming up this morning, and I talked it over with our men, but not in connection with the papers, and I would therefore request that I be given an opportunity of two or three days before we put in our proof on it.

The CHAIRMAN. In other words, that we shall wait for a reply from you in this case, the same as we are waiting for your reply in the case of the Steel Corporation?

Mr. HARTSON. Yes.

Senator JONES of New Mexico. I would like to ask just a few further questions for information. This is the first mining case that we have had, and it will involve the whole procedure regarding depletion of mining property. I would like to ask how they estimated the amount of ore in the ground.

Mr. MANSON. Mr. Burdick, who was the engineer in this case, is here, and he can tell you how they arrived at it.

STATEMENT OF MR. CHARLES ADRIAN BURDICK, VALUATION ENGINEER, NONMETALS SECTION, INCOME TAX UNIT, BUREAU OF INTERNAL REVENUE

Mr. BURDICK. The mine in question is a graphite mine, and is worked as a graphite mine.

Senator JONES of New Mexico. What is your position in the bureau?

Mr. BURDICK. I am valuation engineer in the nonmetals section of the Income Tax Unit.

Senator JONES of New Mexico. What is the scope of that term as used by the department?

Mr. BURDICK. It consists of all the different minerals which do not contain metals, except oil and coal.

Senator JONES of New Mexico. Name what it consists of.

Mr. BURDICK. It consists of sand, limestone, graphite, talc, soapstone, cement, clays; that is, fire clays—there are about 60 of them all told.

Mr. MANSON. Coal?

Mr. BURDICK. All except coal and oil.

Mr. MANSON. I see.

Senator JONES of New Mexico. You may go ahead now.

Mr. BURDICK. It was originally a coal mine which was metamorphosed by igneous nitrates and warped, and the coal became graphite, lying between walls which had been so warped that it is not always easy to follow, due to the squeezing out of the graphite at certain points and thickening in others. This metamorphosed graphite is a very soft and unctious material, and is only mined a short way ahead of the faces, due to the caving and slipping of the material in the formation.

Mr. MANSON. You mean in the limestone?

Mr. BURDICK. No; in this particular case it is schist—an amorphous sedimentary rock, which is schist now. It is operated by shafts to a depth of from 300 to 500 feet in this particular mine.

Senator WATSON. Does that refer to both these mines?

Mr. BURDICK. The second mine, at the time we had this under consideration, was a prospect, or was so sworn to by the owners.

Senator WATSON. You say at the time you had it under consideration. When was that?

Mr. BURDICK. About six months ago, which was the last time it came to my attention. I believe it was before August.

Senator WATSON. No graphite had been taken from it at that time?

Mr. BURDICK. The prospect is operated now as the principal graphite mine. I believe in 1920 or 1919 they moved the machinery over to the new property. While they say they have not abandoned the old property, they are not operating it, due to the fact that they could mine more cheaply in the property acquired. The property acquired is about three and a half miles in a straight line from the old property, and they built a new roadway of some twenty-odd miles to the new point on the railroad. That railroad runs from Nogales City of Hermosillo, on the west coast.

Senator WATSON. How far apart are those two mines?

Mr. BURDICK. Three and a half miles on a straight line.

Senator WATSON. Is the graphite of the same formation, of the same quality, in both of these mines?

Mr. BURDICK. That is so stated by the taxpayer, that both mines contain the same quality of graphite.

Senator WATSON. What is the relative quantity contained in them?

Mr. BURDICK. We have no record as to the quantity in the new property.

The CHAIRMAN. Was there any physical examination made by the engineers?

Mr. BURDICK. No, sir; not from the bureau.

Senator WATSON. You took the statement of the taxpayer as to the quantity?

Mr. BURDICK. We had to take their sworn statement. That is according to the regulations, or the rules, anyway, of our department.

Senator WATSON. And as to prod[illegible]ion.

Mr. BURDICK. As to production?

Senator WATSON. Yes.

Mr. BURDICK. As to the production, Senator, the production may be smaller one year than another at the mine, but we give them depletion on the tonnage ground, as tonnage received from the mine, rather than as mined. You see, if you have a ton of ore mined in the ground, and it was sitting on the surface of the ground, you have not lost title to it. That does not take place until it is sold and you lose it out of your possession. This was in 1918 or 1919, and the section ruled that they were entitled to depletion in those years.

Senator WATSON. Because they had actually sold the output?

Mr. BURDICK. They sold the output in 1918 and 1919 that they had mined previous to 1918.

Senator WATSON. And as long as they hold it, you hold that the rule of depletion does not apply, because they still have it.

Mr. BURDICK. That is it.

Senator WATSON. Notwithstanding that it is taken out of the earth and is put on the surface of the earth?

Mr. BURDICK. That is right.

Senator WATSON. It would be the same thing if it had been put in sheds or on cars and allowed to stand. You hold depletion has not actually occurred.

Mr. BURDICK. Yes, sir.

Senator JONES of New Mexico. What information did you have as to the quantity of ore in these mines?

Mr. BURDICK. The sworn statement of the taxpayer showed the tonnage that they had mined up to 1913 and up to 1918 or 1919, and the estimate of the owners as to the tonnage in the mine as of that date.

Senator JONES of New Mexico. Did you find out how they made their estimates?

Mr. BURDICK. Unless a case is of sufficient size, it has not been customary, when the expense is so great, to check those things up. For instance, this mine is in northern Mexico, and at the time this case came up, the question was as to whether it was large enough to make an examination by the department, but as we did not have an engineer in that section, and as the expense would be considerable, the sworn statement of the taxpayer was accepted.

The CHAIRMAN. How long have you been in the department, Mr. Burdick?

Mr. BURDICK. Two years and three months.

The CHAIRMAN. Is there any other engineer who dealt with this case besides yourself?

Mr. BURDICK. There is.

The CHAIRMAN. You are not the only engineer who has dealt with it since the beginning of the case?

Mr. BURDICK. No, sir; it was originally valued in 1920.

Mr. MANSON. For purposes of invested capital, the first engineer recommended an allowance of $35,000 on mine No. 1 as of date of acquisition, and you recommended about $70,000; is that right?

Mr. BURDICK. Yes, sir.

Mr. MANSON. Who was responsible for the increase to $307,000?

Mr. BURDICK. I am not responsible for it. That occurred at a conference with the taxpayer before a special conferee.

Mr. MANSON. Did you agree with that?

Mr. BURDICK. I had no alternative in the matter. It was before a conferee.

Mr. MANSON. Did you make any protest?

Mr. BURDICK. I did, to my chief.

Mr. MANSON. Who was your chief?

Mr. BURDICK. Mr. J. H. Briggs.

Senator WATSON. You used the same formula to determine depletion in the case of this mine as in the case of all mines with deposits with which you deal?

Mr. BURDICK. When the actual valuation can not be determined otherwise.

The CHAIRMAN. Would you contend that the actual valuation could not have been determined otherwise in this case?

Mr. BURDICK. The data had not been submitted by the taxpayer up to that time on which we could value the property. It was in process of collection at this particular time, but it was sluggish to get it from the taxpayer.

Mr. MANSON. At the time you made the valuation as of the date of acquisition of mine No. 1, you had before you the amount they had paid for the mine, and based your valuation on that, did you not?

Mr. BURDICK. We had the statement that they had paid stock and certain cash payments for services, and defense of title, etc., and valued it on that basis.

Mr. MANSON. And you made that the basis of your valuation?

Mr. BURDICK. Yes, sir.

Mr. MANSON. You did not adopt the analytical method for the purpose of determining value as of date of acquisition?

Mr. BURDICK. I did not.

Senator JONES of New Mexico. Who did?

Mr. BURDICK. The conferee.

Senator JONES of New Mexico. Who is the conferee?

Mr. SHEPHERD. I am, sir.

The CHAIRMAN. What is your name?

Mr. SHEPHERD. Mr. Shepherd.

The CHAIRMAN. Perhaps Mr. Shepherd can tell us how he arrived at it.

STATEMENT OF MR. ALEXANDER R. SHEPHERD, DIVISION CONFEREE, BUREAU OF INTERNAL REVENUE

Senator JONES of New Mexico. What is your position in the bureau?

Mr. SHEPHERD. I am division conferee, Senator. I am called in when the taxpayer and engineer can not get together, in order to report to the head of the division, Mr. Greenidge, what the difficulty is, and to make recommmendations as to the method of settlement.

What is the question which you would like to have answered?

The CHAIRMAN. We had been asking as to how you arrived at the difference between the amount recommended by the previous witness and the amount actually agreed upon?

Mr. SHEPHERD. As has already been explained by your representative, I used the analytical method, which we have used in the metals section and in other sections as well.

Senator JONES of New Mexico. Is that in general use with respect to all mining properties?

Mr. SHEPHERD. There is a difference, Senator. In most mining properties it is, when you can not find a basis of arriving at invested capital. In this property there was a question of $35,000 worth of stock involved, and the law stipulates that the assets back of that stock represent its value. We used the analytic method in arriving at the value of the stock as of that date. Now, as a matter of fact, this case was set up the last time by the engineers for the taxpayer, and they were claiming invested capital as of date, amounting to about a total, with additions, of $780,000 odd, because they issued stock later and also had other expenses there. Of course, the details of the original valuation I had nothing to do with. I am called in there at the last minute to try to come to an adjustment with the taxpayer, which looks reasonable and equitable. Personally, from the experience that I have had, the whole answer to the thing is to arrive at what looks like a just and fair result. We have so many different cases and such a variety of conditions to meet that, to a great extent, it is a question of the personal judgment in the weighing of those conditions. You may have two reasonable men, and they will look at the thing differently.

Mr. MANSON. This provision of the law states that where tangible property is given in exchange for stock, the value of such tangible property for the purpose of invested capital shall in no case exceed the par value of the original stock or shares specifically issued therefor.

Mr. SHEPHERD. That is one section of the law, but there are other sections, and there have always been interpretations of the legal effect of that by the solicitor and by the committee.

Mr. MANSON. Will you cite us any interpretation of that law by the solicitor, or any other superior of yours, which holds that it does not mean what it says?

Mr. SHEPHERD. This is a question of a man exchanging his property for stock.

Mr. MANSON. And that is just what this law covered.

Mr. SHEPHERD. It would depend upon the basis of what year you are handling it there.

The CHAIRMAN. Your contention, then, as I understand you, is that if the value of the stock——

Mr. SHEPHERD. It is not reflected.

The CHAIRMAN (continuing). Just a minute—was in excess of the $35,000, then you took that into account?

Mr. SHEPHERD. Yes, sir; exactly.

The CHAIRMAN. Notwithstanding the fact that the law says par value.

Mr. SHEPHERD. In that particular phrase of the law. I think that is for 1917, if I am not mistaken?

Mr. MANSON. Yes.

Mr. SHEPHERD. If the taxpayer comes in and gives the actual facts of his case, we take those. I would say that the troubles that have arisen are two—the delay caused by the taxpayer in submitting his information, and the interpretation of that information when submitted. Now, there is a wide range of opinion, and the exper-

ience of the man, not only as a practical engineer, but as a practical business man, varies according to the conditions as applied to the individual case. One man takes a broad view, another man takes a narrow view. Personally, I think the regulations, if they are read in full and interpreted, allow an engineer of reasonable experience and knowledge to arrive at a fair answer.

Mr. MANSON. Mr. Shepherd, as conferee, you have sat in more cases than this one, have you not?

Mr. SHEPHERD. Yes, sir; I have been sitting in on from two to six or eight cases a day. In a great many of the cases that I sit in on I do not know the details. I am just called in on one particular point that needs to be settled, which was the case here.

Mr. MANSON. How many cases have you sat in in which this question of the determination of the value of property which was given in exchange for stock has been involved?

Mr. SHEPHERD. How many?

Mr. MANSON. Yes.

Mr. SHEPHERD. That would be pretty hard to say, sir. I have been in the department since February, 1920, and we have those cases right along.

Mr. MANSON. Has it been your custom and practice in all such cases to ignore the provisions of the statute that I have just read and substitute your judgment as to the basis upon which this value should be determined?

Mr. SHEPHERD. Not to ignore it, no; but there is the question what the facts presented by the taxpayer indicate.

Mr. MANSON. It has been your customary practice, as I understand it, then, that where the taxpayer presents facts which, in your judgment, show that the stock which was given in exchange for tangible property exceeded its par value, you allow what, in your judgment, its actual value was, instead of the par value?

Mr. SHEPHERD. If you mean by my own judgment, according to the facts in the case and the information submitted by the taxpayer—is that what you mean?

Mr. MANSON. Yes; I mean your judgment, based on all the information that you have.

Mr. SHEPHERD. Yes, sir.

Mr. MANSON. Can you furnish us a list of the cases in which you have held that the tangible value of property acquired in exchange for stock exceeded the par value of the stock for the purpose of determining invested capital?

Mr. SHEPHERD. I could not furnish you an accurate list; no.

Mr. MANSON. Well, will you furnish us with as good a list as you can?

Mr. SHEPHERD. That would cover all the work that I have done in the last four years.

The CHAIRMAN. Do you recall offhand any case right now?

Mr. SHEPHERD. No; I would not like to recall offhand any case, because I do not remember the details of the cases, Senator. These things are coming up one after another, you know. It is like skipping from one thing to another.

The CHAIRMAN. You have no record of these conferences; there is no stenographic or other record of them?

Mr. SHEPHERD. A record is generally kept by the engineer in charge of the case. I am just there to advise him and to try to reach a conclusion, and to get action in a business way.

Senator JONES of New Mexico. Who was the engineer in charge of this case?

Mr. SHEPHERD. Mr. Burdick.

Senator JONES of New Mexico. But he said he was not in charge of it until recently, as I understood him.

Mr. BURDICK. I was in charge at the time of the conference.

Mr. SHEPHERD. I was called into his conference, at the time of the conference with the taxpayer, and they told me they had settled all questions but this question of invested capital.

Senator JONES of New Mexico. It seems that in this case the engineer in charge did not recommend what was finally decided upon by you. What was it that caused you to overrule the engineer in charge?

Mr. SHEPHERD. I did not overrule him. I made the suggestion that he use that basis.

Senator JONES of New Mexico. Well, is not that overruling?

Mr. SHEPHERD. Not necessarily.

Senator JONES of New Mexico. What is it?

Mr. SHEPHERD. As a matter of fact, Senator, we do not tell the engineers down there that they shall do this or that. We realize that a man has a right to his own opinion. Now, I suggested——

Senator JONES of New Mexico. What is the purpose of calling you into the thing at all if what you have to do is not overruling?

Mr. SHEPHERD. Well, I agree with you perfectly that, from a business point of view, it should be.

Senator JONES of New Mexico. Then, when you suggested that the engineer change his method, was not that equivalent to a direction?

The CHAIRMAN. If I understood him correctly, he referred it first to his chief before it was done.

Senator JONES of New Mexico. I did not catch that.

Mr. SHEPHERD. Yes.

Senator JONES of New Mexico. To whom did you refer it?

Mr. SHEPHERD. I did not refer it to anybody. I made the suggestion to the engineer. Now, if he does not wish to sign the memorandum on that basis, he can pass it right on to the head of the office, to Mr. Greenidge. In this case he signed it, and his chief signed it. I never thought anything more about it.

Senator JONES of New Mexico. What was it that caused you to make the suggestion here?

Mr. SHEPHERD. The equity of the case, I thought.

Senator JONES of New Mexico. That he had better change the basis?

Mr. SHEPHERD. The facts presented by the taxpayer and the equity in the case. The taxpayer was claiming $780,000 all told for invested capital and his additions to it.

Senator WATSON. Have you ever used other statutes on this same subject that ought to be construed in connection with this matter, and when so construed, might make a modification of the rigidity of this language, and what are those statutes?

Mr. SHEPHERD. I can not give them to you offhand, sir. I can give you the regulations.

Senator WATSON. I am not interested in the regulations, but I am interested in the other statutes, and the consideration of those statutes together with this one—not the regulations, but the law. In oher words, I want to find out whether there are other statutes that will enable the engineer, in the exercise of his judgment, or a referee or other person to whom the case finally may be referred, to modify this particular statute that Mr. Manson has read?

Mr. SHEPHERD. In the regulations, the present worth method is mentioned.

Senator WATSON. I am not talking about the regulations.

Mr. SHEPHERD. That is the basis you go by principally down there. The main thing we are after is to get results and get the case closed.

Senator WATSON. You said that an individual, yourself, for instance, will go over the whole proposition and come to what you think is a legitimate result under all the conditions presented.

Mr. SHEPHERD. Yes, sir.

Senator WATSON. But suppose all the conditions presented cause you to arrive at a conclusion which is at variance with the particular statute of law on the subject. Then, do you set aside the law and use your own judgment, or do you take the law into consideration in coming to a conclusion?

Mr. SHEPHERD. I take it into consideration in coming to a conclusion; yes, sir.

Senator JONES. The Solicitor of the Department is here, and I would like to ask Mr. Hartson if he has in mind any regulation or decision which modifies this provision of the statute?

Mr. HARTSON. I do not understand that this settlement was a settlement under the 1917 law.

Senator WATSON. Is this the law of 1917?

Mr. MANSON. Yes.

Mr. HARTSON. Mr. Manson read from the 1917 act. Mr. Manson's interpretation of the statute, it seems, as he reads it, is very plain, and is correct. The language of the regulations, under the 1921 act must do violence to the law itself, because, as you will recognize there, the value of the property exchanged for the stock shall be the basis for determining the invested capital on the basic date.

Senator WATSON. Now, let me ask you a question right there, will you, Mr. Hartson?

Mr. HARTSON. Yes.

Senator WATSON. You say that this particular case was not settled under the 1917 act. Under what act was it settled?

Mr. HARTSON. Under the 1921 act.

Senator WATSON. That 1921 act repealed this particular section that Mr. Manson refers to?

Mr. HARTSON. I am not prepared to answer that on this particular point, Senator.

Mr. MANSON. My point is that they were determining tax for 1917. They were determining the invested capital, which would be a factor to be used in determining the 1917 tax.

The CHAIRMAN. Mr. Hartson, can you read that part of the 1921 statute which you believe liberalizes the 1917 statute?

Mr. HARTSON. I have not here the provisions of the 1921 statute, except on the deductions allowed under section 214 (a) of the 1921 act, which reads as follows:

That in computing net income there shall be allowed as deductions:
(10) In the case of mines, oil and gas wells, 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.

Mr. MANSON. We are talking about invested capital, Mr. Hartson.

Mr. HARTSON. I recognize you are.

Senator WATSON. There are no regulations, Mr. Hartson, governing that absolutely or directly contravening the statute, are there?

Mr. HARTSON. If there were, they would be entirely unlawful.

Senator WATSON. Precisely. That is what I want to get at. Therefore, I am wondering—and this is all new to me—I am wondering whether or not a conferee's action, as the action of Mr. Shepherd in this particular case, took into consideration the express provisions of the statute, or whether there were other statutes which, construed in connection with this statute, would enable him to modify the rigors of this particular case, as it would work a hardship to follow the specific terms of the law?

Mr. HARTSON. My understanding has always been, Senator, that the actual value of the property, the fair cash value of the property at the date it was turned in for the capital stock of the corporation was the determining thing in arriving at the figure for invested capital purposes. The section of the 1917 act which I have not recently had an opportunity to examine, in connection with this question, appears to limit that value to the par value of the stock exchanged therefor. I do not want to say definitely that that has been amended, but I think it has. I think there has been a substitution there, so that the actual value, regardless of the par value of the stock that was exchanged, shall be considered by the bureau for invested capital purposes.

Senator JONES. In the act of 1921, there was no provision for ascertaining invested capital, was there?

Mr. HARTSON. No; there was not, Senator. The excess profits tax was eliminated.

Senator JONES of New Mexico. Yes; and there was no longer any occasion for ascertaining invested capital.

Mr. HARTSON. However, there was occasion, under the 1921 act, in settling cases that were still under consideration.

Senator WATSON. That is right. That is what I want to get at. You will remember, Senator Jones, when we passed that law, the question came up about the settlement of cases arising under the law of 1917, and which should be disposed of and settled.

Senator JONES of New Mexico. I agree with you, that we did try to handle that to some extent.

Senator WATSON. Yes.

Senator JONES. But I do not recall that there was any attempt to modify the provisions of the law regarding invested capital, because, under the 1921 act, it was not necessary to ascertain invested capital.

Mr. MANSON. I have not looked up the matter of whether or not there is a subsequent amendment, for the reason that the 1917 act must govern the liability of the taxpayer to pay the 1917 tax, and a taxpayer who has paid his 1917 tax pursuant to the 1917 act would clearly be prejudiced by the liability of a taxpayer under the 1917 act who had not paid his tax, and whose rights had not been determined——

Senator JONES of New Mexico. I think it may be said generally that it was never the intention of Congress to change the liability of taxpayers for years preceding that covered by the new law.

Mr. HARTSON. It is quite possible that if a change were made—and I have not made the definite statement that one was made—it would affect equally all cases, regardless of whether some of them——

Senator JONES of New Mexico. Yes; but I think we can safely assume that Congress never intended to modify or change the liability of the taxpayer for preceding years.

Senator WATSON. That is my recollection.

Senator JONES of New Mexico. Yes.

Mr. MANSON. That is the assumption that I have gone on.

Senator JONES of New Mexico. I think it is a very safe one.

Mr. HARTSON. I would like to request of the committee an opportunity to report on this and to give the result of my search and investigation at our next meeting on this definite point, namely, the limitation of the bureau in fixing invested capital at the point of the par value of the stock when exchanged for property as of a basic date.

Mr. MANSON. For 1917?

Mr. HARTSON. Yes.

Senator JONES of New Mexico. You will be accorded that privilege, of course.

You are an engineer by profession, Mr. Shepherd?

Mr. SHEPHERD. Yes, sir. The practice down there has been, in working from a practical standpoint, to work the case when the taxpayer's statement is final and we have full information on the case. We then take the case and work it through on that basis; that is, the auditor does. The adjustment of it, on the other hand, is really out of our category.

The CHAIRMAN. I would like to ask Mr. Hartson in this connection if he has ever had any litigation with the taxpayers on the question of amortization or depletion?

Mr. HARTSON. We have had considerable litigation over depletion, Senator. We have a case now before the Supreme Court of the United States, involving the question of depletion. That is the Alworth-Stevens case. So far as I know, we have relatively little litigation over these questions, but we are in court in several depletion cases.

The CHAIRMAN. You are not in court on any case involving amortization, though?

Mr. HARTSON. I would not say that we are not. We are not, so far as my knowledge goes, but I do know that there are several depletion cases where we are in court. I do not know of any amortization cases where we are in court.

The CHAIRMAN. In other words, all of the amortization cases have evidently been settled in agreement with the taxpayer, then?

Mr. HARTSON. I think that is a correct statement, subject to one or two cases that I do not know about, where we are in court.

Mr. MANSON. You had this case down at Hampton.

Mr. HARTSON. Yes, sir; that was the amortization of street railway facilities.

Mr. MANSON. Yes.

Mr. HARTSON. Yes.

Mr. MANSON. Mr. Shepherd, you stated that the engineer is supposed to protest to the chief engineer, if he is not satisfied with your recommendation. Do you know whether this engineer protested to the chief engineer?

Mr. SHEPHERD. I do not. He could probably tell you.

Mr. MANSON. To whom did you protest [addressing Mr. Burdick]?

Mr. BURDICK. I protested to Mr. Briggs.

Mr. MANSON. Who is Mr. Briggs?

Mr. BURDICK. The gentleman on my right.

Mr. MANSON. I know, but what is his position?

Mr. BURDICK. He is chief of the nonmetals section.

Mr. MANSON. I should like to ask Mr. Briggs what he did about it, when you protested to him.

Mr. BRIGGS. Do you want me to answer that?

Mr. MANSON. Yes.

Mr. BRIGGS. I told him that I would not go any further.

Mr. MANSON. You did not protest to Mr. Greenidge?

Mr. BRIGGS. No sir.

Mr. MANSON. Why not?

Mr. BRIGGS. I could explain that better, perhaps, by stating that Mr. Greenidge had as a result of two protests that I had made to him on cases, advised me that, practically, as I read his memorandums to me, he did not want me to protest. In other words, I stated that I had been hit on the knuckles two or three times and I proposed to stand on the signature of the conferee, which I considered protected us.

Mr. MANSON. You say "memorandums."

Mr. BRIGGS. Yes, sir.

Mr. MANSON. Do you mean that Mr Greenidge sent you memorandums telling you not to protest?

Mr. BRIGGS. Well, I can read the memorandum, and you can interpret it for yourself.

Mr. MANSON. I wish you would. Had you received this memorandum that you are about to read prior to the time that this United States Graphite company case was brought to your attention?

Mr. BRIGGS. I had, sir.

Mr. MANSON. Go ahead and read it.

Mr. BRIGGS. This was a case which I protested, and Mr. Greenidge sent it back.

Mr. MANSON. What is the name of the case.

Mr. BRIGGS. Climax Firebrick Co., Climax, Pa. I will not read this whole memorandum. He says in conclusion:

This case will be closed in conformity with conclusions reached at this conference.

The next case that I protested was——

Mr. HARTSON. Let us have the whole memorandum. I think it is unfair to read just a portion of it. I do not know what it says, but I think he should read the whole thing in.

Mr. BRIGGS. This is the first protest. Do you want that?

Mr. HARTSON. Yes; I think he should read the whole thing.

Mr. MANSON. All right.

Mr. HARTSON. If it is material at all.

Mr. BRIGGS. This is dated January 28, 1924, and bears the symbols "IT:eN;MN–JHB."

Mr. S. M. GREENIDGE,
Head Engineering Division,
Re: Climax Fire Brick Co., Climax, Pa.

Enclosed are data in the case of the above-mentioned company, also conference memorandum and valuation memorandum of this unit based upon instructions given in conference.

The questions involved relate to value of leasehold of clay land as at December 31, 1900, at which time the Climax Fire Brick Co. (corporation) acquired the assets of the Climax Fire Brick Co. (partnership).

The leasehold in question was first acquired by a Mr. Bell, under date of April 24, 1899; under date of October 19, 1899, Mr. Bell assigned one-half interest in the leasehold to a Mr. Hows; these two composed the Climax Fire Brick Co. Life of leasehold is 20 years.

No bonus was paid for the leasehold, the clay being paid for on a royalty basis. No statement of any amount paid for one-half interest by Mr. Hows has been made.

The corporation issued $100,000 par value of stock, assuming liability for the assets of the partnership. The allocation of assets at that date makes no mention of leasehold.

In 1920, it appears that company returned Form F to this office in duplicate showing nothing paid for leasehold.

On December 10, 1923, a brief was submitted by the taxpayer in which a value for the leasehold at December 31, 1900, was placed at $250,453.83. This value was computed on the basis of earnings subsequent to acquisition (five year period) and a life of 50 years. Taxpayer was advised that the basis of valuation was not sound, that it would be necessary to base valuation upon data at or before the date of acquisition rather than upon data occurring subsequent to acquisition.

Taxpayer submitted a new brief dated January 10, 1924, in which the valuation is based upon the earnings of the partnership from October 1, 1899, to December 31, 1900, at which time the partnership assets were transferred to the corporation, and a life of 50 years.

In 1907, the company acquired a leasehold covering an adjoining property containing the same kind of clay upon the same royalty terms as in the lease in question, no bonus being paid. In 1919, the original lease expired and a renewal was made upon the same terms—no bonus. Based upon the fact that no bonus was required for the lease acquired in 1907, and that the original lease was renewed in 1919 without bonus, the royalty terms being unchanged this unit held that the original leasehold had no value. The word value as here used means the selling price (or cost) that would pertain between a willing buyer and a willing seller.

The taxpayer protested the holding of the unit and the question being referred to a special committee, instructions were issued to determine valuation based upon earnings from October 1, 1899, to December 31, 1900, making allowance for manufacturing profits, and a life of forty years. In accordance with a memorandum of the committee on appeals and review in the case of the Houston Collieries Coal Co., Cincinatti, Ohio, the valuation should have covered a period not exceeding the life of the lease.

The taxpayer states in support of the value claimed of the clay in question that the finished product is superior to that made from other clays and that it brings a premium in the market. Admitting that this is so, it is apparent that the taxpayer pays for this superiority in the raw material in that the royalty rate per ton is approximately double the royalty paid for other clays used in producing the same finished products.

In the discussion in conference the taxpayer was advised that the entire deposit could have been purchased outright for a mere fraction of the sum claimed for paid in surplus on the leasehold above. The taxpayer replied that the clay deposit had a comparatively low value to the fee owner as he had no ability nor capital to manufacture refractory products.

In this reply the taxpayer unconsciously recognizes the fact that the profits of the business are due not so much to the raw material as to the capital employed in the business and the ability of the management.

This is the same idea that has been expressed by Mr. E. C. Eckles in a discussion of the Portland Cement industry. An analysis of the elements that enter into the business of the conversion of the raw material into a finished product is set out in which it is shown that the raw material is a very unimportant factor (negative). The real factors are the ability of the management, catipal employed, perfection of processes, etc.

This matter is submitted to you for instructions as to further action.

J. H. BRIGGS.
Chief Nonmetals Section.

Mr. Greenidge, in his reply——

Mr. HARTSON. That is what I thought you were reading. I did not know that you were reading the other memorandum.

Senator JONES of New Mexico. I suppose it is necessary, anyway, to an understanding of the other.

Mr. BRIGGS. Yes. This is dated January 30, 1924, and bears the initials: "IT:En:SMG:"

Mr. BRIGGS:
Chief Nonmentals Valuation Section.
In re: Climax Fire Brick Co., Climax, Pa.

There is returned to you the case of the above-named taxpayer.

Conference report dated January 21, 1924, states:

It was finally agreed to accept the valuation claimed by taxpayer in principle, but to revise the factors involved in making his calculations on a fair and reasonable basis. The details are shown in accompanying valuation memorandum dated January 21 (IT:EN:NM:ESB) and the resulting figure of $200,456 was agreed upon as valuation of leasehold at January 1, 1901, this amount to be amortized over 40 years at rate of $5,011.40 annually.

This case will be closed in conformity with conclusions reached at this conference.

Head of Division.

I might state in this connection that after this case did go to the review section, it was sent back because of the point that I pointed out there, in regard to the life of the leasehold being only twenty years, and said that the valuation would have to be made on the basis of a twenty year life rather than on a fifty year life.

Senator WATSON. Do you regard the language used as instruction to you to not make any amortization allowance?

Mr. BRIGGS. Not in that one; no, sir.

Senator JONES of New Mexico. Right in that connection, if this will not be too great a diversion, what argument was presented by which he gave that lease any value at all?

Mr. BRIGGS. I was not at the conference.

Senator JONES of New Mexico. Oh, you were not?

Mr. BRIGGS. My engineers, neither of whom is here at the present, were on the case.

Senator JONES of New Mexico. It seems to me that the statement made by you or by whoever wrote that paper——

Mr. BRIGGS. I wrote that.

Senator JONES of New Mexico. I think that was a pretty sound statement, unless there are some facts not covered by it.

The CHAIRMAN. What is your next case, Mr. Briggs?

Mr. BRIGGS. The next case is the memorandum which was prepared by my engineer handling the case for me.

The CHAIRMAN. What is his name?

Mr. BRIGGS. Mr. Frank H. Madison.

Senator WATSON. Handling what case?

Mr. BRIGGS. Handling the Penn Sand & Gravel Co. case. The Penn Sand & Gravel Co. is located in Philadelphia.

Mr. J. H. BRIGGS,
Chief Nonmetals Section, Engineer Division,
Internal Revenue Bureau.

Re: Penn Sand & Gravel Co.

You will recall that when the case of the Penn Sand & Gravel Co. was returned from the committee of appeals and review, with the notation that discovery of sand and gravel had been allowed the taxpayer by the committee, I questioned the sworn affidavits exhibited by the taxpayer wherein it was stated that gravel deposits were unknown in Falls Township, Bucks County, Pa., prior to the discovery by James Mundy and associates in 1913. With this thought in mind, I examined reports of the Pennsylvania Second Geological Survey and the Trenton Folio of the United States Geological Survey.

In 1881, a geologist, Charles F. Hall, in describing the geology of Philadelphia, Montgomery, and Bucks County, states, concerning Falls Township in Bucks County, page 50:

"Gravel and river deposits cover the greater portion of the south half of the township. Near the northern edge of the gravel we find terraces and escarpments. These escarpments have a diagonal course across the township. The escarpments mark the successive courses of the Delaware River as it has gradually undermined the Cretaceous beds which are now eroded or concealed below the alluvial * *. The course of the river at one time has been on a line between Morrisville and Tullytown."

A rough sketch map of Falls Township, taken from the Trenton Folio of the United States Geological Survey, published in 1909, accompanies this brief notation. Referring to this map, it will be seen that two formations practically cover the township (a minor outcrop of gneiss is shown in red). These formations are called the Pensauken and the Cape May.

The Pensauken formation is one of gravel and sand on the higher terraces and capping hills and divides. The geologists of the survey comment concerning the Pensauken:

"In the Trenton quadrangle the Pensauken is the most important source of gravel; there is hardly a hilltop or divide capped by the formation which has not been pitted to obtain it." (P. 23, Trenton Folio.)

In other words, what they mean by "pitted" is the digging of the postholes to determine that there was gravel there, that there was a gravel formation there.

"The soils of the Pensauken formation are gravelly to clayey loams. In many localities a bed of silt from 1 to 3 feet thick covers the typical sand and gravel of this formation. (P. 23, Trenton Folio.)

"The widespread Pensauken formation consists, for the most part, of unconsolidated gravel and sand, most of which in this region is below the 130-foot contour. * * *.

"Sand predominates over material of larger size in the Pensauken, but gravel is common and boulders can hardly be said to be rare, especially at the base." (P. 15, Trenton Folio.)

The Cape May formation is gravel and sand and clay, forming low terraces; and includes some recent alluvium and swamp muck. The Government geologists (Trenton Folio, p. 16) comment concerning this formation:

"The Cape May formation is confined largely to the valleys of the present streams * * *. This gravel has long been known as the 'Trenton gravel.' When its deposition was completed glacial gravel filled the valley of the Delaware up to a level now 120 feet above the sea. * * *."

The Delaware River in past geological ages, notably after the glacial period, flowed from Trenton to Tullytown in a straight line rather than in the broad, sweeping curve it occupies at present. Great quantities of gravel and sand were carried by the river from the terminal moraines created by the retreat of the ice pack at the close of the glacial period. From those moraines to Trenton the river had a straight sweep, but the bend of the river at Trenton caused a damming effect and the river dropped a great portion of its load. There was thus built up a series of river terraces of sand and gravel roughly parallel and covering the south half of Falls Township.

In the light of the foregoing remarks, and of the geological evidences given on page 50 of the 1881 C 6, report of the Second Geological Survey of Pennsylvania; and the knowledge of the sand and gravel formations of Falls Township as shown in the Trenton Folio of the United States Geological Survey, it is difficult for this office to reconcile the recommendation of the committee that the taxpayer be allowed discovery with the language used in regulations 62, page 99, paragraph 5, wherein it is stated:

"(c) For the purpose of these sections of the act, a mine may be said to be discovered when * * * (2) There is disclosed by drilling or exploration conducted above or below ground a mineral deposit not previously known to exist and so improbable that it had not been, and could not have been, included in any previous valuation for the purpose of depletion." * * *

Respectfully,

FRANK H. MADISON,
Valuation Engineer.

I sent a copy of that, with a note attached to Mr. Greenidge for his consideration, with the view of having the matter brought up before the committee on appeals and review for reconsideration, and this is Mr. Greenidge's reply, dated February 16, 1924:

INCOME TAX UNIT, ENGINEERING DIVISION,
February 16, 1924.

Mr. BRIGGS,
Chief Nonmetals Valuation Section.

In re: Penn Sand & Gravel Co.

In reply to your undated memorandum concerning the above-named taxpayer, I wish to state that I have not examined this case but the information I gather from the report of Mr. Madison makes it apparent that the committee on appeals and review has allowed the taxpayer a right to discovery. Unless it can be clearly shown that this decision of the committee is illegal, I can not see how we can consistently ask the committee to reopen this case.

