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

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SELECT COMMITTEE ON INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

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WILLIAM H. KING, Utah.

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

THURSDAY, MAY 21, 1925

UNITED STATES SENATE,
SPECIAL 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), Jones of New Mexico, and King.

Present also: Mr. L. C. Manson, counsel for the committee.

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, Assistant to the Commissioner of Internal Revenue; Mr. A. W. Gregg, Solicitor Bureau of Internal Revenue; Mr. J. G. Bright, Deputy Commissioner of Internal Revenue; Mr. J. B. Milliken, attorney, office of the solictor; and Mr. F. D. Strader, attorney, office of the solicitor.

Mr. GREGG. I would like to make a short statement in connection with the case of the Pure Oil Co., one of the companies as to which reference was made by Mr. Fay in his last report, you will remember?

Mr. MANSON. Yes.

Mr. GREGG. He questioned the valuation as of November 30, 1916, when he said the actual discovery had been made in 1914.

Mr. MANSON. Yes.

Mr. GREGG. The facts are that in 1916 the property was acquired by a new corporation, and they valued it as of the date of acquisition. There was no question of discovery in it. That was the reason the valuation was as of November 30, 1916, instead as of 1914. That, I think, answers his whole objection to the settlement.

Mr. MANSON. If the property changed hands in 1916, after discovery, it would seem to me that the purchase price would govern the depletion.

Mr. GREGG. That is true. There was no discovery value allowed in the case, but you see, the property had to be valued because it was acquired for stock.

Mr. MANSON. Oh!

Mr. GREGG. And it was valued as of November 30, 1916.

Mr. MANSON. I see.

Mr. GREGG. Instead as of 1914, the date the discovery was made, because of the fact that it was acquired for stock on November 30, 1916.

The CHAIRMAN. I think we would like to look into that, because, as I remember the case, Mr. Fay made the statement that there was a discovery.

Mr. MANSON. Yes; I will look into that.

The CHAIRMAN. And discovery value allowed, and also that the value was excessive.

Mr. MANSON. Yes.

Mr. GREGG. It was excessive, based on the fact that a higher price of oil was used in 1916 than the posted price in 1914, when he said that discovery was made. Well, he is right, the price of oil was higher, but there was no discovery value allowed in the case, and it was valued as of 1916, because it was acquired on November 30, 1916, by the corporation.

Mr. MANSON. I will look into it, and I might say at this time that I will be prepared to discuss Mr. Gregg's reply in the Gulf Oil case to-morrow.

I asked the unit to have some one here this morning to discuss the application of what is known as A. R. R. No. 34. A. R. R. 34 was a recommendation of the committee on appeals and review as to the method to be used in determining the value of the intangible assets of a corporation or of an individual—the good will and the going values, values of patents, trade-marks, and intangible values of that character, where there were no sales at or about the date as of which valuation was to be determined; and this committee's recommendation lays down a general method to be followed, which, as I understand it, is considered at least by the unit as a starting point in the proper method of ascertaining these values.

In order that we may have this before us I will read that portion of it.

Senator JONES of New Mexico. Was that prepared by the unit?

Mr. MANSON. This was prepared by the committee on appeals and review as a recommendation to the unit of a method to be followed in ascertaining these values.

The CHAIRMAN. What date was that?

Mr. GREGG. The values of intangibles.

Mr. MANSON. It is published in cumulative bulletin of June, 1920. None of these rulings appear to be dated. I have often wondered why it was; that is, I mean the published rulings do not appear to have any dates.

Mr. GREGG. The rulings themselves are dated, but the date is not published.

Mr. MANSON. I know; but when you get back to the original ruling it is dated, but the dates are not published.

The CHAIRMAN. Why are the dates not published? Is there any reason for it?

Mr. GREGG. No reason at all.

The CHAIRMAN. I find that by not having the dates, it is difficult for me to follow the sequence of these hearings.

Mr. GREGG. This was not a hearing on this specific case at all.

The CHAIRMAN. I am talking about the hearings we are holding here.

Mr. GREGG. Oh!

Mr. MANSON. For instance, you can tell when a ruling is published, but it is necessary to go back to the case in which the ruling was made and get the original ruling before the facts are deleted, in order to ascertain the exact date on which the ruling was made.

The first two methods set up in this recommendation——

Senator JONES of New Mexico. Do you not think it would be better, and that it would correct the situation, if in future publications you gave the dates?

Mr. GREGG. I do not see the necessity of publishing the date, Senator Jones, when we publish a ruling. I see no necessity of giving the date of its issuance, although I see no objection to it.

Senator JONES of New Mexico. Well, I can see a very important reason that a person reading it should know whether it is a recent ruling or an old ruling, or whether it should apply to a thing. I do not see how you can really get the force of any of those rulings unless you know the dates when they are promulgated.

Mr. GREGG. Of course, all of them are issued in the bulletin shortly after they are promulgated, except in the situation that I referred to yesterday, where about two years ago we dug up a lot of old ones.

Senator JONES of New Mexico. Well, a person would want to know whether it was one of those cases or not.

The CHAIRMAN. The absence of the date seems absurd to me. For instance, even though they are published three weeks after they are issued, during those three weeks a case may have been dealt with and a taxpayer not know that the rule was in existence nor the date when it was promulgated.

Mr. GREGG. I do not see that that is any hardship on the taxpayer. It is binding on the department when it is issued and when it is published, but not before.

The CHAIRMAN. But the taxpayer does not know that it is binding on the bureau. That is the difficulty in the whole thing, that the taxpayer does not know that anything is binding on the bureau half the time, nor what the bureau's rulings are.

Mr. MANSON. This ruling is known as A. R. R. or A. R. M., as I have it. Which is it—A. R. M. or A. R. R.?

Mr. NASH. A. R. M.

The CHAIRMAN. In that connection, Mr. Manson, when you first started out you said it was a recommendation to the bureau. Do we understand that that is the rule, then, because it was a recommendation?

Mr. MANSON. Well, I am coming to that. That is one of the things I wanted to find out this morning.

The CHAIRMAN. All right.

Mr. MANSON. I do not know; it has been followed in a good many cases; but I have not, by such investigation as we have been able to make in the bureau, come to any satisfactory conclusions as to the methods used in arriving at these values, and for that reason I asked the bureau to have men here this morning who could speak with authority on the subject in order that we may get at the facts.

Senator JONES of New Mexico. Now, let me understand that. That ruling was promulgated when?

Mr. MANSON. It was promulgated some time prior to June, 1920, because it was published in the cumulative bulletin of June, 1920.

Mr. GREGG. It was handed down under date of February 6, 1920.

The CHAIRMAN. It was not published until June, 1920.

Mr. MANSON. I do not believe that. I think it was published in one of the weekly bulletins.

Mr. GREGG. In the weekly bulletin?

Mr. MANSON. In the weekly bulletin; yes; but I find it in the cumulative bulletin, which is published once in six months.

The CHAIRMAN. There are always a cumulative bulletin and a weekly bulletin?

Mr. MANSON. Yes; there is a weekly bulletin, and at the end of six months those publications, which come out weekly, are consolidated into a cumulative bulletin.

This recommendation is as follows:

The committee has considered the question of providing some practical formula for determining value as of March 1, 1913, or of any other date, which might be considered as applying to intangible assets, but finds itself unable to lay down any specific rule of guidance for determining the value of intangibles which would be applicable in all cases and under all circumstances. Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets such as good will, trade-marks, trade brands, etc. However, there are several methods of reaching a conclusion as to the value of intangibles which the committee suggests may be utilized broadly in passing upon questions of valuation, not to be regarded as controlling, however, if better evidence is presented in any specific case.

Where deduction is claimed for obsolescence or loss of good will or trade-marks, the burden of proof is primarily upon the taxpayer to show the value of such good will or trade-marks on March 1, 1913. Of course, if good will or trade-marks have been acquired for cash or other valuable considerations subsequent to March 1, 1913, the measure of loss will be determined by the amount of cash or value of other considerations paid therefor——

The CHAIRMAN. The measure of loss, you say?

Mr. MANSON. Yes; in the case of a patent or the good will of a concern, or the trade-mark, which was acquired subsequent to March 1, 1913, and we will say it is lost, as would be the case with a trade-mark on whiskey by the prohibition men.

Mr. MOSS. You mean acquired for cash or some value that was ascertainable?

Mr. MANSON. Yes. Their loss would be measured by what was paid for it.

The CHAIRMAN. And also, I suppose, the depletion in the case of the term of a patent?

Mr. MANSON. Yes. I will go back there. [Reading:]

Of course, if good will or trade-marks have been acquired for cash or other valuable considerations subsequent to March 1, 1913, the measure of loss will be determined by the amount of cash or value or other considerations paid therefor, and no deduction will be allowed for the value of good will, or trade-marks built up by the taxpayer since March 1, 1913. The following suggestions are made, therefore, merely as suggestions for checks upon the soundness and validity of the taxpayers' claims. No obsolescence or loss with respect to good will should be allowed except in case of actual disposition of the asset or abandonment of the business.

In the first place, it is recognized that in numerous instances it has been the practice of distillers and wholesale liquor dealers to put out under well-known and popular brands only so much goods as could be marketed without affecting the established market price therefor and to sell other goods of the same identical manufacture, age, and character under other brands, or under no brand at all, at figures very much below those which the well-known brands commanded. In such cases the difference between the price at which whisky

was sold under a given brand and also under another brand name, or under no brand, multiplied by the number of units sold during a given year gives an accurate determination of the amount of profit attributable to that brand during that year; and where this practice is continued for a long enough period to show that this amount was fairly constant and regular and might be expected to yield annually that average profit, by capitalizing this earning at the rate, say, of 20 per cent, the value of the brand is fairly well established.

Another method is to compare the volume of business done under the trade-mark or brand under consideration and profits made, or by the business whose good will is under consideration, with the similar volume of business and profit made in other cases where good will or trade-mark have been actually sold for cash, recognizing as the value of the first the same proportion of the selling price of the second as the profits of the first attributable to brands or good will is of the similar profits of the second.

I now invite the committee's particular attention to what follows:

The third method, and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for the application of the preceding ones, is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10 per cent upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the committee that this return should be capitalized upon the basis of not more than five years' purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles.

In view of the hazards of the business, the changes in popular tastes, and the difficulties in preventing imitation or counterfeiting of popular brands affecting the sales of the genuine goods, the committee is of the opinion that the figure given of 20 per cent return on intangibles is not unreasonable, and it recommends that no higher figure than that be attached in any case to intangibles without a very clear and adequate showing that the value of the intangibles was in fact greater than would be reached by applying this formula.

The foregoing is intended to apply particularly to businesses put out of existence by the prohibition law, but will be equally applicable, so far as the third formula is concerned, to other businesses of a more or less hazardous nature. In the case, however, of valuation of good will of a business which consists of the manufacture or sale of standard articles of everyday necessity not subject to violent fluctuations and where the hazard is not so great the committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10 to 8 or 9 per cent, and that the percentage for capitalization of the return upon intangibles might be reduced from 20 to 15 per cent.

In any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it, and therefore a representative period should be used for averaging actual earnings, eliminating any year in which there were extraordinary factors affecting earnings either way. Also in the case of the sale of good will of a going business the percentage rate of capitalization of earnings applicable to good will shown by the amount actually paid for the business should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon the basis of capitalization of earnings less than the figures above indicated as the ones ordinarily to be adopted the same percentage should be used in figuring values as of March 1, 1913.

I would like to know who is present that the bureau deems qualified to discuss this rule.

Mr. GREGG. We have with us this morning Mr. Milliken and Mr. Strader, who are both familiar with it.

Mr. MANSON. In the case of an ordinary manufacturing concern, when the average earnings for the period to be used as the basis for determining value have been arrived at, and the amount attributable to good will has been determined; in other words, after you have

eliminated the amount that you set aside upon the tangibles, what percentage is ordinarily used for capitalizing the earnings attributable to intangibles for the purpose of arriving at the value of the intangibles?

Mr. MILLIKEN. Well, the first theory to apply would be to apply an average rate for intangibles, as is laid down in the memorandum. If it is a particularly hazardous business, we would allocate 10 per cent as a fair return on tangibles. If it be a nonhazardous business—for example, if a person is manufacturing a device that is of universal use, where a person may have a patent that amounts to practically a monopoly, the business would not be considered as hazardous——

Mr. MANSON. That is, some article of everyday use?

Mr. MILLIKEN. Yes.

Mr. MANSON. And there is a practical monopoly of the manufacture of it?

Mr. MILLIKEN. For instance, I would illustrate it by a case that came up yesterday. It is a case of a concern in Pennsylvania that manufactures ingot molds. They have a monopoly on a certain process by which they have been able to manufacture, as well as reduce the cost and increase the efficiency of the article. They have a practical monopoly on the patented process for the period of the life of the patent. They have also had extensions of that patent protecting its use. They have a trade name for that particular mold, so that the company is not in a particularly hazardous business. There is no one else in the United States that has been able to successfully compete with them. Its output is 80 per cent of all the ingot molds used in the United States; so for that company their capitalization for tangibles should be at the very lowest, namely, 8 per cent, as outlined here.

Mr. MANSON. That is the lowest factor that is used for the capitalization of tangibles, is it?

Mr. MILLIKEN. Under this A. R. M.; yes.

Mr. MANSON. That is, where you follow the methods——

Mr. MILLIKEN. Yes; this A. R. M. provides for 10, 9, and 8.

Mr. MANSON. Yes.

Mr. MILLIKEN. For tangibles.

Mr. MANSON. And 8 per cent is the lowest that you use for tangibles?

Mr. MILLIKEN. Yes; under this A. R. M. here.

Mr. MANSON. What percentage did you apply to the intangibles in this case?

Mr. MILLIKEN. In this case this company had all of these patents, of course, before 1913. They had not purchased them. There was no sale price and no purchase price—no upset price that you could definitely show. If there had been a purchase or sale price, as this A. R. M. states it, its provisions would not be applied, because there was a more acceptable basis to use. In the absence of that, we had to resort to some other basis for computation of value of tangibles and intangibles; so we allowed an 8 per cent return on tangibles, and this being a nonhazardous business, and the other factors that I have mentioned not being present. Now, it being a nonhazardous business, there likewise should not be a capitalization of 20 per cent

for the intangibles, because that is applied when you have a particularly hazardous business. So we applied the lowest rate of return for intangibles.

Mr. MANSON. What is that rate?

Mr. MILLIKEN. That is 15 per cent.

Senator JONES of New Mexico. Pardon me just a moment; 15 per cent of what?

Mr. MILLIKEN. Well, we will take, for example—I am not an accountant, but I will try to give you a specific case to illustrate it.

Mr. MANSON. I will give you a specific case and this will answer it, and the Senator will see what it is.

Assume a case where your net earnings, we will say, will average $500,000 over a five-year period, and the tangibles are of such amount that 8 per cent of the value of the tangibles will consume $125,000 of the net earnings, or, we will say, $225,000. That will leave you $275,000 of the net earnings over and above 8 per cent of the tangibles.

Mr. MILLIKEN. That is as I understand it; yes.

Mr. MANSON. In other words, your average net earnings over a 5-year period are $275,000 in excess of 8 per cent of the value of the tangibles?

Mr. MILLIKEN. Yes.

Mr. MANSON. Of the tangible assets?

Mr. MILLIKEN. Yes.

Mr. MANSON. I understand that to arrive at the value of the intangibles you divide $275,000 by 15 per cent, or fifteen one-hundredths. In other words, you find the amount that $275,000 is 15 per cent of?

Mr. STRADER. You divide by fifteen one-hundredths, or multiply by 6⅔, the same thing.

Mr. MANSON. Do you understand, Senator Jones, what the method is now?

Senator JONES of New Mexico. No. I want to know, do you take the net income of the business for the year and get your 15 per cent on that as a basis for determining valuation?

Mr. MILLIKEN. What you do is this Senator: As the recommendation there sets forth, you take a 5-year period prior to March 1, 1913. That is the value on basic date we are trying to arrive at, the value of March 1, 1913; so you take five years. You take all of those earnings as the five years' earnings together and divide the total earnings by five, so as to get the average earnings applicable over that period. Now, if it so happens that at any time in that period there has been an unusual situation developed, it may throw out this computation entirely. For example, you might have had during this period—this company got an unusual contract and had forced out all other contractors by, we will say, false competitive bidding or underselling or unfair practices; so that if you take any one of those things in the five years, you would have an income that would be enormous, which is not the ordinary income. This recommendation makes provision for such a contingency as that; but let us assume that it fairly averaged in all of the years and there was nothing unusual in the business.

Mr. MANSON. That is, that you have a constant condition?

Mr. MILLIKEN. Yes.

Mr. MANSON. A more or less constant condition?

Mr. MILLIKEN. Yes. The theory back of it, as I understand it, is this: Suppose, coming up to March 1, 1913, you have a business, and you have large earnings from that business. This business is built up by a certain good will.

For example, I will take the case of the Yale-Towne Lock Co. They manufacture practically all the locks in the United States, and yet the patent on the Yale door lock expired years ago, and every concern in the United States can manufacture an identical lock, the identical patented device, as can the Yale & Towne Manufacturing Co. The patent has expired. It is public property; but yet the Yale & Towne Manufacturing Co., by the high efficiency of their workmen and by the good will of their product, and by the quality of the goods which they have produced, are able to actually get about 15 per cent more for the same article than a competitor can, or any other lock company in the United States. Is there not a value there that the Yale & Towne Manufacturing Co. has built up aside from their tangible investment?

Senator JONES of New Mexico. You are just touching on what I have in mind. You say that they are able to get 15 per cent more. Do you mean 15 per cent for the individual lock or the individual article which they turn out?

Mr. MILLIKEN. I say that for the lock that is manufactured by this company there is an identical lock manufactured by competitors, and yet the Yale & Towne Manufacturing Co. gets 15 per cent more money for their lock than do any of their competitors.

Senator JONES of New Mexico. For the purpose of estimating the value of that good will or trade-mark, or whatever you may call it——

Mr. MILLIKEN. Yes.

Senator JONES of New Mexico. Do you take 15 per cent of the total output of the factory?

Mr. MILLIKEN. Their earnings over a period of five years; not the total output of the factory but their total earnings during those years, after they have deducted such expenses as cost of material, labor, etc. It is actual net earnings over that period of five years.

Senator JONES of New Mexico. You take 15 per cent, you say, of the price, and attribute that to earnings of good will?

Mr. MILLIKEN. No; it just happened in this case that that is so.

Senator JONES of New Mexico. Well, we will take that case as an illustration.

Mr. MILLIKEN. All right.

Senator JONES of New Mexico. That is what I am trying to get at.

Mr. MILLIKEN. All right.

Senator JONES of New Mexico. That 15 per cent amounts to a definite sum of money as an annual return.

Mr. MILLIKEN. Yes.

Senator JONES of New Mexico. Then, what rate do you expect to earn on your capitalization—15 per cent?

Mr. MILLIKEN. No. You earn 8 per cent on your capital investment, on your tangible assets——

Senator JONES of New Mexico. I am talking about intangibles.

Mr. MILLIKEN. All right. We have a specified thing, the tangibles. The company has to have a fair return on their tangible assets, then. The company should have a fair return on the actual value of its business. Now, we are trying to determine that value. Suppose their earnings were $500,000 over that period?

Senator JONES of New Mexico. You mean the net profits?

Mr. MILLIKEN. The net profits; just take the situation that Mr. Manson spoke of.

Senator JONES of New Mexico. A hundred thousand dollars a year.

Mr. MILLIKEN. All right, sir. Well, it would be more than that. It is $500,000, but suppose you take a five-year period and it averaged for all of those years $500,000 earnings.

Senator JONES of New Mexico. For each year?

Mr. MILLIKEN. For each year. Now, still taking that—and, of course, this would be a nonhazardous business, but we will say it is hazardous, just to get round figures—we will assume that 10 per cent of the earnings relates to tangibles——

Senator JONES of New Mexico. No; take 15 per cent.

Mr. MILLIKEN. All right; say $275,000 is the average earnings attributable to intangibles, which we will capitalize at 15 per cent——

Senator JONES of New Mexico. All right.

Senator KING. That is $275,000 of profit?

Mr. MILLIKEN. Yes.

Senator KING. Out of the $500,000 that you attribute to intangibles?

Mr. MILLIKEN. Yes.

Mr. MANSON. My question was this——

Senator JONES of New Mexico. Hold on. Let me clear this up first. Go ahead.

Mr. MILLIKEN. All right. Take $275,000, which we will say is attributable to intangibles——

Senator JONES of New Mexico. All right; take $300,000; that will be easier.

Mr. MANSON. All right. Take $300,000, and we will say it is 15 per cent. We have reduced it down to that. It would be $108,000.

Senator JONES of New Mexico. For what?

Mr. MILLIKEN. The value of the intangibles. We would not allow them the whole sum.

Senator JONES of New Mexico. Now, do you mean to say that you put a value of only $108,000 on intangibles when they bring in a return of $300,000 a year?

Mr. MILLIKEN. Yes, sir.

The CHAIRMAN. I think that is wrong. It should be $2,000,000.

Mr. MILLIKEN. Oh, yes; $2,000,000.

The CHAIRMAN. They multiply it by 6⅔.

Mr. MILLIKEN. Yes; my computation was in error.

The CHAIRMAN. Yes. In other words, they fix the intangible value at $2,000,000, Senator, because they earned $300,000.

Senator JONES of New Mexico. Then, you fix it at that because it will earn 15 per cent of that amount during the year?

Mr. MILLIKEN. Yes.

Mr. MANSON. I do not know that you can answer this question, but I hope that some one here can.

The case you mentioned of the Yale & Towne Manufacturing Co. is a very conservative business, is it not?

Mr. MILLIKEN. Yes; it is.

Mr. MANSON. Their good will does not depend upon their patents; it depends upon the established business, their name for making good locks, does it not?

Mr. MILLIKEN. And their trade-marked article.

Mr. MANSON. And the trade-mark article; yes. In other words, people want the Yale locks because they know what a Yale lock is?

Mr. MILLIKEN. If somebody else could put the trade-mark "Yale" on a lock and produce as good a lock in other respects they would get the same business.

Mr. MANSON. But it is a conservative business, the profits of which from year to year can almost be anticipated?

Mr. MILLIKEN. Yes.

Mr. MANSON. Now, do you know upon what theory 8 per cent upon tangibles and 15 per cent upon intangibles is used for the purpose of valuing a conservative manufacturing business when 5 per cent is used for the purpose of valuing an oil well?

Mr. GREGG. May I answer that?

Mr. MANSON. Yes.

Mr. GREGG. Five per cent is not now used in valuing oil wells. The memorandum of instructions to the oil and gas section, which I one day read into the record, provides for a discount factor of 10 per cent, and, again, the hazard there is taken care of through other factors than the discount. This 15 per cent for the capitalization of the earnings of intangibles includes both discount and the hazard factor.

Mr. MANSON. In the case of all businesses that come before you for valuation there is some irregularity in net earnings from year to year during any five-year period that you select, is there not?

Mr. MILLIKEN. I should say it would be very rarely that it would be constant.

Mr. MANSON. Yes. In some of them there is a decided trend upward, is there not?

Mr. MILLIKEN. Yes.

Mr. MANSON. And in some of them more or less of a trend downward?

Mr. MILLIKEN. Yes.

Mr. MANSON. What consideration do you give to those trends, if any?

Mr. MILLIKEN. Well, we try to develop what is the cause of the trend, why has that trend been downward? For instance, a company might show decreased earnings. We will say they were very high at the beginning of the five-year period, before 1913, and we will say, when we get up to 1912, they might be less than at the beginning of the period. We try to determine those factors to see what abnormality might be present. For example, it may be dishonest employees; there might have been embezzlement; there might have been unfortunate investments in businesses without the scope of the corporation; or it may be that the corporation for 1912 was going through an unusual experimental stage, we will say, on the perfection of a device that they are now working on.

The CHAIRMAN. Or it might be that they bought a lot of material at an excessively high price.

Mr. MILLIKEN. Yes; or conversely, they might show a large earning factor in the beginning of the period, which would represent a lot of material purchased at a low price, and a high price for the finished product. There might be any number of those things that would affect the constancy of the earnings. We try to determine those things.

Mr. MANSON. After you have determined those things, what effect do you give to the trends upward or downward?

The CHAIRMAN. It would depend upon the facts, would it not?

Mr. MILLIKEN. Yes; altogether, I should say.

Mr. GREGG. I can give you an example of a specific case.

Mr. MANSON. Take a case where you determine the trend to be one that you can expect will continue in the future.

Mr. MILLIKEN. Well, if that is something that is so apparent at the end of the period as to show that that company, we will say, for example—I can give you more of an illustration——

Mr. MANSON. Well, take the case of the manufacture of wagons and carriages.

Mr. MILLIKEN. All right. Let us take carriages in 1913. I assume that in the automobile industry no one could foresee in 1913 what it was going to be in 1925, and yet I would assume, without knowing—let us say that there is a gradual decline in the demand for carriages—but suppose this company during that time is making an average return on its carriage business—take the Studebakers.

Mr. MANSON. Yes.

Mr. MILLIKEN. Without knowing, we will say that in 1912 they were beginning to be interested in the automobile industry; say they were trying to rearrange their factory, their output, their employees, their directing heads, to work out some improvement; that this carriage business may be going down—if that be true—and their earnings fairly constant, no abnormality results necessitating a change in the computation. We simply take those average periods.

The CHAIRMAN. Let us take up the Studebaker business again for a minute. I think the capitalization of the good will and the name of Studebaker would be just as valuable in the automobile business as in the carriage business.

Mr. MILLIKEN. It would probably be more so.

The CHAIRMAN. Yes; so that might be considered as an individual fact in determining the good will in a case like that.

Mr. MILLIKEN. Yes.

Mr. MANSON. Take the case of a carriage manufacturing business, which in 1913 made no plans——

Mr. MILLIKEN. All right.

Mr. MANSON. To go into the automobile business, and there had been a consistent dropping off. Just to illustrate, suppose we start off with $500,000 in 1908 as the net income attributable to good will.

Mr. MILLIKEN. Yes.

Mr. MANSON. And that goes down to $350,000 in 1909, to $400,000 in 1910, and on down to $50,000 a year at the end of 1912.

Mr. MILLIKEN. Yes.

Mr. MANSON. That would bring it down to $300,000 in 1912. Now, for the purpose of ascertaining the value of good will of that company, would you take an average of those preceding five years?

Mr. MILLIKEN. It would be necessary to analyze the cause and nature of the decline and give the same proper consideration in working out the computation.

Mr. MANSON. On the other hand, assume that you had a company that in 1908 had net earnings attributable to good will—that is, after taking care of its tangibles—of $50,000, and its business was consistently increasing, so that its net earnings attributable to good will were increasing $15,000 a year.

Mr. MILLIKEN. Yes.

Mr. MANSON. Down to and including 1912?

Mr. MILLIKEN. Yes.

Mr. MANSON. Would you also take a flat average of the net earnings attributable to good will during that five-year period as the basis?

Mr. MILLIKEN. I would answer the same should be done as in the case of declining earnings just referred to.

Mr. MANSON. In such a case as that it might be an automobile plant that was just getting started.

Mr. MILLIKEN. Yes.

Mr. MANSON. We will say that they had gone on for a couple of years and had gotten to the point where they had a net, an actual net earning of over 10 per cent on their tangibles, and in 1908 they had net earnings attributable to tangibles of $50,000, in 1909 of $100,000, and so on up to the end of five years, at which time it would be $250,000. Would you apply the same percentage to the capitalization of the good will in both of those instances under such circumstances?

Mr. MILLIKEN. I would analyze all factors as heretofore answered as in case of downward or upward trend of earnings.

Mr. MANSON. Then the result would be that you would capitalize the good will of a company that was on the decline at the rate of $50,000 a year in 1913 at a higher figure than you would capitalize the good will of a company whose business was ascending at a regular, consistent rate of $50,000 a year?

Mr. MILLIKEN. Well, of course, that would go back to another factor. Suppose you had $500,000 earnings at 1912. That has occurred for one period. Now, it is going up each year, but what reason is there to assume that it is going to continue for the rest of the time, and to take the high earnings?

Mr. MANSON. I am not arguing the proposition. I am trying to get at the facts.

Mr. MILLIKEN. Mr. Strader is here. He was probably with the bureau at the time, in 1920, when A. R. M. 34 was promulgated. He knows more about it than I do. If he can give you anything on it out of his experience, I would be very glad to have him speak.

Mr. MANSON. What would your answer to that situation be?

Mr. STRADER. I think if there was a gradual trend of earnings upward over a five-year period, we would try to reasonably anticipate whether or not those earnings were going to continue, and if all of the surrounding and attendant circumstances indicated that

there was going to be a gradual increase, that any reasonable business man would buy stock in that company on the basis of such an increase, we would then capitalize the excess earnings at a lower figure, or make a theoretical increase in the average earnings.

Mr. MANSON. Can you cite us to any case where you actually have anticipated an average increase in the earnings attributable to good will, and have capitalized your anticipated increase, or, on the other hand, where you have anticipated a future decrease, and have taken that into consideration?

Mr. STRADER. I can not give you the name of any concern. Such a computation would appear reasonable to me.

Mr. GREGG. I think I can give you a specific case on that. It is the John B. Semple case, the valuation of a process of 1913. This inventor had perfected his patent, as I remember it, in 1906. It was on some type of device on high-explosive shells, and the earnings from the patent had increased steadily each year up to 1913, as the patent was adopted and accepted by other governments.

He came in with affidavits on valuations of $5,000,000—from everyone who ever heard of the patent, including Admirals Sims and the officials of the War Department and of the Navy Department—we gave it a value of $400,000, but because of the fact that their earnings were increasing year by year, we used not the five-year period prior to 1913 but we used the 3-year period, and then took the two years subsequent, and took an average from that.

Mr. MILLIKEN. That was the John B. Semple case.

Mr. GREGG. Yes.

Mr. MILLIKEN. I handled that, I remember.

Mr. MANSON. That was a patent case, and a patent, of course, is liable to expire. You cited the case of the Yale lock, where during the life of the patent they had built up a good will that was as valuable, and perhaps more so, than the patent; but in a case where you have good will solely, as you would have in the Yale Lock Co. case to-day, and where the future expiration of patents is not liable to interfere at all—take this situation, the case of a company that starts to manufacture something of universal use—that is, of everyday use—that there is a great demand for, and their ability to manufacture is limited by a lack of capital; but every year they are turning their earnings back into the business and increasing their ability to manufacture, and thereby increasing their net earnings, and they are doing that as rapidly as the capital becomes available. How do you treat such a case as that?

Mr. MILLIKEN. I would try to take just the representative years in that case. As I said, in these cases, in the absence of any great abnormality—suppose the earnings should jump from $50,000 to $500,000, there is a very big abnormality, and I think it would be unfair to the taxpayer to take the $50,000 and penalize him by that; so I would take the median, if I could.

Mr. MANSON. Take a case where you have $50,000 one year, $100,000 the next, $150,000 the next, $200,000 the next, and $250,000 the next. Of course, you have a wide variance?

Mr. MILLIKEN. Yes.

Mr. MANSON. Between the first year and the fifth year.

Mr. MILLIKEN. Yes.

Mr. MANSON. But you have a consistent increase?

Mr. MILLIKEN. Yes.

Mr. MANSON. Under such circumstances to what extent do you take into consideration the possibility of that increase continuing after 1913?

Mr. MILLIKEN. Well, there would be questions of fact, of course, to determine. We are eliminating now the question of the patents where you know your monopoly is going to play out?

Mr. MANSON. Yes.

Mr. MILLIKIN. We will say it is a household necessity that anyone could manufacture who has the capital with which to engage in it.

Mr. MANSON. Yes.

Mr. MILLIKEN. I would simply say in that case it would be unfair to take the first year of that company and only apply that, but would take a median there, probably a year after 1913, as has been done in some cases.

The CHAIRMAN. At this point I would like to suggest that Senator King has to leave town, and Mr. Bright——

Senator KING. No; I am not going.

The CHAIRMAN. You do not want to interrupt us now, so as to interrogate Mr. Bright?

Senator KING. No.

Mr. MANSON. In most instances, you would take, under such circumstances, one or two years, then, subsequent to 1913, and you would not go back five years prior to 1913?

Mr. MILLIKEN. If there was such a great abnormality as a difference between $50,000 and $500,000 a year I would not; no.

Mr. MANSON. Do you call a decided trend upward or downward, which is consistent, an abnormality?

Mr. MILLIKEN. It would seem to me in the nature of an abnormality.

Senator KING. Take a copper company whose earnings are consistently going upward, but sometimes steps are much greater, because of a foreign demand or because of a local demand having been increased?

Mr. MILLIKEN. Yes.

Senator KING. You call that an abnormality, do you, because it is a departure from the rule which you have enunciated?

Mr. MILLIKEN. I do not think simply a fortunate circumstance, but suppose you were going through a war, that you had a year of war, where there was an unprecedented demand for copper. I would not say that that would be an unusual situation, but would be simply a circumstance in the business, which would probably be unusual in its character and not recurring; but where you have a copper company that started out in 1913, and they buy a smelter, which they use in connection with a copper mine, or they have other fortunate circumstances, or if they are having a different grade of copper——

Senator KING. There are no different grades of copper. Copper is copper.

Mr. MILLIKEN. I thought so, too, Senator, until I went to Arizona to practice law. I got into a little case out there which showed me that copper was not copper.

Senator KING. Maybe you are speaking about ores.

Mr. MILLIKEN. Yes.

Senator KING. But I am talking about copper itself.

Mr. MILLIKEN, Well, when you get copper in its last analysis, copper is copper, I guess.

Senator KING. It is an element.

Mr. MILLIKEN. Yes.

Senator KING. You can not transmute it into gold or anything else as yet.

Mr. MILLIKEN. No.

Mr. MANSON. To get back to this matter of an abnormality which would justify a departure from the ruling of taking the five-year average, would you consider a consistent growth from year to year, we will say, of a company that starts out with earnings attributable to good will of $50,000, and which increased regularly every year $50,000; would you consider that abnormal?

Mr. MILLIKEN. It would seem to me so, if it is going up to $500,000 from $50,000.

Mr. MANSON. At the end of the first year?

Mr. MILLIKEN. That would depend on the facts.

Mr. MANSON. And you would consider, on the other hand, a situation where the company had earnings of $500,000 in 1908, which decreased almost constantly; in other words, if you were to chart it, you would have almost a straight line of decrease.

Mr. MILLIKEN. That would be an appreciable decrease, and that works both ways. It is a two-edged sword, I think.

Mr. MANSON. Yes.

Mr. MILLIKEN. For instance, it is unfair to the Government to value good will on March 1, 1913, by taking in these enormous years back here and getting a larger value, when a fact may be present, and allow the taxpayer that; and, conversely, it is unfair to the taxpayer if he has an unusually bad year back here, we will say, in 1918, and his earnings had advanced from $50,000 to half a million dollars, he has more value there represented in his good will than he has been given.

Senator KING. How can you ascribe any pecuniary value to good will, because some corporation by a windfall on account of a war, as you said, increases its output a hundred per cent in a year—how could you ascribe that to good will? It would not be good will if it had been a company just starting up, which would have made the same jump from nothing to a hundred per cent or a thousand per cent.

Mr. MILLIKEN. I think you are quite right, if you take a thing like war; but suppose you take a company—and this is true in 90 per cent of the cases—a company starting with a certain commodity that it manufactures. There are other commodities that are probably just as good, but they do not have the sale for them; they do not earn the money on them. For instance, the Yale & Towne Co.; they only have a small per cent of their locks turned back on them as being defective, and other companies have turned back a larger per cent of the locks which are defective in some respect. The finished product that they have turned out has made this good will

which they have developed. People will buy a Yale lock simply because they have known them for years.

Senator JONES of New Mexico. Let me ask you this question: Where a going concern, whether a new one or an old one, offers beyond the 8 or 10 per cent on the tangible assets, do you attribute any additional earnings to good will; I mean do you attribute to good will all of the additional earnings?

Mr. MILLIKEN. Yes, we do, Senator; as I understand it, unless there be some evidence to show other values, such as patents. That is done only in cases where there is no other evidence on which you can determine that value. Suppose they started out with this patent, and they paid $100,000——

Senator JONES of New Mexico. But suppose there is not any patent? Suppose I start in to manufacture needles and pins.

Mr. MILLIKEN. And suppose the company had not bought out any other company?

Senator JONES of New Mexico. Yes; and I start into that business, and from the beginning I earn more than 8 or 10 per cent on the tangible assets. Do you attribute to the other earnings to good will for capitalization purposes?

Mr. MILLIKEN. Yes; if there be no other factors that should be taken into consideration.

Senator KING. I think such a policy as that is an outrage, if I understand it, and is a robbing of the Government.

Senator JONES of New Mexico. In other words, if a concern is prosperous, you simply, for the purposes of this law here, capitalize any excess earnings into good will?

Mr. MILLIKEN. Now, we will go back as to why that is done. I do not want to let that statement stand. We will go back as to why I understand that is so. We will suppose that a company is——

Senator KING. It is done, of course, for the purpose of saving the taxpayer from paying a tax to the Government.

Mr. MILLIKEN. Let us see what Congress has provided for it first, Senator.

The CHAIRMAN. I want to disagree with my colleague on that, because I think there is a good will in a case such as Senator Jones has suggested.

Senator KING. Then, everybody who makes a profit has good will.

The CHAIRMAN. He certainly has, but it again depends somewhat upon the facts; but if he has more efficient machinery, men of better ability, and he knows how to route his material through the plant better than somebody else, and he gets a better energy out of his employees, that certainly is good will, and it certainly should be capitalized differently, and he is entitled to more consideration than a moribund company, that has no initiative or ability to manufacture.

Senator KING. I do not agree with you at all, Senator. I think that would be productive of the grossest sorts of fraud.

Let me put a case like this: Two persons are engaged in mining. The deposits of one of them are more easily removed; he has better methods of treatment, he is better equipped, he has better experts; he makes a profit on his copper or lead of 50 per cent more than the other fellow; would you attribute that to good will and capitalize those additional profits upon the ground of intangible assets?

Mr. MILLIKEN. Well, of course, if there is an unusual circumstance in any business, but I am talking now about just taking the average run of business.

Senator KING. That is not unusual. That is the situation that occurs in every-day life. One farmer will be a little more efficient than the other.

Mr. MILLIKEN. Yes.

Senator KING. One farmer will live a little nearer the market; one farmer's land has not quite as much clay in it as the other farmer's has; one farmer plows deeper or has better methods. Are you going to capitalize the earnings of the more careful or more prudent farmer, or a farmer who has a little better land or employs more men and more modern methods; are you going to capitalize his surplus earnings above a certain line, and then allow deductions by reason of that?

Mr. MILLIKEN. Would you say in connection with that copper mine that it was worth any more than the other one?

Senator KING. It might or might not be.

Mr. MANSON. In the case of the copper mine that the Senator has mentioned, that has all been brought out time and again before this committee, that the values which the Senator mentions are capitalized in the shape of the giving of additional value to the mine. That has been brought out here time and time again.

Senator KING. It is absurd, though, to give additional value to a mine because you have a little better method of treatment, because you have a cave-in system instead of a glory-hole system of mining, or some more impoved methods.

Mr. MANSON. It has been established here that that is treated by the bureau not as an intangible value due to good will but that the value of the mine is determined by capitalizing the expected profits.

Senator KING. I think we ought to discover, if necessary——

Mr. MANSON. And it becomes a tangible asset in that case.

Senator KING. I think we ought to discover—because most of the States are now levying taxes upon intangibles—how many of these companies that are claiming reductions in Federal taxation, or escape Federal taxation, on account of deductions for intangibles, are paying an ad valorem tax upon their property, their intangible assets, to the States. I venture the assertion that 90 per cent of these corporations to which you are allowing these intangible benefits are making no claims for intangible profits, but, upon the contrary, they are resisting them when made by the States; and before we get through with these hearings I want to find out the amount that you are allowing for intangibles in the bureau.

Mr. STRADER. Senator, this question comes up in the case of the sale of a business, or where a concern quits business, where we have to determine the profit that they made on the disposition of their assets, where this good will developed without cost to the taxpayer except through advertising or something of that kind. He gets no deduction in the way of a reduction of income because of good will; but if he sells his business, and the good will is sold along with it we will have to determine what that good will was worth on March 1 1913, and this A. R. M. 34 was simply intended to lay down method by which good will could be valued, if there was no other way. I-

there is any other possible reasonable way to determine the value of good will, this memorandum would not be used. We might be able to resort to the sale of stock or cash sales of good will in a similar business, or something of that kind.

Senator KING. Let me interrupt you there. In reply to the hypothetical suggestion made by Senator Jones, where he starts in in the manufacture of needles and pins. He invests $500,000 for machinery, and he makes 8 or 10 or 12 or 15 per cent. Would you capitalize that additional profit above the 8 per cent and attribute those earnings to intangible assets and give him credit for it in his tax?

Mr. STRADER. Oh, no.

Mr. MILLIKEN. I did not have in mind a taxpayer being allowed a value for intangibles as concerns his current tax return, but a value solely in accordance with the conditions imposed by A. R. M. 34.

Senator KING. Do you, in figuring the tax due, allow anything for intangibles?

Mr. MILLIKEN. No, sir.

Senator JONES of New Mexico. In settling these excess-profits taxes under the old law, what did you do with this factor of intangible assets?

Mr. MILLIKEN. Of course, the law provides for the computation of invested capital and the limitations are provided for in the statute.

Senator JONES of New Mexico. We have a current provision in the law whereby a value must be ascertained, and that is your capital-stock tax of a corporation. Do you, in figuring the value of the capital for the purpose of capital-stock tax, include any intangibles ascertained on this basis?

Mr. MILLIKEN. Of course, the capital-stock tax is an entirely different thing. I have never worked on anything except income taxes.

Senator JONES of New Mexico. The capital stock is imposed upon the actual value of the stock, and in ascertaining the capital-stock tax, do you ascertain the value of the stock on the basis of including this factor of capitalization of the intangibles?

Mr. MILLIKEN. It is my understanding, without knowing it, Senator, to answer frankly that they do capitalize the earnings.

Senator JONES of New Mexico. We ought not to use this question of intangible assets for one purpose and not use it for another.

Mr. STRADER. In the capital-stock tax, if there are no sales of stock in sufficient volume to establish a value, and, of course, in many cases there are not, we do determine the value of stock by capitalizing earnings, which take into consideration, of course, any intangible value that it may have.

Senator JONES. Do you use this basis——

Mr. STRADER. Well, all of the net earnings are capitalized at an average figure anywhere from 6 per cent, I think, for banks east of the Mississippi, up to 10 or 12 or 15 per cent. It will depend——

The CHAIRMAN. That is in a case where there is no segregation between the tangible assets and intangible assets?

Mr. STRADER. Yes, sir.

Senator KING. Let me see if I understand that question of Senator Jones's. I may not have understood it.

Take, for instance, one of these oil companies producing oil in Mexico. Some of those stocks, as I am told—I have never dealt in them, and do not know much about them—rose in value tremendously, nearly a hundred per cent, or perhaps more. In levying this tax on capital stock do you take the par value, or do you take that swollen value that was justified by virtue of the tremendous increase?

Senator JONES of New Mexico. May I interrupt? The law says that you shall take the actual value.

Mr. NASH. Senator Jones, the law says the fair average value of the capital stock.

Senator JONES of New Mexico. Well, that is the actual value.

Mr. STRADER. If there were sales in sufficient volume, that would establish the value.

The CHAIRMAN. Is not the actual value and the average value the same?

Senator JONES of New Mexico. The fair average value there means the fair actual value of the stock, or the average of the actual value. That is what it means.

The CHAIRMAN. The average over what period of time?

Mr. STRADER. This excise tax refers to a year. We may take the stock on the stock exchange at 50 at the beginning of a year, and at the end of the year at 250. What we are after there is the average.

The CHAIRMAN. So the average in that case would be 150.

Mr. STRADER. We would probably weight the average and consider the volume of sales to roughly establish it.

Senator JONES of New Mexico. Would it not be a fair application of the tax provision, both with respect to sales of these properties and as to your capital-stock tax, that you should adopt the same system?

Mr. STRADER. We do where we can. Where there are sales of stock, we do not apply this A. R. M. 34, because we can value the assets by measuring the value of the stock.

Senator JONES of New Mexico. But there are thousands and thousands of stocks that are not on the stock exchange at all.

Mr. STRADER. That is where we have to use this memorandum, where there is no other basis that we can use. We resort to this theoretical formula when there is absolutely nothing else to rely on.

Senator JONES of New Mexico. Is that theoretical formula applied to the capital-stock tax?

Mr. STRADER. To some extent; yes.

Senator JONES of New Mexico. "To some extent"; that is not a definite answer.

Mr. STRADER. It is to the extent that earnings are capitalized where there is no other basis for the determination of the value.

Mr. MANSON. Do you use the same rates of capitalization in arriving at the value of stock for capital-stock purposes as you use for the purpose of arriving at the value of the stock for income-tax purposes?

Mr. STRADER. No; because in the capital-stock returns there is no segregation of value of tangibles and intangibles. You simply have the net earnings. From the returns you know that the net earnings

are a hundred thousand dollars, and that the business is earning around 10 per cent. You capitalize those earnings to 10 or 15 per cent, or whatever it might be.

Mr. MANSON. Is it not a fact that in the case of a conservative manufacturing business, in valuing for capital-stock purposes, you use not to exceed the 10 per cent factor, while for income-tax purposes you use not less than 15 per cent?

Mr. STRADER. Well, I would not say that we do not use less than 15 per cent in commercial concerns. There are cases where the evidence justifies a lower rate for good will.

Mr. MANSON. Then, I understand that in a case where this same business is subsequently sold after 1913, you ascertain the rate that the purchaser fixed by purchasing the property, and you apply that rate back to ascertain the 1913 value?

Mr. STRADER. Yes; that is one method.

Mr. MANSON. But in case you have no such evidence as that, is it not true that in valuing the intangible assets of a conservative manufacturer 15 per cent is almost universally used?

Mr. STRADER. No, sir; that is not true.

Mr. MANSON. Then what basis for determining the percentage is actually used?

Mr. STRADER. Well, we have to make a study of the statistics to see what the average concern having no abnormalities makes.

Mr. MANSON. Have you collected such statistics with reference to different industries in the United States?

Mr. STRADER. There is what is known as the median, which showed the average percentage of the different concerns made prior to the war.

Mr. MANSON. Do you have those statistics compiled in your section for use in making these valuations?

Mr. STRADER. We certainly have them available.

Mr. MANSON. I would like to have those statistics examined by one of our representatives. I have been unable to locate them.

Mr. GREGG. It is a published bulletin by the department.

The CHAIRMAN. Let me suggest this point, that Mr. Bright wants to get away, and if there is no objection we might let him make his statement now.

Mr. GREGG. May I put in just a word about the capital-stock feature?

The rate used, as I understand it—I may be wrong in this, but I can look it up—now is 15 per cent on the sapital-stock tax.

Mr. NASH. In any number of capital-stock returns 15 per cent is used.

Mr. MANSON. And 15 per cent is your standard rate on income tax; is it not?

Mr. GREGG. I think it is probably the most usual rate.

Mr. MANSON. Yes. Here you have two concerns engaged in identically the same business. In a case of one concern there is an actual sale subsequent to 1913, and by reason of that actual sale you find that the purchaser paid an amount which would net 7 per cent on the intangibles. Do you, in the case of a similar business, then apply that 7 per cent, or do you apply 15 per cent for the purpose of capitalizing intangibles?

Mr. GREGG. I do not know. I should say that if it could be shown that the sales were made of similar businesses on a 7 per cent basis—I am not sure that we would go that low, but we would certainly go under 15 per cent.

Senator JONES of New Mexico. I am very much interested in this question of the capital-stock tax.

Here you have a cattle business; a man owns a lot of land and a lot of cattle. For the purpose of his capital-stock tax, do I understand that you take the net earnings there, allow a 15 per cent profit, and capitalize those earnings on the basis of 15 per cent, and arrive at the capital-stock tax in that way?

Mr. NASH. Not necessarily.

Mr. GREGG. No, sir. The capital stock is based on what the statute says—the fair average value of the capital stock—and I do not think anyone knows quite what that means, but we consider in the capital-stock tax three elements. If the stock is dealt in, we consider that.

Senator JONES of New Mexico. If it is what?

Mr. GREGG. If it is dealt in; if we have sales of it.

Senator JONES of New Mexico. Well, we may assume that there are no sales.

Mr. GREGG. Otherwise, we consider both book values of the assets back of the stock and the earnings of the corporation. We do not base it on either one entirely. Both are considered.

Senator JONES of New Mexico. Suppose you had a concern such as I have spoken of, where, if you would have the land and cattle figured at what you might term the market value of that land and cattle, but yet it is earning only 4 or 5 per cent upon that valuation, what would you do regarding the capital-stock tax there?

Mr. NASH. We would compute the tax on the book value of the stock.

Mr. GREGG. On the value of the assets back of the stock.

Senator JONES of New Mexico. Is that fair? You would not allow any element of good will there?

Mr. GREGG. We have a court decision on that in a timber case. We have a decision of the circuit court of appeals in that case, wherein they claimed a high value as of March 1, 1913, for depletion of the timber, higher than was indicated by the earnings of the corporation.

Senator JONES of New Mexico. Yes; but that was for a wholly different purpose than the capital-stock purpose.

The CHAIRMAN. Is it agreeable that we let Mr. Bright make his statement now regarding the Anaconda Copper Co. case?

STATEMENT OF MR. J. G. BRIGHT, DEPUTY COMMISSIONER OF INTERNAL REVENUE

Mr. BRIGHT. Mr. Chairman, in the hearings before this committee on May 16 Mr. Nash, assistant to the commissioner, was asked that I be present at the next meeting of this committee in order to furnish it with a statement as to my reasons for ordering the case of the Anaconda Copper Mining Co. for the year 1917 to remain closed.

At the time this case was closed in 1920 there existed a great many confused ideas as to what constituted invested capital, paid-in sur-

plus, reorganization, etc., and when this case was brought to me on the question of reopening I was informed that this case had been closed after a conference in the office of the assistant to the commissioner, Mr. J. H. Callan, wherein the taxpayer had waived certain claims with reference to its case, in consideration of the Government waiving the question of sustained depletion. However, the reason I decided that this case should remain closed was the stress that was being placed at that time on not reopening cases on which the taxpayer had previously been advised were closed and settled, as that appeared to be the only way the unit ever was to become current in the audit of its income-tax cases. Prior to the date that this case was brought to my attention the tax simplification board had recommended to the commissioner that cases once closed should be allowed to remain closed in order to expedite the audit. As a result of that recommendation the commissioner, under date of January 20, 1923, issued the following order to the Income Tax Unit:

Numerous complaints from various sources have reached me that taxpayers are being subjected to examinations and requests for information concerning cases in which the audits have been completed and the cases closed. Such examinations are not advisable and are clearly contrary to the spirit of the act and the regulations of the department. The reopening of closed cases should be the rare exception and not the rule. In the absence of evidence of fraud or gross error, cases once closed are not to be reopened.

During the summer of 1922 the question was raised as to reopening the valuation of copper deposits, which valuations were considered to have been made upon an erroneous basis. For the purpose of disposing of this valuation—of this question—the unit granted the copper interests a full hearing, which was held in June of 1922. After numerous conferences in the unit, especially with engineers of the metals valuation section, the Secretary of the Treasury, under date of December 16, 1922, addressed a letter to the president of the Anaconda Copper Mining Co., which letter I believe has been made a matter of record before this committee at a previous hearing. However, I will quote part of that letter which has a bearing on this case:

After full consideration of the question it is believed that the matter should be settled upon a compromise basis. In accordance with this view the valuation of the copper mines for invested capital and depletion purposes for the years 1917 and 1918 will be allowed to stand upon the basis heretofore fixed by the department, but for 1919 and subsequent years the valuation will be corrected to conform to what the department regards as a more proper method of valuing the copper mines.

Senator KING. What is the date of that letter?

Mr. BRIGHT. December 16, 1922.

I have approved an order to the Income Tax Unit directing that the taxes of copper companies be settled in accordance with the above conclusions.

In view of the fact that this particular case had been definitely closed with the approval of the assistant to the commissioner, Mr. J. H. Callan, and the statement contained in the letter from the Secretary to this company, there appeared to me to be only one answer to the memorandum of Mr. Fay as to whether or not this case should be reopened, and that was that the case had been definitely closed and should remain closed.

Mr. MANSON. Mr. Bright, the commissioner's order with respect to closed cases did except the cases in which there had been gross errors, did it not?

Senator KING. Or fraud.

Mr. MANSON. Or fraud; yes. And those were excepted from the operation of that order?

Mr. BRIGHT. Yes.

Senator KING. And he further stated that in their exceptions they should open them anyway.

Mr. MANSON. In this particular case there had been allowed an appreciation to the extent of $30,000,000 as against sustained depletion. In view of the decision of the Supreme Court of the United States in La Belle Iron Works case, would you not consider that the allowance of $30,000,000 appreciation constituted a gross error?

Mr. BRIGHT. Mr. Manson, I do not think the question of appreciation entered into that case. It was a question of the sustained depletion that was involved there.

Mr. MANSON. In what case?

Mr. BRIGHT. In the case of the Anaconda Copper Co.

Mr. MANSON. The record clearly shows in the case of the Anaconda Copper Co., to get back to Mr. Darnell's memorandum, that he ordered appreciation to the extent of $30,000,000 to be offset against $35,000,000 of sustained depletion. In other words, the question was not how much depletion had been sustained, and the question was not what was the value of the mine, but the memorandum of Mr. Darnell specifically stated that $30,000,000 appreciation on the value of the assets in the Anaconda Mining Co. should be considered as offset against $35,000,000 approximately, sustained depletion, and that was not only set forth in the memorandum of Mr. Darnell, but that fact was contained in every memorandum written upon the subject, and particularly in the memorandum prepared by Mr. Tungate, I believe it was, or a subordinate of Mr. Tungate's, which was forwarded through Mr. Fay to you. If that clean-cut question of law, which had been decided by the Supreme Court of the United States prior to the time that you wanted that case closed was a fact in the case, would you not consider that a gross error?

Mr. BRIGHT. If it was a gross error; but, Mr. Manson, at the time this case was under consideration and these matters were up, when I had Mr. Tungate and Mr. Donahue in the office talking to them about that case, they were not decided or sure about the question of reorganization, or whether or not that consolidation which took place in 1910 could be construed at that time as a reorganization. It was not definite with them. That was a general discussion, of which there was no record made.

Mr. MANSON. Yes.

Mr. BRIGHT. I only have my recollections as to what occurred at that conference.

Mr. MANSON. Yes; but there is no question from the record but that when Mr. Darnell settled this case in 1920, his memorandum at that time showed that he actually did allow $30,000,000 of appreciation as an offset against sustained depletion, and the Supreme Court of the United States subsequently held that that could not be done. There is no doubt about that, is there, in the record?

Mr. BRIGHT. So far as the decision of the Supreme Court is concerned, but the last statement of the Supreme Court's decision was with reference to depletion and not to the question of appreciation, to the extent that the matter of depreciation or the like is not before it for consideration, and therefore it does not answer it.

Mr. MANSON. Well, the Supreme Court did hold this in the La Belle Iron Works case, that for purposes of determining invested capital, a mining company could not consider the appreciation in the value of its mining property from the date of acquisition to the date as of which invested capital had to be determined, did it not?

Mr. BRIGHT. That is true.

Mr. MANSON. Yes.

Mr. BRIGHT. But that was in the case of a single corporation.

Mr. MANSON. Yes. Then, in this particular case, the offset here of this $30,000,000 is clearly stated to be due to the appreciation of the value of the assets of the Anaconda Copper Mining Co.; is not that true?

Mr. BRIGHT. No; it does not state that. This is the statement made by Mr. Darnell:

> In the computation of invested capital for the consolidated companies there shall be deducted as impairment through depletion the difference between the actual depletion from fair market value suffered, $35,676,623.55, and the $30,000,000 of paid-in surplus of the Anaconda Copper Co. in 1910; that is, invested capital is to be considered as impaired by $5,676,623.55 through depletion.

Mr. MANSON. That $30,000,000 was based entirely upon the appreciation in the value of the invested capital, was it not?

Mr. BRIGHT. Mr. Manson, the memorandum here does not say anything about appreciation at the time. The memorandum of the auditor goes into the question. At that time, there was a doubt as to whether or not this merger or consolidation that took place in 1910 was a reorganization, wherein this company could have taken into its invested capital its actual value of its property, which was admitted to be $30,000,000 in excess of the par value of its stock.

Mr. MANSON. As a matter of fact, what the Anaconda Co. did at that time, in 1910, was to increase capital stock for the purpose of acquiring other properties; is not that correct?

Mr. BRIGHT. That is so stated in the record there. I am not familiar with all of the facts. I am only giving you the information, as I recall it, at the time this case was discussed with me, and they stated that there was a doubt as to the question of the reorganization.

Senator KING. If it was a question of doubt, it could be easily ascertained; that is, if that is the only point.

Mr. BRIGHT. I might state that at that time we were under instructions to try to get the cases closed and settled. I have seen cases coming through which after being worked on for over a year would be finally settled without the original conclusion being materially changed. The taxpayers of the country did not know when their cases were settled, and the way this matter looked to me, with the doubt expressed at that time, I considered that it having been fairly considered by the assistant to the commissioner and by Mr. Darnell, who was considered one of the best engineers that the department had, to then go back and rehash it and to go over all these things again when the case had been closed, should not be done. It

was just a matter of conviction that I had at the time, not that there had been any error amounting to the extent that is indicated here in the memorandums shown in the testimony. I never had any thought of that. If I had, the thing would have been handled the same as any other case that I handle where errors are involved. It was an honest opinion, honestly arrived at, so far as I was concerned, at the meeting held in my office and at the time I issued this memorandum, and I stand on the opinion that I reached at that time. It was honestly made, and that is all there is to it.

Mr. MANSON. There were two other questions involved there, to which your attention was called at that time.

One was the question as to whether the inventory at the beginning of the year 1917 of the finished product had to be valued upon the basis of cost, or whether it was to be valued upon the basis of selling price. The regulations, the law, and your own rulings of the department are very clear that the value to be placed was whichever would be the lower. That involves an item of some $3,000,000. Would you not consider that a gross error?

Mr. BRIGHT. Mr. Manson, that question was raised in the case of the Cerro de Pasco Co. There was an opinion written by the solicitor with reference to that, where he had allowed that item to be taken into inventory, or, in other words, to consider it as accounts receivable. This copper was sold under contract, to be delivered later. The company had an actual responsibility for the delivery of that copper. In some instances payments had been made on it to the selling agencies, and it was considered in the light of accounts receivable and not as an inventory item, but through their method of bookkeeping it had been taken on to their books as an inventory item, rather than as an accounts receivable, on the basis of the actual sale made at the time the contracts were entered into. That, as I understood it, was the basis upon which this question had been handled and gone through with. There was one opinion one way, and one opinion another way, and there was a statement that was handed to me at the time, which I have here in the file:

The question at issue was the determination of what constituted sales at December 31, 1916, and December 31, 1917. The taxpayer had reported as sales for 1916 all of his production to the end of the year 1916, both of refined copper and of copper which had reached the stage of blister copper; and which was refined in the early part of 1917.

After discussion by the interested parties, Mr. Talbert held that the blister copper was not in a salable condition, since the facts showed conclusively that only refined copper had been sold and delivered. The taxpayer was required to report all blister copper at December 31, 1916, and December 31, 1917, as inventory on hand at the end of the year, and was required to show as sales the amount of copper at those dates which had been refined.

This matter had been presented to the committee on appeals and review, or to Mr. Talbert, who was chairman of the committee on appeals and review, and there were present at the conference Mr. Kelly, president of the Anaconda Copper Co.; Mr. Evans, general counsel; and an accountant. This statement was handed to me as a part of the files at that time. It was considered and passed on and closed.

Mr. MANSON. Then there was another question involved in this case after the depletion of the assets.

Mr. BRIGHT. Elimination of intercompany holdings?

Mr. MANSON. Yes.

Mr. BRIGHT. Amounting to $3,000,000 more.

Mr. MANSON. So far as appears from the files of the case, the auditor who wrote this memorandum, which was sent on to you, found that there was such a duplication that we could not consider that a gross error.

Mr. BRIGHT. Taking into consideration that this was a reorganization and this taxpayer was entitled to a paid-in surplus at that time under the conditions, that this company's property was twice the value of its capital stock, that difference in paid-in surplus would have offset the adjustment of invested capital as a result of the duplication or the failure to eliminate certain intercompany holdings of stock.

Mr. MANSON. Just a minute, now. The Anaconda Copper Co. in 1910 was capitalized at $30,000,000. They contended that they were entitled to value their holdings as of that date at $60,000,000.

Senator KING. Why?

Mr. MANSON. Their claim is based upon the theory that the property had appreciated in value.

Mr. BRIGHT. Mr. Manson, had there not been a complete survey made of all these properties incident to this reorganization, and valuation fixed by competent engineers, before any dealings were ever entered into in this case?

Mr. MANSON. The value claimed by the company—that is, by the original Anaconda Co.—on its property was $60,000,000, according to the record here. You had allowed them, or at least Mr. Darnell had allowed them, $30,000,000 of paid-in surplus to offset $35,000,000 of sustained depletion. The original $30,000,000 was capitalized in the first place. Now, having allowed that extra $30,000,000, upon what theory would the appreciation in the value of their property cover an additional duplication of assets of subsidiary companies in the consolidated books? In other words, you had already taken care of $60,000,000, which was all that they claimed.

Mr. BRIGHT. Mr. Manson, this matter was a question that if they opened up the case on one point they opened it up on everything; that is, open it up on revaluation against the Secretary's orders. They would have opened up the entire case. It was a case of rethrashing and going over the entire case. As I told you before, it was my honest conviction at the time that the case was properly closed. That was my belief, and I closed the case that way. That is the only answer that I can give here.

Senator KING. Well, I think it is quite unsatisfactory, so far as I am concerned.

Mr. BRIGHT. All right, sir. I have honestly performed my duty to my Government as I have seen it. I did the best that I could.

Mr. MANSON. You spoke of certain things having been waived; in other words, that the fact that the company had waived certain claims was a factor which influenced you in settling this case. What claims had they waived?

Mr. BRIGHT. The statement is contained in the file and the record of the case that they had claimed them.

Mr. MANSON. What is it they claimed?

Mr. BRIGHT. I do not know.

Mr. MANSON. Well, did you know at the time you passed on it?

Mr. BRIGHT. No, sir.

Mr. MANSON. In other words, you then took the position at the time you passed on this matter and determined not to reopen it; that you had been informed that they had made some claims, the nature of which you did not know?

Mr. BRIGHT. The statement is made in a memorandum of Mr. Darnell, approved by Mr. Callan.

Mr. MANSON. Yes; that there were some claims that they waived, and you did not inquire into them to find out what they were?

Mr. BRIGHT. No, sir.

Mr. MANSON. Now, to get back to this matter of appraising intangible values where good will has already been capitalized on the books of the company, do you accept valuation thus placed upon good will in lieu of this method of appraisal that we have been discussing?

Mr. MILLIKEN. Do you have in mind where capital stock was specifically issued for good will? There the capitalization is increased and the value back of the stock is the good will of the company.

Mr. MANSON. Yes.

Mr. MILLIKEN. Of course, if you go back of that and show they actually had good will you can work out a computation to show it was actually there, and allow the value. If you can not show it was there, we say that the stock is not bona fidely issued for good will.

Mr. MANSON. I do not mean a case where there was good will to sustain the stock, but where a company has carried it into its capital stock, or has capitalized its good will. Value which it has placed upon its good will for the purpose of issuing stock against it may be accurate; it may be inaccurate; the good will may be worth more or less than that. Do you accept that value as placed by the company?

Mr. MILLIKEN. I would not say that we would accept it just absolutely, hook, line, and sinker. We would go into the question to see whether or not such increased capitalization was warranted by a fair computation of the value of that good will. If the stock was actually issued for good will which was actually in existence, and we could prove the good will was there, they are entitled to it.

Mr. MANSON. How would you prove it other than by valuing the good will as of date?

Mr. MILLIKEN. I would say that we would have to prove it by our computation here. You might have some factors that are not present in this memorandum.

Mr. MANSON. Suppose you had a case where, upon making such a computation as you have described, you find the good will is less than the book value of the stock, less than would be shown by taking the book value of the stock which governs in such instances?

Mr. MILLIKEN. I should say that the stock was not issued then bona fidedly for good will, because good will was not there.

Mr. GREGG. In other words, we take the actual value of the good will rather than the book value?

Mr. MILLIKEN. Yes.

Mr. GREGG. As determined by ourselves?

Mr. MILLIKEN. Yes.

Mr. MANSON. I would like to call your attention to the case of Mrs. Anne O. Haight, of Canton, Ohio.

In this case Mrs. Haight, in July, 1917, was the owner of most of the preferred and common stock—that is, she was the owner of 1,300 shares of the preferred stock and 979 shares of the common stock of the Western Spring Co. She exchanged 1,300 shares of preferred stock and the common stock that I have mentioned for 1,300 shares of preferred stock and 1,666 shares of the common stock of the Standard Parts Co., and the revenue agent determined that she had made a gain in that transaction of $136,843.50.

There was an appraisal made of this stock for the purpose of ascertaining whether or not the gain was made under the provisions of A. R. M. 34. Under this appraisal the profits attributable to tangibles were capitalized at the rate of 8 per cent and the good will at the rate of 8 per cent. Upon such determination she was found to have a profit of $16,169.55.

I call attention to those rates because they seem to be considerably below; at least the rate applicable to good will appears to be considerably below that which has been mentioned here.

The CHAIRMAN. This company was an automobile parts concern?

Mr. MANSON. An automobile parts concern.

Then, after that determination had been made, with those low discount factors or with those low capital stock rates, upon the final audit the book value of the stock was accepted, and her gain was determined to be $3,078.55, involving a tax of $6.23 as against $10,590.

I was wondering to what extent book values are accepted in lieu of appraisals, even where the property is capitalized at such a low rate as 8 per cent.

Mr. GREGG. I have been running through your statement in this case, Mr. Manson, and it looks as if they used the book value, which, goodness knows, is not indicative of the true value of good will, in place of accepting the value which the formula indicated.

Mr. MANSON. Our engineer finds that the value actually allowed as a basis for the tax would represent a capitalization of tangibles at the rate of 7 per cent and of intangibles at the rate of 6.03 per cent.

Senator KING. As I understand it, here was a case where a person had made a profit on the sale of——

Mr. MANSON. There was an exchange of stock.

Senator KING. Oh, there was an exchange of stock?

Mr. MANSON. In order to ascertain the profit, it was necessary to appraise the stock, appraise the value of it.

The CHAIRMAN. Let me get that straight. The profit was eventually made on the sale of the Standard Parts Co. stock, was it not?

Mr. MANSON. No; the profit was made on the exchange. In other words, here they had an exchange of stock of one company for the stock of another, and the question was how much profit was made upon this stock. In other words, the question was, What is the value of the Standard Parts Co. stock acquired in the transfer?

The CHAIRMAN. Yes; but she did not get any cash in the transfer.
Mr. MANSON. She got no cash.
The CHAIRMAN. What was taxable?
Mr. MANSON. The taxable gain upon the exchange.
Mr. GREGG. In other words, an exchange, even if you received no cash, under the old law was taxable. That transaction would not be taxable under the later laws.
The CHAIRMAN. That is what I am trying to get an understanding of.
Mr. MOSS. That was arrived at by an appraisal of the acquired stock.
Mr. MANSON. Yes.
Senator JONES of New Mexico. Would you not have to appraise the old stock, too?
Mr. MANSON. I think the cost of the old stock was a settled question.
Mr. GREGG. I think it had been purchased since March 1, 1913.
Mr. MANSON. Yes.
Mr. GREGG. So the value of the old stock is not a factor.
Mr. MANSON. No.
Mr. GREGG. The question involved, then, was that growing out of the sale of the acquired stock.
Mr. MANSON. Growing out of the value of the acquired stock.
The CHAIRMAN. No; I said the sale.
Mr. MANSON. That was not the question. There was no acquired stock sold, Senator.
The CHAIRMAN. As I remember it, in going over these cases, there were other cases involving the same question.
Mr. MANSON. Not involving the same question. This is the only case which involved the matter of the determination of the value of the Standard Parts Co. I will present this report as an exhibit.
The exhibits submitted by Mr. Manson are on page 3704.
Mr MANSON. When you fix the value of the stock of a corporation for the purpose of taxation, do you keep any record of the value so fixed other than the record that is in the file in that case?
Mr. MILLIKEN. There are 10 stockholders, if I understand your question, in the corporation. There would be one whose value would be fixed for him. Do we keep any records so that the same value would be applied to the other nine?
Mr. MANSON. Yes; that is it.
Mr. MILLIKEN. I will say that I do not know whether that is done or not. I do know this to be a fact, that the Income Tax Unit, in sending cases to the solicitor's office, would send all stockholders' cases together, and there will be 10 written up at the same time. That is the way it is done now.
The CHAIRMAN. Yes; but suppose that when you send those to the solicitor's office, there was a stockholder who had not come under this classification, or had not sold his stock, but he sold it later, and then the question of valuation came up at that particular time, would you have any record to find out what valuation you had fixed prior thereto?
Mr. MILLIKEN. Of course, I am not in the unit, and I do not know how that is done administratively. I know in the solicitor's

office, if we once establish the value of a share of stock, we try to make a cross index.

The CHAIRMAN. I would like to ask Mr. Nash if that is done in the Income Tax Unit.

Mr. NASH. I believe that is done, Senator. I am not absolutely sure about it. We have an information section in the personal audit division, where they have all sorts of information on stock values. I imagine in a case of this kind the information that was arrived at would be sent in to that information section for future use by the unit.

The CHAIRMAN. Would you look that up and advise the committee as to whether you have anything of that kind?

Mr. NASH. I would be glad to.

Mr. MANSON. Anything in the unit in the way of a card index?

Mr. NASH. There are a great many card indexes in that information section.

Mr. MANSON. I have called attention to this case, and we undertook——

Senator JONES of New Mexico. You say "this case."

Mr. MANSON. That is, the Anne O. Haight case. We undertook to follow that case into various ramifications for the purpose of determining whether or not the bureau had any system whereby they availed themselves of information they got in one case for use in other related cases, and the report (Exhibit A) of Mr. Parker, who made that investigation, is very short. I will read it:

The case of profit on sale of Western Wheel & Axle Co. stock by taxpayer, Mrs. Anne O. Haight, has already been reported on; your engineers, starting from the information in this case, and this case only, have followed out some of those lines of inquiry which should suggest themselves to any thinking person wishing to properly safeguard the interests of the Government. We deem the results of a partial investigation very interesting, and trust the bureau can complete and perfect same with the much greater facilities at its disposal.

From a preliminary investigation the following points appear important:

1. Although Mrs. Anne O. Haight was deemed to have made a profit on the exchange of Western Wheel & Axle Co. stock for Standard Parts Co. stock, no profit appears to have been assessed to E. J. Hess or J. B. Childe, other stockholders.

2. The Standard Parts Co. is allowed to include in invested capital a payment of $1,010,000 to the Perlman Rim Corporation, purporting to be a cash payment for license rights under the Perlman patent.

3. The Perlman Rim Corporation claims payment was made in stock of a par value of $1,000,000 of Standard Parts Co. The Perlman Rim Co. did not set this stock up on their books at any value.

4. The Standard Parts Co. claims payment of $1,010,000 was made for patent rights, while the Perlman Rim Corporation shows same to have been for past claims and infringements.

5. The whole matter shows laxity on the part of the bureau in properly comparing related matters in different returns.

As shown in the case of Mrs. Anne O. Haight already submitted, the Standard Parts Co. absorbed the Western Spring & Axle Co. during 1917 by paying the stockholders of the latter company for their stock in the stock of Standard Parts Co. It was also shown that Mrs. Haight was judged to have made a profit by the transaction. A list of the stockholders of the Western Spring & Axle Co. is not available. We have looked at the returns of E. J. Hess and J. B. Childe, who were other taxpayers in this company for the years 1916 and 1917, and find no mention made of the returns or on the papers filed therewith, showing any profit on the sale of Western Spring & Axle Co. stock in 1917.

The Standard Parts Co., in a brief dated September 19, 1922, made protest against the elimination for invested capital of the Perlman Rim Corporation

patent, paid for with cash and amounting to $1,010,000. (See Exhibit B.) Conference was held on this matter on October 6, 1922. (See Exhibit C.) The taxpayer, through his accountants, Ernst & Ernst, states:

"The Perlman Rim Corporation patent was proven to have been purchased for $1,010,000 cash, as evidenced by photostats of the check issued in payment. While it was admitted that Mr. Perlman, immediately after the sale of the patents, purchased $1,010,000 worth of the Standard Parts Co. stock, we have no proof of an obligation or agreement on his part to do so, and his action was apparently entirely voluntary and based solely on his confidence and faith in the future prospects of the investment. It is recommended that the cash value of the Perlman patent, $1,010,000, be restored to invested capital."

Referring now to extract from travel auditor's report dated January 25, 1923, please note as follows in regard to the 10,000 shares of stock taken over by the Perlman Rim Corporation by the million-dollar investment:

"Haskins and Sells (accountants) made the following statement in their audit report dated September 29, 1917: 'We are informed that 10,000 shares of common stock of the Standard Parts Co. are being held in escrow by Perlman Rim Corporation pending outcome of litigation in connection with patent rights.'"

In the conference with the Standard Parts Co. dated October 6, 1922, and previously referred to, it was claimed that the Perlman Rim Corporation patent was purchased for $1,010,000 cash.

On the other hand, the agreement between the Standard Parts Co. and the General Motors Corporation, which had absorbed the Perlman Rim Corporation, dated November 17, 1919, provides as follows [agreement shown in full in Exhibit E]:

"Whereas under date of December, 1916, the Perlman Rim Corporation executed a general relief to the Standard Welding Co., also a corporation of the State of Ohio, of and from any and all claims arising out of or connected with the past infringement by said Welding Co. of any and all patents covering demountable rims, and in particular of the aforesaid letters by the number 1052270 in consideration of the sum of $1,010,000, procured by the Standard Welding Co. to be paid to the Perlman Rim Corporation."

Confirming the above statement that this payment was for damage caused by infringement, note the following citation to court records:

"Two hundred and thirty-one Federal, 453. Judge Hunt in the District Court of the United States for the Southern District of New York. Also 231 Federal Reporter, 734, appeal from above decision. Decree affirmed."

There is also included in this case as showing pertinent facts, Exhibit F, which is a copy of the information contained on the photostat of the check for $1,010,000 drawn by the Standard Parts Co. to the order of the Perlman Rim Corporation. Exhibit D, a copy of a license agreement found in the files between the Standard Parts Co. and the Perlman Rim Corporation providing for the licensing of the former on the payment of certain royalties to the latter. It might be noted that this agreement does not appear to be authentic, for it is not dated closer than November, 1916, and it does not appear to have been filed.

There should be an agreement dated December 6, 1916, of the same nature included in the papers in this case, but in spite of diligent search having been made it can not be located. Exhibit H, recommendation No. 6617, committee on appeals and review, covering the appeal of the United Motors Corporation, but also touching on the value of the Perlman patents, is also attached.

It appears from the history of this case and the exhibits herewith submitted that very great laxity exists in the bureau in comparing related matters in the returns of different taxpayers.

In the first place, it would appear that one stockholder at least in the Western Spring & Axle Co. has been taxed on the transaction in exchanging this stock for the Standard Parts Co., while certain other taxpayers have not been so taxed. We believe that when transactions of this nature take place, lists of all the stockholders should be secured, and it should be ascertained what profit or loss has been made by each, so that we may have some equity between the different taxpayers involved.

A careful analysis of the conflicting statements in this case leads us to the following conclusions: The payment by the Standard Parts Co. to the Perlman Rim Corporation of $1,010,000 was not a payment for patent rights in any

sense, but was a payment for damage claims on infringement, such damages having taken place prior to December 6, 1916. We contend that this million dollars can in no way be considered a part of the invested capital of the Standard Parts Co.

We believe the unit has erred also in the case of the Perlman Rim Corporation in allowing the statement to go unchallenged that it had received 10,000 shares of stock in the Standard Parts Co. to be held in escrow, without making a further examination of this statement. While it is true that the check passed between the Standard Parts Co. and the Perlman Rim Corporation looks like a straw transaction, nevertheless we believe that the Perlman Rim Corporation actually received income at this time and that they should be made to pay tax on the same. We have already shown in the case of Mrs. Anne O. Haight that the Standard Parts stock had a very substantial value at this time.

It should also be noted that the Perlman Rim Corporation was finally taken over by the United Motors Corporation and the United Motors Corporation was finally taken over by General Motors. This latter case is a very voluminous one, and we have not been able to examine same through lack of time. We believe, however, from a very few questions asked about this case that General Motors finally writes off a loss from their books on account of this patent. In the meantime nobody else seems to have paid any taxes on receipt of the $1,010,000 above referred to.

We believe that the matter above presented shows a necessity for setting up some system of adequate check between taxpayers' returns which are related. This is especially true on points where it is advantageous for the different taxpayers to take opposite sides to the same question.

We found that the Standard Parts Co. had included in its invested capital $1,010,000 as having been paid to the Perlman Rim Corporation for a license under the patents owned by the Perlman Rim Corporation. That value was set up by the company and allowed by the bureau as a part of the invested capital of the Standard Parts Co.

In connection with the proof of that item, as a part of invested capital, the Standards Parts Co. exhibited a check. They claim it was a cash transaction, that they paid cash for it, and they exhibited a check, which is in the files, for $1,010,000. That check is made payable to the Perlman Rim Corporation and was collected by them.

The Perlman Rim Corporation does not report that $1,010,000 as a receipt of income, nor as the sale of property, but they claim that $1,010,000 was paid to them under those conditions; that the Standard Parts Co. had been infringing upon their patent; that lawsuits were pending between the Standard Parts Co. and others who had infringed upon their patent—that is, between the Perlman Rim Corporation and others, not the Standard Parts Co.; that the Standard Parts Co. had deposited with them $1,010,000, not all cash, but on their capital stock, to hold in escrow pending the determination of this litigation with other parties.

In other words, they had a claim against the Standard Parts Co. for infringement of patent. There was no lawsuit between them, but manifestly, to avoid a lawsuit, the Standard Parts Co. deposited with the Perlman Rim Corporation—this is what the Perlman Rim Corporation claimed—they deposited this $1,010,000 of their capital stock with the Perlman Rim Corporation, to hold in escrow until the determination of this litigation.

The bureau sustained the Perlman Rim Corporation contention in this case; so here you have two cases involving the same transaction.

Senator KING. Regardless of the fact that the check passed and was cashed?

Mr. MANSON. Well, regardless of the fact that they allowed the Standard Parts Co. to capitalize what they claimed to be the ownership of a patent purchased for $1,010,000, and at the same time they permit the company from whom the Standard Parts Co. claims that it purchased that patent to avoid the payment of tax upon the $1,010,000 by the claim that the stock was held in escrow.

Subsequent to that time the Perlman Rim Corporation is acquired by the United Motors Corporation, and the United Motors Corporation is acquired then by the General Motors Co.

Subsequently we find a contract between the General Motors Co. and the Standard Parts Co. in 1919, and this contract I will offer as an exhibit here, but I will state the substance of it.

This contract recites that the General Motors Co. is the holder of $1,010,000 of the capital stock of the Standard Parts Co., which was given to the Perlman Rim Corporation in the payment of a claim for damages for the infringement of a patent.

This contract further recites that at the time this money was paid to liquidate these damages, a license was given under which the Standard Parts Co. was to pay a royalty of 15½ cents, I believe, upon each set of rims sold.

The Standard Parts Co. then buys back from the General Motors Co. the very patent which it had been permitted to capitalize two years before in 1917. It buys it back for something like $300,000, the same patent, the same patent number. It is identified all through these transactions, and when it buys it back for some $300,000, and gets its stock back from the General Motors Co., and in consideration of the payment of some three hundred thousand and odd dollars and the continuance of a payment due to the inventor, it also agrees to pay a royality of some 5 cents on each set of rims, the General Motors Co. reserving the right to manufacture all of these rims that it needs for its own purposes.

Now, I call attention to this situation, that in the same year one company is permitted to capitalize $1,010,000 as for the purchase of a patent. Another company is not required to either pay a tax upon that money as for its sale of a patent or for the receipt of damages for the infringement of a patent.

In other words, the Perlman Rim Corporation never paid a nickel on this transaction, although they received $1,010,000 of the stock of the Standard Parts Co., which afterwards went to the United Motors Co. and by them was sold to the General Motors Co., and two years later bought back by the Standard Parts Co. from the General Motors Co., and which, in the Anne O. Haight case, the bureau had determined the value, because they taxed a profit on it.

Senator KING. What became of the $1,010,000 in cash represented by that check?

Mr. MANSON. I believe the check was a purely straw transaction. The check passed apparently for the purpose of permitting the Standard Parts Co. to get away with this capitalizing of this patent, or it may have been to clear the transaction on the books.

What happened was that the Standard Parts Co. issued $1,010,000 of its stock to the Perlman Rim Corporation. This check may have passed, and then as turned back to the Standard Parts Co. in payment of that stock; but there is no question about the stock having

value, because the value was fixed in the Haight case. There is no question but what it passed to the Perlman Rim Corporation, because it was decided in this subsequent contract between the General Motors Co. and the Standard Parts Co. just exactly how the General Motors Co. got it. It got it from the United Motors Co., which, in turn, got it from the Perlman Rim Corporation, and the stock was actually delivered in the liquidation of the claim for damages for infringement of a patent and not for the purchase of a license.

The CHAIRMAN. The point, then, really is that there is no cross index or system in the bureau whereby these transactions may be followed up to see that they harmonize with the statements of taxpayers?

Mr. MANSON. It was for the purpose of developing whether or not that situation exists that we just took one case and followed it through to see what happened to it.

Mr. NASH. I just want to say, Mr. Chairman, that the case looks to me like poor work on the part of the field agent of the Income Tax Unit, who made this original examination in the Haight case——

Mr. MANSON. Well, it appears that there were two field agents, and that these concerns were evidently not located in the same man's jurisdiction, because one field agent reports that the Standard Parts Co. was entitled to capitalize the purchase of this stock and another field agent submits evidence that the Perlman Rim Corporation is not chargeable with the receipt of this stock, that it was only holding it in escrow, and you do not finally get all of the facts until you get down to this contract between the General Motors Co. and the Standard Parts Co. when they bought the stock back, and in that contract it recites the whole history of the whole business from start to finish.

Mr. NASH. Well, what I want to bring out is that the field agent should not have closed his case on the Standard Parts Co. until he had verified the other end of the transaction with the Perlman Rim Co. That was a part of his job.

The CHAIRMAN. If it had been in a different district, would it have been a part of his job?

Mr. NASH. Yes; he should have verified it by mail, then, through the office of the agent in charge of the other district.

Senator KING. Mr. Nash, have you any way now to cure this fraud which has been perpetrated on the Government?

Mr. NASH. I will be glad to have this case gone into and see what we can do with it. It looks to me as though it was faulty work on the part of the examining agent in the field.

Mr. MANSON. While there is a tax here involved on the $1,010,000, that was not really the most important angle of this case, to my mind. It was not for the purpose of developing that that we made this investigation. It was for the purpose of determining the very points that are brought out in connection with oil wells—whether or not there is some system in the bureau whereby the information that you get in one case is made use of in——

Senator KING. Related cases.

Mr. MANSON (continuing). In related cases.

Mr. NASH. The procedure would be, as I stated a moment ago, for this agent to follow it up as soon as he had discovered it and check it up with the other company.

The CHAIRMAN. If he failed to do that, then there is no check in the bureau by which it could be caught?

Mr. NASH. There is no further check.

The CHAIRMAN. Do you not think that there ought to be some further check?

Mr. NASH. We have to stop somewhere, Senator. We can not check and recheck indefinitely.

The CHAIRMAN. But the point that Mr. Manson is raising is whether there should not be a system in the bureau which would enable you to use information in one case in connection with related cases and, generally speaking, that could not be passed back to the field agent, because a later date may come up in which he may not be connected. It seems to me that there should be some clearing house whereby the information could be used in future cases.

Mr. NASH. We do have an information section, where we accumulate and keep volumes of information on valuations.

The CHAIRMAN. Have you any other case this morning, Mr. Manson?

Mr. MANSON. That is all I have to present this morning.

I want to have somebody, whom I will designate, look into these statistics that are kept for the purpose of fixing the capitalization rates, and I would wish that you designate somebody to confer with Mr. Parker, whom I will designate to look into it.

Mr. GREGG. Those statistics were not prepared for that purpose. They were prepared under the war-profits tax. There was some provision there that called for them, and they were prepared for that purpose. They were not prepared for the purpose of determining the rate of discount.

The CHAIRMAN. Could you tell us to what extent they are used, Mr. Gregg?

Mr. GREGG. They were used, of course, for the purpose for which they were prepared, but I assume that they are used just as a reference to see the average earnings in the different lines of business.

Mr. MANSON. Let me make this suggestion before we go any further. It may clear up what I really want to get at.

It is my opinion that when a man invests in a certain industry, we will say in the steel industry, if he buys stock in that kind of an industry, with its history and its prospects, he expects to get about a certain return on his money. In other words, he will pay par for stock that will return him 6 or 7 or 8 per cent dividends on its net earnings of a certain amount of money. When he goes into another industry, which may be more speculative, he will expect a higher return. When he goes into another industry, which is less speculative, he will expect a lower return. If he goes into a tremendously big concern, whose business is well settled, he may expect a lower return than he will if he is going into a new concern, even in the same industry, one that is starting out.

I can conceive of no just method of capitalizing profits for the purpose of ascertaining the value of good will, except by the assembling of that kind of statistics, the exhaustive analysis of them,

and a careful use of them. In other words, I can not conceive how it can be just to take a corporation which has been actually sold, we will say, in 1918 or 1919. We find from the price paid for the property of that corporation, or for its stock, that the purchasers expected to get 6 or 7 per cent. Therefore, in determining the 1913 value we use 6 or 7 per cent as the basis for determining it.

Here we have an identical business, with all of the conditions exactly the same, about the same size, engaged in the same line of industry, with about the same history and about the same prospects, and because there has been no actual sale of the stock in that concern, arbitrarily taking 15 per cent, which is about the only figure that I have heard mentioned around this table; I will say this, that we submitted two or three hypothetical questions, and 15 per cent was the figure used there, and except in some extraordinary situation 15 per cent appears to be the accepted basis of capitalization.

I believe that the only just method is by the assembling of extensive statistical data as to what investors expect to get in different lines of industry, in large concerns and in small concerns. In other words, what is the range? It seems to me that we not only have the stock market as a basis for gathering that data but we have all the data that is available to the bureau, because every sale of a corporation is coming into the bureau.

I do not know whether the information that thus becomes available is being gathered and tabulated and utilized, or whether it is not; but it seems to me that it should be, and I can see no other just way.

The CHAIRMAN. Let me get the point there. I understand that a taxpayer whose stock is traded on in the market frequently gets greater advantage. Assume that the stock is traded on on a 6 or 7 per cent basis. He gets a greater advantage than a concern whose stock is not traded in and where it is capitalized on a 15 per cent basis.

Mr. MANSON. There is no doubt about that.

Mr. GREGG. Mr. Manson, have you found any case where we took a sale in a subsequent year? I think very rarely did we take a sale in later years and applied the same ratio, because conditions may be so different at the time the sale was made. I know that in some cases that has been done, but I imagine they will be very rare.

Mr. MANSON. Then I will offer S. M. 2435, A. R. R. 2954, and A. R. R. 252 as evidence of the fact that it has been done at least in those cases, and if the settled policy of the bureau can be determined from its published rulings, the method that I have just described appears to be an accepted method.

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

[Internal Revenue Bulletin, Vol. III, September 22, 1924, No. 38]

SEC. 202. Basis for determining gain or loss.

ART. 1561. Basis for determining gain or loss from sale. (III-38-1788, S. M. 2435.)

REVENUE ACTS OF 1918 AND 1921

Application of A. R. M. 34 (C. B. 2, 31) in computing the March 1, 1913, value of intangibles for determining gain or loss from sale in 1921 of a publication.

In 1921 the M company, publishers, sold out to the O company. The price paid was 15x dollars, represented by an initial payment of x dollars in cash

and 11 promissory notes, each dated ———, 1920, and maturing annually over a period of 11 years, from ———, 1921, to ———, 1931. In determining the gain from the sale the revenue agent found that the value of the tangible assets of the M company at the time of the sale was 1.10x dollars, and that the value of such tangible assets on March 1, 1913, was 1.9x dollars, the reduction in value being due to depreciation. It was therefore concluded that the bulk of the consideration for the sale was paid for intangibles, and in order to ascertain the value of the intangibles on March 1, 1913, the revenue agent applied the third method for ascertaining such value outlined in A. R. M. 34, with the result that the value of intangibles represented by good will of the business on March 1, 1913, was computed at 0.84x dollar and the amount of profit derived from the sale after making certain adjustments and deductions was determined to be 11.74x dollars. The net income of the taxpayer for 1921, including the profit from the sale, was fixed at 11.9x dollars.

The revenue agent in applying A. R. M. 34 allowed a rate of 9 per cent on the value of the tangible assets as of March 1, 1913, and capitalized the remainder of the earnings at 20 per cent in determining the value of the intangibles on that date. This method is objected to by taxpayer's representatives, who contend that the taxpayer should be permitted to capitalize the excess earnings prior to March 1, 1913, on the same basis upon which the intangibles were actually sold, with the result that no gain or loss was derived from the sale. The contention is based upon the last paragraph of A. R. M. 34, which provides that in the case of the sale of good will of a going business the percentage of capitalization of earnings applicable to good will shown by the amount actually paid for the business should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon a basis of capitalization of earnings less than the figures indicated as the values ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.

The taxpayer's total net earnings for the five years ending 1913 amounted to 1.59x dollars, while for the period 1913 up to the date of sale its total net earnings amounted to 1.54x dollars. For 1913 its net earnings amounted to 0.51x dollars, while for 1919 its net earnings amounted to only 0.31x dollars, and for 1920 it had a substantial loss. From 1912 to 1920 there was a steady and substantial decline in the circulation of the publications. For each of the years 1912 and 1913 the circulation amounted to 2.20y, while for 1920 it amounted to only 1.8y. The revenue agent contends that the decrease in circulation was more than offset by the increase in receipts from advertisements, but it is obvious that this is immaterial in view of the decrease in net earnings.

A. R. M. 34 recognizes the impossibility of laying down any specific rule for "determining the value of intangibles which would be applicable in all cases and under all circumstances." Having prescribed certain methods for the determination of the value of intangibles, it specifically states that "in any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it." The purchaser of this taxpayer's business would naturally expect to receive a greater return on his money at a time when the tangible assets were of greater value and the net earnings larger than at a time when the net earnings were smaller and the value of the tangible assets less. As shown above, the value of the tangible assets and the net earnings of the corporation for 1913 and the preceding five years were greater than the value of its assets and its net earnings for 1920 and the preceding six years. Therefore the obvious conclusion is that no gain was realized from the sale.

It is true, as contended by the revenue agent, that subsequent events do not affect the March 1, 1913, value, but in the opinion of this office subsequent events should, under these circumstances, be taken into consideration, at least for the purpose of checking the result of the formula, which at best appears to be a mere guide. This is what the last sentence in A. R. M. 34 intended; that is—

In the case of the sale of good will of a going business the percentage rate of capitalization of earnings applicable to good will shown by the amount actually paid for the business should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon the basis of capitalization of earnings less than the figures above indicated as the ones ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.

When this check is used it proves the value of the intangibles was greater on March 1, 1913, than at the date of sale. In view of this, and the fact that the value of the tangible assets was also less at the date of sale than at March 1, 1913, this office is of the opinion that no gain was realized from the transaction.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

[Cumulative Bulletin II-2, July-December, 1923, p. 202]

SEC. 233. Gross income of corporations defined.
ART. 546. Sale of capital assets. (Also sec. 202, art. 1561; sec. 213 (a), art. 41.) (II-24-1100, A. R. R. 2054.)

REVENUE ACT OF 1918

Where a corporation sells its assets and the consideration is paid to its stockholders there is a sale by the corporation, and the corporation is taxable upon any profit realized on the transaction.

In determining the earnings of a corporation chargeable to good will in accordance with A. R. M. 34 (C. B. 2, p. 31), Federal income taxes may be deducted. In arriving at the investment return of shares of stock the income and profits taxes should be treated the same as other expenses.

The taxpayer appeals from the action of the Income Tax Unit in holding that the appellant realized a taxable profit of 14.27x dollars upon the sale of assets to the N company on July —, 1919.

The M company was incorporated ———, 1889. From the date of organization down to July —, 1919, the business was operated and controlled by A and B. On July —, 1919, these two men owned all or substantially all of the capital stock (9.2x dollars) of the company. All of the tangible assets of the corporation were located in the city of S.

In 1919 A and B desired to convert a large part of their holdings and accordingly entered into negotiations with C, investment banker, of the city of T. As a result of these negotiations the N company was formed, with an authorized capitalization of 60y shares of preferred stock of a par value of 20z dollars and 600y shares of common stock of no par value.

On August —, 1919, A, B, C, D, and E subscribed for the entire issue of the stock of the N company as per the following:

	Number of shares	
	Preferred	Common
A	36.03y	360.33y
B	.13y	1.305y
C	23.71y	237.055y
D	.13y	1.305y
E		.005y
Total	60y	600y

This subscription was irrevocable for 15 days from its date and was conditioned upon the acceptance by the N company of all of the assets of the M company in full payment for such stock.

Under a memorandum of agreement made between the stockholders of the M company and C (trading as P company) on the ——— day of July, 1919, all of the preferred stock and 375y shares of the common stock of the N company were to be deposited in the city of T, bank of O, with a letter of instructions in words and figures as follows:

"Unless second party (the P company) pays into the bank under the terms of said letter (*a*) the sum of 8.8x dollars within three months from this date, (*b*) and such amount as may be required to release to him all of said stock deposited with said letter within six months from this date, then, and in either of said events, this contract will be at an end; second party shall thereafter have no right to buy any stock for which he had not hertofore made deposits,

and thereafter no rights or liabilities shall be claimed or asserted under this contract by any party thereto."

The following resolution was passed at a stockholders' meeting of the M company held on August —, 1919:

"*Resolved, hereby, by the stockholders of the M company*, That this corporation forthwith sell all of its property, real and personal, of every nature, including all its trade-marks, trade names, and the good will of its business as a going concern, to the N company, in consideration of 60y shares full-paid 7 per cent cumulative preferred stock and 600y shares of the common stock of no par value of said N company being issued by said last-referred-to corporation to the stockholders of this corporation.

"*Resolved further*, That the transfer hereby authorized be upon a condition that the N company corporation shall assume and agree to pay all the liabilities of the corporation, including liabilities for taxes on account of being in business heretofore.

"*Resolved*, That this corporation be, and is hereby, dissolved."

Thereafter, on August —, 1919, at a joint meeting of the incorporators and board of directors of the N company, the subscription was accepted and the corporation accepted in full payment of the stock so subscribed the property of the M company.

In its brief the appellant states that all moot questions have been resolved by the Income Tax Unit against it, namely:

(*a*) That the consideration paid by the N company passed to the M company and not to the individual stockholders, as provided in the resolution authorizing the sale.

(*b*) That in determining the relative values of good will in 1913 and 1919 the net income should be taken before the deductions of Federal income and profits taxes and not after such deductions, as claimed by the company.

(*c*) That the consideration received had a market value of of 42x dollars instead of 30x dollars as claimed by the company (assuming the transaction is taxable and the stock had a market value when issued).

It then states that its appeal is based upon the following propositions:

(1) As a matter of law, the sale by the M company of its assets and property to the N company, July —, 1919, did not constitute a taxable transaction.

(2) No taxable profit was realized by M company in the sale of its assets, business, and property to the N company, either in law or in fact.

(*a*) The stock of the N company had neither market nor market value at the time of its issue and delivery.

(*b*) That if the commissioner is of the opinion and so decides that the stock of the N company had both a market and a market value at the date of its issue, the aggregate market value of such stock, properly determined, did not then exceed the fair market value of the assets and property of the M company, as at March 1, 1913, adjusted by changes in the value of tangible assets to July —, 1919.

(*c*) That the relative values of the good will of the M company as at March 1, 1913, and the date of sale, July —, 1919, must be determined after the payment of all taxes.

1. The committee is of the opinion that the sale of the M company of its assets and property to the N company on July —, 1919, constituted a taxable transaction. The decision of the United States District Court, Eastern District of Wisconsin, in United States *v.* Cedarburg Milk Company, decided November 1, 1922 (288 Fed. Rep. 996), appears to be conclusive upon this point. In that case the court held that where a corporation sold its assets and the consideration was paid to its stockholders, there was a sale by the corporation and that the corporation was taxable upon any profit realized on the transaction and that the fact that the consideration was paid directly to the stockholders was immaterial.

2. In computing the amount of the profit made by the appellant upon the sale of its assets in 1919, the Income Tax Unit has held that the price for which the broker, C, sold the common and preferred stock to the public represents the fair market value of that stock to the stockholders of the M company. In other words, the unit held that the fair value of the stock received was 42x dollars. Under the agreement which the stockholders made with C, the stockholders were to and did receive 17z dollars per share for the 60y shares of preferred stock and 0.8z dollars for 375 shares of the 600y shares of common stock. The amount of cash actually received by them from C was 26.4x

dollars. C agreed to and did sell the preferred and common stock to the public at the rate of 20z dollars per share for the preferred stock and 1.5z dollars per share for the common stock. In order to do this he had to create a market for the stock by extensive advertising. The committee does not think, in view of this fact, that the fair market value of the preferred and common stock to the stockholders of the M company was in excess of 17z dollars per share for the preferred stock and 8z dollars per share for the common stock. Upon this basis the M company sold its assets for the cash equivalent of 30x dollars.

In arriving at the value of the appellant's assets on March 1, 1913, the Income Tax Unit has invoked the method which was employed in A. R. R. 252 (C. B. 3, p. 46); it has found the absolute amount paid by the purchaser for the intangibles by deducting from the selling price the book value of the tangibles plus 49x dollars, representing appreciation thereof to March 1, 1913, and then has divided the portion of the average earnings for the preceding five-year period properly allocable to the intangibles after first deducting from those earnings an 8 per cent return upon the average amount of tangibles (plus 0.49x dollars). In making this computation the unit has invoked A. R. M. 145 (C. B. I-1, p. 24), which holds, in effect, that an individual "in determining the earnings chargeable to good will in accordance with A. R. M. 34" (C. B. 2, p. 31) may not deduct Federal income taxes. It has therefore used as the earnings for the five-year period substantially the net income shown upon the corporate returns.

The committee is of the opinion that A. R. M. 145 is not applicable to a corporation. Corporation income and profits taxes were heavy during the war period, and corporation income taxes were also in existence during the pre-war period. In arriving at the investment return of shares of stock the income and profits taxes should be treated the same as other expenses.

The committee is of the opinion that the fair value of the appellant's assets as of March 1, 1913, should be computed upon the basis of a 7 per cent return upon tangibles and a 10 per cent return upon intangibles. This basis is arrived at after a careful study of the earnings of the corporation from the date of its organization in 1889. The average earnings after taxes of the appellant for the five-year period 1908 to 1912, inclusive, were 1.08x dollars. After allowing a 7 per cent return upon the average tangibles of the period, 0.38x dollars, the amount of the earnings allocable to the intangibles is 1.33x dollars, and the capitalization of these earnings upon a 10 per cent basis shows that the value of the intangibles as of March 1, 1913, was 13.27x dollars. The book value of the tangibles on July —, 1919, was 3.24x dollars and the appreciation to March 1, 1913, carried down to July —, 1919, per A-2 letter dated September —, 1922, was 0.49x dollars. The depreciated cost of the tangibles as of July —, 1919, was therefore 8.72x dollars, and the total cost or fair market value of tangibles and intangibles as of March 1, 1913, on the date of sale, was 21.99x dollars. The profit, therefore, realized by the appellant on the sale of its assets in 1919 is shown by the following:

	Dollars	Dollars
Sold for		30x
Book value of tangibles on July —, 1919	8.24x	
Appreciation to Mar. 1, 1913	.49x	
Good will Mar. 1, 1913	13.27x	
		22x
Net profit		8x

The committee recommends that the action of the Income Tax Unit in this case be modified as above indicated and that it be held that the appellant received a profit of 8x dollars upon the sale of its assets to the N company in 1919.

KINGMAN BREWSTER,
Chairman Committee on Appeals and Review.

[Cumulative Bulletin No. 3, July-December, 1920, p. 48]

SEC. 202, ART. 1561. Basis for determining gain or loss from sale. (34-20-1143, A. R. R. 252.)

Determining the value March 1, 1913, of shares of stock in the M company, owned by A.

The committee has had under consideration the appeal of A from the action of the Income Tax Unit in determining the value of certain shares of stock in the M company owned by him March 1, 1913, and sold in 1916.

The difference between the market value of property owned on March 1, 1913 (with, in some cases, proper adjustments for depreciation, etc.), and its selling price determines the profit or loss, as the case may be. In any case, therefore, of the sale subsequent to March 1, 1913, of assets owned on that date, it is necessary to determine the market value of those assets on that date.

The committee is of the opinion that the market value of shares of stock was what they would bring, and that the best evidence of what they would bring is what such shares did in fact bring when offered for sale about that time in a free and open market. However, in the present instance it is understood that there were no sales, and it is necessary to apply other tests, the market value in such case being deemed to be what a willing buyer might reasonably have been expected to pay or a willing seller to accept for the stock.

At the outset the committee desires it to be understood that in using the term "good will" it intends the term to be given not merely the narrow and technical meaning which has been attached to it in numerous court decisions, but to include as well the intangible value which always attached to a more than usually profitable enterprise by reason of its proven earning capacity. A prudent investor contemplating an investment usually takes into consideration primarily two factors—first, the safety of his capital, and, second, the return on it which he may reasonably expect. It is axiomatic that the greater the risk the less the price, and consequently he would be satisfied with a lower return upon an investment which is amply secured by tangible salable assets behind it than he would be from an investment made chiefly because of anticipated profits.

Applying the above principles to the case under consideration, we find that in 1916 all of the stock of the corporation in question was sold for the sum of 1,200x dollars. At the time of the sale the value of the tangible assets of the corporation as shown by the books was 610x dollars. There was paid therefore for the intangible asset referred to above as good will the sum of 590x dollars. Accepting the figures submitted by the taxpayer and the computation based thereon as correct, it appears that the average tangible assets for the period of three and one-third years prior to the sale was 586x dollars, and that the average annual net income for the same period was 112x dollars. In A. R. M. 34, approved by the commissioner, the rule has been laid down that in a hazardous business the investor should have at least 10 per cent upon his tangible assets, and that in a stable line a less return would be satisfactory. It could hardly be contended that in 1913 to 1916 the business of manufacturing automobiles, where the company was putting out a car of recognized merit, with a wide demand, the business was particularly hazardous, and the committee is therefore of the opinion that 8 per cent on the average tangible assets would be a fair return. This would absorb 46x dollars of the average yearly earnings of 112x dollars, leaving 66x dollars as the return upon the intangible assets.

Since it is shown above that the intangibles brought 590x dollars, it is apparent that they were sold on the basis of a prospective return judged by previous experience of a fraction over 11.1 per cent. Since the intangibles were actually sold in 1916 on this basis, the committee is of the opinion that it is only fair to apply the same percentage in ascertaining the value of the same intangibles three years previously. The average earnings of the corporation, covering approximately the five-year period immediately previous to March 1, 1913, were 30x dollars. During the same period the average tangible assets employed were 258x dollars. An 8 per cent return on the average tangible assets of 258x dollars required 20x dollars of this amount, leaving 10x dollars as the earnings attributable to good will at that time, which, capitalized upon the same basis of 11.13 per cent, gives a value of 92x dollars as the value of the good will on March 1, 1913. This, added to the book value of the tangible assets as of March 1, 1913, results in a total value of all of the assets of the corporations, and therefore all of its stock as of March 1, 1913, of 324x dollars. Deducting from this amount 50x dollars, the par value of its preferred stock issued, would leave 274x dollars as the value of the shares of common stock outstanding, or 1/10x dollars per share.

The taxpayer earnestly contends that the method indicated above should not be applied, but that the amount received for the good will in 1916 should be

treated as having ratably accrued over the entire period of existence of the corporation from its organization in 1901 to the date of sale.

The committee can not concede the validity of this contention. While the Supreme Court has held in the case of Hays *v.* Gauley Mountain Coal Copany, 247 U. S. 189, T. D. 2724, that in the absence of any better evidence and in the absence of objection, the prorating method might be resorted to in order to determine the value, in another and later case it held definitely that the value established as at March 1, 1913, must be accepted. While the argument of consistent and steady increase in growth might with some reason be advanced with respect to good will as defined by the courts. It has no bearing upon the determination of good will as broadly interpreted above by the committee, since it includes the intangible value of proven earning capacity, which, of course, may vary very widely. The brief of counsel for the taxpayer in a measure illustrates that this is the case, because it is contended that the value of the good will had been largely increased by the success of the company in 1910, 1911, and 1912.

The committee accordingly recommends that the tax be recomputed on the basis of the value as at March 1, 1913, 1/10x dollars provided that a verification of the figures and computations submitted shows them to be correct; otherwise upon a value computed along the line indicated herein, substituting corrected figures for those used.

(Exhibits submitted by Mr. Manson in case of Anne O. Haight, Perlman Rim Corporation, Standard Parts Co., and Western Wheel & Axle Co., are as follows:)

EXHIBIT A

(Read into record on page 3692.)

EXHIBIT B

THE STANDARD PARTS CO.,
Cleveland, September 19, 1922.

The COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

DEAR SIR: The purpose of this communication is to protest against the assessment of additional taxes as set forth in your letter of September 6, 1922, addressed to the Standard Parts Co. and its affiliated corporations, and to request an opportunity of conferring with officials of your office to facilitate immediate settlement of the issues involved.

The Standard Parts Co. is now in receivership and in urgent need of the tax which has been overpaid. Consequently we object at this time to only the major adjustments made by your office in computing the additional tax for 1917.

The adjustments to which specific objection is made are the following:

First. Failure to include as invested capital the preferred stock of the Bock Bearing Co.

Second. Elimination from invested capital of patents and good will paid for with cash and capital stock, viz:

(*a*)	Perlman Rim Corporation patent paid for with cash	$1,010,000.00
(*b*)	Perfection Spring Co. assets paid for with stock	1,142,997.68
(*c*)	Standard Welding Co. assets paid for with stock	767,614.90
(*d*)	Perfection Spring Co. assets paid for with cash	100,777.78
	Total	3,021,390.36

Third. Absence of adequate allowance for depreciation of patents.

PREFFERED STOCK—BOCK BEARING CO.—$450,000

It is obvious that the failure of your office to include as invested capital the preferred stock of the Bock Bearing Co. was an oversight. This stock was paid for with cash, and during the year 1917 was owned entirely by outside interests. It is presumed, therefore, that further comment upon this item is unnecessary.

PERLMAN PATENT

This item, which you office tentatively excluded from invested capital, represents a cash expenditure in the acquisition of certain rights under United States Patent No. 1052270, covering demountable rims. A copy of the license agreement, as well as a photostatic copy of the check issued in connection therewith, is attached. This expenditure, without question, constitutes a part of the invested capital of the Standard Parts Co.

ASSETS DESIGNATED "GOOD WILL" ACQUIRED FROM THE PERFECTION SPRING CO. AND THE STANDARD WELDING CO.

The amounts which your office has tentatively excluded from invested capital, although designated as "good will" upon the books of the Standard Parts Co., represented, as a matter of fact, tangible assets, principally the value of merchandise inventory acquired from the respective corporations.

During the period of negotiation for the purchase of these two corporations Coats & Burchard, public appraisers and engineers, of Chicago, were employed to appraise the physical property, consisting of buildings, machinery and equipment, inventories of materials, and purchase contracts.

The value of plant and equipment, as shown by the appraisal report, was entered on the books of the Standard Parts Co. This was not true, however, of the inventory valuation or the value of purchase contracts. The latter items, as appraised at current market prices, were as follows:

	The Perfection Spring Co.	The Standard Welding Co.
Merchandise inventory	$1,631,427.00	$2,966,000.00
Purchase contracts	2,149,300.00	2,700,000.00
Total	3,780,727.00	5,666,000.00

It was considered by the management of the Standard Parts Co. that it would be detrimental to the interests of the company and its stockholders to enter the current value of these assets on the books, for the reason that it would to a large extent minimize the first year's profits of the new company. While this decision may have been justified from a standpoint of conservative business, it has caused the corporation to show earnings for the year 1917 which had, as a matter of fact, accrued to the predecessor corporations in prior years, and in this manner the Standard Parts Co. has paid income and excess-profits taxes which were not properly due.

In opening its books the Standard Parts Co. substituted the following values for those computed by Coats & Burchard:

	The Perfection Spring Co.	The Standard Welding Co.
Inventory	$1,029,500.85	$1,695,534.71
Good will	1,243,775.46	767,614.00
	2,273,276.31	2,463,149.61
Appraised values	3,780,727.00	5,666,000.00
Value of assets not entered on books	1,507,450.69	3,202,850.39

In other words, the Standard Parts Co. acquired assets which had an actual value of $4,710,301.08 in excess of the par value of the stock issued therefor. This excess was not entered upon its books and to this extent the profits of the company were subsequently overstated.

It is very apparent from the evidence available at the date the assets were acquired that not only is the invested capital of the Standard Parts Co. grossly understated in its returns but that its profits as reported for the year 1917 were in excess of those earned and accrued in that year. Had the return for 1917 been prepared in conformity with the facts a paid-in surplus

of tangible property in the amount of $4,710,301.08 would have been included as invested capital and the opening inventory used in computing net income would have been decreased $1,872,391.43, thus reducing the earnings of the year 1917 in this amount.

With this explanation, and the fact that the Government has as a result of this procedure benefited by income and excess profits taxes on income overstated for the year 1917, there should be no question as to the inclusion of the "good will" items as invested capital.

In acquiring the Perfection Spring Co. it was agreed as part of the consideration of the purchase that the Standard Parts Co. would pay the premium necessary to retire the preferred stock. This premium was $10 a share, and with accrued interest amounted to $100,777.78. This amount was paid in cash by the Standard Parts Co. and properly constitutes a portion of the purchase price of the assets of the Perfection Spring Co. and is, without doubt, a part of its invested capital.

PATENT DEPRECIATION

The Standard Parts Co. has never received the benefit of losses sustained by reason of expiration of patents which is owned. The principal patents are the Perlman rim patent and the automatic welding patent, the aggregate cost of these being $1,413,243 in cash. These patents are of such character that their value will be totally lost when the period of protection expires, so that a proportionate part of the value is allocable to each year. This loss should be deducted in computing taxable income and the right to make such deduction should not be prejudiced by the fact that no deduction has been previously made.

Respectfully submitted.

THE STANDARD PARTS CO.
By P. A. CONNOLLY.

STATE OF OHIO,
County of Cuyahoga, ss:

P. A. Connolly, being first duly sworn, deposes and says that he is secretary of the Standard Parts Co., now in receivership; that he has read the foregoing statements and to the best of his knowledge and belief they are true and correct.

P. A. CONNOLLY.

LUCY A. O'NEIL,
Notary Public.

EXHIBIT C

CONSOLIDATED RETURNS SUBDIVISION—TAXPAYER'S CONFERENCE

Taxpayer: Standard Parts Co.
Address: Cleveland, Ohio.
Represented by Ernst & Ernst, Mr. J. J. Miller, Mr. W. H. Armat, Mr. W. E. Brunck, Mr. L. C. Weiss.

MATTER PRESENTED

The taxpayer filed a brief dated October 19, 1922, protesting against the proposed assessment of $81,148.16 for the years 1915 to 1919, inclusive.

It was contended that invested capital should be increased by the amount of $450,000 preferred stock of the Rock Bearing Co. outstanding, prorated from the date of acquisition and consolidation, May 31, 1917.

The matter was thoroughly discussed, reference being made to the adjustment shown on line 2 of Schedule D of the original return, for capital stock of the Standard Parts Co. issued at date of acquisition of the Bock Bearing Co., and to the analysis of surplus under Schedule E of the revenue agent's report.

It was shown that the adjustment on the return did not include the preferred stock of the Bock Bearing Co., and the addition to invested capital is, therefore, recommended.

Objection was made to the elimination from invested capital of patents and good will acquired with cash and capital stock.

The Perlman Rim Corporation patent was proven to have been purchased for $1,010,000 cash, as evidenced by photostat of the check issued in payment. While it was admitted that Mr. Perlman, immediately after the sale of the patents, purchased $1,000,000 worth of the Standard Parts Co. stock, we have no proof of an obligation or agreement on his part to do so, and his action was apparently entirely voluntary and based solely on his confidence and faith in the future prospects of the investment. It is recommended that the cash value of the Perlman patent, $1,010,000, be restored to invested capital.

Assets designated as good will on the corporation's books representing the excess of par value of stock issued by the Standard Parts Co. to the Perfection Spring Co. and to the Standard Welding Co. over the book value of assets acquired were shown to be tangible property, being merchandise inventories and purchase contracts, as evidenced by appraisals made by the Coats & Burchard Co. at the time of acquisition.

These values were improperly entered in the books as good will, due to the company's conservative policy in valuing its assets.

It was conceded, therefore, that the amounts of $1,142,997.68 and $767,614.90 should be restored to invested capital.

In acquiring the Perfection Spring Co. it was agreed as part of the consideration of the purchase price that the premium necessary to retire the preferred stock should be paid in cash. The premium of $100,777.78 therefor constitutes good will acquired for cash and should be restored to invested capital.

Request was made for the allowance of depreciation on the Perlman rim patent and the automatic welding patent, having an aggregate cost of $1,413,243 in cash.

It is recommended that depreciation be allowed on these patents upon evidence being submitted in affidavit form by the taxpayer as to the life of each of the patents.

Proper credentials were submitted by the taxpayer's representatives.

Interviewed by:

W. F. MEHRLICH,
Technical Staff.
F. P. SCHMEHL,
Audit Section A.
WM. P. BIRD.
Chief Consolidated Returns Subdivision.

OCTOBER 6, 1922.

EXHIBIT D

[Extract from travel auditor's report, January 25, 1923]

PERLMAN RIM CORPORATION, NEW YORK AND JACKSON, MICH.

HISTORY AND COMMENTS

The Perlman Rim Corporation was incorporated March 14, 1916, under the laws of the State of New York. The authorized capital stock consisted of 100,000 shares of no par value. Three thousand shares were designated as class A stock and only holders thereof were entitled to voting power in said corporation. The remaining 97,000 shares were known as common stock, and holders thereof had no voting power, but were entitled to all other rights and privileges enjoyed by the holders of class A stock.

On March 15, 1916, Louis H. Perlman offered to the corporation United States Letters Patents No. 1052270, dated February 4, 1913, covering improvements in wheels, and four pending applications based on original patent, together with improvements and substitutes subsequently made, including right or claim for profits or damages for past infringements, for $25,000 cash a year during life of patent No. 1052270 and the entire authorized issue of 100,000 shares of stock. The offer concludes with the proposal to donate back to the corporation 2,000 shares of class A and 62,000 shares of common stock.

The offer was accepted by the directors March 15, 1916, and the 100,000 shares were issued to Louis H. Perlman, and he immediately returned 2,000 shares of class A stock and 62,000 shares of common stock to the corporation. This left the outstanding stock at 36,000 shares.

On March 20, 1916, the directors accepted an offer from W. C. Durant and Louis G. Kaufman to purchase 2,000 shares class A stock and 18,000 shares of common stock for $1,000,000 cash, with an option to purchase the balance of 44,000 common shares in treasury at $50 a share. On April 17, 1916, the records show that Durant and Kaufman had purchased 2,000 shares of class A stock and 58,000 shares of common stock for $3,000,000 in cash.

In October, 1916, Mr. Christian Girl and A. H. Goss were given an option to purchase 2,000 shares each at $50 per share. However, this option was never exercised by either of the two mentioned parties.

March 20, 1916, the directors passed a resolution to set up patent rights at $1 and royalties receivable on account of patents owned at $1,999,999. This action was rescinded at a later meeting. The patent was valued on basis of the market value of shares sold to Durant and Kaufman, namely, $50 a share plus cash payments to be made yearly to Perlman during the life of the patent. Thus the patent was set up at $1,800,000, a sum equal to 36,000 shares of stock valued at $50 a share at time of issue. Also $345,833.34 was set up as of June 30, 1916, as liability to L. H. Perlman for nearly cash payments according to agreement above. This $345,833.34 was charged off to capital surplus on June 30, 1917. The reason for doing this is not clear, although the charge was authorized by the directors. It seems apparent that the directors felt that the patent was not worth $1,800,000 plus $345,833.34 at the time (September 25, 1917).