Throughout this division at the present time there seems to be a decided inclination on the part of some of the engineers to disagree with their superior officers and a continuation of such feeling will very soon result in complete disorganization.

This division must regard the decisions of the committee on appeals and review as its instructions to be carried out without question unless it can be shown plainly and unmistakably that any one decision is illegal.

It is my opinion that the above-named case should be closed in accordance with the instructions of the committee on appeals and review and also that something be done to curb the tendency of engineers toward the taking issue with the decisions or instructions of their superior officers.

S. G. GREENIDGE
Head Engineering Division.

The CHAIRMAN. In other words, you construed that as a knock on the knuckles?

Mr. BRIGGS. I considered that as advising me not to protest.

The CHAIRMAN. What is your position now?

Mr. BRIGGS. Chief of nonmetals section.

The CHAIRMAN. The same as it was at that time?

Mr. BRIGGS. Yes, sir.

The CHAIRMAN. So, when you continued to get knocks on the knuckles, you just decided to stop protesting?

Mr. BRIGGS. I tried to protect myself. My method of protecting myself was to put the man who disagreed with us, who was over with our signed papers, in the position of making him responsible for it. In that way I am protected. As a matter of fact, I was advised to do that.

Senator JONES of New Mexico. I do not think you could pursue any other course after that letter.

Senator WATSON. Do you construe that as an instruction to you in cases that had never been referred to the committee on appeals and review, or only in cases that had been; or had any cases come to you that have not been passed on by the committee on appeals and review?

Mr. BRIGGS. Our cases all come to us first for valuation, if practicable. They never get to the committee on appeals and review unless the taxpayer makes a protest, asking to have it go there.

Senator WATSON. You do refer a great many cases to Mr. Greenidge.

Mr. BRIGGS. To whom?

Senator WATSON. To your superior officer.

The CHAIRMAN. Mr. Greenidge.

Mr. BRIGGS. No, sir; those are the only two cases, I think, that I had a memorandum to him on.

The CHAIRMAN. Those are the only two cases that you have ever referred to him?

Mr. BRIGGS. You see, I have only been chief a little over a year, and these were soon after I took charge of this work.

The CHAIRMAN. These are the only two cases, then, that you have ever referred to him?

Mr. BRIGGS. Yes, sir.

The CHAIRMAN. And they both had been passed upon by the committee on appeals and review?

Mr. BRIGGS. Only one of them had been through the committee on appeals and review. The first case was the case that Mr. Shepherd, the witness here, had turned us down on.

The CHAIRMAN. In other words, there was no occasion for this routine unless there was a protest on the part of the taxpayer to the committee on appeals and review; is that correct?

Mr. MANSON. Or a special conferee.

The CHAIRMAN. Or a special conferee?

Mr. BRIGGS. Yes.

The CHAIRMAN. Do cases come to you from the committee on appeals and review, or are they sent by you to the committee on appeals and review?

Mr. BRIGGS. After they have been handled by the committee on appeals and review and have been passed upon, if there is any action changing our action, it comes back to us to write up a memorandum in consonance with their instructions and sign our name as approving the action of the committee on appeals and review. That is done regularly, in all cases.

Mr. MANSON. How is it in the case of a conference? If the conferee of the bureau agrees with the taxpayer as to a different method of determining valuation than that which has been used by your engineer, are you supposed to write up a report or memorandum conforming to the method agreed to in conference?

Mr. BRIGGS. The engineers here writes it up.

Mr. SHEPHERD. I will say right here that it is generally understood that it is agreeable to the engineer. In most cases when an engineer says, "I will not sign my name to that, I will not agree to it," I say, "All right; we will send the case up to the committee on appeals and review, or to the solicitor's office," which is our final court.

The CHAIRMAN. Are you still of the same opinion, that these discovery values should not have been allowed, Mr. Briggs?

Mr. BRIGGS. Well, they hardly should have been, but that was not the question here. This was a question of why I did not make a protest in the case of the United States Graphite Co.

The CHAIRMAN. Yes; I understand that was an explanation of that particular case, but I ask you now whether you are of the opinion that this discovery value should not have been allowed?

Mr. BRIGGS. I do not think so. I do not think there was discovery value to have been allowed in this case.

The CHAIRMAN. Our time is nearly up to-day, but before we adjourn, I would like to ask if Mr. Nash can verify the statement here that 200 employees of the bureau are working on cases for the committee? I observe in this morning's issue of the Post the statement that "Senate tax inquiry is called harmful to bureau morale." Upset to a certain extent, Commissioner Nash declared. Employs 200 workers, he tells committee. Interferes with progress, he adds, saying it has cost $100,000."

I would like to have you tell us where these 200 employes are working. Counsel does not seem to be able to locate them.

Mr. NASH. Mr. Chairman, in my statements before the Appropriations Committee I have always been asked as to where our various employees are assigned, and I made that statement from information which has been furnished me by the Income Tax Division.

The CHAIRMAN. Can you tell us who, in the Income Tax Division, said there were 200 employees working on this case?

Mr. NASH. Mr. Bright.

The CHAIRMAN. I would be glad to have you ask Mr. Bright to tell us where these people are working.

Mr. NASH. Yes; I will be glad to furnish a complete statement showing where these people are assigned.

The CHAIRMAN. It may be that we can aid in reducing the expense, if you will tell us where they are working and how they are working.

Mr. HAETSON. Mr. Chairman, with regard to the question which arose a moment ago as to the statutes in relation to computing the basis for invested capital, I find this situation to be true—as I have thought it over. I find that I am correct: That in the 1918 act, it was changed in order to permit of a value in excess of the par value of the stock issued in exchange for property.

Mr. MANSON. What are you referring to now: what particular section or page?

Mr. HARTSON. Part V, section 325 (a).

Mr. MANSON. That is quoted in the regulations somewhere, is it not?

Mr. HARTSON. Yes. This is the 1918 act, and it is Regulations 45, rather than Regulations 62. However, as Mr. Manson has said, the 1917 law must be used to determine the tax and the invested capital for the year 1917; so that quite properly—necessarily, in fact—conceding a case where the actual value of the property transferred was in excess of the capital stock issued therefor, for the year 1917, the invested capital should not be in excess of the par value of the stock; but for the year 1918 the actual value of the property transferred could have been used, and you have an apparent inconsistency there, which is made necessary by law.

Mr. BRIGGS. It could also be in 1917?

Mr. HARTSON. Yes.

Mr. BRIGGS. Article 63 of Regulations 41 provides for it under certain conditions.

Mr. HARTSON. I understand; but the limitations of law there that Mr. Manson has referred to seem to confine it to the par value of the stock issued in exchange for property; that is, for invested capital purposes.

Mr. MANSON. That is all I referred to, the determination of invested capital for 1917.

Senator WATSON. What does that 1918 act recite in this regard?

Mr. HARTSON (reading):

(2) 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.

Mr. MANSON. Is there not something about a record and report to be made to Congress on that?

Mr. HARTSON. This is a continuation of the same subsection:

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 the net income shown by the return, the value of the taxable 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.

Mr. MANSON. I would like to know whether such a record was made in this case. I do not suppose you can answer that now, but I would like to have that information furnished.

The CHAIRMAN. Does anyone here know whether that record was kept in case a resolution by Congress was passed?

Mr. HARTSON. I can not answer that, Senator.

The CHAIRMAN. Is there anyone here who knows whether that was kept?

Mr. NASH. Mr. Chairman, I do not recall of any specific record being kept. I presume, in the event that either branch of Congress should ask for such information it could be readily ascertained from the files. The record of each case is complete in itself.

Mr. MANSON. You mean that you would have to go back and search through all the files, seek them out and examine the records, the complete record in each particular case, in order to ascertain whether the invested capital was determined by appraisal, and if so, whether it exceeded the par value of the stock given for it?

Mr. NASH. Mr. Manson, so far as I know, no specific record has been kept of such settlements.

The CHAIRMAN. I think, perhaps, no record was kept, because I think the bureau is quite safe in relying upon Congress not asking for those things.

What shall we do now, as to the time of our next meeting?

Senator WATSON. I understand Senator Ernst does not want any meeting next week. I feel that way, too.

The CHAIRMAN. Is that your idea about it, Senator Jones?

Senator JONES of New Mexico. It is immaterial to me. I might say that Senator King told me yesterday that he would have to be away next week, and that he would prefer that the committee not have sessions next week. It is immaterial to me. I would like to go ahead, really, as our time is getting short, but I think, under all the circumstances, it would be better not to have any sessions.

The CHAIRMAN. I am not in disagreement with that, but I would like to get the committee to agree to take more time on this matter after the recess, than we have taken so far. Otherwise, we will not get anywhere at this session.

Senator JONES of New Mexico. I think we had better agree to do that.

The CHAIRMAN. Do you not think so, Senator Watson?

Senator WATSON. Yes; I will agree to that.

Senator JONES of New Mexico. Then, we had better change our place of meeting.

Senator WATSON. I would propose that we meet over at the Capitol, in the finance room, where we had our sessions last spring. It is very handy there.

The CHAIRMAN. I understand Mr. Hartson and Mr. Nash and some of the others would like to catch up on some of their work, and if it is agreeable to all, we will adjourn now until 10 o'clock on Monday morning, December 29. That is a week from Monday.

Senator WATSON. That will be all right.

The CHAIRMAN. Then, we will adjourn now until 10 o'clock Monday, December 29, at which time we will meet in this same room, and decide where we will hold our later sessions.

(Whereupon, at 11.55 o'clock a. m., the committee adjourned until Monday, December 29, 1924, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, DECEMBER 29, 1924

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 Saturday, December 20, 1924.

Present: Senators Couzens (presiding), Jones of New Mexico, and Ernst.

Present also: L. C. Manson, Esq., of counsel for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, Assistant to the Commissioner of Internal Revenue; Nelson T. Hartson, Solicitor, Bureau of Internal Revenue; and S. M. Greenidge, head of Engineering Division, Bureau of Internal Revenue.

The CHAIRMAN. The committee will come to order now.

Mr. MANSON. I understand that Mr. Hartson wishes to take up the United States Graphite Co. case this morning, and before the department presents its side of that case, I desire to make a correction of two statements that I made in my opening, which, I believe, are not borne out by the facts.

I want to say that, in presenting these cases to the committee, it is my earnest purpose to try to state the ultimate facts as briefly and as accurately as it is possible for me to do.

I did not receive the report of the engineers in this case until 9 o'clock on the evening before it was presented. That was due to no fault of theirs. They did not get their work done until then, and I had no opportunity to discuss the case with Mr. Parker after I had gone over their record.

The two corrections which I wish to make are there.

I stated that, in arriving at the value for purposes of depletion and the value as of 1913 for the purpose of invested capital, the engineers multiplied the estimated quantity of ore or graphite in the mines by the price of the finished product sold by the company, less the cost of manufacturing, sale and overhead. At that time, I stated that their finished products consisted of paint, lubricants, and other articles for consumption by ultimate consumers, and ground refined graphite, which was used by lead pencil manufacturers, and other manufacturers, the manufacturers of paints and lubricants.

I find that the record states that the company sells no raw materials, no raw ore as it is taken from the mines. My statement with reference to what that price was based upon was an inference which

I drew from the fact that the record states that they sell no raw materials. I do not believe the record supports my statement that the price of paints and oils and other finished products is the basis for determining the price used here. The record is not clear as to whether it is the finished paints and oils or the half finished, if I may use that term, materials, such as refined ground graphite, and I do not wish to base my objection here upon the theory that the price of paints and oils is included in that price.

The difference between those two bases is one of degree rather than of principle. In either event the investment in the factory at Saginaw, Mich., the capital of the company, the manufacturing organization, the selling organization and the selling expenses, all contribute to produce the basic price, even though all accept the price of this half-finished material.

The market for that half-finished material is created by personal effort, and I maintain that that is not a practical basis for determining the value of ore in the ground.

I think what would come nearest to the value of the ore in the ground would be, perhaps, the value of this material as it leaves Mexico and comes into the United States.

I called attention to the fact that the value given to this material for the purpose of computing these two values is $46.42 a ton.

I have here a copy of a telegram received by the Treasury Department, Division of Customs, on December 20, 1924, from Fowler, collector at Nogales, Ariz. This telegram reads as follows:

> Replying department wire to-day, the United States Graphite Co. has 7,103 short tons graphite, valued at $51,998, since January, 1924

That would be $7.32 per short ton, and that is the value fixed by the company in declaring the graphite at the United States border. That $7.32 a ton would include the cost of mining, and would include the cost of shipping it to the border; therefore, the value of the graphite in the ground, which is the value to be arrived at in determining the value of the mine, must be considerably less than the value of the graphite aboard cars at the point of importation into the United States.

The CHAIRMAN. Have you any figure showing what they valued it at when they brought the material in during the years under discussion?

Mr. MANSON. No, I have not. I will say this, that there was no tariff on this graphite until within the last two or three years.

The CHAIRMAN. Nevertheless, they would have had to declare a value.

Mr. MANSON. They would have had to declare a value, yes; but there was no tariff, and therefore no limitation; that is, any value declared would not be the basis of any payment of tariffs that they would have to make.

Senator ERNST. Where is this United States Graphite Co. located?

Mr. MANSON. In Saginaw, Mich.

The other correction that I wish to make is this: I stated the other day, with reference to the second mine, that that mine had a greater capacity than the first mine, which was valued. The committee will recall I took the position that inasmuch as the second mine was purchased for $37,000 in 1918, that that is now the mine

from which they are deriving their supply of graphite, that purchase price was evidence of the value of the first mine in 1913, particularly in view of the fact that the same governmental conditions existed in Mexico in 1918 as existed in 1913.

I find that there is no support in the record for my statement that that second mine was of equal or greater capacity than the first one. The record does show that in purchasing the second mine they acquired a great deal more land than they did in acquiring the first one. I think that was the basis for that assumption in my mind; that was the only thing I could find to support it, anyway, and I do not want to be inaccurate in my statements.

Senator JONES of New Mexico. Well, what is the relative value of the two mines?

Mr. MANSON. The fact is that the second mine is the present source of supply, and that after the second mine was opened—the second mine was purchased for $37,000—the old mine was abandoned. The second mine was bought in 1918 for $37,000, and the first mine was valued as of 1913 at over a million dollars. I do not know whether the Senator was present when I called attention to that.

Senator JONES of New Mexico. Yes; I heard that.

Senator ERNST. Who valued it in 1913?

Mr. MANSON. It was valued by the department in excess of a million dollars as of 1913.

Senator ERNST. And it was abandoned when?

Mr. MANSON. It was abandoned some time between the date of its purchase and the present time. It was purchased in 1918.

The CHAIRMAN. The last mine was purchased as of 1918, you mean?

Mr. MANSON. The last mine; yes.

Senator ERNST. Did you not say that the first mine was abandoned?

Mr. MANSON. The evidence of the engineer is that he did not know whether it was entirely abandoned, but the second mine is today the principal source of their supply.

Senator ERNST. Well, I was wondering why, if it was so valuable, it was so soon abandoned?

Mr. MANSON. I do not know that. The record does not show that. I understand that the theory upon which this value is figured is that, inasmuch as this company has a monopoly on this business, therefore their capital invested in the business, or, rather, the contribution of their capital invested in the business generally, by their organization, selling force, and those things, to the value of this half finished product, is not to be considered because of the monopoly feature. I wish to call your attention to the fact that in 1913, as of which date the first value was fixed, the second mine was lying there in Mexico. It was owned by other parties; it had not been worked; but the very fact that that mine laid there, with that graphite in it, from 1913 to 1918, available for anybody who saw fit to buy it and work it, in my opinion, destroys this entire monopoly theory, which is predicted upon their having at that time a monopoly of the graphite of this quality.

With those two corrections in the record, I leave my case as I stated it before.

Mr. HARTSON. Mr. Chairman, there are two elements of importance here in considering the United States Graphite Co. case. There were two valuations that had to be made by the bureau of the United States Graphite Co. properties as of two different basic dates. One valuation had to be arrived at for invested capital purposes for the year 1917, and the principal criticism made by counsel as to the method used by the bureau is directed to the year 1917. The other basic date is as of March 1, 1913, when the valuation for purposes of depletion had to be arrived at.

I think the evidence has shown that in 1893 or 1894, this corporation exchanged $35,000 of its capital stock for this first mining property, and that the bureau, when it was determining invested capital in order to arrive at the excess profits tax in 1917, allowed a value to be established of $342,000—that is just a rough figure as of the date of the exchange of the property for the stock in 1894.

Counsel has taken exception to that, and directed your attention to the provisions of section 207(a) of the revenue act of 1917 which, as he contends, limits the value which could be placed upon this property, for invested capital purposes, to the $35,000 of par value of the stock issued therefor.

I want to say in the beginning that the bureau has adopted the policy and the practice, in determining invested capital for the year 1917, when the property was actually acquired prior to January 1, 1914, to include as paid in surplus any excess value between the par value of the stock and the actual value of the property as they determined it.

Senator JONES of New Mexico. State that again, Mr. Hartson, please.

Mr. HARTSON. The bureau generally followed the practice of including the excess value of the assets transferred to the corporation in exchange for its capital stock, the excess of the actual value over the par value of the stock, as paid-in surplus.

Now, paid-in surplus is one of the elements of invested capital under the law of 1917, and I will bring this up to date.

The CHAIRMAN. Just a minute there. Where do you get your paid-in surplus in this case. I do not understand that.

Mr. HARTSON. I do not want to confuse the issue now with the reasonableness of the valuation, because I want to come to that later; but assuming for the present discussion that the assets or mine property had a value in excess of the $35,000, which was the par value of the stock issued therefor, then that excess value over the par value of the stock was included as paid-in surplus.

Senator JONES of New Mexico. You mean there was a paid-in surplus at the time of the exchange of the stock for the mine?

Mr. HARTSON. Yes; that is what I mean exactly.

The CHAIRMAN. That constituted an additional value of the mine over and above the $35,000 that was paid in?

Mr. HARTSON. Yes; that is it, and that was as of 1893 or 1894. I do not remember just the year.

Mr. SHEPHERD. 1893.

Mr. MANSON. Let me be clear as to that. Does not that, in effect, give a value to the property exchanged for stock greater than the par value of the stock?

Mr. HARTSON. Well, it does; it does for invested capital purposes.

Mr. MANSON. Yes.

The CHAIRMAN. Would that also apply to depletion, then?

Mr. HARTSON. The value for depletion has to be arrived at later on, and they do not ignore the first valuation, but there are certain changes that take place in the meantime. There were additional issues of capital stock by this corporation before 1913 and after the date of its organization.

The CHAIRMAN. You were speaking of the general policy of the bureau. Then, if the capital stock issued was much in excess of the value of the property, how would you determine the value of the stock? Would you take the statute requirements for that?

Mr. HARTSON. No; we would take the actual value of the property, and not give the par value of the stock. That is the maximum limit which may be given.

The CHAIRMAN. Then, you ignored the statute in dealing both ways with that question?

Mr. HARTSON. No; I do not so understand it, Senator.

Senator ERNST. I suggest that he be allowed to finish that explanation, and then, when he gets through, let us ask him about it.

Mr. HARTSON. I want to refer now to section 207 (*a*) of the revenue act of 1917, which defines invested capital, and I wish to read that portion of it that is material:

That as used in this title, the term "invested capital" for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money nor other property borrowed, and means, subject to the above limitation:

(*a*)--

Now, this is the definition, really, of "invested capital".

(*a*) 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, or 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),

That is the second element of invested capital—first, cash; second, the exchange of property for stock.

* * * and (3) paid-in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year.

Now, we have three elements, as I see it, that go to make up invested capital, and paid-in surplus is one of those elements.

The regulations that were adopted at that time were Regulations 41, which were approved October 3, 1917, and which carry into effect the provisions of section 207 of the revenue act of 1917, Article 63 of which reads as follows:

When tangible property may be included in surplus: Where it can be shown by evidence satisfactory to the Commissioner of Internal Revenue that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the

stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time.

Evidence tending to support a claim for a paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares.

Those regulations were promulgated soon after the enactment of that act.

The CHAIRMAN. I do not believe I have that clear in my own mind. If the statute desired to place a limitation upon the par value, the regulations do not seem to be in accordance with the statute, do they?

Mr. HARTSON. Senator, in my own view, I believe the regulations are not contrary to the statute. The statute contemplated that paid-in surplus shall be one of the elements of invested capital.

The CHAIRMAN. Does it not place a limit upon that, though?

Mr. HARTSON. Not upon paid-in surplus, but I do think, in subsection 2 of section 207 of the revenue act of 1917, they place a limit upon the value of the property which is exchanged for the stock, but then there are other elements which may be considered in there as making up invested capital.

Mr. MANSON. Mr. Hartson, permit me——

Mr. HARTSON. And I do not believe that it is directly contrary, or flying in the face of the statute.

The CHAIRMAN. You believe that the statute is rather contradictory, then?

Mr. HARTSON. I do. I do believe that is the situation there, and I would like to address myself to the reasonableness of it for a moment.

Mr. MANSON. While we are on that point, permit me to ask you a question to see if my mind is straight on it as to your position:

Assume this situation. We will say that this company acquired in exchange for $35,000 worth; par value, stock, a piece of property that was actually worth, in the judgment of the bureau, $335,000 at the date of its acquisition. The elements of invested capital are, as I take it, the cash that is paid for the stock, the property that is paid for the stock, and paid-in surplus. Is it your position that $35,000 would be considered as having been paid for the stock and that the $300,000 would be paid-in surplus?

Mr. HARTSON. That is my understanding.

Mr. MANSON. Then, would there be any force and effect whatever to be given to the provision of the statute limiting the value of the property to the par value of the stock?

Mr. HARTSON. I think there is force and effect given to it, but it is——

Mr. MANSON. Well, in that particular situation——

Mr. HARTSON. I think this, that in looking at the whole section, looking at section 207 rather than subsection 2 of section 207, you find it was contemplated by Congress that there should be recognized the real value of the property exchanged or put into the business of the company. There is in subsection 2 this limitation, which is placed at the par value of the stock, but which recognizes, on the other hand, that there may be additional assets transferred into that

corporation of a capital nature, identified as paid-in surplus. When they drew the regulations under that act they apparently recognized there must be a recognition of the value of capital assets transferred to a corporation, which together, later on, was considered as the invested capital of that corporation, or one of its elements which were in excess of the par value of the stock issued therefor.

I recognize, gentlemen, that there is an apparent inconsistency here. I believe there is. I believe what actually happened was that when they started to administer this act—and this, bear in mind, was the first excess profits tax act that we had, and no experience had been had upon it at all—they recognized, as soon as they had determined to change it, that the regulations under the 1917 act were substantially correct, and in the 1918 act they really put the 1917 regulations into effect.

Mr. MANSON. Now, Mr. Hartson, at that point——

Senator ERNST. You are speaking of the reasonableness of it. Do you wish to go further on that?

Mr. HARTSON. I certainly believe that the regulations, which were adopted by the Treasury Department in 1917, were justified by every reason. I think not only did the department recognize it but the Congress later recognized it and had it in mind, and certainly had before it when it passed the 1918 act, the departmental interpretation of the 1917 act; so, as Mr. Manson's example would point out to your mind, there is such a thing as transferring to a corporation in exchange for an issue of capital stock, property worth in excess of the par value of that stock.

Now, what is it but paid-in surplus? That is just what it is.

The CHAIRMAN. I agree with you in that case. I can conceive where, in other cases, there might arise any question like that.

Mr. HARTSON. That is what the department had before it. That seems to me, though, a contradiction of subsection 2 of section 207.

Senator JONES of New Mexico. What are the facts about paid-in surplus? When they exchanged this stock, had there been a paid-in surplus?

Mr. HARTSON. In this case?

Senator JONES of New Mexico. Yes.

Mr. HARTSON. What happened, Senator, was that when the department came to place a value on the assets transferred to the corporation in exchange for capital stock as of 1893, they determined a value which was in excess of the par value of the shares of stock; so the balance was treated as paid-in surplus.

Senator JONES of New Mexico. What was the basis for that treatment?

Mr. HARTSON. Well, do you mean how do we justify those figures?

Senator JONES of New Mexico. Yes.

Mr. HARTSON. I wanted to come to that later, after we had satisfied ourselves on this. The reasonableness of the allowance is another question entirely here, because the regulations do make it very positive that the basis for the allowance must be well established and must be reasonable.

Senator ERNST. You want to do that first, then, Mr. Hartson?

Mr. HARTSON. Yes.

Mr. MANSON. On this point, permit me to ask you another question:

In 1918, the Congress amended this act, so as to permit the placing of a higher value upon stock provided a proper record be kept of it, as provided in the statute. Do you not consider the fact that the Congress did so amend it, so that, to use your term, the statute conforms with the bureau's construction of it in 1917, evidences that an amendment was necessary in order to permit the placing of a value upon such stock in excess of the par value?

Mr. HARTSON. I think, Mr. Manson, Congress knew what the bureau had been doing in interpreting the prior act, and it was so well grounded in reason that I doubt very much whether the rule of statutory interpretation which is the basis for your question, has application here. There is that inconsistency; I am prepared to concede that. On the other hand, I do not believe that the law definitely and positively made the regulations unlawful.

Senator JONES of New Mexico. But Congress did not make the act of 1918 retroactive?

Mr. HARTSON. No, it did not.

Mr. MANSON. On this matter of the construction of the 1917 statute, I have one other question. Whether the value was to be treated on the company's books as a payment for stock or as a payment of paid-in surplus, the total amount that is given in exchange for the stock, and any surplus, is the value of the property, is it not?

Mr. HARTSON. That is right.

Mr. MANSON. If Congress had contemplated that the property could be valued in excess of the par value of the stock, then is there any force and effect to be given to the limitation in the act? In other words, does not such a construction of the act as you contend for construe the limitation out of the act?

Mr. HARTSON. It has that effect beyond question. It has that effect.

The CHAIRMAN. I can conceive of a situation arising which would make the rules and regulations of the bureau entirely within reason, although I do not admit that the bureau had the right to make reasonable regulations in contravention of the statute.

Mr. MANSON. Oh, I had not questioned the reasonableness of that.

The CHAIRMAN. No. I say that I can see where the interpretation of the bureau is entirely reasonable, but I do not concede that they would be right in overriding the statute, although I do see some contradictory elements in the statute.

Mr. HARTSON. There is this further thing, too, gentlemen, that should be mentioned: When these cases come up for settlement in the bureau, almost invariably 1917, 1918, and 1919 have been grouped together, those three years, in order to settle the war years at once. We have the 1918 act which, as I have said, bears out and really reenacts the regulations under the 1917 act, in a sense, different from the 1917 act; so that in settling these cases I am sure that, as a matter of policy, it was determined that these 1917 regulations, adopted a number of years ago, should be followed, even though they might be inconsistent to some extent with the law itself, in order to have a consistent basis on which the tax could be settled for several years.

Invested capital, as we all know, was an element carried through into the 1918 act, and fixing the invested capital for one year, it was extremely wise, from an administrative standpoint and practice, to have it determined on the same basis for the succeeding years; and to upset it and say that as of the same date, mind you, the same property had, for invested capital, one value, namely, the $35,000 of par value of the stock, and then as of the same date the same property, for the year 1918, had $342,000 value, or such other value as was reasonable, seemed to be inconsistent. I think the department had that in mind.

Senator JONES of New Mexico. What was the change made in the 1918 statute? Suppose we get that into the record.

Mr. HARTSON. That is shown under part 5 of the revenue act of 1918, section 326 (a):

That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) 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.

The CHAIRMAN. Can Senator Jones tell us why that provision was put in there? Do you remember, Senator, why that provision was put in there that they keep a record?

Senator JONES of New Mexico. It was intended that that feature of the statute should be kept separate, so that the Congress might know how and in what manner the statute was being administered.

The CHAIRMAN. Let us visualize a case like this on the question of the par value of this stock. Assume, for instance, the stock was earning 100 per cent and that when they purchased this property at $35,000 par value of the stock, they capitalized that property at 10 per cent earning capacity, then the property would be valued at $350,000, although they only turned in $35,000 par value of stock, but the value of the stock was really $350,000 when capitalized on a 10 per cent basis.

Senator JONES of New Mexico. Then, the method used by the bureau in determining that value of $350,000 has not appeared as yet, I think.

Mr. MANSON. I explained fully in the former hearing——

Senatro JONES of New Mexico. Well, may I get that formula, Mr. Manson, referred to the other day, that was used in this case in determining the value of that stock at the time?

Mr. HARTSON. I should like to answer that, Senator, by having our engineer, who is here, explain just what was done, the figures that were used, and the basis for it.

Senator JONES of New Mexico. I would like to have it.

Mr. MANSON. I will state this, that so far as the record in this case is concerned, there is nothing to show that any attempt was made to ascertain the market value of the United States Graphite Co. stock at the date that it was exchanged for this property.

Senator JONES of New Mexico. And was there any attempt made to get the actual value of the mine itself?

Mr. MANSON. It was according to the formula which I explained in the last hearing.

Senator JONES of New Mexico. There was no investigation or attempt made to get at the actual market value of the mine, as distinguished from the stock and earning capacity of the company?

Mr. MANSON. There is nothing that appears in the record of the case which indicates that any such attempt was made.

Senator JONES of New Mexico. I think the statute clearly implies that the value of the mine shall be ascertained independently of the stock, where it is claimed that it has value in excess of the par value of the stock or even if it has not. The par value element is clearly a limitation. In any case, it seems to me that the statute clearly implies that the actual value of the property shall be ascertained with reference to the marketability of such properties, and not as to the use to which it may be put, and it seems that in this case nothing has appeared, so far, at least, to indicate that that was done.

The CHAIRMAN. Let us have the statement of the engineer, now.

Mr. HARTSON. Yes.

The CHAIRMAN. As to how he arrived at the value of it.

Mr. HARTSON. Mr. Shepherd, will you take the stand, please?

Mr. MANSON. Is Mr. Shepherd the engineer who made the valuation?

Mr. SHEPHERD. No, sir; I am not.

Mr. HARTSON. No; Mr. Shepherd is not the engineer who made the valuation, but he is the engineer who, it was testified to, had agreed to this settlement in conference, and it was his suggestion which was followed by the engineers who actually made the investigation.

STATEMENT OF MR. ALEXANDER R. SHEPHERD, ENGINEER, BUREAU OF INTERNAL REVENUE

Mr. HARTSON. Mr. Shepherd, do you know whether a field investigation or examination was ever made of the properties of the United States Graphite Co.?

Mr. SHEPHERD. No, sir; there never was.

Mr. HARTSON. Where are they located?

Mr. SHEPHERD. They are located in Sonora, Mexico.

Mr. HARTSON. How far south of the United States border is that?

Mr. SHEPHERD. The State of Sonora borders the United States. I do not know exactly, but I should say that these mines are between two and three hundred miles south.

Mr. HARTSON. When was this valuation before the bureau; in what years?

Mr. SHEPHERD. If you will permit me——

Mr. HARTSON. I want to know, in point of time, when this was before the bureau for consideration, for determining the value for 1893.

Mr. SHEPHERD. They started this case in May, 1920. The last report was made on May 7, 1924. This is a small case, which has taken up much time, and I find upon reviewing it, that four reports were furnished by the taxpayer, twelve letters were written by him and his representatives, three valuation reports made by the nonmetals section, and five conferences were held between the taxpayer's representatives and the Government engineers. As I say, they started this case in 1920, and the last report was signed on May 7, 1924. Now, whose fault is it? It is no one's fault in particular, but everybody's fault in general.

Mr. HARTSON. Just what are you referring to now, Mr. Shepherd?

Mr. SHEPHERD. I am referring now to the way the thing functions, and I just wanted to give the Senators here an idea of the grouping of the thing. We will get down to value in a minute.

Mr. HARTSON. My only idea was to get down to the thing under discussion, when I asked you to take the stand.

Mr. SHEPHERD. All right. Excuse me.

Mr. HARTSON. I do not wish to shut off the witness. If, for any reason the Senators should desire to pursue this line of his testimony, I would be very glad to have him go ahead.

The CHAIRMAN. I would like to know why it took four years. It will only take a few minutes to state that. Let him go ahead.

Mr. SHEPHERD. I just want to give you an idea, Senator, of the trouble. I am a very poor talker, and I put the thing down on paper, to try to get it lined up.

Mr. HARTSON. Is that your own memorandum, Mr. Shepherd?

Mr. SHEPHERD. Yes, sir.

Mr. HARTSON. You wrote it yourself?

Mr. SHEPHERD. I was leading up to it to give you an idea of the work that had been done on this case before we finally got to a decision.

Here is the conference report of April 24, 1924, into which conference I was called.

Senator JONES of New Mexico. Suppose we take them chronologically. What was the first report in this case?

Mr. HARTSON. Do you wish to have the reports of the conferences as well?

Senator JONES of New Mexico. Let us have those reports.

Mr. SHEPHERD. Suppose we start with the taxpayer's information, as submitted, if that suits you.

Senator JONES of New Mexico. Well, take the report of the conference.

Mr. SHEPHERD. All right, sir. The first report was made on July 12, 1920. It was made on information submitted by the taxpayer on May 18, 1920, on what they call Form F of the nonmetals section. The taxpayer protested that.

The CHAIRMAN. What was that which he protested?

Mr. SHEPHERD. Do you mean the value?

The CHAIRMAN. We want the report.

Mr. SHEPHERD. You want me to read the whole report through?

The CHAIRMAN. If you have to, yes. If you can give us the substance of it, that will do, I suppose.

Mr. SHEPHERD. He arrived only at the 3-1-13 value.

The CHAIRMAN. What is that? He arrived at what?

Mr. SHEPHERD. At the March 1, 1923, value of $516,926.45.

Senator JONES of New Mexico. That was the value of what?

Mr. SHEPHERD. The value of the Santa Maria mine; the mine we are discussing, Senator.

Mr. HARTSON. That is, for purposes of depletion.

Mr. SHEPHERD. For purposes of depletion.

Senator JONES of New Mexico. What was the basis of that valuation?

Mr. SHEPHERD. July 13——

Senator JONES of New Mexico. Not the date—the basis.

Mr. SHEPHERD. The basis?

Senator JONES of New Mexico. Yes.

Mr. SHEPHERD. As I say, it was based on this incomplete information that was furnished by the taxpayer. Generally the first information furnished by the taxpayer is very scant. He gave no selling price and no profit.

The CHAIRMAN. What value did the taxpayer put on it?

Mr. SHEPHERD. The valuation as of March 1, he was claiming $516,000, the same figure I gave you before.

Mr. MANSON. That engineer's report is very brief, and I think it would be illuminating if it were read into the record.

Mr. SHEPHERD. All right.

Senator JONES of New Mexico. Just read it.

Mr. SHEPHERD (reading):

SECTION OF MISCELLANEOUS NONMETALS,
Washington, D. C., July 13, 1920.

THE UNITED STATES GRAPHITE CO., SAGINAW, MICH.—TAXABLE YEARS 1913 TO 1919, INCLUSIVE—INCORPORATED APRIL 20, 1891—MINING AND MANUFACTURING GRAPHITE INTO PAINT, LEAD PENCILS, FOUNDRY FACINGS, ETC.

1. The taxpayer owns two graphite mines in Sonora, Mexico, the Santa Maria mine and the Moradillas mine. The former was practically a gift. It was purchased as the Santa Maria Ranch of 6,250 acres in 1894 for $1,000 cash. The Moradillas mine was purchased in 1917 for $37,500, and both properties were subsequently denounced to conform to the new 1918 Mexican mining law and the company have absolute title to both mines. Development costs were apparently not capitalized, as practically little development work is done in advance of actual mining, owing to the nature of the deposits. The foregoing is all the data submitted as to costs, as a basis of valuation. The tonnages involved in reserves and removal of the two properties are not segregated in Form F.

2. Re Capitalizing profits as a basis of valuation: The operation is intimately interwoven between mining any manufacturing and the company have a practical monopoly of the product, so that there is no basis of comparison to judge the value of the raw product. The company manufactures their entire product. They produce an amorphous graphite and the only other source of the product is Chosen, Korea. The attached letters indicate the market value of this product, but it does not compete with taxpayer's product, because of inferior quality and prohibitive price.