The United Motors Corporation started acquiring Perlman Rim Corporation's stock on or about June 2, 1916. By June 30, 1916, the United Motors Corporation had acquired 12,000 shares of Perlman Rim Corporation's capital stock, being 3,000 shares of class A voting stock and 10,000 shares of common stock. The exchange appears to have been made on the basis of two shares of United Motors Corporation's stock for one share of Perlman Rim Corporation's capital stock. The United Motors Corporation as of June 30, 1916, reserved 166,000 shares of its stock to acquire the remaining 83,000 shares of Perlman Rim Corporation's stock not acquired to said date.

From October 20, 1916, to July 1, 1917, the United Motors Corporation appears to have acquired an additional 81,637 shares of Perlman common stock, making its total holdings at close of June 30, 1917, 94,637 shares of the 96,000 then outstanding. An additional 60 shares of common stock were acquired by the parent company by October 5, 1917, making its total holdings 94,697, which amount was held by United Motors Corporation until dissolution of the Perlman Rim Corporation.

The Perlman Rim Corporation during fiscal year ended June 30, 1918, purchased 711 shares of its common stock, and 70 shares were purchased during July, 1918, and charged to surplus by the Jaxon Steel Products Division.

April 17, 1916, this corporation purchased the entire $100,000 capital stock of Jackson Rim Co. for $200,000 in cash. The latter company manufactured rims for the Perlman Rim Corporation at its plant at Jackson, Mich. As of February 8, 1917, the Jackson Rim Co. directors voted to transfer all assets and liabilities, excepting $5,000 in cash, to the Perlman Rim Corporation. The transaction was ratified by the Perlman Rim Corporation September 25, 1917, although the actual transfer was made as of June 30, 1917. The capital stock of the Jackson Rim Co. was reduced to $5,000 and the corporation became the selling agency of the Perlman Rim Corporation until June 30, 1918, when both corporations were dissolved.

Owing to difficulties with minority stockholders of the Perlman Rim Corporation, the United Motors Corporation on March 14, 1918, offered to purchase all assets and assume all liabilities of the Perlman Rim Corporation for $5,500,000 cash (for patents $1,800,000 and all other property $3,700,000). This offer was accepted by Perlman stockholders May 13, 1918, and steps for dissolution ordered. The Jaxon Steel Products Division of United Motors Corporation was organized as of July 1, 1918, taking over the net assets of Perlman Rim Corporation as they stood at the close of business June 30, 1918. The cash for purchase of Perlman net assets passed August 5, 1918, and was disbursed to the Perlman stockholders, the United Motors receiving $5,469,848.45 for its holdings of 94,697 shares, leaving $30,151.55 for the 522 shares held by minority. Seven hundrel and eighty-one shares were in treasury of Perlman Rim Corporation, 70 sharese having been purchased during July, 1918.

The original return of the Perlman Rim Corporation for the fiscal year ended June 30, 1917, includes the loss of the Jackson Rim Co. In this report the income of Perlman Rim Corporation has been set up separately as required

by the act of October 3, 1917. The loss sustained by the Perlman Rim Corporation upon partial liquidation of the Jackson Rim Co. is allowed for income-tax purposes but is not allowable in stating income of Perlman Rim Corporation subject to excess-profits tax, being an intercompany loss.

ROYALTIES AND CLAIM FOR DAMAGES CONNECTED WITH INFRINGEMENTS OF PATENTS

The sale of patent No. 1052270 to Perlman Rim Corporation on March 15, 1916, carried with it any claims Perlman may have had for damages arising out of past infringements. Litigation was in process on March 15, 1916, against the Standard Welding Co. for alleged infringement. A settlement appears to have been made with the Standard Parts Co., the successor to the Standard Welding Co., on December 6, 1916. The Perlman Rim Corporation accepted 10,000 shares of a par value of $1,000,000 in full settlement of past claims against the Standard Welding Co. However, these shares of Standard Parts Co. were never set up on the books of the Perlman Rim Corporation. Other suits were in prosecution against alleged infringers and were decided adversely against the Perlman Rim Corporation in 1917.

At any rate, it certainly can not be held that the Perlman Rim Corporation received any income upon the receipt of this Standard Parts Co. stock in 1916, even if its right to receive the stock as damages for infringement were unquestioned. It appears from the information which can now be gathered that the Standard Parts Co. stock merely was held as security pending outcome of the litigation now in process against other concerns involving the same question of infringement on patent No. 1052270.

The General Motors Corporation became the owner of this patent by purchase from United Motors Corporation on or about December 31, 1918. It returned the 10,000 shares of stock to the Standard Parts Co. in a deal in 1919, involving the sale of patent No. 1052270 to the Standard Parts Co. for a consideration equal to a sum representing the cost payments due to L. H. Perlman for the remaining life of the patent.

Haskins & Sells made the following statement in their audit report dated September 29, 1917:

"We are informed that 10,000 shares of common stock of the Standard Parts Co. are being held in escrow by Perlman Rim Corporation pending outcome of litigation in connection with patent rights."

The following were interviewed in connection with the examination:

Mr. C. A. Souther, tax expert of General Motors Corporation.
Mr. L. F. Bomhoff, treasurer of Jaxon Steel Products Co.
Mr. Rudesill, accountant of Jaxon Steel Products Co.
Mr. Lloyd Blackmore, patent expert General Motors Corporation.

W. A. PRIEGNITZ, *Auditor.*

NOVEMBER 17, 1922.

EXHIBIT E

Agreement made this 17th of November, 1919, between General Motors Corporation, a corporation organized under the laws of the State of Delaware, hereinafter called "General Motors" and the Standard Parts Co., a corporation of the State of Ohio, hereinafter referred to as the Standard Co., witnesseth:

Whereas under date of the 6th day of December, 1916, the Standard Co. entered into an agreement with the Perlman Rim Corporation, also a New York corporation, providing among other things for the granting of a license to the Standard Co. under the terms of Letters Patent of the United States No. 1052270, granted February 4, 1913, to Louis H. Perlman for an improvement in demountable wheels; and

Whereas under date of the 6th day of December, 1916, the Perlman Rim Corporation executed a general release to the Standard Welding Co., also a corporation of the State of Ohio, of and from any and all claims arising out of or connected with the past infringement by said Welding company of any and all patents covering demountable rims, and in particular of the aforesaid Letters Patent No. 1052270 in consideration of the sum of $1,010,000 procured by the Standard Welding Co. to be paid to the said Perlman Rim Corporation; and

Whereas on said December 6, 1916, and as part of the above consideration the Perlman Rim Corporation subscribed for 10,000 shares of the common capital stock of the Standard Parts Co. and paid therefor the said consideration received by it aforesaid, viz, $1,010,000, and there were subsequently issued to it certificates representing said 10,000 shares; and

Whereas Perlman Rim Corporation has been dissolved and its assets transferred to and its liabilities assumed by the General Motors Corporation, also a corporation of New York, including the said shares of stock and said license agreement; and

Whereas United States Motors Corporation was thereafter dissolved and its property taken over and liabilities assumed by General Motors Corporation, including the said 10,000 shares and the said license agreement; and

Whereas General Motors is now the owner of said 10,000 shares of the common capital stock of the Standard Parts Co. and is entitled to the benefits and bound by the obligations of said agreement dated the 6th day of December, 1916, made by the Perlman Rim Corporation and the Standard Parts Co.; and

Whereas under date of the 15th day of March, 1916, said Perlman Rim Corporation entered into an agreement with Louis H. Perlman wherein and whereby the said Perlman, among other things, agreed to sell to said Perlman Rim Corporation said Letters Patent No. 1052270, and the following applications for letters patent filed by said Louis H. Perlman:

Serial No. 701214 for improvements in demountable rim wheels, filed on June 7, 1912;

Serial No. 746078 for improvements in processes of applying pneumatic tires to demountable rims, filed on February 3, 1913;

Serial No. 483815 for improvements in wheels, filed on March 16, 1909; and

Serial No. 823764 for improvements in wheels filed on March 10, 1914;

together with any claim or claims for damages or profits incurred for the infringement of the aforesaid patent No. 1052270, in consideration of the payments to the said Perlman of 3,000 shares of the class A stock of the said Perlman Rim Corporation and 97,000 shares of the common stock of said corporation, together with the yearly sum of $25,000 payable in monthly installments on the 30th day of each and every month commencing on the 5th day of April, 1916, and continuing during the life of said patent No. 1052270; and

Whereas the said original agreement was modified by an agreement made on the 1st day of September, 1917, between Perlman Rim Corporation and the Standard Parts Co., which agreement was thereafter and on or about the 15th day of July, 1918, extended to cover the period from July 1, 1918, to January 1, 1919; and

Whereas under date of the 1st day of January, 1919, General Motors and the Standard Parts Co. entered into an agreement, among other things fixing the royalty to be paid by said licensee at 5 cents a set instead of 15½ per cent of the actual sale price, as in said original license agreement provided, and providing that except as modified by said agreement the original license agreement should remain unaffected, and on and after January 31, 1920, should be in full force and affect, according to its original tenor; and

Whereas it is desired by the parties hereto to cancel said agreement of license and to transfer said shares of stock to the Standard Parts Co. and said patent and patent applications upon the terms and conditions hereinafter mentioned;

Now, therefore, in consideration of the premises, the covenants herein contained and other valuable considerations, it is agreed by and between the parties hereto as follows;

ARTICLE 1. General Motors hereby sells and delivers and the Standard Parts hereby agrees to purchase and pay for the said United States patent No. 1052270, and the aforesaid applications for patents, or patents that may be subsequently issued thereon, and General Motors agrees to cause to be executed, from time, such assignments of said patent or patents and applications as may be necessary or proper to transfer to the Standard Parts Co. all of its right, title, and interest therein without, however, making any warranty in respect thereto, and reserving unto itself, and for the benefit of any corporation a majority of whose stock shall be owned by it, a license to make, use and vend articles embodying the said inventions or any of them, the same as if the said patents and applications therefor had not been assigned to the Standard Parts Co.

ART. 2. General Motors Corporation agrees to sell and transfer and the Standard Parts Co. agrees to purchase and pay for the said 10,000 shares of common capital stock of the Standard Parts Co.

ART. 3. The Standard Parts Co. further agrees to pay General Motors Corporation for the foregoing the sum of $256,250, in equal monthly installments of $2,083.33, commencing on the 25th day of November, 1919, and continuing until the said sum shall be paid in full.

ART. 4. The parties hereto hereby agree to cancel, as of the date hereof, the said license agreement dated the 6th day of December, 1916, entered into between Perlman Rim Corporation and the Standard Parts Co., and each party hereto hereby mutually releases and discharges the other from any and all claims, causes of action, rights of action, or claims to or in respect of dividends on said 10,000 shares of stock or damages at law or rights in equity, in respect of said agreement or shares, or any obligation arising out of or connected therewith, including any right or claim enuring to the parties hereto in their own right or in the title of the said Perlman Rim Corporation or the United Motors Corporation or the said Welding Co., as the successor or successors thereof, or to the rights and liabilities formerly belonging to said corporations or any of them, except as in this agreement expressly provided.

ART. 5. This agreement shall bind and inure to the benefit of the parties thereto and assigns.

In witness whereof the parties hereto have caused these presents to be executed and their corporate seals to be hereunto affixed the day and year first above written.

GENERAL MOTORS CORPORATION,
By ALFRED SLOAN, *Vice President.*

Attest:

WILLIAM M. SWEET,
Assistant Secretary.

THE STANDARD PARTS CO.,
By CHRISTIAN GIRL, *President.*

Attest:

P. A. CONNOLLY, *Secretary.*

EXHIBIT F

COPY OF PHOTOSTAT

No. ——

(Front):

THE GUARDIAN SAVINGS & TRUST CO.,
GUARDIAN BUILDING, 322 EUCLID AVENUE,
Cleveland, Ohio, December 6, 1916.

Pay to the order of Perlman Rim Corporation one million and ten thousand and no one-hundredths dollars ($1,010,000.00).

THE STANDARD PARTS CO.,
By BENJ. A. GAGE, *President.*

(Back):

Pay to the order of the Guardian Savings Trust Co.

THE PERLMAN RIM CORPORATION.
By L. H. PERLMAN, *President.*

EXHIBIT G

LICENSE AGREEMENT

This agreement made and entered into this —— day of November, 1916, by and between Perlman Rim Corporation, a corporation duly organized and existing under and by virtue of the laws of the State of New York, and having its principal place of business at New York, in the County of New York, and State of New York, hereinafter referred to as the party of the first part, and the Standard Parts Co., a corporation duly organized and existing under and by virtue of the laws of the State of Ohio, and having its principal place of

business at Cleveland, in the county of Cuyahoga, and State of Ohio, hereinafter referred to as the party of the second part; Witnesseth that

Whereas the party of the first part is the sole and exclusive owner of Letters Patent of the United States No. 1052270, granted February 4, 1913, to Louis H. Perlman, for improvement in automobile wheels; and

Whereas the party of the second part is desirous of manufacturing, using, and selling articles falling within the scope of said letters patent;

Now, therefore, for and in consideration of the sum of $1 by each party to the other party paid and of other good and valuable considerations from each party to the other party moving (including the mutual agreements hereinafter contained) the receipt whereof is hereby acknowledged, the parties hereto have agreed and do hereby agree as follows:

1. The party of the first part hereby grants unto the party of the second part a license under said Letters Patent No. 1052270 to manufacture and use throughout the United States and the territories thereof, and to sell to others to use to the full end of thte terms of said letters patent, all articles covered by said letters patent, it being however specifically understtod and agreed that this license and all rights and privileges thereunder are nonassignable except to the successors of substantially the entire demountable rim business of the party of the second part.

2. This license is to be known as license No. 1 and the party of the first part agrees to grant no nother license bearing the same number, and also agrees not to grant any license to anyone providing any more favorable terms and conditions than granted to the party of the second part; and, if in the case a license is granted to any other party more favorable than this license, then the same privileges as exist in any such other license granted shall become operative in this license.

3. The party of the first part also agrees to grant unto the party of the second part a license to manufacture, sell, and use any and all articles falling within the scope of letters patent of the United States, relating to demountable rims or rim constructions now owned or subsequently acquired or controlled by the party of the first part; such license, in each instance, however, being subject to the restriction that it shall be nonassignable, as also all rights and privileges thereunder, except as above provided.

4. The party of the second part hereby grants to the party of the first part, without additional consideration, the perpetual license to make, use, and sell, all articles falling within the scope of all patents relating to demountable rims and rim constructions, which the second party may hereafter acquire or control, subject, however, to the restrictions that all such licenses shall be nonassignable, as also all rights and privileges thereunder, except as indicated in article 1 hereof, i. e., to the successors of the business, of the party of the first part. Patents now owned or controlled by the party of the second part shall not be included in this license agreement and the party of the first part shall have no rights under the patents now owned or controlled by the party of the second part.

5. The party of the first part shall, from time to time, give to the party of the second part notice in writing as to the prices at which it is selling articles under said patent No. 1052270, and it is an expressed condition of this license that articles sold hereunder by the party of the second part shall not be sold at prices less than those at which the party of the first part, is, at the time, selling similar articles. The party of the first party guarantees that its prices shall be not less than 30 per cent above the cost to it of manufacturing and selling the same. Nothing herein shall be construed to prevent the party of the second part from selling at prices higher than those of the party of the first part.

6. The party of the first part agrees to promptly from time to time, on the request of the party of the second part, specify prices with reference to types or sizes of rims or parts, under this license which it, the party of the second part, desires to make and sell.

The party of the second part, shall be entitled to 30 days written notice of any and all changes in prices.

No action of the party of the first part in the matter of prices shall prevent the party of the second part from fulfilling without change contracts which may be made for 18 months or less.

7. The party of the second part agrees to pay unto the party of the first part, a sum equal to 15½ per cent of the actual sale price of all articles sold by it covered by the license hereby granted under said Letters Patent No.

1052270, throughout the life of said patent, or of any other demountable rim patents owned by the party of the first part, which may be covered by this license, but it is expressly understood and agreed that the party of the second part shall not pay for any one article a sum in excess of an amount equal to 15 per cent of the actual sale price thereof, and it is expressly understood and agreed that the 15½ per cent shall be calculated upon the amounts of invoices; and it is further understood and agreed that in the event that said Letters Patent No. 1052270, shall be declared invalid by the Supreme Court of the United States, the obligation of the party of the second part to any royalties thereafter accuring shall cease and determine.

8. When the regular annual statement of the party of the second part is prepared, it is mutually understood and agreed that a contraaccount shall be entered against the part of the first part for 15½ per cent of the bad accounts of the preceding year, and also 15½ per cent of the discounts taken by customers allowed for cash payments, which discounts shall not in any case exceed 2 per cent. The party of the second part agrees to pay to the party of the first part 15½ per cent of all collections from such bad accounts whenever received.

9. The license hereby granted by the party of the first part to the party of the second part is, until January 1, 1920, exclusive for the serving by the party of the second part of the following concerns; viz, Willys-Overland Co., Dodge Bros., and all manufacturers of automobiles and all other users of rims and rim parts having their principal place of business in Cleveland, county of Cuyahoga, and State of Ohio; but no license whatever is hereby granted to the party of the second part to sell up to January 1, 1920, to the following concerns; viz, makers of the Studebaker, Chalmers, Hudson, Monroe, Dort, Briscoe, Chevrolet cars, and to such makes of cars as are now controlled by The General Motors Co. Each party is free to accept business from the makers of all other cars no matter where such makers are located excepting those named in this paragraph. On and after January 1, 1920, the license herein granted by the party of the first part to the party of the second part shall extend to all territory but be nonexclusive.

10. The party of the second part agrees not to make any demountable rims or demountable rim constructions, except such as fall within the scope of United States Letters Patent No. 1052270, without the written consent of the party of the first part, and shall give all moral support (but not financial) to the protection of the patents owned or controlled by the party of the first part, and the party of the second part shall do nothing to avoid the spirit of this license agreement, which is to make and sell rims under the patents of the party of the first part and under the patents of the party of the second part.

11. The party of the second part agrees to give all moral support (but not financial) to the upholding of the patents of the party of the first part, under which the party of the second part shall be licensed.

12. Each of the parties hereto agrees to submit to the other for its information only, each new form of rim or rim construction which it may from time to time propose to market.

13. The party of the first part agrees at its own expense to use all reasonable and diligent endeavors to prevent and enjoin infringement by makers of rims and rim constructions of United States Letters Patent No. 1072270, and of all other patents owned or controlled by the party of the first part, and upon request of the party of the second part, in writing, the party of the first part agrees to bring legal action under said Letters Patent No. 1052270, against any rim manufacturers, or agent, or customer of his rim product, when said manufacturer is producing more than 25,000 sets of demountable rims per annum in infringement of said Letters Patent No. 1052270.

14. The party of the second part agrees to apply to all tire rims and felly bands licensed hereunder due notice of patent No. 1052270, by stamping thereon these words: patented February 4, 1913. Perlman patent manufactured by Standard Parts; and to display conspicuously on the outer face of all wedges the word Perlman.

15. The party of the second part agrees to render monthly statements to the party of the first part, showing all licensed articles shipped or invoiced during the preceding month, each statement running from the first of one month to the first of the next succeeding month, and to be furnished not later than the last day of the succeeding month, and payment of all accrued royalty as indicated by such statement to be made not later than the day of said succeeding month.

Each of said statements shall include the names of purchasers, the dates of shipping, and the amounts of invoices.

16. The party of the second part agrees to furnish to the party of the first part a statement on the 1st day of February and the 1st of August of each year showing the quantity of all articles manufactured during the six months preceding the first of the previous month, under the license of the party of the first part.

17. The party of the second part also agrees that the party of the first part shall have access to its books, referring to the manufacture and sale of Perlman demountable rims, at all reasonable times for purposes of inspection and for checking back the item of statements rendered, such inspection to be made at the expense of the party of the first part.

18. All license herein granted or provided for shall expire on February 3, 1930, unless otherwise agreed between the parties hereto.

PERLMAN RIM CORPORATION,
Per ——— ———,
President.
THE STANDARD PARTS CO.,
Per ——— ———,
President.

EXHIBIT H

RECOMMENDATION NO. 6617—COMMITTEE ON APPEALS AND REVIEW

In re appeal of United Motors Corporation and affiliated companies, 33 West Forty-second Street (removed to 1764 Broadway) New York, N. Y., fiscal year ended June 30, 1917.

Mr. COMMISSIONER:

(For deputy Commissioner, Head, Income Tax Unit.)

The committee has considered the appeal of the United Motors Corporation from the action of the Income Tax Unit in the proposed assessment of additional taxes for the fiscal year ended June 30, 1917.

After careful consideration of the evidence of record, as well as that presented at oral hearing on September 19, 1923, the committee finds:

(1) That the value of the assets acquired with 942,160 shares of no par stock was at date of acquisition $51,818,800.

(2) That the value of organization services, an intangible asset, was at date of acquisition $55,000.

(3) That the 20 per cent limitation for intangible assets should be based upon the market value of the no par value stock outstanding March 3, 1917 as at the date or dates of issue as claimed by the appellant.

(4) That the tentative valuation of the good will of each of the corporations involved in this appeal should be computed in accordance with A. R. M. 34, C. B. 2, page 31, based upon the earnings of each corporation for the three years next preceding June 30, 1916.

(5) That in the tentative computation of the value of good will it was proper for the unit to consider the average tangible assets for each of the three years.

(6) That in the tentative computation of the value of good will the unit should accept the appellant's contention that 8 per cent represents a fair return on the tangible property of each of the companies and that the earnings applicable to good will should be capitalized upon the basis of a 15 per cent return.

(7) That in the computation of the tentative value of good will the Unit should first deduct from the average earnings of each company the earnings applicable to patents as determined by the appellant in its tentative valuation of the patents, then deduct an amount equal to 8 per cent of the average tangible assets and multiply the remaining earnings by $6\frac{2}{3}$ to arrive at the tentative value of good will.

(8) That for the purpose of computing depreciation the Perlman Rim patent should be valued at $2,330,000 (value at date acquired by the Perlman Rim Corporation), and that for the purpose of computing the consolidated invested capital the Perlman Rim patent should be valued at $7,792,653.86.

(9) That for the purpose of computing consolidated invested capital the difference between the total value of the assets, $51,818,890, acquired with 942,160 shares of stock, and the sum of the value placed upon the tangible assets and the value placed upon the intangible assets (including patents and organization expense), as above set forth, should be added to or subtracted from the value of the good will and the patents (not including the Perlman Rim patent), allocation to be based upon the percentage that the tentative valuation of the patents (not including the Perlman patent), and the tentative valuation of the good will bears to the total tentative valuation of both the good will and the patents other than the Perlman patent.

(10) That the depreciation of both tangible assets and patents must be computed upon the basis of cost to the subsidiary companies without regard to the amount paid by the parent company for stock in the subsidiary companies.

(11) That the rates of depreciation used by the unit in the last audit made of the appellant's returns are fair to the taxpayers and to the Government and therefore should not be changed.

(12) That for the taxable year involved no depreciation should be allowed on patents other than the Perlman Rim patent, as the appellants exercised an option in not claiming depreciation in their original returns and in not charging same off on their books.

(13) That that part of the distribution made during the taxable year by the Hyatt Roller Bearing Co. and the Remy Electric Co. to the United Motors Corporation out of earnings accrued since March 1, 1913, should for tax purposes be considered a dividend and taxed at either 2 per cent or 1 per cent (not 4 per cent), depending upon the years in which the earnings distributed were accumulated by the corporations.

(14) That the appellant admits that the result of the surplus reserve computations arrived at and set forth in the unit's memorandum is the same as the results of its computations arrived at by a different method.

(15) That the contribution made by the Perlman Rim Corporation in the amount of $25 to the Switchman's Union is not deductible in the computation taxable income.

(16) That with reference to other minor adjustments referred to in the unit's memorandum to the committee, the appellant states in last brief submitted "the committee need not be burdened."

KINGMAN BREWSTER,
Chairman Committee on Appeals and Review.

Approved.

D. H. BLAIR,
Commissioner of Internal Revenue.

Mr. MANSON. I would call the attention of the committee at this time to what I believe to be true, and if it is not true I want to be corrected.

I find nothing in any published ruling of the bureau which even indicates that where a corporation is on the upgrade—in other words, we will take the case of a corporation that starts in in 1908 with a net income attributable to good will of $50,000, and that net income attributable to good will increases regularly every year at about $50,000 a year until it reaches $500,000 in 1917—I can find nothing in any published ruling of the bureau which even indicates that upward trend shall be considered, or will be considered, in determining the value of good will as, we will say, in 1913, although there is a consistent history both before and after 1913 of an upward trend.

Senator JONES of New Mexico. Let me ask this question, Mr. Manson: Take an article that is newly discovered or newly manufactured. There may be no patent in connection with it at all, but gradually there arises a greater demand for it. People through some means find out that there is such an article. Take an ordinary tool, for instance, and the demand for it increases. Of course, that

increases the profit. According to that system is that increased profit attributable to good will?

Mr. MANSON. According to the method of valuing that increased profit is attributable to good will.

Senator KING. And they capitalize that?

Mr. MANSON. And that is capitalized for the purpose of determining value. Here is one of the best illustrations I know of of that very thing. In one case the use of automobiles is involved and in another case the use of aluminum for kitchen utensils. There are any number of concerns that are engaged in the manufacture of aluminum kitchen utensils. They have become very popular. The growth of that business has developed tremendously in the last few years. There it is due to an appreciation—a gradual growth of appreciation—upon the part of the public of the usefulness and advantage of that sort of thing.

Senator KING. Would they capitalize that, and would they capitalize the aluminum companies which have a monopoly upon the production of raw material; that is, the material which goes into the finished product, because its sales are increasing every year owing to the greater demand for aluminum utensils for household purposes?

Mr. MANSON. Oh, yes. The point is this, that the purchaser of any industry or any stock does not buy the past. He looks to the past, it is true, for the purpose of getting such information as may be useful to him in order to predict the future; but when any man invests in an industry or invests in stock what he buys is the hope of profit in the future, and he can only look to the past for the purpose of judging what he may expect in the future.

In other words, there is no doubt in my mind but that any individual will pay more for the good will of a concern which shows a consistent history of growth and a consistent history of increased profit than he will for stock in a concern which may have exactly the same average earnings over the past but whose average earnings are decreasing.

It may be true that the bureau considers the trend of a business in arriving at the valuation of its good will; but I can find nothing in any publication of the bureau which bears out the theory that they do consider the trend of a business in determining the value of its good will.

That is one thing.

Here is another criticism I have of what appears from the publications of the bureau to be a policy of accepting the rate of earnings, we will say, in 1919, as a standard for judging the 1913 value.

In other words the Dodge Co. was sold recently and its securities were put on the market. We will assume that the public invested in those securities on a basis that would give the purchaser a 6 per cent return on his money.

I do not know, of course, what the bureau will do with that case, and I just use it as an illustration; but in arriving at the 1913 value, if that same basis is considered as is used for the purpose of capitalizing the earnings prior to 1913, it will leave out of consideration entirely the fact that the value of money changes.

In other words, in 1918 or 1919, with all of the governments of the world competing with each other in the market for money; with bond rates high, and with other rates upon loans high, an investor

would naturally expect a higher return in investing in stock than he would expect, for instance, in 1913, when you had an entirely different kind of condition in the money market. Anybody who has ever followed the money market must necessarily know that when interest rates are high for one purpose, it boosts interest rates for all purposes, and it boosts investment rates as well; and I can find nothing in any publication of the bureau which indicates that that factor is considered.

I believe that the trend of a business, upward or downward, and the value of money as about the time of the sale of that business, are the two most important factors that have to be considered in arriving at any just valuation; and, at least so far as the publications of the bureau are concerned, there is nothing to indicate that either one of those factors is considered, and there is nothing to indicate that the rate of return which an investor would ordinarily expect in a given line of industry has been arrived at by the preperation of any statistical data whatever.

Senator KING. Before you go into that, I would like to ask one question. I may not understand this; in fact, I do not, and I would like to ask one of these gentlemen representing the department.

Take the case where a corporation was organized and was a going concern in 1913. It had good will, and you capitalized that, say, for $500,000, and that bears a reasonable ratio to the invested capital. and you allow a very high depreciation. Do you allow depreciation not only upon the tangible, but upon that intangible capital?

Mr. MOSS. No, sir; good will does not depreciate.

Mr. MANSON. Unless it is a patent?

Mr. MILLKEN. Well, if it is a patent, it will merge into good will; but if you have a patent, you have a definite known value there and we, of course, allow that.

Mr. MANSON. Suppose you are valuing a patent? In a case where the profits of a business are used as a basis for valuing the physical property; that is, if the property is depletable, it always enters into the depletion allowance, does it not?

Mr. MILLIKEN. Yes. If you have a brick building, and that is a tangible unit, of course, you usually have the cost somewhere, or you have the reproduction value, or you have some basis of arriving at what that building is worth at that time, and that age, and that type of construction, and you know what the depreciation rate should be.

Mr. MANSON. Have you ever ascertained the value in case of a brick building on the basis of earnings?

Mr. MILLIKEN. I do not know whether it has ever been done.

Mr. STRADER. I do not know of a case where it has ever been done.

Mr. GREGG. I think what Mr. Manson had in mind was a mining property.

Mr. MANSON. Yes; that is it.

Mr. GREGG. Of course, we have always taken the position that a mining company has no good will.

Mr. MANSON. The reason for it is that all of the earnings are capitalized as a part of the value of the physical property.

The CHAIRMAN. So they do get good will, if it is a profitable property, through efficient management?

Mr. MANSON. Yes.

Mr. GREGG. I do not think that is properly good will.

The CHAIRMAN. Well, it has the same result.

Mr. MANSON. It is depleted by every ton of ore taken out.

Mr. GREGG. Certainly.

Senator KING. Then, as a matter of fact, you allow depreciation in one form or the other, in depletion, or what not, upon good will in the case of mining companies?

Mr. GREGG. Well, if you say a mining company has good will, yes. I do not think a mining company has good will. In other words, we value the property of a mining company on the basis of an appraisal, which takes into consideration the earnings of the company.

Senator KING. Take a case like this; I want to get this clear in my own mind. It may be infantile to you wise men here.

Suppose Senator Jones goes to Chicago and establishes a big department store, something like Marshall Field. He has a lot of capital, and his friends go with him. They established a corporation last year, and they do just as much business for the year 1925 as Marshall Field. They sell, say, $50,000,000 worth of goods, and their net profits are $10,000,000. Their capital, just for illustration, is $50,000,000 in cash, which they have put in. Marshall Field has assets of just the same character and of the same quality and kind as Senator Jones, but you have been allowing them, as I understand it, for good will, prior to 1913, and right along since, a large sum, because their earnings were very large, and you have capitalized their good will. Marshall Field had a good name and a good reputation.

What do you allow them as deductions or as capital for good will which would diminish their tax, so that they would have to pay less than Senator Jones's company?

Mr. GREGG. You see, the Marshall Field Co. would not get any depreciation of their good will.

Senator KING. But you would allow them something on their capital?

Mr. GREGG. If they acquired a going business in 1916, assuming that Marshall Field was reorganized in 1916, a new corporation was organized to take over all of the properties, including all of the intangibles, we would then allow them something.

Senator KING. But suppose they are just the same now as they were in 1912 or 1913, and that they have just the same kind of assets as Senator Jones's company, which was formed last year, has, and the profits this year are just the same; that is, $10,000,000. What are you going to allow them that you do not allow Senator Jones's company, so that their tax would be less?

Mr. GREGG. Nothing.

Senator KING. I think there is some misunderstanding here.

Mr. STRADER. This question comes up where stock is sold and we have to determine a profit, and where a business is sold.

Mr. MANSON. It comes up in connection with invested capital also?

Mr. STRADER. Yes. Now, if Marshall Field was selling it, and we will assume that they were incorporated before 1913, we would have to go back and determine the value at March 1, 1913, for the good

will. We would know what they got for it, and the difference would be their profit. So far as affecting their annual income for intervening years is concerned, it does not affect it.

Mr. MANSON. For instance, the Dodge Co. has just sold out. The holders of that stock would pay a tax on the increase in value since 1913. In that case you would know what they got for it, if it became necessary to take the value as of March 1, 1913.

Senator KING. Do you not capitalize all intangibles for a business which is being conducted now? Do you not do that?

Mr. MILLIKEN. No, sir.

Senator KING. All right.

Mr. MILLIKEN. As to depreciation being allowed on intangibles, there is no depreciation, as I understand it, that is allowed on intangibles as such.

Senator KING. My latter question did not involve a question of depreciation. It involved a question of what you would permit as deductions from taxation by virtue of intangibles being capitalized.

Mr. MILLIKEN. Well, of course, you have the only deduction that I would say they would get. That would be in the excess-profits tax years, when you have the computation of invested capital. You know, technically, invested capital is subject to several limitations provided in the act of 20 and 25 per cent, under requirements to show that that good will has actually been purchased for its value, and the good will was worth the stock issued for it; but in any income-tax situation, as I understand it, you never get a depreciation of good will as such. You may get a benefit through invested capital, but this year, when invested capital is out of the picture, I do not see where it takes place, one way or the other.

Mr. GREGG. You see, we have only had to value intangibles for two purposes. The first, take a patent—depreciable property—we have to value them as of March 1, 1913, for purposes of depreciation. That is in the statute.

Senator KING. Yes.

Mr. GREGG. Where there was a reorganization or acquisition of property, we had to value the intangibles, when taken over for purposes of invested capital, but that is the only time that we ever had to value good will. It had no effect whatever on current returns.

Mr. MILLIKEN. The only deduction that Marshall Field would get from income through those years would be to take their fixed assets. They have a building that is subject to a depreciation rate of 2 per cent. They have fixtures and furniture subject to a rate of 10 per cent. They get their inventory, and their inventory then affects their income, of course, and they have certain unmerchantable goods on hand at the end of the year that affect income, and many other factors affecting their income.

Mr. GREGG. But they have no deduction for depreciation of good will?

Mr. MILLIKEN. No.

Senator JONES of New Mexico. Would it be of value in related transactions, such as we were discussing awhile ago, about that rim corporation, to require each field agent to report whether or not he has examined the related transaction?

Mr. NASH. It should be a part of his report. That is already required, Senator.

Senator JONES of New Mexico. And should not some one be designated to follow up the examination where it appears that they have not been examined?

Mr. NASH. There is a review of that report in the office of the agent in charge, and another review in Washington after it was received. This appears to be a faulty examination.

Senator JONES of New Mexico. Yes; I was just going to remark that in this case it does not appear from this report whether he did follow up the related transaction or not.

Mr. NASH. Yes, sir.

Senator JONES of New Mexico. And should they not be required, in each instance, to report whether it has been followed up, so that if it is not then someone else may be designated to do that?

Mr. NASH. Yes, sir; that is part of the examination procedure. An agent is required to follow up a transaction of that sort and check it from the other end, and comment on it in his report.

The CHAIRMAN. There is another fact in there that I think neither Senator Jones nor you, Mr. Nash, has referred to, and that is the question of the other stockholders who sold out this concern and received stock in return of the Standard Parts Co. They had made no report, according to the records, and had paid on no profit, like this woman was required to pay on a profit. It seems to me that nothing has been developed here to indicate that there is any method in the bureau by which that may be caught.

Mr. NASH. I did not understand from Mr. Manson's reading of the report that their had been other transactions, similar to the exchange of stock in the Haight case. He mentioned two names, and I was trying to find out whether there were any similar transactions, and I did not catch it.

Mr. MANSON. Well, you see, all the stock——

The CHAIRMAN. Of the concern was sold.

Mr. MANSON. Yes; and these two concerns were consolidated.

Mr. NASH. Yes, sir.

Mr. MANSON. All of the stock of this original company was taken over by the stockholders of the new company. In other words, the stock of the new company was exchanged for stock of the old company.

Mr. NASH. It gets back to the fact that the agent, when he checked up on the Haight case, ought to have reported on the other case.

Senator JONES of New Mexico. Should not something appear in the report as to whether or not he did follow it?

Mr. NASH. Yes, indeed; Senator. He is required to do it.

Senator JONES of New Mexico. Why was not this report sent back, then?

Mr. NASH. It appears to have been a faulty investigation, and apparently it was not properly reviewed.

Mr. MANSON. The fact of the matter is this, that the last transaction that took place in this case took place in 1919, when the General Motors Co. had this contract with the Standard Parts Co. All of the facts which I have presented to the committee here were contained in the files of the Income Tax Unit here in Washington at

the time that the audit of the Standard Parts Co. case was made in 1922. Even if the field agents had overlooked this it strikes me that the auditors, when they passed on the Standard Parts Co. case, should have called for the file in the Perlman Rim Co. case, and have determined what disposition had been made of this $1,010,000 in the Perlman Rim Co. case. In other words, we have not any information here that is not in the files of the bureau, and which was not in the files of the bureau.

Senator JONES of New Mexico. As I understand it, Mr. Nash, this is a case where, in the reviewing division down here, or in the auditing division, or what not, it was faultily handled?

Mr. MANSON. Yes.

Senator KING. It occurs to me to inquire whether there is any requirement of corporations, through your regulations or otherwise, that when consolidations are effected and exchanges of stock result, the secretaries of the merging companies are required to advise the department of that fact?

Mr. GREGG. These transactions have not been taxable since 1921, Senator.

Senator KING. No; but take old corporations now, that are consolidated.

Mr. GREGG. They are not taxable now.

Mr. MANSON. No; but if you sell that stock now——

Senator KING. Where there is an exchange of stock, which amounts to a sale, they are not taxable now?

Mr. GREGG. No.

Mr. MANSON. No; but if you sell that stock now, it is necessary to ascertain the value of the stock that was exchanged for the stock that is now being sold.

Mr. GREGG. The cost of it, but not the value, the March 1, 1913, value.

Mr. MANSON. The March 1, 1913, value. When that value has been ascertained, we will say that John Jones sells some of that stock this year. You go back and ascertain the March 1 value for the purpose of determining John Jones's tax. Next year, or the year thereafter, Phil Smith may sell some of the stock, which was also obtained in that same transfer; that is, at the same time. It strikes me that it is important that when you have determined the value of the Standard Parts Co. stock of March 1, 1913, that determination ought to apply to all of the stockholders in that concern who acquired the stock in transfer, no matter when they may sell their holdings. In other words, it is more important now than it was before the tax was levied, when the exchange was made, and all of the stockholders who made an exchange received their stock within the same tax year. I may be assessed upon that stock this year, and Senator King, who got some of it, may be assessed on it next year, and so on. Therefore it strikes me as more important to see that some sort of a proper record be kept of those determinations. Of course, I know that they are kept in the files of the case, but that might as well be buried in the cemetery.

Mr. MILLIKEN. There is one type of case that always comes to the bureau's attention where we find out all about it, and that is if we

increase the value of the stock of one stockholder over that of another stockholder.

The CHAIRMAN. But they may not know that it has been decided in the case of another stockholder.

Mr. MILLIKEN. They always find it out if the par value is higher.

The CHAIRMAN. I would like to put this sort of a case up to the officials here:

Assuming that one stockholder of a corporation buys out all of the other stockholders, and there are, say, six stockholders, each owning, say, 10 per cent of the stock. They all receive the same price for their stock, and one of the individuals who sells out, in making his returns, divides the receipt of that money received for that 10 per cent of the stock among all of his family, and returns are made on that basis, which, in effect, brings it away down toward the bottom instead of up to the top of the surtax bracket.

Is there any way in which the bureau would catch a thing of that sort?

Mr. GREGG. Yes, sir; through a field examination.

The CHAIRMAN. Has that always been brought out?

Mr. GREGG. It has been brought out in the case that the Senator has in mind; yes, sir.

The CHAIRMAN. But it was not caught at the time?

Mr. GREGG. No; it was not.

The CHAIRMAN. Why not?

Mr. GREGG. I do not know. I can not understand why it was not done.

The CHAIRMAN. It was an error in the bureau, was it not?

Mr. GREGG. Probably it was, that it was not caught originally.

Mr. MILLIKEN. It appears also in the case that I have in mind that the person who sold that stock represented that his family had a prior deed to this stock before its sale and that he then in turn was not acting for himself at the time of its sale, but was acting as an agent.

The CHAIRMAN. But the records of the corporation would show the ownership of the stock.

Mr. GREGG. Of course that is not controlling.

The CHAIRMAN. No; but how would the field agent have caught this, in the first place?

Mr. NASH. He would have to check the transfer from the records of the corporation and follow it down through the individuals involved.

The CHAIRMAN. You say the records of the corporation would control. This is an individual transaction, not a corporate transaction. It is an individual stockholder who buys, and not a corporation. How would you find out what that individual paid for that stock? How would you get anything from him to show that? There is nothing in the returns to show that.

Mr. GREGG. I do not quite understand your question.

The CHAIRMAN. I say, supposing it was an individual who bought the stock, there is nothing in the requirements of the bureau that makes him report that purchase?

Mr. GREGG. No, sir.

The CHAIRMAN. Nor to whom he paid the purchase price of the stock?

Mr. GREGG. We have to get that information from the one to whom he sold and check it with his return. Of course, if on his return he does not make any disclosure, it may be difficult for us to get it.

The CHAIRMAN. Well, if the seller's report is divided as between five or six, instead of receiving it all himself, how would you catch that if he fixes his record all right? How would you catch a case like that?

Mr. NASH. We catch a great many of those cases from an examination of the stock books of the corporation and a checking up of the documentary stamp tax. When we check those taxes on transfers of stock we discover many leads on such transactions as we are discussing.

Mr. MILLIKEN. You might also get it from the corporation on a distribution of dividends, showing to whom they distribute the dividends.

Mr. MOSS. May I inquire to see whether or not I understood Mr. Manson's purpose of introducing this case to-day?

Mr. Manson's idea, I believe, is that where a value has been placed on certain stock there should be in the Income Tax Unit some other record, not incidental to some particular record, where the value of that particular stock can be kept and found, not depending on an incidental inquiry for some other purpose, but that that stock shall stand there with that value, and that when other taxpayers file returns with a similar stock involved somebody down there must go right at once and find out about that.

Mr. MANSON. Yes. That is it exactly. Suppose you had a card index——

Mr. MOSS. I wanted to make that clear, because it is very important. I do not know what exists now.

The CHAIRMAN. That also applies to oil wells. When there is a sale of an oil well it appears that there is no check back to find out that thing, and that has resulted in several valuations of the same property.

Mr. MOSS. Inequality of taxation.

The CHAIRMAN. Yes.

Mr. MANSON. Suppose you had a card index, and you had determined the value of the Standard Parts Co.——

The CHAIRMAN. That is just what Judge Moss spoke about. I think we understood that. That is just a matter of the mechanics, Mr. Manson. It is just a question of how to keep it.

Mr. MOSS. I do not know what is actually kept, but it seems to me to be a very good suggestion.

The CHAIRMAN. Have you anything further, Mr. Manson?

Mr. MANSON. Not this morning.

Senator JONES. If such an index were kept, it seems to me that it would make for both efficiency and a saving in expense.

Mr. MANSON. Yes. You have to do this work all over again unless you do have some way of being informed that you have done it once before.

Mr. GREGG. The matter of keeping more records than we have kept is a very important one, and one which we are always working on. For example, in the solicitor's office we are having difficulty right now, by having the same point raised in the different divisions and decided differently, occasionally, in the different divisions.

Only once in a while does that occur, that a case is decided separately in the divisions, but it is not at all rare to find the case being prepared on a question in one division, when the same case is being worked on in another division. We are trying now to keep a running index of questions involved in cases pending in each division, and that, of course, is a big job in an office of that size.

The CHAIRMAN. Will it be satisfactory to adjourn now until 10 o'clock to-morrow?

Senator KING. I do not want to take it up now, but I am not satisfied with this question of capitalizing good will and these intangibles, and the method adopted, and I want to make a little further inquiry into that.

Senator JONES of New Mexico. That was very important when we had the excess-profits tax, but we do not have that now.

The CHAIRMAN. It is just as important now when it comes to a sale of stock.

Senator JONES of New Mexico. By the way, I am extremely interested, Mr. Gregg, in your reference to having some digest of rates of profit allowed in different sections of the country in various classes of business, and so on. You say that is printed in pamphlet form?

Mr. GREGG. I will say frankly that I do not know what there is in that pamphlet.

Mr. MANSON. I would like to see it.

Mr. STRADER. It is known as the Median, and was published under the requirements of the act of 1917, as I remember it, which required the commisisoner to compile statistics showing the rate of profits earned by certain classes of business.

Senator JONES of New Mexico. That is, where normal earnings were varied from 7 to 9 per cent?

Mr. GREGG. That is it.

Senator JONES of New Mexico. I would like to have a copy of that.

Mr. MILLIKEN. We have another check in the bureau of the special assessments statistics. That is sometimes used.

Mr. GREGG. Of course, that is not public.

Mr. MILLIKEN. No; that is not public.

Mr. MANSON. I have looked into that, but I can see where the data that you have gathered for the purpose of making special adjustments is of almost untold value for many other purposes if it is utilized. You have a mine of immensely valuable information on those cards.

Mr. GREGG. That is very true.

Senator KING. You mentioned just now the large salaries. I was noticing in the 1922 returns that the salaries for a number of corporations amounted to, I think it was, $800,000,000 plus, which was entirely disproportionate to the amount paid to all other employees. It amounted to about one-third of the salaries and compensation paid to other employees. Are you checking up on that now?

Mr. GREGG. Yes; we are checking them.

Mr. MILLIKEN. The act says "reasonable compensation."

Senator KING. Do you cut them out?

Mr. MILLIKEN. Some of them, but almost every time we get into the courts the courts say that the company is the best judge of the reasonableness of compensation of their officers and not the bureau.

Senator KING. There were 171,000 corporations reporting no net income for taxes, and yet they were allowed $800,000,000, as I recall it, for salaries.

I think, on this matter, that if the bureau has not the power now to reduce those amounts and to prevent this abuse, that Congress must do it.

Mr. GREGG. Congress gave us all the power it could. It said we had a right to determine what was a reasonable allowance for salaries. I think you can appreciate the difficulty of our sitting here in Washington and deciding the reasonableness of salaries paid in all industries.

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

(Whereupon, at 12.45 o'clock p. m., the committee adjourned until to-morrow, Friday, May 22, 1925, at 10 o'clock a. m.)

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INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, MAY 25, 1925

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

The committee met at 10 o'clock a. m., pursuant to adjournment of Friday, May 22, 1925.

Present: Senators Couzens (presiding), Jones of New Mexico, and King.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. Raleigh C. Thomas, investigator for the committee.

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; and Mr. A. W. Gregg, solicitor, Bureau of Internal Revenue.

The CHAIRMAN. Do you want to introduce any statement now, Mr. Nash?

Mr. NASH. I had a statement on the anthracite coal matter. I was showing it to Mr. Gregg before starting up here this morning, but I think I left it on my desk.

The CHAIRMAN. We can put that in at some other place, then.

Mr. NASH. Yes, sir.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. The first matter that I desire to call to the attention of the committee this morning is the matter of the compromise of the tax of the Kerr Navigation Corporation.

The chief auditor of the committee, Mr. Box, has stated in his report the history of this Kerr Navigation Co. and the facts leading up to the compromise. I am not going to state all the details, but it appears that Messrs. Kerr and Clegg were citizens of Great Britain. They conceived the idea of purchasing the interned steamships belonging to the Hamburg American Line. It was nec ssary to secure the cooperation of an American citizen for this purpose, and they took in with them a man by the name of Geer.

The steamships were purchased for something over $8,000,000 and at the time that they were refitted and ready for s rvice they represented an investment of approximately ten million. About $800,000 was paid in, and the remaining inv stment was represented by money borrowed on gold bonds from Scandinavian interests.

Subsequently, after the war was over, a deal was made to sell this property to the Harriman interests.

At that time the taxes of the Kerr Navigation Co. and associated companies were undetermined, and there is evidence also in this record of considerable fraud and many attempts to defraud the Government.

At the time the deal with the Harriman interests was about to be closed, a proposition was made by Kerr & Clegg, who owned 76 per cent of the stock, to have the money paid to them in London. The Harriman people would not agree to that. Representatives of the Income Tax Unit of the bureau were informed. I do not recall just now how they got their information, but, at any rate, they were informed that Kerr & Clegg were endeavoring to have this money paid to them outside of the country, in order to escape income tax, that the Harriman interests had refused to agree to this sort of a proposition, and that the final arrangement was to pay them in cash at the Chase National Bank in New York, and they had made arrangements to sell on the basis the money was to be turned over to them. The revenue agents took the matter up with the Harriman interests, and the Harriman interests agreed to notify the revenue agents whenever the money was to be paid. They did notify them. The money was turned over in cash at the Chase National Bank in New York, and the revenue agents immediately served notice upon them; $5,000,000 was put in the safe deposit box to cover any taxes that might be due from Kerr & Clegg. So that there was no tax lost so far as these individuals are concerned.

I cite the circumstances which I have just related for the purpose of showing the character of the people who owned and controlled the taxpayer involved in this case.

At about this time, in September, 1920, this company was in a state of dissolution, and it appears that the property of this company was turned over to another company, and it was the second company that the Harriman interests bought.

The CHAIRMAN. But it was the same property that was involved?

Mr. MANSON. The same property. At the time the deal with the Harrimans was made, a part of that deal provided that the Kerr Navigation Co. should deposit with a trustee between $1,300,000 and $1,400,000 to meet any taxes that might be found to become due from the Kerr Navigation Co. That money was impounded with the trustee for that purpose.

The CHAIRMAN. Who was the trustee?

Mr. MANSON. I do not recall who the trustee was.

The CHAIRMAN. Does the record show that?

Mr. MANSON. I assume that the record does show it somewhere, but I do not think the record that I have here shows it.

Mr. GREGG. I think it was the New York Trust Co.

Mr. MANSON. Yes; well, there is no dispute about the fact that it was on deposit.

Following this attempt to get out of the country, a tax was assessed for the years 1917, 1918, and 1919, of $$6,553,372.45 on the company. That was more or less an arbitrary assessment, to protect the Government.

A claim in abatement was filed, and the matter was taken to the committee on appeals and review. After the committee on appeals and review had heard the taxpayer, they made a finding in the

matter, and a reaudit of the case was completed in January, 1923, in accordance with the determination of the committee on appeals and review.

The result of this reaudit discovered that there had been an overassessment of $5,181,841.60, leaving due the Government $1,381,580.85, together with a 5 per cent penalty and 1 per cent interest for the failure to pay within the specified time after notice and demand.

The CHAIRMAN. What was the 5 per cent penalty for? Was that according to the statute?

Mr. MANSON. Yes. That is the regular penalty. Under date of March 20, 1923, it was proposed, on behalf of the taxpayer, to offer the sum of $800,000 in compromise and settlement of the additional income and profits taxes claimed to be due from the taxpayer, together with penalties and interests. This proposal was rejected by the commissioner. Upon further consideration the commissioner authorized the solicitor to inform the representatives of the taxpayer that he would be inclined to give favorable consideration to an offer in the amount of $900,000. On May 15, 1923, the sum of $900,000 was deposited with the collector of internal revenue of the second district of New York as an offer in compromise.

Under date of April 16, 1923, the Solicitor of Internal Revenue wrote the commissioner (Exhibit D) in relation to an offer in compromise of $800,000 by this taxpayer, in which he reminded the commissioner that he had under distraint or other process a large amount of cash impounded in New York to secure the payment of an alleged tax liability against the individuals comprising the corporation, stating that "the above is mentioned merely to refresh your memory as to some of the very high lights in the case and to put you on notice that very great care should be exercised in passing on any offer in compromise."

Under date of June 27, 1923, Deputy Commissioner Bright recommended the acceptance of the offer of $900,000 in a memorandum, which I will read into the record.

The first part of this memorandum appears to be the form, merely recommending the acceptance of $900,000.

The memorandum then proceeds as follows:

The Kerr Navigation Corporation was incorporated under the laws of the State of New York on the 14th of July, 1917, and was dissolved pursuant to the laws of the State of New York on the 28th of October, 1919. Its capital was $800,000, consisting of 160 shares without par value issued for $5 per share. The corporation filed income and profits tax returns for the taxable years 1917, 1918, and 1919, and paid taxes thereon as follows:

For the year 1917	$214,453.57
For the year 1918	3,024,273.16
For the year 1919	800,625.90
Total	4,039,352.63

Additional income and profits taxes were assessed against the taxpayer in September, 1920, as follows:

For the year 1917	$865,578.24
For the year 1918	5,652,217.24
For the year 1919	45,576.97

At the time the additional assessments were made taxpayer was in dissolution. As it appeared that the former stockholders of the

taxpayer, who were in possession of all if its assets, were about to depart from the country, summary assessments of the additional taxes which seemed to be due were made. These additional assessments were based largely upon estimates, and all doubtful questions were resolved against the taxpayer and in favor of the Government. Within a few days after the additional assessments had been filed, the taxpayer filed claims for abatement thereof. Thereafter appeals were taken to the committee on appeals and review and affidavits, certificates, and letters were submitted and oral argument was presented and conferences were held between the representatives of the corporation, the committee on appeals and review, the solicitor of internal revenue, and representatives of the Income Tax Unit. The principal points in dispute before the committee on appeals and review were the alleged realization of income from the reorganization of the Kerr Navigation Corporation, amortization, requisition charter hire in 1919, classification under section 209 of the revenue act of 1917, special assessment under sections 327 and 329 of the revenue act of 1918, expenditures for reconditioning ships, reorganization expenses disallowed as a deduction and charged to capital account, deduction for salary paid to president, reallocation of certain items to 1918 income, and the closed voyage adjustment account. The consideration of the appeal involved many difficult questions and the examination of a mass of detailed and complicated data. The committee on appeals and review in recommendation No. 497, under date of March 19, 1921, allowed the appeal in part and denied it in part. The case was thereupon returned to the Income Tax Unit for reaudit in accordance with the recommendation of the committee on appeals and review. Owing to the extremely complicated nature of the case, the reaudit was not completed until on or about the 1st of January, 1923. As a result of the reaudit, certificates of overassessment have been listed as follows:

For the year 1917	$222,323.14
For the year 1918	4,699,452.49
For the year 1919	260,065.97

There are accordingly outstanding assessments for the taxable years 1917, 1918, and 1919 in the total amount of $1,381,530.85, which is claimed to be due from the taxpayer, together with 5 per cent penalty and 1 per cent interest for failure to pay within 10 days after notice and demand.

The taxpayer disputes the correctness of the recommendation by the committee on appeals and review and the computation of tax liability based thereon. The principal points on which the taxpayer and the bureau are not in accord are as follows:

1. The taxpayer claims that it should be assessed under section 209 of the revenue act of 1917 at the 8 per cent rate, because it is a corporation having a nominal capital, the term "nominal" being a relative term; its capital stock, $800,000, is nominal relative to the cost of the eight ships which it purchased, which was $9,847,650. The capital is also nominal in comparison with the net income as stated above.

2. The bureau fixed the excess profits tax rate for 1918 at 66.8043 per cent. The corporation paid taxes at the rate of 50 per cent and

claims that the rate should not in any event exceed 58 per cent, and this rate may be too high.

3. The bureau has allowed an amount of amortization which the company believes to be correct, the ships having been written down in the bureau's computation to $4,000,000. The bureau, however, has spread this amortization between January 1, 1918, and September 3, 1919. This latter date is the date on which the formal transfer of title to the ships was made pursuant to the reorganization of the Kerr Navigation Corporation. The taxpayer submitted evidence to the committee on appeals and review showing that the value of the ships on January 1, 1918, was less than $4,000,000 and that the value of the ships on September 3, 1919, was less than $4,000,000.

The taxpayer has also submitted an affidavit and brief (in the hands of the Solicitor of Internal Revenue) showing that the value of the ships in terms of their income-producing capacity did not decrease between December 31, 1918, and September 3, 1919, and contending that if the value of the ships was $4,000,000 on September 3, 1919, it was no greater on December 31, 1918, and that the full amount of amortization allowed had been sustained during the taxable year 1918. In spreading this amortization, the bureau has allocated $808,133.73 to 1919. This amount the taxpayer contends should be allocated to 1918.

4. The bureau has also disallowed as an expense the sum of $51,006.24 paid to Messrs. Haight, Sandford & Smith, the attorneys who incorporated the company and who rendered the legal services in connection with its note issue and mortgages and in connection with the acquisition of the steamers and the transfer of their flags. These attorneys have apportioned their bill as follows:

Organization of company	$1,967.47
Services and disbursements in connection with note issue and mortgages	24,788.77
Services in connection with acquisition of steamers	24,250.00
Total	51,006.24

This bill for legal services was paid in 1918 and the note issue and mortgages were canceled in 1918. The taxpayer contends that the charge for services and disbursements in connection with the note issue and mortgages should be allowed as a deduction in 1918 and that the charges for services in connection with the acquisition of the steamers should be added to the cost of the steamers and amortized in 1918.

Trustees in dissolution of the taxpayer hold assets of the value of $1,350,051.90. There are no secured liabilities so that the Government has a first claim on all the assets of the taxpayer for the payment of any taxes due. The liabilities other than the liability for taxes amounts to the sum of $63,038.75.

Under date of March 20, 1923, it was proposed on behalf of the taxpayer to offer the sum of $800,000 in compromise and settlement of the additional income and profits taxes claimed to be due from the taxpayer together with penalties and interest. This proposition was rejected by the commissioner under date of April 19, 1923. Upon further consideration the commissioner authorized the solicitor to inform the representatives of the taxpayer that he would be inclined to give favorable consideration to an offer in the amount

of $900,000. This information was communicated to the representatives of the taxpayer, and on May 15, 1923, the sum of $900,000 was deposited with the Collector of Internal Revenue for the Second District of New York as an offer in compromise.

It appears that the Government by resorting to distraint could undoubtedly force the payment of a greater amount than has been paid by the taxpayer as an offer in compromise. However, the indications are that if an attempt should be made to collect the outstanding assessments in full, the assets would not be sufficient to entirely satisfy the assessments, and such payments as would be made would be made under protest and would be litigated.

The CHAIRMAN. The shortage would be some $30,000, would it not?

Mr. MANSON. I have not considered that, but it would hardly be much more than that. It is about $31,000.