The Mexican graphite mine is unique and in a class by itself. The average profit on manufactured graphite is $32.50 per ton, but the portion of this profit applicable to the mining operation is indeterminate. The tonnage estimated for both mines as of March 1, 1913, is 75,000 tons. If one-half the profits were assigned to mining, the mine valuation as of March 1, 1913, would be over a million dollars. In schedule for depletion with the 1918 return the taxpayer values the mine at $516,926.45, as of March 1, 1913, but does not state in the schedule, or in Exhibit E of Form F, how the figure is arrived at. If 5 per cent of the gross income for 1918 were taken as the allowable depletion

and multiplied by a 20-year life, as estimated as the life of the mine dating from March 1, 1913, the valuation would be nearly a million dollars.

In view of the above, the valuation of $516,926.45, as of March 1, 1913, as placed on the property of the taxpayer, appears conservative and it is recommended that it be approved. It is doubtful if anything would be gained by writing the taxpayer for additional information. Also mining conditions in Mexico are difficult, which suggests another reason for accepting the taxpayer's valuation.

3. Re depreciation: The amounts deducted in 1917 and 1918 are high. The rate should not be over 10 per cent of the depreciable assets annually.

ACTION TAKEN

Fair market value as of March 1, 1913, for graphite properties, $615,926.45; tonnage estimate as of same date, 86,298 tons; depletion rate, $5.99 per ton.

Year	Depletion claimed	Depletion allowed	Year	Depletion claimed	Depletion allowed
1913	None.	$26,176.30	1917	None.	$49,345.62
1914	None.	23,922.23	1918	$32,465.80	26,102.34
1915	None.	12,351.38	1919	None.	24,618.90
1916	None.	28,907.74			

JOHN SEWARD, *Valuation Engineer.*

Approved.

O. R. HAMILTON,
Chief, Metals Valuation Section.

The CHAIRMAN. Can anyone here tell me how it is no depletion was claimed, and yet large amounts were allowed?

Mr. SHEPHERD. Yes, sir; the law of depletion did not go in until 1918. Most of the taxpayers had not gotten wise to the fact that they should state depletion.

The CHAIRMAN. Was the law retroactive that went in force in 1917?

Mr. SHEPHERD. Well, as to the value as of 1913, I think it was, sir, because we figured them all that way in the beginning.

Mr. MANSON. It would necessarily be, in one way. We will say, in arriving at the amount of value in 1918, if the value of 1913 is used as a basis for arriving at the value of 1918, the depletion during the interval must be considered and deduction made from the 1913 value.

The CHAIRMAN. I get it.

Mr. SHEPHERD. In other words, they reduce their property as they go along.

Senator JONES of New Mexico. How much depletion had been allowed up to the year 1918 or 1917?

Mr. SHEPHERD. On that value?

Senator JONES of New Mexico. On that value; yes, sir.

Mr. SHEPHERD. One thousand and odd dollars.

Mr. MANSON. Up to what date was that?

Mr. SHEPHERD. That is through 1916, according to the pencil memorandum here.

Senator JONES of New Mexico. Well, deducting that $1,000 from the $50,000-odd valuation put on it by the taxpayer would leave how much? Is that on your memorandum there?

Mr. SHEPHERD. No, sir; it is not.

Senator JONES of New Mexico. Well, what would it be?

Mr. NASH. It would be approximately $425,000, Senator.

The CHAIRMAN. Proceed now with the next report, the report of 1920, as I understand it?

Mr. MANSON. I have never been able to understand that $1,000 that that engineer found was paid for the property.

Mr. SHEPHERD. That is explained in the reports of the taxpayer's engineers at a later date.

Mr. MANSON. I have assumed that it is $35,000 of stock, which everybody seems to assume.

Mr. SHEPHERD. As I say, this first report was on very incomplete information, and it was just a case of getting the case out of the section and sending it on to the auditor. We have hundreds of cases on that one point.

The CHAIRMAN. Just proceed with this case, please, and give us your next report.

Mr. HARTSON. Before Mr. Shepherd proceeds, I wish to make a correction of a statement made by him, to the effect that the provisions in the law of 1917 and 1918 contained no allowance for depletion. They did. The 1916 act contained it, and my recollection is that the 1913 act contained it. Lessee depletion and discovery value did not come until later, but in the case of mines, depletion was allowed.

Mr. SHEPHERD. Yes; 5 per cent gross income for the first three years, and from 1916 on it was figured on the basis of 1913 value.

Mr. HARTSON. Yes.

Mr. SHEPHERD. The taxpayer then submitted a brief by his engineers on July 26, 1923.

The CHAIRMAN. Was that the first statement submitted after the 1920 report was written?

Mr. SHEPHERD. Yes, sir.

The CHAIRMAN. Where was the claim all during that time?

Mr. SHEPHERD. Probably in the audit section. The auditors had not gotten around to sending out the letter yet. That can be found by looking up the details. This report——

The CHAIRMAN. Which one are you talking about now?

Mr. SHEPHERD. The report made by the firm of Wilson & Wagner, who were representing the taxpayer, which was received in the department on July 26, 1923. The report is quite complete and, broadly speaking, is in full accord with the regulations and the information as called for by the department to be furnished. In other words, it has the set-up of a mining property, not of a nonmetals property.

The CHAIRMAN. Does this report show the value?

Mr. SHEPHERD. Yes, sir; this report shows it. The schedules are complete. This report gives the history of the property.

Mr. MANSON. This is the brief of the taxpayer's representative.

The CHAIRMAN. So he stated.

Mr. SHEPHERD. It is really Form D of the taxpayer's representative, which gives the information that is required in order to make a valuation. I will not go into the details of the figures here, because I suppose you do not want them.

For value as of March 1, 1913, on the basis of future expected profits, that is, the present worth of their future expected profits, $1,687,787.72. Pardon me, that is wrong. I have to deduct the plant from that.

Cash value as of March 1, 1913, for ores only, $1,323,863.32, which gives a depletion unit of $14.14 per ton. He also sets up invested capital.

Mr. MANSON. For the purpose of computing depletion prior to 1013, you arrived at a valuation of $2.40 odd a ton?

Mr. SHEPHERD. That was invested capital. We do not call that depletion. We call it amortization of their invested capital.

Mr. MANSON. Well, it amounts to the same thing, does it not?

Mr. SHEPHERD. In 1913 it was different.

Mr. MANSON. What I mean is this. Here you have one mine that went into operation in 1893 or 1894. You adopt a method of determining value as of March 1, 1913, and under your formula you get a value of the material that has been taken out between the time that it went into operation and the 1st of March, 1913, which is based upon a value of two dollars and forty odd cents a ton and a value of the material taken out subsequent to that of some fourteen dollars plus a ton.

Mr. SHEPHERD. That is entirely due to the life of the——

Mr. MANSON. Well, it is a fact, is it not? That is what I am getting at.

Mr. SHEPHERD. It is entirely due to the length of life of the property and of the factor used.

Mr. MANSON. There is no doubt about its being a fact, is there?

Mr. SHEPHERD. If you want to go into that comparison, it is shown right here.

The CHAIRMAN. Well, it is a fact, is it not?

Mr. SHEPHERD. Yes, sir. The longer the life of the property—that is, the more reserves they have—the factor reduces that value as of 1913. For instance, in this particular case we worked both the invested capital and the 1913 value on the basis of the present worth of the finished product. For invested capital, we used a life of 47 years. For 1913 value we used a life of 28 years, I think it was.

Mr. HARTSON. What was the reason for using that? Explain to the committee the reason for using two different assumptions as to the periods of life.

Mr. SHEPHERD. For this reason: The time between 1903 and 1913, plus the life as established beyond 1913, is 47 years.

Senator JONES of New Mexico. How do they arrive at any number of years as the life?

Mr. SHEPHERD. By the average number of tons extracted yearly, divided into the total of ore reserves.

Senator JONES of New Mexico. How do they get the total ore reserves?

Mr. SHEPHERD. The total reserves, Senator, are set up by the taxpayer, and in a mine of this kind they are accepted, unless we can refute them in some way. Now, this mine had produced——

Senator JONES of New Mexico. Was there not any attempt made to measure the contents of the mine? Did the taxpayer give any of those figures?

Mr. SHEPHERD. He gave nothing but the operating history, the production, the number of tons taken out, and the basis for ore reserves as of 1913.

Let me see if I can find you what he says on that:

Ore reserves: Due to the character of the ore body and the relative smallness of the tonnage produced annually as compared with other mining operations, the company has never found it necessary to survey or map the mine working and maintain detailed ore reserve records as we usually understand the terms.

Further, it is, to quote Mr. Woodruff, general manager of the company, "impractical to develop or block out ore bodies by means of shafts, drifts, or tunnels much ahead of the rate required for extraction of ore, for the reason that not only is the graphite itself a very slippery substance, difficult to hold, but the walls of the mine consist of limestone of a character which, when exposed to the air, swells, thereby rapidly breaking up heavy timbers with the result that constant retimbering is necessary."

The company is therefore unable to furnish the maps usually desired by the Government authorities. However, Mr. Woodruff has furnished us with a reasonable and conservative ore reserve estimate as of March 1, 1913, of 93,604 tons. Considering that Mr. Woodruff has been with the company for over 20 years and was on March 1, 1913, and for many years prior thereto, actively in charge of the Mexican mining property here being valued, we believe his estimate is as good as could have been arrived at by having detailed maps and records available. Mr. Woodruff, in explaining how he arrived at his estimate, said: "The course of the vein can be definitely traced by surface outcroppings, its width and depth are fairly consistent, and as production commences practically at the grass roots, the quantity of ore as above given was readily determinable and may be said to be practically developed or known ore."

Now, there are thousands of properties on the mine range, for instance—take it in Michigan, Senator. How much ore do they develop ahead there, as a rule? About two years, and yet they know from past history that that ore goes to great depths. They can not develop their ores or carry too big reserves, because the State taxes would put them out of business.

The CHAIRMAN. You may proceed with your next report.

Mr. MANSON. I just want to ask the witness one question. Did not Mr. Woodruff raise the estimated quantity of ore 7,000 tons in the brief over the original statement of the quantity as made by the taxpayer?

Mr. SHEPHERD. You mean in this original Form F?

Mr. MANSON. 7,000 tons; yes.

Mr. SHEPHERD. Are you referring to this first valuation that I read?

Mr. MANSON. Yes.

Mr. SHEPHERD. The tonnage here is given as 68,298.

Mr. MANSON. And the tonnage that you have just read was some 93,000 tons, was it not? That would be more than that difference, then?

Mr. SHEPHERD. 93,604 tons.

Mr. MANSON. Yes.

Mr. SHEPHERD. That very often happens. We have innumerable cases where when a brief is set up you get a greater tonnage.

Mr. MANSON. What I am driving at is this: The first engineer here had never visited the property, and manifestly based his estimates on some claim that had been made by the taxpayer, and the

brief of the taxpayer manifestly raises the quantity to nearly 50 per cent over the amount that is set up in the first engineer's report.

Mr. SHEPHERD. Ninety-three thousand as against 86,000 is hardly 50 per cent.

Mr. MANSON. You said 68,000. I thought it was 86,000 myself.

Mr. SHEPHERD. Did I read it incorrectly?

Mr. MANSON. You said 68,000.

Mr. SHEPHERD. Eighty-six thousand. That is my fault.

Mr. MANSON. That is a difference of 7,000 tons, then.

The CHAIRMAN. Have you got the next report there, following that?

Mr. SHEPHERD. Yes, sir.

The CHAIRMAN. What was done after you received this brief from the taxpayer?

Mr. SHEPHERD. I think some conferences were held. There were three conferences held after this brief was received, August 7, October 3, and November 22.

The CHAIRMAN. What year?

Mr. SHEPHERD. Nineteen twenty-three. Then, here is a report by the nonmetals section dated December 12, 1923, for the taxable years 1917 and 1918; returns in case 1917 to 1920 inclusive; incorporated 1891; amorphus graphite. Do you wish me to read the whole thing in or to just give the 1913 value?

The CHAIRMAN. If you will give the conclusions, I think that will be satisfactory.

Mr. SHEPHERD. All right, sir.

He gives a value to the Santa Maria mine as of March 1, 1913, as $1,032,726.92; depletion allowed, $11.03.

The CHAIRMAN. Per ton?

Mr. SHEPHERD. Yes, sir. That is on the basis of 93,603 tons reserves. In other words, he accepts the taxpayer's figures.

Now, on invested capital in this report, he makes no mention——

The CHAIRMAN. Has the witness answered the question, Mr. Hartson, that you put him on the stand for?

Mr. HARTSON. I wanted to develop just exactly what was done, and what method was used in determining invested capital, which was the basis for the final assessment of this tax.

Mr. SHEPHERD. All right, sir.

Mr. HARTSON. I have tried to show, sir, that if a definite value could have been established beyond the par value of the stock as of the date it was transferred, it was lawful under the regulations to include that as paid in surplus, and I wanted to develop by this witness what was done in order to determine that excess value.

The CHAIRMAN. We have not gotten at that yet, have we?

Mr. HARTSON. No, we have not.

Mr. SHEPHERD. I will give it to you right now. This is the conference report of April 24, 1924. Mr. Wagner and Mr. Walker represented the taxpayer, with powers of attorney.

Mr. MANSON. By the way, was not Wagner a former employee of the department?

Mr. SHEPHERD. Yes; he was in the department for about two years, I should say.

The Government's representatives were Alexander R. Shepherd, special conferee, and C. A. Burdick, valuation engineer. The report reads:

Matters discussed: (*a*) Valuation report, December 12, 1923; (*b*) report of taxpayer conference on November 22, 1923; (*c*) protest dated March 3, 1924.

Discussion: (*a*) Depletion allowable, taxpayer's estimated tonnage, March 1, 1913.

Average yearly production of ground graphite, 1907–1916, inclusive, 2,863 tons.

Indicated average yearly production, 3,300 tons.

Life indicated, 28 years.

Estimated profit per ton based on profit on pulverized graphite sold in 1907 to 1916, inclusive, $46.42.

Profits expected, March 1, 1913, $4,345,097.68.

Hoskold's factor for present worth based upon 10 and 4 per cent, 0.297587.

March 1, 1913, value of the business	$1,293,044.56
Estimated plant investment required to deplete the ore in 28 years	250,000.00
March 1, 1913, value of the ore	1,043,044.56
Depletion indicated, based on March 1, 1913, value obtained as above	11.14

(*b*) Invested capital: Based upon present worth of profits obtained in later years discounted at 20 and 4 per cent to obtain value of stock, $35,000.00, paid for the mine in 1893:

Tonnage mined previous to March 1, 1913	33,967
Estimated tonnage available March 1, 1913	93,604
Estimated tonnage at acquisition	127,571
Indicated average profits per ton	$46.42
Estimated profits	5,921,845.82
Years operated previous to 1913	19
Years indicated after 1913	28
Total years life indicated	47
Present worth factor for 28 years, at 20 and 4 per cent	.102527

That is practically one-tenth of the gross expected profits.

The CHAIRMAN. In dealing with that invested capital I still do not get that $1,043,000.

Mr. SHEPHERD. I have not got to that yet.

The CHAIRMAN. All right; go ahead.

Mr. SHEPHERD (reading):

Indicated value of business at acquisition	$607,149.08
Indicated investment in plant required for production of product	300,000.00
Indicated value of ore at acquisition	307,149.08
Sustained depletion in 1893 per ton produced	2.4077
The additional amounts paid to acquire mine as claimed and allowed in conference on November 22, 1923, were	35,041.18
Total indicated value of stock and additional cost of property	342,190.26

CONCLUSION

It was agreed by taxpayer's representatives that the above basis will be recommended for acceptance and taxpayer's representative will submit a schedule setting forth how these rates and investments will change the deductions for depletion and invested capital in taxpayer's income tax returns.

This is the schedule submitted with that [exhibiting paper].

Mr. MANSON. I understand from that that you assumed the investor in this property in 1893 would expect a 20 per cent profit, while an investor in the property in 1913 would expect a 10 per cent profit.

Mr. SHEPHERD. No, sir; I did not assume that. We know that the invested capital, as a rule, is less than the 1913 value, because the 1913 values generally include an ore reserve, which takes in possibilities to a certain extent. I had this staring me in the face. The book entries of the company——

Mr. MANSON. Now, let's get down to my question.

Senator ERNST. Let him explain it.

Mr. MANSON. He is getting away from it; that is the trouble. In capitalizing the future expected profits, he used a discount factor, which is intended to include, among other things, the profit that a purchaser is expecting to make in buying the property at the appraised value.

Senator ERNST. Now, Mr. Manson, pardon me a minute. You were asking about this particular case?

Mr. MANSON. Yes.

Senator ERNST. And he was proceeding to explain it. You are now asking him a general question. I submit you should give him an opportunity to make his explanation, and then, if you want to ask any further questions, you may do it.

The CHAIRMAN. He started to tell about something that was staring him in the face.

Senator ERNST. Yes; he wanted to explain here why he did just what he did.

The CHAIRMAN. He did not admit that he did that. I want to get out of the witness whether he did assume those things that Mr. Manson has, and then he can proceed with his explanation.

Senator ERNST. You ought to let the witness proceed to do it in his own way.

The CHAIRMAN. He can say yes or no, and then explain his answer.

Senator ERNST. Yes; but a yes or no answer does not explain it particularly.

Mr. SHEPHERD. Senator, as to the present worth of operating profits method, the details involved are quite complicated, and I would suggest that we make that a special subject some time and dig into it.

The CHAIRMAN. What did you do in this particular case? Go ahead and tell us that.

Mr. SHEPHERD. I just read what we did, what we allowed the taxpayer.

The CHAIRMAN. In other words, you did allow him the 20 per cent up to 1913?

Mr. SHEPHERD. Yes, sir.

The CHAIRMAN. And 10 per cent afterwards?

Mr. SHEPHERD. The 1913 value was already established. I had nothing to do with it. I will say this: As far as I know, this method is correct for the March 1, 1913, value. It is the basis used in hundreds of other cases. We standardize our rate of risk in that respect. To a certain extent, we have to.

The CHAIRMAN. I appreciate that, and I think that answers Mr. Manson's question.

Mr. SHEPHERD. Yes, sir. Here is what the taxpayer calls Exhibit B, "Mine purchase account." This was taken from his records:

Payments made for purchase of fee, obtaining certificates of title, and the acquisition of mineral rights.

1892, Roundtree contract and option account paid for in stock	$35,000.00
1893, cash paid for services and expenses, reacquisition of mine and title	2,374.81
1894, cash paid for services and expenses, reacquisition of mine and title	10,453.04
1894, Pacific Graphite Mfg. account	1,961.55
1894, Pacific Graphite Mfg. account notes	3,653.88
1894, notes given by stockholders and indorsed over to Mexican Title Co	28,750.00
1894, loss on operation under the Pacific Graphite Mfg. Co. contract	18,027.64
1895, cash paid for services and expenses reobtaining mine and title	276.40
1896, cash paid for services and expenses reobtaining mine and title	150.00
1897, cash paid for services and expenses reobtaining mine and title	30.00
1899, aditional stock issued	400,000.00
1903, expense and compromise settlement re suit on retention of title	16,141.50
1904, expense and compromise settlement re suit on retention of title (additional expense)	107.63
1919, Moradillas claim	27,500.00
	544,426.45

Mr. MANSON. Is not that additional stock which you have just mentioned a stock dividend that was declared?

Mr. SHEPHERD. According to his report——

The CHAIRMAN. You call that a report. What you mean is the taxpayer's brief; is not that correct?

Mr. SHEPHERD. That was the taxpayer's brief and the facts submitted under oath. In other words, he was claiming practically for invested capital for all those years over $500,000.

Here is the engineer's report dated May 17, 1924.

Senator JONES. That report was made as the result of a conference?

Mr. SHEPHERD. Yes, sir.

Senator JONES. In which you participated?

Mr. SHEPHERD. Yes, sir.

Senator JONES. And he simply made a report carrying out your recommendations in the matter?

Mr. SHEPHERD. Well, no; I do not think that is the case.

Mr. MANSON. The engineer testified that that was so.

Mr. SHEPHERD. I heard nothing more about this until recently, when it was taken over by your representatives here.

Senator JONES. But you had a conference before this final report was made, as I understand it?

Mr. SHEPHERD. Yes, sir.

Senator JONES. And it has been testified here, I think, by the engineer in this case, that your recommendation in the matter was taken as final, and that the report subsequent to that was made up because of your recommendation?

Mr. SHEPHERD. Possibly that is his viewpoint of it, sir. Here is the report on the case, in which he shows the taxpayer's claim for invested capital and the amount allowed.

Senator JONES of New Mexico. That report really embodies what was arrived at in the conference with you, does it not?

Mr. SHEPHERD. Only as regards invested capital. I had nothing to do with the 1913 value, which was already established.

Senator JONES of New Mexico. When was that established?

Mr. SHEPHERD. That was established in his report of December 12, 1923. He changed a few figures in conference with the taxpayers' representative, which made a difference—the difference between $43,000 and $32,000—about $11,000 difference.

Senator JONES of New Mexico. Does that report in 1923 state the basis for arriving at the invested capital?

Mr. SHEPHERD. No, sir.

Senator JONES of New Mexico. What does he give the invested capital at in that report?

Mr. SHEPHERD. I am mistaken. I was looking for invested capital, but he has it here. It is shown on the last page of the report:

Cost of Santa Maria mine is claimed at $516,926.45 in revenue agent's report and letter dated September 24, 1923, and allowed at $70,011.18, as set forth above.

Mr. MANSON. Is not that $70,041.18?

Mr. SHEPHERD. Possibly it is. It is blurred here.

Mr. MANSON. On the second page of his report dated December 12, 1923, he gives the items, and they foot up to the amount that he recommends as the amount to be allowed. They foot up to $70,041.18.

Mr. SHEPHERD. I stand corrected. Thank you. I was looking for invested capital.

Mr. HARTSON. How was that $70,000 arrived at in that report? Was it by the method of determining the present worth of expected future earnings?

Mr. SHEPHERD. No.

Mr. HARTSON. How was it?

Mr. SHEPHERD. I will read this.

Mr. HARTSON. Just state the basis for it.

Mr. SHEPHERD. The taxpayer was claiming a total for invested capital of $516,926.45, in which item is shown an additional capital stock issue in 1899 of $400,000, which it is claimed in his brief was an appraisal made of the property at the time by Mr. Woodruff. The property was found to be much more valuable than the stock originally allowed for it. That was in 1899. Now, if you care to, I will find that somewhere in the taxpayer's brief.

Senator JONES of New Mexico. What was the date of that stock issue?

Mr. SHEPHERD. In 1899, for $400,000.

Mr. MANSON. That was issued long after the company acquired this property, and it was manifestly a stock dividend.

Mr. SHEPHERD. Six years, practically.

Mr. MANSON. Yes.

Mr. SHEPHERD. But the question comes up that all additions in capital have to be considered by us.

Senator JONES of New Mexico. That was not an addition in capital, was it?

Mr. SHEPHERD. Well, it was this, Senator: It was a correction on their books of what their actual values were. You have in this case a paid-in surplus, practically.

The CHAIRMAN. Do you know when those books were written up?

Mr. SHEPHERD. According to the sworn statement, these facts are taken off the books. They are the original book figures of the company.

Senator ERNST. He wants to know when those books were made up.

The CHAIRMAN. Do you know when the books were made up? Were they the old books?

Mr. SHEPHERD. The old books.

The CHAIRMAN. The continuing books of the corporation, or were they new books, like some other concerns write up?

Mr. SHEPHERD. It is the sworn statement here that they were taken right off of the records of their old accounts.

Senator JONES of New Mexico. Do they say "old accounts"?

Mr. SHEPHERD. They say the book records.

Senator JONES of New Mexico. What do they say there as to where those items were taken from?

The CHAIRMAN. Was there any inquiry made as to when that $400,000 of stock was actually issued, because if that stock was really issued in 1899, in all probability that would be correct?

Mr. SHEPHERD. Yes, sir; there is a statement in one of these records as regards that stock, sir. Here it is——

Mr. HARTSON. Have you the revenue agent's report there, which would throw any light on it, Mr. Shepherd?

Mr. SHEPHERD. I do not know whether there is a revenue agent's report in the case or not.

Mr. HARTSON. You have not it with you?

Mr. SHEPHERD. No; I did not see any revenue agent's report. There may be one. Here is what they say in regard to that:

Inasmuch as the value of the Santa Maria mine was in 1893 known to be far in excess of the par value of the stock issued specifically therefor, we do not believe the company should be penalized by having its invested capital written down to $35,000 par value of the stock issued therefor, or even to $100,000—

which was the total par value of the stock—

the value written on the books of the company as of the date of acquisition. The company should be granted a paid-in surplus as of the date of acquisition, 1893. Authority for this is granted in article 63, Regulations 41, and in other rulings since issued by the department. As a basis of this paid-in surplus the company can well and conservatively use the change in the book value of the Santa Maria mine made on January 11, 1899. On that date the officers of the company, realizing that they had made an error in the original statement of the mine value at $100,000, decided to issue an additional $400,000 of the capital stock of the company and place the value of the mine on its books at somewhere near its true value. The value was then stated to be $500,677.22, and the note made in the books that this value was based upon an appraisal at that time.

The CHAIRMAN. That is, 1899?

Mr. SHEPHERD. 1899. That is their statement, sir, sworn to.

The CHAIRMAN. Have you any further questions that you want to ask the witness, Mr. Hartson?

Mr. HARTSON. I want to ask him what other methods could be developed to arrive at the value of the assets transferred for the stock there?

Mr. SHEPHERD. Well, the Senator suggested one a while ago. Take the annual earnings. This property had 23 years of pre-war earnings, which averaged about $67,000 a year. If you capitalize that, even at 5 per cent, you have about $3,500,000 right there.

Mr. HARTSON. Were there any other methods, such as the regulations suggest that might be used: namely, transactions at that time for similar properties in that vicinity?

Mr. SHEPHERD. No, sir.

Mr. HARTSON. There were not?

Mr. SHEPHERD. This property was, as has been stated time and again, unique in a way.

The CHAIRMAN. I think that is very strange, that the answer is in that form, in view of the fact that this new mine was bought in 1918 at approximately the same price as the original mine, without any enhancement in value.

Mr. SHEPHERD. I think your representatives have overlooked a matter there, which was stated in the record here. The Santa Maria mine is on the side of a mountain. That was the mine they had developed. They have a 27-mile wagon haul from this mine down over here to the station. On this side is the Moradillas mine, which was bought.

Mr. MANSON. That is the second mine.

Mr. SHEPHERD. That is the second one. Now, at the time they bought it, according to the statement there, it was nothing but a prospect. They bought the ranch from the Mexican that owned the ranches around there, because that was the basis in those days. It was nothing but a prospect.

The CHAIRMAN. I would like to ask Mr. Manson if he understood that it was only a prospect at the time?

Mr. MANSON. Yes.

The CHAIRMAN. You did not say in your statement that you understood it was only a prospect.

Mr. SHEPHERD. You might go a little further. This mine over here, the Santa Maria mine, is not exhausted at all. With this deposit over here there is a haul of 27 miles, practically, a wagon haul.

Mr. MANSON. Would not that make it a very much more valuable property than the mine located 27 miles further away from the railroad?

The CHAIRMAN. Yes; but it was not a prospect, and that makes some difference.

Mr. MANSON. I want to ask the witness a question: Is it not a fact that the records showed in the case of both these mines outcroppings all along the surface?

Mr. SHEPHERD. The record speaks of——

Senator JONES of New Mexico. And is it not a fact that it was from these outcroppings on the surface that they estimate the quantity of the ore?

Mr. SHEPHERD. The Santa Maria outcrops. I do not remember anything in the record as regards this later purchase.

The CHAIRMAN. If this later purchase were a prospect, and only a prospect, there could certainly be no outcropping. Otherwise it would not be only a prospect, but it would be a reality.

Mr. MANSON. I will look that up.

The CHAIRMAN. Yes; look that up.

Mr. MANSON. It is my recollection that in the case of both mines there were outcroppings all along the surface.

Mr. SHEPHERD. I would like to call your attention to another thing.

Mr. MANSON. I would like to ask you another question.

The CHAIRMAN. Let him make his statement.

Mr. MANSON. All right.

Mr. SHEPHERD. The fundamental basis of profit in the mining industry is a market for your product. This is a controlled commodity. We can not deny that they have a market. They can supply the demand. Now, the reason that other properties are not worked down there, if there are these millions of tons of similar ore, as claimed by your representative, they would be exploited. The fact that they have not a market for it makes it of practically no value. These people control the supply for the market.

Mr. MANSON. That is, they control the market?

Mr. SHEPHERD. They control the market. They can produce apparently as much as is needed for the market.

The CHAIRMAN. So that there is no need for the new development?

Mr. SHEPHERD. If there was a market for it, and if there is as much ore there as has been stated by your representative, there would be a lot of people down there operating to-day.

Senator JONES of New Mexico. Then, why should not the valuation be based upon the fact that they have a market rather than upon the fact of the value of the ore in the ground?

Mr. SHEPHERD. That is what we do in figuring the present worth of operating profit based on what they can sell.

Mr. MANSON. In other words, then, the value that you give to the ore in the ground, which is the thing the law requires to be valued, is based upon the market that this particular concern has, rather than upon the fact that the ore in the ground has a particular value.

Mr. SHEPHERD. I will answer that in this way: What is the market for lead or zinc ore? Before you can market it you have to put it into a pound of lead or a pound of zinc. You have to concentrate it. This grinding of graphite is practically similar to the metallurgical treatment of copper or silver or lead or zinc ores. In other words, you have to concentrate it. You have to grind it to make it merchantable. I was going to attack you on that point this morning, because you said there was a manufacturing profit. But you corrected it yourself. Their basis, as set up in their information, is perfectly correct, according to the regulations and the law, as we understand it.

Mr. MANSON. The law requires you to value the mine property, does it not?

Mr. SHEPHERD. Yes, sir.

Mr. MANSON. And the regulations provide that the value you shall give to the mine property is the value which a willing seller would take and a willing buyer would pay for the mine property; is not that true?

Mr. SHEPHERD. Generally; yes, sir.

Mr. MANSON. All right. Then, assume that we have a mine identical with the mine involved in this case, located in Mexico, with the same quality of ore, the same distance from the railroad, but with no organization in the United States through which the product can be marketed. Would that mine have a value anywhere nearly comparable to the value that you have placed on this mine owned by this company?

Mr. SHEPHERD. Not on the basis of present worth of operating profits.

Mr. MANSON. Yes.

Mr. SHEPHERD. Because you have a market for your stuff?

Mr. MANSON. Sure. In view of that fact, what you have of real value is the organization, the business genius, and the good will of the United States Graphite Co., instead of the mines in Mexico, is it not?

Mr. SHEPHERD. No.

Senator JONES of New Mexico. I would like to ask you to explain why that is not the case?

Mr. SHEPHERD. Well, I think it is apparent, Senator, that it is not.

Senator JONES of New Mexico. In other words, it is this organization here that gave value to it at all, is it not?

Mr. SHEPHERD. The market and the organization combined.

Senator JONES of New Mexico. Yes; the market and the organization combined is the thing that gave value to it at all.

Mr. SHEPHERD. But we get right back to the fact that the basic thing is the market. If you have not that market it is not worth anything.

Senator JONES of New Mexico. That seems to be true, but these mines down there were not worth anything until they took up this organization, and that is the reason they could get them at a nominal value, relatively speaking. It is perfectly clear, it seems to me, that the profit of this thing is in the working of the ore, and not in the ore itself.

Mr. SHEPHERD. Well, on that basis, Senator, a gold vein would not be worth anything unless you had a mill to work it with.

Senator JONES of New Mexico. That is true; but to give the value to the ore in the ground after it is found, and what can be gotten from the manufactured product, it seems to me is all wrong, and certainly it is quite clear to me that the statute never intended any such thing when it said that you should value these mines according to the market value of the mine and similar properties, etc. I have tried my best to work out some theory to justify the basis of this valuation, but I have been totally unable to do it, if you take into consideration the language of the statute itself. I do not think your basis for valuation has any justification found in the statute, according to which you are to ascertain the value of the mine as a mine, and not the value of the manufactured product after it is taken out.

Mr. SHEPHERD. Senator, I am very poor——

Senator JONES of New Mexico. I tried my best to justify in my own mind what apparently has been the custom there, but I am unable to arrive at any justification for it at all.

The CHAIRMAN. I do not think there is any justification for it, as a matter of fact.

Senator JONES of New Mexico. No.

The CHAIRMAN. They have stated how they have done it, and I think we understand that perfectly clearly.

Senator JONES. Yes.

The CHAIRMAN. But I do not think there is any justification for it, unless they submit some further evidence that there is no more of that kind and no other mine that may be compared with it for the purpose of arriving at value.

Mr. MANSON. Let me ask you this. You stated that the factors that you used here of 10 and 20 were standardized factors that were generally in use in similar cases; is that correct?

Mr. SHEPHERD. I said the risk rates were generally standardized in those cases; otherwise, we would have taxpayers coming in and claiming that they were not given the same treatment as the other fellow.

Mr. MANSON. Are those the same risk rates that you would apply or have applied to property located in the United States?

Mr. SHEPHERD. No; I think originally we used a lower risk rate. It depends on the property.

Mr. MANSON. What I am driving at is this. Would similar property located in the United States be valued in accordance with those rates that you have used in connection with this property?

Mr. SHEPHERD. Would they be valued according to these rates?

Mr. MANSON. Would you use these rates, these discount rates, in arriving at a value for similar property in the United States?

Mr. SHEPHERD. We would probably use lower.

Mr. MANSON. How much lower?

Mr. SHEPHERD. Two per cent.

Mr. MANSON. Do you know of any cases where you have used lower rates in the United States?

Mr. SHEPHERD. Oh, yes. Take the Iron Range. When you are dealing with a different metal, you have to consider the metal and consider the hazard to a certain extent that is involved.

Mr. MANSON. There is one thing that I want to point out to the committee, as I pointed it out in my opening statement here, and that is that in 1913 and 1918, the two years in which valuation was made, Mexico was in a state of revolution, and that revolution was largely brought about by agitation which finally resulted in the adoption of a constitution under which this very property was denounced.

Mr. SHEPHERD. Pardon me. I think you are off there. I think you are wrong.

Mr. CHAIRMAN. I understand that counsel desires to take up the Steel Corporation case to-morrow?

Mr. MANSON. Yes.

The CHAIRMAN. If agreeable, we will meet here at 10 o'clock to-morrow morning for the consideration of the Steel Corporation case. It is after 12 o'clock now.

(Whereupon, at 12.05 o'clock p. m., the committee adjourned until to-morrow, Tuesday, December 30, 1924, at 10 o'clock a. m.)

CLIMAX FIRE BRICK CO. CASE

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, JANUARY, 6, 1925

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

The committee met at 10.30 o'clock a m., pursuant to adjournment of yesterday.

Present: Senators Couzens (presiding), Jones of New Mexico, and King. Present also: L. C. Manson, Esq., of counsel for the committee, and L. H. Parker, chief engineer for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, solicitor, Bureau of Internal Revenue; and Mr. S. M. Greenidge, head engineering division, Bureau of Internal Revenue.

The CHAIRMAN. The committee will be in order.

Mr. MANSON. Mr. Chairman, Senator Ernst requested me to say that he is tied up with the Committee on Revision of the Laws and will be unable to be here.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. NASH. Mr. Chairman, before Mr. Manson proceeds, I just want to say that on yesterday afternoon we discussed at the office the suggestion of the committee on refund claims, and an order has been issued which will stop the scheduling of any claim for refund or credit where the elements of natural resource valuations or amortization are involved in the case. A survey will also be made of all schedules that are now in process, and if any claims are discovered on these schedules where the elements of natural resource valuations or amortization are involved they will be withdrawn from the schedules.

In addition, we have taken steps to place technical personnel in the claims-control section, where all claims go for final schedule, to review all claims and segregate those cases where the items questioned above are involved.

The CHAIRMAN. That will include, of course, oil discovery and depletion?

Mr. NASH. Natural resource valuations would include both the valuations for depletion and valuations for invested capital. Both of those elements were discussed in some of these nonmetals cases.

Mr. MANSON. I wish to say that Mr. Nash called me up yesterday afternoon and wanted my opinion as to whether the order he has mentioned would cover this situation, and I advised him that, in my opinion, it would.

The CHAIRMAN. That will be very satisfactory.

Mr. MANSON. This is the case of the Climax Fire Brick Co.

The question involved here is almost identical with that which was involved in the United States Graphite Co. matter. The question involved is the valuation of the lease. In that instance it was the valuation of the fee. In this instance it is the valuation of the lease to mine fire clay, for purposes of invested capital and for purposes of depletion.

The amount claimed in the final claim of the taxpayer as the valuation of this property as of November, 1900, is $380,137.20. The amount allowed is $154,120.70. The matter involves the refund of a tax amounting to $26,192.48.

This taxpayer is a manufacturer of fire brick. The principal product appears to be the brick that is used for the lining in the base of blast furnaces.

The company was incorporated in November, 1900. The incorporators were a partnership. This partnership has carried on this business for a period of 15 months prior to the incorporation of this company. The capital stock of the company, amounting to $100,000, was issued to the partners in payment for the business and the assets of the partnership.

Mr. HARTSON. Mr. Manson, may I interrupt you right at that point?

Mr. MANSON. Yes.

Mr. HARTSON. Did your engineers find, in going through the files, that the revenue agent had reported that $200,000 in capital stock had been issued, but that the engineers of the Unit, in reviewing the revenue agent's report, did find, as you have said, that $100,000 capital stock was issued in exchange for this lease?

Mr. MANSON. No.

Mr. HARTSON. You found no such inconsistency, so far as your reports are concerned?

Mr. MANSON. No; that is the first I heard of that. At least, if that was the fact, it was not a fact which was before the engineers or before the conferees at the time they fixed this value, and, if it is a fact, it is a fact that has not been brought to the attention of the Unit by any brief of the taxpayer. If it is a fact, it is a fact which does not appear on the books of the taxpayer.

On the books of the taxpayer, the assets acquired by the corporation from the partnership are listed, and they amount to $123,427.26.

The lease in question was owned by the partnership; it was transferred to the corporation, and no value was given this lease upon the books of the corporation. I make that statement advisedly for the reason that the exact items making up the $123,427.26 of capital charges are set forth in detail in the brief of the taxpayer, and are set forth in detail in the report of Mr. Parker, the committee's engineer.

The first claim filed by the taxpayer was on September 20, 1920, when the taxpayer claimed $25,500 as the value of this property. This claim was allowed in whole by the engineer.

The CHAIRMAN. Just what was the claim for?

Mr. MANSON. For the value of the lease to the property from which they procured that clay, out of which they made their fire brick.

The CHAIRMAN. But was the claim for a refund or for an abatement?

Mr. MANSON. No; they set up the $25,500 as a part of their invested capital, and as the basis for depletion, as the amount they had depleted to take care of this lease.

The CHAIRMAN. Had the case been closed then? You call it a claim. Just what do you mean by that?

Mr. MANSON. They claimed a value on this lease of $25,500. It was the amount set up in a letter which accompanied the form upon which the claim for depletion is made.

Mr. HARTSON. Mr. Manson, I think I can straighten this out. The thing the taxpayer was claiming was the value as of the date of incorporation of this lease for invested capital purposes in 1917. It is true that after the value was set up in 1900, when the company was incorporated, they depleted it down to 1917 for the purpose of invested capital in that year. It is not a depletion claim; it is an invested capital claim.

Mr. MANSON. The $25,500?

Mr. HARTSON. Well, the thing that had to be determined was the value of a lease, if any, at the date of the incorporation.

Mr. MANSON. Yes.

Mr. HARTSON. Which was in 1900?

Mr. MANSON. Yes.

Mr. HARTSON. Now, the reason why that value had to be determined was to find out what the company's invested capital was in 1917.

Mr. MANSON. Exactly.

Mr. HARTSON. So this lease, after the value had been ascribed to it as of 1900, was depleted or depreciated down to 1917, when it was given a value for invested capital purposes.

Mr. MANSON. I see. Well, I stand corrected as to that. That fact had not been brought to my attention.

The second claim of the taxpayer for the value of this lease was filed on December 7, 1923, on which they claimed $250,453.83 as the value of this lease as of November, 1900. This claim was disallowed in full by the engineers of the bureau, upon the ground that the lease was not a proper part of their invested capital, and upon the ground also that they were entitled to no depletion on it, for reasons which I will hereafter give.

The CHAIRMAN. Does the record show what reason they advanced for jumping the value from $25,000 to $250,000?

Mr. MANSON. They just recomputed it. They presented a new computation.

The CHAIRMAN. What was there to compute in valuing the lease—earnings?

Mr. MANSON. That is what they finally did compute; yes. This value is set up on the basis of prospective earnings.

The CHAIRMAN. They jumped that value ten times in that period from 1920 to 1923?

Mr. MANSON. That was the inference that I drew, but Mr. Hartson has explained that those two values were not as of the same date, and I do not take exception to his statement.

As I stated, the second claim for $250,000 plus was disallowed. The third claim was filed on January 1, 1924, in which they set up a value on this date of $380,137.22. This is the claim which was finally acted upon. This claim was disallowed in toto by the engineers.

A conference was had. The special conferee was the same man, Mr. Shepherd, who was special conferee in the United States Graphite Company Case. At this conference, an allowance was made of $200,456, as the value of this lease as of the date of incorporation.

The facts with reference to the lease are as follows:

The lease was a 20-year lease. It contained no clause providing for renewal. It permitted the mining of fire clay upon this property.

For the benefit of the Senator who has just come in, I might make that statement over again.

This is a claim for value for purposes of depletion and invested capital on a lease. The valuation is made as of November, 1900. The lease, as I have stated, permitted the corporation or permitted the lessees to mine this fire clay upon the payment of a royalty of 25 cents a ton for the best grade of clay and 15 cents a ton for the second grade of clay. No bonus was paid for the lease at the time it was entered into.

In 1907, about seven years after the date as of which this valuation is made, the taxpayer acquired another lease upon an adjoining property for the same purpose, namely, the mining of clay, upon exactly the same terms, namely, 25 cents a ton for the best grade of clay and 15 cents a ton for the second grade. No bonus was paid for that lease.

Upon the expiration of the lease in question in 1919, it was renewed, and, as I have stated, it was not renewed pursuant to a provision of the lease, but it was renewed by voluntary action of the partners, without the payment of a bonus, and upon the same terms.

For the purpose of showing the arguments that influence the bureau in making this valuation, I am going to read some short exhibits, and, for that reason, I am not going into that subject at this time, but I will merely state that the basis of this value is the capitalization of the prospective profits which the bureau held the company would make, not out of the fire clay it mined, but out of the sale of the finished product, namely, fire brick used to line furnaces.

The bureau found that the profit of the manufacturer upon this fire clay was $1.38 a ton—and, mind you, the lease provides for the payment of a royalty of 25 cents a ton for one grade of clay and 15 cents for another. The whole $1.38 was capitalized and reduced to a present value by the application of a discount factor of 8 per cent, representing their theory of what the profit ought to be, notwithstanding the fact that they were making a profit of $1.38 and there was a royalty of 25 cents and 15 cents.

Senator KING. Why did they not proceed to levy an assessment upon the basis of the profits, without attempting a capitalization?

Mr. MANSON. I am going into the reasons which actuated them, Senator.

Senator KING. All right.

Mr. MANSON. I am merely describing now how they arrived at those figures.

As I have already stated, this lease was for 20 years. It contained no provision for renewal, and yet the profits were capitalized over a period of 40 years in making this valuation of $200,456.

As I stated before Senator King came in, this entire claim has been disallowed by the engineers on several occasions—at least on three separate occasions—and this value of $200,000 was allowed in a conference presided over by a special conferee, Mr. Shepherd, with whom we became acquainted in a former hearing. After this conference, the chief of the nonmetals section, the section which had passed on this claim three times and rejected it, wrote a letter to the head of the engineering division, Mr. Greenidge, in which he calls attention to the essential facts in this case more briefly than I could relate them and, for that reason, I am going to read this letter. This is our Exhibit G, which I offer. This letter is dated January 29, 1924, and reads:

JANUARY 29, 1924.

Mr. S. M. GREENIDGE,
Head, Engineering Division.

(Re: Climax Fire Brick Co., Climax, Pa.).

Inclosed are data in the case of the above-mentioned company, also conference memorandum and valuation memorandum of this unit based upon instructions given in conference.

Mark that fact, that determination here is, according to this memorandum, based upon instructions given in conference, and that fact is borne out by further exhibits which I will offer.

The questions involved relate to value of leasehold of city land as at December 31, 1900, at which time the Climax Fire Brick Co. (corporation) acquired the assets of the Climax Fire Brick Co. (partnership).

The leasehold in question was first acquired by a Mr. Bell under date of April 24, 1899; under date of October 19, 1899, Mr. Bell assigned one-half interest in the leasehold to a Mr. Haws; these two composed the Climax Fire Brick Co. Life of leasehold is 20 years.

No bonus was paid for the leasehold, the clay being paid for on a royalty basis. No statement of any amount paid for one-half interest by Mr. Haws has been made.

The corporation issued $100,000, par value of stock, assuming liability for the assets of the partnership. The allocation of assets at that date makes no mention of leasehold.

In 1920 it appears that company returned Form F to this office in duplicate showing nothing paid for leasehold.

On December 10, 1923, a brief was submitted by the taxpayer in which a value for the leasehold as at December 31, 1900, was placed at $250,453.83. This value was computed on the basis of earnings subsequnet to acquisition (five-year period) and a life of 50 years. Taxpayer was advised that the basis of valuation was not sound, that it would be necessary to base valuation upon data at or before the date of acquisition rather than upon data occurring subsequent to acquisition.

Taxpayer submitted a new brief dated January 10, 1924, in which the valuation is based upon the earnings of the partnership from October 1, 1899, to December 31, 1900, at which time the partnership assets were transferred to the corporation, and a life of 50 years.

In 1907 the company acquired a leasehold covering an adjoining property containing the same kind of clay upon the same royalty terms as in the lease in question, no bonus being paid. In 1919 the original lease expired and a renewal was made upon the same terms—no bonus. Based upon the fact that no bonus was required for the lease, acquired in 1907, and that the original lease was renewed in 1919 without bonus, the royalty terms being unchanged

this unit held that the original leasehold had no value. The word "value" as here used means the selling price (or cost) that would pertain between a willing buyer and a willing seller.

The taxpayer protested the holding of the unit and the question being referred to a special committee, instructions were issued to determine valuation based upon earnings from October 1, 1899, to December 31, 1900, making allowance for manufacturing profits, and a life of 40 years. In accordance with a memorandum of the committee on appeals and review in the case of the Houston Collieries Coal Co., Cincinnati, Ohio, the valuation should have covered a period not exceeding the life of the lease.

The taxpayer states in support of the value claimed of the clay in question that the finished product is superior to that made from other clays and that it brings a premium in the market. Admitting that this is so, it is apparent that the taxpayer pays for this superiority in the raw material in that the royalty rate per ton is approximately double the royalty paid for other clays used in producing the same finished products.

In the discussion in conference the taxpayer was advised that the entire deposit could have been purchased outright for a mere fraction of the sum claimed for paid in surplus on the leasehold above. The taxpayer replied that the clay deposit had a comparative low value to the fee owner as he had no ability nor capital to manufacture refractory products.

In this reply the taxpayer unconsciously recognizes the fact that the profits of the business are due not so much to the raw material as to the capital employed in the business and the ability of the management.

This is the same idea that has been expressed by Mr. E. C. Eckels in a discussion of the Portland cement industry. An analysis of the elements that enter into the business of the conversion of raw material into a finished product is set out in which it is shown that the raw material is a very unimportant factor ("negative"). The real factors are the ability of the management, capital employed, perfection of processes, etc.

This matter is submitted to you for instructions as to further action.

J. H. BRIGGS, *Chief of Section.*

I submit that after receiving that letter, the head of the engineering division had before him every element which should be considered in determining whether or not that lease was entitled to a value. If any further action in this case was taken improperly, it can not be because everyone who had anything to do with it from this point on was not fully advised of the premises, yet this is the reply of the head of this section.

Senator KING. Who was the head of that section then?

Mr. MANSON. Mr. S. M. Greenidge.

I would call attention to the fact that all of the valuation, that all of the determination of amortization, that everything that required the use of engineers, comes under the jurisdiction of the man who wrote the letter that I am about to read, after receiving the advice that he received in the letter which I have just read.

This is a memorandum addressed to Mr. Briggs, dated January 30, 1924:

JANUARY 30, 1924.

Mr. BRIGGS,
Chief, Nonmetals Valuation Section.
(In re Climax Fire Brick Co., Climax, Pa.)

There is returned to you the case of the above-named taxpayer.

Conference report dated January 21, 1924, states:

"It was finally agreed to accept the valuation claimed by taxpayer in principle, but to revise the factors involved in making his calculations on a fair and reasonable basis. The details are shown in accompanying valuation memorandum dated January 21 (IT:EN:NM:ESB) and the resulting figure of '$200,456 was agreed upon as valuation of leasehold at January 1, 1901, this amount to be amortized over 40 years at the rate of $5,011.40 annually."

This case will be closed in conformity with conclusions reached at this conference.

S. M. GREENIDGE, *Head of Division.*

The CHAIRMAN. It is worth a lot of money to have Mr. Greenidge the chief of that division?

Mr. MANSON. Oh, yes. After Mr. Briggs, the head of this section, whose men had examined this case, had been thus summarily disposed of, the case went to the review section of the audit division. A man by the name of Smith was the head of the section to which this case was referred. This allowance was too much for Smith to swallow, and Mr. Smith protested to the conferees, and to the chief conferee, a man by the name of Shepherd.

For the benefit of the Senator who was not present when Mr. Shepherd was on the stand before, I might state that Mr. Shepherd is a man who impressed us with the fact that his good judgment was of greater controlling force in the determination of these valuations than even an act of Congress.

After Mr. Smith had made this protest——

The CHAIRMAN. In just what form did Mr. Smith make this protest?

Mr. MANSON. Evidently it was verbal, because I do not find it in the record; but after he had made this protest, Mr. Shepherd wrote a memorandum dated February 29, 1924.

Before I read that memorandum, I wish to call the attention of the committee to the fact that when Mr. Shepherd was a witness before this committee in the United States Graphite Co. case, he took the very meek attitude that he was a mere advisor at these conferences, and he had no authority to order the engineers to do anything, and that if, after one of these conferences in which he participated, the engineers saw fit to revise their reports, that was their responsibility; it was not his. I merely wish to refresh the recollection of the committee on that point, because the memorandum I am now about to read in this case throws considerable light upon that point.

This is the memorandum by Mr. Shepherd, our Exhibit I:

IT:EN:NM:ESB
Ref: INTR:G-9 Mr. Austin

ENGINEERING DIVISION—NONMETALS SECTION—SPECIAL MEMORANDUM

In re Climax Firebrick Co., Climax, Pa. Manufacturers of refractories. Organized 1900. Taxable year 1917 and 1918.

This case was valued on January 21, 1924, by the nonmetals section following conference with taxpayer held on that date.

Valuation and conference reports bearing that date are in the case.

As shown therein settlement was made with taxpayer on the basis of discounting expected profits over a normal operating life of 40 years.

This action was taken by the section upon instructions from the undersigned special conferee.

A 40-year life was allowed in spite of the fact that taxpayer only held a 20 year lease at organization, for the following reasons:

1. Taxpayer maintained that a custom, amounting almost to unwritten law, exists in his district which provides that any lessee is given the privilege of renewal at the expiration of his lease.

2. Taxpayer demonstrated that he had obtained control of all the surrounding property in such a way that the fee owner would not have been physically able to lease the property to any one else without his (taxpayer's) consent.

Shades of Blackstone! It seems to be almost unnecessary——

Senator KING. Do not comment.

Mr. MANSON (continuing). To comment.

Senator KING. Because that is a sort of blackmailing proposition.

Mr. MANSON. It is not only that, but anyone who knows the least thing about the fundamental principles of the law of real property, knows that if, by any means, a man's property is surrounded, the law has from time immemorial recognized the right of the man thus surrounded to demand a right of way to his property. From time immemorial that has been the law. It is laid down as a fundamental principle in Blackstone, and recognized ever since.

There is as much soundness in that and as much merit as there is in the first proposition, that because it was the custom of the community to renew leases, therefore, the lessee of a farm had a property right extending beyond his lease.

The CHAIRMAN. I think, Mr. Manson, if you would give those reasons in continuity, without interjecting these remarks, we would probably get a better picture of it.

Mr. MANSON. I guess so.

3. Taxpayer cited the fact that he had secured a renewal of his lease when it expired in 1919, at its original terms, thus demonstrating the truth of his contentions as above set forth under (1) and (2). This renewal was practically a lease in perpetuity.

A memorandum from review section, dated February 25, 1924, is now referred to nonmetals, by audit G, stating that 20 years should be the period adhered to, the life of the original lease, and that paid-in surplus allowed as valuation of lease at organization of the company in 1900, should be amortized over 20 years, instead of over 40 years, as was determined by this section.

RECOMMENDATION

Case has now been reviewed by nonmetals section in consultation with special conferee, undersigned.

Inasmuch as the settlement with taxpayer, set forth in above mentioned conference report, was arrived at as a compromise after prolonged controversy; and final calculations regarding valuation and amortization of leasehold were set down in taxpayer's presence; and he was assured that his case would be closed upon that basis.

The memorandum of review section is herewith returned with the recommendation that final audit be completed on basis of valuation report originally written under date of January 21, 1924.

A. R. SHEPHERD,
Special Confree.
E. S. BOALICH,
Subsection Chief.

Noted:

J. H. BRIGGS,
Chief, Nonmetals Valuation Section.

I am going to offer as exhibits in this case, the various memoranda which show the course that the case took.

They finally did prevail, after repeated efforts, and in spite of the backing that Mr. Shepherd had from his own chief—they finally did prevail upon him to cut the life of this valuation down to 20 years, which makes the amount $154,120.70, which was finally allowed. Regulations 62, article 206, beginning at page 87, provide as follows:

Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight: (1) If the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer, or to extrinsic

causes other than the possession of the mineral itself. Where the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

I submit that in this case the fact that another lease was obtained upon an adjoining property during the period between the beginning and the termination of this lease, upon the same terms, is conclusive of the value of that property, and shows that the royalty paid was equal to the value. The fact that this lease was renewed at the end of its term, without bonus and upon the same royalty terms, shows that the lease itself was not considered to have any value.

I have discussed this matter of capitalization of prospective profit in other cases, but I want to call the attention of the committee to this fact, that in a case such as this, where it is conceded that the clay had little or no value to one who did not possess the capital to exploit it, to one who did not have the machinery and equipment with which to convert it into brick, and to one who did not have a market for his brick, that is conceded. I take the position, therefore, that this value, as set up here is dependent mainly not upon the value of the clay in the ground, but upon the value of the business.

I would call the attention of the committee to the fact that in the conference reports which I shall introduce in evidence, it is shown that the taxpayer was confronted with that situation by the engineers, and that he took the position that if this partnership were sold as a whole, as a going business, you would have to capitalize these profits, and that that was the basis on which this valuation was made.

Take the case of any lease. If I have an advantageous lease over a long period of time, at a rental much below the going rates of rental for that class of property, that lease is an asset to me; it has a value to me regardless of whether I conduct my business at a profit or at a loss. I have known of cases where bankrupt concerns left as the only valuable element of their estate an unexpired lease which was sold by the trustee, and upon which the only real assets of the estate were realized; yet, if you had applied this method of capitalizing profit in that instance, you would have been able to make a real asset appear to be a liability. Or, to put the case the other way around: Here we have a profit of $1.38 a ton accepted by the bureau. It is conceivable that this taxpayer, making a profit of $1.38 on this clay could have paid 50 cents for the clay and still have made a profit. If this taxpayer had paid 50 cents for this clay when the going price of that clay was 25 cents, clearly his lease, instead of being an asset, would have been a liability. But by capitalizing even that reduced margin of profit, by capitalizing at $1.13 instead of $1.38, you would have this lease appear to be of enormous value, although it was actually a liability.

It seems to me that those illustrations demonstrate the fallacy, the utter fallacy, of applying this rule to any case of a lease.

The CHAIRMAN. If the taxpayer, after receiving this large capitalization on the value of the property, had failed the year afterwards, through incompetent management or a change in the industry, that would have defeated the whole principle under which this tax was assessed, would it not?

Mr. MANSON. Certainly; because the taxpayer himself says—and I do not think it is necessary for me to go all the way through these exhibits—the taxpayer himself says that the reason he should receive a higher valuation on this lease than the value of the fee—mark you, that the reason he should receive a higher valuation on this lease than the value of the fee—was because the fee owners did not have the capital, the business genius, the organization, and the salesmanship with which to exploit the property and give the value that it had to them.

Senator KING. Is this case closed as yet?

Mr. MANSON. Is it, Mr. Parker?

Mr. PARKER. I do not know for certain whether it is or not. The refund letters were made out, but I could not tell whether they were collected or not.

Senator KING. You mean they ordered a refund?

Mr. MANSON. They ordered a refund of $26,193.48.

Senator KING. Has that refund been paid, as yet, Mr. Nash?

Mr. NASH. I do not know, Senator. I will check that up and find out.

Mr. MANSON. To complete the record in this case, I wish to offer Exhibits A to K.

There is another point in this case that is so tersely stated by Mr. Parker, the chief engineer of the committee, in the conclusion of his report, that I desire to read it into the record.

> The very essence of the law in its purpose of setting up invested capital, is defeated in this case by the employment of this method of valuation based on anticipated profits. If this method could be applied to the business of all taxpayers alike there would be no need of an excess profit tax, for the invested capital would be fixed by the profits themselves at a point where only 8 per cent could be realized on this fictitious capital, and there would not be any excess profits worth mentioning.
>
> We submit that the law in allowing the inclusion in invested capital of good will and other intangibles in a specific manner and under specific limitations certainly implied that such intangibles should not be included with the valuation of tangibles. This is what has happened in this case.
>
> To sum up briefly, we conclude the unit to be fundamentally in error, in making valuations of the intrinsic worth of natural resources from the total profits of a business when it is obvious that such profits are in a great measure due to good will, superior management, marketing ability, sufficient capital, and superior methods or processes.

The CHAIRMAN. As I understand it, it is just as necessary for the future that this matter be gone into, because the fixing of invested capital for depletion purposes is still necessary, even though we do not have any excess profit tax now.

Mr. MANSON. The fixing of valuation for depletion purposes, Senator, is still necessary, because depletion is going on as long as natural resources are being used.

The CHAIRMAN. Yes; I wanted to get that in the record here, because some people may have the impression that because the excess profits tax has been abolished it may not be necessary to again go through this same process of fixing invested capital, but it is necessary in view of the depletion that is allowed .

Mr. MANSON. I wish to offer Exhibit L, being the report of the committee's engineer.

The exhibits offered by Mr. Manson in connection with this case are as follows:

EXHIBIT A

In the Treasury Department, Bureau of Internal Revenue. Before the natural resource division in the matter of the valuation at date of incorporation of clay leaseholds of the Climax Fire Brick Co. Brief on behalf of the Climax Fire Brick Co.

This brief is filed supplementing the brief previously filed covering the valuation of the clay leaseholds at the date of incorporation which was disallowed by the Bureau of Internal Revenue in conference, for the reason that it was valued on the basis of the profits earned subsequent to the date of incorporation, instead of those earned prior thereto.

The Climax Fire Brick Co., which was incorporated under date of November 7, 1900, under the laws of the State of Pennsylvania, was organized for the purpose of taking over the business of a partnership, conducted under the same name by Henry Y. Haws and W. G. Bell

Under the date of December 31, 1900, the Climax Fire Brick Co. (corporation) purchased the assets of the Climax Fire Brick Co. (partnership) and assumed the then existing liabilities for a nominal sum of $100,000.

At the time of taking over the assets of the partnership the corporation delivered the entire amount of the capital stock of the corporation to Messrs. Haws and Bell, in payment for the said assets. The assets taken over the liabilities assumed by the corporation at December 31, 1900, are shown in the opening balance sheet of the company, attached hereto and designated as Exhibit "I."

The business engaged in by the partnership and continued by the corporation was the manufacture and sale of fire-clay products, such as fire brick, furnace blocks, tuyeres, etc., used in the construction of kilns, furnaces, Bessemer furnace bottoms, etc.

The primary and fundamental requisites for the manufacture of fire-clay products and the operation of a profitable business of this nature is a sufficient and suitable supply of fire clay.

There was included in the assets which were purchased from the partnership for the nominal sum of $100,000, a leasehold covering the mining of fire clay from an operating mine known as Cathcart Mine, for which no value was recorded on the books of the corporation.

Under date of April 24, 1899, prior to date of incorporation, a lease was entered into by Mr. W. G. Bell, a member of the partnership, with Mrs. M. V. and Wm. Cathcart, whereby they conveyed for a period of 20 years all rights to the mining of fire clay on, in, or under a certain tract of land situated in Porter Township, Clarion County, Pa., at a royalty of 25 cents per gross ton for No. 1 fire clay and 15 cents per gross ton for No. 2 fire clay.

At the date the corporation acquired the assets of the partnership, this lease was assigned by W. G. Bell and Henry Y. Haws to the corporation, for which the fair value at the date of acquirement is now claimed as paid-in surplus.

This company is engaged, and was engaged prior to the date of incorporation, in the manufacture of a high quality of fire-clay products. Its principal business being the manufacture of tuyeres and blocks, used in the construction of Bessemer furnace bottoms, the manufacture of which requires the use of an exceptionally high quality of fire clay.

By reason of the quality of these products being far superior to any manufactured by its competitors, namely the long endurance in the resistance of the intense heat of molten steel and iron, which is attributed to the unique structure of the clay in this deposit the company is known as the manufacturers of the highest grade products of this nature.

Since the date of incorporation of this company the earnings have been exceptionally large as compared with the values at which the assets appear in the balance sheet, and its prosperity has been continuous. The results of the operations have shown large returns on the capital, and the dividend rates have been exceptionally high. For the period from the date of incorporation, up to 1918, the company shows annual average earnings at 21 per cent and average annual dividend payments of 14 per cent.

In Exhibit II, attached hereto and made a part of this brief, is presented a copy of the lease, for which the value is now claimed at the date of incorporation.

By reference to the copy of this lease, it will be noted that it provided for a period of 20 years, and further provided for the exclusive right to mine all the fire clay on or under the respective tract.

This company now submits that the valuation be made on the basis of the entire life of the mine, for the reason that it is implied and understood in this region that the lessee shall be required to mine clay or pay an annual royalty for the period embodied in the lease, and that he is permitted to mine clay as long thereafter as it can be mined, on a profitable basis, which inference is characteristic of all gas, oil, and clay leases entered into on a royalty basis in this region.

At the date of the expiration of this lease a new lease was entered into upon the same conditions and royalty as was provided for in original lease.

VALUE OF LEASEHOLDS AT DATE OF INCORPORATION

The method used in valuing this leasehold is as recognized by the coal valuation section of the natural resource division, Bureau of Internal Revenue, namely, by the use of Hoskold's formula, which provides interest on the present worth of $1 at 8 per cent annually.

By applying this method to the average total estimated earnings for the life of the mine of $1,766,320, based upon the average profit per ton from clay consumed of $1.80 for the period from October 1, 1899, to December 31, 1900, after providing an average annual return of 8 per cent on the average annual net tangible assets for the same period, the value arrived at, based upon the 50-year life of the mine, is $408,621.62. From this value there has been deducted $28,484.40, representing the present worth (Hoskold's formula, 8 per cent—4 per cent) of the estimated capital expenditures, which it would be necessary to make to keep the mine on a producing basis, or a net value for the leasehold of $380,137.22. The estimated capital expenditures have been based upon the original investment at the date of incorporation, which have an estimated life of 10 years plus four similar expenditures for the remaining 40 years of the estimated life of the mine.

The 50-year term used as the estimated life of the mine is based upon an engineer's report, a copy of which is designated as Exhibit III, which report shows unmined clay at November 9, 1922, of 753,970 gross tons. During the period from January 1, 1901, to November 9, 1922, 146,854.3 gross tons of clay were mined, which when added to the unmined tonnage at November 9, 1922, shows 900,824.3 gross tons at January 1, 1901. The total clay mined for the period from January 1, 1901, to November 9, 1922, was 428,925 gross tons, or an average annual production of 19,648 gross tons, which when divided into total tonnage of 998,982.5 gross tons at January 1, 1901 (900,824.3 Cathcart mine, 98,158.2 Buzzard mine), reflects a life of possibly 50 years. The Buzzard mine consisted of an old tract which was entirely worked out and abandoned during 1907.

In Exhibit IV, attached hereto, is presented a statement, setting forth a detailed valuation of the leasehold on the basis as outlined above, and in Exhibits I and V are presented balance sheets and statements of income, profit, and loss for the period from October 1, 1899, to December 31, 1900.

Wherefore, it is respectfully submitted that the values claimed herein for the leasehold at date of acquirement of $380,137.22 be allowed as paid-in surplus and that a deduction from taxable net income be allowed for depletion, based upon this valuation and the actual tonnage in the mine as stated herein.

DAVID BARRY.

COMMONWEALTH OF PENNSYLVANIA,
County of Cambria, ss:

Before me, the subscriber, personally appeared David Barry, who, being duly sworn according to law, deposes and says that he is president of the Climax Fire Brick Co. and that the statement of facts as hereinbefore set forth is true and correct as he verily believes.

(Signed) DAVID BARRY.

Sworn to and subscribed before me this 9th day of January, A. D. 1924.

[SEAL] HARRY V. KUNTZ,
Notary Public.

My commission expires January 15, 1927.

EXHIBIT I OF A

Climax Fire Brick Co. balance sheets, October 1, 1899, to December 31, 1900, inclusive

	Oct. 1, 1899	Dec. 31, 1899	Dec. 11, 1900
ASSETS			
Cash		$1,307.14	$6,950.33
Notes receivable		2,546.62	2,689.55
Accounts receivable		5,650.84	7,142.49
Inventory	$5,712.00	7,201.73	11,038.79
Real estate	1,240.00	1,240.00	2,260.00
Clay mine development	3,500.00	3,500.00	10,670.26
Gas wells development	683.00		15,000.00
Buildings	11,000.00	11,000.00	10,632.63
Dwelling houses			8,146.18
Machinery and equipment	27,865.00	34,766.05	48,817.88
	50,000.00	67,212.38	123,648.11
LIABILITIES AND CAPITAL			
Accounts payable—trade		4,920.83	8,078.64
Accounts payable—officers, etc		80.00	51.66
Capital	50,000.00	62,211.55	115,517.81
	50,000.00	67,212.38	123,648.11

EXHIBIT II OF A

This agreement made the 24th day of April, A. D. 1899, by and between Mrs. M. V. Cathcart and William Cathcart, her husband, of Porter Township, Clarion County, Pa., of the first part; and W. C. Sell, of Climax, of said county and State, of the second part.

Witnesseth: That the said parties of the first part for and in consideration of the sum of $1 to them in hand paid the receipt whereof is hereby acknowledged, and in further consideration of the covenants and agreements hereinafter mentioned, have granted, sold, demised, and let unto the said party, his heirs or assigns, all the fire clay on, in, or under that certain tract of land situated in Porter Township, Clarion County, Pa., bounded and described as follows:

North by lands of W. C. Sell, east by lands of J. J. Anthony, south by lands of J. J. Anthony, and west by waters of Red Bank Creek, containing one hundred (100) acres or less.

To have and to hold the same unto the said second party, his heirs or assigns, for the term of twenty (20) years from the date hereof. Together with the right of way over said premises to and from the places of operating, and also sufficient ground to erect buildings, construct railroads, or platforms necessary for mining and carrying away all fire clay mined on said lands.

The said second party hereby agrees, in addition to the sum of one dollar hereinbefore mentioned, to pay a sum of twenty-five (25) cents per ton of 2,240 pounds for each and every ton of number one fire clay and fifteen (15) cents per ton of same number of pounds, for each and every ton of number two fire clay that may be mined and removed from said premises.

And the said second party also binds himself, his heirs or assigns, to mine fire clay to the amount of one hundred (100) dollars per year or pay for the same, unless the fire clay will not justify him on account of quality or quantity; said second party to be the judge; settlements to be made every three months.

And it is hereby further agreed by both parties hereto, that a certain article of agreement dated the first day of August, A. D. 1884, by and between Mrs. M. V. Cathcart and William Cathcart, her husband, of the one part and Thomas Johnston, of the other part, acknowledge the 16th day of August, A. D. 1889, and recorded in Clarion County on the 4th day of September, A. D. 1889, in the recorder's office of said county, in license, agreements, etc., volume 8, page 44, is hereby rescinded and canceled in so far as its terms are inconsistent with

the terms of the present lease. Failure to comply with the terms of this lease shall render it null and void.

In witness whereof the said parties have hereunto set their hands and seal the day and year above written.

MIRIAM V. CATHCART. [SEAL.]
WM. CATHCART. [SEAL.]
W. G. BELL. [SEAL.]

Signed, sealed, and delivered in the presence of—
KATIE SHOEMAKER.
J. T. SHOEMAKER.
W. T. A. CRAIG.

STATE OF PENNSYLVANIA,
Armstrong County, ss:

On this 24th day of April, 1899, before me, the subscriber, a justice of the peace in and for said county, personally came the above-named Mrs. M. V. Cathcart and William Cathcart, her husband, who in due form of law acknowledge the foregoing indenture to be their act and deed and desired it to be recorded as such:

She, the said Mrs. M. V. Cathcart, being of full age, and examined by me separate and apart from her said husband, and the contents of the within indenture being by me first made fully known to her, declared that she did voluntarily and of her own free will and accord, sign, seal, and as her act and deed deliver the within written indenture, without any coercion or compulsion of her said husband.

Witness my hand and official seal the day and year aforesaid.

[SEAL.] J. T. SHOEMAKER,
Justice of the Peace.

STATE OF PENNSYLVANIA,
County of Clarion, ss:

Recorded on this 25th day of April, A. D. 1899, in the recorder's office of said county, in lease, agreement, etc., book, vol. 13, page 136.

Given under my hand and seal of office at Clarion, the date above written.

[SEAL.] S. S. LAUGHLIN, *Recorder.*

Now, Oct. 19, 1899, for a valuable consideration, I hereby sell, assign, transfer, and set over to Henry Y. Haws, of Johnstown, Pa., his heirs and assigns, all my interest to and in one-half of the within agreement or lease.

W. G. BELL. (SEAL.)

Witness my hand and seal—
JNO. M. ROSE.

STATE OF PENNSYLVANIA,
County of Cambria, ss:

On this 19th day of October, 1899, personally appeared before me the subscriber a Notary Public in and for said County, W. G. Bell, above named, who in due form of law acknowledged the foregoing assignment to be his act and deed and desired the same to be recorded as such.

ALEX N. MART, *Notary Public.*

Nov. 17, 1899, for a valuable consideration, I hereby sell, assign and transfer to the Climax Fire Brick Co., all my rights, title and interest in the within lease.

W. G. BELL.
HENRY Y. HAWS.

CLIMAX, PA., *April 1, 1902.*

CLIMAX FIRE BRICK CO.,
Climax, Pa.

GENTLEMEN: Please pay to Flora May Shoemaker one-fourth (¼) of all amounts coming to me for clay royalties after January 1, 1903.

MIRIAM V. CATHCART.

EXHIBIT III OF A

CLIMAX FIRE BRICK CO., CLIMAX, PA.—ESTIMATE OF UNMINED CLAY TONNAGE AS OF NOVEMBER 9, 1922

DEPOSIT BANK BUILDING,
DuBois, Pa., November 30, 1922.

a Lease number, 1—2.
b Name of lessor, Jacob J. Anthony—Alex. and Bolls Cathcart.
c Date of lease, March 11, 1907—April 25, 1919.
d Name of tract, Anthony—Cathcart.
e Workable seams, 1—1.
f Average thickness, 9 feet—6 feet.
g Recovery per acre-foot, 2,270 net tons—2,270, 75 per cent basis.
h Area leased, 64—93.
i Nonclay bearing area, 14—13.
j Mined-out area three-fourths of 20A, mined), 15—8.
k Nonmineable; faulty, 30—10.
l Net clay area, 5—52.
m Total recovery, 102,250 net tons—844,440; 91,300 gross tons—753,970.