If litigation should be resorted to it would undoubtedly be very complicated and long drawn out, involving a very large expenditure on the part of the Government. Moreover, some of the questions in dispute are not entirely free from doubt and many of the employees of the bureau who participated in the consideration of the case and who were intimately acquainted with its details have since severed their connection with the Government. It is, therefore, doubtful whether the net result of attempting to collect the outstanding assessments by distraint would in the end be more favorable to the Government than the acceptance of the amount offered in compromise.

The collector of internal revenue for the second district of New York recommends that the offer be accepted.

Pursuant to that memorandum the offer in compromise was accepted.

I have this to say with respect to that compromise settlement, and that my immediate point may be clearly brought out permit me to recapitulate very briefly.

Here is a case where a tax of something over $6,000,000 was summarily assessed. There is no doubt but what that tax was assessed because the people who controlled this property were known by the bureau to be attempting to defraud the Government, and the tax was assessed to protect the Government.

A plea in abatement was filed. This taxpayer was heard by the unit. The case was considered by the committee on appeals and review. The whole matter was threshed out, and subsequent to the action of the committee on appeals and review the case was reaudited. As Mr. Bright states in his memorandum, there were conferences between the taxpayer and the representatives of the unit, between the taxpayer and the solicitor, and, as I have stated, the taxpayer had a full hearing before the committee on appeals and review.

As a result of that action, it was announced that this taxpayer owes the Government $1,381,000 in taxes. There is $1,350,000 in taxes impounded with the trustee for the express purpose of paying this tax. There are no secured liabilities. The only other liabilities there are approximately $63,000. In other words, the officers of the bureau have determined that there is a tax due, after full hearing, amounting to $1,381,000; the money is there to pay $1,350,000, and yet this case is compromised for $900,000.

Upon what theory? Upon the theory that this taxpayer may go to court.

Now, let us take that theory. I submit that if a taxpayer has paid more or is assessed more than he should legally pay, his assessment should be reduced. In other words, you have two functions of the commissioner here. You have, on the one hand, the determination of how much tax the taxpayer should pay under the law. You have certain machinery set up here for the purpose of ascertaining that. You have certain rules and regulations laid down for the ascertainment of that fact. Congress itself, in the act, has provided, at least to some extent, what the rights of the taxpayer are.

It is my position that unless a tax assessment is based upon its merits, unless the rights of the taxpayer are determined in accordance with the law and in accordance with the regulations of the department, and unless each claim is determined upon its own merits, you have no such thing as an assessment of taxes.

In this case, if you can assess a tax of $1,381,000, and then afterwards compromise that tax for $900,000, throwing off $480,000, approximately one-third of the tax, wihout determining the merits of the different claims of the taxpayer, there is absolutely no rule, there is no precedent established in that case, there is no way whereby anybody can review it, there is no way whereby you can determine whether this taxpayer was entitled to what he claimed or not.

If the bureau had exercised its honest judgment, which judgment I do not impeach, but if it had exercised its judgment in determining that this taxpayer owed $1,381,000, and the money was there to pay it, there is no justification whatever for throwing off one nickel of that tax, other than, perhaps, the $31,000 that was not impounded; but so far as reducing the amount which the bureau was clearly able to collect is concerned, there is no justification for doing it. If there was any merit in this taxpayer's claims, if the responsible officers of the bureau, whether the committee on appeals and review, the solicitor, or the commissioner himself, believed that this taxpayer had been over-assessed, then that assessment should have been reduced, and the ground upon which it was reduced should have been made a matter of record. In other words, if this taxpayer was entitled to consideration under the special assessment statute, that matter should have been determined.

Senator KING. Were not all of the questions coming under the head of merit—and you used that word several times—involving a determination in the final judgment which was rendered, considered by the highest appellate tribunal in the department?

Mr. MANSON. They were.

Senator KING. It is an impeachment, then, of the judgment of the highest appellate tribunal in the department?

Mr. MANSON. It is.

Senator KING. May the commissioner, or any subordinate, in the face of that final judgment, use his own whims and caprice, and make a settlement on any basis he pleases?

Mr. MANSON. I believe that, under the statute, the commissioner can settle any tax upon any basis he pleases.

What I do say is this: If you are ever going to have an orderly procedure, if you are ever going to have taxes determined in a way whereby that determination can be reviewed, you have got to have an assessment stand on its own bottom. After that tax has been assessed, if it is then impossible to collect that tax, the matter of compromising the tax which has been assessed is entirely another question; but if you are going to merge those two and compromise assessments upon the theory that the assessment may be wrong, or upon the theory that the courts may overturn the assessment, you will wipe out every vestige of orderly procedure.

Suppose some court, some judge who has before him a case involving many arguments, should find that the plaintiff is entitled to judgment upon item No. 1 in the sum of $100,000, upon item No. 2 in the sum of $200,000, and upon item No. 3 in the sum of $300,000, a total of $600,000, and he refuses to enter judgment for more than $400,000, how long should such a judgment stand?

Here you have identically the same situation.

Senator KING. The judgment would be mandamused by an appellate court and he would be compelled to render judgment.

Mr. MANSON. Yes; of course.

Senator KING. Or removed?

Mr. MANSON. Probably both is what would happen to him. You have identically the same situation here. Could any judge say, would any judge be permitted to say, that he had found that the plaintiff was entitled to recover on No. 1, No. 2, and No. 3, but he was doubtful about all those items and therefore he would only enter judgment for $400,000?

When you get to the merit of this proposition there is absolutely no distinction between compromising an assessment amounting to $1,381,000 for $900,000, upon the ground that it is doubtful whether the assessment is valid; there is no distinction between such a case and the case of the court that I have mentioned.

I claim that if there was any doubt as to the validity of that $1,381,000 in the minds of the bureau it should be reconsidered in the bureau.

Senator KING. Why, of course.

Mr. MANSON. And an examination should have been made which the bureau was willing to stand upon. If the taxpayer was not willing to accept that determination, they should have let him go to court. That is what the courts are for, and when he goes to court you have a determination by a court which is an open public matter, and you have at least got a contribution toward the permanent settlement of income tax law.

The CHAIRMAN. From the record of the case it would seem that the more crooked and more dishonest a taxpayer is and the more fight he puts up the less tax he pays.

Mr. MANSON. I called attention to the fact—Senator King was not here at the time, but I call his attention to this fact, that before this original assessment was made it was found that the men who controlled 76 per cent of the stock of this company, and who had sold it, had endeavored to have the money paid to them in London in order to escape income tax. Failing in that they had the money paid to them in cash on the day that they were ready to sail for Europe. They already had clearance on their income tax on their passports

and were ready to sail for Europe on the very day that the money was turned over to them, but the bureau's representatives were informed of this. The Harriman interests who bought the property reported the facts and notified the bureau when the money was to be turned over, and the bureau representatives were present when the cash was delivered and got the money, as far as these individuals were concerned, set aside.

I call attention to that for the purpose of showing the character of the people that the bureau knew it was dealing with when they made this compromise.

The CHAIRMAN. And still they gave then $481,000.

Mr. MANSON. The facts are all set forth in this report, which I will offer. Mr. Bright made this statement, which showed on its face what seems to be a characteristic ground of Mr. Bright, that the taxpayer made claims which might have some merit, and in this case he sets up what those claims are. I repeat, if they had any merit they should have been decided in the taxpayer's favor; if they had no merit, the taxpayer should have been relegated to his remedy at law.

Mr. GREGG. I want to say, in justice to Mr. Bright, that that statement was not Mr Bright's. That statement was prepared in the solicitor's office.

Mr. MANSON. Mr. Bright signed it.

Mr. GREGG. No, sir; Mr. Bright signed the recommendation for acceptance, but that memorandum which you have read, containing the reasons for the recommendation for acceptance, contains the reasons which the solicitor gave, and was written in the solicitor's office, stating his reasons.

The CHAIRMAN. But he incorporated that in his letter to the commissioner.

Mr. GREGG. Yes; but that had nothing to do with Mr. Bright.

The CHAIRMAN. I understand he incorporated it.

Mr. GREGG. No, sir.

Mr. MANSON. I want to say frankly that I do not want to do any injustice to anybody, but I have here what is marked "Exhibit E," and that is Mr. Bright's communication to the commissioner, recommending the acceptance of this settlement.

Mr. GREGG. Yes; but if you——

Mr. MANSON. Now, I have never seen the original document, myself; I do not know.

Mr. GREGG. I should like to clear this up. The exhibit is signed by the solicitor, in which he recommends the acceptance.

Mr. MANSON. Yes.

Mr. Gregg, do you say that this file has been put together wrong?

Mr. GREGG. Yes.

Mr. MANSON. I see. All right.

Senator KING. Who was solicitor then?

Mr. MANSON. Mr. Hartson.

Senator KING. Mr. Manson, the case had been fully reviewed, counsel for the taxpayer being present?

Mr. MANSON. Oh, yes.

Senator KING. And it was heard by the tribunal set up in the department to hear these cases?

Mr. MANSON. Yes.

Senator KING. And the tax had by that tribunal been reduced from six million to one million three hundred and some odd thousand?

Mr. MANSON. That tribunal reduced the tax something in the neighborhood of $5,000,000.

Mr. GREGG. I might say, since that statement is going into the record, that the original assessment was obviously, on its face, excessive.

Mr. MANSON. Yes; I stated that.

Mr. GREGG. Yes; I assume that you did have no objection to the reduction of that original assessment.

Mr. MANSON. Oh, no; I take no exception to that at all. I do not even attempt to pass upon the merits of these different questions raised. I say if they had merit, the tax should have been determined in accordance with the regular routine of the bureau, so that the grounds upon which the different allowances were made would be set forth in the record. If they had no merit, they should have been rejected; but that power to assess taxes should not be confused with the power to compromise taxes after they are assessed, because it reduces the whole thing to a matter of bargaining.

Senator KING. Yes; I understand.

The CHAIRMAN. I would like to ask Mr. Gregg is he has any idea as to what extent this method has been followed in the bureau?

Mr. GREGG. I do not know of other cases. The committee has had presented to it several compromise cases. Compromise cases are the most difficult class of cases that we have in the department. They are the ones that cause us the most trouble.

The CHAIRMAN. Why should there be a compromise in a case like this, where the cash was available?

Mr. GREGG. I do not know just why this case was compromised; I am not at all familiar with this case. The question of what cases we can compromise is a very doubtful question. We have conflicting opinions of the Attorney General as to our power of compromise, and we have held pretty strictly to the theory that we can compromise legally only on the grounds of insolvency.

The CHAIRMAN. But in this case there was no question of insolvency involved, was there?

Mr. GREGG. As I understand it, the tax exceeded the cash—the cash that was on hand—which would have made the taxpayer insolvent and which justified the compromise.

Mr. MANSON. It exceeded it about $30,000?

Mr. GREGG. Yes.

The CHAIRMAN. That is, it only exceeded the cash by $30,000. It did not exceed any other assets of the corporation.

Mr. GREGG. Well, the sole remaining assets were the cash that had been placed in trust.

Mr. MANSON. Yes; but here were two people who had impounded to cover their individual taxes some $5,000,000. If in the process of liquidation there were more of the assets of this concern distributed than were then distributed, the individual stockholders who had received the liquidating divided would not have been liable for it?

Senator KING. It was not a question so much of bankruptcy. It was a question of a corporation going out of business.

Mr. MANSON. Yes.

Senator KING. Liquidating?

Mr. MANSON. Yes.

The CHAIRMAN. Who was it that put Mr. Blair on notice as to the character of these men? Was that Mr. Hartson?

Mr. MANSON. In the first place, the agent in New York got wind of what was going on, and did a very skillful job of following it up. Then, when the first offer of compromise was made of $800,000, Mr. Hartson called the commissioner's attention to the character of the people that he was dealing with.

The CHAIRMAN. Was that the same agent in New York who recommended the acceptance of $900,000 that first drew this matter to the attention of the bureau?

Mr. MANSON. The agent did not recommend it. The collector recommended it.

The CHAIRMAN. Oh, the collector recommended it?

Mr. MANSON. Yes.

Mr. GREGG. To clear up that point, we were put on notice originally by the Department of Justice.

Mr. MANSON. I looked up the notice in the report, but it is a rather lengthy report, and I have read it.

Mr. GREGG. The case is a quite interesting one. For that reason I remember it.

Mr. MANSON. Yes.

Mr. GREGG. The Department of Justice put us on notice and we sent a man up to New York. The man who grabbed the $5,000,000 in cash was a man from the solicitor's office, Mr. McCawley, that we sent up to take care of it.

Senator KING. To what extent, may I ask, Mr. Gregg and Mr. Nash, have some of these flitting taxpayers and capitalists escaped from the country and escaped taxation?

Mr. NASH. I do not know that they have done it to any extent, Senator. We have had many cases similar to this one, where we got advance information that people were contemplating leaving the country. In those cases we usually take steps to stop them, and every taxpayer under the law—that is, under the old 1918 law—must make a declaration of his taxes before he is permitted to board the boat. We have agents at the landing or at the docks in New York who either examine the passenger or get a statement from him showing that his tax liability has been settled.

Mr. MANSON. I might say that these men were aliens.

Senator KING. The reason I ask that is that I have been told of a good many aliens who have been returning to Europe during the past few years, some of whom have been here for a number of years, employed in various lines of industries, but not in big business, and who have paid no income tax at all; that they went back to their respective countries with their earnings and have not paid a tax.

Mr. NASH. We have agents at every point of embarkation. We cooperate with the customs authorities and the steamship authorities, and every alien boarding a boat must show a clearance certificate in regard to his taxes. They do sometimes get out through Canada or Mexico, because we are unable to effectively guard the border

The CHAIRMAN. Does the collector, in the records, give any reason for recommending a settlement of $900,000?

Mr. MANSON. In my report I do not find any. We have tried recently to boil some of these things down to the most material things. Even this report is so long that I have not read it into the record.

Mr. GREGG. We will look that up and make a statement on the case.

Mr. MANSON. I think it was the judgment of Mr. Box that the reasons for this settlement are stated in the memorandum, which I read.

The CHAIRMAN. But the collector would not have that in the same form?

Mr. MANSON. No.

The CHAIRMAN. That the bureau afterwards had it?

Mr. MANSON. No.

The CHAIRMAN. Have you any other cases this morning, Mr. Manson?

Mr. NASH. Senator, if I may interrupt, you just asked a moment ago how many compromise cases had been passed on by the bureau.

You will recall that when the Atlantic, Gulf & West Indies case was being considered, I was asked at that time to furnish the committee with a list of compromise cases, in which amounts of $100,000 or more had been accepted, and I furnished Mr. Box with such a list.

There were 15 cases in which a compromise offer of $100,000 or more had been accepted, during the period extending from 1916 up to March 1 of this year. That list included the Atlantic, Gulf & West Indies Co., the Kerr Navigation Co., the American Blower Co., the Slim Jim Oil Co., and the Arthur Lewis Co. I think the committee has taken up about half of the cases included in that list, and this case was included in the list. I just wanted to point out that there have been only 15 cases of this matter extending over a period of about nine years.

Mr. MANSON. I do not know that we will have that completed this week, but we will have a report, I think, on 11 out of the 15 cases.

The CHAIRMAN. You have another case to present now, Mr. Manson?

Mr. MANSON. Yes.

(The report and exhibits relating to the case of the Kerr Navigation Co., are as follows:)

EXHIBIT A

MAY 20, 1925.

In re Kerr Navigation Corporation, New York, N. Y.

The Kerr Navigation Corporation was incorporated July 14, 1917, under the laws of the State of New York. Its capital was $800,000, consisting of 160,000 shares without par value, issued for $5 per share.

All of the stock of the Kerr Navigation Corporation was owned by the Kerr Steamship Co. (Inc.), and 76 per cent of the stock of the latter corporation was owned by Messrs. H. F. Kerr and A. E. Clegg.

The Kerr Steamship Co. (Inc.) was organized under the laws of the State of Delaware on June 17, 1917, and took over the business of the Kerr Steamship Lines, a copartnership.

About the time of the organization of the Kerr Steamship Co. (Inc.), Messrs. Kerr and Clegg became associated with one Edward F. Geer, an American citizen who had connections with the Hamburg-American Line officials and other Austrian or German shipowners. Opportunity presented itself to purchase eight interned steamships formerly owned by the Hamburg-American Line. Mr. Geer entered into a contract to purchase the same for an agreed price of $8,033,875, of which 10 per cent was paid by him in cash. An agreement was entered into between Messrs. Kerr and Clegg and Mr. Geer whereby the Kerr Navigation Corporation was to be organized and take over the option of Mr. Geer for the purchase of the interned steamships. To finance the purchase the Kerr Navigation Corporation issued $6,500,000 of its 6 per cent gold notes, which were taken by certain Scandinavian financiers after having been indorsed by the Kerr Steamship Co. The total cost to the corporation for these steamers, including the cost of repairs and refitting prior to their being placed in commission, amounted to a sum slightly in excess of $10,000,000.

Of the total of 160,000 shares of stock of the Kerr Navigation Corporation held by the Kerr Steamship Co., as stated above, 24,021 shares were given by the latter company as bonuses to purchasers of the 6 per cent gold bonds issued to provide funds to purchase the ships. The balance of shares amounting to 135,979 in number were apparently held by the Kerr Steamship Co. until April 11, 1919, when Geer purchased from the steamship company 20,668 of these shares for his own account and the balance of 115,311 for the account of Messrs. Kerr and Clegg.

Entry in the stock transfer books of the Kerr Navigation Corporation shows that on November 14, 1919, Edward F. Geer transferred to H. F. Kerr 57,656 and to A. E. Clegg 57,655 shares of the stock of the Kerr Navigation Corporation. The eight ships were turned over by the Kerr Navigation Corporation to the Kerr Steamship Co. (Inc.) for a period of five years, and the terms of the agency contract provided for the payment of a 5 per cent commission on all gross freight lists to the steamship company.

On or about August 1, 1919, the plan for the so-called reorganization of the Kerr Navigation Co. was decided upon. Pursuant to this plan the American Ship & Commerce Navigation Corporation was organized under the laws of the State of New York some time prior to September 3, 1919, with a total authorized capital stock of 190,000 shares without nominal or par value. Of the total number of shares of stock, 40,000 were denominated class A stock and had preference as to dividends, but had no voting power, and the balance of 150,000 shares was known as class B stock, the holders of which had the right to vote. Seventy-six thousand shares of class B stock were subscribed for at the time of the organization by the American Ship & Commerce Corporation, a Delaware corporation organized as a holding company, at $100 per share, of which amount 20 per cent, or $1,520,000, was paid into the treasury of the American Ship & Commerce Navigation Corporation in cash at the time of the organization, or shortly thereafter. The entire issue of class A stock, viz, 40,000 shares, and 35,000 shares of class B stock were issued by the American Ship & Commerce Navigation Corporation to the Kerr Navigation Corporation in return for all of the assets of the latter.

At a special meeting of the stockholders of the Kerr Navigation Co., held on September 3, 1919, a resolution was adopted consenting to the sale by the Kerr Navigation to the American Ship & Commerce Navigation Corporation of all of the ocean steamships owned by the Kerr Navigation Corporation, together with all the net earnings of the said eight ships from and after the 1st of January, 1919, up to the time of the transfer of said ships to the American Ship & Commerce Navigation Corporation, and also all of the good will and franchises of the Kerr Navigation Corporation, together with the right to use its corporate name.

Shortly after the above-mentioned sale and the transfer of all of the assets of the Kerr Navigation Corporation that corporation was duly dissolved. The actual sale of the eight steamships appears to tave taken place on August 1, 1919. In the agreement of sale made between the Kerr Navigation Corporation and the American Ship & Commerce Navigation Corporation it was specifically agreed that the sale was made pursuant to the plan of reorganization and the American Ship & Commerce Navigation Corporation under that agreement obligated itself to enter into all of the agreements and do all of the things provided in said plan of reorganization to be done by it. It was provided that the American Ship & Commerce Navigation Corporation enter into a contract with the Kerr Steamship Co. (Inc.), so that between

these two companies the same business relations as then existed between the Kerr Navigation Corporation and the Kerr Steamship Co. (Inc.) were established. It was stipulated that this agreement of agency should continue for a period of five years with the right to the American Ship & Commerce Navigation Corporation to terminate such agency contract at any time upon 90 days' notice. Provision was also made that in case of the termination of the agency contract with the Kerr Steamship Co. (Inc.) any stockholder of the Kerr Navigation Co. who received stock of the American Ship & Commerce Navigation Co. at the time of the reorganization should have the option to sell such stock of the latter company at $100 per share, and that upon the exercise of said option the American Ship & Commerce Corporation must purchase such stock.

The details of the dissolution of the Kerr Navigation Corporation do not appear in the record, but such information as is at hand shows that the greater part of the shares of stock of the American Ship & Commerce Navigation Co. received from the sale were distributed by the Kerr Navigation Corporation to its stockholders upon surrender by them of their shares of stock in the liquidating corporation. Approximately 8,000 shares of stock were retained in the treasury of the Kerr Navigation Co., with some cash to satisfy any claims which the Government might have for additional income and excess profits taxes against the corporation.

About July, 1920, the American Ship & Commerce Navigation Co. gave the Kerr Steamship Co. (Inc.), the requisite 90 days' notice of its intention to terminate the above-mentioned agency contract, and on August 28, 1920, Messrs. Kerr and Clegg tendered to the American Ship & Commerce Corporation the shares of stock held by them in the American Ship & Commerce Navigation Corporation and demanded payment at the rate of $100 per share as agreed. Such payment was made on that date, and Messrs. Kerr and Clegg received the sums of $2,456,959.80 each for their stock. The details in regard to these payments, which were made in cash, will be referred to hereafter.

The transactions in connection with the purchase by the Kerr Navigation Co. of the eight steamships had been under investigation by the Department of Justice and was fully covered by report of Judge C. E. Waite, of that department. The investigation developed the fact of apparent irregularities in connection with income-tax returns of the corporation. As a result of the request of Judge Waite for an income-tax investigation, W. B. Wight and Leo J. Stevens, employees of the bureau, proceeded to New York and reported on May 24, 1920, to Mr. Hugh I. McQuillan, special agent, Special Intelligence Unit, who took them to the office of Judge Waite in the old post-office building. The latter turned over to them all data and information that had been collected by the Department of Justice. They report that it was Judge Waite's idea that they should first investigate thoroughly the affairs of Mr. E. F. Geer, who had the original option to purchase the ships, it being Judge Waite's opinion that German interests still had a string on the ships.

The report shows that they called on Mr. Geer on June 7, 1920. The latter explained in detail the turning over by him of the option to purchase the eight ships to the Kerr Navigation Co.; the reorganization plan whereby the assets of the latter company were transferred on September 3, 1919, to the American Ship & Commerce Navigation Co.; and the fact that he was elected president of the latter company at a yearly salary of $50,000. Mr. Geer informed the agent that in November, 1919, on account of a difference which he had with Mr. Kerr he was requested to resign as president of the American Ship & Commerce Navigation Co., and that at the annual meeting held soon thereafter he presented his resignation and that Mr. Clegg was elected president to succeed him. Mr. Geer informed Mr. Wight that as president of the Jason Steamship Co. his salary was $50,000 per year, and as president of the Carib Steamship Co. his salary was $25,000 per year. These salaries were voted each year after the annual meeting.

Messrs. Kerr and Clegg were in control of the stock of these companies. He resigned from both of the companies in November, 1919, but his resignation was not acted upon until February, 1920. Reserves were set up on the books of both companies for the respective amounts of his salaries, but he stated that Kerr and Clegg refused to pay him the $75,000 salary due him, and that he was telling this to Wight and Stevens to show them the character of Kerr and Clegg, as he felt sure there was something wrong there and that they were spiriting their money to Jamaica or else to Spain. He also informed the investigators that Kerr and Clegg had sold the steamship *Carib* for a nomi-

nal sum, much less than she was worth, to a Spanish corporation which they had formed, and that their sole purpose in this sale was to avoid payment of taxes to the United States Government.

The report shows that in the examination of Geer the investigators questioned him in regard to an item of $105,853 commissions. In respect to this matter the following appears in Mr. Wight's notes which appeared in the record:

"I asked if this item was from same source as shown in former years, 1918. Mr. Geer hesitated a few moments and then replied, 'No.' I asked him a second time in regard to this item. His reply was, 'God! This is embarrassing. It affects others than myself!' He became very nervous and perturbed, exceedingly so, and after thinking a few moments said, 'Well, I guess I will have to tell it all. It's hell! God! It will ruin me. I will be looked on in the light of an informer. That's what hurts. It will look as though I have told the Government these things on account of my pique with the other crowd. You must protect me; for God's sake do!'

"He requested a few moments to collect himself and to decide how best to go about it. In a few moments he leaned forward and said 'Well, I'll make a clean breast of it.' He hesitated a moment and I was afraid he would change his mind, so I said, looking at him intently, 'Mr. Geer, it behooves you to tell me all and to tell it straight, for I have knowledge of many things in connection with these affairs and I am giving you a chance to come clean.' He replied, 'All right, here goes!'

"He said that one day he was called aside by Kerr and Clegg and told that they had secreted a fund and that his share, 20 per cent, amounted to about $100,000, which they were ready to turn over to him.

"It was in the shape of securities and no record would be found in the books. He stated that he told them he would accept the securities but that he was going to include them in his income-tax report, to which they demurred, saying 'Hell, no; you are not. That's what we have this fund for, to avoid tax.' Mr. G. stated that K. and C. told him that the fund was not intact, that whenever they needed money they had 'tapped it,' but that the amount of about $100,000 was his share.

"I asked Mr. G. if he thought they were turning over to him his full 20 per cent and he said, yes; he was confident of it (displaying a more intimate knowledge of the fund than he had formerly tried to impress upon me), as in his first mention of the matter he had tried to give me the impression that the whole thing was news to him. He says he told them he would take the securities only upon the condition that he report the amount as income in his tax returns. They said, 'Hell! if you report it we will have to, too.' He said he told them he didn't give a damn what they had to do, he would take the securities only with that understanding.

"He kept saying every few moments 'God! This is hell. I'll be disgraced. I'll be ruined! I'll be put down as an informer!'

"He turned to me and asked if I had authority to question anyone. I replied that I had, so as to see what he had in mind. He repeated his question in different form, asking just what powers I had, etc. I felt he was trying in a smooth way to find out if I had any connection with the Department of Justice, so I told him that if I could not get such informaton from anyone as desired, I could turn the matter over to one of our other departments that could get it. He then said this whole matter was handled through a third party, a quiet, unimportant man, who would never be suspected, and after due deliberation and in a very secretive manner told me that Melsome had handled the fund, purchased all securities, and knew all about the matter, and said 'For God's sake, get the information from him. He can easily be made to tell it. I don't want the odium of it. It will ruin me!'

"He went on to tell me of Melsome, giving Melsome's history, which we already know, and how Kerr and Clegg knew of Melsome's trouble in England, and that they used it as a club and made him do as they wished and that Melsome was scared to death and finally got out of their clutches on account of his fears and finally forced them to purchase his (Melsome's) 1 per cent of stock of Kerr Steamship Co. for $40,000 through Mr. Geer."

(The Melsome referred to in the last above paragraph was secretary and treasurer of the Kerr Steamship Line, the copartnership referred to above.)

Subsequently in relation to the examination of Mr. Geer, Mr. Wight's report is as follows:

"Several days ago Mr. Geer told me that Mr. Kerr had previously told him of the formation by him (Kerr) of a Spanish corporation (Kerr Steamship Co.) in Spain. The taxes were cheap in Spain, and that he was going to dump all profit possible into this Spanish corporation, including his personal affairs, and told Mr. Geer that he could include his personal affairs in the Spanish company also if he wished to. Mr. Geer told Mr. Kerr that he (Kerr) had him down wrong, and that he would not care to get mixed up in any such manner and cautioned Kerr he was likely to get into trouble, to which Kerr replied, 'The border is only a short distance away.'"

The report shows that Mr. Geer received as salaries in 1919 the following amounts:

President Kerr Navigation Corporation	$100,000.00
President Jason Navigation Corporation	50,000.00
President Carib Steamship Co	25,000.00
President Shoshone Navigation Corporation	6,000.00
Vice president Kerr Steamship Co	74,543.31
Total	255,543.31

All of the above-named corporations, excepting the Shoshone Navigation Corporation, were controlled by Messrs. Kerr and Clegg.

In the investigation of the return for 1918 of the Kerr Navigation Corporation $50,000 of the above-mentioned salary paid to Mr. Geer was disallowed as being excessive. In the Jason Navigation Corporation $44,000 was disallowed as being excessive, and in the Carib Steamship Co. $10,000 was disallowed as being excessive. In explanation of the disallowance the following details were given:

"The Kerr Navigation Co., the Jason Navigation Corporation, the Carib Steamship Co., and the Shoshone Navigation Corporation all owned steamships belonging formerly to German and Austrian interests. The American attorneys for the German interests were Haight, Sanford & Smith, Lords Court, New York.

"Mr. Geer was a personal friend of Mr. Haight of long standing (about 30 years). He was also a friend of Mr. Sanford. The Hamburg-American Line, former owners of the steamships all purchased during 1917, with the exception of one ship owned by the Shoshone Navigation Corporation, were hard pressed for money to meet obligations in America and had to sell their ships. Mr. Geer, through Haight, Sanford & Smith, secured options on the ships. Eight of them were purchased through Mr. Geer by the Kerr Navigation Corporation, 3 by the Jason Corporation, 1 by Carib Steamship Co., and 1 by Shoshone Navigation Corporation.

"Mr. Geer had a one-third interest in the corporation, owning the Shoshone, and the remainder of the stock was held by some personal friends of his, including quite an interest purchased by Mr. Haight and Mr. Sanford personally. The stock of all of the other companies was held by new connections formed by Mr. Geer, viz, Mr. H. F. Geer and Mr. A. E. Clegg, and some Spanish interests, friends of Mr. Kerr and Mr. Clegg. Mr. Geer had no money invested in any of the other companies, but owned small shares of stock received as bonus for certain investments in bonds, etc. Mr. Kerr and Mr. Clegg are both Englishmen, and during the war with Germany it was essential that the ships be owned by American citizens. Mr. Geer made a contract with Messrs. Kerr and Clegg personally to receive as his share of the connection he made with them in turning over his contract to purchase the Hamburg-American eight ships bought by the Kerr Navigation Corporation 20 per cent of Kerr and Clegg's earnings in the Kerr Steamship Co. (Inc.), which was an operating company having a lease to operate the eight ships owned by the Kerr Navigation Corporation for 5 per cent of gross freight receipts as well as charters on other ships. The Kerr Steamship Co. (Inc.) owned all of the stock of the Kerr Navigation Corporation. Kerr and Clegg personally owned 76 per cent of the Kerr Steamship Co. (Inc.), so that Mr. Geer's contract with Kerr and Clegg was to be 20 per cent of the 76 per cent earnings of Kerr Steamship Co. (Inc.) owned by Kerr and Clegg. A copy of this contract is attached.

"It is to be noted in the contract that the reference is made that 'inasmuch as the agreement between us makes no provision for a salary for you, you may find it convenient to have a drawing account.'

"This contract was a personal contract between Mr. Geer and Messrs. Kerr and Clegg for the reason that only 76 per cent of the earnings of the Kerr Steamship Co. (Inc.), which is owned by Messrs. Kerr and Clegg, is considered as a basis for making the contract, and the other 24 per cent of the ownership of Kerr Steamship Co. (Inc.) are in no way affected."

Mr. Wight states that on Thursday morning, August 26, he learned that Mr. H. F. Kerr had booked passage abroad; that he immediately went to see him at his office, 44 Beaver Street, and Mr. Kerr told him he was to sail Saturday and asked if he knew any reason for his not doing so, stating that he had secured his income-tax clearance papers. He states that he went to the office of Mr. E. E. Geer, one of the trustees in dissolution of the Kerr Navigation Co., knowing that under certain contract agreements Mr. Kerr and Mr. Clegg were to receive some time between July 24 and October 22, 1920, a sum amounting to around $5,000,000, he having been told by Mr. Geer that Clegg and Kerr were planning to avoid payment of any income tax on account of this transaction. He asked Mr. Geer if by any chance Mr. Kerr could secure payment of this money before Saturday. Mr. Geer took Mr. Wight to the office of W. A. Harriman, at 120 Broadway. Mr. Harriman was the president of the American Ship & Commerce Corporation, which was to make payment of the money above referred to. (This payment was to be made for the American Ship & Commerce Navigation Corporation stock owned by Kerr and Clegg mentioned above.)

Mr. Harriman agreed to advise Mr. Wight when payment to Kerr and Clegg was to take place. Upon being questioned by Mr. Wight as to what endeavors had been made to provide for the payment of this stock abroad, Mr. Harriman called his attorney, Mr. George A. Ellis, who came to Mr. Harriman's office and stated as follows:

"They had drawn up a trust agreement appointing Mr. Goldman attorney for Mr. Kerr and Mr. Clegg, and himself attorney for the Harriman interests, as trustees. In the agreement there was a clause setting aside a certain amount of money (about $1,500,000, as I remember it), to be held for a period of five years for settlement of any income taxes demanded from the Kerr Navigation Corporation, of which Mr. Kerr and Mr. Clegg owned about 72 per cent. An article agreed to turn over immediately to the Harriman interest 10 of the ships owned by Harriman interest and under lease to Kerr Steamship Co., owned by Kerr and Clegg. An article covered the agreement to pay over to the trustees within five days after demand $100 per share for such number of shares as tendered to them by another trustee for beneficiaries to be named by Kerr and Clegg, to whom they were going to give their stock (their wives and other relatives), and upon demand later within 20 days to pay over the money to trustees for the beneficiaries when and where designated."

Mr. Ellis says he asked Mr. Goldman what this clause meant, and he said, "Oh, you don't need to worry about that. Its all right." Mr. Ellis said he told Mr. Goldman that under this agreement the money might have to be paid over in China. Mr. Goldman suggested London as a place of settlement, or if objectionable, Montreal. Mr. Harriman refused positively to be a party to any such transaction and the negotiations on this basis were called off.

Subsequently negotiations were entered into along the same lines, but making payment due to be made in New York. Mr. Goldman then notified Mr. Ellis that they would not accept a certified check, but demanded a cashier's check. In the meantime, through Mr. McCawley, of the solicitor's department, and Mr. B. A. Matthews, assistant district attorney, and Mr. McQuillan, special agent, the necessary papers were drawn to protect the Government and prevent their getting away with the money if so intended. The matter of settlement was delayed and finally put off until 10 a. m. Saturday morning.

Arrangements had been made whereby Mr. Harriman was to advise the Government agents as to the exact hour and place of closing the transaction. In the meantime the necessary subpœnas and notice of lien were prepared to be served upon Messrs. Kerr and Clegg. About 11 a. m., Mr. Harriman telephoned that the deal was to be closed at the Chase National Bank by the delivery of the purchase price in cash. Thereupon Mr. Wight, Mr. McCawley, Deputy Collector Konstant, and Mr. Priest, special attorney, went to the Chase National Bank and arrived there about the time Messrs. Kerr and Clegg and Mr. Ellis, representing the Harriman interests, appeared. The money was counted out and paid to Mr. Herbert Noble, attorney for Messrs. Kerr and Clegg, and the shares of stock were delivered simultaneously. Deputy Collector Konstant then served notice of demand for taxes as assessed upon

Messrs. Kerr and Clegg by personally handing said notice to the gentlemen named in the presence of the other Government employees, demanding payment of income taxes for the year 1919.

After considerable discussion the proposition was made that the sums, amounting to about $5,000,000, be taken to a safe-deposit vault, there deposited and made subject to a lien. The money was taken to the Equitable Safe Deposit Co.; deposited in the safe-deposit box, and the deputy collector served the secretary of the said company with a notice of the tax lien against A. E. Clegg and H. F. Kerr in the respective sums of $1,501,288.20.

Mr. Wight states in his report that he was advised that Mr. Kerr canceled his sailing and that he subsequently was advised that Mr. Tom Clegg, a brother of A. E. Clegg, who was present during the whole transaction of making the payment referred to above, had also booked passage abroad on a steamer other than that on which Mr. Kerr intended to sail. Both of these steamers were due to sail early in the afternoon of the day of payment.

In their examination of this taxpayer the revenue officers interrogated one Charles Henry Melsome, formerly secretary and treasurer of the Kerr Steamship Line, and secured from him two affidavits (Exhibits B and C), in which he sets forth the details of certain transactions, the propriety of which was questioned by him.

Additional income and profits taxes were assessed against the taxpayer in September, 1920, as follows:

For the year 1917	$865,578.24
For the year 1918	5,652,217.24
For the year 1919	45,576.97
Total	6,563,372.45

At the time the additional assessments were made the taxpayer was in dissolution. The taxpayer filed a claim in abatement and appeals were taken to the committee on appeals and review. A reaudit of the case was completed about the 1st of January, 1923, as a result of which certificates of overassessment were stated as follows:

For the year 1917	$222,323.14
For the year 1918	4,699,452.49
For the year 1919	260,065.97
Total	5,181,841.60

This left outstanding assessments for the years in question aggregating $1,381,530.85, which was claimed to be due, together with 5 per cent penalty and 1 per cent interest for failure to pay within 10 days after notice and demand.

Under date of March 20, 1923, it was proposed, on behalf of the taxpayer, to offer the sum of $800,000 in compromise and settlement of the additional income and profits taxes claimed to be due from the taxpayer, together with penalties and interests. This proposal was rejected by the commissioner. Upon further consideration the commissioner authorized the solicitor to inform the representatives of the taxpayer that he would be inclined to give favorable consideration to an offer in the amount of $900,000. On May 15, 1923, the sum of $900,000 was deposited with the collector of internal revenue of the second district of New York as an offer in compromise.

Under date of April 16, 1923, the Solicitor of Internal Revenue wrote the commissioner (Exhibit 20) in relation to an offer in compromise of $800,000 by this taxpayer; in which he reminded the commissioner that he had under distraint or other process a large amount of cash impounded in New York to secure the payment of an alleged tax liability against the individuals comprising this corporation, stating that "the above is mentioned merely to refresh your memory as to some of the very high lights in the case and to put you on notice that very great care should be exercised in passing on any offer in compromise."

Under date of June 27, 1923, Deputy Commissioner Bright recommended the acceptance of the offer of $900,000. (Exhibit E.) In this memorandum the deputy commissioner states, among other things, that the trustees in dissolution of the taxpayer hold assets in the value of $1,350,051.90; that the liabilities other than liability for taxes amount to the sum of $63,038.75; that it

appears that the Government by resorting to distraint could undoubtedly force the payment of a greater amount than has been paid by the taxpayer as an offer in compromise. He thought the indications were that if a demand should be made to collect the outstanding assessments in full the assets would not be sufficient to entirely satisfy the assessment, and such payments as would be made would be made under protest and would be litigated, and that if litigation should be resorted to it would undoubtedly be very complicated and long drawn out, involving a very large expenditure on the part of the Government.

Under date of June 27, 1923, the solicitor advised the Commissioner of Internal Revenue that in his opinion it would be proper and for the best interests of the United States to accept the terms proposed by the Kerr Navigation Co., namely, the sum of $900,000, in compromise of income and profits taxes for the taxable years 1917, 1918, and 1919, including 5 per cent penalty and 1 per cent interest. (Exhibit F.) This action was approved June 30, 1923, by Assistant Secretary of the Treasury Wadsworth.

In view of the fact that the record shows that the trustees in dissolution of this taxpayer held assets of the value of $1,350,051.90 and there were no secured liabilities, so that the Government had the first claim on all the assets of the taxpayer for the payment of tax due, it appears that the Government lost $450,051.90 in accepting the compromise offer of this taxpayer, which might have been collected.

GEO. G. BOX, *Chief Auditor.*

EXHIBIT B

STATE OF NEW YORK,
County of New York, City of New York, ss:

Charles Henry Melsome, of Dunwoodie Country Club, Yonkers, N. Y., being duly sworn says:

During and prior to the month of May, 1917, I was secretary and treasurer of the Kerr Steamship Line, a copartnership having at that time its place of business at No. 17 Battery Place, city of New York. About that time, to my personal knowledge, the Kerr Steamship Line placed insurance through Frank B. Hall & Co. (Inc.), covering prospective profits to be made by that partnership through operating the steamship *Suctoppen*, a Scandinavian vessel. The premium for this insurance was, to my personal knowledge, paid by the Kerr Steamship Line, a copartnership.

There is some doubt in my mind, as a matter of recollection, as to whether this premium was paid by the partnership or the corporation which was formed about that time, but I am certain that no part of this premium was paid by Kerr or Clegg individually.

The steamship *Suctoppen* was torpedoed or sunk on or about July 10 or 11, 1917.

The Kerr Steamship Co., the corporation, was organized on or about June 16, 1917. Messers. Kerr and Clegg did not, however tell me at that time of the change in the form of business organization and I recall that as late as June 19, 1917, I drew a check on the funds of the Kerr Steamship Line.

Check No. 46872, drawn by Frank B. Hall & Co. (Inc.) on the National City Bank, payable to the order of the Kerr Steamship Co. (Inc.) for $88,906.97, check dated October 26, 1917, which I have in my hands, was received in the mail on or about October 27, 1917. On or about that date I had a conversation with Mr. Clegg, when he told me that the proceeds of the *Suctoppen* insurance would not be passed through the Kerr Steamship Co. books, but the proceeds of the check were to be invested in Government bonds or other securities, which he would take charge of.

I then took the above-mentioned check to the Equitable Trust Co. and cashed the same, receiving either a cashier's check or currency. I then took the proceeds to bond brokers, either Wardwell & Adams or Bonbright & Co., and requested them to purchase Government securities, I think United Kingdom 1921 notes. I told the brokers to let me know when the bonds were ready, and upon being advised that the bonds had been purchased, Mr. Clegg and I went to the office of the brokers and Mr. Clegg took the bonds. He took them to the Equitable Safe Deposit Co., accompanied by me, and placed them in a safe deposit box in that company. The box in which these securities were placed by Mr. Clegg was the safe deposit box of the Kerr Steamship Co. Some time later these bonds were removed from this particular box and put in a personal box of Kerr and Clegg, in the same safe deposit company.

At the time I had the above-mentioned conversation with Mr. Clegg it occurred to me that this fund should have been deposited to the account of the Kerr Steamship Co., and should have been divided eventually among the stockholders, of whom I was one. The other small stockholders and amount of their stockholdings was, at that time, approximately as follows:

	Per cent
H. S. Quick	10
W. H. Cowley	10
J. J. Sharp	1
R. A. Krug	1
C. H. Melsome	1

The proceeds of the above check were to my knowledge never taken up on the books of the Kerr Steamship Co. (Inc.), or the Kerr Steamship Line, while I was connected with the company; that is to say, November 18, 1918, and were not reflected in the income tax return of the corporation for the calendar year, 1917, which return was filed on or about March 15, 1918.

CHARES H. MELSOME.

Sworn to before me this 14th day of September, 1920.

WM. J. FINERTY, *Notary Public.*

EXHIBIT C

STATE OF NEW YORK,
County of New York, City of New York, ss:

Charles Henry Melsome, of the Dunwoodie Country Club, Yonkers, N. Y., being duly sworn, says:

About June, 1916, I was secretary and treasurer of the Kerr Steamship Line, a copartnership having at that time its place of business at No. 17 Battery Place, city of New York.

About that time C. Kenyon & Co., or Clarence Kenyon individually, being the owner of a dock known as Pier 57, Brooklyn, leased that dock to the Kerr Steamship Line for a period of ten (10) years at an annual rental of $90,000.

One of the terms of this lease was that the sum of $100,000 be deposited by the Kerr Steamship Line with Kenyon as a security for the payment of rental and also as security for the building of the dock, which Kenyon undertook to do.

There was considerable delay in completing the building of the dock, the same not being turned over until about April 1, 1917.

About this time the Northern Dock Co. was incorporated by H. F. Kerr and A. E. Clegg. I was instructed by Mr. Clegg to prepare a lease to the Northern Dock Co. of the dock at an annual rental of $150,000. I prepared such draft of lease, using the Kenyon lease as a model, but this lease was never actually signed. The Northern Dock Co. became a tenant of the dock in question on a verbal agreement to pay $150,000 per annum rental. The terms of both leases were that the rental be paid in equal quarterly installments. As each rental date arrived I would go to the Northern Dock Co., collect the sum of $37,500, which would be placed to the credit of the Fifty-seventh Street Pier account in the Kerr Steamship Line books. Thereupon I would draw a check upon the account of the Kerr Steamship Line, or later the Kerr Steamship Co., to the order of Kenyon for $22,500; at the same time I would draw two checks for $7,500 each to H. F. Kerr and A. E. Clegg individually and deliver the checks to them.

The $100,000 fund above mentioned, deposited with Kenyon as security, was taken from the funds of the Kerr Steamship Line, and one of the terms of the agreement was that Kenyon would pay interest upon that amount at 4 per cent per annum to the Kerr Steamship Line. This interest when received was placed in the account of that company and duly entered on its books.

No part of the $60,000 profit, however, between the rental received from the Northern Dock Co. and the rental paid to Kenyon was ever credited, to the best of my knowledge, on the books of the steamship line or of the corporation so long as I remained in connection therewith; that is to say, until about November 18, 1918.

CHARLES H. MELSOME.

Sworn to before me this 14th day of September, 1920.

WM. J. FINERTY, *Notary Public.*

EXHIBIT D

APRIL 16, 1923.

MR. COMMISSIONER:

Herewith is transmitted for your signature a proposed letter addressed to Messrs. Noble, Morgan & Scammell in which they are advised that the informal offer of the Kerr Navigation Corporation of $800,000 to compromise a liability of $1,381,530.85 is rejected.

This case is one which a couple of years ago attracted very wide newspaper publicity, due to which the Government charged to be fraudulent activities on the part of the officers of the company and an attempt to get large sums of money out of the country without settlement of the tax liability. You will perhaps remember that you now have under distraint or other process a large amount of cash impounded in New York to secure the payment of an alleged tax liability against the individuals comprising this corporation. The above is mentioned merely to refresh your memory as to some of the very high lights in the case and to put you on notice that very great care should be exercised in passing on any offer in compromise.

The statement of assets furnished by the company indicates that there are now in the hands of the trustees in liquidation liquid assets of an amount approximately the same as the amount of the Government's claims. There are accounts payable of $63,000 and probably some additional miscellaneous administrative expenses.

It appears to me that while it might be advisable to compromise in this case, due to the company being out of business and dissolved and the assets all being in possession of trustees, nevertheless I personally am not satisfied with the $800,000 tendered, because it is not as much as they can pay nor is it as much as they should pay, as I read their financial statement. I might add that Captain Rogers is rather of the opinion that it might be well to accept the $800,000 without further controversy and thereby close the case, which has occupied so much time and has been so troublesome of settlement over a course of several years.

If you wish to talk with me further about this matter I should be glad to discuss it with you further at your convenience.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT E

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, June 27, 1923.

Compromise Case No. SOL:C:196804, Second District New York. Not in Suit

United States *v.* Kerr Navigation Corporation (In Dissolution), 21 State Street, New York, N. Y.

Charge: Additional corporation income and profits taxes for the taxable years 1917, 1918, and 1919 in the amount of $1,381,530.85 plus 5 per cent penalties, and 1 per cent interest thereon for failure to pay within 10 days after notice and demand.

Offer: The sum of $900,000 in compromise of income and profits taxes for the years 1917, 1918, and 1919.

(See following pages for detailed statement.)

I recommend acceptance.

J. G. BRIGHT, *Deputy Commissioner.*

Date: First offer, May 15, 1923. Tax, $900,000. Total specific penalty costs, $900,000.

The Kerr Navigation Corporation was incorporated under the laws of the State of New York on the 14th of July, 1917, and was dissolved pursuant to the laws of the State of New York on the 28th of October, 1919. Its capital was $800,000, consisting of 160 shares, without per value, issued for $5 per share. The corporation filed income and profits tax returns for the taxable years 1917, 1918, and 1919 and paid taxes thereon as follows:

For the year 1917	$214,453.57
For the year 1918	3,024,273.16
For the year 1919	800,625.90
Total	4,039,352.63

Additional income and profits taxes were assessed against the taxpayer in September, 1920, as follows:

For the year 1917	$865,578.24
For the year 1918	5,652,217.24
For the year 1919	45,570.97

At the time the additional assessments were made taxpayer was in dissolution. As it appeared that the former stockholders of the taxpayer, who were in possession of all of its assets, were about to depart from the country, summary assessments of the additional taxes which seemed to be due were made. These additional assessment were based largely upon estimates, and all doubtful questions were resolved against the taxpayer and in favor of the Government. Within a few days after the additional assessments had been filed the taxpayer filed claims for abatement thereof. Thereafter appeals were taken to the committee on appeals and review, and affidavits, certificates, and letters were submitted and oral argument was presented and conferences were held between the representatives of the corporation, the committee on appeals and review, the Solicitor of Internal Revenue, and representatives of the Income Tax Unit. The principal points in dispute before the committee on appeals and review were the alleged realization of income from the reorganization of the Kerr Navigation Corporation, amortization, requisition charter hire in 1919, classification under section 209 of the revenue act of 1917, special assessment under sections 327 and 329 of the revnue act of 1918, expenditures for reconditioning ships, reorganization expenses disallowed as a deduction and charged to capital account, deduction for salary paid to president, reallocation of certain items to 1918 income, and the closed voyage adjustment account. The consideration of the appeal involved many difficult questions and the examination of a mass of detailed and complicated data. The committee on appeals and review in recommendation No. 497, under date of March 19, 1921, allowed the appeal in part and denied it in part. The case was thereupon returned to the Income Tax Unit for reaudit, in accordance with the recommendation of the committee on appeals and review. Owing to the extremely complicated nature of the case, the reaudit was not completed until on or about the 1st of January, 1923. As a result of the reaudit certificates of overassessment have been listed as follows:

For the year 1917	$222,323.14
For the year 1918	4,699,152.49
For the year 1919	200,065.97

There are accordingly outstanding assessments for the taxable years 1917, 1918, and 1919 in the total amount of $1,381,530.85, which is claimed to be due from the taxpayer, together with 5 per cent penalty and 1 per cent interest for failure to pay within 10 days after notice and demand.

The taxpayer disputes the correctness of the recommendation by the committee on appeals and review and the computation of tax liability based thereon. The principal points on which the taxpayer and the bureau are not in accord are as follows:

1. The taxpayer claims that it should be assessed under section 209 of the revenue act of 1917 at the 8 per cent rate because it is a corporation having a nominal capital, the term "nominal" being a relative term; its capital stock, $800,000, is nominal relative to the cost of the eight ships which it purchased, which was $9,847,650. The capital is also nominal in comparison with the net income as stated above.

2. The bureau fixed the excess-profits tax rate for 1918 at 66.8043 per cent. The corporation paid taxes at the rate of 50 per cent and claims that the rate should not in any event exceed 58 per cent, and this rate may be too high.

3. The bureau has allowed an amount of amortization which the company believes to be correct, the ships having been written down in the bureau's computation to $4,000,000. The bureau, however, has spread this amortization between January 1, 1918, and September 3, 1919. This latter date is the date on which the formal transfer of title to the ships was made pursuant to the reorganization of the Kerr Navigation Corporation. The taxpayer submitted

evidence to the committee on appeals and review showing that the value of the ships on January 1, 1918, was less than $4,000,000 and that the value of the ships on September 3, 1919, was less than $4,000,000. The taxpayer has also submitted an affidavit and brief (in the hands of the Solicitor of Internal Revenue) showing that the value of the ships in terms of their income-producing capacity did not decrease between December 31, 1918, and September 3, 1919, and contending that if the value of the ships was $4,000,000 on September 3, 1919, it was no greater on December 31, 1918, and that the full amount of amortization allowed had been sustained during the taxable year 1918. In spreading this amortization the bureau has allocated $808,133.73 to 1919. This amount the taxpayer contends should be allocated to 1918.

4. The bureau has also disallowed as an expense the sum of $51,006.24 paid to Messrs. Haight, Sandford & Smith, the attorneys who incorporated the company, and who rendered the legal services in connection with its note issue and mortgages and in connection with the acquisition of the steamers and the transfer of their flags. These attorneys have apportioned their bills as follows:

Organization of company	$1,967.47
Services and disbursements in connection with note issue and mortgages	24,788.77
Services in connection with acquisition of steamers	24,250.00
Total	51,006.24

This bill for legal services was paid in 1918 and the note issue and mortgages were canceled in 1918. The taxpayer contends that the charge for services and disbursements in connection with the note issue and mortgages should be allowed as a deduction in 1918 and that the charges for services in connection with the acquisition of the steamers should be added to the cost of the steamers and amortized in 1918.

Trustees in dissolution of the taxpayer hold assets of the value of $1,350,051.90. There are no secured liabilities, so that the Government has a first claim on all the assets of the taxpayer for the payment of any taxes due. The liabilities, other than the liability for taxes, amount to the sum of $63,038.75.

Under date of March 20, 1923, it was proposed on behalf of the taxpayer to offer the sum of $800,000 in compromise and settlement of the additional income and profits tax claimed to be due from the taxpayer, together with penalties and interest. This proposition was rejected by the commissioner under date of April 19, 1923. Upon further consideration the commissioner authorized the solicitor to inform the representatives of the taxpayer that he would be inclined to give favorable consideration to an offer in the amount of $900,000. This information was communicated to the representatives of the taxpayer, and on May 15, 1923, the sum of $900,000 was deposited with the collector of internal revenue for the second district of New York as an offer in compromise.

It appears that the Government by resorting to distraint could undoubtedly force the payment of a greater amount than has been paid by the taxpayer as an offer in compromise. However, the indications are that if an attempt should be made to collect the outstanding assessments in full the assets would not be sufficient to entirely satisfy the assessments, and such payments as would be made would be made under protest and would be litigated. If litigation should be resorted to, it would undoubtedly be very complicated and long drawn out, involving a very large expenditure on the part of the Government. Moreover, some of the questions in dispute are not entirely free from doubt and many of the employees of the bureau who participated in the consideration of the case and who were intimately acquainted with its details have since severed their connection with the Government. It is therefore doubtful whether the net result of attempting to collect the outstanding assessments by distraint would in the end be more favorable to the Government than the acceptance of the amount offered in compromise.

The collector of internal revenue for the second district of New York recommends that the offer be accepted.

EXHIBIT F

DEPARTMENT OF JUSTICE,
OFFICE OF THE SOLICITOR OF INTERNAL REVENUE,
Washington, D. C., June 27, 1923.

To the COMMISSIONER OF INTERNAL REVENUE.

SIR: I have considered the proposition of Kerr Navigation Corporation _____ to compromise its liabilities, as charged herein.

In view of the statement and recommendation contained in this brief, which are made a part hereof, and the papers on file herein, I am of the opinion and advise that it will be proper and for the best interests of the United States to accept the terms proposed, the sum of $900,000 in compromise of income and profits taxes for the taxable years 1917, 1918, and 1919, including 5 per cent penalty and 1 per cent interest.

Respectfully,

NELSON T. HARTSON, *Solicitor.*

Mr. MANSON. Several days ago, I presented to the committee the case of Anne O. Haight, and stated that at that time, for the purpose of checking up on the system, Mr. Parker began a course of investigation something along this order: From the Haight case he ran into the Standard Parts Co. case. In other words, he would follow up any suggestion that appeared from an examination of one case; that is, wherever, in the examination of one case, facts were disclosed which suggested the running down of another case, he ran it down. I have already presented to the committee the various ramifications of that investigation.

I find here another ramification of that same investigation.

There appears in the record the following memorandum: This memorandum is not signed, but at the bottom of it appears the title, chief personal audit section, Mr. S. Alexander, head, special audit division. It is dated August 11, 1922, and is addressed to J. H. Akers, chief, special assignment section, attention J. W. Carter, chief fraud subsection, through Mr. B. S. Kimbrell, head, personal audit division:

Attached hereto is the file in the case of Louis G. Kaufman, 149 Broadway, New York, N. Y., for the year 1916.

It appears from an examination of the books of account and records of the Chevrolet Motor Co. of Delaware that Mr. Louis G. Kaufman received during the year 1916 approximately 100,000 shares of the United Motors Corporation stock as payment for his service in organizing the United Motors Corporation. It also appears from the return filed by Mr. Kaufman that he failed to report this stock, which had a market value of from $4,000,000 to $6,000,000.

Inasmuch as the period during which assessments on 1916 returns are permissible has elapsed, this return is being forwarded to you to determine whether or not fraud exists.

I take it that the chief of the personal audit section was proceeding on the theory that if there was fraud in this case, the fact that the statute would not run would not prevent the assessment of the tax.

Mr. GREGG. The statute does not run on a fraud case.

Mr. MANSON. No. That is the theory, I take it, on which he was proceeding.

Mr. Parker called my attention to this memorandum, and I asked him to run it down and see what action had been taken on that memorandum.

I have the following memorandum from Mr. Parker, under date of May 25, 1925:

Attached please find copy of a memorandum from chief of personal audit No. 2 to J. W. Carter, chief fraud subsection (now special adjustment section).

From this memorandum it appears that Mr. Kaufman failed to report as income in the year 1916 the value of $100,000 shares of United Motors Corporation stock which he received as payment for services to the syndicate promoting this corporation. The market value of the stock at this time was $4,000,000, at least.

The special adjustment section has told me over the telephone that they have only a card record of this case covering the receipt of the file and the return of the file to audit. This means nothing was done in the case, or if there were, nothing is on record about it. The penal division of the solicitor's office has no record of the case.

This is the second time the writer has found no adequate records in the fraud section out of only two inquiries.

The returns and certain files of the taxpayer for the years 1916, 1917, 1918, and 1919 have been examined. If same are complete, it is evident from them that no additional tax or fraud penalty has been collected. We also find no evidence of a profit being reported by Mr. Kaufman when he turned in this stock for stock of the General Motors Co.; on the contrary, there is a record of a conference, dated December 16, 1921, in which Mr. Kaufman claimed a deduction from income in the amount of $442,634.97 from his 1920 income. The principal item of this deduction was the loss on 80,000 shares of stock in the United Motors Corporation, converted into stock of the General Motors. This loss is based on a value at acquisition of $45 per share in 1916. If this is the same stock that Mr. Kaufman received for his services, it looks decidedly as though the investigators of the bureau are lax.

We do not wish to form judgment in this case without all the facts, but from those at hand we are at a loss to account for the lack of action by the bureau. Certainly if the bureau forgives tax on income received in the form of stock in 1916 and then allows taxpayer to deduct a loss on the same stock in 1920 a serious condition exists, for the taxpayer gets out of tax "coming and going."

This matter is one of those in the chain beginning with the Mrs. Anne O. Haight case and continuing with the Western Wheel & Axle & Standard Parts Co. cases.