EXHIBIT IV OF A

CLIMAX FIRE BRICK CO.—VALUATION OF CLAY LEASEHOLDS

Net profit prior to incorporation (Exhibit V):		
Oct. 1 to Dec. 31, 1899	$6,924.34	
Jan. 1 to Dec. 31, 1900	28,342.01	
Total		$35,266.35
Average net tangible assets (Exhibit I):		
Oct. 1, 1899	$50,000.00	
Dec. 31, 1899	62,211.55	
Total	112,211.55	
Average annual net tangible assets	56,105.78	
Average net profit attributed to tangible assets (8 per cent per annum, 15 months)		5,610.58
Net profit attributed to leaseholds		29,655.77
Tonnage mined Oct. 1, 1899, to Dec. 31, 1900 (inc.) (gross tons)		16,485.45
Average profit per gross ton attributed to leaseholds		$1.80
Estimated consumption of clay subsequent to Dec. 31, 1900:		
19,648 gross tons per year for 50 years (gross tons)		982,400
Estimated total value (982,400 by $1.80)		$1,768,320.00
Present worth, Jan. 1, 1901 (Hoskold's formula 8 per cent—4 per cent factor 0.231079)		408,621.62

Cost of machinery and development

	Estimated capital expenditures	Life (years)	Factor	Present worth
1901	$10,670.26	10	1.00	$10,670.26
1911	10,670.26	10	.612404	6,534.51
1921	10,670.26	10	.440211	4,697.17
1931	10,670.26	10	.340726	3,635.64
1941	10,670.26	10	.276171	2,946.82
				28,484.40

Value of leasehold January 1, 1901, claimed as paid-in surplus, $380,137.22.

EXHIBIT V OF A

Climax Fire Brick Co.—Statement of income, profit and loss

	Oct. 1 to Dec. 31, 1899	Jan. 1 to Dec. 31, 1900
Income:		
Merchandise sales	$16,068.63	$78,800.61
Rent	110.00	445.36
	16,178.63	79,245.97
Expenses:		
Clay	2,705.47	14,268.78
Labor	4,722.19	25,916.53
Fuel	888.54	5,771.63
Repairs	337.34	1,523.31
Miscellaneous expenses	600.75	3,209.39
Pittsburgh office expense		514.32
	9,254.29	50,903.96
Net profit for period	6,921.34	28,342.01

EXHIBIT B

CONSOLIDATED CASE

CLIMAX FIRE BRICK CO., CLIMAX, PA., AND LONG RUN FUEL CO.

SECTION OF MISCELLANEOUS NONMETALS,
Washington, D. C., September 30, 1920.

Taxable years 1916 and 1917.

Bessemer tuyeres and No. 1 fire brick manufacturing.

Leases of clay and natural gas for production purposes.

1. There are two affiliated companies involved in this operation; the parent company being the Climax Fire Brick Co., engaged in manufacturing tuyeres and fire brick and the subsidiary company, the Long Run Fuel Co., dissolved in 1919, and was incorporated to supply natural gas at cost to the parent company.

2. As to valuation of the fire clay, Form F was submitted in blank with the statement that it does not apply. The taxpayer states in letter of September 20, 1920: "We lease the land from which fire clay is mined" * * *. "During 1919 we figured 5 per cent depletion from our clay mines account." As Form F shows that nothing was paid for the clay lease, no asset representing clay is allowed. Depletion is not involved.

Action taken:

Fair market value of clay as of March 1, 1913, account "Clay mine and equipment," claimed $25,500.00

Allowed: Nothing for clay.

1916

Depletion claimed:	
Clay mine and equipment	$700.14
Gas well line and leases	3,674.93
Total	4,465.07

Depletion allowed: Nothing for clay.

1917

Depletion claimed:	
Clay mine and equipment	$4,085.53
Gas well lines and leases	10,541.77
Total	14,627.30

Depletion allowed: Nothing for clay.

JOHN SEWARD,
Valuation Engineer.

EXHIBIT C.

TAXPAYER'S CONFERENCE

DECEMBER 11, 1923.

Taxpayer: Climax Firebrick Co.
Address: Climax, Pa.
Represented by Mr. Morgan, treasurer; Mr. N. C. Domhoff.
Matter presented: Claim for paid in surplus on clay leasehold acquired in 1900, amounting to $250,453.83.
Issues discussed: The merits of above claim.
Conclusions: Taxpayer was given until January 13, 1923, to submit additional evidence. Brief, as submitted was not accepted as satisfactory substantiation of claim as to valuation of leasehold.
Interviewed by,

FRANK H. MADISON,
Conferee.
E. S. BOALICH,
Subsection Chief.

Noted:

J. H. BRIGGS,
Chief Nonmetals Valuation Section.

EXHIBIT D

DECEMBER 12, 1923.

Climax Fire Brick Co., Climax, Pa., lessees of fire clay deposits, and manufacturers of tuyeres, firebrick, etc. Organized 1900. Valuation report for 1917 and 1918.

This case was valued in nonmetals section September 30, 1920. At that time all value and depletion for clay were disallowed.

On December 10, 1923, a brief was filed by taxpayer claiming value of clay leasehold at acquisition as $250,453.83 and asking that that value be allowed as paid-in surplus, and that a deduction from taxable net income be allowed for depletion, based upon this valuation and the total available units as shown in engineers' report attached to brief.

At the same time Mr. Morgan, treasurer of the company, and Mr. N. C. Domhoff, his auditor, appeared in conference to support that claim.

It was shown that the original leasehold was secured in 1899, by predecessor partnership, on a straight royalty basis, no bonus of any kind being paid.

At organization of the company in 1900 the leasehold was turned in for nothing, not even being entered on the books as an asset.

In 1907 an adjoining property was leased at same royalty rates, nothing being paid for the lease in the way of a bonus.

In 1919 the first lease expired and was renewed on same terms, apparently to the satisfaction of all concerned.

Valuation at the above-mentioned figure is set up by taxpayer on the basis of average profits for 1901, 1902, 1903, 1904, and 1905, discounted over 50 years.

Nothing was paid for the lease either in stock or cash. There is nothing to indicate that it had a market value, known or ascertainable, at date that it was turned into the corporation by the partnership. Leases taken in 1899, 1907, and 1919 were all on a straight basis, no bonus or other payment being required in any case.

It is held that the lease hold had no marked value, from the standpoint of income tax law, either at acquisition or at March 1, 1913.

Action taken: Valuation of leasehold at acquisition in 1900 claimed (paid-in surplus), $250,453.83; allowed (as above set forth), nothing.

Valuation report of September 30, 1920, is confirmed, in which March 1, 1913, value, and depletion were disallowed.

E. S. BOALICH,
Subsection Chief.

EXHIBIT E

TAXPAYER'S CONFERENCE,
ENGINEERING DIVISION, NONMETALS SECTION,
January 21, 1924.

Taxpayer: Climax Firebrick Co.
Address: Climax, Pa.
Represented by: L. R. Morgan, Secretary and Treasurer; M. C. Dornhoff, F. C. Miller.

Matter presented: Claim for paid-in surplus on clay leasehold acquired by corporation from predecessor partnership, at organization November 7, 1900, amounting to $390,137.22. This amount was arrived at by discounting the expected profits of the predecessor portnership over 50 years.

Issues discussed: In considering the above claim the following points were discussed:

The lease was obtained by one of the partners a little more than a year prior to the organization of the company, on a straight royalty agreement.

Adjoining clay deposit was leased by the corporation in 1907 on same terms; no bonus asked or paid.

The original lease was renewed in 1919 on same terms that held in 1899; no bonus.

The total royalties over a period of 50 years would approximate $200,000, and the present value of the total royalties at acquisition is equivalent to about $45,000.

In reply to arguments that the entire deposit could have been purchased outright for a mere fraction of the sum claimed for paid-in surplus on the leasehold alone, taxpayer maintained that:

The clay deposit had a comparative low value to the fee owner, as he had no ability nor capital to manufacture refractory products.

The partnership made great profits from the moment it started business October 1, 1899, to the organization of the corporation.

The value of the leasehold to the partnership was incalculably greater than the value of the clay to the owner, as the partnership had demonstrated its ability to earn many times the amount of the royalty income received by the fee owner of the clay.

A "willing buyer" contemplating purchase of partnership business, at date the business was incorporated, would have calculated value of leasehold on basis of the earnings, giving due consideration to value of physical assets and attributing a fair percentage of the net profits to those assets.

The reason the adjoining property was leased in 1907, and the original lease renewed in 1919, on such easy terms, being that taxpayer had bought up the surrounding property on every side and the owners of the clay deposits had to do business with the taxpayer or let their property be idle, producing no income whatsoever.

Conclusions: It was finally agreed to accept the valuation claimed by taxpayer in principle, but to revise the factors involved in making his calculations on a fair and reasonable basis. The details are shown in accompanying valuation memorandum dated January 21 (IT:EN:NM:ESB), and the resulting figure of $200,456 was agreed upon as valuation of leasehold at January 1, 1901, this amount to be amortised over 40 years at rate of $5,011.40 annually.

Interviewed by:

F. H. MADISON,
Conferee.
E. S. BOALICH,
Subsection Chief.

Noted:
J. H. BRIGGS,
Chief, Nonmetals Valuation Section.

EXHIBIT F

JANUARY 21, 1924.

Climax Firebrick Co., Climax, Pa. Lessees of fire-clay deposits, and manufacturers of tuyeres and fire brick. Organized 1900. Valuation report for 1917 and 1918. (Case in audit section.)

This case was reviewed in nonmetals section September 30, 1920, at which time all value and depletion for clay was disallowed.

On December 10, 1923, a brief was filed by taxpayer claiming valuation of clay leasehold at acquisition as $250,453.83 and asking that value be allowed as paid-in surplus.

That figure was determined by discounting expected profits of corporation based on average earnings during the first five years after organization.

In conference December 11, 1923, taxpayer was informed by this section that his brief was not acceptable as satisfactory substantiations of his claim for valuation of leasehold, and at his request he was given an extension of time to submit additional evidence.

On January 21, 1924, taxpayer again appeared in conference, having submitted a second brief under date of January 10, 1924.

In this brief he discounts the profits of the predecessor partnership—as shown from 15 months' operating experience—over 50 years, and arrives at a valuation of leasehold, at organization of corporation, amounting to $380,137.22.

As shown in conference memorandum of January 21, 1924, taxpayer's method of valuation was accepted in principle, but various adjustments were made in the factors entering into the calculation.

The items shown in the "allowed column" were each agreed to by the taxpayer, as well as the final result.

Action taken	Claimed	Allowed
Net profits of partnership prior to incorporation	$35,266.35	$35,266.35
Value of physical assets of partnership	$56,105.78	$100,000.00
Per cent of net profit attributed to physical assets.....per cent	8	10
Net profits attributed to physical assets	$5,610.58	$12,500.00
Net profits attributed to leasehold	$29,655.77	$22,766.35
Tonnage mined by partnership (15 months)	$16,435.45	$16,435.45
Average profit per gross ton	$1.80	$1.36
Estimated future annual production.....tons	19,648	13,152
Life of deposit.....years	50	40
Total tons over life of deposit	982,400	526,080
Total expected profits	$1,768,320	$725,990.40
Hoskolds factor	.231	.276

Present worth of expected profits, i. e., valuations of leasehold at acquisition:

Claimed as paid in surplus	$380,137.22
Allowed as paid in surplus	200,456.00

The above to be amortized over a life of 40 years beginning January 1, 1901, in equal amounts of $5,011.40.

Amortizations of leasehold

1901 to 1916, inclusive	$80,182.40
1917	5,011.40
1918	5,011.40

E. S. BOALICH,
Subsection Chief.

Noted:

J. H. BRIGGS,
Chief, Nonmetals Valuation Section.

EXHIBIT G

JANUARY 29, 1924.

Mr. S. M. GREENIDGE,
Head, Engineering Division.

Re: Climax Fire Brick Co., Climax, Pa.

Inclosed are data in the case of the above-mentioned company, also conference memorandum and valuation memorandum of this unit based upon instructions given in conference.

The questions involved relate to value of leasehold of clay land as at December 31, 1900, at which time the Climax Fire Brick Co. (corporation) acquired the assets of the Climax Fire Brick Co. (partnership).

The leasehold in question was first acquired by a Mr. Bell under date of April 24, 1899; under date of October 19, 1899, Mr. Bell assigned one-half interest in the leasehold to a Mr. Haws; these two composed the Climax Fire Brick Co. Life of leasehold is 20 years.

No bonus was paid for the leasehold, the clay being paid for on a royalty basis. No statement of any amount paid for one-half interest by Mr. Haws has been made.

The corporation issued $100,000 par value of stock, assuming liability for the assets of the partnership. The allocation of assets at that date makes no mention of leasehold.

In 1920 it appears that company returned Form F to this office in duplicate, showing nothing paid for leasehold.

On December 10, 1923, a brief was submitted by the taxpayer in which a value for the leasehold as at December 31, 1900, was placed at $250,453.83. This value was computed on the basis of earnings subsequent to acquisition (five-year period) and a life of 50 years. Taxpayer was advised that the basis of valuation was not sound, that it would be necessary to base valuation upon data at or before the date of acquisition rather than upon data occurring subsequent to acquisition.

Taxpayer submitted a new brief dated January 10, 1924, in which the valuation is based upon the earnings of the partnership from October 1, 1899, to December 31, 1900, at which time the partnership assets were transferred to the corporation, and a life of 50 years.

In 1907 the company acquired a leasehold covering an adjoining property containing the same kind of clay upon the same royalty terms as in the lease in question, no bonus being paid. In 1919 the original lease expired and a renewal was made upon the same terms; no bonus. Based upon the fact that no bonus was required for the lease acquired in 1907 and that the original lease was renewed in 1919 without bonus, the royalty terms being unchanged, this unit held that the original leasehold had no value. The word "value" as here used means the selling price (or cost) that would pertain between a willing buyer and a willing seller.

The taxpayer protested the holding of the unit, and the question being referred to a special committee, instructions were issued to determine valuation based upon earnings from October 1, 1899, to December 31, 1900, making allowance for manufacturing profits and a life of 40 years. In accordance with a memorandum of the committee on appeals and review in the case of the Houston Collieries Coal Co., Cincinnati, Ohio, the valuation should have covered a period not exceeding the life of the lease.

The taxpayer states in support of the value claimed of the clay in question that the finished product is superior to that made from other clays and that it brings a premium in the market. Admitting that this is so, it is apparent that the taxpayer pays for this superiority in the raw material, in that the royalty rate per ton is approximately double the royalty paid for other clays used in producing the same finished products.

In the discussion in conference the taxpayer was advised that the entire deposit could have been purchased outright for a mere fraction of the sum claimed for paid in surplus on the leasehold above. The taxpayer replied that the clay deposit had a comparative low value to the fee owner, as he had no ability nor capital to manufacture refractory products.

In this reply the taxpayer unconsciously recognizes the fact that the profits of the business are due not so much to the raw material as to the capital employed in the business and the ability of the management.

This is the same idea that has been expressed by Mr. E. C. Eckels in a discussion of the Portland cement industry. An analysis of the elements that enter into the business of the conversion of the raw material into a finished product is set out in which it is shown that the raw material is a very unimportant factor ("negative"). The real factors are the ability of the management, capital employed, perfection of processes, etc.

This matter is submitted to you for instructions as to further action.

J. H. Briggs.
Chief of Section.

EXHIBIT H

BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT, ENGINEERING DIVISION,
January 30, 1924.

Mr. BRIGGS,
Chief, Nonmetals Valuation Section.

In re: Climax Fire Brick Co., Climax, Pa.

There is returned to you the case of the above-named taxpayer.

Conference report dated January 21, 1924 states:

"It was finally agreed to accept the valuation claimed by taxpayer in principle, but to revise the factors involved in making his calculations on a fair and reasonable basis. The details are shown in accompanying valuation memorandum dated January 21 (IT:EN:MM:ESB) and the resulting figure of $200,456.00 was agreed upon as valuation of leasehold at January 1, 1901, this was agreed upon as valuation of leasehold at January 1, 1901, this amount to be amortized over 40 years at the rate of $5,011.40 annually."

This case will be closed in conformity with conclusions reached at this conference.

S. M. GREENIDGE,
Head of Division.

EXHIBIT I

ENGINEERING DIVISION, NONMETALS SECTION

Special memorandum

In re: Climax Firebrick Co., Climax, Pa. Manufacturers of Refractories. Organized 1900. Taxable years 1917 and 1918.

This case was valued on January 21, 1924, by the nonmetals section following conference with taxpayer held on that date.

Valuation and conference reports bearing that date are in the case.

As shown therein, settlement was made with taxpayer on the basis of discounting expected profits over a normal operating life of 40 years.

This action was taken by the section upon instructions from the undersigned special conferee.

A 40-year life was allowed in spite of the fact that taxpayer only held a 20-year lease at organization, for the following reasons:

1. Taxpayer maintained that a custom, amounting almost to unwritten law, exists in his district which provides that any lessee is given the privilege of renewal at the expiration of his lease.

2. Taxpayer demonstrated that he had obtained control of all the surrounding property in such a way that the fee owner would not have been physically able to lease the property to any one else without his (the taxpayer's) consent.

3. Taxpayer cited the fact that he had secured a renewal of his lease when it expired in 1919, at its original terms, thus demonstrating the truth of his contentions as above set forth under (1) and (2). This renewal was practically a lease in perpetuity.

A memorandum from review section, dated February 25, 1924, is now referred to nonmetals, by audit G, stating that 20 years should be the period adhered to, the life of the original lease, and that paid-in surplus allowed as valuation of lease at organization of the company in 1900 should be amortized over 20 years, instead of over 40 years, as was determined by this section.

Recommendation: Case has now been reviewed by nonmetals section in consultation with special conferee, undersigned.

Inasmuch as the settlement with taxpayer set forth in above-mentioned conference report was arrived at as a compromise after prolonged controversy, and final calculations regarding valuation and amortization of lease-

hold were set down in taxpayer's presence, and he was assured that his case would be closed upon that basis:

The memorandum of review section is herewith returned, with the recommendation that final audit be completed on basis of valuation report originally written under date of January 21, 1924.

A. R. SHEPHERD,
Special Conferee.
H. S. BOALICH,
Subsection Chief.
J. H. BRIGGS,
Chief, Nonmetals Valuation Section.

EXHIBIT J

BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT, NATURAL RESOURCES AUDIT DIVISION,
March 3, 1924.

Mr. W. C. TUNGATE,
Chief, Section C.
In re: Climax Fire Brick Co.

The memorandum of February 29, from the engineering division is noted. In conference with Mr. Shepherd, it was understood that the result would not be greatly different whether the deduction should be allowed on a 20-year basis, or a 40-year basis, and this section indicated that it might approve the case if such were the facts.

However, on investigation it is found that by handling the case on a 20-year basis, the resulting refund is changed over $4,000. It is true that this case has been settled in conference and that the conferees were not conversant with the new ruling in making adjustments of this nature; but since the amount has such a marked effect on the tax liability, I see no reason why it should not be done in accordance with the recent ruling.

I, therefore, recommend that the adjustment be made on a life of 20 years instead of 40 years. I discussed the matter with Mr. Griggs, assistant head of engineering division, and he stated that they desired to have the adjustment made correctly.

ROBT. C. SMITH,
Chief, Review Section.

EXHIBIT K

ENGINEERING DIVISION, NONMETALS SECTION,
March 22, 1924.

Ref: IT:NR:G-9-WLA. Climax Fire Brick Co., Climax, Pa. Organized 1900. Valuation report for 1917 and 1918. (Case in audit section.)

This report supersedes all prior reports.

Valuation memoranda previously written on January 21, 1924, and February 29, 1924.

Value of leasehold was allowed, at acquisition in 1900, on basis of discounted expected profits over a life of mineral deposit of 40 years, although the lease itself was for 20 years.

The attention of this section has now been called to the unpublished A. R. R. No. 6459, by the chief of review section in memorandum dated March 3, 1924.

In compliance with the provisions of that ruling the valuation of taxpayer's leasehold at acquisition has been established as follows:

The lease was dated April 24, 1890, and was granted for a term of 20 years. The original lessee was W. O. Bell, one of the partners who formed the Climax Fire Brick Co. on November 7, 1900.

The life of the lease, to the corporation, was therefore from November 7, 1900, to April 24, 1919, or 18 years 5 months and 17 days, i. e., 1 month 23 days in 1900; 18 years from 1901 to 1918, inclusive; 3 months and 24 days in 1919.

The partnership was in operation 15 months prior to incorporation and valuation of leasehold at acquisition is based on discounted expected profits, as indicated by the results of the partnership earnings.

ACTION TAKEN

Net profits of partnership prior to incorporation (15 months)	$35,266.35
Value of physical assets of partnership	$100,000.00
Per cent of net profit attributed to physical assets	10%
Net profit attributed to physical assets	$12,500.00
Net profit attributed to leasehold	$22,766.35
Tonnage mined by partnership	16,435.45
Average profit per gross ton	$1.38
Estimated future annual output, tons	13,152
Life of lease, years	18.46
Total expected production over life of lease (13,152×18.44)	242,786
Total expected profits (242,786×$1.38)	$335,045.00
Hoskold's factor (at 8 per cent and 4 per cent)	.46
Present worth of expected profits, i. e., valuation of leasehold at acquisition is 335,045×0.46, or	$154,120.70

This value, $154,120.70 to be amortized over a life of 18 years 5 months and 17 days on a prorata basis, from November 7, 1900, to April 24, 1919.

NOTE.—The actual calculation is not made because the taxpayer's returns are not at hand and it is not known whether he reports on a calendar or fiscal year.

J. H. BRIGGS,
Chief, Nonmetals Valuation Section.

Noted.

E. S. BOALICH, *Subsection Chief.*

EXHIBIT L

OFFICE REPORT NO. 7

Taxpayer: Climax Fire Brick Co., Climax, Pa.
Business: Fire-brick manufacturer.
Subject: Valuation and depletion for invested capital purposes, nonmetal section.

Amounts involved:

Original value of leasehold claimed	$25,500.00
Claimed by taxpayer 12-7-23	250,453.83
Claimed by taxpayer 1-9-24	380,137.22
Allowed by order of conferee	200,456.00
Finally allowed on account protest review section of audit	154,120.70
Refund involved 1917-1919	26,402.48

SYNOPSIS OF CASE

The case of the Climax Fire Brick Co. is a case of setting up a fictitious value as of date of acquisition. This value is set up by the unit under the special conferee system as was the case in the United States Graphite Co. It is allowed taxpayer by special conferee in direct opposition to the views of the engineers in the nonmetal section as being directly contrary to methods used by them.

The set up finally allowed in this conference before the special conferee was as follows:

Net profits prior to incorporation (15 months' period)	$35,266.35
Value of physical assets	$100,000.00
Per cent annual profit allowed on physical assets (per cent)	10
Net profits attributed to physical assets (15 months)	$12,500.00
Net profits attributed to leasehold	$22,766.35
Tonnage mined prior to incorporation (15 months)	16,435.45
Average profit per gross ton	$1.38
Estimated future annual production, tons	13,152.00
Life of deposit years	40
Total tons over life of deposit	526,080.00
Total expected profits	$725,990.40
Hoskold's factor (at 6 per cent and 4 per cent)	.276

Present worth of expected profits—i. e., valuation of leasehold at acquisition, $200,456.

We believe that this value of $200,456 set up as the intrinsic value of the unmined clay as of date of acquisition on November 7, 1900, is entirely unwarranted, as well as the value of $154,120.70 as later set up on protest of review section of audit.

This revision made at the insistence of the review section modified the set-up shown in detail above as follows:

Life of lease (years)	18.46
Total expected production over life of lease in tons (13,152 by 18.46)	242,786
Total expected profits 242,786 by 1.38	$335,045.00
Hoskold's factor at 8 per cent and 4 per cent	.46

Present worth of expected profits—i. e., valuation of leasehold at acquisition, is $335,045 by 46 or $154,120.70.

This value is set up on the basis of profits; and throws into the value of the unmined clay all the profit arising from the good will of the business, the marketing ability of the manufacturers, the superior workmanship of his employees, and the business management of his organization.

This method of valuation is definitely condemned and prohibited in regulation 62, arts. 205 and 206.

HISTORY OF CASE

The Climax Fire Brick Co. is a manufacturing concern producing fire brick, furnace blocks, tuyeres, etc., as used in the construction of kilns, furnaces, Bessemer furnace bottoms, etc. The company's raw material is therefore fire clay.

The Climax Fire Brick Co. was incorporated under the laws of the State of Pennsylvania on November 7, 1900, taking over the business of the partnership of Henry V. Haws and W. G. Bell.

At this time of incorporation there was turned over to the company by the partnership a lease covering the right to mine and remove fire clay from a certain 100-acre tract. This lease was not included in the assets turned over to the corporation at any value. In fact no bonus was paid for the lease either by the partnership or corporation. The consideration was in the shape of a royalty of 25 cents per gross ton on No. 1 fire clay and 15 cents per gross ton on No. 2 fire clay. See brief of taxpayer, dated January 9, 1924, Exhibit II, for complete copy of this lease. (Exhibit A attached.)

On September 20, 1920, taxpayer in a letter transmitting Form F schedule, stated the value of lease for depletion purposes at $25,500.

Engineer John Seward of the unit reported on this claim on September 30, 1920, disallowing this value and all depletion allowances. (See Exhibit B attached.)

Nothing further appears on the record, until on December 7, 1923, taxpayer through his accountants, Richter & Co., of Pittsburgh, Pa., files a brief setting up a value of $250,453.83 as the value of leasehold on date of acquisition. This value is arrived at by the present value method (Hoskold's) using rates of 8 per cent and 4 per cent for operating profit and discount, respectively. The profit is estimated from the average profit for 5 years following date of acquisition, and the life of lease is taken at 50 years, although 20 years is the time specified in that document.

Following the presentation of this brief taxpayer was granted a conference under date of December 11, 1922. (See Exhibit C attached.)

On December 12, 1923, an engineer's report was prepared covering the results of above conference. This reports allows nothing for value of leasehold at date of acquisition and no depletion. (See Exhibit D attached.) This report was not used in audit as taxpayer had been granted additional time to submit more data.

On January 9, 1924, taxpayer filed an amended brief similar to that of December 7, 1923, except that lease is valued on basis of profits made by partnership in the period of 15 months prior to incorporation. This profit appears to have been a statement of fact by taxpayer rather than a substantiated statement. This brief is shown in full with exhibits under our Exhibit A attached. It claims a value of $380,137.22 for leasehold.

On January 21, 1921, taxpayer was granted a conference, as per Exhibit E attached.

The main portion of this conference report is quoted in full herewith as pertinent to this case.

"MATTER PRESENTED

"Claim for paid in surplus on clay leasehold acquired by corporation from predecessor partnership, at organization November 7, amounting to $380,137.22. This amount was arrived at by discounting the expected profits of the predecessor partnership over 50 years.

"ISSUES DISCUSSED

"In considering the above claim the following points were discussed:

"The lease was obtained by one of the partners a little more than a year prior to the organization of the company, on a straight royalty agreement.

"Adjoining clay deposit was leased by the corporation in 1907 on same terms; no bonus asked or paid.

"The original lease was renewed in 1919 on same terms that held in 1899; no bonus.

"The total royalties over a period of 50 years would approximate $200,000, and the present value of the total royalties at acquisition is equivalent to about $45,000.

"In reply to arguments that the entire deposit could have been purchased outright for a mere fraction of the sum claimed for paid-in surplus on the leasehold alone, taxpayer maintained that—

"The clay deposit had a comparative low value to the fee owner as he had no ability nor capital to manufacture refractory products.

"The partnership made great profits from the moment it started business October 1, 1899, to the organization of the corporation.

"The value of the leasehold, to the partnership, was incalculably greater than the value of the clay to the owner, as the partnership had demonstrated its ability to earn many times the amount of the royalty income recieved by the fee owner of the clay.

"A 'willing buyer' contemplating purchase of partnership business, at date the business was incorporated, would have calculated value of leasehold on basis of the earnings giving due consideration to value of physical assets and attributing a fair percentage of the net profits to those assets."

The reason the adjoining property was leased in 1907, and the original lease renewed in 1919, on such easy terms, being that taxpayer had bought up the surrounding property on every side and the owners of the clay deposits had to do business with the taxpayer or let their property be idle, producing no income whatsoever.

CONCLUSIONS

It was finally agreed to accept the valuation claimed by taxpayer in principle, but to revise the factors involved in making his calculations on a fair and reasonable basis. The details are shown in accompanying valuation memorandum dated January 21 (IT:EN:NM:ESB) and the resulting figure of $200,456 was agreed upon as valuation of leasehold at January 1, 1901, this amount to be amortized over 40 years at rate of $5,011.40 annually.

This conference was held before special conferee, although his signature is not attached, and a value of leasehold of $200,456 was allowed. It appears that this conclusion was ordered by the special conferee, Mr. A. R. Shepherd. This is shown by the statement of the other signatories of this conference and also in the special memorandum dated February 29, 1924, which will be referred to hereafter, and which states in regard to valuation of January 21, 1924:

"This action was taken by the section upon instructions from the undersigned special conferee."

Also on January 21, 1924, a valuation report was made by the nonmetals section, confirming the valuation of $200,456 and showing the depletion for various tax years based upon this figure. (See Exhibit F attached.)

On January 28, 1924, Mr. J. H. Briggs, chief of the nonmetals sections, addressed a protest to Mr. S. M. Greenidge, head Engineering Division, setting forth a résumé of the salient features of taxpayer's claim and the reasons for disallowing same. (See Exhibit G attached.)

On January 30, in a memorandum in answer to above, the head of the division ruled that finding must be made as per conclusion of conference, which had been held before special conferee. (See Exhibit H attached.)

On February 20, 1924, a special memorandum was prepared in answer to a protest from the Review Division, questioning the legality of allowing a forty year life on a twenty year lease. This memorandum refused to change the finding of special conferee on basis of an agreement with taxpayer. (See Exhibit I attached.)

On March 3, 1924, a memorandum from Mr. Robert C. Smith, chief of the Review Section, made further request for the determination of this valuation on a proper basis. (See Exhibit J attached.)

In accordance with this request a new valuation was prepared by the non-metals section on basis of 20-year life, amounting to $154,120.70. This is the last determination of valuation.

We refer again to section 207(a) of the revenue act of October 3, 1917, as showing this valuation to be illegal as it exceeds even the total par value of stock issued to partnership for all its assets on incorporations.

The Climax Fire Brick Co., when it took over the assets of the partnership, issued therefor $100,000 in stock.

This list of assets is as follows:

Cash	$6,950.33
Notes receivable	2,689.55
Accounts	7,221.64
Inventory	11,038.79
Real estate	2,260.00
Clay mine development	10,670.26
Gas wells	15,000.00
Buildings	10,632.63
Dwelling house	8,146.18
Machinery and equipment	48,817.88
Total	123,427.26

From the above list of assets it is seen that the leasehold was not considered of any monetary value. Further, the total amount of stock issued being $100,000, it is obvious that the placing of any value on this leasehold in excess of this amount, as has been done in this case, is clearly illegal for the year 1917, at least.

We contend that the only possible valuation for invested capital purposes for years subsequent to 1917 is a valuation based on the actual market value of the lease of the clay deposit at date of incorporation.

In the conference of January 21, 1924, it is stated:

"In reply to arguments that the entire deposit could have been purchased for a mere fraction of the sum claimed for paid-in surplus on the leasehold alone, taxpayer maintained that—

"The clay deposit has a comparative low value to the fee owner as he had no ability nor capital to manufacture refractory products."

We maintain that the intrinsic value of the leasehold must not be greater than the value of the land in fee, and this position is, we believe, borne out by law and regulation. All such matters as necessary capital, ability to market, good will, and business genius in management are intangibles, which should in no case enter into the valuation of the lease.

We condemn in this case as in the United States Graphite case the policy of having a special conferee adjust matters of this kind without having had sufficient opportunity to thoroughly study the case. It is clearly brought out by the various conferences that both the engineer making the valuation, the subsection chief, and the chief of the section were all opposed on proper grounds to this valuation, and that further the review section of audit also protested the finding on a specific point, as being entirely illegal.

We contend that when taxpayer was able to renew this lease in 1919 on the same terms of royalty without bonus, it further proved no cash value of lease at time of acquisition.

We further contend that when taxpayer was able to make a similar lease on adjoining property in 1907 with other parties, he also established the fact that there was no market value to these leases outside of what was covered by the royalty payments, which, of course, are deducted from income in any event as being part of operating expenses.

The very essence of the law in its purpose of setting up invested capital, is defeated in this case by the employment of this method of valuation based on anticipated profits. If this method could be applied to the business of all taxpayers alike there would be no need of an excess profit tax, for the invested capital would be fixed by the profits themselves at a point where only 8 per cent could be realized on this fictitious capital, and there would not be any excess profits worth mentioning.

We submit that the law in allowing the inclusion in invested capital of good will and other intangibles in a specific manner and under specific limitations certainly implied that such intangibles should not be included with the valuation of tangibles. This is what has happened in this case.

To sum up briefly, we conclude the unit to be fundamentally in error, in making valuations of the intrinsic worth of natural resources from the total profits of a business when it is obvious that such profits are in a great measure due to good will, superior management, marketing ability, sufficient capital, and superior methods or processes.

Respectfully submitted.

L. H. PARKER, *Chief Engineer.*

Senator KING. Is this case typical of other cases?

Mr. MANSON. This appears to be the practice, so far as we have been able to ascertain it. I hesitate to commit myself any further than that.

Mr. HARTSON. Now, Mr. Manson, on that very question I was going to bring out the same point that Senator King has in mind. Mr. Briggs has told me informally, and I think there can be no misunderstanding about it—that he called the attention of the representatives of the investigating committee to a group of cases that have come out of his nonmetals section, wherein the adjustment had been made over his head and contrary to his views, and, if I remember correctly, he said that there were five or six cases; I do not know just how many.

I believe that all of these cases that have been before the committee from the nonmetals section were cases that Mr. Briggs, the chief of that section, disagreed with, and I want to ask Mr. Manson whether these cases which have been brought out here are cases which, in his judgment, and based upon the reports which came to him from the Committee's engineers, are representative of the usual practice of the nonmetals section in fixing valuations, both for purposes of depletion and purposes of invested capital.

Mr. MANSON. My answer to that is that it will be noted that this case was closed within the last year. I would call attention to the fact that the same was true of the United States Graphite Co. case, and I think the same was true of the New Jersey Calcide Co. case.

Mr. HARTSON. Yes; and those are all cases in this group of five or six, Mr. Manson?

Mr. MANSON. Yes; I understand, but the point is that these cases illustrate the legal, if I may so label these views—illustrate the legal views and the economic theories and the engineering theories entertained by the present head of the engineering division.

Senator KING. Mr. Solicitor, I do not think you ought to minimize or attempt to minimize, or that any of the officers of the department or the bureau ought to minimize or attempt to minimize these practices, but, rather, you ought to aid in trying to find out the extent to which they have been pursued, and whether they are continuing.

Mr. HARTSON. Senator King, I have no such purpose at all, but what I would like to know is this, whether cases are going through that nonmetals section in a way which these cases clearly reflect?

Senator KING. I understand.

Mr. HARTSON. My own information is that that is not the case, that these are instances which have received the criticism and the disapproval of the chief of that section, and that the usual case that goes through his section is a case which he himself settled as the head of the section, and therefore it is unnecessary to call in the special conferee that Mr. Manson has referred to, and in such cases a more satisfactory method of determining these valuations is used. That is my impression.

Mr. MANSON. Oh, I wish to say this, that as far as the chief of the nonmetals section is concerned, I do not believe there is anything that gets by him, if he can help it, that is not proper. I was referring to Mr. Briggs.

Mr. HARTSON. He is in charge of that section.

Mr. MANSON. I do not assume that the majority of cases are appealed. I do not know about that.

In order that the Senator may know, I wish to say that up to within a few days we have had a force of five engineers who have been put on from time to time. The five have averaged 72 days of service as of the 1st of January, and in order to get before the committee at the start a general view of all of the operations of the engineering section, we have not devoted our attention exclusively to any one subject.

I am not attempting here to charge that this is the general practice. All the cases that I know anything about are the particular cases that have been brought to my attention. We have one more nonmetals case, involving discovery value of a gravel pit that we will present tomorrow. Those are the only cases of this kind that I know anything about. I do not know whether Mr. Parker knows of any other cases; but I have never intended—I want to be fair to the bureau—I have never intended to make the inference that anything was the general practice until I had gone far enough into that particular subject to determine, at least to my own satisfaction, that it was the practice, and I do not think I have ever taken the position that any principle was generally followed until it was admitted by the bureau in committee meeting that that was true.

The CHAIRMAN. In view of the fact that Mr. Greenidge is here, and apparently Mr. Shepherd and Mr. Smith are still in the service, I think it would be perfectly proper to ask if they approve of a continuance of this policy?

Mr. HARTSON. I think, Mr. Chairman, the regulations would have to speak for these individuals, unless they deliberately went flying in the face of the regulations, which I can not believe they are doing. The regulations say that the analytic appraisal method, or any theoretical method of determining value by capitalization of earnings, or determining present worth of future earnings, is unsatisfactory, and is looked upon with disfavor, and shall not be used except in the absence of any other method of determining value. The regulations are very specific about it.

The CHAIRMAN. Do you think they have followed the regulations in these cases?

Mr. HARTSON. I think, Mr. Chairman, that the effort down there, in the engineering section, is to determine, in some satisfactory way,

the fair cash value of these leases on a given basic date. I believe, however, that the opportunity to show definitely what the fair value is is very slight. In many of these cases, there is not a single thing to which they can point to determine a value, and yet the taxpayer comes in, and, with considerable force, argues, as he does in this case, that there must have been some value there beyond the mere paper itself on which this lease was written.

Now, Mr. Manson, in this case, takes the position that the lease has no value as a lease. I rather differ with that, in all fairness. I do not know that $154,000 was the proper value of that lease. I do not know just what the value is, but it does seem to me that, after a partnership had acquired a lease on a clay deposit, giving them the exclusive right to mine, if you will, this clay product——

The CHAIRMAN. Oh, but it was not an exclusive right.

Mr. HARTSON. It was on the area, Mr. Chairman.

The CHAIRMAN. But there was another area near by which they later acquired on the same terms on which they acquired the original area.

Mr. HARTSON. That is quite true, but, on the other hand, there is nothing to show that this other area was commercially advantageous for use at that time. There is a complete absence of proof of that, but they did have an exclusive right to take the clay out of this particular tract, and the partnership did work the deposit for 10 months, or something over a year, or some such short period, and did it profitably. At the conclusion of that time, the corporation was formed and took over the lease. They had had the experience of a profitable operation of a tract of land covered by a lease which, on their books, they did not give any value to, as such, but——

Senator KING. Yet, if you will pardon the interruption, Mr. Briggs, I think it was, finds that the value of the lease as fixed was evidently more than the value of the fee itself.

Mr. HARTSON. I am not arguing the correctness of the $154,000, Mr. Chairman—not at all; but I believe I am entitled to argue the correctness of trying to find out a value for that lease, if it had any, and, in all fairness, I think the lease did have a substantial value.

The CHAIRMAN. Do you concur in the reasons advanced by Mr. Shepherd for fixing this value?

Mr. HARTSON. Certain legal views that were evidently entertained by Mr. Shepherd I do not concur in, and I think Mr. Shepherd himself, if he were asked, would say that he was a little out of his own province when he expressed himself in the way he did. But that lease would not have been sold, Mr. Chairman, by the company for nothing, it would not have been given away, and if you had held it you would not have sold it for a nominal sum.

The CHAIRMAN. I would like to know whether that lease carried with it any obligations to extract any minimum amount of that deposit.

Mr. HARTSON. I do not understand it did.

Mr. MANSON. No; it did not.

This last remark of Mr. Hartson's opens up something that is inherent in this whole system of valuations. In other words, the thing to be determined in a depletion case is not the utility value of the property to the owner. It is the market value. The law says the market value.

Mr. HARTSON. Is not that the same thing, Mr. Manson?

Mr. MANSON. No; it is not the same thing, by any means, for this reason. If the market value was the same as the utility value, there would be no reason in the world why anybody would buy anything, because you buy with the expectation of making a profit; you buy with the expectation of investing your capital, or using your organizing and managerial ability, and out of the combination of your purchased property, your capital, your organization, your salesmanship, and your ability as a manager, to make money. If you are to capitalize as the value of the thing you buy the profit that you expect to make beyond the assumed profit fixed by the engineers in advance, just as Mr. Parker pointed out in the pithy statement that I have read from his report, there would be absolutely no sense in an excess-profits tax, because you assume that in the beginning. The whole thing is a process of reasoning in a circle. You start out with your assumed profit; you capitalize your earnings upon the basis of your assumed profit to get a basis for figuring a profit, and you are bound to come back to the point where you started from.

Senator KING. But the courts have held uniformly, Mr. Manson, that in determining the market value of a given piece of property, the jury may take into account, and the question is submitted to the jury, all the uses to which the property may be put. I remember the standard case, which was one involving a small island in the Mississippi River. This island had very little value, except that it could be used as a sort of rendezvous, if I may use that expression, for logs that were floated down there.

Mr. MANSON. Yes.

Senator KING. And they could be gathered between the island and the mainland.

Mr. MANSON. Yes.

Senator KING. If the person who sued resisted the claim that you could taken into account the particular and peculiar value which attached to it, because it may hold the logs in there, the court would charge the jury that that contention was not right; that they could take that into account and any other use to which it might be put in determining the fair market value of the property.

Mr. MANSON. But, of course, you have two different aspects of that question. For instance, if you are determining damage I suffer from an injury to my property, or, as in the case of a condemnation proceeding, where my property is taken for a public use, while the market value is the thing to be determined there, the market value to be determined there is quite a different thing, and the courts will permit the consideration of vastly different factors in a case where I am deprived of something than they will in a case of this sort, where you are starting out with something which has but little value, unless you apply capital to it.

Senator KING. Well, I can not conceive that the market value would be in excess of the fee.

Mr. MANSON. Oh, no; of course not.

Senator KING. In a case like that, that would seem to me to be absurd.

Mr. MANSON. But I do wish to point out this fact, that the utility value of a piece of property to its owner is quite a different thing from what he can get for it.

Take the case of a new automobile. That is the best illustration I know of. You go out and buy a new automobile, for which, we will say, you pay $2,000. You run that automobile around for a month and you do not abuse it; you take perfect care of it. That automobile has a utility value to you, as its owner, that is approximately as great as it was on the day of its purchase, but as a marketing proposition, it is a secondhand car, and you could not get anywhere near what the utility value of it to you is, if you have a use for it.

But what I do mean to say in the case of all of these natural resources is that they are purchased by people with capital, with every expectation of making money.

The CHAIRMAN. What would be the capitalization, and what would be the policy of the bureau, if, next to this particular property there was an operator who was losing 8 per cent a year? What would be the relative value of those two properties for capitalization? How would you capitalize the next property, which was losing money, with relation to the property that was making money?

Mr. MANSON. It is very clear that the clay in both instances has some intrinsic value, but there is one element in this case that is conclusive. It is very clear that no clay, nor any other natural resource, is increasing in quantity. It is very clear that over a period of 20 years, the value will tend to increase instead of decrease; that is, the value of any useful natural resource. At the expiration of this lease in 1919 it was voluntarily renewed by two parties, neither one of whom was under the slightest legal obligation to renew it. It seems to be manifest that if, in 1919, the owners of that property saw fit to renew that lease upon the same terms as those provided 20 years before, they did so because that was all they could get for it, and if that was all they could get for it, certainly the lease had no value.

The CHAIRMAN. I would like to ask Mr. Hartson if he sees any reason for capitalizing this over a period of 40 years when the lease only ran for 20 years.

Mr. HARTSON. Mr. Chairman, this was not capitalized over a period of 40 years. There is every reason why it should not have been, and, in fact, it was not.

Mr. MANSON. In the final allowance it was not.

Mr. HARTSON. Mr. Manson laid great stress upon the proposed action by Mr. Shepherd, which was not the action of the bureau.

The CHAIRMAN. I see.

Mr. HARTSON. And Mr. Manson pointed it out very clearly, but with principal emphasis on the proposed action, rather than on what actually did take place.

Mr. MANSON. I will tell you my reason for that.

The CHAIRMAN. I think that was done, perhaps, not so much to influence the committee in this particular case, but to influence the action of the type of men that Mr. Shepherd had in dealing with these cases.

Mr. MANSON. Also the further fact that this thing was brought to the attention of the present head of the engineering section.

The CHAIRMAN. Yes.

Mr. MANSON. The man of all men who is responsible for enforcing whatever uniform practices may exist in the bureau.

The CHAIRMAN. But he ignored that.

Mr. MANSON. He ignored it.

Senator KING. That is the way I understood it.

Mr. HARTSON. But the fact was that that was emphasized and the other was not emphasized, and apparently the impression left upon the mind of the cahirman was that the 40-year period had been used.

The CHAIRMAN. Yes; I confess that I overlooked the latter part of that.

Mr. HARTSON. And I am sure Senator Jones went out of the room thinking that that was the case, too, and I had in mind calling his attention to it before he left, that the 20 years was used, and the 40 years was not used, and should not have been.

The CHAIRMAN. And yet both Mr. Greenidge and Mr. Shepherd agreed to the 40-year proposition.

Mr. HARTSON. I do not know that Mr. Greenidge did. Mr. Shepherd apparently did.

The CHAIRMAN. Oh, yes; he sent it back indorsing that proposition.

Senator KING. He said that closed it.

The CHAIRMAN. Yes; Mr. Greenidge was apparently of the opinion that that was the proper basis.

Mr. HARTSON. If he is, I do not agree with him.

The CHAIRMAN. What steps will be taken to correct his attitude of mind as to all of these matters?

Mr. HARTSON. I do not know that Mr. Greenidge's attitude of mind is entirely wrong about these matters. I am sure that he did not have before him all of the facts.

The CHAIRMAN. We can hardly let that stand on the record, after the communication that Mr. Briggs sent to him.

Mr. HARTSON. I know, but you can not sit at a desk like Mr. Greenidge does, and catch all of the details in all of the reports sent to him by all of his subordinates. I am in a position myself which enables me to recognize the difficulties on the part of the chief of any section in going into the detail of each one of these cases. He might have relied upon his subordinates. He might have a great deal of confidence in a subordinate, and have accepted some of the things that his subordinate said, without that opportunity of research or study which should be afforded in passing on a difficult question.

The CHAIRMAN. What do you think ought to be done with Mr. Shepherd, in view of that communication that he sent?

Mr. HARTSON. I doubt very much whether my view on that would be of much value, Mr. Chairman.

The CHAIRMAN. Mr. Nash's view on it ought to be of some value, because he is in charge of the work there.

Mr. NASH. I have already suggested to the commissioner that I thought Mr. Shepherd was in the wrong place.

Mr. CHAIRMAN. I am glad to see that some recognition is being taken of these things.

Mr. GREENIDGE. Before Mr. Nash made that suggestion, Mr. Shepherd's services as conferee had been discontinued.

Mr. HARTSON. I want to say one further thing about the point that Mr. Manson made when he last spoke.

It must be borne in mind that we are valuing a lease; we are not valuing a clay deposit; we are valuing a right of this taxpayer to extract clay from the earth.

The CHAIRMAN. Do you think that his right is of greater value than the fee, however?

Mr. HARTSON. I would be inclined to believe that it would be most surprising if it were. The lease had been owned by a partnership, and was transferred to the corporation. I made the statement, to which Mr. Manson took exception, that the partnership would not have sold this lease, or the corporation, after it acquired it, would not have sold this lease, except upon payment of some substantial consideration. I believe that to be true. I believe that is a thing which does throw some light on the value of the lease.

Mr. MANSON. Just a minute.

Mr. HARTSON. Now, just a minute, Mr. Manson.

Mr. MANSON. I want to call attention——

The CHAIRMAN. Just a minute.

Mr. HARTSON. Let me complete this statement, because if I let you interrupt me, I will have difficulty in getting back to it again.

Mr. MANSON. All right, I beg your pardon.

Mr. HARTSON. I want to say this, that if there had been a sale by this company of the lease, on or about that date, that would have been—and I think you will agree with me—a clear indication, providing the parties were dealing at arm's length, of the value of that lease, would it not?

Mr. MANSON. Yes.

Mr. HARTSON. Now, if a sale had occurred at that time, this seller, the corporation, would have had in mind the earnings that that lease had made, if any, during the period of time it held it, and would also have had in mind the future prospects of profit in the operation of that lease, and the figure at which a willing seller would have parted with his interest in that lease at that time would have involved the consideration of some of these elements which you are criticising the bureau for having used.

Now, take the buyer. What does he do? He looks at what has happened in the operation of that property under the lease, and he has seen that company operating under the lease has made certain profits. Those things would have been considered by the contracting parties, dealing at arm's length, had there been a sale of this property at or about that time.

The CHAIRMAN. May I ask you a question at this point?

Mr. HARTSON. Yes.

The CHAIRMAN. Assuming, for instance, I had got an option on this other piece that was later acquired; then you would come to me and say, "I would like to buy your lease." I would say yes, because I knew I had this other piece in sight, from which I could make identical earnings, and I would be very glad to take a quick profit and sell my lease to you, knowing that I had an option on that next piece. I raise that question because I do not believe the other assumption is correct, that the seller would have fixed the earnings

over a twenty-year period as a basis on which he would have sold the property at that time.

Mr. MANSON. I would call attention to this fact, in answer to Mr. Hartson's argument, that there is an element of value in the property which would not attach to the adjoining property where it had been developed, and that element has already been allowed in another form. In other words, many of the tangible assets for which allowance is made are included in the sum of $10,670.26 for mine development; so the only difference that there could be between these two pieces of property, lying along side of each other, in the value of the two, would be that one was a developed piece of property and the other was not. The value of that development, which is the only element of difference, is already included in another allowance, which we do not question at all.

Supposing I saw this company making a lot of money, and I wanted to go into the clay business or into the fire brick business. If I had the capital, and if I believed that I had the same genius that they had for making money out of that business, I would be just as apt to go and buy that piece of property that was acquired in 1907 and develop a clay mine there as I would be to buy their property, and I certainly would not pay any more for that property than the additional value contributed by the development of the property which has already been allowed in another item.

Senator KING. Does it not simmer down to this, that there is, as Mr. Hartson maintains, some value to the lease? What that is is a matter of ascertainment, but I can see that there is a great deal of force in Mr. Hartson's position. However, if you go further and say that the leasehold value was as great as the fee value, I would have to part company with you radically.

Mr. HARTSON. I have not suggested so, Senator.

Senator KING. No; I said if you did that.

Mr. HARTSON. Yes.

Senator KING. It does seem to me that, taking the case by and large, it does not bear scrutiny, and I think the department erred, if I understand all the facts.

Mr. HARTSON. There is one further point, in order to bring the picture more clearly before the minds of the members of the committee, and that is this. There was this $154,000, I think in round numbers, which was finally allowed as the value of the lease in 1900. The thing that had to be determined, however, was invested capital for 1917, so that this $154,000 was depreciated or depleted down to 1917, giving an invested capital figure as of that time of $19,000.

Now, I merely point that out to show that the value of $154,000 was not the figure used for invested capital for 1917 at all. On the other hand, $19,000 was the figure that was used as paid in surplus because of the acquisition of this lease in 1900.

There is this further thing, too; the books of the company in 1900 did not set up as a capital asset separate from other capital properties owned by the corporation the lease itself. They, however, as I understand it, did have on their books certain properties acquired at that time, for which expenditures had been made of a capital nature, of around $62,000. There was a capital stock issue in excess

of the capital assets which were carried on their books, indicating that there was some unexplained issue of stock beyond the clearly identifiable capital assets which were carried on their books.

When Mr. Manson opened his statement of the case, I asked him whether a revenue agent had not reported that $200,000 in stock had been issued at the date of incorporation. That is not necessarily material, because I agree with Mr. Manson that the figure used in the settlement of the case in the bureau was $100,000 issued at the time of the incorporation. However, my information is, and I think it can be shown by the record, that while the taxpayer did not argue it, and while the settlement was made without consideration of the additional issue, in view of the revenue agent's report, that there was a $200,000 stock issue at that time. Assuming, however, that there was only $100,000 stock issued, and that the $200,000 is immaterial, you have an unexplained issue of stock there, which may account—I do not say it does, but may account for a value for the lease. If the $200,000 were issued, there could be said to be a substantial amount issued in exchange for the lease.

Senator KING. That would be a fictitious stock issue, would it not?

Mr. HARTSON. Well, we all know the practice of corporations in that respect.

Mr. MANSON. Having in mind now the fact that there is a consolidated schedule in this case of the gas company and of this brick company, the capital of the two companies is $200,000.

Mr. HARTSON. That may be the explanation, Mr. Manson. I am not prepared to say that it is, at this time.

Mr. MANSON. You spoke of there being $62,000 carried onto the books. My information is—and this is taken from the brief of the taxpayer—that there was set up on the books as against the capital of $100,000 items consisting of $123,427.26, instead of $62,000 and something, and that those items are enumerated; they have been set up on page 7 of Exhibit L, and among them is this item of $10,620.26 of mine development, to which we have taken no exception. But the assets, exclusive of the lease—the lease is not included among the assets—set up on the books as against the capital stock exceed the amount of the stock issued. Therefore, there was no discrepancy between the amount of the stock issued and the taxable assets which might have been construed to cover the value of this lease.

Mr. HARTSON. That is a point that can easily be verified, Mr. Manson.

Mr. MANSON. Yes; I took those figures from the taxpayer's brief.

Senator KING. Mr. Nash, by inquiring of the various officials in the bureau, can you find out whether there are any other cases that would come within this category, not only in the nonmetals section, but in the mineral section? I can conceive that this principle could be applied to the mineral section as well as to the nonmineral, because many leases, as you know, are executed for mining property, and the same principle might be applied to those leases, to the great disadvantage of the Government.

The CHAIRMAN. I might say to the Senator in that connection that we are preparing a number of oil, copper, and silver mine cases.

Senator KING. I see.

The CHAIRMAN. Which we will present to the committee later on, as to how these things are being done.

Senator KING. I think, however, that Mr. Nash, whose attention has been called to the significance of this, ought to aid the committee in every possible way, because we want to deal fairly and make a proper report. I should be delighted to find that that is the only case, but if there are any other cases, I think every officer of the bureau should aid this committee in finding out about it, and advise themselves and advise us.

Mr. NASH. Senator, the principle that was used in determining value in this case—that is, of this lease—is something that is recognized in the regulations in extraordinary situations, such as Mr. Hartson has explained, and the same principle could be applied to metals cases or to oil cases.

Senator KING. Yes.

Mr. NASH. And I presume it is.

Senator KING. Yes.

Mr. NASH. I want to say that we, of the bureau, are trying in every way we can to cooperate with this committee here.

Senator KING. I think that is true.

Mr. MANSON. I want to confirm that statement.

Senator KING. Yes.

Mr. MANSON. With reference to the mine situation——

The CHAIRMAN. Before we adjourn, I would like to make this statement, that Mr. Hartson has laid considerable emphasis on the fact that these cases that we have gone into, and which have been presented to the committee, represented only the cases to which Mr. Briggs objected; I mean the nonmetals cases. I think it would be interesting, Mr. Manson, at least it would be to me, if you could pick out a case that was settled in accordance with Mr. Briggs's theory, showing by comparison the difference in that particular case and the cases about which you have complained.

Mr. MANSON. We shall do that. In other words, we had to start somewhere.

The CHAIRMAN. I understand; but I would like to know about that.

Mr. MANSON. Yes.

The CHAIRMAN. I would like to make an inquiry at this point with respect to this mine situation. We have had a man working for two months now on a copper and silver mine valuation. He was about ready to make a report, when he learned verbally that the commissioner was about to put into force a revaluation of copper mines, made about two years ago, and was about to order a revaluation of silver mines. Of course, I do not want to bring before this committee any matter that is in that condition, if that is true. This is just something that Mr. Wright has picked up around the bureau, and I do not want to bring that situation before the committee and take up its time arguing moot questions, nor to criticize anything that the bureau itself recognizes should be reexamined.

Do you know, Mr. Nash, whether or not that statement is authoritative?

Mr. NASH. The subject of copper valuations has been under discussion in the bureau for several years, and I believe it was in December, 1922, that it was definitely decided to go again into the question of copper valuations. A revaluation has been ordered, and

there have been revaluations made on a number of properties. I believe it is intended to go into all the copper cases. There have been additional assessments proposed in some cases, and audit letters have gone out. It is work that is now in the mill.

Mr. HARTSON. What I meant to say was this, that there has been a revaluation made, but that for some reason or other it has never been put into effect through assessment in taxes.

Mr. NASH. I think that is true. Under the 1924 act, we sent out the 30-day letter, giving the opportunity of appeal to the bureau, and then the 60-day letter, giving the opportunity of appeal to the Board of Tax Appeals, and I do not think any of the cases have come up to the point of assessment.

The CHAIRMAN. It will be necessary to adjourn now. You can make a further answer as to that to-morrow, at which time we will proceed at 10.30 o'clock.

Mr. HARTSON. Before you go, let me say that the Climax Fire Brick Co. paid a 60 per cent excess-profits tax during the year 1917, so that they paid a substantial tax.

The CHAIRMAN. Have you anything further to say in connection with that settlement?

Mr. HARTSON. Nothing of an extensive nature, Mr. Chairman.

The CHAIRMAN. Then we will adjourn until to-morrow morning at 10.30 o'clock.

Mr. MANSON. We will then take up the case of the Penn Sand & Gravel Co.

(Whereupon, at 12.05 o'clock p. m., the committee adjourned until to-morrow, Wednesday, January 7, 1925, at 10.30 o'clock a. m.)

PENN SAND & GRAVEL CO. CASE

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, JANUARY 7, 1925

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

The committee met at 10.30 o'clock a. m., pursuant to adjournment of yesterday.

Present: Senators Couzens (presiding), Ernst, and King.

Present also: L. C. Manson, Esq., of counsel for the committee; Mr. L. H. Parker, chief engineer for the committee; and Mr. H. M. Parker, investigating engineer for the committee.

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

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. This is the case of the Penn Sand & Gravel Co. The issue arises over an allowance for discovery value on a gravel pit. The actual price paid for the property was $54,954.36. The original discovery value claimed by the taxpayer as depletable was $173,261.26. The amount allowed by the engineers was $54,954.36, the cost of the property. The discovery value subsequently claimed was $220,500. Upon this claim the same amount was allowed as before—the cost of the property.

The final value claimed was $341,400, upon which an allowance, according to the method of capitalizing prospective profits, was made, amounting to $150,297.07.

There are refunds involved, amounting to $48,233.

Before going into the facts in this case, I urge the first objection to this allowance upon the ground that the law does not provide for the allowance of discovery value or of discovery depletion in the case of a gravel pit.

I will read that portion of the statute which is applicable. It is section 214, subdivision 10.

> In the case of mines, oil and gas wells, 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, 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 discovery, or within 30 days thereafter—

I would call the committee's attention to the fact that while this statute specifically provides for depletion upon four things, namely, mines, oil and gas wells, other natural deposits, and timber, the proviso permitting discovery depletion applies only to mines and oil and gas wells.

It may be claimed that technically any natural deposit constitutes a mine, and that any extraction of inorganic matter from the soil or beneath the soil constitutes mining. If that construction of this statute were to be applied, it would be necessary to read out of the statute that provision which specifies "other natural deposits," as being subject to depletion.

It is a fundamental and cardinal principle of statutory construction, adhered to by the courts for all time, that in construing a statute it is necessary to give force and effect to every word in that statute, if it is possible to do so. My position is that Congress, in using the words "other natural deposits," as distinguished from mines, in the first part of this section, used the word "mines" in accordance with its commonly accepted meaning, and not in any technical sense, as it might be used by scientists, by geologists, or by engineers. It is used in the sense in which the ordinary man uses the word "mines."

For instance, if we are to include stone quarries, clay banks, sand pits, and gravel pits as embraced in the word "mines," no significance or meaning can be given to the term "other natural deposits" as being subject to depletion.

Under the rule of statutory construction which I have just stated, it is necessary to give some significance to those words, if it is possible to do so. It is possible to do so if we are to use the term "mines" as that term is commonly used and accepted, and apply to the term "other natural deposits" the meaning which the common man applies to it, such as in the case of quarries. No one thinks of calling a stone quarry a mine. No one would refer to a man working in a stone quarry as a miner. No one thinks of calling a clay bank a mine. No one ever has, as far as the common acceptation of that term is concerned, and no one would think of calling a laborer working in a gravel pit a miner. No one would think of calling a gravel pit a mine.

I admit that technically, in the parlance of geologists and engineers, the word "mines" can be applied to this class of deposits, and the term "mining" can be applied to that kind of business; but, as I say, it is not so commonly applied, it is not commonly understood, and Congress, by designating "mines" and "other natural deposits" separately in this act, clearly did not contemplate "other natural deposits" could be included in "mines."

The CHAIRMAN. Does your entire objection to this case rely upon that contention?

Mr. MANSON. No. No; I have many other objections. I would call attention to the fact that while this first portion of the statute

providing for depletion of costs includes "other natural deposits," the proviso covering depletion or discovery value specifically omits "other natural deposits," and that specific omission of "other natural deposits" and the specific omission of "timber" clearly shows that it was not the intention of Congress to allow discovery value upon such natural deposits as clay banks, stone quarries, gravel pits, sand pits, and things of that character, which, in accordance with the commonly accepted meaning of the term "mines" are not included.

The CHAIRMAN. In other words, you believe that Congress intended to put this in the same category as they would a forest?

Mr. MANSON. Absolutely.

The CHAIRMAN. The timber?

Mr. MANSON. Yes.

Now, to proceed with the facts in this case:

The taxpayer is a corporation organized for the specific purpose of acquiring the property in question and of developing and working such property as a sand and gravel pit.

This company was caused to be organized by a man who was securing an option on this property for the purpose of developing it as a real estate project. After securing the option he visited the property and found that in sinking a well for one of the houses being erected upon the real estate project, gravel was brought up in the material taken out of the well. He was a building contractor, and, realizing the significance of the existence of gravel and the value of the property as a gravel pit, proceeded to interest some of his friends in the organization and capitalization of a company to acquire the property under his option. It did acquire the property under this option.

The second objection that I urge is this, that the discovery of gravel was not made on this property by the taxpayer, namely, the corporation. The statute specifically provides that the discovery must be made by the taxpayer. In this instance the discovery was made by the promoter of the corporation before the corporation was organized, and the corporation was organized for the express purpose of acquiring the property as a gravel pit—not as a real estate proposition. The very name of the corporation, whose sole business it is to operate this property, and which was organized for the express purpose of acquiring this property, indicates that it was acquired for the purpose of doing a sand and gravel business, and it is clear that at the time the corporation was organized, as is indicated by its very name, it was known that this property contained sand and gravel. In addition to that, it is an admitted fact here, as far as the record is concerned—in fact, it is specifically represented by the taxpayer himself—that the sand and gravel were discovered upon this property in the way I have described.

So my second objection is that the claim itself and the basis supporting the claim specifically sets up on behalf of the taxpayer facts which show that the taxpayer was not the discoverer of this sand and gravel.

Furthermore, many years before this property was developed or was acquired by this company——

Senator KING. May I interrupt you right there?

Mr. MANSON. Yes, sir.

Senator KING. Did they allow a value in settling the tax for this alleged discovery which was greatly in excess of the price which he agreed to pay under his option?

Mr. MANSON. Oh, yes.

Senator KING. When he sought it as a real estate project?

Mr. MANSON. Yes. The price under the option was $54,000 plus, and the amount allowed was $150,000 plus. Furthermore, I will show in the exhibits which I desire to offer to the committee that, according to the reports of the United States Geological Survey and the reports of the Geological Survey of the State of Pennsylvania, the whole township in which this gravel pit is located is shown to contain gravel of the character found here and that those examinations were made and those reports were published many years before this gravel property was acquired.

The CHAIRMAN. Just why do you want to put that in, in view of the fact that the taxpayer did not make the discovery?

Mr. MANSON. Well, there is another question involved here. There is nothing in the statute to the effect that it must be demonstrated that there is sufficient gravel or sufficient material in the mine to warrant its commercial development and operation. There is nothing in the statutes which provides that, but a departmental construction of this statute provides that, and I mention the fact that these geological surveys show the existence of this gravel for two reasons. In the first place, it is cumulative evidence, and in the second place, it shows that the gravel which was found to come out of that well was not a mere pocket of gravel located at a particular point where the well was sunk, but that the same gravel deposit extended over the entire township.

That is the second objection that we raise to the allowance of discovery value in this particular case.

The third objection is to the basis upon which the allowance was made.

When it had been determined over the protest of the engineers to allow discovery value in this case, the engineers made a very careful study of comparative sales which had taken place in this same township, and it was found that after the development of this property several thousand acres of land changed hands with a view to its use for gravel development, and that many other gravel pits were opened in the locality.

The engineers made a careful study of the prices paid and the depletion unit which would be allowable in accordance with the prices which were actually paid for property in the same township containing the same sort of gravel, and arrived at the depletion unit based upon that sort of discovery value, although they did find this, that if you applied a depletion unit which was based upon a comparative sales value to the facts in this particular case, you did not get such a difference between the amount that would be allowed and the actual price that this company paid for this property as would cause it to be so disproportionate to the actual price as to come within the terms of the statute. In other words, the statute only permits the use of discovery value as a basis for depletion when the actual value is entirely disproportionate from the price paid.

So that is my third objection in this case.

The whole case is completely set up in the exhibits which I wish to offer for the record.

Senator KING. Are those exhibits extensive?

Mr. MANSON. They are not.

The CHAIRMAN. They are not to be printed in the record?

Mr. MANSON. They are not to be copied into this record.

Senator KING. I was thinking of the printing bill.

Mr. MANSON. I believe these exhibits should be printed in the printed record, but not be copied into this record.

Senator KING. I was wondering if you could make a sort of abridgement of the record which would give the same information, without having to print the entire record. Of course, if that would involve any great labor, the saving, perhaps, would not be worth while.

Mr. MANSON. I will say to the Senator that I am moving heaven and earth to try to boil this thing down, but I do not want to have the record contain my mere unsupported statement in connection with any case.

Senator KING. No.

Mr. MANSON. As to the point that I mentioned with respect to this gravel being shown by the geological surveys, which, in my opinion, is the strongest point in the case, showing not only the existence of the gravel, but the extent of the gravel, after this case had gone to the committee on appeals and review, and the committee on appeals and review had determined that the taxpayer was entitled to discovery depletion, Mr. Briggs, the chief of this section, caused the investigating engineer, Mr. Madison, to prepare a memorandum which he, in turn, gave to Mr. Greenidge, the chief engineer of the Income Tax Unit.

This memorandum is addressed by Mr. Madison to Mr. Briggs, and reads as follows:

You will recall that when the case of the Penn Sand & Gravel Co. was returned from the committee of appeals and review, with the notation that discovery of sand and gravel had been allowed the taxpayer by the committee, I questioned the sworn affidavits exhibited by the taxpayer wherein it was stated that gravel deposits were unknown in Falls Township, Bucks County, Pa., prior to the discovery by James Mundy and associates in 1913. With this thought in mind I examined reports of the Pennsylvania second geological survey and the Trenton Folio of the United States Geological Survey.

In 1881, a geologist, Charles F. Hall, in describing the geology of Philadelphia, Montgomery, and Bucks Counties, states, concerning Falls Township in Bucks County, page 50:

"Gravel and river deposits cover the greater portion of the south half of the township. Near the northern edge of the gravel we find terraces and escarpments. These escarpments have a diagonal course across the township. The escarpments mark the successive course of the Delaware River as it has gradually undermined the cretaceous beds which are now eroded or concealed below the alluvial * * *. The course of the river at one time has been on a line between Morrisville and Tullytown."

A rough sketch-map of Falls Township taken from the Trenton Folio of the United States Geological Survey, published in 1909 accompanies this brief notation. Referring to this map it will be seen that two formations practically cover the township (a minor outcrop of gneiss is shown in red). These formations are called the Pensauken and the Cape May.

The Pensauken formation is one of gravel and sand on the higher terraces and capping hills and divides. The geoolgists of the survey comment concerning the Pensauken:

"In the Trenton quadrangle the Pensauken is the most important source of gravel; there is hardly a hilltop or divide capped by the formation which has not been pitted to obtain it." (P. 23, Trenton Folio.)

Senator KING. Of course, the pitting will show the existence of the gravel?

Mr. MANSON. Yes. In other words that they mean by "pitted" is the digging of the postholes to determine that there was gravel there, that there was a gravel formation there.

"The soils of the Pensauken formation are gravelly to clayey loams. In many localities a bed of silt from 1 to 3 feet thick covers the typical sand and gravel of this formation. (P. 23, Trenton Folio.)

"The widespread Pensauken formation consists, for the most part, of unconsolidated gravel and sand, most of which in this region is below the 130 foot contour, * * *.

"Sand predominates over material of larger size in the Pensauken, but gravel is common and boulders can hardly be said to be rare, especially at the base." (P. 16 Trenton Folio.)

The Cape May formation is gravel and sand and clay forming low terraces; and includes some recent alluvium and swamp muck. The Government Geologists (Trenton Folio, p. 16) comment concerning this formation:

"The Cape May formation is confined largely to the valleys of the present streams * * *. This gravel has long been known as 'Trenton gravel.' When its deposition was completed glacial gravel filled the valley of the Delaware up to a level now 120 feet above the sea. * * *"

The Delaware River is past geological ages, notably after the glacial period, flowed from Trenton to Tullytown in a straight line rather than in the broad, sweeping curve it occupies at present. Great quantities of gravel and sand were carried by the river from the terminal moraines created by the retreat of the ice-pack at the close of the glacial period. From those moraines to Trenton the river hal a straight sweep but the bend of the river at Trenton caused a damming effect and the river dropped at great portion of its load. There was thus built up a series of river terraces of sand and gravel roughly parallel and covering the south half of Falls Township.

In the light of the foregoing remarks, and of the geological evidences given on page 50 of the 1881 C 6 report of the Second Geological Survey of Pennsylvania, and the knowledge of the sand and gravel formations of Falls Township, as shown in the Trenton Folio of the United States Geological Survey, it is difficult for this office to reconcile the recommendation of the committee that the taxpayer be allowed discovery with the language used in regulations 62, page 99, paragraph c, wherein it is stated:

"(c) For the purpose of these sections of the act, a mine may be said to be discovered when * * * (2) there is disclosed by drilling or exploration conducted above or below ground, a mineral deposit not previously known to exist and so improbable that it had not been, and could not have been, included in any previous valuation for the purpose of depletion * * *."

Respectfully,

FRANK H. MADISON,
Valuation Engineer.

This memorandum was communicated, as I stated, to Mr. Greenidge, and this is his reply to Mr. Briggs:

INCOME TAX UNIT,
ENGINEERING DIVISION,
February 16, 1924.

Mr. BRIGGS,

Chief, Nonmetals Valuation Section.

In re Penn Sand & Gravel Co.

In reply to your undated memorandum concerning the above-named taxpayer, I wish to state that I have not examined this case, but the information I gather from the report of Mr. Madison makes it apparent that the committee on appeals and review has allowed the taxpayer a right to discovery. Unless it can be clearly shown that this decision of the committee is illegal, I can not see how we can consistently ask the committee to reopen this case. Throughout this division at the present time there seems to be a decided inclination on the part of some of the engineers to disagree with their superior officers and a continuation of such feeling will very soon result in complete disorganization.

This division must regard the decisions of the committee on appeals and review as its instructions to be carried out without question unless it can be shown plainly and unmistakably that any one decision is illegal.

It is my opinion that the above-named case should be closed in accordance with the instructions of the committee on appeals and review and also that something be done to curb the tendency of engineers toward the taking issue with the decisions or instructions of their superior officers.

S. G. GREENIDGE,
Head Engineering Division.

Senator KING. If I may express myself in regard to that, that seems to me to be a very improper letter. You might just as well abolish your investigating engineers, if they are to be sat upon and denounced because of their independent judgment. I think Mr. Greenidge there exhibited a lack of appreciation of the responsibilities of his position.