Investigation of such related matters appears to be up to the individual initiative of the auditor handling the case. More systematic effort in following up related matters should be made obligatory.

That is respectfully submitted by L. H. Parker, chief engineer.

The CHAIRMAN. Was not W. C. Durant involved in that matter?

Mr. MANSON. I think we called for the returns of W. C. Durant, although I have received no report on them as yet.

The CHAIRMAN. I think the complaint that came to my office originally included both Mr. Kaufman and Mr. Durant, and I think the committee ought to know something about the Durant case also.

Mr. MANSON. I have called for the Durant returns. Whether they have been received or not I do not know, but it may be that Mr. Parker has not had an opportunity to report on it as yet.

Mr. NASH. Mr. Chairman, I might say that the date of this memorandum indicates that the case was considered in 1922. At that time the information section, which we now have in the audit divisions, did not exist. The fraud section at that time was a part of the old special audit division, a section under an audit division, responsible to Mr. Alexander. It did not function properly, and about a year and a half ago or so we abolished the old special audit division entirely. We took the various sections and added them to the other audit divisions; but the fraud section, inasmuch as it related to the entire work of the Income Tax Unit, was placed directly under the

deputy commissioner, and that is where it is now. This section always functions closely with the solicitor's office.

The CHAIRMAN. Do I understand from that statement that a case like this can not occur again?

Mr. NASH. I do not believe it would go through the fraud section without an adequate record. The file here just indicates a card record of the case, and I think if this case went to the fraud section to-day we would find a record in the files as to what was considered and what action was taken.

Mr. MANSON. I do not believe it is too late to collect that tax yet.

Mr. NASH. If there is fraud involved, it is not.

The CHAIRMAN. Will you make an inquiry into that and advise us as to whether there is fraud?

Mr. NASH. Yes, sir. I also want to say that we have a special intelligence unit that investigates fraud cases, and a case of this kind should go there first for an investigation of the facts in the field.

The CHAIRMAN. Mr. Manson, if I remember correctly, there was a complaint made to us, containing a number of names in addition to that of Mrs. Haight, involving the same transaction, and that no report was made in the same manner as Mrs. Haight made her report. Do you recall whether that is true or not?

Mr. MANSON. In the Haight report it is stated that those two parties had not reported any income from that transaction. That was in connection with the Standard Parts Co. stock.

The CHAIRMAN. If that is the situation, that is a case of fraud also, is it not?

Mr. NASH. We are now going into the Haight case, Senator.

Senator KING. May I say, Mr. Nash, that a number of statements have been made to me that in these reorganizations, where people have turned in their stock of an old company and have taken stock in a new company, at greatly increased prices; that is, they have made great profits and no returns have been made, and that the Government has lost a great deal of money in connection with these consolidations, sales of stock, etc.

Mr. GREGG. I was just going to say in that connection, in answer to Senator Couzens's question, that the omission from a return of the gain from a reorganization does not necessarily involve fraud. Many taxpayers thought, and thought with a great deal of reason, that when they gave up a certificate of stock in corporation A and received in exchange for it a certificate in the same corporation, in fact, but now called corporation B, they realized no income from that transaction. The later acts so provided. There were a good many cases, particularly back under the 1916 and 1917 acts, where the taxpayer made no return, and in some of those cases we did hold that there was no fraud. For example, in the case of Stearn *v.* Weiss, the Supreme Court held that there was no income from the transaction.

Mr. MANSON. In this case, however, this was not the case of an exchange; but here we have a case where a man received these 106,000 shares of stock as payment for services.

Mr. GREGG. Yes; but I was going back to the Haight case, not the Kaufman case.

Mr. MANSON. Yes.

The CHAIRMAN. I was wondering whether or not the facts in the Haight case as reported put the bureau on notice to look into other holders of stock.

Mr. GREGG. It should have, yes, sir; but it was held at that time that it was a 1916 transaction, as I remember it, and at that time the records were quite incomplete.

Mr. MANSON. Here is the big point in this Kaufman case, to my mind: Kaufman receives 106,000 shares of stock in 1916 in payment of services, which were not reported as income. Later, there is a memorandum passed in the bureau from one section to another, calling attention to that fact. We are unable to find that up to the present time any action has been taken on it.

Senator KING. Yes; I understand.

Mr. MANSON. Then, in 1920, Kaufman reports a loss upon an exchange of 80,000 shares of the same stock. Of course, we are unable to say that those 80,000 shares upon which he was permitted a deduction of over $400,000 were a part of the 106,000 shares he received in this deal; but he did receive them in the same year in which this deal took place. I do maintain that where a man claims a loss of $400,000 on the disposition of stock, a proper investigation of that loss as a deduction would certainly disclose the fact that he had received that stock, and had not reported it as income.

Mr. GREGG. Was the loss allowed, Mr. Manson?

Mr. MANSON. I think the loss was allowed; yes.

The CHAIRMAN. While we are on this point, before the committee makes its report to Congress, will the bureau put in the disposition of these controverted cases for the record?

Mr. NASH. Yes, sir. Senator, I have before me now a statement on the anthracite coal cases that you asked for the other day.

This is a statement signed by Robert C. Davis, chief, coal valuation section, and it is dated May 25, 1925.

He says:

In reply to your verbal request made on the 23d instant, the following information is submitted.

Then he shows closed cases—1917, 254; 1918, 320; 1919, 299; 1920, 287; 1921, 116; 1922, 55; 1923, 21; and 1924, 2; or a total of 1,354 case years.

In process in the division: One 1917 case, one 1918 case, four 1919 cases, one 1920 case, seven 1922 cases, three 1923 cases, and three 1924 cases.

On file in the division and not acted on: Two 1920 cases, two 1921 cases, eight 1922 cases, two 1923 cases, and one 1924 case; a total of 15.

He says these cases have come into the section recently; that is, the ones that have not been acted on.

There have been 491 taxpayers' returns sent to the coal-valuation section, of which 458 have been acted upon. Thirty-three cases are now in process.

So, according to this statement, most of the anthracite coal cases are closed up through 1920.

The CHAIRMAN. Where did we get our information, Mr. Manson?

Mr. MANSON. We called for, I think, six or seven anthracite coal cases, and everyone that we called for was one that had not been acted upon, and for that reason they made no report on it.

The CHAIRMAN. I see Mr. Thomas is here. As stated before, I would like to get more data for the committee on the depletion which has been allowed in the cases of anthracite coal.

Mr. MANSON. Mr. Thomas has nothing to do with that.

Senator KING. That statement of Mr. Nash's would show that, with respect to the anthracite coal cases, the business is nearly current.

Mr. NASH. Up through 1920, at least, it is in very good shape.

The CHAIRMAN. I may have been misinformed by some of our own staff. They inform me that they had not been able to get the depletion rates allowed for anthracite coal, so I must have been misinformed by our own staff.

Mr. MANSON. I think there was a general misunderstanding. My information is that the particular cases that we had called for were not closed. There is in process of preparation by Mr. Wright a general report of the anthracite situation which will deal with the question of depletion, but what I assume the chairman had reference to are the cases that had been called to our attention and which we have looked up and found were not closed.

Mr. NASH. As I understand it, there are less than 500 anthracite producing companies in the country, and, according to this statement, 458 of them had been closed up to 1920.

The CHAIRMAN. It may be a coincidence that those that we have asked for were not among the ones which were closed, but it may be that I have gotten the wrong information. However, we do want to get before the committee some information on these anthracite coal cases.

Mr. MANSON. I have just given Mr. Thomas the statement of Mr. Nash, and I have asked him to telephone to Mr. Wright and get some information on the subject. I know that Mr. Wright has in process of preparation a general report on the anthracite cases, and I have been informed right along that the particular cases that we have called for have not been closed.

The CHAIRMAN. Do you wish to present another case now?

Mr. MANSON. Yes; I have another matter to present now. I desire to call the committee's attention to a situation under which, under the method of handling at least one case, a taxpayer who owns practically all of a corporation is permitted to reduce his individual income by assuming corporate losses.

Before I go into that case, however, I would like to deal with the general situation.

There are many businesses which are conducted in corporate form, whose activities can be so subdivided that while the business generally is a profitable business, you can find some phase of it which is a losing venture.

Take a hotel business. It is a matter of common knowledge, almost, that the dining room of a hotel ordinarily does not pay, but in order to maintain a hotel and properly provide for guests, it is necessary to maintain the dining room, even though that, as a separate part of the business, may be running at a loss. I just cite that as an illustration.

I might cite other illustrations.

I may be a dealer in automobiles. My business generally is profitable, but I take in old cars. I may make no profit on the old cars. In other words, I make an allowance upon them, but when I come to add the cost of reconditioning, repainting, and the salesman's commission for selling, I have made an actual loss, but I have managed to sell a new car and make a profit on the new car, which is enough to more than overcome the loss. If I were to separate my used-car business, from my new-car business, the used-car business would show a loss.

I do not mean that that is generally true, but I mention it as a possibility.

Now, assume that this hotel or this automobile business is incorporated. The owner has a large income. By making a contract whereby he will receive in possible profits of the used-car end of the business, or in possible profits of the dining room, he agrees to assume the loss, and he is thus able to convert a corporate loss into an individual loss, and if he is paying a high tax rate, he is able to convert a loss which would go into his corporate income and offset a 12½ per cent rate at a very much higher individual rate.

As an illustration of that weakness in the law, in my opinion, I call attention to the case of William Randolph Hearst. That is a good typical case of what I am trying to bring out here. In my opinion, if that is a weakness in the law, as it exists, it should be remedied, because it has a great many ramifications.

The CHAIRMAN. Do you consider it as a weakness in the law, or do you think the bureau is compelled to accept such contracts as that?

Mr. MANSON. I am frank to say that I am in doubt.

The facts in this case are there——

The CHAIRMAN. Just read the case, and then we will decide it afterwards.

Mr. MANSON. I do not intend to read this whole report.

The CHAIRMAN. Just give use the substance of it.

Mr. MANSON. The substance of it is this:

Mr. Hearst controls several newspapers. He made a contract with these newspapers that if they would put in a rotogravure section and would give him the proceeds of the advertising from the rotogravure section, he would pay the cost of the rotogravure section.

The rotogravure section will carry about so much advertising. If they put enough advertising in the rotogravure section to make that section a paying proposition, without so loading it up with advertising that it loses its attractive qualities as one of the features of the newspaper——

The CHAIRMAN. Newspaper men tell me that generally that is a losing feature of the business.

Mr. MANSON. That has been found by the bureau in another department that the rotogravure is always a losing venture. In other words, he might just as well have made a contract to pay the cost of the first page. It would not be quite as——

The CHAIRMAN. Disastrous a loss.

Mr. MANSON (continuing). Disastrous a loss; but the rotogravure section is one of the incidents of the newspaper. As long as newspapers will carry that section, which is the section that contains all

of the attractive pictures in the Sunday papers—as long as newspapers will carry that section, and offer that service to their subscribers and purchasers, other newspapers must carry it. It is one of the features of a newspaper; it is incidental to it, just exactly as the front page is.

By charging off the loss incident to this rotogravure section, the following results in Mr. Hearst's taxes are arrived at:

Under date of April 18, 1923, Revenue Agent Harry Herskowitz made a report of his investigation of the income of this taxpayer and recommended the assessment of an additional tax for the year 1918 of $204,615.68, 1919 of $47,964.66, and of 1920 of $21,009.55. (Exhibit B.)

Under date of August 15, 1923, the bureau forwarded an A–2 letter (Exhibit C) to the taxpayer notifying him of a proposed assessment of $272,978.38, representing additional taxes for the years in question, as follows: 1918, $204,004.17; 1919, $47,964.66, and for 1920, $21,009.55.

The taxpayer filed a protest against the proposed assessment of the bureau. As a result of this protest a reaudit of the taxpayer's income was made and on February 9, 1924, a second A–2 letter was mailed to the taxpayer notifying him of a proposed assessment on account of additional taxes of $17,033.19, and $47,964.66 for the years 1918 and 1919 respectively, and an overassessment of $8,626.39 for the year 1920. (Exhibit D.)

Senator KING. It shows that recommendation of the agent of approximately $278,000 was not followed.

Mr. MANSON. If the committee will bear with me for just a minute, I will try to ascertain how much of that is due to the charging off of these manifestly corporate losses against his individual income.

The taxpayer set up as a loss, due to this transaction, the sum of $301,232.95 for the year 1918. If this loss had been deducted from the income of the corporation under which they were incurred, their taxes would have been reduced approximately $36,000, at the rate of 12 per cent. However, by allowing the loss from the individual return of this taxpayer, a saving of $187,582.49 was made by him, with a resultant loss to the Government, by allowing the deduction to be made from the individual return instead of the corporation return, of approximately $151,000 in income tax.

Mr. GREGG. May I interrupt you there?

Mr. MANSON. Yes.

Mr. GREGG. Is it possible that the newspaper companies with which he had these contracts paid a tax of only 12 per cent in 1918?

Mr. MANSON. That is what the auditor reports.

Mr. GREGG. That seems hard for me to believe, in the highest excess-profits tax year. Of course, they may have had a large invested capital.

Mr. MANSON. I have made no personal investigation of it. He reports that they were not subject to any excess-profits tax but only to the normal tax based on the 12 per cent rate.

Mr. GREGG. Possibly they had such an enormous invested capital that they were not subject to the excess-profits tax.

Mr. MANSON. The agent says:

The return of the Star Co., which is the principal corporation of a group of over 30 affiliated corporations, of which Mr. William Randolph Hearst owned 100 per cent of the capital stock, showed a net income for the year 1919 of $1,171,332.14. This income was not subject to war-profits or excess-profits taxes but only to a normal tax of 12 per cent.

I offer the full report as an exhibit in this case.

(Exhibits submitted by Mr. Manson in case of William Randolph Hearst are as follows:)

EXHIBIT A

MAY 22, 1925.

In re William Randolph Hearst, New York, N. Y.

Under date of April 18, 1923, Revenue Agent Harry Herskowitz made a report of his investigation of the income of this taxpayer and recommended the assessment of an additional tax for the year 1918 of $204,615.68, 1919 of $47,964.66, and of 1920 of $21,009.55. (Exhibit B.)

Under date of August 15, 1923, the bureau forwarded an A-2 letter (Exhibit C) to the taxpayer notifying him of a proposed assessment of $272,978.38, representing additional taxes for the years in question as follows:

1918	$204,004.17
1919	47,964.66
1920	21,009.55

The taxpayer filed a protest against the proposed assessment of the bureau. As a result of this protest a reaudit of the taxpayer's income was made and on February 9, 1924, a second A-2 letter was mailed to the taxpayer notifying him of a proposed assessment on account of additional taxes of $17,633.19, and $47,964.66 for the years 1918 and 1919, respectively, and an overassessment of $8,626.39 for the year 1920. (Exhibit D.)

The bureau sustained the revenue agent in his finding for additional taxes for the year 1919 and allowed as a deduction from taxpayer's gross income for 1920 the inheritance tax paid to the State of California on the estate of his mother, of which he was the chief beneficiary.

No criticism is made of the action of the bureau on its treatment of the 1919 and 1920 income. The difference between the action of the revenue agent and that of the bureau in connection with the 1918 income of this taxpayer is an item of $301,232.95 which the taxpayer claims as a deduction and which the revenue agent disallowed. This item was finally allowed by the bureau as a deduction from taxpayer's gross income and is subject to criticism by this committee.

In regard to this item the revenue agent reports as follows:

"Mr. Hearst made a contract in 1918 with the Boston, Chicago, and New York papers to purchase all materials and defray all expenses necessary in the production of the photogravure section of the above publications, provided he received all advertising receipts of these particular sections.

"This feature was in its experimental state. It was quite evident to any man that the advertising receipts of the photogravure section would not by far be sufficient to offset the disbursements. As a matter of fact that section was a losing proposition to all newspapers. Here we have a shrewd, successful, far-visioned newspaper man of vast experience entering into a contract which in advance he must have known to be a losing venture. The inference is simple. Mr. Hearst had a large income from dividends. The corporations were his. Why not experiment with his personal income, of which the Government would get 56 per cent, and develop his newspaper enterprise? At best this money was a loan, an advance, a capital outlay.

"It is strange that this contract obtained in a high-rate year. Why was it not continued in 1919 and the following year? On the theory that this venture was not entered into with a view to investment and profit, but solely to relieve himself of the high rate of taxation, the loss has been disallowed. The contract would certainly not have been entered into if the corporations were under control of outsiders. This fact alone spells out his intention."

The taxpayer, in his brief filed in support of his protest to the assessment of additional taxes, proposed to be assessed by the bureau's A-2 letter of August 15, 1923, referred to above, submitted in relation to the item in question the following:

"The revenue agent disallowed as a deduction in the year 1918, $301,232.95, which amount represents a loss sustained in connection with the financing of the production of the rotogravure sections in Sunday editions of three newspapers.

"The facts in connection with this particular undertaking are as follows:

"Early in 1918 the taxpayer conceived the idea of increasing the revenues of certain newspapers by adding to the Sunday editions a rotogravure section. The rotogravure section had proved successful and remunerative prior to this time with other newspapers.

"The managers of Mr. Hearst's newspapers were not in accord with the taxpayer's view because of the difficulty of financing a rotogravure section during the war years. After much consideration the taxpayer agreed to finance the venture and to pay all expenses in connection with the publication of a rotogravure section, provided all revenues derived from the advertising placed with this section of the newspapers were credited and paid to the taxpayer. Pursuant to this agreement, the rotogravure sections were published in three newspapers for a period of several months. At the end of the period the venture was abandoned because it proved a financial loss.

"The taxpayer has annexed hereto the affidavits of Messrs. Julian M. Gerard, Bradford Merrill, and A. J. Kobler in support of his contention.

"The taxpayer, as a result of this agreement, suffered a loss of $301,232.95 in the year 1918 and deducted it from his net income when the tax return was filed.

"Article 141, regulations 45, states in part as follows:

"'Losses sustained during the taxable year and not compensated for by insurance, or otherwise, are fully deductible (except by nonresident aliens) if (*a*) incurred in the taxpayer's trade or business, or (*b*) incurred in any transaction entered into for profit, or (*c*) arising from fires, storms, shipwreck, or other casualty, or from theft. * * *.'

"The taxpayer respectfully submits that this loss of $301,232.95 was incurred in a transaction entered into for profit, and under the provisions of article 141, regulations 45, is an allowable deduction from income for the year 1918."

The taxpayer claims this loss should be allowed as a deduction from his individual gross income under the authority of article 141, regulations 45, for the reason that it was a transaction entered into for profit. The facts speak for themselves. The return of the Star Co., which is the principal corporation of a group of over 30 affiliated corporations, of which William R. Hearst owned 100 per cent of the capital stock, showed a net income for the year 1919 of $1,171,332.14. This income was not subject to war profits or excess profits taxes, but only to a normal tax of 12 per cent. If the taxpayer had actually felt that a profit could have been made by publishing this new section of his Sunday papers, he would naturally have arranged for the financing of the section by the corporations interested therein. However, if a profit had been derived from the advertising in these sections, the taxpayer would have had to pay a tax at the rate of approximately 60 per cent on such income if it were included in his individual return instead of approximately 12 per cent if taxed to the corporations.

Affidavit of Bradford Merrill, vice president of the Star Co. in 1918, which is attached to the brief, states that Mr. Hearst discussed with him his proposal to include rotogravure sections in the Sunday editions of the New York, Chicago, and Boston papers; that he strongly opposed this proposal in several conferences with Mr. Hearst on the account that the section could not be made profitable in view of its cost in their very large Sunday circulation.

It is apparent that Mr. Hearst must have known that this venture was a losing one and that by assuming the loss personally rather than allowing the corporations involved to deduct the loss, he would save a considerable amount in his income tax. If this loss had been deducted from the income of the corporations under which they were incurred, their taxes would have been reduced approximately $36,000 (at the rate of 12 per cent). However, by allowing the loss from the individual return of this taxpayer a saving of $187,582.49 was made by him, with a resultant loss to the Government, by allowing the deduction to be made from the individual return instead of the corporation return, of approximately $151,000 in income taxes.

GEO. G. BOX, *Chief Auditor.*

EXHIBIT "B"

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
New York, N. Y.

In re William Randolph Hearst, 238 William Street, New York, N. Y. Examining officer, Harry [illegible]skowitz; examination commenced, March, 1922; completed, April 18, 1923; time spent, 32 days (intermittent).

SUPERVISING INTERNAL REVENUE AGENT,
New York, N. Y.

An examination of the returns of the above taxpayer for the years 1917, 1918, 1919, and 1920 disclosed the following:

	Additional tax
1917	None.
1918	$204,615.68
1919	47,964.66
1920	21,009.55
Total	273,589.89

Authority for examination: 1917 photostat.

COMMENTS

Taxpayer is publisher of various newspapers throughout the country. His sources of income consist of salaries drawn from such corporations, dividends, etc. It is to be noted that no records are kept by Mr. Hearst in spite of the various ramifications of his interests.

All information for this report was practically extracted from the taxpayer's attorney—piecemeal. The examination was protracted over a long period because the information necessary for the verification had to be elicited by oral interrogations and supplemented by original vouchers which were obtained from various parts of the country, from San Francisco to New England, all dependent upon the location of the taxpayer's newspapers.

REASONS FOR ADDITIONAL TAXES

1917

Rents, $18,000. This was received from the Los Angeles Examiner. Mr. Hearst owns this newspaper and it is significant that he pays interest on the mortgage amounting to $50,000, plus the taxes for the small rental of $18,000. A comparison of the returns for 1917, 1918, 1919, and 1[illegible] reveals that the personal income tax returns of the taxpayer is intimately connected with his corporate newspaper holdings. In one year he would draw salaries; in another dividends. It would therefore, be feasible to consider his personal return in conjunction with his corporation returns.

1918

Additional taxes due to elimination of interest deduction of $37,500 and loss of $301,232.95. Why $50,000 was deducted as interest paid upon the Hill Street property, Los Angeles, when only $12,500 was actually disbursed, is inexplicable.

So far as the loss of $301,232.95 is concerned, this should not be allowed. Mr. Hearst made a contract in 1918 with the Boston, Chicago, and New York papers to purchase all materials and defray all expenses necessary in the production of the photogravure section of the above publications provided he received all advertising receipts of these particular sections. This feature was in its experimental state. It was quite evident to any man that the advertising receipts of the photogravure section would not by far be sufficient to offset the disbursements. As a matter of fact, that section was a losing proposition to all newspapers. Here we have a shrewd, successful, far-visioned newspaper man of vast experience entering into a contract which in advance he must have known to be a losing venture. The inference is simple. Mr. Hearst had a large income from dividends. The corporations were his. Why

not experiment with his personal income of which the Government would get 56 per cent and develop his newspaper enterprises? At best, this money was a loan, an advance, a capital outlay. It is strange that this contract obtained in a high rate year. Why was it not continued in 1919 and the following years? On the theory that this venture was not entered into with a view of investment and profit but solely to relieve himself of the high rate of taxation, the loss has been disallowed. The contract would certainly not have been entered into if the corporations were under control of outsiders. This fact alone spells out his intention.

It is also to be noted that in 1918 he received no interest on the Atlanta, Georgia, bonds, because, he alleges, none was paid that year.

1919

Income: It is to be noted that this year no income is reported for salaries or interest on bonds, but in lieu thereof the taxpayer shows interest on notes. Mrs. Phoebe Hearst in 1919 loaned more than $1,000,000 to the New York American. She took interest-bearing notes and assigned them to her son, William R. Hearst, for apparently no consideration. Mr. Hearst collected the interest which he reported on his personal return. In 1919, the same year, Mrs. Phoebe Hearst died. Mr. Hearst in 1920 canceled these notes. The attention of the estate tax division is invited to this gift, exceeding a million, just prior to death of donor. The transfer might be of a voidable nature for inheritance tax purposes.

Interest allowed except the $50,000 originally deducted as payment of interest on Los Angeles property which on verification was found not to have been paid.

Loss $32,473.33 disallowed. Mr. Hearst in 1900 ran for Congress. He was elected. To celebrate this event he made a celebration at Madison Square Garden, where crowds and fireworks joined. Some of the works exploded to the injury of several individuals. These sued Mr. Hearst for damages for personal injuries sustained as a result of his negligence. They won in the lower courts. Appeals were taken until finally in 1919 the judgments were paid. The taxpayer deducts this in 1919 because he paid them then. Disallowed as being a judgment for personal injuries not incurred in scope of business.

1920

Income correctly reported.

No salaries again were drawn. Notes made by New York American seem to have been canceled by Mr. Hearst.

DEDUCTIONS

Interest again reduced by $50,000, same as in 1919.

Losses were properly taken by taxpayer.

CONCLUSION

While certain deductions were made and not paid, no recommendation as to deliberate understatements is made because the affairs of the taxpayer are so closely related with those of his corporations that the returns of the two should be considered simultaneously before any inference is drawn. One thing is certain, that there was juggling and manipulations between corporation and taxpayer each year with a view of lightening tax burdens.

Schedules: 1 to 7–A.

Transcripts 1915, 1916, 1917, and 1918.

HARRY HERSKOWITZ,
Internal Revenue Agent.

EXHIBIT C

AUGUST 15, 1923.

MR. WILLIAM RANDOLPH HEARST,
238 William Street, New York, N. Y.

SIR: An examination of your income-tax returns and of your books of account and records for the years 1917 to 1920 discloses an additional tax

liability for the years 1918 to 1920, aggregating $272,978.38 and overassessments for the years ——— amounting to $——— as shown in detail in the attached statement.

In accordance with the provisions of section 250(d) of the revenue act of 1921, you are granted 30 days within which to file an appeal and show cause or reason why this tax or deficiency should not be paid. No particular form of appeal is required, but if filed it must set forth specifically the exceptions upon which it is taken; shall be under oath; contain a statement that it is not for the purpose of delay; and the facts and evidence upon which you rely must be fully stated. The appeal, if filed, must be addressed to the Commissioner of Internal Revenue, Washington, D. C., for the specific attention of IG:SA:AJ-HMS 281, and will be referred to the Income Tax Unit before transmittal to the agency designated for the hearing of such appeals.

You may, if you desire, request a conference before the Income Tax Unit in connection with the appeal, to be held within the period prior to the expiration of five days after the time prescribed for the filing of the appeal. If the Income Tax Unit is unable to concede the points raised in your appeal, it will be transmitted, together with the recommendation of the Income Tax Unit, to such agency as the commissioner may designate for final consideration.

Where a taxpayer has been given an opportunity to appeal and has not done so, as set forth above, and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement of the assessment will be entertained.

This assessment is in addition to all other outstanding and unpaid assessments appearing upon the collectors' lists.

Payment should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.

Statement

1917

Additional tax	None.

1918

Additional tax		$204,004.17
Net income as originally reported		78,890.75
Plus:		
Deduction for interest on Los Angeles property disallowed		37,500.00
Loss as result of advertising contracts disallowed		301,232.95
Net income as corrected		417,623.70

COMPUTATION OF TAX

Net income	$417,623.70	
Less:		
Dividend	$351,030.00	
Exemption	3,000.00	
	354,030.00	
Income subject to normal tax	63,593.70	
Income taxable at 6 per cent	4,000.00	240.00
Income taxable at 12 per cent	59,593.70	7,151.24
Surtax on $417,623.70		211,612.93
		219,004.17
Tax previously assessed		15,000.00
Additional tax assessable		204,004.17

1919

Additional tax		$47,964.66
Net income as originally reported		94,366.30
Plus:		
Interest deduction for Los Angeles property disallowed		50,000.00
Loss on account of litigation disallowed as considered as a personal expense		32,473.33
Net income as corrected		176,833.63

COMPUTATION OF TAX

Net income	$176,833.63	
Less:		
Dividends	$85,046.00	
Exemption	3,000.00	
	88,046.00	
Income subject to normal tax	88,787.63	
Income taxable at 4 per cent	4,000.00	160.00
Income taxable at 8 per cent	84,787.63	6,783.01
Surtax on $176,833.63		64,536.83
Total tax assessable		71,479.84
Tax previously assessed		23,515.18
Additional tax assessable		47,964.66

1920

Additional tax		21,009.55
Net income as originally reported		61,780.65
Plus interest deduction for Los Angeles property, disallowed		50,000.00
Net income as corrected		111,780.65

COMPUTATION OF TAX

Net income		111,780.65
Less:		
Dividends	$114,084.00	
Exemption	3,000.00	
		117,084.00
Income subject to normal tax		None.
Surtax on $111,780.65		29,635.94
Total tax assessable		29,635.94
Tax previously assessed		8,626.39
Additional tax assessable		21,009.55

SUMMARY

	Additional tax
1917	None.
1918	$204,004.17
1919	47,964.66
1920	21,009.55
Additional tax assessable	272,978.38

J. G. BRIGHT.

H. M. S.	B. F. C.	J. W. H.	J. W. C.	S. A.
7/31/23	8/1/23	8/2/23	8/4/23	8/6/23

EXHIBIT D

FEBRUARY 9, 1924.

Mr. WILLIAM RANDOLPH HEARST,
238 William Street, New York, N. Y.

SIR: A reaudit of your income-tax returns, Forms 1040, for the years 1918, 1919, and 1920, in connection with additional evidence submitted in your brief and the evidence submitted by your attorneys in a letter dated January 2, 1924, discloses additional tax liabilities of $17,033.19 and $47,964.66 for the years 1918 and 1919, respectively, and an overassessment of $8,626.39 for the year 1920 instead of an additional tax liability, aggregating $273,589.89 for the years 1918, 1919, and 1920, of which you were notified in office letter dated August 15, 1923.

Additional information was furnished in your brief showing that a net loss of $301,232.95 constituted a proper deduction for the year 1918, in accordance with article 141 of regulations 45, in which provision is made for losses incurred in transactions entered into for profit.

The net loss of $32,473.33 claimed on your 1919 return for an amount explained as "Payment of judgment on liability incurred as result of accident" has been considered. You are advised in this connection that this office holds that the loss does not constitute an allowance deduction since it cannot be construed to fall within the classes of losses for which provision is made in section 214(*a*) 6 of the Revenue Act of 1918.

Additional evidence has also been received by this office substantiating the deduction of $500,000 for State inheritance taxes paid to the State of California during the year 1920. Your return for the year 1920 accordingly reflects a nontaxable status.

Since your contentions have been fully allowed for the year 1918, the additional tax of $17,033.19 for that year will be assessed immediately.

You are advised, however, that you will be given 30 days to present further evidence in the event that you disagree with the disallowance of the loss of $32,473.33 upon your 1919 return.

The overassessment shown herein will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district. If the tax in question has not been paid, the amount will be abated by the collector. If the tax has been paid, the amount of overpayment will first be credited against unpaid income tax for another year or years and the balance, if any, will be refunded to you by check of the Treasury Department. It will be thus seen that the overassessment does not indicate the amount which will be credited or refunded since a portion may be an assessment which has been entered but not paid.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.

The CHAIRMAN. The part that appeals to me is that, no matter whether there was an excess-profits tax or any other tax, the taxpayer, before he made his return, had an opportunity to destroy the contract, and put his return in whatever group paid the least tax. In other words, after having made the contract if, at the end of the year, it was found that he would save taxes personally, he could produce the contract. If he found that it was going to cost him more to put it into his personal account than in the corporation account, he could simply destroy the contract and put it in the corporate tax rather than in the personal tax.

Mr. MANSON. If there were any other holders of a substantial interest in these newspapers, you would have had an entirely different question. We will say that the minority stockholders should agree to do something that would build up the newspaper, but where there was only one person, and one person only, interested, it is manifestly a bald-faced attempt to get out of paying a personal income tax.

Mr. GREGG. I should like to say something on the chairman's question as to whether this was a defect in the law or in the administration. Not passing on this specific case at all, I think the general trouble is a defect in the law, and one which the department can not remedy.

I will give you an example, a case which I had up just the other day.

A taxpayer owned all of the stock of one corporation and a majority of stock of the second corporation. We will call the first corporation A, and the second one B. The first one was losing money—this was in 1918—losing heavily. He was trying to build it up to the point—it was not a hobby or anything of that sort—he was trying to build it up to a point where it would become a money-making proposition, but at that time it was losing money. The second corporation was making a large profit and paying large dividends. So he made an absolutely bona fide transfer of stock from Corporation B to Corporation A. It was not a transaction that could be set aside. It was a legal transfer of the stock, with the result that dividends paid on the stock of Corporation B, when in the hands of Corporation A, would be used as an offset against the income of Corporation A.

Senator JONES of New Mexico. Against the loss of Corporation A?

Mr. GREGG. Yes, sir; and it effected a reduction in the tax. I think unquestionably he went through the transaction with the tax in mind. We could not possibly prove that, but I was convinced that that was so. At the same time, we had to hold that we could not ignore this legal transaction.

The CHAIRMAN. You would not call this Hearst case analogous to that, where one was a personal matter, and the other was——

Mr. GREGG. No, sir; it is not the same case, by any means; but it is, in general, the same proposition.

I have seen other cases; I know of other cases where taxpayers had a corporation which was losing money and where the securities that were owned were paying dividends or interest. To be able to offset the loss of his losing corporation against some income, the taxpayer would transfer the securities of the corporation, and wherever it is a bona fide, absolute transfer, I do not think we can go behind it.

The CHAIRMAN. That may be true, but here was a case where there was simply a contract, which may be destroyed or held until the outcome was determined after the year was over.

Mr. GREGG. That is true, as a practical matter, Mr. Chairman, but the fact remains that it was an enforceable contract; at least, I assume it was.

Mr. MANSON. The Supreme Court has gone so far in holding that a separate entity corporation must be recognized in contracts with the stockholders——

Mr. GREGG. Yes.

Mr. MANSON (continuing). That I have been unable to satisfy my mind that that contract should not have been recognized. In other words, I can not say that my mind is free from doubt. What I may have done if I had been in a position of authority at the bureau I do not know, but I do know that I am satisfied that the whole proceeding was for the purpose of escaping taxation.

Senator JONES of New Mexico. Let me make an observation here. In the case mentioned by Mr. Gregg, it strikes me that that is not a transaction that can be properly criticized, because, after all, the question of income taxes is supposed to be based upon the real ability of the taxpayer to pay; but in the case suggested by Mr. Manson, the Hearst case, I think the difficulty there arises from the very unequal way in which taxes are levied on individual incomes and corporate incomes.

Mr. GREGG. That is absolutely the basis of that case.

Senator JONES of New Mexico. Yes.

Mr. MANSON. I can see where that can be carried into any number of instances. In other words, that principle can have a very wide application, if the taxpayer sees fit generally to avail himself of it, because there are very few corporate businesses in which you can not segregate some branch of that business to show that it has a loss, even though the business generally may be a highly profitable business.

Mr. GREGG. So long as the taxes between corporations and individuals are different, it is profitable to show the loss against the income which is subject to the higher tax.

Mr. MANSON. Yes.

Senator KING. Mr. Gregg, do you think the law contemplated that corporations, regardless of the ownership of the stock, might unite for the purpose of escaping taxation?

Mr. GREGG. Congress specifically so provided in the consolidated returns section.

Senator KING. Was it in contemplation that those unions, those consolidations, should take place for the purpose of escaping taxation?

Mr. GREGG. It is not a question of escaping it, Senator. It is a question of legally reducing it.

Take two corporations: Assume Corporation A owns all of the stock of Corporation B. One of them may be making money and one of them losing money. It seems perfectly fair that the one that is making money and the one that is losing money should be combined, and that only the net income, looking at the two of them together, should be subject to taxation.

The CHAIRMAN. You mean on the theory that the same ownership is involved?

Mr. GREGG. Yes, sir.

Senator JONES of New Mexico. I think you will find other instances that are at least analogous to that mentioned by Mr. Manson, which operate in just the other direction. You may have a small corporation, doing a small amount of business, and a transaction might be had with the stockholders whereby the stockholders would derive the profit of the corporation, and not pay at the rate of 12 per cent.

Mr. MANSON. That has been done frequently, in this way: A stockholder makes a contract with a corporation to receive as his compensation a certain percentage, we will say, of the gross receipts of the corporation, which is high enough to wipe out any profit of that corporation. I have a case on my desk where a deal of that sort was made.

Senator JONES of New Mexico. What is there to prevent such a corporation from agreeing to pay all of its income to its stockholders?

Mr. MANSON. I believe that if a corporation made a contract to pay its net income to an officer as his compensation, the bureau, of course, under its authority to determine the reasonableness of compensation, could go behind that transaction, and I take it that they would do so; but where a contract is made to pay 4 or 5 or 10 per cent of the gross receipts—of the gross sales— to an officer as his compensation, even though that absorbs all the net income, as an administrative proposition it is very difficult for the bureau to show that that is not a legitimate transaction. It might result in an enormous income one year, but inasmuch as that stockholder is taking his chance, or that officer is taking his chance, of receiving no income, we will say, the following year, it makes it a difficult matter to overcome from an administrative standpoint, in my judgment.

Senator KING. Do you not think, Mr. Manson, that contracts of that character are so unusual that prima facie they are fraudulent? It seems to me a contract of that kind should not be encouraged.

Mr. GREGG. They are not unusual, Senator.

Mr. MANSON. They are not unusual.

Mr. GREGG. They are not unusual.

Mr. MANSON. For instance, I have in mind this sort of a case: The principal stockholder in this corporation, by the way, does not own what would be technically a controlling interest in the corporation. The stock of the corporation is very widely distributed. The principal stockholder owns enough stock, so that for any office, he is able, through proxies, to control the corporation. He has an agreement with them whereby he personally guarantees that corporation against loss, and, on the other hand, receives a salary based upon a percentage.

The CHAIRMAN. A percentage of the sales or a percentage of the profits?

Mr. MANSON. It is a percentage of gross income.

The business of the corporation is lending money, and the welfare of the corporation is absolutely dependent upon his discretion and the discretion of those working under him. That is virtually a contract of insurance. That is what it amounts to—the insuring of the stockholders against loss. They, in turn, receive a simpler contract of a guaranteed profit. He, by the way, is financially responsible.

Senator KING. He does not guarantee them a profit; he merely guarantees them against loss.

Mr. MANSON. He guarantees them against loss.

Senator KING. Yes.

Mr. MANSON. But the contract is, in substance, a contract of insurance. That is what it amounts to.

I believe the law ought to be amended so as to throw the burden of proof upon the stockholder in the case of such a contract to show that that contract is reasonable, instead of throwing the burden of proof upon the bureau to show that it is unreasonable.

Senator JONES of New Mexico. Why would not an adjustment of the ratio of taxation between corporations and individuals meet that situation?

Mr. MANSON. It will not only meet that but it will meet many other situations in connection with income tax.

Mr. GREGG. Of course, that is one of the most difficult problems that we have had. It was particularly acute during the excess-profits tax years, when, in the case of corporations paying salaries to their stockholders who were officers, they naturally wanted to pay as large salaries as they could, because it relieved them of excess-profits tax on that amount. The bureau had authority to go back of the return of the corporation and determine for itself whether that salary was reasonable. It was an impossible task for us to perform, but we did it as well as we could. It was never a particularly satisfactory situation.

The CHAIRMAN. To get back to the Hearst case again, I would like to ask Mr. Gregg if any effort has been made to get Congress to pass a statute which would prevent that sort of procedure.

Mr. GREGG. No, sir; not that I know of.

The CHAIRMAN. Do you think it would be a wise thing to enact a statute to prevent that procedure?

Mr. GREGG. The question of how far you are justified in going to stop individual cases of tax avoidance is a very difficult one. In 1924 we had gone further than we had ever gone before, particularly on reorganizations. You have all of the situations that you can think of. You have five or six lawyers working on it, possibly, and you think of every situation that is possible to arise, and you put in the statute provisions to meet those situations. Immediately you have all of the lawyers of the country looking for the ones that you missed, and they do find some. That has been our experience all along. I am not at all sure that it is possible to stop it; I feel reasonably certain that it is not possible to stop all of them; but I think, where there is any method of avoidance which is being generally used, a provision should be placed in the statute to take care of it. I say, if it is being generally used. I do not think, if it is used in a few isolated cases, it would warrant a statutory provision.

Mr. MANSON. I do not know how far this method of converting corporate into personal losses is followed. I can see the possibilities in it, because, as I say, I know of few corporate businesses in which you could not segregate some feature of the business which carries a loss, and which always carries a loss. It is always a losing part of the business.

Mr. GREGG. Of course, however, anything that is done to remove the disparity between the tax of a corporation and the tax of an individual will decrease the desire to make such contracts.

Mr. MANSON. Well, you might say that that would be controlling an evil from a constitutional instead of from a symptomatic standpoint. You would be removing the source of the trouble.

The CHAIRMAN. Have you any more cases, Mr. Manson?

Mr. MANSON. Yes; I have another matter that I would like to call to the attention of the committee.

This is the matter of the tax of W. G. Skelly of Tulsa, Okla.

Senator JONES of New Mexico. Is he the Skelly of the Skelly Oil Co.?

Mr. MANSON. The Skelly Oil Co.

This is not a closed case, but I call it to the committee's attention for the reason that it bears out what I said a day or two ago, which might have looked like a rather general and rash statement upon my part, to the effect that, so far as the oil and gas section of the engineering division is concerned, the taxpayer gets away with about what he asks for.

Inasmuch as one of the members of the committee is about to leave, I will state very briefly the high points in this case, although I deem it important to get the history of this case before the committee. However, I will preface that with this statement:

Skelly organized the Skelly Oil Co., and turned into the Skelly Oil Co. various oil properties, and received in return therefor the stock. He made a large profit on the transaction, which was taxable.

When he discovered that that profit was taxable, and for the acknowledged purpose—not the inferred purpose, but for the acknowledged purpose—of escaping that tax, he then organized another corporation, and sold the stock of the Skelly Oil Co. to the new corporation at a sufficient loss, so that when the loss was offset against the profit that he had made on the other transaction, there was no profit left to tax.

Senator KING. Was that such a fraud as should have been rebuked, or prevented at least, so far as the tax was concerned, by the department?

Mr. MANSON. Steps were taken in that direction. The solicitor, Mr. Mapes, held that there was a fraud, and fraud penalties were imposed. Later on it was held that there was no fraud, but that the stock of the second corporation should be considered to have the value of the stock which was turned over to it, so that the paper loss disappeared. Then the solicitor, after holding that, in which holding I concur, took the position that this stock should be referred to the oil and gas section for valuation, to determine what its value was.

Skelly desired to place his stock on the market. He made a contract with a broker, under which contract the broker agreed to market some hundred and forty-odd thousand shares, Skelly retaining, I think, about four hundred or four hundred and fifty thousand shares. Skelly agreed with the broker that he would not sell on the market the stock that he retained.

The purpose of that contract was to permit the broker to dispose of the 145,000 shares and establish a market for the stock without the competition of the stock that Skelly still held.

It was the same situation as, for instance, if I owned 600 acres of land in the Northwest here. I want to put it on the market, and I make a deal with a real-estate man. The real-estate man says to me:

I will give you $2,000 an acre for 150 acres of your land, but I want a chance to dispose of the 150 acres that I buy, without competition, and therefore I want you to agree not to sell your remaining 450 acres until the expiration of two years, to give me a chance to sell this off.

When this stock came back to the oil and gas section for the purpose of determining the value it was shown that the same stock on the market was bringing at least $10, and I think as high as $14. The oil and gas section held that, notwithstanding the fact that that stock had never been sold for less than $10 a share, it had no value,

for the reason that there was no market, because this man had bound himself not to sell it until 1920.

In other words, here, because this man had entered into a contract with his broker whereby he had voluntarily agreed not to dispose of a part of his stock, they held that that stock has no value whatever, because he would not sell it. They ignored the fact of the restriction upon the right to sell as against this broker in no way interfered with the power to sell. He could sell every share of that stock. He would be answerable to his broker for any damages that the broker might sustain by reason of the breach of contract, but he still could sell it. They ignored the fact that a market consists of people who are willing to buy.

Senator KING. If I have a million dollars worth of gold locked up in the safe and I agree to hold it for a couple of years, it has no value!

Mr. MANSON. Exactly.

Senator KING. Well, of course, that is so silly it does not need any comment.

Mr. MANSON. I offer the report in this case.

(Exhibits submitted by Mr. Manson in case of W. G. Skelly, are as follows:)

EXHIBIT A

MAY 21, 1925.

In re W. G. Skelly, Tulsa, Okla.

The above-named taxpayer is an oil operator and deals in leases and oil properties.

For the year 1919 he filed an income tax return and paid a tax of $160,441.83.

After an examination of the taxpayer's income for 1919, Revenue Inspector Harry L. Erb, in a report dated December 31, 1921, disclosed a transaction which the taxpayer failed to report in his return as follows:

The taxpayer and others organized a corporation named the Skelly Oil Co. on October 1, 1919. The taxpayer transferred property costing, according to the revenue agent, $1,167,238.98 to the corporation in exchange for 431,187 shares of stock, which at the time, was selling at about $10 per share, making a value of approximately $4,311,870, plus the proceeds from the sale of 141,316 shares, whose value was $1,413,630, thus realizing a profit of $4,558,-261.02. Other property costing $15,725.41 was sold for 60,000 shares of Ranger-Gulf stock (owned by Skelly Oil Co.). This stock had a market value of $11 per share, making the market value of the stock received by the taxpayer $660,000, which represented a profit of $644,274.59. (See Exhibit B.)

On December 31, 1919, taxpayer with the aid of friends in New York, organized the Midland Securities Co., and on the same day transferred to this company 467,937 shares of Skelly Oil Co. stock and 34,800 shares of Ranger-Gulf Co. stock for $700,000, taking a loss of $5,026,170. On the same day the taxpayer bought the entire stock of the Midland Securities Co. for $750,000. Both payments were made by check. Mr. Skelly giving his check to the company drawn on an Oklahoma bank for $50,000, and a check on a New York bank for $700,000, the company giving a check to Skelly for $700,-000 on the same bank, arranging so that the checks would cancel each other, neither drawer having an account at this bank. Mr. Skelly was under contract with his promotor of the Skelly Oil Co., not to sell all his Skelly Oil Co. stock, but to hold 467,937 shares until July 1, 1920, for the reason that it would adversely affect the marketing of the stock. It was this stock which was transferred to the Midland Securities Co.

The foregoing facts seem to be agreed upon by all parties. See taxpayer's brief (Exhibit C), solicitor's memorandum of October 7, 1922 (Exhibit D), and solicitor's memorandum of October 18, 1923 (Exhibit E).

It is admitted that taxpayer entered into the transaction with the Midland Co. for the purpose of establishing a loss for income-tax purposes. (Exhibit C.)

Under date of October 7, 1922, Solicitor Carl A. Mapes advised Deputy Commissioner Batson that the taxpayer should be assessed on the basis of the profit from the Skelly Oil Co. transaction, and that the Midland Securities Co. transaction should be ignored in the computation of the 1919 taxes, stating that the sale by taxpayer to the Midland Securities Co. and the purchase of said company's stock was a subterfuge for the purpose of evading income-tax liability and may be ignored in computing taxpayer's tax liability for 1919; that taxpayer filed a fraudlent tax return for 1919, and recommended the assertion of fraud penalty for that year.

After a hearing at which the taxpayer contended that the two transactions with the Skelly Oil Co. and the Midland Securities Co. should stand, Solicitor Hartson, under date of October 18, 1823, wrote Deputy Commissioner Bright a memorandum in which he expressed the opinion that the transaction with the Midland Securities Co. was not a sale but a transfer of stock for stock; and that the stock received had a value equal to the value of the stock transferred, on the date of such transfer. He advised that the oil and gas valuation section determined such value as at December 31, 1919. (Exhibit E.)

On June 25, 1924, the oil and gas valuation section of the engineering division made a report (Exhibit F) in which it stated in part:

"This section has been asked to compute the profit, if any, arising from (1) the transfer of the properties by Skelly for stock in the Skelly Oil Corporation, and (2) also the profit or loss, if any, arising from the transfer by the taxpayer of the stock of Skelly Oil Corporation and the Ranger-Gulf Corporation for stock of the Midland Securities Co.

"As to the first transaction, which was completed October 2, 1919, a profit arose to Mr. Skelly as to the stock which was free from restrictions as to sale and disposal and which actually was sold by him. The profit is determined as follows (computation of $951,601.75 profit on the 141,313 shares sold for cash):

"As to the stock, which by the terms of the agreement dated September 30, 1919, an inhibition as to the sale or disposal was made, neither profit or loss could arise, as only under certain conditions could the stock be sold. These conditions never arising, 'the existence of a public of possible buyers at a fair price' being denied by the very terms of the agreement, and a situation created wherein there could be neither a willing buyer nor a willing seller, no value can be determined by this section. In other words, this section has no means of determining the fair market value of a property or stock when there was no market for it. Nor could the stock in any way be considered the equivalent of cash, because there was no way to convert it into cash. Hence it follows that there could be neither profit or loss. The profit or loss must be determined at such subsequent time as Mr. Skelly disposes of this stock, the cost thereof having been ascertained as set out above.

"For the same reasons the same conclusions must of necessity be reached as to any profit or loss arising because of the transfer to the Midland Securities Co., the stock which was transferred being the identical stock to which the inhibition applied."

The foregoing reason is unsound because of the general principle that a contract by an owner not to alienate property has no bearing upon the value. Such value is determinable by sales of like property, and such data was before the oil and gas valuation section in the form of sales prices of shares of the same issue. The contract did not impair the value of the stock, as it was made for the purpose of keeping up the market value. Assuming that the unit is correct in stating the contract not to alienate kept this stock from having a market value because "the existence of a public of possible buyers at a fair price being denied by the very terms of the agreement," this contract was restrictive until July 1, 1920, therefore, if such contract affected the value of the stock, then the stock was worth when received what it could be sold for on October 1, 1919, less discount at the legal rate, from the time it was received until the time it could be sold. This data must have been procurable on March 3, 1924, the date of the engineer's recommendation—that is to say, even if the contract prevented fixation of value at the date of acquisition, yet that value can now be fixed by reference to market for this stock as of July 1, 1920.

The unit assigns the same reason for failure to find the value of the stock transferred to the Midland Securities Co. It is stated that it could not be valued at the time of the transfer because the transfer was inhibited. The inhibition did not prevent transfer but only prevented valuation. Such a ruling is absurd.

Thus the unit fixed a value upon 141,313 shares actually disposed of by taxpayer and refused to fix the value of 467,937 shares of the same issue also disposed of by the taxpayer.

It would seem that in view of the fact that only a part of the understatement by the taxpayer of his income was subsequently explained, as shown by solicitor's memorandum of October 18, 1923 (Exhibit E), the solicitor's memorandum of October 7, 1922 (Exhibit D), to the effect that the assertion of fraud penalty for 1919 was recommended, should prevail. This additional assessment has been made upon the taxpayer for the year 1919.

An A-2 letter mailed March 7, 1925, proposed an additional assessment of $559,801.82 for the year 1919 in accordance with the unit's conclusions discussed above. It has been protested by the taxpayer and is still unsettled.

In the case of Miller, Collector, v. Gearin (250 U. S. 667), the defendant leased a lot in 1907 to a corporation for 23 years, with an agreement that the latter was to erect a building on the land, which it did in 1907 at a cost of $140,000. In 1916 the corporation defaulted in the rent and the defendant acquired possession of the property. The Government treated the then value of the building as income to the defendant for 1916 and required her to pay the tax thereon. It was held by the Supreme Court that the lessor acquired nothing in 1916 save the possession of what was hers. The possession so acquired was not income, and in assuming that the building was income derived from the use of the property it was clear that the time when it was derived was the time when the building was added to the real estate and enhanced its value. At the time it represented a prepayment to the lessor of a portion of the rental distributable over a period of 23 years.

In the last above-mentioned case the taxpayer derived income when the building was completed, notwithstanding the fact that she did not realize on the improvements to her property until the year 1916, or nine years later.

Under this principle it is clear that W. G. Skelly, the present taxpayer, derived income on October 1, 1919, at the time he received stock from the Skelly Oil Co. in payment of the property which he sold to it, notwithstanding the fact that he agreed to not sell a portion of the stock until July 1, 1920.

GEO. G. BOX, *Chief Auditor.*

EXHIBIT B

(R. A. R. 12/31/21)

EXPLANATION 1919

Received 431,187 shares Skelly oil stock at $10	$4,311,870.00
Plus cash from sale of 141,313 shares	1,413,630.00
Total selling price	5,725,500.00
Net cost of property exchanged for stock	1,167,238.98
Net profit from exchange	4,558,261.02
Received 60,000 shares of Ranger-Gulf stock at $11	660,000.00
Less net cost of property exchanged	15,725.41
Net profit from exchange	644,274.59
Sold 467,937 shares of Skelly oil stock cost	4,679,370.00
Sold 34,800 shares of Ranger-Gulf stock cost	382,800.00
Total cost of stock sold	5,062,170.00
Sold for	700,000.00
Net loss from sale	4,362,170.00
40,000 shares of Skelly oil stock	400,000.00
24,000 shares of Ranger-Gulf stock	264,000.00
	664,000.00

Paid to J. W. Bell, by W. G. Skelly, in connection with organization of Skelly Oil Co. and the sale of stock.

Profits	$4,558,261.02 644,274.59	
		5,202,535.61
	5,026,170.00	
Net profit		176,365.61
Losses	4,362,170.00 664,000.00	
		5,026,170.00

With regard to the first transaction on October 1, 1919, W. G. Skelly, J. S. Sankey, and F. P. Lieuallen had the Skelly Oil Co. organized, Mr. Skelly turning over all of his personal oil property, Mr. Sankey turning over his interest in the Sluss and Woodruff leases, and the three of them turning over their Skelly-Sankey Oil Corporation stock for Skelly Oil Co. stock. The Skelly Oil Co. stock sold on the open market on October 1, 1919, for $10 and $10.50, later for $12.50, and by the 23rd of October, 1919, reached $14.25. Skelly oil stock had never fallen below par until the recent break in price of oil.

EXHIBIT C

[From brief filed by Miller & Chevalier and Will R. Gregg]

THE FACTS

The taxpayer for some time prior to 1919 had been extensively engaged in the production of oil and gas and kindred lines of endeavor, and had had under consideration the many obvious advantages of carrying on business in corporate form. In 1918, he caused to be formed a comparatively small corporation, the Ranger-Gulf Corporation, under the laws of Delaware, to take over several of his properties, which were exchanged for stock on January 10, 1919. A portion of the stock of this corporation was sold to the public, the taxpayer pledging certain of his other properties to secure dividends upon the stock, such guarantee to continue until the earnings of the corporation reached a certain specified figure, which was reached in 1920.

The taxpayer was pleased with the results of the incorporation of the Ranger-Gulf Corporation and determined to form a much larger corporation to take over the balance of his properties. With this in view, on June 30, 1919, he entered into a firm contract with Mr. J. R. Bridgeford, a broker in New York City, for the formation of this corporation, a portion of the stock of which was to be marketed through Mr. Bridgeford. The corporation was organized under the laws of Delaware, as the Skelly Oil Co., on August 20, 1919, with a total authorized capital of $15,000,000, divided into 1,500,000 shares of the par value of $10 each. Subsequently and after the events narrated herein, the number of shares was reduced and the par value increased to $25.

The contract of June 30, 1919, was modified by mutual consent on September 30, 1919. Pursuant to the contract as so modified, on October 2, 1919, at the first meeting of the directors of the Skelly Oil Co., it was agreed that the taxpayer should transfer to the corporation certain oil and gas properties, comprising substantially all of his holdings except the few transferred to the Ranger-Gulf Corporation, and receive in exchange 790,000 shares of the stock of the corporation, of the par value of $7,900,000. The transfer was consummated on that day.

Of the shares so received, the taxpayer transferred 138,750 to two individuals in payment for certain properties he had acquired from them and included in his transfer to the Skelly Oil Co.; transferred 40,000 shares to the corporation specialist who had promoted the organization of the corporation, pursuant to a contract with him; donated 2,000 shares to certain individuals; and sold 141,313 shares through Mr. J. R. Bridgeford, pursuant

to the contract for the organization of the corporation, for $1,413,630, the proceeds being used largely to liquidate indebtedness incurred by the taxpayer in acquiring the properties which he had turned over to the corporation.

The remaining 467,937 shares the taxpayer could not sell prior to July 1, 1920, under the terms of the contract between himself and Mr. Bridgeford, except upon certain conditions not here material. This limitation upon the right of sale was demanded by Mr. Bridgeford for the reason that it would have been impossible for him to maintain the price at which he was selling the stock to the public had the stock of the taxpayer been put upon the market, and for the further reason that one of the principal inducements he held out to the purchasers of the stock was that the taxpayer was a large stockholder and devoted substantially all of his business time to the affairs of the company.

Of the 710,000 shares remaining in the treasury of the corporation after the transfer of 790,000 shares to the taxpayer, the corporation sold on various subsequent dates, through Mr. Bridgeford, 650,000 shares for $10 per share net, and issued 60,000 shares in 1920 in exchange for certain properties.

Before entering into the contract for the organization of the corporation, the taxpayer sought advice of counsel in regard to the tax liability which might be incurred by reason of the organization. His personal counsel, Mr. C. C. Herndon, advised him that he would incur no tax liability by reason of exchanging his properties for stock of the corporation to be organized, this advice being based upon the provisions of article 1566 of regulations 45, which then read, in part, as follows:

"ART. 1566. *Exchange of property and stock.*—(*a*) Where property is transferred to a corporation in exchange for its stock, if the previous owner of the property receives 50 per cent or more of the stock of the corporation, so that an interest of 50 per cent or more in such property remains in him, then no gain or loss is realized by such owner from the transaction."

Article 1566 was radically changed by Treasury Decision 2024 which, based upon the separate corporate entity theory, established the so-called "closed transaction rule," the rule that where property is transferred to a corporation in exchange for its stock gain or loss is relalized if the stock has a market value which is greater or less than the cost of the property given in exchange. Treasury Decision 2024 was approved September 26, 1919, more than a month after the organization of the Skelly Oil Co. and six days before the transfer of assets to that company in exchange for its stock. Had the taxpayer or his counsel been advised of the change in article 1566 before the execution of the amended contract on September 30, or before consummating the sale to the corporation on October 2, it would nevertheless have been impossible on either of those dates to have withdrawn from the transaction, as the taxpayer had been, since June 30, under firm contract for the formation of the corporation. But the taxpayer and his counsel, who were in New York at the time, were not then advised of the issuance of Treasury Decision 2924. The Bureau of Internal Revenue is consistently tardy in making Treasury decisions public, and it is doubtful if, on October 2, more than a dozen persons outside of the bureau were advised of the change in article 1566.