The CHAIRMAN. Are you through with the presentation of this case, Mr. Manson?

Mr. MANSON. Just to complete the record, I wish to offer my exhibits A to O, as well as the report of Mr. H. M. Parker, the investigating engineer for the committee, which is approved by Mr. L. H. Parker, our chief engineer.

(The exhibits and report submitted by Mr. Manson in connection with this case are as follows:)

REPORT OF H. M. PARKER

JANUARY 6, 1925.

Mr. L. C. Manson, counsel Senate Committee for Investigation Bureau of Internal Revenue.

Office report No 9.
Taxpayer: Penn Sand & Gravel Co., Philadelphia, Pa.
Business: Gravel, crushed stone, and sand.
Subject: Discovery value, nonmetal section.
Amounts involved:

Actual price paid for real estate including expenses	$54,954.36
Original discovery value claimed by taxpayer as depletable	173,261.26
Original value allowed for depletion	54,954.36
Discovery value subsequently claimed	220,500.00
Value allowed by unit engineer	54,954.36
Final discovery value claimed by taxpayer	341,400.00
Final discovery value allowed by unit engineer	150,297.07
Total refunds involved, 1917 to 1921, inclusive (approximate)	48,233.00

Status of claim: Completed in engineering division; now in audit.
Final set-up allowed:

Total tonnage, as of date of acquisition	4,552,000
Productive life of property, years	21
Average annual production, tons	215,000
Average profit per ton, 1916 to 1920	$0.175
Total expected profits	796,600.00
Cost of second plant	200,000.00
Present worth at discovery, using Hoskol's formula (8 per cent and 4 per cent)	255,297.07
Cost of first plant	105,000.00
Value of the mineral	150,297.07
Depletion unit	.0329

SYNOPSIS OF CASE

Taxpayer has been allowed a discovery value for gravel which is classified under section 214a, revenue act of 1921, as "other natural deposits" for which discovery value is not provided. The allowance for discovery value made in this case is therefore contrary to law.

No real discovery of gravel was made, as fully proved by the Geological Survey charts as published prior to date of acquisition. Those charts show gravel in this whole territory.

Even if discovery value could be allowed, the amount allowed is greatly in excess. This value has been arrived at by the use of the analytical method of appraisal, which throws into the value of the gravel all the good will, marketing ability, business genius, and other intangible assets of the company. Figured on a comparative sales method, the value of the property on which discovery is claimed, as computed by one of the nonmetal section engineers, would not be in excess of the $54,954.36 paid for the same.

HISTORY OF THE CASE

The Penn Sand & Gravel Co. is engaged in excavating, washing, separating, and marketing gravel in Tullytown, Bucks County, Pa.

The company was incorporated September 9, 1913, but did not commence operations until a year later.

Depletion was originally claimed by taxpayer on his returns for years 1915 to 1921 inclusive. The depletion deducted not being substantiated he was required to submit the Form F schedule, furnished by unit. This form was dated May 21, 1921. The discovery value claimed on the form as subject to depletion amounts to $173,261.26.

Under date June 1, 1921, taxpayer was notified by unit, that depletion was disallowed on basis of insufficient information. (See Exhibit A.)

On December 14, 1921, taxpayer submitted a revised Form F, showing the discovery value of $220,500 and a total tonnage on date of discovery of 2,940,000 tons of pebbles and sand.

On May 24, 1922, taxpayer was allowed a value at acquisition based on cost of $54,954.36 and the depletion rate of $0.0186. (See Exhibit B.)

Taxpayer having protested the above finding the unit reaffirmed the action taken May 24, 1922, by a valuation report dated June 16, 1922. (See Exhibit C.)

Under date of January 5, 1923, taxpayer filed a brief appealing from additional tax liability occasioned by the denial of his discovery value claimed. (See Exhibit D.)

On January 9, 1923, taxpayer was granted a conference, shown in full in Exhibit E. Claim for discovery value was denied on the basis that Mr. Mundy, one of the members of the company, had discovered the gravel prior to date of incorporation, and that therefore at the time company was formed existence of gravel was known. The name of the company being significant of the fact that existence of sand and gravel was known and that company expected to operate for that purpose.

Taxpayer appealed and case was sent to Committee on Appeals and Review. Taxpayer asked for an oral conference.

On May 19, 1923, after having an oral hearing on May 10, the Committee on Appeals and Review gave the opinion that no discovery value should be allowed for purposes of depletion and sustained action of the unit. (See Exhibit F.) Case was recommended for audit and on August 27, 1923, taxpayer was notified that his additional tax liability was now $10,613.15.

On August 30, 1923, through his attorney, taxpayer appealed for reopening of case and have Committee on Appeals and Review hear new evidence. (See Exhibit G, attached.)

Committee on Appeals and Review under date of January 14, 1924, reversed its prior ruling and recommended allowing discovery value. (See Exhibit H.)

Following this decision, Mr. Madison, valuation engineer, nonmetal section, in a memorandum to his chief, Mr. Briggs, protested this action. (See Exhibit I, attached.) Mr. Briggs forwarded this protest to the head of division, Mr. Greenidge, for action. This protest shows plainly that gravel was known to exist in this locality in large quantities before acquisition by company.

On February 16, 1924, Mr. Greenidge in a memorandum to Mr. Briggs, administered a reprimand to him for disagreeing with his superior officers. (See Exhibit J, attached.)

On May 10, 1924, taxpayer transmits additional information asked by unit. (See Exhibit K, attached.)

Valuation report is then issued by unit on October 17, 1924, based on comparative sales method for determining discovery value and allowing a valuation of $54,954.36 and a depletion unit of $0.0186. (See Exhibit L, attached.)

Taxpayer again protests this action by unit and at a conference on November 19, 1924, he is allowed privilege of making a further statement of his case. This he does on November 24, 1924. (See Exhibit M, attached.)

A conference was then held with taxpayer on November 25, 1924, before the special conferee, Mr. Shepherd, in which taxpayer was allowed the use of the analytic method of appraisal in arriving at his discovery value. (See Exhibit N, attached.)

Conforming to the instruction of conferee, the final valuation of $150,297.07 for discovery value was allowed by unit, which allows a depletion factor of $0.0329. (See Exhibit O, attached.)

This is last paper in the case, and we understand same is now in audit on this basis of valuation.

DISCUSSION OF CASE

We submit that it is contrary to law to allow a discovery value on gravel as has been done in this case. An examination of section 214 (a) (10), revenue act of 1921, will show that while depletion is allowed on "Mines, oil and gas wells, other natural deposits, and timber," discovery value is only to be allowed on "mines, and oil and gas wells." The omission of the words "other natural deposits, and timber" from the discovery clause, clearly prevents the allowance of a discovery value on gravel, as in the four classifications given in the law, gravel must clearly be included in the term "other natural deposits."

If further reason was necessary for disallowing the discovery value in this case, it is contained in the protest of Mr. Madison, engineer (see Exhibit I), which refers to the fact that the existence of large quantities of gravel all through this country is shown on the Geological Survey charts published in 1909, or four years before date this company was incorporated. In fact, in 1881, a geological report covering this locality showed the predominant material of this soil to be gravel.

If a still further reason is required in addition to the two conclusive reasons shown above for disallowing discovery value, it is in the fact that discovery value is not disproportionate to the cost of the property. This is shown by the comparative values of other properties as contained in valuation report of Mr. Madison, dated October 17, 1924. (Exhibit L.) In this report it is shown that the total of purchases of gravel lands purchased in 1918, 1919, and 1920 showed that though these were years of high prices, that they did not establish a value to taxpayer's gravel above his original cost.

In view of the above reasons it would seem at first glance that this must have been a mistake which inadvertantly slipped through the department.

This, however, is not the fact. The history of the case already given shows clearly that the most careful consideration was given to it. The engineers disallowed discovery value several times, the Committee on Appeals and Review sustained the engineers, and then, without any adequate reason, reversed its decision. Then nonmetals section still protested the obviously wrong decision, only to be finally overridden by a reprimand for their interest in the Government's welfare.

The taxpayer has been allowed the use of the analytical method of appraisal by special conferee, Mr. Shepherd, when other methods were available.

The taxpayer has been allowed to raise his estimates of total tonnage from 2,940,000 tons to 4,552,000 tons, and is allowed to base his value on discovery on the average profit subsequent to this date for the period 1916 to 1920.

This method, of course, as shown in preceding cases, throws the value of good will, marketing ability, business genius, and other intangibles into the value of the gravel in the ground.

We do not believe we need to proceed further with the discussion of a case which has been finally determined on such obviously improper principles. We will sum up, therefore, by saying that we believe the final allowance for discovery value in this case to be contrary to law, contrary to the fact requiring proof of discovery, and contrary to any reasonable value established by the application of sound engineering principles.

Respectfully submitted.

H. M. PARKER,
Investigating Engineer.

Approved:

L. H. PARKER,
Chief Engineer.

EXHIBIT A

SECTION OF INORGANIC NONMETALS,
Washington, D. C., June 1, 1921.

PENN SAND & GRAVEL CO.,
207 South Ninth Street, Philadelphia, Pa.

Sand and gravel.

1. Form F received May 24, 1921. Taxpayer claims gravel land purchased 1913, 1914, 1917 and 1918 for $54,954.36 cash, acreage is not given, amount of land exhausted by removal of sand and gravel not stated and residual value of land after removal of sand and gravel not submitted.

2. Taxpayer states lands were purchased as farm lands and seeks to establish discovery value of $173,261.26 for sand and gravel in deposit. For depletion he claims 7½ cents per ton an arbitrary rate and computes depletion at this rate. Cost of land subsequent to 1913 governs and a discovery value can not be recognized. Valuation given on Form F as cash paid for land does not agree with statements on returns. Valuation shown in balance sheet attached to 1918 returns shows assets as of December 31, 1917, "gravel mines," $34,805.11. Valuation of gravel mines in depletion schedule of 1917 returns shows "cost acquired subsequent to March 1, 1913," $47,745.36.

3. It is recognized by this section depletion may enter into this case but it is impossible to determine the correct amount from evidence submitted by taxpayer, and it is not advisable to approve any valuation until taxpayer submits necessary information to check up the amounts on the income tax returns of the various parties from whom purchased with the respective amounts in various years mentioned; this has not been done.

4. All claims for valuation and depletion are disallowed for reasons stated above.

ACTION TAKEN

Valuation claimed: for mineral, $173,261.26.
Valuation allowed: cost of land not to be depleted.
Approved June 2, 1921, by Head of natural resources subdivision.

Depletion claimed on Form F:

1915	$625.00
1916	1,250.00
1917	6,725.25
1918	15,846.30
1919	11,250.00
1920	13,507.20
Total	49,203.75

Depletion allowed: None.

C. C. GRIGGS,
Valuation Engineer.

Approved:

ORR R. HAMILTON,
Chief, Metals Valuation Section.

EXHIBIT B

MAY 24, 1922.

PENN SAND & GRAVEL CO.,
207 South Ninth Street, Philadelphia, Pa.

SIRS: Reference is made to your income-tax returns for the years 1915 to 1920, inclusive, and to the question of the fair market value, the recoverable reserves and depletion rate per ton of sand and gravel.

In this connection, you are advised that as a result of an examination of the data submitted by you on Form F received December 17, 1921, the following valuation and depletion rate have been determined.

Fair market value at acquisition	$54,954.36
Recoverable reserves, tons	2,940,000
Depletion rate per ton	$0.0186

This value and depletion rate will govern during the life of your property, subject to capital additions, deductions, or corrections (should error be discovered), which would require modification of these figures. The above results will be reflected in the audit of your case, which will begin 20 days from date of this letter.

Respectfully,

E. H. BATSON,
Deputy Commissioner.
By A. H. FAY,
Head of Division.

EXHIBIT C

SECTION OF INORGANIC NONMETALS,
June 16, 1922.

[Penn Sand & Gravel Co., 207 South Ninth Street, Philadelphia, Pa., Incorporated September 9, 1913]

Case reviewed by C. C. Griggs, valuation engineer, who disallowed depletion at that time.

Form F received December 17, 1921. Taxpayer states 156 acres of farm land valuable as sand and gravel land purchased in 1913, 1914, 1917 and 1918 for $54,954.36 cash. An attempt is made to set up a greatly appreciated value for the land claiming additional valued due to discovery but this is not allowed.

ACTION TAKEN

Valuation at acquisition in 1913 to 1918, inclusive.
Claimed: $220,500 mineral land.
Allowed: $54,954.36 as mineral land subject to depletion.

DEPLETION

Taxpayer estimates 2,940,000 tons of recoverable sand and gravel which with a cost of $54,945.36 gives a unit value of $0.0186, which is approved as the sustained and allowed depletion rate per ton of sand and gravel.

Years	Tons	Depletion claimed	Depletion sustained and allowed at $0.0186 per ton
1915	200,000	$625.00	$3,720.00
1916		1,250.00	
1917	224,175	6,725.25	4,169.66
1918	211,284	15,846.30	3,929.88
1919	156,000	11,250.00	2,700.00
1920	180,096	13,507.20	3,349.79
Total	965,555	49,203.75	17,959.33
1921	[1]153,384	11,503.73	2,852.90

[1]Tonnage estimated.

Approved: Chief nonmetals valuation section.

W. W. HANSON,
Assistant Valuation Engineer.

EXHIBIT D

In re Penn Sand & Gravel Co, Philadelphia, Pa.

To the COMMISSIONER OF INTERNAL REVENUE:

Exceptions to and appeal from decision of Income Tax Unit in letter of December 5, 1922, regarding additional tax liability or deficiency of $10,613.15 against the Penn Sand & Gravel Co. for years 1917–1920, inclusive.

James A. Mundy, being duly sworn according to law, deposes and says that he is the president of the Penn Sand & Gravel Co. and as such is instructed to

file exception to, and an appeal from, the findings and decision of the Internal Revenue Bureau in its letter to the company dated December 5, 1922, and to show cause or reasons why the additional tax or deficiency of $10,613.15 for the years of 1917 to 1920, inclusive, therein stated to be due from said company, should not be paid; that the exceptions and appeal are not filed for the purpose of delay but to acquaint the bureau with the true facts in the case; that the Penn Sand & Gravel Co. excepts specifically to the determination made by the bureau of the value of its property for purposes of depletion; to the bureau's allowances for depletion during the years 1917 to 1920, inclusive, as contained in the statement attached to said letter of December 5, 1922; to the findings as to the amounts of surplus during the different years; as to the allowances for depreciation; as to the deduction for so-called inadmissibles; and as to the additional tax assessed for the different years involved.

Deponent further states that he was one of the original incorporators of the Penn Sand & Gravel Co. and has been its president ever since incorporated; has personal knowledge of all transactions preceding the incorporation of the company, as well as of all subsequent transactions relating to the company's affairs which have any bearing upon its income and profits tax liability, and that the following is a correct exposition of the facts:

The company's depletable property consists of several tracts of land, acquired at a total cost of $54,054.36, as follows:

Leland farm, acquired in August, 1913.
Lane & Blackford, or Starkey farm, acquired in August, 1913.
Jesse Smith farm, acquired in May, 1916.
Raub farm, acquired in November, 1917.
Mather farm, acquired in March, 1918.

Prior to the incorporation of the Penn Sand & Gravel Co. deponent owned and controlled the American Paving & Construction Co. and was engaged in the contracting business. In carrying on the business of that company he had occasion frequently to pass by the first two properties—the Leland farm and the Lane & Blackford, or Starkey farm—located adjacent to the New York division of the Pennsylvania Railroad. He noticed considerable building activity in the vicinity and, upon investgaton, found that Lane & Blackford had been engaged in developing the territory by dividing these farm properties into building lots, constructing bungalows thereon, and selling same, and that their efforts were meeting with considerable success.

The success of their operations caused him to interest three other parties, namely, John Seely and Walter Barnum, of New York City, and Frank A. Furst, of Baltimore, Md., to become associated with him in the purchase and development of property in the neighborhood.

He thereupon began negotiating for the purchase of property and in July, 1913, secured an option of purchase on the property known as the Leland farm, containing about 78 acres, at a price of $10,000 for the sum of $50, which was paid on August 4, 1913, by check of his company, the American Paving & Construction Co.

That on August 21, 1913, he obtained an option of purchase on the Lane & Blackford, or Starkey farm, containing approximately 150 acres, at a rate of $125 per acre, giving as consideration therefor a check of the American Paving & Construction Co. for $100.

Lane & Blackford had but recently purchased this farm, laid it out in lots and started the construction of a bungalow on one of the lots.

That, after the option was secured, deponent went upon the land, which was covered with weeds waist high, for the purpose of observing how the lots had been laid out and the development then in progress. In examining the work done on the bungalow, which the parties in question had started constructing, he noticed that they had dug a well in the vicinity to furnish a water supply for the bungalow, and that the excavated material scattered about the well contained a large quantity of sand and gravel or pebbles such as used in building operations.

Deponent thereupon conceived the idea that if the land contained sand and gravel in relative quantity and grade to that shown by the excavation from the well it would render him and his associates a greater return on their investment to mine and sell the material than would the real estate operations, as at that time there was no sand and gravel operation anywhere in that vicinity. Upon his suggestion that the land would probably be found to contain sand and gravel deposits of sufficient value to justify such a development, he and his associates agreed to form a corporation for the purpose of

exploring the property and mining and selling the material should it be found upon investigation to contain deposits sufficiently valuable to justify the same. They thereupon incorporated, under the laws of the State of Delaware, as the Penn Sand & Gravel Co., the charter being issued on the 9th day of September, 1913.

The first meeting of the board of directors of the Penn Sand & Gravel Co. was held on the 29th day of October, 1913, at which meeting was presented stock subscription agreement containing subscriptions to stock to the company at par ($10) for cash, as follows:

	Shares
Walter Barnum	1,497
American Paving & Construction Co	1,406
Seely Engineering Co	497
Frank A. Furst	500

which, with the 100 shares originally issued to secure incorporation, constituted all of the stock issued.

Other resolutions relating to the business of the company were adopted, among which was one authorizing the proper officers of the company to purchase the properties upon which the options had been obtained, and another as follows:

"Upon motion, duly seconded, it was further

"*Resolved*, That the proper officers be, and they hereby are, instructed to make a thorough investigation of the properties, before incurring any further liability as to the class and quantity of material existing in the different properties, either by open pit work, drilling, or any other manner which in their judgment should be done, if it is necessary to consult experts in this line of business. This is offered with a view of not going too far into it until the amount of material in the deposits is ascertained, before making any larger investments than are now made. The properties are farm properties and investigation or discovery has not been thoroughly made at the present time."

Immediately after that meeting of the board, the properties were purchased in accordance with the terms of the option and an investigation started to determine the class and quantity of material existing therein. The investigation was continued during that fall and in the early spring of 1914. The investigation disclosed sand and gravel in sufficient quantity, in the opinion of the board of directors, to justify the purchase of machinery suitable for a commercial development, and the board at a meeting held April 16, 1914, passed a resolution authorizing the president of the company to take such action. Commercial production did not commence until 1915. The company, therefore, claims that it is entitled to a discovery valuation on its property for purposes of depletion.

The property has been explored sufficiently to determine by a very close approximation the quantity of sand and gravel contained therein. Sixty acres of the Leland farm has been mined to water level, producing a total of 960,000 tons, and there is remaining in said farm below the water level enough material to produce 9,000 more tons per acre, or a total of 540,000 tons. There is also in the Leland farm 10 acres of marsh land which the company has as yet been unable to drill and explore, but which it is estimated will produce 25,000 tons per acre or 250,000 tons, making a grand total of 1,750,000 tons on that farm.

A portion of the Leland & Blackford, or Starkey, farm (85.7 acres) was taken by the United States Government under condemnation proceedings, leaving the company 64.3 acres, which has in it an average of 35,000 tons per acre, or 2,240,000 tons of material.

The company considers that its property has a valuation of 7½ cents per ton.

As an illustration of the fact that the value of these properties has become entirely disproportionate to the purchase price as a result of the discovery of the sand and gravel, attention is invited to the award made in connection with the condemnation proceedings instituted by the United States Government. In 1920 a jury of viewers, appointed by the District Court for the Eastern District of Pennsylvania, in which the proceedings were instituted, awarded the company $285,231 for the 85.7 acres of the Leland & Blackford, or Starkey, farm. This sum was later reduced by compromise to $145,000, or approximately $1,700 per acre.

It will be observed from the minutes of the meeting of the board of directors held October 29, 1913, that at that time it was unknown whether the properties

would contain sand and gravel in sufficient quantity to justify commercial development and, therefore, the land could not possibly be regarded as having been purchased as a proven tract.

Deponent states that in presenting this data no calculation has been made of the quantity of material contained in the other properties which were acquired in 1916, 1917, and 1918, respectively, as the results of explorations made on them is already available to the bureau and as the action of the bureau as set forth in the letter is based upon the ground that the company is not entitled to a discovery valuation of its property.

The depreciation deducted by the company is based upon experience which has indicated that six years is the probable useful life of plant used in excavating and preparing sand and gravel for market and that the rate of depreciation allowed by the bureau is incorrect.

Deponent therefore believes and avers that under the revenue laws and regulations the Penn Sand & Gravel Co. is entitled to a revaluation of its property based on a discovery of sand and gravel made subsequent to purchase of same which has resulted in the fair market value of the property coming disproportionate to the cost.

JAMES A. MUNDY.

Sworn to and subscribed before me this 5th day of January, 1923.

C. WM. SPIESS,
Notary Public.

My commission expires 21st day of February, 1928.

EXHIBIT E

TAXPAYER'S CONFERENCE,
NATURAL RESOURCES DIVISION, NONMETALS SECTION
January 9, 1923.

Taxpayer: Penn Sand & Gravel Co.
Address: 207 South Ninth Street, Philadelphia, Pa.
Company represented by: James A. Mundy, president; W. S. Hammers, attorney.

The case came up for conference to consider "Exceptions to and appeal from decision of Income Tax Unit in letter of December 5, 1922, regarding additional tax liability or deficiency of $10,613.15 against the Penn Sand & Gravel Co. for years 1917–1920, inclusive."

The exceptions taken by the company were to the bureau's allowances for depletion during the years 1917 to 1920, inclusive; to the findings as to the amounts of surplus during the different years; to the allowance for depreciation; to the deduction for so-called inadmissibles; and to the additional tax assessed for the different years involved.

Little or no contention was made in support of these exceptions other than the question of depletion. It may be stated that depreciation was reduced somewhat in addit, the amount allowed being the usual 10 per cent rate upon plant and equipment. It appears that 5 per cent only had been taken in earlier operations and the company had increased the rate excessibly to make up for failure to take proper amount in the past.

Form F (revised) received in this office May 24, 1921, set up information as follows:

Date acquired, 1913, 1914, 1917, 1918; amount paid in cash, $54,954.36; to whom paid, Jos. Leland, Lane & Blackrod, J. Smith, J. S. Raub, and C. Mather.

"These properties were purchased as farm properties and have not been fully explored.

"EXHIBIT A OF E

"Depletion is claimed on fair value of the properties based upon after discovery of natural deposits of sand and gravel * * *. After due consideration we considered 7½ per cent a fair value for depletion."

The content of property was stated, "unknown"; value of unit in place, "unknown."

Under date of December 17, 1921, another copy of Form F (revised) was received in this office which set out additional information as follows:

Number of acres, 156 acres; value per acre, 96 acres at $1,875, 60 acres at $675, $220,500.

Remarks: Ninety-six acres consist of 82 acres of Raub and 14 acres of Smith property is figured will yield 25,000 tons per acre and 60 acres of Leland property below water level will yield 9,000 tons per acre as per Exhibit A.

The content is stated at 2,940,000 tons; value per unit in place, 7½ cents per ton for pebbles and sand.

The table of production and depletion deducted is then stated.

Under date of June 16, 1922, a valuation was made in which the cash cost of $54,954.36 was allowed for invested capital purposes and based upon the content of 2,940,000 tons and the cost the depletion rate was computed at $0.0186 per ton.

In the brief submitted by the company claim is made for discovery value upon which to base depletion. A digest of the basis of the claim follows:

The company's depletable property consists of several tracts of land, acquired at a total cost of $54,954.36, as follows: Leland farm, acquired in August, 1913; Lane and Blackford, or Starkey, farm acquired in August, 1913; Jesse Smith farm, acquired in May, 1915; Raub farm, acquired in November, 1917; Mather farm, acquired in March, 1918.

Prior to the incorporation of the Penn Sand & Gravel Co. Mr. Mundy, who was engaged in the contracting business, frequently passed by the first two properties—the Leland farm and the Lane and Blackford, or Starkey farm. He observed building activity and found that Lane and Blackford were dividing these properties into building lots, constructing bungalows thereon, and selling same. The success of their operations caused him to interest three other parties to become associated with him in the purchase and development of property in the neighborhood. He began negotiating for purchase of property and in July, 1913, secured an option of purchase on Leland farm, containing about 78 acres, at $10,000, the sum of $50 being paid on August 4, 1913.

On August 21, 1913, an option of purchase was obtained on the Lane and Blackford, or Starkey farm, containing approximately 150 acres at a rate of $125 per acre, a check for $100 being given as consideration.

After the option was secured Mr. Mundy went upon the land for the purpose of observing how the lots had been laid out. He noticed that a well had been dug and that the excavated material scattered about contained a large quantity of sand and gravel or pebbles such as used in building operations.

Mr. Mundy conceived the idea if the land contained sand and gravel in relative quantity and grade to that shown by the excavation from the well it would render him and his associates a greater return on their investment to mine and sell the material than would the real estate operations. Upon his suggestion that the land would probably be found to contain sand and gravel deposits of sufficient value to justify such a development, he and his associates agreed to form a corporation for the purpose of exploring the property and mining and selling the material.

They incorporated the Penn Sand & Gravel Co., charter issued September 9, 1913. At the first board of directors meeting October 29, 1913, stock subscriptions were made at par for cash. A resolution was adopted to investigate the properties, before incurring further liability, either by open pit, drilling, or any other manner, etc.

Immediately after that meeting of the board, the properties were purchased in accordance with the terms of the option and an investigation started to determine the class and quantity of material existing thereon.

The company makes the claim that the option in itself constitutes a purchase; that the discovery of the sand and gravel at the well was subsequent to the option and that as the option was taken for real estate purposes the finding of the sand and gravel constitutes a discovery.

The representatives of the Government held that no purchase was made until after the Penn Sand & Gravel Co. was formed, cash paid in for stock and the property thereafter acquired for cash, at which time the presence of sand and gravel was known. That the company that was formed to acquire the property was named the Penn Sand & Gravel Co. is significant of the fact that sand and gravel was known to exist and that the incorporation expected to operate the property for that purpose. Otherwise, if it had been intended to operate it as a real estate business a more appropriate name would have been used.

At this point the representative of the company raised the point that the fact that it may have been known that there was sand and gravel in the property at the time the Penn Sand & Gravel Co. made payment for same under the terms of the option, it became a sand and gravel property only

after exploration and development and then only after it was demonstrated that sand and gravel in quality and quantity sufficient to make it a valuable operation was proven.

The Government representatives held that it was a sand and gravel prospect and that whatever work was done in demonstration constituted development and the cost was a proper capital charge.

At this point Mr. Mundy stated that he, one of the individuals that formed the company, discovered sand and gravel after he took an option for another purpose, viz, real estate operations, that he and his associates were the company and he did not know that it was a sin for them as individuals to protect themselves by forming a corporation.

Without admitting that a discovery was made by the individuals that formed the company taxpayer was advised that any rights as such were waived when the company was formed and the property thereafter acquired for cash.

Claim for discovery value was denied. Taxpayer stated that an appeal would be taken.

Interviewed by:

W. W. HANSON,
Valuation Engineer.
P. A. BARNES,
Auditor, Audit F.
J. H. BRIGGS,
Assistant Chief of Section.

Approved:
CHIEF, NONMF ALS SECTION.
CHIEF, AUDIT F SECTION.

EXHIBIT F

RECOMMENDATION No. 3526.—COMMITTEE ON APPEALS AND REVIEW

In re appeal of Penn Sand & Gravel Co., 207 South Ninth Street, Philadelphia, Pa. Years 1917–1920.
207 South Ninth Street, Philadelphia, Pa. Years 1917–1920.

MAY 10, 1923.

Mr. COMMISSIONER
(For Deputy Commissioner, head Income Tax Unit).

The committee has considered the appeal of the above-mentioned taxpayer from the action of the Income Tax Unit in refusing a valution for depletion purposes based on a discovery, resulting in a proposed assessment of additional taxes amounting to $10,613.15 for the years 1917 to 1920, inclusive.

Oral hearing was held on May 10, 1923.

The committee finds that James A. Mundy, with three business associates, took an oral option on two pieces of land in Bucks County, Pa., for a period of 30 days, paying $60 on July 23, 1913, by a check signed by James A. Mundy, president of the American Paving & Construction Co. It was the purpose of Mr. Mundy and his associates to purchase the land as a real estate speculation, but soon after the option had been obtained he visited the land to see how the lots had been laid out, and to examine a building then in process of construction. He found that a well had been dug for water supply and that the material excavated from the well contained a large percentage of pebbles or gravel such as is used in building operations. His experience as a contractor led him to believe that the property could probably be developed for the production of gravel more profitably than as a real estate venture.

After discussing the matter with his associates, they incorporated the Penn Sand & Gravel Co., securing a charter on September 9, 1913, with an authorized capital stock of $100,000—shares having the par value of $10 each. At the first meeting of the board of directors shares of stock to the amount of $40,000 par value were subscribed to be paid for in cash, and the purchase of the property upon which the option had been obtained was authorized. Photostatic copies of deeds have been submitted wherein it shows that the title was transferred to the appellant corporation. The board of directors also authorized a thorough investigation of the properties by drilling and in other ways to

ascertain the amount of material in the deposits. The total cost of the depletable property and development was $54,964.36.

The question before the committee is whether or not a discovery value should be allowed to establish a valuation for depletion deductions.

It is contended on the part of the appellant that under article 219(c) of Regulations 62, discovery means the disclosing by drilling or exploration of a mineral deposit not previously known to exist and "in quantity and grade sufficient to justify commercial exploitation"; that discovery "did not take place until after the corporation had been organized and the tests authorized at the meeting of October 29, 1913, had been completed."

Article 219(d) of Regulations 62 provides in part that no discovery can be allowed "as of a date subsequent to that when, in fact, discovery was evident, when delay by the taxpayer in making claim therefor has resulted or will result in excessive allowances for depletion."

Article 219(g) of Regulations 62 reads as follows:

"In the case of a mine, a 'proven tract or lease' includes, but is not necessarily limited to, the mineral deposits known to exist in any known mine at the date as of which such mine was valued for purposes of depletion, and all extensions thereof, including 'probable' and 'prospective' ores considered as a factor in the determination of the value or cost."

The committee is not convinced that the corporation is entitled to a discovery since a deposit of gravel was known to exist before the formation of the corporation, as is shown in the statements filed by the appellant, and as is further indicated in the name chosen for the corporation.

A similar case has been considered by the committee and is covered by A.R.R. 1781, wherein no value on account of discovery was recommended.

The committee, therefore, is of the opinion that no discovery value should be allowed to the appellant corporation for purposes of depletion and accordingly recommends that the action of the unit be sustained and the appeal denied.

KINGMAN BREWSTER,
Chairman Committee on Appeals and Review.

Approved:

D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT G

AUGUST 30, 1923.

To the COMMISSIONER OF INTERNAL REVENUE.

In re Penn Sand & Gravel Co., 207 South Ninth Street, Philadelphia, Pa.
Reference: IT:NR:E-2-PAB-3518.

We respectfully request a reconsideration of the decision of the committee on appeals and review, as expressed in its letter of June 21, 1923, of the Income Tax Unit denying the company a valuation for depletion purposes based on discovery.

The request for reconsideration is based upon two grounds, either of which, if fully considered, will entitle the company to a reversal of the conclusions stated in the committee's letter, viz:

First. The facts in the case present a legal question that should have been passed upon by the Solicitor of Internal Revenue, namely, what, under the act and regulations, constitutes discovery of a mine.

Second. The conclusion reached by the committee admits discovery but denies the corporation the increased valuation of its property for depletion purposes contrary to the conclusions reached in a previous decision (A. R. R. 712; 1 C. B. 183) and a subsequent decision published in Bulletin of June 25, 1923, page 3, 11-12 949, I. T. 1701.

Briefly stated, the facts are as follows: James A. Mundy, with three business associates, took an option of purchase on a piece of property known as the Leland farm, in Bucks County, Pa. This option of purchase was obtained July 23, 1913, for the sum of $50. On August 21, 1913, for the sum of $100 an option of purchase was obtained on another tract of land known as the Lane and Blackford farm. On August 23, 1913, the option of purchase on the first tract of land was exercised and a first payment made on the property of $450. The properties were being acquired purely as a real estate speculation,

the purpose being to continue a building operation then in progress by Lane and Blackford. After the option was obtained on the Lane and Blackford (Starkey) farm, the property was visited by Mr. Mundy to ascertain how the lots had been laid out. During the visit he noticed that the material which had been excavated from a well dug to supply water to the occupants of a bungalow under construction contained a large percentage of pebbles or gravel such as used in building operations. It occurred to him that the property might be underlaid with a quantity of the material and, because of its vicinity to the railroad, conceived the idea that if the land proved upon investigation to contain these pebbles in sufficient quantity, it would render a greater return to him and his associates to mine and sell the material than to continue with the proposed real estate operations. He took the matter up with his associates and they agreed to incorporate a company with a view to exploring the property and engaging in the mining business in case, upon examination, the pebbles were found to exist in quantity and grade sufficient to justify commercial exploitation.

A company was thereupon formed, to be known as the Penn Sand & Gravel Co., and a charter secured September 9, 1923. The company was to have authorized capital stock of $100,000, divided into 10,000 shares of $10 each. Of the authorized capital stock 4,000 shares were issued for cash to the four partners, namely, James A. Mundy, 1,500 shares; Walter Barnum, 1,500 shares; John Seely, 500 shares; Frank Furst, 500 shares. With the money received for the stock the payments were made on the properties on which the options had been taken, and deeds were made out transferring the title to the corporation.

The first meeting of the board of directors of the corporation was held October 29, 1923, at which meeting the following resolution, among others, was adopted.

"Upon motion, duly seconded, it was further RESOLVED that the proper officers be, and they hereby are, instructed to make a thorough investigation of the properties, as to the class and quantity of material existing in the different properties, either by open pit work, drilling, or any other manner which in their judgment should be done; if it is necessary, to consult experts in this business. This is offered with a view of not going too far into it until the amount of material in the deposits is ascertained, before making any larger investments than are now made. The properties are farm properties and investigation or discovery has not been thoroughly made at the present time."

The investigations which were made during the fall of 1913 and early spring of 1914 proved that the material existed in quantity and grade sufficient to justify commercial exploitation, and during 1914 machinery was purchased and installed and commercial production started in 1915.

On the question of discovery there were filed with the committee on May 10, 1923, four affidavits, three of which were by reputable business men who had lived for over 20 years in the community where the properties are located, testifying to the fact that a deposit of pebbles or gravel had never been known to exist in that locality until the discovery thereof by Mr. Mundy and his associates. These affidavits follow:

STATE OF PENNSYLVANIA,
County of Bucks, ss:

Personally appeared before me, a justice of the peace in and for the State and county aforesaid, Barney Maguire, who, being duly sworn according to law, deposes and says: That he has lived in Falls Township, Bucks County, Pa., for over 20 years, is familiar with the site and location of the Penn Sand & Gravel Co.'s gravel and sand deposits, and that to his knowledge there was never known any pebbles or gravel to exist in this territory until same was discovered by James A. Mundy and his associates.

There were several side hill sand banks, but none producing pebbles. The said James A. Mundy and his associates being the discoverers of same.

BARNEY MAGUIRE.

ELMER MINSTER,
Justice of Peace.

My commission expires first Monday, January, 1926.