Upon returning to Oklahoma Mr. Herndon learned of the change in the regulations and advised the taxpayer that it was possible that the Government would hold the Skelly oil stock to have a market value far in excess of the real market value of this stock to this taxpayer and claim that a large tax liability resulted from the organization of the Skelly Oil Co. The taxpayer was, of course, very seriously perturbed by this suggestion, and he and Mr. Herndon studied the matter thoroughly and sought the advice of such persons as they thought competent to advise them. In December, 1919, Mr. E. C. Stebbins, of Tulsa, Okla., a friend of the taxpayer, introduced him to Mr. Frank Pace, an attorney of Little Rock, Ark., as an attorney familiar with matters of Federal taxation. The taxpayer had several conferences with Mr. Pace, at which he explained the situation in which he found himself and asked the advice of Mr. Pace in that connection. Mr. Pace, after consideration, advised the taxpayer that in his opinion the taxpayer, under the theory of separate corporate entity, by which the bureau might hold that a large paper profit had been realized, might form a new corporation, by which the Skelly oil stock could be sold, thus wiping out any fictitious paper profit which the bureau could possibly consider as having been realized.

EXHIBIT D

OCTOBER 7, 1922.

In re W. G. Skelly, Tulsa, Okla.
Attention Mr. S. Alexander, head, special audit division.

Deputy Commissioner BATSON:

Reference is made to your memorandum of May 11, 1922, in which you request consideration of the element of fraud which appears to be involved in a transaction analyzed in the memorandum relative to transfer of property to certain corporations and the organization of a holding corporation by taxpayer in 1919.

Taxpayer, W. G. Skelly, is an oil and gas operator interested in both the production and marketing of oil and its products and gas on a very extensive scale, whose address is Tulsa, Okla. He seems to have operated as an individual with numerous interests in partnerships and corporations covering widely separated interests until 1919, when he converted his interests largely into corporate holdings. His income-tax liability was investigated in October, November, and December of 1921, covering the years 1917 and 1920, in connection with the investigation of the partnership, Skelly Drilling Co. The examination covered extensive operations in the oil and gas business for these years and extended through a wilderness of activities of personal, partnership, and corporate character, which resulted in reporting large additional taxes due which he admitted. The following table of taxes shows the comparative result of the above years:

Year	Original	Reported	Additional
1917	$22,922.62	$166,386.84	$143,464.22
1918	19,662.10	230,640.65	210,978.55
1919	160,441.83	[1] 140,987.43	19,454.41
1920	3,275.86	56,721.28	53,447.42

[1] Refund.

The report does not charge fraud in the conduct of taxpayer in making up his original returns for any of these years, but the unit is of the opinion that the action of taxpayer in December, 1919, in converting his large ownership of corporate oil and gas stocks into stock of a holding corporation showing an enormous book shrinkage in value was fraudulent, which opinion is shared in by the engineers of the oil and gas valuation section.

It seems that taxpayer, together with other interested persons, organized the Skelly Oil Co. in October, 1919, and sold and transferred to this company their holdings in numerous oil and gas leases and property. Taxpayer received for his interests $1,413,630 in cash and stock to the value, as fixed by the market value of the Skelly Oil Co. stock, which company had 1,500,000 shares of authorized capital with a par value of $10 per share, of $4,311,870. The revenue agent in his report states that taxpayer received 431,187 shares of this stock, valued at $4,311,870, and the proceeds from the sale of 141,311 shares, which amount of cash he fixes at $1,413,630. It appears that these shares were sold to the public and may, therefore, be used as a basis for fixing the market or trade value of the stock taxpayer received for his properties in addition to the cash. It is reasonable to assume that taxpayer actually received $5,725,500 actual money value for his interests in the properties turned over to the Skelly Oil Co. in October, 1919. If not, these parties worked a gigantic fraud on the public when they sold 14,313 shares of this stock for $1,413,630.

After taxpayer had secured possession of this $1,413,630 and had under his control some 431,180 shares of Skelly Oil Co. stock, he, together with close associates, organized the Midland Securities Co. in December, 1919, under the laws of Delaware apparently, with headquarters or main offices in the city of New York. In the meantime taxpayer had evidently secured other shares of Skelly Oil Co. stock and a number of shares in the Ranger-Gulf Co. At any rate on December 31, 1919, he sold or pretended to sell to the Midland Securities Co. 467,937 shares of Skelly Oil Co. stock and 34,800 shares of Ranger-Gulf Co. stock for the small sum of $700,000. He then, on the same day, agreed to take, and did take, 75,000 shares of Midland Securities Co. stock at the par value of $100 per share, or for a purported consideration of $750,000. Tax-

payer himself is reported to have said to the examiner that this was all the stock issued by the Midland Securities Co. The agent reports that Skelly Oil Co. stock was on the increase in price on the market during the month of December, 1919, and actually reached the value of $14.25 per share on the 23d of October that year; and also states "Skelly oil stock had never fallen below par until the recent break in prices of oil." This was written in December, 1921. From this information we have the spectacle of taxpayer turning over stock well worth $1,679,370, together with other property worth at least $348,000 in the form of Ranger-Gulf Co. stock, to this holding company which he owned and controlled, for $700,000, or less than 14 per cent of its real market value, and then in effect taking a loss in his tax returns. Only ulterior motives can be ascribed to this performance, and as the reduction in tax liability is so enormous and so overshadows any other advantage possible in the transaction, it forces the conclusion that tax evasion was the motive. Taxpayer can not hide behind the cleverly designed legal barricade of corporate entity and evade tax liability on his enormous income or profit realized on the sale of his interests to the Skelly Oil Co. and Ranger-Gulf Co. in 1919. This legal fiction can not be used as a mask to hide ulterior motives and sharp practices to evade tax liability. "Corporate entity," says the court in McCaskil Co. *v.* U. S. (216 U. S. 504), "shall not be carried so far as to enable the corporation to become a means of fraud or a means to evade its responsibility."

Aside from this, taxpayer reported in his original return for 1919 only an income or profit of $70,277.39 on sales to Skelly Oil Co. and none from sales to Ranger-Gulf Co. The examiner fixes the value of cost to taxpayer of the property sold to Skelly Oil Co. at $1,167,238.98, the engineers heretofore referred to, at only $220,906.31. Taking the agent's figures, he had a profit of $246,391.02, and taking the figures of the engineers of $1,192,623.39, from the cash alone that he received from the Skelly Oil Co., which is reported at $1,413,630. This will not, it is thought, allow taxpayer to escape the charge of fraud, as it is such an understatement of known income as to justify the charge of intentionally understating income for the purpose of evading income-tax liability. It will be noticed that taxpayer makes no reference to the Midland Securities Co. in the original returns for 1919.

It is, therefore, held that the transaction analyzed in your memorandum of May 11, 1922, as to a sale of property by taxpayer to the Midland Securities Co. and the purchase of said company's stock is a subterfuge for the purpose of evading income-tax liability and may be ignored in computing taxpayer's tax liability for 1919, and, further, that taxpayer filed a fraudulent tax return for 1919, and the assertion of the fraud penalty for that year is recommended.

Criminal prosecution at this time is not contemplated and the files are herewith returned.

It is suggested that if a hearing is requested it be held in this office.

CARL A. MAPES,
Solicitor of Internal Revenue.

EXHIBIT E

OCTOBER 18, 1923.

In re W. G. Skelly, Tulsa, Okla.
For special adjustment section.

DEPUTY COMMISSIONER BRIGHT:

Reference is made to your memorandum of May 15, 1923, IT:SA:Aj:JWH-P-2283, transmitting the file in the case of the above-named taxpayer, the appeal filed by the taxpayer from the proposed assessment of additional taxes for the years 1917 to 1920, inclusive, and ad valorem fraud penalty for the year 1919 having been forwarded with your letter of April 24, 1923, IT:SA:Aj:JWC. The issues raised in the appeal are as follows:

First. Fraud penalty: The taxpayer will show that his action with reference to the transaction upon which the fraud penalty is based was a bona fide transaction, legally taken upon the advice of reputable counsel, and that the entire transaction was fully disclosed on his tax return for the year in which transaction was consummated.

Second. Invested capital: The taxpayer will show that invested capital used by the examiner and upon which the assessment is based is erroneous and does not allow the invested capital to which the taxpayer is entitled.

Third. Income: The taxpayer will show that the income used by the department in arriving at its assessment is erroneous. The depletion schedules, prepared by the taxpayer in conformity with Form O, have not been checked and accepted and the taxable income of the taxpayer can not be correctly determined prior to date when such schedules have been acted upon by the department. The correct allowances for depreciation of physical equipment owned and used by the taxpayer can not be determined and allowed with the information now in hand by the department.

The taxpayer was actively engaged in the business of producing oil and gas, and in addition to his own individual operations was interested in joint adventures in the same line of business and the additions to his capital and the resulting increases to his allowable depletion and depreciation deductions have not been correctly computed by the department.

An oral hearing was granted this taxpayer and held in this office on September 4 and 5, 1923, at which Mr. B. F. Carpenter, of your unit, was present. In the oral discussion of the case by the taxpayer and his attorneys and in the brief thereafter filed, no mention is made of issue No. 2, "Invested capital." This office, therefore, assumes that the invested capital was correctly determined in registered letter of December 31, 1922, and makes no further comment.

Under issue No. 3, in the original and supplemental briefs filed, no exception is taken to the proposed assessment of additional taxes for any year except the year 1919, and, at the oral hearings on the dates above mentioned, this taxpayer and his attorneys presented evidence and arguments only as to the year 1919. The only exception specifically made in the briefs and at the oral hearing is as to the item of income in the year 1919, "Profit from sales, $5,501,811.98," set out in the proposed assessment letter. This item arises as a result of transactions in the year 1919 between this taxpayer and the Skelly Oil Co. (Inc.) and the Midland Securities Co. (Inc.). The taxpayer contends that these transactions were correctly treated in his return, but this office does not agree with the contention of the taxpayer.

It appears that some time prior to 1919 Mr. Skelly had acquired title to various oil properties and oil leases. Early in that year he organized the Ranger Gulf Corporation, to which company he transferred certain of his properties for stock. Thereafter, on October 1, 1919, he organized the Skelly Oil Co. with an authorized capital stock of 1,500,000 shares of a par value of $10 per share. To this company, under date of October 2, 1919, he transferred certain oil and gas leases, properties and plants, and all of the capital stock of the Skelly-Sankey Oil Co. for a total consideration of 790,000 shares of the par value of $10 each. A portion of the shares of stock of the Skelly Oil Co. received by the taxpayer was by him transferred in payment of certain properties which he had turned into the Skelly Oil Co. and some 40,000 shares were turned over to the broker who had been employed in connection with the organization, leaving the taxpayer with 611,250 shares, of which number 141,313 shares were sold at par, $1,413,130 cash, and 2,000 shares donated to sundry persons, leaving Mr. Skelly 467,937 shares.

At the time that the plans were made for the organization of the Skelly Oil Co. article 1566 in Regulations No. 45 provided that such a transaction would not produce taxable income. A few days before the plan was carried out, however, the regulations had been amended and article 1566 of Regulations 45, as it stood at the date of the organization of the Skelly Oil Co., read as follows:

"*Exchange of property and stock.*—Where property is transferred to a corporation in exchange for its stock, the exchange constitutes a closed transaction and the former owner of the property realizes a gain or a loss if the stock has a market value, and such market value is greater or less than the cost or the fair market value as of March 1, 1913 (if acquired prior thereto), of the property given in exchange. For the rule applicable where a corporation, in connection with a reorganization, merger, or consolidation, exchanges property for stock, see article 1567."

With the regulations changed to read as above set forth, Mr. Skelly was confronted with a possible tax running into large figures upon a transaction which he regarded as producing only paper profits. The stock of the newly organized Skelly Oil Co. was selling on the New York curb at from $10 to $13

per share, and a certain number of shares had been sold at private sale at figures to net the corporation a pay value of $10. At the time of the hearing in this office the taxpayer stated that a pool had been organized for the purpose of keeping up the price of Skelly oil stock and that the prices received for the stock on the market were made possible largely, if not entirely, by the operation of this pool. It was accordingly urged that the sales on the exchange were artificially created and did not represent the values in a free market. It appears from the record that this case has been considered by the oil and gas section of your unit and a value of $10 per share placed upon the stock received by Mr. Skelly in payment for his oil properties.

Regardless of what value may be placed upon this stock, under article 1566, Regulations 45, Mr. Skelly was confronted with a large tax and, in order to avoid this possible tax and acting upon the advice of his counsel, there was organized on December 30, 1919, the Midland Securities Co., a Delaware corporation. One hundred shares of the authorized capital stock of the Midland Securities Co. was subscribed for by its incorporators, which 100 shares were transferred to C. C. Herndon, the personal counsel of Mr. Skelly. Nothing of value, however, appears to have been given by these parties for their stock. The remaining 74,000 shares of stock of the Midland Securities Co. were subscribed for at par by Mr. Skelly, although the shares were placed in the names of various parties. The payment for the stock of the Midland Securities Co. was made by Mr. Skelly giving a check in the amount of $50,000 on a Tulsa, Okla., bank, and another check for $700,000 on the Mechanics & Metals National Bank of New York. On the same day, December 31, 1919, the Midland Securities Co. purchased from Mr. Skelly the 467,937 shares of stock held by him in the Skelly Oil Co., and also the 34,800 shares of capital stock of the Ranger Gulf Corporation, having a par value of $10 per share, at the stated figure of $700,000. The Midland Securities Co. and Mr. Skelly arranged with the Mechanics & Metals National Bank of New York that the two checks, each in the amount of $700,000, should reach the bank at the same time and that they should offset each other, as neither the Midland Securities Co. nor Mr. Skelly had at the Mechanics & Metals National Bank money with which to meet those checks if they had been presented for actual payment. It is urged by the taxpayer that the transaction which took place between him and the Midland Securities Co. constituted a sale of Skelly Oil Co. stock for $700,000 and that whatever profit he may have made by the transfer of his property to the Skelly Oil Co. for stock in that company, such profit was substantially wiped out by his sale to the Midland Securities Co., and the fact that the sale made in order to wipe out any profit that may have been made is entirely immaterial.

While the transfer of stock of the Skelly Oil Co. to the Midland Securities Co. served to transfer the title to those shares from Mr. Skelly to the Midland Securities Co. this office is not willing to concede that the transfer was in effect a sale for cash. It is perfectly clear from the taxpayer's own showing that he did not subscribe for the stock of the Midland Securities Co. for cash and that that company did not, in turn, pay him cash for the shares of Skelly Oil Co. stock to which it took title. What occurred was a transfer by Mr. Skelly of stock held by him in the Skelly Oil Co. and the Ranger Gulf Corporation for stock of Midland Securities Co., and the value of the stock of Midland Securities Co. received by him on December 31, 1919, would have a value equal to the value of stock in the Skelly Oil Co. and the Ranger Gulf Corporation as of that date. It is contended by taxpayer that the agreed figure of $700,000 represented the value at December 31, 1919, of the stock turned over to the Midland Securities Co. No attempt was made at the oral hearing or in the briefs to fix a definite value on the stock of the Skelly Oil Co. or the Ranger Gulf Corporation. In support of their contention that $700,000 was representative of the value of stock, they submit the evidence of the pool mentioned and two affidavits from New York brokers that the market for this class of stock materially declined in December, 1919. They further contend that between October 2, 1919, when Mr. Skelly received the stock from the Skelly Oil Co., and December 31, 1919, the actual value of stock of the Skelly Oil Co. was materially decreased, due to the fact that drillings in the Ranger field during those months had proved extremely disappointing. There is no evidence in the record of this last contention except the mere statement. The figure claimed by the taxpayer seems ridiculously low, when at the same time the stock of the Skelly Oil Co. was selling on the New York curb around par or better, and but a short while before large blocks of stock had been sold at private sale at from $10 to $12 per

share. If it should be shown as a fact that the Skelly Oil Co. stock and the Ranger Gulf Corporation stock was on December 31, 1919, of a value less than at the date of its acquisition by Mr. Skelly, such difference may be taken by him as an offset against any profit which may be shown by the original transfer of his property to the Skelly Oil Co. and to the Ranger Corporation. Since it has been held, as above stated, that the transfer of the Skelly Oil Co. stock and the Ranger Gulf Corporation stock to the Midland Securities Co. was not a sale to the Midland Securities Co. for cash, but constitutes, in effect, an exchange of stock for stock, it follows that the consideration received by Mr. Skelly for the Skelly Oil Co. and the Ranger Gulf stock is the value of the Midland Securities Co.'s stock, and since the only value the stock of the Midland Securities Co. had was the value of the stocks of Skelly Oil and Ranger Gulf Corporation, it necessarily follows that the consideration received in the transaction by Mr. Skelly was the value of the stock of the Skelly Oil Co. and the Ranger Gulf Corporation. The value of the stock of the Skelly Oil Co. and the Ranger Gulf Corporation on December 31, 1919, is a matter more properly for the determination of the Income Tax Unit, and it is suggested that the oil and gas section of the engineering division consider what value should be placed on these stocks as of that date.

As to issue No. 1, under which taxpayer contends that there was no fraud in the preparation of his return for the year 1919, this office is of the opinion, under all the evidence, that the return for 1919 was not false and fraudulent with intent to evade tax, and recedes from recommendation contained in memorandum of October 7, 1922, that the penalty be asserted. The recommendation of assertion of the penalty was based upon failure of the taxpayer to make disclosure in his return of the transaction with the Midland Securities Co. At the oral hearing and in the brief filed taxpayer contends that schedules were attached to his return at the time it was filed disclosing the entire matter, and in support thereof submits his retained copy showing these schedules. Mr. Skelly testified that the schedules disclosing the Midland Securities Co. transaction were attached to his return at the time he signed it and delivered it to John B. Logan for file. Mr. John B. Logan, the accountant who prepared the return, and Mr. C. C. Herndon, Mr. Skelly's personal counsel, testified that the schedules were attached to the original return when it was filed. Other affidavits from persons who assisted in preparation of the return were submited to the same effect. It was contended that these schedules became separated from the return and misplaced after the return was filed, and there is some evidence to indicate this.

The administrative file, together with the briefs, contracts, and affidavits filed in this office, are herewith returned.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT F

ENGINEERING DIVISION, OIL AND GAS VALUATION SECTION,
June 25, 1924.

W. G. SKELLY, *Tulsa, Okla.*

Taxable years 1917, 1918, and 1919.
Waivers inclosed for 1917 and 1918.

Depletion computed on cost, March 1, 1913, value, and discovery appreciation

Year	Gross income from oil	Depletion claimed (Form O)	Depletion allowable
1917	$549,308.25 RAR	$73,425.11	$25,945.88
1918	741,980.08 RAR	220,022.52	149,267.35
1919	733,698.18 RAR	281,272.98	205,656.47

Profit on sale of Skelly oil stock, 1919

Total number of shares received	611,250
Cost of leaseholds, physical equipment, Skelly-Sanky stock, and liabilities assumed	$2,305,136.73
Less depletion and depreciation	308,322.22
Total cost of property and stock	1,996,814.51
Cost of each share of stock ($1,996,814.51÷611,250)	3.266
Selling price of 141,313 shares	1,413,130.00
Cost of 141,313 shares	461,528.25
Profit on sale	951,601.75

DISCUSSION

The taxpayer prior to 1917 was a producer of oil, but at that time he enlarged his activities, securing additional production as well as engaging in the drilling, refining, and marketing end of the business.

Late in 1919 Mr. Skelly decided to combine his several interests and holdings in producing and nonproducing properties into a corporation. On October 1, 1919, the Skelly Oil Co. was organized, the details of which are set out in the revenue agent's report and in various briefs filed by the taxpayer.

In determining the profit that accrued to Mr. Skelly by the transfer of his holdings to the Skelly Oil Co., the actual cost of the assets, depleted to date of transfer, was computed. This amount divided by the number of shares of stock received gives the cost per share as $3.266 and a profit on the stock actually sold of $6.734 per share.

A conference memorandum dated January 18, 1924, deals with the profit arising from the formation of the Skelly Oil Co.

The following paragraphs from the above-mentioned conference memorandum show the conclusions arrived at by this section:

"A résumé of the various transactions by which the properties of the taxpayer were transferred to the Skelly Oil Corporation for stock of that corporation and the various transactions affecting that stock will not be made by this section, as these details are set out in full, and clearly, in the solicitor's opinion and also in the brief contained in the file of the case.

"Valuation features arise as indicated by the following brief summary:

"On October 2 Mr. Skelly turned in his properties in return for stock of the Skelly Oil Corporation. Part of this stock so received was free from all restrictions as to sale, disposal, etc.; the balance of the stock could not be sold for a period of nine months, except under certain conditions, which conditions never arose. Later, on December 31, 1919, this latter class of stock was transferred to the Midland Securities Co. in exchange for stock of that corporation, the Midland Securities Co. taking the stock with the same inhibition applied to Mr. Skelly.

"This section has been asked to compute the profit, if any, arising from (1) the transfer of the properties by Skelly for stock in the Skelly Oil Corporation, and (2) also the profit or loss, if any, arising from the transfer by the taxpayer of the stock of Skelly Oil Corporation and the Ranger Gulf Corporation for stock of the Midland Securities Co.

"As to the first transaction, which was completed at the date of the organization of the Skelly Oil Corporation on October 2, 1919, a profit arose to Mr. Skelly as to the stock which was free from restrictions as to sale and disposal and which actually was sold by him. The profit is determined as follows:

Total number of shares received	611,250
Cost of leaseholds, equipment, Skelly-Sankey stock, and liabilities assumed	$2,305,136.73
Less depletion and depreciation	308,322.22
Total cost of property and stock	1,996,814.51
Cost of each share of stock ($1,996,814.51÷611,250)	3.266

Selling price of 141,313 shares	$1,413,130.00
Cost of 141,313 shares	461,528.25
Profit on sale	951,601.75

"As to the stock which by the terms of the agreement dated September 30, 1919, an inhibition as to the sale or disposal was made, neither profit or loss could arise, as only under certain conditions could the stock be sold. These conditions never arising, 'the existence of a public of possible buyers at a fair price' being denied by the very terms of the agreement and a situation created whereon there could be neither a willing buyer nor a wiling seller, no value can be determined by this section. In other words, this section has no means of determining the fair market value of a property or commodity when there was no market for it. Nor could the stock in any way be considered the equivalent of cash, because there was no way to convert it into cash. Hence it follows that there could be neither profit nor loss. The question of profit or loss must be edtermined at such subsequent time as Mr. Skelly disposes of this stock, the cost thereof having been ascertained as set out above.

"For the same reasons the same conclusions must of necessity be reached as to any profit or loss arising because of the transfer to the Midland Securities Co., the stock which was transferred being the identical stock to which the inhibition applied.

"As to the question of profit or loss, if any, of the exchange by Mr. Skelly of the stock of the Ranger Gulf Corporation for stock of the Midland Securities Co., it is held that inasmuch as the solicitor states 'it necessarily follows that the consideration received in the transaction by Mr. Skelly was the value of the Skelly Oil Corporation and the Ranger Gulf Co., and as it is impossible for this section to determine any value for the Skelly Oil Corporation stock, no profit or loss can be ascertained.'"

The revenue agent's report covers all years through 1920 and should be followed in making an audit of the case, with the exception of the item of depletion.

Schedules attacked to the returns in support of depreciation, dry hole, and canceled lease losses have not been passed on by this section at this time. The revenue agent has gone into the case very thoroughly, and it is recommended the report be followed.

Form C data, from which the depletion shown in this report is computed, was submitted without a jurat and none has been furnished. In the absence of a jurat the allowable depletion is only tentative; however, all valuations have been agreed upon in conference with the taxpayer's representatives on January 24, 1924.

Recommended by:

L. D. WOODDY, *Engineer.*

Approved by:

O. N. THAYER, *Chief of Section.*

MARCH 3, 1924.

Senator KING. I think the officials who held that ought to be rebuked, if not discharged.

Mr. MANSON. But I believe a consideration of that case in connection with other cases that I have presented here, coming from the oil and gas section, shows that the mind of the person in control of the oil and gas section must be wholly incapable of conceiving the idea that an oil man is subject to tax.

Senator KING. Is Mr. Thayer the man who handled that?

Mr. MANSON. This matter has been disposed of by the oil and gas section, and has the approval of Mr. Thayer.

The CHAIRMAN. Was it passed on by Mr. Greenidge, too?

Mr. MANSON. I do not think so, not specifically. It is not closed. I do not anticipate that if it reaches the Solicitor's office, the opinion of the oil and gas section will be concurred in. I do not anticipate that that case will ever get through the audit sections, because the holding is so absolutely ridiculous that I do not believe there is an auditor down there but what will catch it.

Senator JONES of New Mexico. Why should the oil and gas section pass upon such a question?

Mr. MANSON. They passed on the valuation of this stock, but they took the position that because this man has voluntarily imposed a restriction as against one individual, mind you——

Senator JONES of New Mexico. That is not a question to be passed upon by a man who is supposed to be dealing in valuations of oil or oil properties, is it?

Mr. MANSON. Well, I do not believe so, either. He took this position, that the fact that a man who is an engineer, who is not supposed to be dealing with that class of questions, has no justification or no excuse for that kind of a holding. It is so utterly ridiculous that a person who will take the view that because of a voluntarily imposed restriction as against one individual having a contract voluntarily entered into, to dispose of the property, that thereby that property loses all value, is so utterly ridiculous that I take the position that that man is incompetent to hold any position in the bureau above that of office boy, if he should entertain any such idea.

The CHAIRMAN. In that connection, did you not tell me the other day that there was some firm of lawyers who represented the Petroleum Institute, in the presentation of a large number of cases before the bureau?

Mr. MANSON. I do not think they are interested in this particular case. There is one firm in New York—I do not think they are lawyers—who represent some 625 of these claims in the bureau, but I do not think that they were involved in this case in any way.

The CHAIRMAN. What are they?

Mr. MANSON. And I do not blame particularly any lawyer who can get away with a proposition of that sort; but I do say that the thing is so manifestly raw on its face that a man who will even entertain such an idea is wholly incompetent to value anything.

The CHAIRMAN. Yes; but you do not pay a very high compliment to the legal fraternity. You say you do not blame them for trying to get away with a case like that.

What is the name of that firm?

Mr. MANSON. I do not know who is involved in this case.

The CHAIRMAN. But I mean the firm that is interested in these six hundred and some odd cases down there.

Mr. MANSON. Mattison & Davies.

The CHAIRMAN. Are they lawyers?

Mr. MANSON. No; I think they are accountants. Are they not?

The CHAIRMAN. Do you know who they are, Mr. Nash?

Mr. MANSON. They represent the oil industry.

Mr. NASH. I understand Mattison is an accountant. I do not know who Davies is. I have heard of the firm name but I do not know either one of them.

The CHAIRMAN. Are they lawyers or accountants?

Mr. NASH. I understand Mattison is an accountant and not a lawyer.

The CHAIRMAN. Have you anything more this morning?

Mr. MANSON. Yes; there is one other matter that I want to present.

To go back to that Skelly case, it seems to me that any man who is capable of entertaining any such idea is wholly disqualified from valuing anything.

The CHAIRMAN. In that connection I might say that this matter has been brought to the committee's attention so frequently by the staff of the committee that I just wonder what the attitude of the bureau is. They have listened to all of these criticisms of the oil and gas section, but I have not heard anything from the assistant to the commissioner, Mr. Nash, as to whether they propose to make any changes or whether they propose to let matters go along in this manner.

Mr. MANSON. Well, before——

The CHAIRMAN. Let us find out first what Mr. Nash has to say in that connection.

Mr. NASH. Senator, it is not within my jurisdiction to state definitely whether or not any change will be made in the oil and gas section or any other section. The criticisms that are made before the committee are being investigated and some changes have been made in our organization, and although I can not authoritatively say so, I think that more changes will be made.

The CHAIRMAN. Is it advisable for the committee to write to Mr. Blair and ask him about this matter, or does he have all of this testimony before him, so that he can decide it for himself without any suggestions from us?

Mr. NASH. The testimony is all available to Mr. Blair, and these situations are discussed with Mr. Blair as rapidly as they come up. Mr. Blair has been out of the city now for several days, and the recent criticism with reference to the oil and gas section, of course, has not been brought to his attention. I might say in this connection, Mr. Chairman, that, so far as I can recall, all of the criticism of the oil and gas section has been presented in the past week.

Mr. GREGG. Very recently.

Mr. NASH. The criticism of the committee has been directed more to the old amortization section. They have dealt with metals and nonmetals cases and we have had one or two timber cases, but it is only within the last week or so that we have been going into the oil cases.

Mr. MANSON. Several days ago, I made a statement to the committee to this effect, that from the very beginning of my connection with the work of this committee, there has been the most wholehearted effort upon the part of Mr. Nash and upon the part of all the employees of the bureau, with one exception, to give us the fullest possible cooperation. There have been times when there has been a little friction, but the engineers and the accountants have always been more or less reluctant to even bring that to my attention.

However, from the very beginning of this investigation, before we ever presented an oil case to this committee, before we even began to call for any special cases from the oil section, there has been a determined resistance in that section to the work of this committee, right from the beginning. That has manifested itself in various ways. The manner in which it has manifested itself, that has caused the most anonyance, is that we have called for records. In the first place, there was always the interminable delay in getting data. Then, when we did get them, the record was always incomplete. Out of a record that would stand 2 feet high, we would get a little handful of papers, and it was just a case of checking and checking and

checking on, and keeping on insisting and demanding, and in some instances in going with our own engineers to the file to see that we got the record. That situation was not brought to my attention. The engineers did not complain to me about it, and finally the way it did come to me was when I persisted in hammering our own representatives over the fact for their failure to get quicker action on oil cases.

When the matter was brought to my attention, I wrote to Mr. Nash about it, and he took immediate steps to have the situation remedied; but I want to impress this fact on the committee, that that resistance antedated the presentation of a single case before this committee. Up to that time, the most of our criticism had been directed toward the amortization section—I believe that is called the appraisal section—but there never was a time that we failed to get out of the appraisal section anything we called for, even though it was the butt of our attack.

It appears that recently one of our engineers went to the oil and gas section—I believe it was Mr. Bailey—to get some papers or to consult with an engineer about some case, and he was ordered out of the section. That fact was not brought to my attention, until finally I did learn about it, and I have here a record of a statement made by Mr. Thayer to Mr. Wright, one of our engineers, in the presence of Mr. Kenney, Mr. Archbald, Mr. Morrison, and Mr. Bailey. Kenney, Archbald, and Bailey are engineers, and Mr. Morrison is an accountant. All of these men are employed by the committee, and all of these men have signed this statement, which is as follows:

I never have been very much in favor of this investigation. In fact, I have even looked on it as a nuisance at times. However, I have tried to be agreeable and had instructed my men to do everything to expedite matters, but the real thing that has made me sore, in the past week or so, is the report of the E. R. Black-G. A. Simons case. It would have been all right providing you people had gotten the facts of the case straight, but you only seemed to have a one-sided point of view in the case. For all I know, Kenney, you may have been the one who was responsible for that report. However, I don't hold that against you and don't think that that is the reason I put you out of our section yesterday morning.

That is signed by five of our employees; but I do want to impress this fact, and I do not want any misunderstanding about it, that I do not hold the administration of the bureau, I do not hold Mr. Nash, I do not hold anybody responsible for that situation, except Mr. Thayer. I do say that Mr. Nash has done everything possible to not only give us general assistance but to even overcome this.

The CHAIRMAN. Who is Mr. Thayer's immediate superior?

Mr. MANSON. Mr. Greenidge.

The CHAIRMAN. And did not Mr. Greenidge have charge of the same staff who dealt with the amortization cases?

Mr. MANSON. Yes.

The CHAIRMAN. He is the same official down there who had to do with the reappraisals of the copper and silver mines?

Mr. MANSON. Mr. Greenidge?

The CHAIRMAN. Yes.

Mr. MANSON. Yes.

The CHAIRMAN. Do you want to go on to-morrow at 10 o'clock, Mr. Manson?

Mr. MANSON. Yes.

The CHAIRMAN. You have nothing further to-day?

Mr. MANSON. That is all.

I want it understood that I did not bring this matter to the attention of the committee for any other reason than that our investigation up to this time has satisfied my mind that the situation in the oil and gas section is deplorable.

The CHAIRMAN. Is it not also true in some of the other engineering sections with regard to which Mr. Greenidge has charge?

Mr. MANSON. I think the same thing is true in the appraisal section, but we have not met with any resistance there.

The CHAIRMAN. If agreeable, we will adjourn to 10 o'clock to-morrow morning.

(Whereupon, at 12.15 o'clock p. m., the committee adjourned until to-morrow, Tuesday, May 26, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, MAY 26, 1925

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

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

Present: Senators Couzens (presiding), Watson, and King.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. Raleigh C. Thomas, investigator for the committee.

Present on behalf of the Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury, and Mr. A. W. Gregg, solicitor Bureau of Internal Revenue.

Mr. MANSON. I would next call the committee's attention to the valuation allowed as of date of acquisition for the property of the Temple Coal Co., of Scranton, Pa.

The business of this company is mining anthracite coal. The years involved are 1917 to 1920, inclusive.

The Temple Iron Co. was owned by five or six of the anthracite coal-carrying railroads, and at the time of the litigation under the Sherman Act, I believe it was, the Supreme Court determined that the property, being owned by the railroads, must be disposed of. It was bought in by a man by the name of Thorne, who, seven days after he bought it in, organized the Temple Coal Co., and turned the property over to the Temple Coal Co.

On June 24, 1914, the property was sold for cash by the Temple Iron Co. to Thorne for $5,609,423.33.

On July 1, 1914—that is, seven days later—the property was taken over by the Temple Coal Co. from Thorne, and is valued as of that date for tax purposes, which would be the value for the purpose of determining invested capital in this instance, at $11,188,298.01, That is approximately double what was paid for the property seven days earlier.

I take it that the amount of tax involved was about a half millon dollars.

The Temple Coal Co. was orga ized June 24, 1914, and commenced business on July 1, 1914, acquiri g on that date all the capital stock of six coal mining companies and four-fifths of the capital stock of a seventh. All the companies were going concerns which had been in operation for a quarter of a century.

Previously these properties had been owned by the Temple Iron Co., which was an old company possessing an advantageous charter. It was this company which was made use of in 1896 when the inde-

pendent anthracite operators had associated to free themselves from the domination of the anthracite-carrying railroads. The Temple Iron Co. bought up all the holdings of the leaders of the independent operators and the railroads maintained their position. It was because the Temple Iron Co was being used as a means to defeat the antitrust laws that it was later prosecuted and in the spring of 1914 was ordered dissolved by a decree of the United States Supreme Court.

The history of the Temple Iron Co. and the Temple Coal Co. is important in this case. As a letter from the attorney for the taxpayer states:

In order to have an accurate understanding of the matter, it is necessary to go back to year 1899. Prior to that year the coal properties known as Northwest, Sterrick Creek, Lackawanna Coal Co. (Ltd.), Babylon, Mount Lookout, and Forty Port Coal Cos. were owned and controlled by the firm of Simpson & Watkins. During that year all the coal which Simpson & Watkins had acquired by means of certain perpetual leaseholds, which, under the decisions of the Supreme Court of Pennsylvania, were actually sales of the coal in place in the mine, together with the mining improvements, to wit, the shafts, slopes, gangways, airways, breakers and machinery, cars, mine motors, and mine locomotives, was sold to the Temple Iron Co. for a specific sum, said sum being based upon the appraised value of the shafts, breakers, mining improvements, and personal property, plus the sum of 15 cents per ton for each ton of coal estimated to be minable from the properties comprising the leasehold estates, and plus the value in place in the mine of certain coal owned in fee simple. Under the terms of the sale the Temple Iron Co. bound itself to pay the monthly, quarterly, or annual installments of the purchase price for the coal contained in the various leaseholds, and which payments, commonly termed rentals or royalties, were to be paid in addition to the specific sum then paid, based as aforesaid.

These properties were owned and controlled by the Temple Iron Co. until, by a decree of the Supreme Court of the United States, effective in 1913, they were ordered sold so as to divest the title from the owners of the Temple Iron Co. stock, which was five or six of the commonly known anthracite-carrying railroads.

After full notice to the public by means of advertisements in trade and other newspapers, the coal properties, breakers, and all mining rights, and privileges, were sold to the highest and best bidder for cash.

All the said properties were purchased for a specific sum by Mr. S. B. Thorne, of New York City. This sum was based upon an examination made for the Temple Iron Co. by an expert mining engineer, and comprehended the valuation of the mining improvements above enumerated, plus 19 cents and a fraction per ton for each ton of coal estimated by the engineer to be contained in place in the various mines, and in addition thereto the purchaser undertook and assumed the payment of the various installments of the purchase price for the coal remaining unmined in the leasehold estates, known as rents or royalties.

"No stock of the Temple Iron Co. changed hands. It was a sale for cash of the physical properties and not a sale of stock certificates controlling them.

"Mr. Thorne and his associates then formed the Temple Coal Co., and on July 1, 1914, it took possession and has remained in possession and control to this date.

"The advertisement calling for bidders at the time of sale by the Temple Iron Co., in 1914, called for bids upon the properties as a whole, and it was upon this basis that Mr. Thorne put in his bid, and upon which the properties were sold to him prior to the formation of the Temple Coal Co."

In addition to the statement of the attorney for the Temple Coal Co., the report of the revenue agent gives in greater detail the financial transactions which occurred between June 24 and July 1, 1914:

Financial history; description of business: Mining coal from fee lands and leased lands and preparing it for market.

History of each corporation, with the name of each corporation and the date incorporated: Sterrick Coal Co., incorporated 1892; Babylon Coal Co., incorpo-

rated 1891; Northwest Coal Co., incorporated 1890; Mount Lookout Coal Co., incorporated 1888; Edgerton Coal Co., incorporated 1892; Forty Fort Coal Co., incorporated 1893; and Temple Coal Co., incorporated June 3, 1914.

"These corporations, except Temple Coal Co., were owned and operated by what is referred to as the Simpson & Watkins interests prior to 1899. In 1899 they were acquired by Temple Iron Co. Pursuant to a decree of the court, effective in 1913, the Temple Iron Co. divested itself of title to its coal lands; the coal lands were owned by the above-named corporations which were owned by Temple Iron Co. through stock ownership. In June, 1914, the capital stock of these subsidiaries was sold to S. B. Thorne, of New York City, who was the highest bidder. Mr. Thorne's bid was $5,800,000, which, according to the minutes of the Temple Iron Co., was payable and actually paid as described by said minutes, which in part read as follows:

"MINUTES OF TEMPLE IRON CO.

"[Page 181, book No. 2, to page No. 1, book No. 3]

"NEW YORK, *June 10, 1914.*

"*Resolved*, That in the absence of the president, Robert W. De Forest be and hereby is appointed president pro tempore with all the powers of president and that as such he is specially authorized and empowered to execute and deliver any instruments necessary or expedient to effect a sale and disposition of the shares of the capital stocks, assets, and properties of Northwest Coal Co., Edgerton Coal Co., Sterrick Creek Coal Co., Babylon Coal Co., Mount Lookout Coal Co., Forty Fort Coal Co., and Lackawanna Coal Co. (Ltd.), the selling and disposing of which is provided for under decree of the United States Circuit Court for the Eastern District of Pennsylvania.

"After discussing the matter of bonds which S. B. Thorne was to turn over as part payment on his bid for the coal stocks of the company, the following resolution was offered and on motion duly made and seconded was carried:

"*Resolved*, That in lieu of the bonds to be received from S. B. Thorne upon and under his bid for the purchase of the coal stocks of this company, accepted May 1, 1914, this company will accept and receive cash in amount equal to 90 per cent of the face value of the bonds specified in this company's public offer of sale of such stocks, together with 5 per cent interest upon the face value of such bonds from May 1, 1914, until the date of such cash payment.

"Mr. Thorne's proposition accepted June 1, 1914, is as follows: Bonds, $2,320,000; cash, $3,480,000; total, $5,800,000.

"The final proposition would then be as follows:

Bonds	$2,320,000.00×90 per cent,	$2,088,000.00
Cash	3,480,000.00	3,480,000.00
Interest	41,423.33	41,423.33
Totals	5,841,423.33	5,609,423.33

"The sale was consummated at 1 o'clock by the payment to the treasurer of the Temple Iron Co. of the sum of $5,609,423.33.

"President pro tem De Forest reported that he had turned over the stocks of the subsidiary coal companies to Mr. S. B. Thorne, and had received in payment therefor, after all adjustments had been made, $5,609,423.33, and that this money had been deposited in the Guaranty Trust Co. of New York."

Two unassociated typewritten sheets found in the files of this case give information as to the purchase by the Temple Coal Co. of the assets which Mr. S. B. Thorne had purchased on June 24, 1914, from the Temple Iron Co. and are attached to this report as Exhibit C.

Discussion: In support of the protest against the additional taxes which had been assessed against the Temple Coal Co., counsel for the taxpayer filed an elaborate brief, and detailed Form E. The argument in the brief emphasizes the transactions of July 1, 1914, when Mr. S. B. Thorne transferred the stock in the separate coal companies and received in return all the stock of the Temple Coal Co. In contrast the brief makes no mention of the transactions which had occurred seven days previously, when Mr. Thorne acquired the property he so quickly sold.

In making a valuation the engineer for the coal-valuation section has been led astray through following the brief and by considering only the transactions of July 1, 1914. The revenue agent, in making his report, recognized

the importance of the transactions of the week previous and allowed the invested capital to be the cash paid for the properties on June 24, 1914.

It needs to be remembered that this purchase from the iron company on June 24, 1914, was a cash purchase and that according to the statement of the attorney for the taxpayer the sale took place after a valuation had been made by a disinterested engineer and that the sale was consummated after open bidding and the price paid represented the market price of the property.

Under such circumstances there is no need to consider the transactions of July 1. It can be admitted frankly that Mr. Thorne purchased stock and that he sold the same stock and received in turn more stock. Mr. Thorne paid cash for the original stock and after possessing it seven days sold it without any change in the physical property which the stock represented.

Moreover, it must be remembered that these coal mines whose value was in question were not new mines upon which discoveries could be made. They were old mines and one of them had been abandoned as worked out. Nor is this a case of the valuation of the assets of a company whose stock had been long and closely held and whose management had been conservative. The stock was held for seven days.

The par value of the stock sold by the Iron Co. was $1,100,000. The price paid was $5,609,423.33. The taxpayer claims as invested capital at July 1, 1914, $9,655,611.67 for the six properties owned in entirety and for the property in which it owned a four-fifths interest, a value as at date of organization of the company (October 30, 1908) of $2,141,586.42. The allowed value gives an approximate value for this latter of $1,532,686.34 as of July 1, 1914. Exact calculations for this date were not made by the valuation engineer, as the unit had ruled that this four-fifths interest (in the Lackawanna Coal Co.) was not affiliated until 1918.

The basis which the valuation engineer used in making the allowances is "since the transaction occurred, July 1, 1914, prior to March 3, 1917, the value of the stock of the parent company for invested capital purposes would depend upon the value of the stock of each subsidiary company, which in turn would be determined by the value of the property and assets as of July 1, 1914, of each company." Thereupon an appraisal was made using expected operating profits as a basis.

It is noteworthy that the engineer for the unit follows blindly the argument of the taxpayer and gives no attention to the sale which occurred on June 24, 1914. The attorney for the taxpayer contradicts the theory applied in making the valuations concerning the transactions of June 24, 1914, stating specifically "it was a sale for cash of the physical properties and not a sale of stock certificates controlling them. After full notice to the public by means of advertisements in trade and other newspapers, the coal properties, breakers, and all mining rights and privileges were sold to the highest and best bidder for cash. This sum was based upon an examination made for the Temple Iron Co. by an expert mining engineer, and comprehended the valuation of the mining improvements. The advertisement calling for bidders at the time of sale by the Temple Iron Co. in 1914, called for bids upon the properties as a whole, and it was upon this basis that Mr. Thorne put in his bid, and upon which the properties were sold to him prior to the formation of the Temple Coal Co." (seven days later).

Reference to the records of the United States Supreme Court will show that an open sale at the market price had been ordered. Moreover, records of the Lackawanna County courts of Pennsylvania will show that after the sale occurred the court decided that the market price had been obtained.

In the face of court records a valuation on an appraisal basis can hardly be claimed or allowed.

If the sale of June 24, 1914, was not an open sale and the market price was not obtained, then there was a violation of an order of the Supreme Court.

Under these circumstances it is not necessary to critically examine the valuation made by the engineer for the unit. It can be pointed out, however, that the engineer apparently made free use of his imagination and did not stick to fact. For instance, in determining a value for the culm (fine sizes of coal considered waste in earlier years). The engineer assumed that if the culm was all in one place (which it was not, being in five), then it could be prepared in a washery costing so much (instead of five washeries costing nearly five times as much), and therefore would have the value of one culm bank. Moreover, as the company could prepare the culm in the coal breakers along with fresh mined coal and therefore avoid the cost of

building washeries, the estimated cost of a washery should be added to the paid in surplus, because the company would not have to invest this money, and therefore the property was more valuable and invested capital should be increased by the amount the company would have had to invest if the culm was all in one place (which it was not) and if the company built a washery (which it did not need).

Comment: If there is a difference of $5,578,874.68 between the two sales of June 24, 1914, and July 1, 1914, this amount would seem to be income for some one and should have paid tax.

To claim or allow such a difference is an admission that there was a violation of an order of the Supreme Court.

Conclusion: Your investigators recommend that a valuation be made of the properties of the Temple Coal Co. on the basis of the cash sale of June 24, 1914.

The CHAIRMAN. There is a point that is not quite clear in my mind. In one instance I understood that this property was sold for cash—that is, the physical property was sold for cash—and then you said it was purchased for stock.

Mr. MANSON. Yes; the revenue agent said it was a sale of stock, but a full investigation of the record shows that it was a sale of the actual physical property. As I said, Thorne's first bid of $5,800,000 provided for the payment of $3,480,000 in cash and $2,320,000 bonds. Then the company accepted a modification of the bid, providing for the whole amount to be paid in cash; that is, they accepted cash for 90 per cent of the amount of the bonds, making the actual purchase price in cash $5,609,423.33. The value finally arrived at here is the valuation based upon the capitalization.

The CHAIRMAN. You mean the value arrived at by the bureau?

Mr. MANSON. The value arrived at by the bureau is based upon the capitalization of this property seven days after it was purchased for cash, and, as I have stated, that is about double the amount of the cash purchase.

The CHAIRMAN. Well, does not the record show how they arrived at this $11,000,000 plus?

Mr. GREGG. Was not that valuation based upon the sale of the stock issued for the property?

Mr. MANSON. Yes; there was a valuation of the stock issued for the property.

Mr. GREGG. Based on the market value of the stock at the time it was issued. As I read the report, that is what I gather from it.

The CHAIRMAN. Mr. Gregg, when was that valued; as of what date?

Mr. GREGG. Seven days after the sale, I think; that is, as I got the transaction. The statement was a little long to read in full at this time.

Mr. MANSON. I want to avoid reading these details, if I can, and I am trying to pick out the salient points.

The CHAIRMAN. On that particular point, I understand that if the property was purchased seven days before the valuation was set for actual cash, and it appeared that seven days after the purchase of the stock it was worth more than was paid for it, would you date the value of the stock seven days after the purchase?

Mr. GREGG. Let me put it this way: Suppose the property was sold for cash. Seven days subsequently the property was turned over to a corporation for stock of the corporation.

The CHAIRMAN. Yes.

Mr. GREGG. Now, we are bound, in determining the valuation at that time, seven days later, by the value of the stock paid for the property. Of course, we should consider the previous sale, but if we have better evidence as to the value of the stock paid for the property seven days later, I think we are bound by it.

The CHAIRMAN. Let me put it this way, then: Supposing that seven days after the property was really purchased for cash the stock was issued for the value of the property, and the stockholders among themselves agreed to put, through the New York Stock Exchange or otherwise, a value by the exchange of stock on the stock for a particular price much in excess of the price paid. Would the bureau be bound by that price?

Mr. GREGG. No, sir; we have to make sure that the value of the stock, based upon the sale of this stock, represents a real value. In other words, a few isolated sales would not be satisfactory.

Take this case, for example:

The value of the stock of the United States Steel Corporation is well settled to-day or a week ago or a month ago. Assuming the property were purchased by A for $5,000,000 and several days later he turns that property over for stock in the United States Steel Corporation for $10,000,000. The value of the stock of the United States Steel Corporation is so well settled that we would be bound by that in the valuation, I think.

The CHAIRMAN. Of course, in using the Steel Corporation case, you are using a well-known case?

Mr. GREGG. I am using a very extreme case.

The CHAIRMAN. Yes. Can you tell the committee what might occur within that seven days' period which would cause a doubling of the value?

Mr. GREGG. No, sir; I can not tell what would possibly occur.

Mr. MANSON. What they did was this: They determined the value of the stock. In other words, they base the cost as of date of acquisition. Here stock was exchanged. Thorne bought this property for a little over $5,000,000 cash. Seven days later he turned it over to the Temple Coal Co. for some $11,000,000 of stock. Then the bureau took the position——

Mr. GREGG. But was there actually $11,000,000 plus of stock issued? I did not understand that. I understand that it is just the valuation that you are talking about.

Mr. MANSON. I am coming to that now.

He turned it over for stock. The bureau took the position that the value as of date of acquisition was the value of the stock. They then determined the value of the stock, not by stock sales, but by an appraisal based upon anticipated profits.

Now, here, you have an actual cash transaction, and in that cash transaction, mind you, the big price was based upon an appraisal made by an engineer who was employed by the company whose assets were being disposed of. In other words, these assets were being disposed of pursuant to an order of the Supreme Court. The company employed an engineer, who made an examination of the property and determined the value of the property. This man Thorne bid in the property for a price fixed by an engineer employed by the company whose assets were being disposed of for something

over $5,000,000. He in turn turned that physical property over to a new company seven days later for stock.

Mr. GREGG. I think the par value was a little over $11,000,000.

Mr. MANSON. Yes; it appears that the par value was a little over $11,000,000. I think that is the amount fixed, approximately.

Mr. GREGG. Yes.

Mr. MANSON. The stock thus received by him is then valued by setting up an anticipated profit and discounting that back date.

The CHAIRMAN. Tell us what procedure they followed. That is what I am trying to get at for some time, the method of arriving at anthracite coal values.

Mr. MANSON. The report states:

> Thereupon an appraisal was made using expected operating profits as a basis.

The CHAIRMAN. But it does not show how?

Mr. MANSON. It does not show how; no. It does not show the factors used. It does not go into detail.

The CHAIRMAN. I would like to know about that before we adjourn, because I turned over to you some complaints about the Delaware, Lackawanna & Western Co. and the Glen Alden Co., in which there was some serious consideration of that same principle.

Senator KING. If I understand this case, the course pursued by the department can not be defended. It throws to the winds all business experiences; it injects an element of speculation into a matter which is concrete and specific, and is calculated—of course, it can not be otherwise—to operate to the disadvantage of the Government.

Mr. MANSON. Here is my viewpoint:

What they are determining here is invested capital. Here is a group of men who go and buy this property or exchange the property for stock.

Senator KING. Surely; I understand that.

Mr. MANSON. Instead of valuing the stock to determine what the property is, it strikes me that you here have an actual sale of the property which constitutes the value of the stock.

Mr. GREGG. Let me explain my statement of a minute ago in that connection: If this sale which was made seven days prior was an arm's length transaction and there were no peculiar circumstances connected with it, then it is certainly entitled to more weight than an analytical appraisal made as of a date seven days subsequent. I do not think there is no doubt about that, but I want to inquire into the case a little further to see just what the facts were with reference to that sale. The sale may have been a prearranged matter and the purchase price may not have represented the true value of the property.

Mr. MANSON. The fact is, doubtless, as disclosed by the record, that the purchaser of the property, evidently as the result of an agreement with the Temple Iron Co., bought the property in at a price fixed by an appraiser.

Senator KING. By an engineer.

Mr. MANSON. By an engineer, who was employed by the Temple Iron Co., the owner of the property being sold.

The CHAIRMAN. In that connection, I want to say that I think we are wasting time in discussing this matter; in view of the lack of information you have, Mr. Manson, it seems to me that we can not get a picture of this thing without knowing the methods adopted by the bureau, because if the methods adopted by the bureau in fixing this valuation are based upon justice, and take into consideration the things Mr. Gregg has stated, there might have been a prearrangement as to the price to be paid. I do not think we need spend any further time on that.

Mr. MANSON. If the chairman of the committee would desire all of the details as to how that appraisal was arrived at, we can get those very readily?

The CHAIRMAN. I think that is very important, because I think that has a bearing on the whole question of valuing any such coal companies, because, as I am informed, the methods used are entirely too generous with the anthractice coal people. Is the report that you have there from your engineers in this case silent on that point?

Mr. MANSON. The report merely states that the value of $11,188,298.01 was arrived at by an appraisal based upon the expected profits basis.

Senator KING. That would negative the idea of——

The CHAIRMAN. Yes; but we have gone at great length into this method, this retrospective method of appraising that property, and I think some cases have disclosed what appears to be an absurd situation. Before we pass upon this matter, it seems to me that we ought to get a picture in our minds as to the procedure adopted in arriving at the $11,000,000.

Senator WATSON. This was a forced sale. Nobody knows what the transaction was, and we will not know that until we go into it.

Mr. MANSON. In explanation of the reason why we did not explain all of the details here, that is because we have gone into such great detail in many cases that I assume the committee was fully familiar with the method of arriving at the values, by estimating the expected profits and discounting them back to date.

Before offering this report, I will have the additional information looked up, so that it will all go into the record.

Before taking up any other specific case, while I have this in my mind, I would like to find out what the disposition of the committee is relative to calling the representatives of the Bureau of Mines and the Geological Survey on the matter of discovery areas in oil. The matter was brought up at a committee meeting one day.

Senator WATSON. It was brought up here, and we agreed that that should be done. I do not know whether it has been done as yet or not, due to the fact that I have had to be absent from the committee hearings.

Mr. MANSON. Since then I have made some investigation as to who would be the proper parties to call, and I was wondering when it was the desire of the committee that they should be called and what the committee wanted in that regard.

The CHAIRMAN. I read the memorandum which Mr. Fay prepared, after his conference with some of the chiefs or heads of the Bureau of Mines and the Geological Survey, and his report to you,

Mr. Manson, stated that these men, of course, had no knowledge of tax matters, but could go into a long explanation of how discovery oil wells might be determined more scientifically than has been done by the bureau; but in reading that statement over, I got the impression that we would get into a very technical discussion of the whole procedure, and it would perhaps take up too much time between now and our closing of the investigation here.

Then, I had the impression also that the committee is of the opinion, from discussing it with a majority of the members at least, that we should recommend the abolishing of all discovery values on oil lands, and if that should be the decision of the committee, the going into the technical means of discovery wells would be a waste of energy and effort, and it would not be worth while to encumber the record with a lot of technical matter.

So far as I am concerned, I am not desirous of spending a whole lot of time going into the question of locating discovery wells. In fact, it is my conviction, as it is of some of the other members of the committee, that the whole question of discovery value should be abolished, and if we should reach that conclusion, such testimony before us would be valueless.

Senator KING. My idea is this, Mr. Chairman, and I am really making it as a suggestion: Ask the Bureau of Mines and the Geological Survey to submit a memorandum, in concise and brief form, as to what they have done in determining the area of oil sands and oil pools, the methods which they have employed in such determination, and what recommendations they care to offer respecting the procedure in determining for taxation purposes—and their views, of course, would not be very important on that, because they do not know—the location of pools and discoveries and what areas should be embraced within a discovery, etc., with any recommendations they care to make, and then we could give it such consideration as we think proper.

The CHAIRMAN. I think if our staff can get such a document, we can attach it to our report for the use of the Ways and Means Committee and the Finance Committee, if they determine to continue a discovery value on oil wells, and we need not file it if we learn that both committees are determined to abolish it.

Senator KING. That would be my idea—just a memorandum report as to their methods——

The CHAIRMAN. Yes.

Senator KING (continuing). Of determining discovery areas.

The CHAIRMAN. Do you not think that that would answer the purpose, Mr. Manson?

Mr. MANSON. I do. They have a similar situation under the general leasing act, for the reason that the general leasing act gives to the discoverer of an oil pool certain advantages as a reward for discovering it over the advantages that other lessees upon that pool receive. It involves a similar principle, and I am satisfied that we can get a more or less nontechnical report explaining how that situation is handled under the general leasing act.

The CHAIRMAN. You will get that after June 1, Mr. Manson, and then you can submit it to the committee for consideration afterwards. I see no necessity for bringing all of those people down here.

Senator KING. I agree with you, Mr. Chairman.

Mr. MANSON. It has become evident to the members of the staff of the committee that one of the difficulties that the bureau has to face is the character of practitioners before the bureau, and I have here a report with respect to the firm of Ernst & Ernst, a firm which the committee has probably observed by this time is composed of very active practitioners before the bureau, they having been involved in quite a number of cases, or having represented the taxpayers in quite a number of the cases that have been presented.

In that connection, I will read from a report made to me by Mr. Parker. [Reading:]

There are, of course, many accounting firms and other experts who maintain a high standard of ethics, but the other class is sufficiently numerous to cause serious trouble.

The corrective organization for this matter is the committee on enrollment and disbarment. This committee appears to be doing good work, but two suggestions can be made. One suggestion is that delay in trying cases should be reduced to a minimum on account of cases which may go through, handled by accountants whose work is questionable and thus cost the Government money. The second suggestion is that there should be a set-up whereby employees of the bureau can send in charges direct to the committee on enrollment and disbarment instead of solely, through the section chiefs and so on up through the line of superior officers, any of whom might suppress the information.

To illustrate the workings of this important matter we give the following brief history of the case of Ernst & Ernst, of Cleveland, Ohio, whose case is now in the hands of the committee for action. It will be recalled also that this is especially pertinent for the reason that your engineers have presented several cases in which we consider the reports of this company to have been, to say the least, erroneous.

The partnership returns of Ernst & Ernst for the years 1918 to 1920 distributed the income derived from the home office at Cleveland to the following persons: A. C. Ernst, L. W. Blyth, F. H. Figsby, H. C. Royal, C. F. Ernst, A. H. Blyth, and G. O. Figsby.

While there was no indication to that effect on the returns, it later developed that the three last named were the wives of the three first named.

From the records in the case it would appear that the wives of the three original partners were included in the return in order to split the income between husband and wife and thus keep the individuals in a lower surtax bracket with a resultant total saving in excess of $400,000 in tax for the three years.