STATE OF PENNSYLVANIA,
County of Bucks, ss:

Personally appeared before me, a justice of the peace in and for the State and county aforesaid, Elmer E. Johnson, who states for the past 25 years he has been a storekeeper at Tullytown Borough, Bucks County, Pa., who being duly sworn according to law, deposes and says: That he is familiar with the roads and conditions in this territory and to his knowledge there was never known to exist a sand and gravel producing plant until gravel and pebbles were discovered by James A. Mundy and his associates. There were known to be sand deposits but no pebbles or gravel. The same as stated herein was discovered entirely by James A. Mundy and his associates, and were first to erect a sand and gravel producing plant in this county.

ELMER JOHNSON.

ELMER MINSTER,
Justice of Peace.

My commission expires first Monday, January, 1926.

STATE OF PENNSYLVANIA,
County of Bucks, ss:

Personally appeared before me, a justice of the peace in and for the State and county aforesaid, A. Brock Shoemaker, who states that he has been in the building and supply business, including lumber and feed, for the past 25 years, located at Tullytown Borough, Bucks County, Pa., who being duly sworn according to law deposes and says: That he is entirely familiar with Falls Township, Bucks County, Pa., wherein the plant of the Penn Sand & Gravel Co. is located, and to his knowledge there was never known pebbles or gravel to exist in any commercial quantities until same was discovered and developed by James A. Mundy and his associates. It being an entirely new enterprise in this territory.

A. BROCK SHOEMAKER.

ELMER MINSTER,
Justice of Peace.

My commission expires first Monday, January, 1926.

These affidavits are by disinterested parties, reputable citizens who have lived in the vicinity of the properties for more than 20 years and thoroughly familiar with conditions existing in 1913 and prior years. They are furnished in addition to the affidavit of Mr. Mundy and one by Mr. Walter Barnum, both of which are on file with the bureau. When read in connection with the resolution passed by the board of directors of the Penn Sand & Gravel Co., at its meeting of October 29, 1913, and quoted above, prove conclusively that a discovery of pebbles or gravel occured.

The facts presented, therefore, show conclusively that discovery took place. This is not denied by the committee, but is conceded as it is stated in the letter of June 21 that it "is not convinced that the corporation is entitled to a discovery since a deposit of gravel was known to exist before the formation of the corporation, as is shown by the statements filed by the appelant." As the statements filed by the appellants all show that gravel was not known to exist until first observed by Mr. Mundy, the discovery is conceded but the decision turns on the question of whether the right to its valuation for depletion purposes belongs to the corporation or to the partners, thus raising a legal question, namely, what constitutes a discovery of a mine.

The question of what constitutes a discovery of a mine is obviously a legal question to be passed upon by the Solicitor of Internal Revenue.

Article 219 (c) of Regulations 62 provides that for the purposes of the act a mine may be said to be discovered when—

"(1) There is found a natural deposit of mineral * * * which * * * exists in quantity and grade sufficient to justify commercial exploitation.

"(2) There is disclosed by drilling or exploration, conducted above or below ground, a mineral deposit not previously known to exist and so improbable that it had not been and could not have been included in any previous valuation for the purpose of depletion, and which * * * exists in quantity and grade sufficient to justify commercial exploitation."

In article 220 it is stated that "quantities sufficient to justify commercial exploitation" are deemed to exist when the quantity and quality of the material recovered are such as to "afford a reasonable expectation of at least returning the capital invested" through the sale of the material.

Inasmuch as at the time the appellant corporation was chartered its board of directors did not have sufficient information upon which to reach a conclusion that the properties contained gravel in quantity and grade sufficient to "afford a reasonable expectation of at least returning the capital invested," and therefore adopted a resolution at its first meeting held on October 29, 1913, directing the officers "to make a thorough investigation of the properties, as to the class and quantity of material existing" therein, the position was taken in the papers previously presented to the bureau, and in the oral arguments presented that under the regulations the actual discovery took place when the investigations had progressed sufficiently to afford a reasonable expectation that the material existed in quantity and grade sufficient to return the capital invested if mining operations were carried on.

Since the regulations say that discovery does not take place until it becomes known that the material exists in quantity and grade sufficient to justify commercial exploitation, and the courts have so held, the United States Supreme Court as well as the State courts, as evidenced by the numerous decisions cited in a brief which was filed with the committee on May 17, 1923, and the facts as presented show clearly that the material was not found to exist in such quantity and grade until after the corporation was formed and the investigations ordered October 29, 1913, had been completed, the company felt, and still is of the view, that under a fair interpretation of the act and regulations it is entitled to a discovery value.

Inasmuch as the committee has apparently taken the view, in reaching its conclusion, that there was sufficient evidence available upon which to base a conclusion that the material existed in quantity and grade sufficient to justify commercial exploitation when Mr. Mundy first observed the excavation made for the well, it raises a question upon which the appellant was not afforded an opportunity to be heard viz, did the partners lose their right to a valuation based upon discovery by subsequently incorporating?

The question is the basis for the second ground upon which this request for reconsideration is presented. In A. R. R. 712 (I-1 C. B. 183) the sole point at issue was stated to be "whether the incorporation of the partnership with stock distributed to the partners as stockholders in the same proportion as their share interest in the partnership precludes a claim for depletion on the certain oil properties, the value of which was discovered by the partners." In that particular instance the committee held that the rights which vested in the partnership also vested in the corporation and allowed the corporation a depletion deduction on the basis of known value of the properties at the date acquired by the corporation, reversing the action of the Income Tax Unit in disallowing depletion based on values discovered prior to the incorporation of the company.

We can observe no essential difference between that case and the one of the Penn Sand & Gravel Co.

Since the receipt of the letter of June 21, 1923, denying the appellant company an increased valuation for the purposes of depletion based on discovery, Internal Revenue Bulletin No. 72 has been published containing another ruling of the same purport as A. R. R. 712, and citing the previous ruling.

Under the circumstances herein recited, it is the view of the Penn Sand & Gravel Co. that it is entitled to a review of the ruling of June 21, 1923, involving as it does in its present shape the two legal questions hereinbefore mentioned.

We respectfully request therefore that the case be further considered in the light of these facts.

Respectfully submitted.

WM. S. HAMMERS,
Attorney for the Penn Sand & Gravel Co.

EXHIBIT H

RECOMMENDATION No. 6393.—COMMITTEE ON APPEALS AND REVIEW

In re: Appeal of Penn Sand & Gravel Co., 207 South Ninth Street, Philadelphia, Pa. Years 1917 to 1920, inclusive.

JANUARY 14, 1924.

MR. COMMISSIONER:

(For Deputy Commissioner, Head Income Tax Unit.)

The committee has reconsidered its recommendation (A. R. R. 3526) in the appeal of the above-named taxpayer from the action of the Income Tax Unit in denying a discovery valuation for depletion purposes.

The committee finds from the preponderance of evidence submitted, both oral and written, that gravel was not determined to exist in commercial quantities in the land in question until after the formation of the appellant corporation and the completion of the boring tests conducted by it. It therefore appears within the meaning of the word "discovery" as set forth in article 219(b) of regulations 45 (1920 edition), that the appellant company is entitled on principle to such discovery value as can be established in connection with the gravel deposit in question.

It is therefore recommended in the appeal of the above-named taxpayer that the action of the Income Tax Unit be reversed and that the previous recommendation of the committee in this case (A. R. R. 3526) be revoked.

CHARLES D. HAMEL,
Chairman Committee on Appeals and Review.

Approved:

D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT I

MR. J. H. BRIGGS,
Chief Nonmetals Section, Engineering Division,
Internal Revenue Bureau.

Re Penn Sand & Gravel Co.

You will recall that when the case of the Penn Sand & Gravel Co. was returned from the Committee of Appeals and Review, with the notation that discovery of sand and gravel had been allowed the taxpayer by the committee, I questioned the sworn affidavits exhibited by the taxpayer wherein it was stated that gravel deposits were unknown in Falls Township, Buck County, Pa., prior to the discovery by James Mundy and associates in 1913. With this thought in mind I examined reports of the Pennsylvania second geological survey and the Trenton folio of the United States Geological Survey.

In 1884 a geologist, Charles E. Hall, in describing the geology of Philadelphia, Montgomery, and Bucks Counties, states, concerning Falls Township, in Bucks County, page 50:

"Gravel and river deposits cover the greater portion of the south half of the township. Near the northern edge of the gravel we find terrace sand escarpments. These escarpments have a diagonal course across the township. The escarpments mark the successive courses of the Delaware River as it has gradually undermined the Cretaceous beds which are now eroded or concealed below the alluvial. * * * The course of the river at one time has been on a line between Morrisville and Tullytown."

A rough sketch map of Falls Township taken from the Trenton folio of the United States Geological Survey, published in 1909, accompanies this brief notation. Referring to this map it will be seen that two formations practically cover the township (a minor outcrop of gneiss is shown in red.) These formations are called the Pensauken and the Cape May.

The Pensauken formation is one of gravel and sand on the higher terraces and capping hills and divides. The geologists of the survey comment concerning the Pensauken:

"In the Trenton quadrangle the Pensauken is the most important source of gravel; there is hardly a hilltop or divide capped by the formation which has not been pitted to obtain it." (P. 23, Trenton folio.)

In other words, what they mean by "pitted" is the digging of the postholes to determine that there was gravel there, that there was a gravel formation there.

"The soils of the Pensauken formation are gravelly to clayey loams. In many localities a bed of silt from 1 to 3 feet thick covers the typical sand and gravel of this formation" (P. 23, Trenton folio.)

"The widespread Pensauken formation consists, for the most part, of unconsolidated gravel and sand, most of which in this region is below the 130-foot contour. * * *

"Sand predominates over material of larger size in the Pensauken, but gravel is common and bowlders can hardly be said to be rare, especially at the base." (P. 15, Trenton folio.)

The Cape May formation is gravel and sand and clay forming low terraces; and includes some recent alluvium and swamp muck. The Government geologists (Trenton folio, p. 16) comment concerning this formation:

"The Cape May formation is confined largely to the valleys on the present streams * * *. This gravel has long been known as the "Trenton gravel." When its deposition was completed glacial gravel filled the valley of the Delaware up to a level now 120 feet above the sea. * * *"

The Delaware River in past geological ages, notably after the Glacial period, flowed from Trenton to Tullytown in a straight line rather than in the broad, sweeping curve it occupies at present. Great quantities of gravel and sand were carried by the river from the terminal moraines created by the retreat of the ice pack at the close of the Glacial period. From those moraines to Trenton the river had a straight sweep, but the bend of the river at Trenton caused a damming effect and the river dropped a great portion of its load. There was thus built up a series of river terraces of sand and gravel roughly parallel and covering the south half of Falls Township.

In the light of the foregoing remarks, and of the geological evidences given on page 50 of the 1881 C 6, report of the second geological survey of Pennsylvania, and the knowledge of the sand and gravel formations of Falls Township as shown in the Trenton folio of the United States Geological Survey, it is difficult for this office to reconcile the recommendation of the committee that the taxpayer be allowed discovery with the language used in regulations 62, page 99, paragraph c, wherein it is stated:

"(c) For the purpose of these sections of the act, a mine may be said to be discovered when * * *. (2) There is disclosed by drilling or exploration conducted above or below ground, a mineral deposit not previously known to exist and so improbable that it had not been, and could not have been included in any previous valuation for the purpose of depletion. * * *"

Respectfully,

FRANK H. MADISON,
Valuation Engineer.

EXHIBIT J

INCOME TAX UNIT, ENGINEERING DIVISION,
February 16, 1924

Mr. BRIGGS,
Chief Nonmetals Valuation Section:

In re Penn Sand & Gravel Co.

In reply to your undated memorandum concerning the above-named taxpayer, I wish to state that I have not examined this case, but the information I gather from the report of Mr. Madison makes it apparent that the committee on appeals and review has allowed the taxpayer a right of discovery. Unless it can be clearly shown that this decision of the committee is illegal, I can not see how we can consistently ask the committee to reopen this case.

Throughout this division at the present time there seems to be a decided inclination on the part of some of the engineers to disagree with their superior officers, and a continuation of such feeling will very soon result in complete disorganization.

This division must regard the decisions of the committee on appeals and review as its instructions to be carried out without question unless it can be shown plainly and unmistakably that any one decision is illegal.

It is my opinion that the above-named case should be closed in accordance with the instructions of the committee on appeals and review and also that something be done to curb the tendency of engineers toward the taking issue with the decisions or instructions of their superior officers.

S. G. GREENIDGE,
Head Engineering Division.

EXHIBIT K

WASHINGTON, D. C., *May 10, 1924.*

In re: Penn Sand & Gravel Co.
COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

DEAR SIR: To comply with the request in bureau letter of March 11, 1924, (the time for compliance with which was extended to May 11) requesting information to substantiate the depletion rate based on discovery used by the Penn Sand & Gravel Co., there is submitted the following:

Letter of James A. Mundy, president of Penn Sand & Gravel Co., dated April 29, 1924.

Five copies of Form F duly executed, one for each property belonging to the company.

Sketch map showing location of company's properties and the location of the property of other operators.

Statement showing net profits detailed for the year 1915.

It will be seen by reference to the copies of Form F that all of the company's operations have been conducted on the Leland farm. Full information in regard to the purchase of the Leland and Starkey farms on which discovery was first made has already been furnished. There has also been furnished a large blueprint showing the boundaries of all of the company's properties except the Mather farm, the location of which is shown on the map here accompanying.

The bureau letter asks for an elaboration of the acreage containing gravel on the Starkey farm and the portion sold to the Government. This information is given in Form F herewith, and on the blueprint now in the bureau's files. There is also on file in the bureau a copy of the report of the Jury of Viewers awarding the company $285,231 damages for the 85.7 acres of the Starkey farm taken by the United States Government.

It is believed that all information asked for in the bureau letter of March 11 has been furnished.

Yours very truly,

WM. S. HAMMERS,
Attorney for Penn Sand & Gravel Co.

PENN SAND & GRAVEL CO.,
Philadelphia, Pa., April 29, 1924.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

Attention J. H. Briggs, chief of section.

GENTLEMEN: Replying to yours of March 11, in which you request us to fill out copies of Form F for each of the properties known as the Leland farm, Starkey farm, Smith farm, Raub farm, and the Mather farm, we herewith inclose said forms as per your request.

The price marked for each farm is price to be paid to owner for property, but does not include the cost of attorney fees, transfer insurance, the cost of drilling and exploring of the Starkey, Raub, Leland, and Smith farms, the cost of which was $7,360.95. The result of this drilling and exploration was shown in blue print sent you and which you have. You will notice by Form F of these farms that the excavation has been done entirely on the Leland property. In your letter you state that it appears we are deducting depletion on the Raub farm purchased in 1917. We are not. All our deplention and excavation, as stated, is entirely confined to the Leland farm.

In addition, you ask for what purpose the land in question was purchased. We assume that you refer to the Smith, Raub, and Mather farms.

The Smith farm was purchased for the purpose of providing a place for wasting our excess sand, which we are obliged to do, as the market for sand is very light. When we get into sand we have a great excess for which there is no market, while we do have a market for all our pebbles, and, therefore, were obliged to buy this Smith property.

The Raub farm we owned to the center of the creek, and this farm owned the other half of said creek. We are using the water from it in great quantities at the rate of 1,000 to 1,500 gallons per minute and the overflow from our washeries, which was very dirty and carried a large amount of sediment, dirties the creek, and the farmers on adjacent farms complained. As the property was for sale and could be bought cheap, we considered advisable to purchase, and for the further reason we would own the entire body of the creek passing through our property. We had not made any examination nor was there any surface indication of gravel or sand. Our full thought was as stated herein.

The Mather farm is adjacent to the new line of the Pennsylvania Railroad. This property being offered for sale, we bought it for the reason that it was cheap and adjacent to the Pennsylvania Railroad, New York division. This property we have not used nor explored.

In computing our valuation we figure it at 7½ cents per ton for the units in a deposit, these units being based from our drilling and exploration. We are informed that the following firms are paying as a royalty prices below quoted, and have heard of others who are paying a great deal more money, but at the present time we have not been able to confirm same. We consider 7½ cents a very low royalty for the quality of material in these deposits which we have discovered. While the writer does know of a good many deposits and has seen same, none equal the percentage of clean pebbles that are in these deposits. As stated, we are informed the following royalties are being paid:

J. T. Dyer & Co., Birdsboro, Berks County, Pa. Have been paying to the Brooks Iron & Steel Co. a royalty of 4½ cents per ton on stone extracted from their land; have been paying this for 30 years.

Birdsboro Crushed Stone Co., Birdsboro, Pa. Pay to Mrs. Brooks a royalty of 5 cents per ton on crushed stone. This agreement recently made.

John Goll & Co., Philadelphia, Pa. Pay to the John Hodgkins at Vale, N. J., 9 cents per ton, from 1907 to 1909, for all sand and gravel extracted from his property. Note this occurred prior to the war.

Hodgkins Sand Co. and Linde & Griffith Co., Netcong, N. J. Prior to the war they paid a royalty of 10 cents per ton; since the war, they pay 5 cents per net ton and 6 cents per gross ton.

Succasunna Sand Co., Succasunna, N. J. They pay a royalty of 10 cents per ton on sand and gravel where the selling price is in excess of 35 cents per ton, and 6 cents per ton where the selling price is less than 35 cents per ton.

The Good Sand & Gravel Co., Charlestown, Md. From 1910 to 1917 they paid George and John Cooper a royalty of 5 cents per ton on approximately 100,000 tons. In 1917 a new agreement was made for another tract, and the lessee agreed to pay a royalty of 8 cents per ton, and has continued doing so to the present date.

Chas. Warner Co., Wilmington, Del. Pay to the Manor Sand & Gravel Co., who own 600 acres in Falls Township, Bucks County, Pa., 8 cents per ton for pebbles and 5 cents per ton for sand, with a minimum payment of seven to ten thousand dollars a year.

Dean & Biddle, Eastern Sand Co., Eastburn & Co. Three plants working on a royalty in Morrisville district, Bucks County, Pa., are paying 15 cents per ton.

Trusting the above will give you the information you desire, beg to remain,

Very truly yours,

PENN SAND & GRAVEL CO.,
JAMES A. MUNDY, *President*

Detailed statement of operations for 1915

Gross income		$26,787.27
Deductions:		
Coal, oil, sheet iron, bolts, etc	$4,740.50	
Title insurance, attorney fees	175.66	
General expenses, office, etc	958.87	
Fire insurance	250.00	
Liability insurance	100.00	
Commissions	764.78	
Prepaid freight	276.78	
Labor	9,914.36	
Salesman	516.61	
Discounts and rebates	273.59	
Renewals and general repairs to machinery	1,064.53	
Depreciation	1,250.00	
Depletion	625.00	
Interest	1,711.73	
Taxes, domestic	506.08	
		23,128.49
Net profit		3,658.78

EXHIBIT L

OCTOBER 17, 1924.

Sand and gravel. Valuation report for 1917, 1918, 1919, 1920.

The case was reviewed by this section on June 1, 1921, and June 16, 1922, at which time a depletion rate of 7½ cents per ton for gravel on a discovery basis was denied and the taxpayer allowed depletion on a cost basis of $0.0186 per ton. The taxpayer protested these findings and carried the case to the committee on appeals and review, who in recommendation No. 3526 sustained the action of the nonmetals section in denying the taxpayer discovery of sand and gravel. The taxpayer was informed on August 27, 1923, of this action and notified that there was no change in the tax liability as outlined in the office letter dated December, 1922. On August 30, 1923, the corporation requested a reconsideration of the decision of the committee in denying the company a valuation for depletion purposes based on discovery. This request was granted and on January 14, 1924, the committee on appeals and review reconsidered its recommendation (A. R. R. 3526), and found "from the preponderance of evidence submitted, both oral and written, that the taxpayer was entitled to such discovery value as can be established in connection with the gravel deposit in question."

This office has since been engaged in reviewing records of sales of sand and gravel lands in the county courthouse for Falls Township, Bucks County, Pa.; in checking up tonnage estimates on various sand and gravel deposits in Falls Township; and in ascertaining prevailing royalty rates in the Delaware River, Tullytown to Trenton district. The purpose of these investigations has been to conform strictly to Regulations 62, article 219, relating to discovery of mines, the pertinent paragraphs of the regulations being:

"(*b*) To entitle a taxpayer to a valuation of his property, for the purpose of depletion allowances, by reason of the discovery of a mine on or after March 1, 1913, the discovery must be made by the taxpayer after that date and must result in the fair-market value becoming disproportionate to cost.

"(*c*) The value of the property claimed as a result of a discovery must be the fair-market value, as defined in article 266, based on what is evident within 30 days after the commercially valuable character and extent of the discovered deposits of ore or mineral have with reasonable certainty been established, determined, or proved.

"ART. 206. (*a*) Where the fair-market value of the property at a specified date in lieu of the cost thereof is the basis for depletion * * * deductions such value * * * should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The

commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales, and transfers of similar properties, royalties and rentals, etc."

This office has consistently held that the fairest criterion of value whenever the fair market value of any common nonmetal, such as sand and gravel, is in dispute is that which results from the purchase of such deposits from a willing seller by a willing buyer.

There have been a number of sales of sand and gravel lands in Bucks Township since the "discovery" of sand and gravel in 1913. Numerous companies have come into the field, the most important of which are Hill & Curtis Sand & Gravel Co., whose property is now under lease to the De Frain Sand Co.; the De Frain Sand Co.; the Charles Warner Co., who lease the Manor Sand & Gravel Co., whose stock in 1920 was owned two-thirds by the Penn Sand & Gravel Co. and one-third by the Charles Warner Co.; and several small operators near Morrisville. These different companies came into the field in 1918, 1919, and 1920, after the value and extent of the sand and gravel deposits in Bucks Township had been demonstrated by the Penn Sand & Gravel Co. It is therefore believed that the various purchases of these different corporations illustrate thoroughly that value found by use of article 206, Regulations 62, through actual sales and transfers of similar properties.

In 1918 one corporation purchased 342 acres of land at an average price of $137.05 per acre, with a low of $100 per acre and a high of $181 per acre. The tons of sand and gravel purchased, the price paid for the 342 acres less the residual value of land and buildings, was such that the resultant depletion rate was $0.00688 per ton.

In 1919 two corporations purchased 142 acres of sand and gravel lands at an indicated price of $27,518, or an average price of $193.79 per acre, with a low of about $105 per acre and a high of $270 per acre. The tons of sand and gravel purchased, the price paid for the 142 acres less the residual value of land and buildings, was such that the resultant depletion rate was $0.01 per ton.

Careful test drilling and rechecking, together with allowances for fine and rough bottom of over 1,400 acres of the above, and allowing proper amounts for residual value and buildings, gives a depletion rate of slightly over $0.01 per ton of sand and gravel. Six hundred acres of these 1920 purchases were bought by the Manor Sand & Gravel Co., 207 South Ninth Street, Philadelphia, Pa., whose stock was owned 66⅔ by the Penn Sand & Gravel Co. and 33⅓ by the Charles Warner Co. A contract was made in 1921 whereby the 600 acres referred to above were leased to the Charles Warner Co. at royalty rate of 5 cents per ton for gravel and 5 cents per ton for sand. Due to a new contract the present royalty rates are 8 cents per ton for gravel and 4 cents per ton for sand.

The Charles Warner Co. is now building a $750,000 sand and gravel plant on this property to mine the sand and gravel contained therein. Depreciation will be taken on this plant on the basis of a 10-year life and an annual output of between 1,000,000 and 1,500,000 tons per year. If the average is 1,250,000 tons per year, this would indicate a tonnage of 12,500,000 tons of sand and gravel. On this basis the estimated production gives a life of 14 years, 10 years in the future plus 4 years since the purchase in 1920. The present worth of a royalty for 10 years of 8 cents per ton of gravel at 8 per cent and 4 per cent is 4.24 cents. On the basis of cost in 1920, however, the figure is greatly different. The cost as given to an engineer from this office who visited the office of the Manor Sand & Gravel Co. in September of the year was as follows:

Purchased from	Acres	Cost	Cost per acre
Bond	100	$20,000.00	$200.00
Wright	150	18,000.00	120.00
Taylor	137	22,550.00	164.25
Girard Trust Co.	213	22,000.00	103.00
	600	82,550.00	137.60

Based on a total cost of $82,550, as given above, and a total tonnage recoverable of 12,500,000 tons, the depletion rate per ton of sand and gravel is $0.006604.

However, the 1920 return of the Manor Sand & Gravel Co. lists "gravel mines" at $123,837.53 amongst its assets. Pending receipt of Form F from the Manor Sand & Gravel Co., this office is in doubt as whether the $123,837.53 is the correct figure for the 600 acres purchased in 1920, or if the actual cost was $82,550.00 as given the engineer from this office. However, if we accept the cost at $123,837.53, and ascribe no residual value to either land or buildings, the depletion rate based upon the tonnage estimate given by the Charles Warner Co. is under $0.01 per ton of sand and gravel. A division of the expected tonnage into tons of sand and tons of gravel is fair on the basis of about 33⅓ per cent for gravel and 66⅔ for sand. If gravel is twice as valuable as sand, as would appear from the royalty rates, then the corporation paid:

For--	Cost	Tons	Cost per ton
Sand	$41,245.88	8,300,000	$0.0050
Gravel	82,591.65	4,200,000	.0197
	123,838.53	12,500,000	.01

The highest price per acre of sand and gravel paid during 1920 when over 2,117 acres exchanged hands was at the rate of $502 per acre. The Leland Farm, one of the original purchases of the taxpayer upon which depletion based on a discovery value of 7½ cents is claimed, is estimated by the taxpayer to contain 25,000 tons to the acre of available gravel reserves. If the highest cost price found in 1920 of $502 per acre for gravel lands is given the taxpayer he would be entitled to a depletion rate for gravel of $0.02004 per ton. The Lane and Blackford Farm averages 40,000 tons to the acre and based upon a price equal to the highest price per acre paid in 1920 of $502 per acre the depletion rate would be $0.01255 per ton.

A total of purchases during 1918, 1919, and 1920 amounting to 2,601 acres and costing $532,691.36 or an average $204.80 per acre together with the tonnage estimates indicate that sand and gravel could have been purchased in 1918, 1919, and 1920, five to eight years after the taxpayer's "discovery" in 1913 at the average cost of $0.01 per ton of sand and gravel in place. These were in the "high-cost years."

It is apparent that the valuation memorandum dated June 16, 1922, in allowing the taxpayer $0.0186 per ton for gravel based on a total cost of $54,954.36 with no allowance for residual value and an estimated tonnage of 2,940,000 tons has granted the taxpayer all that could be allowed even under the "discovery clause" of the law. The "fair market value" is not disproportionate to cost of similar properties similarly situated.

It is recommended that 1917 to 1920 be audited on the basis of the prior memorandum dated June 16, 1922.

FRANK A. MADISON,
Valuation Engineer.

Approved:

SEWARD,
Subsection Chief.

Noted:

J. H. BRIGGS,
Chief of Section.

EXHIBIT M

WASHINGTON, D. C., *November 24, 1924.*

COMMISSIONER OF INTERNAL REVENUE,
Treasury Department,
Washington, D. C.

DEAR SIR: In accordance with the understanding reached at the conference of November 19 in regard to the property of the Penn Sand & Gravel Co. on which a discovery value is claimed, we were to furnish a statement as to the estimated tonnage in the deposits. Mr. Mundy has accordingly examined his records and reports that the company has mined 60 acres of the Leland farm to water level producing 16,000 tons per acre or a total of 960,000 tons. When

the reports on Form F were made up mining operations had been carried on in a crude way to a depth of 16 to 18 feet below water level, which indicated a prospective recovery of 9,000 tons per acre. Since then, however, developments have been carried to 28 feet below water level, indicating a recovery of 15,000 tons per acre or a total of 900,000 tons below water level on the 60 acres. These operations indicate that the 10 acres of marsh land on the farm will yield 40,000 tons to the acre which totals 400,000 tons, and makes the total tonnage for the Leland farm 2,260,000 tons. (Pencil): 52,000 more to be added.

The tests made on the Land and Blackford (Starkey) farm indicated a yield of 35,000 to 40,000 tons to the acre, or a total of at least 2,240,000 tons.

The Starkey farm lies across the railroad so that all operations have been conducted on the Leland farm, operations on the Starkey farm being deferred until the deposit on the Leland farm is exhausted.

I am inclosing a copy of the statement furnished by the company showing net profit per ton for the material mined. This net profit is exclusive of depreciation and depletion.

I am furnishing also a copy of the plant account from 1915 to 1921, to which the bureau assigned a 10 year life, as follows:

1915	$2,802.72	1919	$22,351.88
1916	8,343.34	1920	22,351.88
1917	13,662.50	1921	22,351.88
1918	22,351.88		

(In pencil): Digging plant only; total plant will cost more; about $200,000.

The average yearly production as shown on the Form F on file with the bureau is about 213,000 tons.

Yours very truly,

WM. S. HAMMERS.

MAY 28, 1924.

Mr. J. G. BRIGHT,
Deputy Commissioner Internal Revenue,
Treasury Department, Washington, D. C.
(Attention Mr. J. H. Briggs, chief of section.)

DEAR SIR:

Depletion claim—Average sales price and cost of production of sand and pebbles during the years 1914 to 1920, inclusive

Year	Average sale price	Cost of production
	Per ton	*Per ton*
1914	(1)	(1)
1915	$0.40	
1916	.40	$0.25
1917	.56	.37
1918	.83½	.68
1919	.80	.60
1920	1.00	.82
	5)3.595	5)2.72
	.719	

[1] Only turned plant over and tried out machinery.

COMMONWEALTH OF PENNSYLVANIA,
County of Philadelphia, ss:

The undersigned, president of the Penn Sand & Gravel Co., being duly sworn, deposes and says that the above facts as set forth are true and correct to his best knowledge and belief.

Sworn to and subscribed before me this ——— day of May, 1924.

EXHIBIT N

TAXPAYER'S CONFERENCE

NOVEMBER 25, 1924.

Taxpayer: Penn Sand and Gravel Co.
Address: 207 South Ninth Street, Philadelphia, Pa.
Represented by Wm. S. Hammers, attorney; James Mundy, President.
Credentials: Power of attorney and enrollment card to Mr. Hammers.

Matter presented: Revised tonnages on Leland and Starkey farms, net profit per ton for the years 1916 to 1920, and digging plant account for the years 1915 to 1921.

Issues discussed: The taxpayer argued that discovery value should be based upon separate computations by the "discount of profits method of the two tracts involved. This office stated it was their opinion that this would grant two discovery values whereas only one discovery was made. It was also pointed out that under this system, "discovery value" on the second tract would be being deferred over ten years have little value and that the average of the two would give a lower rate than that computed by taking the two tracts as a whole.

The taxpayer protested the use of the figure $223,000 as plant value stating that while his underwater digging plant cost about $200,000, his surface plant which he had used 8 years only cost him about $100,000. A rough computation for "discovery value" using a life of 21 years, a factor of 8 and 4 per cent, and the above plant costs gave approximately 3 cents as the value of gravel in place. The taxpayer pointed out that the jury had awarded them 9½ cents in the government condemnation proceedings in 1920 when a portion of the original "discovery tract" was taken over by the Government in building its Tullytown plant and that the taxpayer had finally accepted 4.8 cents as a compromise figure in 1921. He stated that inasmuch as a jury of unbiased, disinterested viewers appointed by the courts had granted 9½ cents for gravel in place that this should be taken as the criterion of value, or at least the minimum of 4.8 cents accepted by the taxpayer as a compromise figure. He stated that his only reason for compromising at 4.8 cents was because he needed the money to construct an underwater digging machine costing $150,000.

Conclusions: The taxpayer was informed that the Unit in granting a value of about 3 cents per ton had gone as far as possible in calculating a "discovery value" and that if it were unacceptable he could appeal to the solicitor or to the board. He stated that he wanted an A–2 letter based upon the rate found by using $200,000 as the value of the second and the cost of the first plant as shown in the returns. However, the plant as shown in the returns is not correct and the taxpayer agreed to furnish a schedule showing plant expenditures up to 1921. Early action was requested upon the 1921 return which involves a claim for refund of $31,000. The taxpayer was promised that an expedite would be attached to the case.

FRANK H. MADISON,
Engineer.
E. S. BOALICH,
Subsection Chief.
A. R. SHEPHERD,
Engineering Division Conferee.

Noted:

J. H. BRIGGS,
Chief Nonmetals Section.

EXHIBIT O

DECEMBER 9, 1924.

Gravel. Valuation report for 1917, 1918, 1919, 1920, 1921.

A valuation memorandum dated October 17, 1924, and based upon the findings of an engineer from this office who examined the Bucks Township sand and gravel deposits in August and September, 1924, was sent the taxpayer on October 27, 1924. The taxpayer protested these findings and conferences were held on November 18 and November 25, 1924. At these conferences it was held

by the engineering division conferee that the taxpayer was entitled to value his mineral property by the "discount of profits" method and that the tonnage on the "discovery" tracts, the Leland and Starkey farms, should be used. The tonnage in the two farms is 4,552,000 tons; the average production was agreed to be 213,000 tons; the life of the property is 21 years; the cost of the first plant is, from the tax returns, about $105,000; the depreciation rate is 10 per cent on the plant as a whole and the cost of the second plant (an underwater digging plant) is $200,000; and the average profit in the years 1916 to 1920, inclusive, is $0.175 per ton. The total expected profits are (4,552,000 times $0.175) $796,600. Deducting the second plant ($200,000) the present worth of $596,600, using Hoskold's formula at 8 per cent for interest on capital invested and 4 per cent of the sinking fund (0.427920), is $255,297.07. The first plant, costing about $105,000, deducted from $255,297.07, gives $150,297.07 as the value of the mineral. This divided by the tonnage, 4,552,000 tons, gives $0.0329 as the resultant value of mineral.

The taxpayer's representative stated he wished an A-2 letter based upon this, although he was not wholly satisfied. He was informed by the engineering conferee that this office had gone as far as possible in granting this value for "discovery" purposes and that if he was dissatisfied with the value shown above it would be necessary to appeal to the committee or to the tax board.

Cost of real estate to the taxpayer is as follows:

Penn Sand & Gravel Co.

	Date purchased	Cost
Leland farm	1913	$10,000.00
Starky farm	1913	18,736.25
Smith farm	1916	5,250.00
Raub farm	1917	6,507.16
Mather farm	1918	7,100.00
Exploration and development work		7,360.95
Total		54,954.36

The Starkey farm was condemned as to 85.7 acres by the Government in 1918 and sold by agreement in 1921 for $145,000. The remaining value on the Starkey farm (64.3 acres) was $8,037.50. Adding the Leland farm cost and the exploration work gives a cost of $25,398.45 to the depletable assets. The Smith and Raub farms, while containing depletable assets, will not be mined for several years and hence need not be considered for rate of depletion. Since the tonnage on the Leland-Starkey tract is 4,552,000 tons, the depletion rate based on cost is $0.0056. Depletion based on cost and depletion allowed on income tax returns through discovery is then as follows:

Year	Tons	Depletion rate		Depletion	
		Cost	Discovery	Sustained on cost	Allowed on income tax returns
1915-16	200,000	$0.0056	$0.0329	$1,120.44	None.
1917	224,175	.0056	.0329	1,255.38	None.
1918	211,284	.0056	.0329	1,183.19	$6,951.24
1919	150,000	.0056	.0329	840.00	4,935.00
1920	180,096	.0056	.0329	1,008.54	5,925.16
1921	153,383	.0056	.0329	858.94	5,046.30

Depletion based on discovery in 1915, 1916, and 1917 was 424,175 times $0.0329 or $13,955.36. Since the 1918 law first contained the "discovery" clause the taxpayer is not allowed depletion in 1915, 1916, 1917 based on discovery but is only legally entitled to depletion based on cost as shown above. The resultant

discovery value as at January 1, 1918 is $150,297.07 less $13,955.30 or $136,341.71. However, for invested capital purposes the taxpayer is entitled to the paid in surplus resulting from the "realization of appreciation" due to "discovery" for all years subsequent to 1918 unless the "realization of appreciation" is distributed as a dividend.

Attention of the audit is called to the claim for refund for 1921. The taxpayer has requested that this be given attention and consideration with the audit of the years 1917 to 1920 in order that the matter be settled as soon as possible.

FRANK H. MADISON,
Valuation Engineer.

Approved:

DURAND,
Subsection Chief.

Noted:

J. [illegible] BRIGG,
Chief of Section.