In the revenue agent's report dated October 30, 1923 (p. 4), the following statement is made:

"The examiner has never before investigated a case in which there was such obvious subterfuge employed to evade tax liability."

Senator KING. Have they sought to collect that?

Mr. MANSON. I believe that that tax has been collected, but I call attention to the fact that while this report was made in October, 1923, these people are still practicing before the bureau and have been involved in some of the most important cases called to the attention of this committee.

Senator KING. Yes.

Mr. MANSON. Ernst & Ernst base their claim on certain so-called partnership agreements. A copy of the most important of these is shown in full in Exhibit B attached.

In regard to these agreements, it appears from the record that these were probably dated back, as it is stated in a letter from E. G. Rarey, internal revenue agent in charge, to the commissioner, dated January 27, 1925, that—

"While in Washington the week of January 5, I had the opportunity to examine to some extent the brief submitted by these taxpayers, and noticed that they set forth two partnership agreements. When I returned to Cleveland I talked with revenue agents Ward and Williams, and attached please find letters from each agent setting forth the fact that they were advised at the

time of making their investigations that no partnership agreements existed for the year 1918 or any prior years."

On December 11, 1924, Mr. Nelson T. Hartson, Solicitor of Internal Revenue, in a very convincing brief on the subject, determined that the husbands were liable for the taxes on the income distributed to the wives. We do not think there is any doubt as to the very able handling of the subject by the solicitor. (See Exhibit C attached.)

The tax evasion on the returns of the partners of Ernst & Ernst are under investigation by the committee on enrollment and disbarment, but there are also other charges, which we summarize briefly as follows:

In the case of the Consolidated Iron & Steel Manufacturing Co. of Cleveland, Ohio, it appears that there has been manipulation of invested capital, and that the manager of Ernst & Ernst has admitted in writing that at the direction of the company they have knowingly made up a return contrary to the internal revenue laws and liable to a penalty assessment. (See Exhibit D.)

In the case of Taylor & Boggis Co., Cleveland, Ohio, there appears to have been also a manipulation of invested capital by Ernst & Ernst.

In the case of Jones & Blankenship, Roanoke, Va., it appears that Ernst & Ernst have rewritten the books on the installment basis instead of the accrual basis, and in this work have used a former employee of the bureau, Mr. W. G. Anderson, who had formerly audited the books of this company for the Government. It also appears Anderson solicited the work for Ernst & Ernst and while he found a tax of over $9,000,000 in this case while working for the Goverenment, he only found a tax of about $1,000 subsequently, when working on the same case for Ernst & Ernst.

The CHAIRMAN. That is the same firm that rewrote the books of the Gulf Oil Corporation, is it, the firm of Ernst & Ernst?

Mr. MANSON. Yes; that is the same firm that was involved in that case and in many other cases that have been before the committee.

In the case of the Henderson Shipbuilding Co., of Mobile, Ala., it appears that this company turned over to Ernst & Ernest all prospectile refunds for amortization that they might secure in lieu of payment on certain audit work.

We call your attention to the fact that Ernst & Ernst have handled cases involving many millions in taxes before the bureau, and if the above charges are proved, it will be very reasonable to conclude that large sums have been lost to the Government through sharp practices in cases where such practices could not well be discovered.

In closing this subject on tax experts we are attaching Exhibit E which shows how low the ethics of the profession have sunk in the case of Mr. Osborn, of the firm of Seidman & Seidman, of Grand Rapids.

Mr. Osborn tells taxpayer that his report was correct, showing a tax of $5,500, but we can increase salaries and date the minute book back to January, 1924, so as to reduce the amount.

In conclusion, we repeat that every possible effort should be made to encourage and force a high standard of ethics among tax lawyers, accountants, and engineers, as the accomplishment of this result will make the work of the bureau much easier and give greater justice between taxpayers.

The CHAIRMAN. Who has signed that report?

Mr. MANSON. This is signed by Mr. Parker, and it is born out by the exhibits attached to this report.

The CHAIRMAN. You will put the whole report in the record?

Mr. MANSON. I am putting the whole report in the record.

(The report submitted by Mr. Manson is as follows:)

EXHIBIT A

APRIL 27, 1925.

Mr. L. C. MANSON,
General Counsel, Senate Committee Investigating
Bureau of Internal Revenue.

System Report No. 1.
Subject: Ethics of tax experts.

It has been made evident from conference with various employees of the bureau that one of the principal difficulties encountered is the unethical practices of tax accountants and experts.

There are, of course, many accounting firms and other experts who maintain a high standard of ethics, but the other class is sufficiently numerous to cause serious trouble.

The corrective organization for this matter is the committee on enrollment and disbarment. This committee appears to be doing good work, but two suggestions can be made. One suggestion is that delay in trying cases should be reduced to a minimum on account of cases which may go through, handled by accountants whose work is questionable and thus cost the Government money. The second suggestion is that there should be a set-up whereby employees of the bureau can send in charges direct to the committee on enrollment and disbarment instead of solely through the section chiefs, and so on up through the line of superior officers, any of whom might suppress the information.

To illustrate the workings of this important matter, we give the following brief history of the case of Ernst & Ernst, of Cleveland, Ohio, whose case is now in the hands of the committee for action. It will be recalled also that this is especially pertinent for the reason that your engineers have presented several cases in which we consider the reports of this company to have been, to say the least, erroneous.

The partnership returns of Ernst & Ernst for the years 1918 to 1920 distributed the income derived from the home office at Cleveland to the following persons: A. C. Ernst, L. W. Blyth, F. H. Figsby, H. C. Royal, C. F. Ernst, A. H. Blyth, and G. O. Figsby.

While there was no indication to that effect on the returns, it later developed that the three last named were the wives of the three first named.

From the records in the case it would appear that the wives of the three original partners were included in the return in order to split the income between husband and wife and thus keep the individuals in a lower surtax bracket with a resultant total saving in excess of $400,000 in tax for the three years.

In the revenue agents' report dated October 30, 1923 (p. 4) the following statement is made.

"The examiner has never before investigated a case in which there was such obvious subterfuge employed to evade tax liability."

Ernst & Ernst base their claim on certain so-called partnership agreements. A copy of the most important of these is shown in full in Exhibit B attached.

In regard to these agreements, it appears from the record that these were probably dated back, as it is stated in a letter from E. G. Rarey, internal revenue agent in charge, to the commissioner, dated January 27, 1925, that—

"While in Washington the week of January 5 I had the opportunity to examine to some extent the brief submitted by these taxpayers, and noticed that they set forth two partnership agreements. When I returned to Cleveland I talked with Revenue Agents Ward and Williams, and attached please find letters from each agent setting forth the fact that they were advised at the time of making their investigations that no partnership agreements existed for the year 1918 or any prior years."

On December 11, 1924, Mr. Nelson T. Hartman, Solicitor of Internal Revenue, in a very convincing brief on the subject, determined that the husbands were liable for the taxes on the income distributed to the wives. We do not think there is any doubt as to the very able handling of this subject by the solicitor. (See Exhibit C attached.)

The tax evasion on the returns of the partners of Ernst & Ernst are under investigation by the committee on enrollment and disbarment, but there are also other charges, which we summarize briefly as follows:

In the case of the Consolidated Iron & Steel Manufacturing Co., of Cleveland, Ohio, it appears that there has been manipulation of invested capital, and that

the manager of Ernst & Ernst has admitted in writing that at the direction of the former company they have knowingly made up a return contrary to the internal revenue laws and liable to a penalty assessment. (See Exhibit D attached.)

In the case of Taylor & Boggis Co., Cleveland, Ohio, there appears to have been also a manipulation of invested capital by Ernst & Ernst.

In the case of Jones & Blankenship, Roanoke, Va., it appears that Ernst & Ernst have rewritten the books on the installment basis instead of the accrual basis, and in this work have used a former employee of the bureau, Mr. W. G. Anderson, who had formerly audited the books of this company for the Government. It also appears Anderson solicited the work for Ernst & Ernst and while he found a tax of over $9,000 in this case while working for the Government he only found a tax of about $1,000 subsequently when working on the same case for Ernst & Ernst.

In the case of the Henderson Shipbuilding Co., of Mobile, Ala., it appears that this company turned over to Ernst & Ernst all prospective refunds for amortization that they might secure in lieu of payment on certain audit work.

We call your attention to the fact that Ernst & Ernst have handled cases involving many millions in taxes before the bureau, and if the above charges are proved it will be very reasonable to conclude that large sums have been lost to the Government through sharp practices in cases where such practices could not well be discovered.

In closing this subject on tax experts we are attaching Exhibit E, which shows how low the ethics of the profession has sunk in the case of Mr. Osborn, of the firm of Seidman & Seidman, of Grand Rapids.

Mr. Osborn tells taxpayer that his report was correct, showing a tax of $5,500, but we can increase salaries and date the minute book back to January, 1924, so as to reduce the amount.

In conclusion we repeat that every possible effort should be made to encourage and force a high standard of ethics among tax lawyers, accountants, and engineers, as the accomplishment of this result will make the work of the bureau much easier and give greater justice between taxpayers.

Respectfully submitted.

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

JANUARY 18, 1918.

Whereas certain contingencies have arisen not contemplated in our partnership contract dated June 17, 1912, and it may become necessary for certain of our partners and managers to devote all or most of their time to duties outside of our business; and whereas it is advisable for us to arrange additional financial backing, now, in consideration of the payment of $1 and other valuable consideration, we hereby mutually agree that, commencing with January 1, 1918, we will join together with Mrs. C. F. Ernst, Mrs. A. H. Blyth, and Mrs. G. D. Figsby so that the six of us will be firmly bound together, having in view the safeguarding of Ernst & Ernst as an organization, the terms of this arrangement to be as follows:

First. All of us to share in the profits and losses as stated herein and assume our full share of any future claims that may arise, but no consideration to pass at any time for or account of good will at the termination of this agreement.

Second. In the event of withdrawal or death, settlement to be made under terms of existing contract dated June 17, 1912.

Third. This arrangement to apply to the profits and losses of Ernst & Ernst, Cleveland, with the right of extending it upon agreement of all the parties hereto.

Fourth. A. C. Ernst, L. W. Blyth, and F. H. Figsby agree to have transferred to their said wives one-half of their respective shares in the profits or losses of the business commencing January 1, 1918, thereafter as determined. The understanding being that after the profits of Ernst & Ernst, Cleveland, Ohio, have been determined, then one-half of the shares belonging to A. C. Ernst to be paid to C. F. Ernst, one-half of the share belonging to L. W. Blyth to be paid to A. H. Blyth, and one-half the share belonging to F. H. Figsbuy to be paid to G. D. Figsby, as compensation to said wives for the responsibilities they hereby assume. Should it be determined that a loss has been incurred, then and in that event the said C. F. Ernst, A. H. Blyth, and G. D.

Figsby shall contribute their share thereof in proportion to their respective interests as set forth herein.

The said wives agree to the above and to hold themselves ready to perform such services as may be requested by A. C. Ernst and to contribute such amount of additional capital to Ernst & Ernst, Cleveland, as may become necessary for the conduct of the business in Cleveland or in other cities, and any other ventures in connection with their business affairs, such additional capital to be contributed by them pro rata to their interest in the profits and losses, or as may be mutually agreed upon. The purpose of this contract being to make available the additional capital of said wives and to provide for the future, the consideration here passing is for these reasons.

(Signed) A. C. ERNST.
(Signed) L. W. BLYTH.
(Signed) F. H. FIGSBY.

We hereby accept and agree to abide by the terms thereof:

(Signed) C. F. ERNST.
(Signed) A. H. BLYTH.
(Signed) G. D. FIGSBY.

EXHIBIT C

DECEMBER 11, 1924.

In re A. C. Ernst, A. H. Blyth, and F. H. Figsby.

Mr. COMMISSIONER:

Reference is made to the proposed additional assessments against each of the above-named taxpayers for the years 1918 to 1920, inclusive. Except for minor adjustments the proposed assessments are based on additions to the income as reported by each of them for those years of amounts reported by their respective wives as income in their separate returns. My opinion has been requested as to the liability of the respective husbands for tax on this income.

The income in question arises from profits made during the years aforementioned by a partnership of public accountants doing business under the firm name of Ernst & Ernst and paid to the wives of the aforementioned taxpayers. The taxpayers were the general partners of this accounting partnership. During the years in question it maintained offices in various cities of the United States. Other men were local or limited partners with the taxpayers, participating with 'em in the business of certain of the partnership offices. The home office of the partnership was located at Cleveland, Ohio. Prior to January 18, 1918, the partners of the Cleveland office were the three taxpayers and H. C. Royal.

On January 18, 1918, the taxpayers and their respective wives, Mrs. C. F. Ernst, Mrs. A. H. Blyth, and Mrs. G. D. Figsby, signed the following instrument. (The matter italicized is mine):

JANUARY 18, 1918.

"Whereas certain contingencies have arisen not contemplated in our partnership contract dated June 17, 1912, and it may become necessary for certain of our partners and managers to devote all or most of their time to duties outside of our business; and whereas it is advisable for us to arrange additional financial backing; now, in consideration of the payment of $1 and other valuable consideration, *we hereby mutually agree, that commencing with January 1, 1918, we will join together with Mrs. C. F. Ernst, Mrs. A. H. Blyth, and Mrs. G. D. Figsby* so that the six of us will be firmly bound together, having in view the safeguarding of Ernst & Ernst as an organization, the terms of this arrangement to be as follows:

First. All of us to share in the profits and losses as stated herein, and assume our full share of any future claims that may arise, but no consideration to pass at any time for, or account of good will at the termination of this agreement.

Second. *In the event of withdrawal or death, settlement to be made under terms of existing contract dated June 17, 1912.*

Third. This arrangement to apply to the profits and losses of Ernst & Ernst, Cleveland, with the right of extending it upon agreement of all the parties hereto.

Fourth. A. C. Ernst, L. W. Blyth, and F. H. Figsby agree to have transferred to their said wives one-half of their respective shares in the profits or losses of the business commencing January 1, 1918, thereafter as determined. The understanding being that after the profits of Ernst & Ernst, Cleveland, Ohio, have been determined, then one-half of the share belonging to A. C. Ernst to be paid to C. F. Ernst, one-half of the share belonging to L. W. Blyth to be paid to A. H. Blyth, and one-half the share belonging to F. H. Figsby to be paid to G. D. Figsby, *as compensation to said wives for the responsibilities they hereby assume.* Should it be determined that a loss has been incurred, then in that event the said C. F. Ernst, A. H. Blyth, and G. D. Figsby shall contribute their share thereof in proportion to their respective interests as set forth herein.

The *said wives agree* to the above and to hold themselves ready *to perform such services as may be requested by A. C. Ernst and to* contribute such amount of additional capital to Ernst & Ernst, Cleveland, *as may become necessary for the conduct of the business in Cleveland, or in other cities, and any other ventures in connection with their business affairs, such additional capital to be contributed by them pro rata to their interest in the profits and losses, or, as may be mutually agreed upon.* The purpose of this contract being to make available the additional capital of said wives and to provide for the future, the consideration here passing is for these reasons.

(Signed) A. C. ERNST.
(Signed) L. W. BLYTH.
(Signed) F. H. FIGSBY.

We hereby accept and agree to abide by the terms thereof.

(Signed) C. F. ERNST.
(Signed) A. H. BLYTH.
(Signed) G. D. FIGSBY.

About January 1, 1918, the taxpayers transferred to their wives property valued at several hundred thousand dollars. In affidavits to the commissioner the wives aver that they had an understanding with their husbands prior to the transfers above referred to that the wives were part owners of the property transferred. Aside from the property tansferred as above mentioned, the property owned by the wives was of little value and was of such kind that it would not be considered as available for commercial purposes.

From 1918 to 1920 the business of Ernst & Ernst was very profitable. The wives rendered no services therein; they contributed no capital to Ernst & Ernst or to their husbands. During the years 1918 to 1920, inclusive, Ernst & Ernst distributed to the wives of the taxpayers partnership profits equal in amount to those distributed by the firm to their respective husbands. The wives and not the husbands paid tax on the profits distributed to them. The unit now recommends that such profits be added to the incomes of the husbands for the years in question and that they be assessed additional tax based on this inclusion. The husbands protest, contending that by the contract of January 18, 1918, such profits were not income to themselves but were income to their wives.

The writing dated January 18, 1918, is not an instrument of conveyance or assignment. It relates to the capital and future income of Ernst & Ernst, of Cleveland, Ohio. By it no partnership assets are transferred to the wives, nor is title to any of the partnership property to be transferred to them. The writing provides:

"Second. In the event of withdrawal or death, settlement to be made under terms of existing contract dated June 17, 1912." (The articles of partnership of Ernst & Ernst.)

Thus the husbands are to maintain title to the partnership assets. The wives are to receive only a portion of the future profits of the partnership. Moreover, the husbands do not assign a portion of their rights to partnership earnings to their wives. The writing provides:

"The understanding being that after the profits of Ernst & Ernst, Cleveland, Ohio, have been determined, then one-half of the share belonging to A. C. Ernst to be paid to C. F. Ernst, one-half of the share belonging to L. W. Blyth to be paid to A. H. Blyth, and one-half the share belonging to F. H. Figsby to be paid to G. D. Figsby, as compensation * * *."

The husbands only "*agree* to have transferred to their said wives" a portion of their earnings. There is no present assignment.

"The writing of January 18, 1918, is not an agreement to make and it does not make the wives partners or subpartners of Ernst & Ernst, or of their husbands. On January 18, 1918, Ernst & Ernst, of Cleveland, Ohio, consisted of four partners. The fourth partner, H. C. Royal, was not a party to the writing of January 18. His assent would be necessary to make the wives partners of Ernst & Ernst. Then the writing is not in the usual form of a partnership agreement. There are no words used in it that refer to the parties as partners, or to the relations to be established between them as that of partners. Further, the writing does not provide for a community of interest between the husbands an wives as coowners of a business. The wives are not made principals in the business with their husbands as well as agents thereof. The dual relation of principal and agent is indispensable to the formation of a partnership." Municipal Paving Co. *v.* Herring (Okla.), 150 Pac., 1067. Rowley, in his Modern Law of Partnership, vol. 1, p. 116, states this rule as follows:

"It is enough to say that an interchangeable relation of principal and agent between the parties is indispensable to the existence of a partnership."

The writing of January 18, 1918, is not, accordingly, a partnership agreement.

"As the writing of January 18, 1918, does not transfer or assign to the wives any title in, or right to, property and as it does not establish a partnership between the parties thereto, it must be treated as nothing more than an executory contract."

My opinion is that the writing dated January 18, 1918, is not even a contract. As stated in the beginning of this alleged contract, the parties to it are the husbands. They mutually agree to enter into an agreement with their wives under terms there set forth. Then follows a recitation that the wives will agree to those terms and that they will assume other responsibilities not included in those terms. There next appears the signatures of the husbands. Below them there appears the following:

"We hereby accept and agree to abide by the terms thereof."

The signatures of the wives appear below the above-quoted sentence. The most liberal interpretation that can be given to this writing is that the husbands agree with each other to make a contract with their wives. The wives agree to accept the offer of their husbands when made to them. But that does not make a contract between husbands and wives. Furthermore, the husbands do not make a contract with each other, nor do the wives make a contract with each other, because they only agree to agree with others in the future. As the writing is not a contract between the husbands and their wives, nor a contract between the husbands, nor a contract between the wives, it is a nullity.

If, however, I adopt the taxpayer's contention that the writing evidences the mutual undertaking of the husbands and wives, my opinion is that it created no obligations. The writing fails as a contract for lack of certainty. It is grossly ambiguous. It is impossible to determine with certainty from the terms of the instrument whether the promises of the parties thereto are joint or several, or whether the wives promised each other or promised their husbands, or whether the writing consists of an agreement between the six parties or of three separate agreements between the three husbands and their respective wives. The uncertainty of parties and their relations to each other makes the agreement nonenforceable.

In addition to the uncertainty of parties, certain of the obligations provided for in the writing are too indefinitely expressed therein to be enforceable. The writing provides that the wives agree to perform such services "as may be requested by A. C. Ernst." No provision is made for the kind of service, where it is to be rendered, to whom it is to be rendered, and what compensation, if any, is to be paid therefor. In Briggs *v.* Morris et al. (244 Pa., 139; 90 Atl., 532) a contract in which service was a part of the consideration was held void for uncertainty the court said:

"It (the contract) places the promise of the defendants squarely upon an offer of services, vague and general in terms and without limitation of time or amount of services to be performed. The contract is so vague, uncertain, and indefinite that it must be held to be unenforceable."

The provision in the writing of January 18, relative to promises for service is too indefinite to be enforceable.

The writing of January 18, 1918, provides that the wives are "to contribute such amount of additional capital to Ernst & Ernst, Cleveland, as may become necessary for the conduct of the business in Cleveland, or in other cities, and any other ventures in connection with their business affairs, such additional capital to be contributed by them pro rata to their interest in the profits and losses, or as may be mutually agreed upon."

The writing provides no way for determining who is to decide the necessity for capital, the amounts to be required, or what ventures are to be considered as carried on in connection with the business of Ernst & Ernst. Even the provision for contributing the amount of capital "that may become necessary" is too vague to be enforceable. (Erwin *v.* Ersin, 25 Ala. 236; Canet *v.* Smith, 149 N. Y. S. 101; Blackstone *v.* German Bank of Baltimore City, 87 Md. 302; 39 Atl. 855.

Furthermore, the proportions of additional capital to be contributed is left to future agreement. This is very objectionable because the parties may never come to an agreement. As to provisions for future agreement, Williston, in his work on contracts, volume 1, page 57, says:

"Especially a reservation to either party of a future untrammeled right to determine the nature of the performance, or a provision that some matter shall be settled by future agreement has often caused a promise to be too indefinite for enforcement."

The writing does not provide for the terms under which the wives are to contribute capital. Are they to loan the money? If so, is interest to be paid thereupon? This is a very pertinent inquiry in view of that portion of the writing providing that upon withdrawal and death "settlement is to be made under terms of existing contract dated June 17, 1912." The existing contract referred to is the articles of partnership theretofore entered into of Ernst & Ernst. By taking the two provisions together it is possible to construe them as providing that the additional capital contributed by the wives is to be paid upon settlement to the husbands. Under this construction the husbands could get back all the profits paid to the wives by Ernst & Ernst.

It is my opinion, therefore, that the provisions of the writing relative to the contributions of capital are too vague and indefinite to render them enforceable.

The writing provides:

"The purpose of this contract being to make available the additional capital of said wives and to provide for the future, the consideration here passing is for these reasons."

Thus the principal consideration purported to be furnished by the wives for the promises of their husbands is their obligation to furnish additional capital. As this obligation is unenforceable, it is my opinion that all the obligations set forth in the writing should be deemed nonenforceable. The alleged contract is void for uncertainty.

The contentions of the taxpayers that any uncertainty has been cured by performance under the contract by the parties is untenable. The only performance since the writing was executed has been payments made to the wives. These did not give the wives any rights not acquired by the execution of the alleged agreement. In Briggs *v.* Morris (244 Pa., 139; 90 Atl., 532) the court said:

"It must be held that payments on account of a void contract can not give it form, nor make precise and definite that which lacks those qualities. If the payments were made without consideration, they were voluntary payments."

My opinion is, therefore, that the husbands were under no contractual obligations to distribute to their wives any portion of the partnership profits. Such profits as were distributed to the wives should be considered as gifts to them from their husbands. The husbands should be liable for tax thereupon.

I am further of the opinion that were this writing of January 18, 1918, sufficiently certain in its provisions to be enforceable, the husbands would still be liable for tax on the profits of the partnership paid to their respective wives. As pointed out above, the writing is not an agreement to make and it does not make the wives partners or subpartners of Ernst & Ernst or of their husbands. Furthermore, the writing of January 18, 1918, is not an undertaking of the partnership of Ernst & Ernst. That partnership is not a party to the writing, for H. C. Royal, the fourth partner, is not made a party thereto. The husbands do not purport to contract as partners of Ernst & Ernst. Accordingly, the writing of January 18, 1918, can not be taken as establishing a partnership obligation, and sums paid by Ernst & Ernst to the wives are

not partnership expenses. They constitute payments of profits belonging to the husbands and made on their behalf. Accordingly, the husbands as partners should include in their tax returns all the profits of that partnership with the exception of the profits belonging to Royal, the fourth partner. The portion of the profits paid to the wives may then be deducted from the gross incomes of the respective husbands if the payments meet the requirements of the law relative to deductions. (A. R. M. 25; 2 C. B. 104; L. O. 912.) Section 214 of the revenue act of 1918 provides in part:

"(a) That in computing net income there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

It is my opinion that the payments to the wives by their husbands can not be considered as ordinary or necessary business expenses.

The payments made to the wives do not constitute business expense. I think the husbands and wives did not intend to contract under the terms and for the purposes expressed in the writing of January 18, 1918. It is difficult to believe that men engaged in a lucrative business would for purposes of profit agree to pay half of their probable gains in exchange for indemnity against half of their probable losses. The husbands were engaged in the practice of accounting. Their wives were not accountants. It is very difficult to believe that the husbands intended to employ the services of their wives in their business. The only other consideration that the husbands were to receive in this unbusinesslike arrangement was the promise of the wives to contribute capital. The husbands had ample capital to carry on their business. The only property of any consequence the wives owned had been given to them by their husbands only a few days before the parties executed the writing of January 18, 1918. Looking at the whole transaction, I am of the opinion that the husbands and wives did not intend to enter into business relations with each other and that the writing of January 18, 1918, is not an expression of their true intentions. Where the parties do not intend to make the contract the law does not make one for them. Central Paving Company *v.* Highland Park (164 Mich. 223; 129 NW. 46).

My conclusion is, therefore, that Messrs. Ernst, Blyth & Figsby are individually liable for tax during the years 1918 to 1920, inclusive, on the profits of Ernst & Ernst paid to their respective wives in those years.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

Approved, December 20, 1924.

D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT D

CLEVELAND, *June 18, 1921.*

THE CONSOLIDATED IRON & STEEL MANUFACTURING CO.,
Cleveland, Ohio

(Attention I. T. Kahn.)

GENTLEMEN: We have made certain changes in the 1920 income and profits tax return of your company, at your direction, and submit the same in duplicate herewith. These changes consist principally of the exclusion as a deduction from invested capital of appreciation of permanent assets, and of including as a deduction from income depreciation of such appreciated values, a portion of this depreciation not being shown on your books.

In this connection, we desire to state that we assume no responsibility whatsoever for the changes made in the return, nor do we believe them to be in accordance with the internal revenue laws and regulations pertaining thereto.

The revenue act of 1918 applying to the return in question is peculiar to prior revenue acts in that it provides certain penalties for failure to prepare the return in accordance with the regulations of the Treasury Department. The penalty provided is 5 per cent of the understatement of tax together with interest at the rate of 1 per cent a month on the amount of such understatement.

We assure you that we are always desirous of serving the best interests of your company and are writing merely to avoid any misunderstanding in the future.

Yours very truly,

L. C. WEISS,
Manager Federal Tax Department.

EXHIBIT E

[Confidential report]

DETROIT, MICH., *March 23, 1925.*

Mr. GEORGE E. NEAL,
Internal Revenue Agent in Charge, Detroit, Mich.:

The result of an investigation of Seidman & Seidman's office procedure is herewith submitted.

Mr. Frank E. Seidman, of Seidman & Seidman, first appeared in Grand Rapids shortly after the World War as an auditor from the aircraft section or division of Detroit. His duties were investigating claims made for payment on account of contracts between various Grand Rapids companies and the United States Government.

Owing to the sudden termination of the World War and the cancellations of contracts many adjustments were necessary, and these were based in a large measure upon the reports made by field auditors. It is stated to agent by Mr. Robert Davidson, auditor for State of Michigan, that Frank E. Seidman favored the contractors and subcontractors in every way he dared, and at this time solicited the auditing and tax work, anticipating an enormous volume of this work to follow.

Mr. Seidman being a very likable fellow, besides being a most excellent accountant, very soon ingratiated himself in the good graces of some of the most prominent business men of Grand Rapids.

After the completion of war contracts he engaged in accounting tax work, and by his clever appraisals, appreciating assets for invested capital purposes, rewriting inventories and increasing salaries, he saved large sums for the Grand Rapids taxpayers.

To illustrate his method of procedure, the examining agent at this time when working in Seidman's office overheard a conference between D. E. Osborn, office manager for Seidman & Seidman, and Mr. Chaffee, of the Chaffee Bros. Furniture Co., of Grand Rapids. Mr. Chaffee said to Mr. Osborn, "I have the tax return you made up for my firm. It shows tax amounting to $5,500. I do not intend to pay that much and you must reduce this amount." Mr. Osborn said, "The report is correct according to your books, but we can increase salaries and date the minute book back to January, 1924." Mr. Chaffee agreed that this would be satisfactory.

Agent stated to Mr. Osborn that he could not help but overhear this conversation and inquired the name of his client. He was told his name was Mr. Chaffee. Mr. Osborn agreed that the conversation was correct as overheard, and claimed that it was customary to raise salaries when clients requested it.

Mr. Thomas, president of Thomas Canning Co., of Grand Rapids, stated that Seidman would eventually overreach himself, and if he continued his present line of proceedings he will sooner or later find himself in a very serious trouble.

Frank E. Seidman is very clever; he even hoodwinks his own clients by leading them to believe that they are justified in following his advice.

Many cases of tax evasion were related to the agent by a Mr. Christenden, formerly office manager of Seidman & Seidman. Mr. Christenden did not care to volunteer any written statement but would, if subpœnaed, give all the information he had knowledge of.

Agent believes that a large proportion of Seidman's business was procured on a contingent-fee basis and that this method of securing business is still being used.

ROBERT HARRIS, *Internal Revenue Agent.*

EXHIBIT F

CLEVELAND, OHIO, *October 30, 1923.*

In re Ernst & Ernst, 1400 Hanna Building, Cleveland, Ohio. Examining officer, Jos. E. Williams; examination commenced, September 5, 1923; examination completed, October 30, 1923; days spent on examination, 24.

E. G. RAREY,
Internal Revenue Agent in Charge,
Cleveland, Ohio:

An examination of the books and records of the above-named partnership for the years 1918 to 1920, inclusive, disclosed the information contained in this report.

Authority for examination: Receipt of photostats of 1919 and 1920 returns, Forms 1065.

Basis for comparison: The partnership's books and records.

District in which returns were filed: Eighteenth, Ohio.

Nature of business: The rendering of public accounting services.

CHANGES NOT ADMITTED

The various items have been fully discussed with the changes explained to L. W. Blyth, one of the principal partners. The examiner's findings are not admitted.

Partnership returns, Forms 1065, were filed for each of the years covered by this examination.

All sources of income appear to have been indicated in the returns filed for the years 1918, 1919, and 1920.

Reports on the following individual partners of the Ernst & Ernst partnerships are being submitted under date of November 10, 1923; A. C. Ernst, L. W. Blyth, F. H. Figsby, F. L. Gilbert, H. C. Royal, Horace Manning, F. W. Pendexter, and C. B. Adams. Reports on the wives of Messrs. A. C. Ernst, L. W. Blyth, and F. G. Figsby are also being submitted under date of November 10, 1923.

The Ernst & Ernst partnership, which has branch offices in several principal cities, each branch keeping its own records and submitting reports thereof in the parent office at Cleveland, Ohio, consists of three principal partners, A. C. Ernst, L. W. Blyth, and F. H. Figsby. These partners share in the profits of each of the branches. In addition to these three principal partners there are six other partners who share in the profits of one or more of the branch offices. The six other partners just referred to are: F. L. Gilbert, H. C. Royal, Horace Manning, F. W. Pendexter, C. B. ACams, and L. W. Coyle. A report is being submitted on L. W. Coyle (deceased), Cincinnati, Ohio. Mr. Coyle died some time after December 31, 1920. Retained copies of the returns filed by Mr. Coyle (deceased), not being at hand, a report on that individual is not being submitted. The Central Union Trust Co. of Cincinnati, Ohio, is trustee of the estate of L. W. Coyle.

With the exception of New Orleans, Denver, and Richmond (Va.), the records of each of the branch offices were checked as to income and expense, and occasional tests made as to the accuracy of the balance sheets. Minor errors were discovered but as these errors did not materially affect the profit and loss or balance sheet items, no changes have been made. The examination of the various branch office records was of a more or less superficial nature; however, the income and expense items were satisfactorily checked. The three offices last referred to were not organized until the early fall or 1920, therefore it had not been considered necessary to check over these records in detail as has been done with the records of the other branches.

The distribution of the earnings of the various branches is being shown in various schedules of this report. The only balance sheets which are included as a part of this report are those of the Cleveland, Ohio (home office), partnership. Each office keeps a separate and distinct set of records. The balance sheet items of each of the branch offices (except New Orleans, Denver, and Richmond, were tested as to accuracy and found to be as represented. The examiner is not submitting exhibits of the balance sheets of the branches for the reason that such exhibits would be of no particular value, and also that the preparing of these exhibits would take considerable time and would in no

way clarify the main point at issue in this case. An analysis of the partners' capital accounts, all branches, separately and consolidated, for each of the years covered by this examination, are being submitted in this report as Exhibits F, G, and H, for the years 1918, 1919, and 1920, respectively. As has been stated before, all phases of this case have been discussed fully with Mr. L. W. Blyth, one of the principal partners. His explanations as to the nature of various items questioned by the examiner have been accepted as represented by him.

There has been only one important change made, and that is in the matter of the distribution of the net income of the Cleveland, Ohio, office for the years covered by this examination. Beginning with 1918 and continuing through all of the years covered by this examination, and probably beyond that period, the wives of the three principal partners (Messrs. Ernst, Blyth, and Figsby) were given a portion of the profits of the Cleveland, Ohio, Ernst & Ernst partnership. The examiner has gone over, very carefully and thoroughly, all available data, and has found that the only advantage in "taking" in the wives as members of the Cleveland, Ohio, Ernst & Ernst partnership is in the matter of the Federal tax liability of Messrs. A. C. Ernst, L. W. Blyth, F. H. Figsby. In other words, the examiner honestly believes, and this belief is supported by actual findings, that the wives of the three partners just referred to brought nothing into the partnership that would or did affect the partnership in the matter of business possibilities, that is, they brought in no additional capital, and have not rendered, nor do not render, personal services to the business.

It is the examiner's further opinion that the wives of the three aforementioned partners have been represented to be partners for the purpose of affording relief against the high surtax rates, as applied to the net income of their respective husbands, and that the whole plan is a mere subterfuge employed to reduce tax liability.

During 1917, and probably prior to that year, the three principal partners, A. C. Ernst, L. W. Blyth, and F. H. Figsby, shares in what was known as a joint account. This account consisted of securities (almost exclusively) and the three above-named members received 72 per cent, 16 per cent, and 12 per cent, respectively, of the earnings therefrom.

Apparently, as of January 1, 1918, this joint account was eliminated and in its stead there was set up an account which is called the "E and E" Investment Co. (At this point the examiner emphasizes the fact that the joint account consisted of the men, Messrs. A. C. Ernst, L. W. Blyth, and F. H. Figsby; and that the E and E Investment Co. consisted of the wives of these men, Mrs. C. F. Ernst, Mrs. A. H. Blyth, and Mrs. G. D. Figsby.) Exhibit I of this report shows the journal entries transferring various stocks, two bank accounts, and one other account (liability of the men to the men), from the joint account to the E and E Investment Co. account. These two entries clearly show that the women brought nothing into the so-called E and E Investment Co. It will be noted that the wives' capital accounts are in the amounts of $288,000, $64,000, and $48,000, to Mrs. Ernst, Mrs. Blyth, and Mrs. Figsby, respectively, which is in the ratio of 72, 16, and 12. and it will be noted by reference to Exhibit L of this report that the portion of the Cleveland office earnings allocated to the women (Mrs. Ernst, Mrs. Blyth, and Mrs. Figsby) is in the same proportion, 72, 16, 12; that is, of the total amounts given to the women, $154,817.96, other income, and $136.57, Liberty bond interest income in 1918; and $227.356.47, other income, $2,449.15, Liberty bond interest in 1920, the distribution is in the ratio of 72. 16, and 12. The distribution made to the men (Messrs. Ernst, Blyth, and Figsby) is in the same proportion. After the manager of the Cleveland office (H. C. Royal) has been credited with his portion of the profits (6 per cent), the remainder is divided among Messrs. Ernst, Blyth, and Figsby, and their wives. Interest on capital investment is included in the net earnings distributed. The wives, having no capital investment, do not share in this item, which was $15,000 in each of the years covered by this examination (6 per cent of $250,000); consequently the portion allocated to Messrs. Ernst, Blyth, and Figsby is greater than the portion allocated to the wives. (At this point the examiner calls attention to the fact that the aforementioned wives have not only no capial accounts in the Ernst & Ernst records, but have no individual accounts in the general ledger. The Cleveland, Ohio, Ernst & Ernst partnership carries an account called the

E and E Investment Co. account, which is credited with the portion of the profits allocated to the wives. Sometimes this account is credited with the total amount in one sum, and again the three amounts are credited separately to this account.)

In 1918, after the distribution had been made in accordance with the procedure outlined above, Mr. A. C. Ernst distributed $40,612.50 of his portion to Messrs. Blyth, Figsby, and Royal, in the following respective amounts: $15,000, $12,500, and $13,112.50; therefore, in 1918, the distribution shown in Exhibit L, to Messrs. Ernst, Blyth, and Figsby will not be in the proportion of 72, 16, and 12. In 1919 and 1920 the distribution to these gentlemen is in the proportion of 72, 16, and 12.

Exhibit J is the January 1, 1918, balance sheet of the E and E Investment Co. This exhibit substantiates Exhibit I, which indicates that the aforementioned wives (in the name of the E and E Investment Co.) merely took the places of their husbands, Messrs. Ernst, Blyth, and Figsby, in the name of "Joint account."

Exhibit K shows the net worth of Mr. A. C. Ernst from January 1, 1917, to December 31, 1920; and balance sheet of (Mrs.) C. F. Ernst, January 1, 1918. This exhibit shows that Mr. A. C. Ernst gave his wife certain material assets, which, of course, he had a perfect right to do. (It has not been ascertained whether the transfers were actually made or were mere book entries.) It has been ascertained that the wives of the three principal partners had no rights relative to the business affairs of the partnership and that no partnership agreements were entered into between the husbands and wives. (Mr. L. W. Blyth is the source of this information.)

The wives of Messrs. Blyth and Figsby were "brought" into the business in the same way that Mrs. C. F. Ernst was "drafted."

The examiner calls attention to the distribution of the Cleveland, Ohio (home office), Ernst & Ernst partnership profits as made by Ernst & Ernst. This distribution is shown in Exhibit L of this report.

If the wives of Messrs. Ernst, Blyth, and Figsby, Mrs. C. F. Ernst, Mrs. A. H. Blyth, and Mrs. G. D. Figsby, were partners in fact, which, of course, they were not, having contributed nothing, either by way of financial assistance or personal services to the business, they were entitled to a portion of the profits of each of the branches of the Ernst & Ernst partnership. The fact that the above-named respective wives were not "brought" into the various branch distributions, is, in itself, an inconsistency, which tends to refute any superficial claim put forth by Ernst & Ernst relative to the merits of the distribution of the Cleveland, Ohio (home office), Ernst & Ernst partnership profits.

The examiner has never before investigated a case in which there was such obvious subterfuge employed to evade tax liability. Any individual taxpayer in business would have as much right to allocate a part of his net earnings to his wife as had Messrs. Ernst, Blyth, and Figsby.

The Ernst & Ernst partnerships, particularly the Cleveland, Ohio, partnership, has grown rapidly in the volume of business transacted, and there always has been a great deal of cash at hand, so that it never has been necessary (nor has such a thing, in fact, been done) to solicit financial assistance. The wives of Messrs. Ernst, Blyth, and Figsby brought nothing to the Ernst & Ernst, Cleveland, Ohio, partnership; are not, in fact, treated as partners; and do not, or have not, contributed anything to further the business interests of the partnership. It is, therefore, inconceivable to believe that such a ridiculous claim as their apparent contention, that their respective wives should be and are entitled to recognition as partners of the Ernst & Ernst, Cleveland, Ohio, partnership, will be considered by the department.

The examiner has the thought in mind that the three principal partners, Messrs. Ernst, Blyth, and Figsby, conceived and put into execution the plan to "bring" their respective wives into the partnership (in the manner explained hereinbefore), with a view to a great deal of possible gain and no probable loss. In other words, it is not unlikely that they believed that by such a procedure they had everything to gain and nothing to lose by way of reducing their individual income-tax liabilities.

MEMORANDUM BY REVIEWING OFFICER

I fully concur in the conclusions, findings, and recommendations of the examining officer as set forth in the above letter, and it is therefore recommended that the department sustain and approve the allocation of the income of the Cleve-

land office only to the real partners thereof, as indicated in Schedules 2, 15, and 30 of the report. In view of the fact that the wives of the partners can not by any construction of the revenue act of 1918 be considered in fact or in theory as partners, they should not be allowed to take up and report for income-tax purposes any part of the income accruing to their respective husbands merely for the purpose of relieving their husbands of the tax burden placed upon them by virtue of their large incomes in these years.

E. A. BECK,
Internal Revenue Agent, Reviewing Officer.

The CHAIRMAN. Who controls this committee on enrollment and disbarment?

Mr. NASH. The committee on enrollment and disbarment is a committee appointed by the Secretary, which passes on all applicants who desire to practice before the Treasury Department. The Bureau of Internal Revenue is represented on that committee, but does not control it, and has no jurisdiction over it.

The CHAIRMAN. Who is at the head of it?

Mr. NASH. Captain Jacobs is the chairman of the committee.

The CHAIRMAN. Of how many members is that committee composed?

Mr. GREGG. Five, I think—two bureau men and three Treasury men—as I remember it.

The CHAIRMAN. Is there any way that the bureau representatives here can inform the committee as to what is delaying the action on the case of Ernst & Ernst? I would like to know what has caused the delay in that case from 1923 on.

Mr. NASH. I would be glad to have a copy of this report and take it up with the chairman of the committee.

The CHAIRMAN. I wish you would. I would like to get a report on that, because we have heard a good many of these Ernst & Ernst cases, and a good many criticisms have come in anonymously, which we have not dealt with, concerning the practice of experts before the bureau, and which these people say should be dealt with by this committee.

I do not understand that it is the province of this committee to go into that work of the committee on enrollment and disbarment, because that is not a part of the Bureau of Internal Revenue; but I think the secretary might inform the committee, if he so desires, of how many cases the committee has dealt with, how many are still pending, and how many persons have been disbarred for unethical practices, because it seems to me that that is one of the most important things, if we are going to get honesty in tax administration.

Mr. GREGG. We have just begun recently to put into the weekly publication—the bulletin of the Bureau of Internal Revenue—a list of those who are disbarred from practice. I think that is going to be quite effective. This is the first time that has ever been published.

Mr. MANSON. I think the publication of that list is about the best warning to the profession generally. I do really believe that that is going to be a very effective thing.

Mr. GREGG. It gives the reasons, too.

Senator KING. Mr. Chairman, I think this committee could investigate, and we have, to some extent, the methods by which persons are permitted to practice before the Bureau of Internal Revenue on

matters of taxation, refunds, etc., and that we could make recommendations. We might not be able to control, or we might not have the right to investigate the general rules in the Treasury Department with respect to disbarment of attorneys, etc., but certainly we would have cognizance of the question of determining this and for the purpose of recommending to Congress some way of finding out who is permitted to practice before the bureau and who is not.

It has occurred to me, as these proceedings have gone on, that it might be wise, and I think the committee should consider that, and the department should prohibit anybody from practicing before the bureau who was not a lawyer of experience, high standing, and of fine character. I doubt the wisdom of permitting mere experts, and particularly those who have gone out and opened the books and made up the accountants of a concern, to come before the department as attorneys. That certainly is not ethical in law. A lawyer is not an accountant; he is not an expert. The experts may be called as witnesses to testify, but they are not lawyers, and I doubt the propriety of admitting merely licensed experts and accountants to practice before the department.

Mr. NASH. Mr. Chairman, this subject came up before you when the committee first began its sessions, and I think at that time I furnished to the committee a list of attorneys and accountants who had been admitted to practice before the department, and also furnished a copy of the departmental rules and regulations.

The CHAIRMAN. I think that is correct. I remember that, but I have more in mind the procedure which has been adopted by the committee on enrollment and disbarment, how many have been refused and how many have been disbarred, and all of that, and because that, it seems to me, would give us a picture of just how effective and efficient this committee was. I have a very great doubt in my own mind as to the effectiveness of this committee. I doubt whether it is very effective at all.

Mr. MANSON. I believe there is one suggestion made in the report of Mr. Parker that I just read which is a very vital one, and that is that if any employee of the department feels that a representative of the taxpayer, a licensed representative of the taxpayer or an enrolled representative of the taxpayer, is engaging in unethical practice that employee should have the means of making his complaint directly to the committee on enrollment and disbarment and not be under the necessity of making it through his section chief and his section head and so on up the line.

The CHAIRMAN. I think that is absolutely correct, because Mr. Greenidge would stop almost anything or could stop almost anything that he wanted to stop in his particular division.

Mr. MANSON. If a practitioner is engaged in an unethical practice without casting any particular reflections on anybody, he necessarily has to have the cooperation of his section chief or division head, and it does not seem that either a section chief or a division head should be in a position to head off a complaint.

Mr. NASH. Mr. Chairman, I do not know personally that there is any rule that would prevent an employee from reporting to the committee on enrollment and disbarment any attorney or accountant whom he thought was guilty of an unethical practice. I agree with Mr. Manson's suggestion that if there were such a rule——

The CHAIRMAN. It isn't a matter of whether there is a rule against it or not; the whole proceeding is a sort of a military affair; they must step up to the chief of the section. The employees should know that they could take such matters over the heads of their chiefs, and it ought not to be a negative matter, but it should be an affirmative matter that should be required of them.

Mr. MOSS. Mr. Chairman, my own opinion is that the way should be made easy for any proper information to reach this committee on enrollment and disbarment as to the unethical practitioner. I know that that is the great desire of the Secretary and the Commissioner of Internal Revenue—to get at every one of these cases, it they can do it. I have no doubt that the committee would be somewhat interested in knowing what has been accomplished. What remains to be accomplished simply shows the bigness of the job to keep these fellows out.

On the question of your authority, if you will permit me to suggest it, I am inclined to believe that the general authority under your Senate resolution to investigate the Bureau of Internal Revenue for the purpose of offering amendments to the law or correcting the procedure would carry with it authority to inquire as to how men obtain permission to practice there. It would seem to me almost necessarily so.

The CHAIRMAN. In that connection, may I ask Judge Moss or Mr. Nash or Mr. Gregg if they can make a report to this committee before we are through with our hearings as to what is holding up the Ernst & Ernst case and how many cases are pending before the bureau? In other words, it seems reprehensible to me if men like Ernst & Ernst can engage in such practices as have been called to our attention here this morning, day after day, and year after year, and no action against them really taken. I mean, if that is all they have to fear, then they do not need to be very ethical. I believe there is something more than that involved, that Ernst & Ernst have some influence somewhere that prevents a decision on the part of this committee on enrollment and disbarment, because it seems to me that no case could be pending for this length of time that was genuinely being considered.

Senator KING. I would like to ask Mr. Nash, Mr. Gregg, and Judge Moss——

Mr. MOSS. I know little about this personally.

Senator KING (continuing). If they think it is wise to have large accounting firms take over the handling of the books of large concerns, rewriting their books from the beginning, and then present their returns for taxation purposes to the department, and then become the attorneys for the concerns which they have represented as bookkeepers, as accountants, and as experts, in order to try to avoid paying a tax, or in order to recover taxes after they have been assessed by the deptartment; or whether experts and accountants ought to be regarded as experts and accountants and not as lawyers and denied the right to practice in the department, particularly where they are urging as lawyers accounts which they have made up as experts and accountants for big taxpayers?

Mr. NASH. Senator King, accounting is just as much a part of tax practice as law is. The department must recognize both ac-

countants and lawyers. Every tax case will probably present as many accounting problems, or more, than it will legal problems. Very few lawyers are also accountants. The board of tax appeals recognizes both lawyers and certified public accountants. Treasury regulations do not limit practitioners to certified public accountants, but they recognize any accountant. They also recognize employees of a firm or the officers.

Mr. Moss. Agents.

Mr. NASH. Also the agents of a firm.

I do not see anything harsh in having an accountant go into a business and adjust the accounts and present an amended tax return, if he has an honest case. If he has complied with the law and the regulations, and the taxpayer has overpaid his tax, he certainly is entitled to get his money back.

Senator KING. Undoubtedly.

Mr. NASH. An accountant is a sort of a doctor to a business. If a taxpayer has made an erroneous report, or is not keeping his books properly, and the books do not correctly reflect the income, the accountant's job is to adjust the accounts and, at the same time, correct any errors that have been made in the tax return. Honest accountants adjust taxes up as well as down. We have many cases on the basis of accountants' reports before us, where they have made examinations and amended returns have been submitted by taxpayers and additional taxes have been paid.

The CHAIRMAN. I can see the logic in the statement, Mr. Nash, and so far as my knowldege of accounting goes, I am entirely in accord with you, but in such cases as have just been referred to by Mr. Manson, where the firm of Ernst & Ernst took an employee out of the bureau who was familiar with the case, I would not think that is proper. Also, as in the case of an estate that we had before us awhile ago, there are employees of the bureau who know that cases are pending, and on account of court decisions, can get a reversal, and they can go out and stir up all of these claims against the Government on a percentage basis. I do not know; I am not convinced of any particular methods that you can adopt to stop that practice, but it is certain that the greatest degree of vigilance should be used to prevent that sort of thing.

Mr. NASH. Senator, in that estate tax case, those former employees of the bureau were not admitted to practice before the bureau, and have never been admitted to practice, and the bureau is vigorously investigating them and will try to prosecute them.

The CHAIRMAN. I think that is true, and I point that out with no intention to criticize the bureau, but merely to show the possibilities that these men have who work within the bureau.

Mr. GREGG. We recognize the possibilities, Mr. Chairman, and we have done everything we can to stop it. Let me give you some of the difficulties, however.

The principal difficulty is caused by the taxpayer himself. If some one comes to a taxpayer and boasts about having inside information with reference to his case, and wants to take his case on a contingent basis, the ordinary, honest taxpayer, will tell him nothing doing, but he will not give us the facts.

The CHAIRMAN. Why not?

Mr. GREGG. They seem to have a feeling that it may prejudice their case in some way.

There are lawyers who come to me time and again and tell me about such and such a thing happening, that an ex-employee approached a client of theirs, saying that he had inside information, or something of that sort. The lawyers tell me that they try to get their clients to give us the information. Of course, the lawyer can not do that, without the permission of the client, and the client will not do it for fear it will harm his case. Occasionally, they will. Occasionally they will work right with us in a case.

The CHAIRMAN. I think undoubtedly the press takes that attitude too, does it not? I mean the press takes the attitude that any criticism that is addressed might hurt their case before the bureau?

Mr. GREGG. Well, I do not know about that, but I have seen the other cases. Sometimes they do it, and it does a great deal of inconvenience to them. Sometimes they cooperate with our intelligence men. We had a case the other day where they had to make false affidavits, with the knowledge of our intelligence men, upon the advice of these co-called experts who approached them. Finally, through the cooperation of the taxpayer, we had them indicted. But it is very difficult to get taxpayers to cooperate with us in these cases.

I think you will find that it has not only been impossible for us to keep undesirables from practicing before the bureau, but the courts have had the same experience. You all know that there are shyster lawyers who are practicing before the courts. It is impossible for the courts to keep unethical and crooked practitioners out of the courts and, of course, it is going to be impossible for us to do it.

The CHAIRMAN. What could the bureau do in a case like this, for instance: In going over the record of one of the cases in the bureau, I find a case where Mr. Doheny employed one of your staff, while he was still an employee of the bureau. He accepted Mr. Doheny's offer, and then had the nerve to ask for two weeks' leave of absence, and he wanted pay from both sources, pay from the bureau and pay from Mr. Doheny. The bureau properly took the position that he could not be on both pay rolls. That man, of course, could go to Mr. Doheny or Mr. Sinclair, or any other big interest, and convey to them all the intricacies of discovery valuation and depletion and the maximum results to be derived by the most favorable decision for his employer.

There is nothing under the law that can stop that, is there?

Mr. NASH. He can not actively appear on any of their tax cases for a period of two years.

The CHAIRMAN. Oh, I understand that; but he can remain in the office and feed them all of the information?

Mr. GREGG. If he does that, we can not stop him.

The CHAIRMAN. No; that is one of the difficulties.

Mr. GREGG. Neither can you stop a man in court from appearing on both sides of the case, if he does it in a backhanded manner.

Mr. MANSON. At least he can not do it in open court where everybody is looking at him.

Mr. GREGG. No; but he may be working in the interest of the other party on the outside.

Mr. NASH. In this particular case I think his personal record would be so noted as to prevent a reinstatement in the Treasury Department if he ever should seek reappointment, because of the conditions under which he resigned. If he should ever seek employment elsewhere and refer to the Treasury Department for a reference, the conditions under which he left the Treasury Department would be made known.

Mr. Moss. Mr. Chairman, let me make this suggestion for Senator King's serious consideration, in view of his statement awhile ago as to the exclusion of auditors and accountants, that the committee should very seriously consider the danger of suggesting to Congress a rule, because of a few bad cases, a rule which would operate against very many hundreds of perfectly honest accountants and auditors, and the very many thousands of taxpayers who are entitled to the services of these auditors and accountants. We can not legislate always for the rascal. You have to legislate for the average run of people, and I think, Senator King, you may want to think about that a little further. I doubt very seriously the advisability of adopting anything that would look to the exclusion of auditors and accountants with relation to the taxpayer. A taxpayer may not want to hire a lawyer, but just wants to send an agent here to Washington to explain things.

Mr. GREGG. In that connection I would like to bring out the fact that in England any tax report of a firm of accountants is accepted by the revenue department. No field examinations are made at all and, except in the case of fraud or something of that sort, the accountant's report is accepted as to the facts stated in it.

Mr. Moss. In the absence of a showing of fraud.

Mr. GREGG. In the absence of a showing of fraud, or something of that sort.

Mr. MANSON. In that connection, I would like to call Mr. Gregg's attention to the fact that accounting in Great Britian has been a recognized profession, subject to the most rigorous regulation, for over a century; that it has traditions behind it as a profession; that in this country we had no real accountants for a great many years, except those who had trained in England or Scotland, and without casting any reflection on individuals, the accounting profession in this country is a thoroughly new profession, as such, and a large part of its personnel is made up of men who have acquired their license under the provision of the recent laws which permits all of those to be made certified public accountants who have been in actual practice for a certain period of years. In other words, in England, the profession of accounting has a hundred years of tradition behind it.

Senator KING. But what I had in mind when I made the suggestion was merely tentative. I did not mean to commit myself to it as a policy, but the evidence which we have had here is that some of these accountants, for a contingent fee, offer their services to get all of the reduction that they can bring about under the head of amortization; so that they are more than accountants. They have a specific and direct interest in securing reductions. They have a financial interest;

the amount of their fee depends on how they can arrange those books—and I do not use those words offensively—so as to secure large amortization reductions, etc.

Mr. MANSON. I believe you have a regulation, have you not, which provides that any representative of a taxpayer who has a contingent fee contract shall file a copy of the contract with the Treasury Department?

Mr. NASH. Yes; he discloses his contract, and it becomes a part of the file in the case. If his contingent fee is considered abnormal to what is involved in the case, he is not permitted to appear in the case.

Mr. MANSON. That is a fairly recent regulation, is it not?

Mr. NASH. It was adopted about two years ago.

The CHAIRMAN. Have you any other case this morning, Mr. Manson?

Mr. MANSON. Yes; I have here the valuation of an iron mining property, which involves a fairly simple question of the regulations.

In this case the metals section placed a value as of 1913 for depletion purposes on this property of about $1,600,000 and for invested capital purposes of $555,000. The case went to the committee on appeals and review——

The CHAIRMAN. What is the name of the case?

Mr. MANSON. Oh, pardon me. It is the Hollister Mining Co., of Cleveland, Ohio.

The case went to the committee on appeals and review, and the committee on appeals and review reasoned that if the valuation for depletion purposes was correct, that same basis of valuation should be used for invested capital purposes.

Mr. GREGG. May I ask Mr. Manson if they set the same value for invested capital purposes?

Mr. MANSON. Discounted to the difference in dates; in other words, the same basis of value was used for both purposes.

I am not going to read this report, but to merely call attention to the question involved.

It would appear, perhaps, at first sight, that if a value is accurate for depletion purposes, that same should be considered for invested capital purposes, but this taxpayer deducted a very large amount of lands, which you might call unproven ore lands. A certain portion of his land was determined to contain iron ore. A certain portion of his land was what is called prospective ore land. In other words, the prospects were that the ore was there, but it was not established.

For purposes of depletion the regulations require the consideration of the probable contents of the prospective lands, the reason for that being that the depletion rate does not depend upon the quantity of the ore, but it is advisable that depletion can only be established once. The regulations provide that it shall be established once, but that when it is once established it shall cover all of the ore owned by the taxpayer, even though a part of that ore is merely prospective ore, bearing in mind that the quantity of ore is a minor factor in determining depletion.

Just to explain that, I will describe briefly the process.

When the prospective profit on a ton of ore has been determined, that prospective profit is multiplied by the number of the estimated

tons in the reserve. That is discounted to date and then divided by the number of estimated tons; so it is manifest that inasmuch as the same factor used to multiply is again used to divide it, it is not a highly important factor in arriving at valuations for depletion purposes.

On the other hand, for invested capital purposes the regulations provide that only ores ascertained to exist shall be valued, upon the theory that men do not pay for mere prospects. What they will pay for is what they actually know to be there.

There is the distinction between the two bases of valuation.

In the one instance, the regulations specifically provide that prospective ores be included in the valuation.

The CHAIRMAN. Is that sound?

Mr. MANSON. I believe it is. In the other instance, they definitely provide that the prospective ores shall not be included in the valuation.

The CHAIRMAN. Then, it is directly within the law, and within reason, to have one valuation for depletion purposes, and another valuation for invested capital purposes?

Mr. MANSON. Absolutely. I can see no objection to it. Consequently, the valuation that was made by the mine section for depletion purposes did include the prospective ores.

The CHAIRMAN. Why did the officials, the Board of Tax Appeals, or the Committee on Appeals and Review, whichever it was, raise that question that you have just called our attention to, namely, the difference between the——

Mr. MANSON. They did not raise it. They ignored it. That is the objection that I have to this valuation.

In other words, the committee on appeals and review took the position that because the engineer had determined this value of $1,661.000 to be sound as the March 1st value for depletion purposes, it necessarily followed that that depletion, discounted to the date of acquisition, should be used for invested capital purposes, when, as a matter of fact, it included prospective ores and amounted to about twice as much as the basis used for invested capital purposes.

The details are all included in the report.

The CHAIRMAN. What was the final conclusion? Did they agree upon a basis for both purposes?

Mr. MANSON. The committee on appeals and review allowed a value of $1,373,303.84, which we maintain is about $800,000 too much for invested capital purposes.

The CHAIRMAN. And thereby reduce the excess-profits tax?

Mr. MANSON. And thereby reduce the excess-profits tax.

Mr. GREGG. I am not at all sure that I agree with Mr. Manson.

Depletion is based, under the language of the statute, on the fair market value of the property as of a given date. Invested capital is based, as I remember it, on the actual fair value of the property as of a given date. I do not think that little difference in phraseology between fair market value and actual fair value or actual cash value, whichever it is, is sufficient to justify a different basis for valuation.

Mr. MANSON. Well, how about your regulations? Article 63, regulations 41, provides that the value allowed for paid in surplus must

be definitely known or accurately ascertainable as of the date of acquisition.

Mr. GREGG. Of course, that regulation you have already said was unsound, Mr. Manson.

Mr. MANSON. I have said that it was unsound, for the reason that it allows any paid-in surplus at all.

Mr. GREGG. Yes.

Mr. MANSON. Under the 1917 act.

Mr. GREGG. Yes.

Mr. MANSON. I have not taken the position that were the language of the 1917 act different than the language of the other act—you have made it to be more unsound here by including values not definitely known, nor accurately ascertainable.

Mr. GREGG. I think, really, the explanation of that difference is——

Mr. MANSON. Article 208, regulations 45, stipulates that the ore reserve on which the value as of March 1, 1913, is based shall include "ores that are 'assessed' and ores that are 'prospective' or 'probable.'" Prospective and probable ores are described as "ores or minerals that are believed to exist on the basis of good evidence, although not known actually to occur on the basis of existing development."

Mr. GREGG. You are still reading from the regulations?

Mr. MANSON. Yes. Clearly, the language of that regulation includes property which could not be included under the former regulation; in other words, under a regulation that provides that what is to be valued must be definitely known or accurately ascertainable at the date of acquisition.

Mr. GREGG. Well, of course, that regulation——

Mr. MANSON. I can see the reason for the difference.

The CHAIRMAN. I was going to ask Mr. Gregg if he does not see the difference between those regulations with reference to depletion and invested capital.

Mr. GREGG. The difference in the regulations is perfectly obvious. That, however, is regulations 41, back under the 1917 act, when, for paid-in surplus purposes, there was really no authority in the act, and the regulation which was issued allowing a paid-in surplus was restricted very decidedly. I think that is the explanation of the difference.

Coming back to the language of the statute, and taking the 1918 act, one says the fair market value, and the other says the actual cash value. Those two terms, to my mind, do not carry a very definite meaning. I am not at all sure that we are justified in putting a different construction on the two terms.

The CHAIRMAN. But you have done it.

Mr. GREGG. That was back under the 1917 act, when we had nothing to construe as to paid-in surplus.

The CHAIRMAN. What do you do now? Do you put two constructions on that now?

Mr. GREGG. Expressing my opinion, I do not think so. I think we use the same basis for valuation for invested capital purposes as we use for valuing for depletion purposes.

The CHAIRMAN. Is that your observation, Mr. Manson?

Mr. GREGG. I may be wrong on that; I am not sure.

Mr. MANSON. I do not think that regulation has been substantially changed.

The CHAIRMAN. Has the practice been carried out?

Mr. MANSON. The uniform practice has been in cases of this character to fix valuations for invested capital purposes upon the oil reserves which were known to exist.

The CHAIRMAN. That has been the actual practice?

Mr. MANSON. Yes; that has been the actual practice.

The CHAIRMAN. And the fault in this particular case is that they did not follow that?

Mr. MANSON. Yes.

The CHAIRMAN. And this is an exceptional case, then?

Mr. MANSON. Yes. For instance, if you were to put both of them on the same basis, then it is manifest that the lower valued ore of $550,000, it would have been necessary to use instead of the higher valued ore.

The CHAIRMAN. After you use that, however, for depletion purposes, you would have increased the depletion rate per ton?

Mr. MANSON. Yes; it would have increased it per ton.

The CHAIRMAN. I mean, the depletion unit would have been raised if you had used the lower value?

Mr. MANSON. Well, not necessarily, because you would multiply by a lower number and divide by a lower number, and except to the extent that you deduct from your value for plant, the quantity of reserves has practically no relation to depletion.

For instance, suppose you have a hundred thousand tons; your profit is $1 a ton; you multiply your profit of $1 per ton by a hundred thousand tons. You have an expected profit of a hundred thousand dollars. You discount that 10 per cent, we will say. You have an expected profit of $90,000. You have a hundred thousand tons, and you divide by $90,000, and you get 90 cents per ton.

Suppose you had 200,000 tons. You multiply 200,000 by $1 and you get $200,000. Discounted at 10 per cent, you have a hundred thousand dollars. You divide that by 200,000 and you get 90 cents. You come back to the same thing.

So that for depletion purposes the amount of the reserves is not controlling, for the reason that the regulation provides that the prospective ores shall be taken into consideration in determining depletion, because the depletion valuation is intended to cover everything there. If there is less there than the amount value, the taxpayer can not get it back, if the depletion rate is properly fixed, because he has exhausted his reserves before he has charged off his depletion, and that is the end of it. But if you were to use the same basis of value you would necessarily have to use the smaller, because nobody would ever think, or at least there would be no sound basis for contending, that you should include an expected profit on mere prospective but unascertained reserves in determining invested capital. So, in this case, if but one standard is to apply, then the valuation for depletion is too high.

Senator KING. How is it they reach the valuation for invested capital of a half million dollars plus? Did they take the actual amount which has been invested?

Mr. MANSON. No; there are two classes of ores——

Senator KING. Yes; I know that.

Mr. MANSON (continuing). And in determining invested capital they only included those portions of the ores which were blocked out.

Senator KING. Which were known?

Mr. MANSON. Which were known.

Senator KING. Is that the way?

Mr. MANSON. Yes; that is the way the profits were arrived at. In both instances the prospective profits were capitalized.

In arriving at the value for invested capital purposes the mine section, pursuant to the regulation here, only took what was definitely ascertainable to exist, while in arriving at valuation for depletion purposes they included, as the regulations require, the prospective or probable ores.

The CHAIRMAN. Have you computed what the difference in tax would have been if they had followed out the procedure which you say was customary and which was not followed in this case?

Mr. MANSON. No.

Senator KING. While you are doing that, it does seem to me, Mr. Gregg, that if your interpretation was right and if your position was right, there must be something wrong where there is such a great disparity and where the results to the Government in the amount of taxes paid and received are so variable.

Mr. GREGG. I was just going to recall what had been the practice. I rather think, although I am not sure of this and I can look it up, that for purposes of depletion, in determining a fair market value, we consider probable and prospective ores. I think that for the purposes of invested capital we consider in determining actual cash value probable and prospective ores when the property is paid in for stock. I think, however, that in determining paid-in surplus the rules are much stricter than in determining any other valuation, and we do not consider probable or prospective ores.

I think that is the situation.

Senator KING. It would seem to me as a practical proposition, giving a concrete case, if you have a mine and I am a prospective purchaser, I examine it; I figure that there are by actual borings a million tons of known ore; that the geological studies which the experts have made show a possible, if not probable, reserve of 250,000 tons more. I buy it from you. I figure upon the known and the character of the expert testimony as to the geological structure, and I allow for that, say, one-tenth of the known, and I pay you $1,100,000. I do not see how, as a practical proposition, when you come to tax you are going to put two values, one for depletion and one for invested capital, because when I bought it I bought it as an entirety, as an entity, and I had in mind the possibility of ore deposits undeveloped as well as those which are actually known.

Mr. GREGG. Maybe I can clear this up. Was there any question of paid-in surplus in this case, Mr. Manson?

Mr. MANSON. Yes; this is a case of paid-in surplus.

Mr. GREGG. This is a case of paid-in surplus?

Mr. MANSON. Yes.

Mr. GREGG. I think what I have just said is borne out by the regulations and the act. The portion of the act dealing with paid-in

surplus, when it was first put in the act in 1918, was more strict than the act dealing with property paid in for stock, when a value is not claimed in excess of the par value of the stock, and the regulations which Mr. Manson has quoted apply only to paid-in surplus and do not apply to property paid in for stock when a valuation in excess of the par value of the stock is not claimed.

So I think the same rule should apply for invested capital and for depletion, except where the invested capital is a paid-in surplus, in which case the rules are stricter and the taxpayer is held down to known or accurately ascertainable facts as to the dates paid in.

Mr. MANSON. You would not give the same value for invested capital purposes to mere prospective or probable ores that you would give to ores known and definitely blocked out, would you?

Mr. GREGG. No; I would not give the same value to the ores, but I would give the same value to ores for invested capital purposes as for depletion purposes.

Mr. MANSON. For depletion, of course, your regulations provide that those prospective or probable ores shall be included.

Mr. GREGG. Yes; but not at the same value as blocked-out ores.

Mr. MANSON. Under any system of appraisal that I have ever seen, I have not detected any means of differentiating the value; but your method of value is to set up the amount of your estimated reserves and multiply that by your expected profit per unit. You estimate the length of time it is going to take to recover it, and you arrive at a composite discount factor by applying your estimated time to your discount factor, discounting your total expected profits back to the date of valuation. You might, in estimating your prospective ores, reduce them somewhat, because they are merely prospective.

Senator KING. But not in value.

Mr. MANSON. Not in value.

Senator KING. No.

Mr. MANSON. Except that the value is fixed upon the prospective profits discounted down to date.

Mr. GREGG. That is true; but you have discounted the value of those prospective ores when you have reduced the extent of the prospective ores. I was trying to find the regulations here.

Senator KING. You discount quantitatively but not qualitatively?

Mr. GREGG. Yes.

The CHAIRMAN. I do not think there is any evidence here that they have been discounted quantitatively.

Mr. MANSON. There is no way to ascertain that. They just estimates the quantity of the reserve.

The CHAIRMAN. Yes.

Mr. MANSON. I would like to quote from a memorandum written by Mr. Grimes, the chief of the metals section, who is certainly familiar with the practice of the department in the construction of these regulations.

Mr. Grimes says:

> Article 63, regulations 41, stipulate that value allowed for a paid-in surplus must be "definitely known or accurately ascertainable as of the date of acquisition." This office has consistently held that the language of this article makes it imperative that no entirely prospective ore be included in the reserve on which the value of a paid-in surplus is determined.

Mr. GREGG. That is exactly what I said.

Mr. MANSON. Yes; I understand; but Senator Couzens asked a question as to what the practice was.

The CHAIRMAN. Then, the practice was not followed in this case?

Mr. MANSON. Was the practice followed?

Mr. GREGG. Are you sure that this is a paid-in surplus case?

Mr. MANSON. I am taking Mr. Grimes's word for it.

The CHAIRMAN. Then, in this case, they deviated from what you quote there from Mr. Grimes.

Mr. MANSON. As being the practice of the bureau; yes.

The CHAIRMAN. Then, there has been a deviation in this case?

Mr. MANSON. Yes.

The CHAIRMAN. And that is the reason you have brought it before us?

Mr. MANSON. That is the reason I bring it before you.

The CHAIRMAN. I would like to ask Mr. Gregg if he agrees with the decision in this case.

Mr. GREGG. If it is a paid-in surplus case; no.

The CHAIRMAN. Then, you and Mr. Grimes are in accord in this matter?

Mr. GREGG. If it is a paid-in surplus case, I think they would have been limited under the regulations to a valuation of known ores. If it is not a paid-in surplus case, and is not valued in excess of the par value of the stock that is claimed, then I do not think so, and they should have, either for depletion or invested capital purposes——

Mr. MANSON. Let me continue to quote from Mr. Grimes here:

Article 208, regulations 45, stipulate that the ore reserve on which the value as of March 1, 1913, is based shall include ores that are "assessed" and ores that are "prospective" or "probable." Prospective and probable ores are described as "ores" or minerals that are believed to exist on the basis of good evidence, although not known actually to occur on the basis of existing development. This office has consistently held that the language of this article makes it imperative that probable ore be included in the reserve which is used in determining the value as of March 1, 1913.

"If it is imperative that prospective ore be excluded from the reserve in determining a paid-in surplus and also imperative that prospective ore be included in the reserve in determining the value as of March 1, 1913, then it is imperative that a paid-in surplus and the value as of March 1, 1913, be determined on different ore-reserve estimates, except when the ore reserve is fully proven and there is no additional prospective ore. It then follows that no process determining the present worth of an ore deposit as at March 1, 1913, can be used in determining its value as of acquisition, except where there is no prospective ore."

Mr. GREGG. That last conclusion is broader than——

Mr. MANSON. When it is taken in connection with the tax, it appears that he refers to the March 1, 1913, values as valued for depletion purposes.

Mr. GREGG. May I see that to see if I can determine whether it is a paid-in surplus case?

Mr. MANSON. Yes. [Handing paper to Mr. Gregg.]

Mr. GREGG. I really do not think there is any difference for paid-in surplus purposes. I have just been reading that regulation again. The act says:

The actual cash value of tangible property bona fidedly paid in for stock, but not to exceed the par value of the stock 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."

The CHAIRMAN. Is that the law or the regulations?

Mr. GREGG. That is the law.

The regulation construing that says:

Where it is shown by evidence satisfactory to the commissioner that tangible property has been paid in by a stockholder to a corporation as a gift or at a value definitely known or accurately ascertainable as of the date of such payment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess shall be deemed to be paid-in surplus.

That is article 837 of regulations 62, page 228.

In construing that, Mr. Grimes takes the position, evidently, that that language "at a value definitely known or accurately ascertainable" applies to the ore——

Mr. MANSON. Now, how are you going to definitely know or definitely ascertain the value of something that you do not know exists?

Mr. GREGG. You may have had a sale of a property a week before it was transferred to the corporation for stock.

Mr. MANSON. In which event, you would not have to value it at all, unless you followed the procedure that was followed in the Temple Coal Co. case.

Mr. GREGG. You would have to value it, but possibly not by the method of analytical appraisal, but you would still have to value it.

Mr. MANSON. Yes; but you would not have to value it attached to your unit of ore, or the prospective profit you expect to make on it. I maintain that whenever you are bound to ascertain a definite value; in other words, wherever you are bound by the language of that act to determine something definitely, and you resort to a method which requires you to attach a value to each ton of something that is in the ground, in order to ascertain that definite value, you can not do that, unless you have a definite quantity of ore to attach that value to.

Mr. GREGG. I can not agree with that. You are applying the "definite" not to the value, but to the ore body, which Mr. Grimes did, and which I did until I read the regulations over again.

Mr. MANSON. My point is that you can not get a definite value on a unit basis of an unknown quantity.

Mr. GREGG. But you can get a definite value of probable or prospective ore. You can take the cost of probable or prospective ores, which sets the definite value.

Mr. MANSON. Yes; but there you have set up a sale. But when you are setting up an appraisal, it takes into consideration a number of points, and you can not readily ascertain, to use the language of the act, a definite value by applying a known or an estimated profit to an unknown quantity.

Mr. GREGG. If by a "readily ascertainable," it is meant easily ascertainable, you can never readily ascertain the value of an ore body; but I believe it means what it says. It must be really a conservative valuation, but I still think that probable or prospective ores can be valued for either depletion, invested capital, or paid-in surplus purposes. I think the valuation must be stricter and more conservative for paid-in surplus purposes, both under the law and

under the regulations, than for the other purposes, but I still think those ores can be valued for both purposes.

Senator KING. I think, Mr. Manson, Mr. Gregg is substantially correct. Take, for instance, coal mines, the bituminous coal mines. In most coal districts, those measures are of the same thickness. Take the coal beds in Utah. You will have two or three measures, one above the other. The thicknesses, there may be 17 feet. The measures are 17 feet, 9 feet, or 5 feet. From the geological investigations, it has been determined that those veins persist for long distances, and you can estimate within a very few hundred tons the quantity of coal upon a given 160 acres, or two or three sections, or 2,500 acres, though you may have no exploratory work done, and your known coal measures, if you use the word "known" as meaning that you have actually penetrated the veins and have measured them, may reveal only a few thousand tons, and a man buys those properties with almost as much certainty that if those conditions persist through an entire quarter section or 2,500 acres as if he ran tunnels through the entire mountain.

Mr. MANSON. I do not know what construction the coal section would apply to the language of that act for the purpose of determining the reserves of coal under the circumstances that the Senator mentioned. It would strike me that there you have something which is definitely known or readily ascertainable; but conditions with respect to coal, where you have a constancy of depth, are entirely different from Michigan iron-ore lands, which are involved in this case.

The CHAIRMAN. That is what I was going to point out to the Senator. The premises that he outlined are not the same premises that figure in this ore case.

Senator KING. Oh, I understand that. I agree with you.

Mr. MANSON. This is Michigan iron ore, where you get all sorts of depths and all sorts of qualities.

Senator KING. Oh, yes; I agree with you; and you may take ore deposits, iron ores, or especially in lime or porphyry. It is impossible to predict what you are going to get in a hundred feet, unless you have made borings.

Mr. MANSON. In iron-ore land you can—well, in northern Minnesota, up in the Mesabi range, there is more or less constancy of depth, but in most iron-ore lands you get a very poor ore and a very good ore. It is absolutely necessary to grade iron ores everywhere, except in northern Minnesota. They are graded a great deal as wheat is, and they are sold according to the different grades, and you will get a dozen different grades of ore out of the same property.

Senator KING. Yes.

Mr. MANSON. And that is also true of Michigan ores.

I will submit this report in the case of the Hollister Mining Co.

(Exhibits submitted by Mr. Manson in the case of the Hollister Mining Co. are as follows:)

EXHIBIT A

MARCH 31, 1925.

Mr. L. C. Manson, counsel, Senate Committee Investigating Bureau of Internal Revenue.
Office report No. 30.
Taxpayer: Hollister Mining Co., Cleveland, Ohio.
Business: Iron-ore producer.
Subject: Decision of the committee on appeals and review in increasing the paid-in surplus for invested-capital purposes above that recommended by the metals valuation section.
Amounts involved:

Capital stock issued	$418,612.75
Paid-in surplus	954,691.09
Total claimed by taxpayer	1,373,303.84
Capital stock issued	475,000.00
Paid-in surplus	80,835.87
Total allowed by metals section	555,835.87
Capital stock issued	418,612.75
Paid-in surplus	954,691.09
Total recommended by committee	1,373,303.84

STATUS OF CASE

Waivers are on file for 1917, 1918, and 1919, dated November 28, 1924, and expiring on June 15, 1926, all signed by the Hanna Furnace Co., successor to the Hollister Mining Co.

SYNOPSIS OF CASE

Taxpayer filed its 1917 return March 30, 1918, showing a tax of $10,423.12, which was paid to the collector at Cleveland, Ohio. Later, after the natural resources subdivision was formed, the taxpayer filed reports and data for the purpose of valuation. In June, 1920, they filed a claim for refund of the total 1917 tax paid, claiming a revision of figures had resulted in an operating deficit for that period. When the valuation section submitted its final valuation memoranda the taxpayer protested the paid-in surplus allowed; and as no agreement could be reached, the unit requested an opinion of the committee on appeals and review, who, after considering the case, decided against the metals valuation section and upheld the taxpayer's claim for paid-in surplus for invested capital purposes.

HISTORY OF THE COMPANY

The Hollister Mining Co. was incorporated in the State of Michigan, January 15, 1909, with an authorized capital stock of $25,000. On April 28, 1909, the directors authorized the purchase from M. A. Hanna & Co. of certain leasehold estates created by indenture made the 24th of December, 1906, by J. M. Longyear to M. A. Hanna & Co., in consideration of which the company paid to M. A. Hanna & Co. the sum of $25,000. On September 8, 1911, the capital stock was increased from $25,000 to $500,000.

The Ravenna mine lease was purchased for capital stock of $75,000; the lease to be in effect from February 23, 1911, to December 31, 1950.

The Monongahela mine lease was purchased September 9, 1911, for $150,000 of the capital stock of the Hollister Mining Co. This lease is in effect from January 1, 1911, to December 31, 1950.

The Carpenter mine lease was purchased September 9, 1911, for $250,000 of the capital stock of the company.

The company operated the Hollister mine, which it had at time of incorporation as lessee until 1914, when the mine was abandoned as a failure and the lease surrendered shortly afterwards.

The properties of the Hollister Mining Co. are located near Crystal Falls, Mich., on the Menominee Iron Range. In 1917 the Hollister Mining Co. purchased considerable stock of the Producers Steamship Co., a company transporting ores for other companies. Listed as a large stockholder in this steamship company is also the Wakefield Iron Co.

Later the Hanna Furnace Co. took over the holdings of the taxpayer and became its successor, although the date of this is not definitely known.

HISTORY OF THE CASE

On March 30, 1918, the Hollister Mining Co. filed its return for the taxable year 1917, showing a net income of $149,569.65 and a tax liability of $10,423.12, which was later paid. On June 16, 1919, its 1918 tax return was filed which showed a net income of $241,388.17 and tax due of $47,832.67. On May 15, 1920, its 1919 return was filed with a tax due of $19,110.04 and a net income of $228,152.19.

When the valuation sections were formed in 1919 the metals valuation section on looking into the case of the taxpayer found additional information necessary, and on February 18, 1920, wrote requesting answers to certain questions essential for the determination of the value of its property.

This information, with maps, tables, etc., was sent to the bureau under date of April 27, 1920.

On June 5, 1920, in a letter to the collector at Cleveland, Ohio, taxpayer sent in a claim for refund of the $10,423.12 paid on the 1917 taxes, due to a revision of its figures which showed an operating deficit for that year; and also filed Form D.

The matter was looked into by the metals valuation section, conferences held, valuation memoranda prepared, and finally, on February 3, 1921, Mr. A. W. Gaumer submitted the valuation allowed the taxpayer by the section.

This valuation did not please the taxpayer in the matter of invested capital, and on July 14, 1921, it filed a claim presenting its arguments in favor of a value for paid-in surplus.

The metals valuation section replied to this letter under date of August 2, 1921, reaffirming their side of the case, and recommended that the case of this taxpayer be closed on the basis of the memorandum dated February 3, 1921.

The metals valuation section and the taxpayer could not agree on any figures, and finally the case was sent to the committee on appeals and review for an opinion. This request for an opinion was forwarded March 6, 1922, by the deputy commissioner.

On April 13, 1922, the taxpayer filed a brief in support of its claim.

On May 16, 1922, memorandum No. 176 was handed out by the committee on appeals and review, in which the paid-in surplus allowed by the metals valuation section was discarded and the amount claimed by the taxpayer was allowed. In the same memorandum the valuation for March 1, 1913, as recommended by the unit was allowed. An opinion on this had been requested also by the unit, although the matter was not under dispute. (See Exhibit B.)

On March 10, 1923, the metals valuation section prepared a memorandum based on the decision of the committee and giving the figures for depletion, invested capital, etc.

An A-2 letter, no date, is in the files showing a tax adjustment for 1917, on the basis of the ruling and a final audit. No final audit has apparently been made on the 1918 and 1919 taxes. A protest, dated March 22, 1924, was made to this letter, and showed the assessment letter to have been made May 9, 1923. (Extensions of time for filing protest had been granted.) This protest was directed to the audit section, and an engineering problem was not involved.

Taxpayer said regarding depletion in this letter:

"On account of the great difficulty this company had with the metals valuation section as to depletion and capital surplus, we do not wish to have these matters reopened. We are confident that the basis which we have suggested for calculating the depletion for each year will be found in accord with the accepted practice. If, however, the audit section can not agree with this basis, we should like to be advised before any action is taken which might reopen the question of valuation and depletion."

Final action on this case is contained in a memorandum prepared by Mr. J. A. Grimes, chief of the metals valuation section, dated March 5, 1925, and

addressed to the commissioner in which he stated that "apparent errors are indicated, and permission is requested for a redetermination of both the value for invested capital—and March 1, 1913, value for depletion." (See Exhibit C.)

DISCUSSION

The question presented in this case, and the principle involved, is similar to that in the case of Witherbee, Sherman & Co.

The metals valuation section in its final recommendations for values to be allowed the taxpayer dated February 3, 1921, gave the company a value for invested capital of $555,835.87. This was made up of $475,000 as the par value of the stock paid to M. A. Hanna & Co., and $80,835.87 for exploration and development costs which M. A. Hanna & Co. had spent on the property prior to acquisition by the taxpayer. This was according to the agreement in which the M. A. Hanna & Co. sold its options to lease for mining purposes.

1. Assumption by the Hollister Mining Co. of the entire amount expended by M. A. Hanna & Co. for prospecting, drilling, and development.

2. Stock of the Hollister Mining Co., 19,000 shares of a par value of $25 per share. It was as a result of this agreement that the taxpayer increased its capital from $25,000 to $500,000. Conferences were held with the taxpayer over the figures allowed by the section, as a result of which the taxpayer submitted a letter showing the basis for the claims for value which it thought should be allowed. These were contained in a letter to the section dated July 14, 1921, and signed by G. M. Humphrey, the secretary.

In this letter attention is drawn to the fact that the metals valuation section in its valuation memorandum gave the taxpayer a March 1, 1913, value of $1,540,217.18, and since they stated there had been no change in conditions or factors the value of the property at date of conveyance 18 months prior to March 1, 1913, should be the value allowed by the metals valuation section as of March 1, 1913, deferred 18 months at 8 per cent, which gives $1,373,303.84. On this basis they computed a value for paid-in surplus which they claim they should be allowed of $954,691.09. The following figures show how the taxpayer computed its claim for these figures:

Value at Mar. 1, 1913, as fixed by the metals valuation section:	
Carpenter mine	$1,333,318.13
Monongahela mine	206,899.05
Total	1,540,217.18
Value at Sept. 15, 1911, the date of conveyance, above values deferred for 1½ years at 8 per cent (0.89163):	
Carpenter mine	1,188,826.44
Monongahela mine	184,477.40
Total	1,373,303.84
Paid-in surplus:	
Value at Sept. 15, 1911, as above	$1,373,303.84
Proportion of capital stock exchanged for leases[1]	418,612.75
Paid-in surplus	954,691.09

	Tons	
Carpenter	4,178,585	equals 88.129 per cent
Mongongahela	1,018,114	
Ravenna	700,000	
Total	5,896,699	

88.129 per cent of $475,000 equals $418,612.75.

(NOTE.—A tonnage was given the Ravenna mine by the valuation section in its memorandum, but no value was assigned the same, since it operated at a loss and was abandoned in 1917 by the company.)

Quoting from the letter the taxpayer says:

"From these factors, all definitely determinable at the time of conveyance, the valuation section computed a value for these properties of $1,540,217.18 as of March 1, 1913, and at the same time fixed a value for the same properties, based upon exactly the same information, of only $475,000 as of September 15,

[1] Based on tonnage used by metals valuation section in assigning value fixed by it at date of conveyance, i. e., $475,000.

1911, the date of conveyance, just 18 months previous. This sum of $475,000 represents the par value of the capital stock issued in consideration for these leaseholds.

"The corporation respectfully presents its objection to this valuation and bases its claim for a greater value as of date of conveyance on the provisions of article 63 of regulations 41, reading 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 * * * at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of * * *. 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.'

"The facts in this case satisfy completely the requirement that the value at date of conveyance must be 'accurately ascertainable or definitely known,' because the facts used by the valuation section on which the calculation of value was based were all definitely known at the date of conveyance."

The metals valuation section replied to this under date of August 2, 1921, in which Mr. A. W. Gaumer, valuation engineer, stated:

"It is the opinion of this office that the par value of the stock of this company issued for the mining properties acquired in 1911 is the maximum value that can be allowed for these properties for the following reasons:

"1. The tonnage of ore valued by this office as at March 1, 1913, includes a large tonnage of prospective ores in each case. This is in accord with regulations 45, article 208, but the inclusion of prospective ore in a computation of value for invested capital and paid-in surplus, based upon the expected operating profit to be derived from prospective ore, gives a speculative value for invested capital which can not be allowed. (Article 836.)

"2. The fair market value as at March 1, 1913, has no bearing on invested capital as at acquisition. (Articles 201, 831, and 1561.)

"3. As at date of acquisition one property was entirely undeveloped and the other was developed to the extent of five drill holes. This development gave these properties a speculative value which this office considers was not in excess of the par value of the stock issued for the properties. That the prospective value of such mines is frequently overestimated is shown by the taxpayer's estimate of 700,000 tons of ore in the Ravenna mine, which was abandoned as worthless after 287,406 tons has been removed at a loss. This property was acquired in the same transaction as the Carpenter and Monongahela, for which the paid-in surplus is claimed.

"4. By comparison with data filed by the taxpayer with the Michigan State Tax Commission, the estimates of value by this office are shown to be very liberal, both as to tonnages and values."

Michigan State Tax Commission tonnages

		Tons
1914.	Carpenter and Monongahela mines:	
	Prospective ore	1,271,000
	Developed ore	None.
1914.	Ravenna mine:	
	Taxpayer's estimate of developed ore	152,866
	Commission's estimate of developed ore	117,188

Michigan State Tax Commission values

	Carpenter and Monongahela	Ravenna	Total
Appraisal in 1911	$50,000	$8,000	$58,000
Valuation in 1912	300,000	100,000	400,000
Valuation in 1913	396,240	81,152	477,392
Valuation in 1914	[1] 473,160	[2] 192,212	665,372

[1] Includes 10,769 tons of ore in stock pile.
[2] Includes 110,060 tons of ore in stock pile.

The values are for both the lessor and lessee equities.

Taking into account the total ores on January 1, 1919, and those mined between 1913 and 1919, a figure is obtained which shows the liberal basis allowed the taxpayer by the section.

	Carpenter	Monongahela	Ravenna
Total on above basis	3,136,256	691,659	287,406
Allowed by unit	4,178,585	1,018,144	700,000
Excess ore valued	1,042,329	326,485	412,594

Total mined, developed, or prospective ore as considered by Michigan State Tax Commission 4,115,321
Allowed by metals valuation section 5,896,729

Continuing, Mr. Gaumer stated:

"The above comparisons should be sufficient to assure the conviction that the taxpayer has received very liberal values from this office both as to date of acquisition and as at March 1, 1913. If any error has occurred, it is that the values allowed by this office are too liberal.

"It is recommended that the case be audited and closed on the basis of the memorandum from this office dated February 3, 1921."

The taxpayer in submitting its data for valuation on April 27, 1920, which had been requested by the unit, stated:

"The cost of its leases to the Hollister Mining Co. is represented—

"1. By the cash payment of $80,835.87 assumed; and

"2. The then present worth of 19,000 shares of its capital stock.

"The Hollister Mining Co. at the time of the acquisition of these leases, had a total authorized capital of 20,000 shares. It paid for these leases with 19,000 of those shares. The worth of those shares, therefore, was necessarily reflected in the worth of the properties acquired, and until the worth of the properties acquired has first been accurately estimated, it is impossible to ascribe any definite value to the shares."

In this letter the taxpayer advances the figures which were submitted in Form D, for valuation purposes, and encloses maps, etc., of the property and drill holes.

In its memorandum No. 176, dated May 16, 1922, the committee on appeals and review (Exhibit B) decided that the March 1, 1913, value allowed by the section was correct, but that their paid-in surplus was wrong, and sustained the taxpayer on the value of $954,691.09. In their memorandum they state that—

"The consideration paid for the two leases and the option was $475,000 par value of the capital stock of the Hollister Mining Co. plus the reimbursement of M. A. Hanna & Co. for all sums theretofore and thereafter expended by that company on account of advance royalty and the cost of exploration, construction, and other expenses incident to the opening and development of the properties. The total cost of drilling, prospecting, and development assumed by the Hollister Mining Co. was $80,835.87."

These were the figures that the metals valuation section found and allowed the taxpayer.

However, the committee further along presented the claims as made by the taxpayer for a greater value for paid-in surplus than that represented by the par value of the stock, and agreed with it that it should be allowed such a value. In doing this they use the tonnage allowed by the section, prorate the stock to the two mines with a value and discount for one and one-half years, in the same way the company did in its letter of July 14, 1921, in presenting its claim.

In the memorandum they stated, regarding the March 1, 1913, value as a fair estimate of the reserves as at date of acquisition, that—

"In reaching this conclusion the committee has recognized that this estimate includes minerals in sight, blocked out, developed, or assured, as well as probable or prospective ores. Purchases and sales of mining property are made every day on the basis of similar estimates by reputable engineers and a value thus established measures the fair market value as between a willing seller, and a willing buyer. Under the circumstances of this case, such value should be accepted as the actual cash value."

This statement appears to be contrary, according to the metals valuation section, to article 63, regulations 41, which states that—

"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 value, accurately ascertainable or definitely known as at 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.

"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."

On the other hand, the committee was of the opinion that under the same provisions, the value for paid-in surplus as claimed by the taxpayer should be allowed.

MARCH 1, 1913, VALUE

In connection with this report a few figures regarding the March 1, 1913, value and tonnage at that time might be interesting, although the matter, until Mr. Grimes made his recommendation of March 5, 1925 (Exhibit C) was not under dispute.

Taxpayer in his Form D (dated June 8, 1920) submitted the following:

Ore reserves March 1, 1913

	Tonnage	Mar. 1, 1913, value
Carpenter mine	4,178,585	$1,648,117.50
Monongahela mine	1,018,114	450,108.20
Ravenna mine	700,000	
Total	5,896,699	2,098,225.70

In Form D taxpayer made no claim for value of the Ravenna mine lease.

The metals valuation section, in its final recommendation on this taxpayer, submitted the following, after consultations and agreements with the taxpayer:

	Mar. 1, 1913 value	Tonnage
Carpenter mine lease	$1,333,318.13	4,178,585
Monongahela mine lease	206,899.05	1,018,114
Ravenna mine lease	Nothing.	700,000
Total	1,540,217.18	5,896,699

It is noted here that the section allowed the taxpayer his claims on tonnage, which appeared to be on a rather liberal basis. The taxpayer apparently accepted the value of $1,540,217.18 which the section allowed, since this question was not contested, and the figure given was later used by the taxpayer in making its claims for value for invested capital purposes.

CONCLUSION

Your engineers after careful review of this case are of the opinion:

1. That the committee on appeals and review erred in allowing this taxpayer an invested capital of $1,373,303.84, as follows:

(*a*) In considering subsequent events in an invested capital determination by deducting from a value as of date of acquisition a prorated value for a lease found in later years to be unprofitable and abandoned.

(*b*) In allowing a discounted, March 1, 1913, value for "prospective" ores, as paid-in surplus at date of acquisition, when such value was speculative, the allowance of which in invested capital is contrary to the regulations; and in disregarding evidence as to assessed values in sworn statements to the Michigan State Tax Commission, as provided for in the regulations.

2. That, this case being properly covered by waivers, it should be revalued as to invested capital; in view of Mr. Grimes's memorandum of March 5, 1925, in which the March 1, 1913, value is also declared excessive, a revision should also be made of same.

Respectfully submitted.

O. A. MILLS,
Assistant Engineer.

Approved.

E. T. WRIGHT,
Assistant Chief Engineer.

Approved.

L. H. PARKER,
Chief Engineer.

EXHIBIT B

Memorandum No. 176

COMMITTEE ON APPEALS AND REVIEW

Section 207, revenue act, 1917; section 12 (a), second revenue act, 1917; section 326 (a), (a) revenue act, 1918; section 234 (a), (9) revenue act, 1918.

Held, in the matter of tax liability of the Hollister Mining Co., Cleveland, Ohio, that a paid-in surplus of $954,691.09 should be allowed and that the March 1, 1913, value established by the valuation engineers of the bureau for depletion purposes should be accepted.

MAY 16, 1922.

Mr. COMMISSIONER
(For Deputy Commissioner, Head, Income Tax Unit):

The committee is in receipt of a memorandum from the Income Tax Unit dated March 6, 1922, in which an opinion is requested as to the value for invested capital purposes of a certain option and two leases paid in to the Hollister Mining Co., Cleveland, Ohio, for stock and also as to the fair market value of this property at March 1, 1913, for depletion purposes.

The Hollister Mining Co. was incorporated on January 15, 1909, under the laws of the State of Michigan with an authorized capital stock of $25,000 and until 1914 operated what is known as the Hollister Mine, which was abandoned as a failure in that year.

During 1910 and 1911 M. A. Hanna & Co., a copartnership of Cleveland, Ohio, procured options to lease and leases on a number of descriptions of land near Crystal Falls on the Menominee Range in Michigan. Under these options and leases M. A. Hanna & Co. did a considerable amount of prospecting, drilling, and development work from which it was determined that several of the descriptions contained valuable deposits of ore.

At a special meeting of the stockholders of the Hollister Mining Co. held on September 8, 1911, authority was voted for the acquisition from M. A. Hanna & Co. of the following:

"An option dated January 10, 1911, for a mining lease covering the north half of the southeast quarter and the north half of the southwest quarter of section 31, township 43 north of range 32 west in Iron County, Mich.

"A mining lease dated January 11, 1911, expiring December 31, 1950, covering the east half of the northeast quarter, the northwest quarter of the northeast quarter, and the northeast quarter of the northwest quarter of section 36, township 43 north of range 33 west, in Iron County, Mich., commonly known as the Monongahela mine.

"A mining lease dated February 23, 1911, expiring December 31, 1950, covering the south half of the northeast quarter, the south half of the northwest quarter, the north half of the southwest quarter, the southeast quarter of the southwest quarter, the southwest quarter of the southwest quarter, the northwest quarter of the southeast quarter, and the southwest quarter of the southeast quarter of section 19, township 43 north of range 32 west, in Iron County, Mich., commonly known as the Ravenna mine."

The property first described above covers what is known as the Carpenter mine. The option itself was not assignable, but the lease provided for in the option was assignable, and the vendors agreed to take out said lease during the life of the option and to assign it to the purchaser. The option was exercised on December 11, 1911, and at the request of M. A. Hanna & Co. the lease was made direct by the Hollister Mining Co. with the lessors. The leases to the Monongahela mine and the Ravenna mine, the second and third properties described above, were assigned by M. A. Hanna & Co. to the Hollister Mining Co. under indenture dated September 8, 1911.

The consideration paid for the two leases and the option was $475,000 par value of the capital stock of the Hollister Mining Co. plus the reimbursement of M. A. Hanna Co. for all sums theretofore and thereafter expended by that company on account of advance royalty and the cost of exploration, construction, and other expenses incident to the opening and development of the properties. The total cost of drilling, prospecting, and development assumed by the Hollister Mining Co. was $80,835.87.

The company contends that the option and leases at the date they were transferred to the corporation had an actual cash value largely in excess of the par value of the stock issued therefor, and that under the provisions of article 6", Regulations 41, it is entitled to a paid-in surplus equal to the excess of this value over the par value of the stock. It appears that the outstanding stock of the Hollister Mining Co. previous to the transfer of these leases was all owned by the partners in the firm of M. A. Hanna & Co., the owners of the option and leases, and after the transfer the stock was held by the same persons in exactly the same proportions.

On the basis of information submitted by the company in its Form D the valuation engineers of the bureau have made a valuation as of March 1, 1913, for depletion purposes. Inasmuch as the Ravenna mine operated at a loss and was abandoned in 1917, no value returnable through depletion was assigned to it except the actual capitalized expenditures. The value assigned to the Carpenter mine was $1,333,318.13 and to the Monongahela mine, $206,809.05.

The ore reserves calculated by the company on the basis of exploration and development work have been accepted by the unit as being reasonable estimates of ore in place on March 1, 1913. It develops that all of the drilling and prospecting had been done prior to the acquisition of these properties by the Hollister Mining Co. in September, 1911. Eleven drill holes had been sunk on the Carpenter mine and three on the Monongahela mine, and with the exception of one check hole put down on the Carpenter mine within less than two months after acquisition, no further prospecting or drilling has been done to the present day. It therefore appears to be perfectly clear that no mineral deposits were discovered or developed after the date of conveyance, and that the tonnage at date of acquisition was as accurately ascertainable as at March 1, 1913. In the opinion of the committee this tonnage, computed by the company's own engineers and accepted by the valuation engineers of the bureau as representing the ore in place on March 1, 1913, must therefore be also accepted as a fair estimate of the ore reserves as at date of acquisition. In reaching this conclusion the committee has recognized that this estimate includes minerals in sight, blocked out, developed, or assured as well as probable or prospective ores. Purchases and sales of mining property are made every day on the basis of similar estimates by reputable engineers and a value thus established measures the fair market value as between a willing seller and a willing buyer.

Under the circumstances of this case such value should be accepted as the actual cash value.

The committee has carefully considered the three other factors entering into the computation of the March 1, 1913, value, namely, the estimated profits to be derived from operation, the life expectancy of the mines, and the necessary plant and equipment, and expresses the opinion that they are computed on a basis consistent with good engineering practice, are probably as accurate as any estimate which can now be made, and that their use in this case will be fair both to the taxpayer and to the Government.

As stated above, the capital stock of $475,000 was issued for the three properties—the Carpenter, Monongahela, and Ravenna mines. In the absence of specific allocation of stock to particular properties it seems to the committee fair to assume that the stock was issued ratably in accordance with the estimated tonnage in each mine. The accepted estimates of ore reserves are as follows:

	Tons
Carpenter mine	4,178,585
Monongahela mine	1,018,114
Ravenna mine	700,000
Total	5,896,699

On this basis it is assumed then that 88.129 per cent of the stock, or $418,612.75, was issued for the Carpenter and Monongahela properties. The ore reserves in these two mines as at March 1, 1913, have been valued by the natural resources subdivision as follows:

Carpenter mine	$1,333,318.13
Monongahela mine	206,899.05
Total	1,540,217.18

These amounts discounted at 8 per cent from March 1, 1913, to date of acquisition, using the factor 0.89163, give:

Carpenter mine	$1,188,826.44
Monongahela mine	184,477.40
Total	1,373,303.84
Deduct proportionate part of capital stock issued therefor	418,612.75
Excess value of properties over stock issued	954,691.09

It is the opinion of the committee that in accordance with the provisions of article 63 of regulations 41 and the similar provisions of the subsequent regulations this excess value should be recognized in the computation of this company's invested capital as well as in the determination of the cost of the properties to the company for purposes of return of capital under the 1917 and previous acts.

It is, therefore, held that a paid-in surplus of $954,691.09 should be allowed in this case and that the March 1, 1913, value established by the valuation engineers of the bureau for depletion purposes should be accepted.

N. T. JOHNSON,
Chairman Committee on Appeals and Review.

Noted:

(Signed) CARL A. MAPES,
Solicitor of Internal Revenue.

Accepted for the guidance of the Income Tax Unit.

(Signed) D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT C

MARCH 5, 1925.

Memorandum to the Commissioner.

In re Hollister Mining Co. A. R. M. No. 176.

The evidence available, actions taken, and decisions reached in the audit of the tax returns of this company are summarized in the following memorandum.

Apparent errors are indicated, and permission is requested for a redetermination of both the value for invested capital in depletible assets and the March 1, 1913, value for depletion in the case of this taxpayer.

The Hollister Mining Co. was incorporated under the laws of the State of Michigan January 15, 1909, with par value capital stock $25,000.

The company operated the Hollister mine, as lessee, until 1914, when the mine was abandoned as a failure and the lease was surrendered shortly afterwards. The total shipments from the mine were 148,920 tons of iron ore, of which 21,949 tons were shipped prior to the operations of the Hollister Mining Co. The records of the Michigan State Tax Commission show that there was no ore in the mine as of January 1, 1914. The operations show that little or no value can be attached to the Hollister Mining Co. stock because of the Hollister mine. The par value of the stock issued for the Hollister lease should be considered as depleted to no value at the date of abandonment of the lease.

In the late summer of 1911 the Hollister Mining Co. stock was increased from $25,000 to $500,000. On September 8, 1911, the $475,000 additional stock thus authorized was issued to M. A. Hanna & Co. for—

1. An option for lease on the Carpenter mine. The option was dated January 11, 1910, and was not assignable, but the lease that it provided for was assignable and the vendors agreed to take out said lease and assign it to the purchasers.

2. Mining lease, dated January 11, 1911, covering the Monongala mine.

3 Mining lease, dated February 23, 1911, covering the Ravenna mine.

The Hollister Mining Co. also agreed to reimburse M. A. Hanna & Co. to the amount of $80,835.87 for money spent on account of advanced royalties, exploration, construction, etc.

The Hollister Mining Co. contends that as of September 8, 1911, the option to lease the Carpenter mine and the lease on the Monongahela mine had a combined cash value greatly in excess of the par value of the stock issued therefor and that the company is accordingly entitled to a paid-in surplus.

This office was and is unable to determine an acquisition value greater than the par value of the capital stock issued for the option to lease the Carpenter mine and the lease on the Monongahela mine. While the information available is somewhat incomplete, it is doubtful whether any information available is sufficient to prove a value as great as or greater than the par value of stock issued therefor.

The Hollister Mining Co. refused to accept the acquisition value of the option to lease the Carpenter mine and the lease on the Monongahela mine, as determined by this office, and carried the case to the committee on appeals and review.

In memorandum dated February 3, 1921, this office determined values as follows:

1. Acquisition value of the Carpenter, Monongahela, and Ravenna mines, $555,835.87, which amount was the $475,000 par value capital stock issued therefor and $80,835.87 payable M. A. Hanna & Co. to reimburse them for expense of development, etc.

2. Value of the Carpenter mine as of March 1, 1913, in the amount of $1,333,318.13, based upon a reserve of proven and prospective ore of 4,178,585 tons.

3. Value of the Monongahela mine as of March 1, 1913, in the amount of $328,322.60, which was based upon a reserve of 1,018,114 tons of proven and prospective ore.

4. No value for the Ravenna mine beyond the cash investment in development, because the property was operated at a loss for the entire period of operation and was exhausted and abandoned before the end of 1917.

The committee on appeals and review determined as follows:

1. That of the $475,000 par value capital stock issued 88.129 per cent, or stock of a par value of $418,612.75, was issued for the Carpenter and Monongahela mines.

2. That the combined value of the Carpenter and Monongahela mines as of the date of acquisition was $1,373,303.84, which amount was determined by discounting $1,661,640.73 from March 1, 1913, back to September 8, 1911, at 8 per cent. The March 1, 1913, value of $1,661,640.73 was accepted by the committee on appeals and review as the proper amount to be discounted, because this office had determined that the combined value of the Carpenter and Monongahela mines as of March 1, 1913, was $1,661,640.73, and the committee states

that no development had been done between September 8, 1911, and March 1, 1913.

Article 63, Regulations 41, stipulates that value allowed for a paid-in surplus must be "definitely known or accurately ascertainable as of the date of acquisition." This office has consistently held that the language of this article makes it imperative that no entirely prospective ore be included in the reserve on which the value of a paid-in surplus is determined.

Article 208, Regulations 45, stipulates that the ore reserve on which the value as of March 1, 1913, is based shall include ores that are "assessed" and ores that are "prospective" or "probable." Prospective and probable ore are described as "ores" or minerals that are believed to exist on the basis of good evidence, although not known actually to occur on the basis of existing development." This office has consistently held that the language of this article makes it imperative that probable ore be included in the reserve which is used in determining the value as of March 1, 1913.

If it is imperative that prospective ore be excluded from the reserve in determining a paid-in surplus, and also imperative that prospective ore be included in the reserve in determining the value as of March 1, 1913, then it is imperative that a paid-in surplus and the value as of March 1, 1913, be determined on different ore reserve estimates, except when the ore reserve is fully proven and there is no additional prospective ore. It then follows that no process determining the present worth of an ore deposit as at March 1, 1913, can be used in determining its value as of acquisition, except where there is no prospective ore.

The following will show conclusively that there was a very large tonnage of probable ore in the Carpenter and Monongahela mines both as of acquisition and as of March 1, 1913.

The Michigan State Tax Commission placed the following values upon the Carpenter and Monongahela mines:

1911	$850,000
1912	300,000
1913	396,240
1914	462,391

This office does not know the tonnage estimates used in determining the values for the years 1911, 1912, and 1913. The year 1914 was based upon an ore reserve estimate of 1,271,000 tons, which estimate was submitted by the Hollister Mining Co. and accepted by the State tax commission after verification. The value for 1914 also included $10,769 value for ore in stock. The 1,271,000 tons estimate as of January 1, 1914, may be considered as proven ore as of that date, because the tax commission includes very little or no prospective ore for tax purposes, though its figures are designated "proven and prospective ore." The assumption that the whole reserve of 1,271,000 tons was proven favors the taxpayer. It is known that some ore was proven between March 1, 1913, and January 1, 1914, but, for the present purpose, it can be assumed that no additional ore was proven between those dates. This assumption also favors the taxpayer.

	Tons
Taxpayer's estimate of ore reserve in Carpenter and Monongahela mines as of March 1, 1913	5,196,699
Proven ore as per taxpayer's sworn estimate submitted to and checked by the Michigan State Tax Commission	1,271,000
Prospective ore	3,925,000

This office included the above 3,925,000 tons of prospective ore in determining the value as of March 1, 1913, which is a very liberal basis, including a large element of speculative value.

Since the committee on appeals and review determined the value for paid-in surplus by discounting the March 1, 1913, value, to date of acquisition, the committee incorrectly included the value of 3,925,000 tons of prospective ore, of speculative value, not of a definitely known and accurately ascertainable value as required by the regulations.

Article 63, Regulations 41, stipulates that "assessed value" shall be used in determining the value of a paid-in surplus. The value determined by the committee and the assessed value are as follows for the Carpenter and Monongahela mines:

Assessed value January 1, 1911	$80,000.00
Value for paid-in-surplus September 8, 1911, as determined by committee on appeals and review	1,373,303.84
Assessed value January 1, 1912	300,000.00
Assessed value January 1, 1913	396,240.00
Assessed value January 1, 1914	462,391.00

Thus it is apparent that the decision of the committee disregards all comparative bases of valuation and relies exclusively upon an analytical appraisal on a basis contrary to the regulations.

As an additional indication of the inconsistency of the decision of the committee on appeals and review, consider the allocation of different values to different shares of stock issued at the same time for a mixed aggregate of assets. The allocation follows:

Description of asset acquired	Shares of stock issued *	Values or cost allowed	Value per share of stock allowed
Ravenna mine lease	$2,255.49	$41,277.59	$18.30
Monongahela mine lease (option to lease Carpenter mine)	16,744.51	1,373,303.84	82.02

* Committee's basis of allocation and value.

It is inconceivable that different blocks of a single issue of stock paid in a single transaction for a mixed aggregate of assets, should have different values, yet A. R. M. 176 values one block at $18.30 a share and the other block at $82.02 a share.

The March 1, 1913, value determined by the metals valuation section is excessive as indicated by all available evidence. The committee on appeals and review accepted and magnified the error of the Income Tax Unit in A. R. M. 176. Authorization by the commissioner is requested for a reconsideration of both the values for invested capital and depletion in this case, and as a precedent to that authorization it will be necessary to revoke A. R. M. 176.

(Signed) JOHN ALDEN GRIMES,
Chief, Metals Valuation Section.

NOTE.—In the above letter on pages 2 and 3 the following corrections are noted: Mr. Grimes having copied the wrong figure from the original valuation report:

Value of the Monongahela mine March 1, 1913, should be $206,899.65, and not $328,322.60.

Combined value as of March 1, 1913, should be $1,540,217.18, and not $1,661,640.73.

These corrections will not affect any of the other figures quoted. Above have been called to the attention of Mr. Grimes.

Mr. GREGG. Mr. Chairman, if that completes Mr. Manson's statement. I have the request of the committee for some data on section 220, that I can answer now, as well as I can answer at any other time.

The CHAIRMAN. I would like to draw this to the attention of Mr. Nash before you put that in, Mr. Gregg.

Sometime toward the close of the last session, Senator Reed of Missouri spoke to me about the tax of the Guyton-Harrington Horse & Mule Co., the Stockyards Horse & Mule Co. of Kansas City, and the Wolcott, Beers & Grant Co. I had paid no particular attention to it until the matter came to my attention by the receipt of a letter by a Kansas City law firm, which does not interest this committee, except this particular feature of it. I think that Judge Moss knows something about the case. What I would like to ask

Mr. Nash is whether he can enlighten the committee on this portion of the letter, which says:

> After the Government had made an investigation and Mr. Koerner had been to England and obtained information there in regard to records of the war council of Great Britain the Government filed this lien against these parties for $19,000,000, and after it had pended awhile it was then announced that progress had been made, and that instead of Guyten & Harrington and the other parties owing the Government the Government was owing them.

I think it is rather late now for us to request the department to go into the case, but I would like to know if Mr. Nash could submit a statement to us at one of our later hearings with regard to that matter.

Mr. NASH. I am not personally familiar with the case, but I will be glad to have a memorandum prepared as to what happened in that case, and submit it to the committee.

The CHAIRMAN. I would be glad to have you do that. I do this largely because Senator Reed of Missouri spoke to me about it some time ago, and I overlooked it.

Mr. Moss. There is litigation pending between the parties out in Missouri, and the picture of that case in my memory is that they wanted to use records of the Income Tax Unit in their litigation between themselves.

The CHAIRMAN. That is outlined in the letter, Judge Moss, and I did not put it in, because, as I say, this committee is not concerned with this. The only thing that the committee is concerned with is the amount of taxes paid and refunded.

Mr. Moss. Yes; the policy of the department.

The CHAIRMAN. Will you let us know, Mr. Nash, as soon as you can have that prepared?

Mr. NASH. Yes, sir.

Mr. GREGG. What is the point that you were interested in?

The CHAIRMAN. As to what happened in the case which caused you to first assess them at $19,000,000, and then to waive the assessment, and then determine that the Government was owing them instead of their owing the Government. I think that is the only point at issue in this whole matter, which the committee can take any interest in. That is the only point I am interested in, and not the litigation that Judge Moss has referred to.

Mr. MANSON. As I read that letter, I do not see that Judge Moss could do any different than what he did do.

The CHAIRMAN. Nobody is criticizing Judge Moss for that, and I do not raise that question.

Mr. Moss. No; I just wanted to report what I did on it.

The CHAIRMAN. What is it, Mr. Gregg, that you want to put in as to section 220?

Mr. GREGG. The committee asked for the revenue that has been paid under section 220. We have kept no record of taxes collected under section 220. Frankly, I have been able to find about three cases, none of them large ones, where section 220 has been applied and the tax collected. The reason for that, however, is this——

The CHAIRMAN. Can you give us the names of three cases and the amounts involved?

Mr. GREGG. The amounts involved in all of them were small. We do not have in the office the amounts involved, but the amount involved in all of them was small.

The CHAIRMAN. And were they collected or just assessed?

Mr. GREGG. I think it was collected in all three of them. One of them may not have reached the point of collection, but, as I remember it, it was collected, all of them comparatively trifling, however.

Section 220 was designed to penalize the family corporation and the close corporation in cases where the members of a family transferred their securities to a corporation for the purpose of having the corporation receive the dividends on the securities and accumulating them to avoid the payment by the stockholders of the surtaxes. Unfortunately, the acts prior to the 1924 act—take the 1921 act—imposed the penalty upon the net income of a corporation, the statutory net income.

The CHAIRMAN. Of 25 per cent?

Mr. GREGG. A penalty of 25 per cent on the statutory net income of the corporation.

Take the cases to which it was intended to apply. The taxpayer, his wife and children, transfer all of their stock to a corporation. The corporation, which they have organized just for that purpose, receives the dividends on this stock, and distributes none of the dividends. Thus the members of the family, the taxpayer and his wife and children, avoid the payment of a surtax.

The CHAIRMAN. Was that the only case it was intended to get at?

Mr. GREGG. No; it is not the only case, but it is the case that it was primarily aimed at.

In that case the penalty levied is 25 per cent of the net income of the corporation; dividends received by the corporation on stock owned by it are not net income of the corporation. In that particular case the penalty would be 25 per cent of nothing. It had no application; it just did not fit. It was a hole in the statute, and did not fit the case at which it was aimed.

The CHAIRMAN. If it had income from bonds, of course it would be.

Mr. GREGG. Yes; but the dividends it did not touch at all.

The CHAIRMAN. How would it act in the case of a large corporation, such as the Ford Motor Co., where it is all held within the family?

Mr. GREGG. In a case of that sort the turning point in the act is whether or not the corporation is accumulating earnings of the profits beyond the reasonable needs of the business. I think the committee can recognize, without my discussing it, the difficulty of determining what constitutes an unreasonable accumulation by any active business concern. In the case of a corporation in active business, it is almost impossible to say that it is accumulating its surplus unreasonably, beyond the reasonable needs of the business, if it is putting that surplus back in expansions and developments. If it is putting it in Liberty bonds or something of that sort, we can hold them.

The CHAIRMAN. In a case where Liberty bonds and other securities have been bought by a corporation, what have you done?

Mr. GREGG. If it is beyond a reasonable cash reserve for the corporation, working capital, the tax should be applied. I have never

seen a case where we could prove that it was beyond the reasonable needs of the corporation.

The CHAIRMAN. Take this case, for instance: Suppose company A had been going on for 10 years prior to the enactment of this particular statute, and had been accumulating a cash balance of $25,000, and carried no Government securities or other investments, and then when these excess and other profits taxes came on and the surtaxes were high they increased their cash to two or three times that amount and invested it in Liberty bonds or municipal bonds or any securities, would that not prima facie prove that they were carrying more than was reasonable?

Mr. GREGG. Yes; it would, unless they could show some fact which necessitated this company's carrying more cash or working capital than it carried in prior years.

The CHAIRMAN. How many cases like that have come to your attention that the bureau has given attention to?

Mr. GREGG. I do not think the application of section 220 has ever been computed in more than 25 cases.

The CHAIRMAN. Just why is that?

Mr. GREGG. Because of the difficulty of determining, the impossibility of our saying in 99 per cent of the cases that a corporation in active business is accumulating earnings beyond the reasonable needs of its business.

The CHAIRMAN. Then the bureau has practically nullified that section, because they concluded in advance that it was difficult to execute it. Is not that so?

Mr. GREGG. I did not say that; no, sir.

The CHAIRMAN. I know you did not say it, but I ask you if that is not a fact?

Mr. GREGG. No, sir; I do not think it is.

The CHAIRMAN. Why not, if you only have considered it in 25 cases?

Mr. GREGG. Because it is impossible to say in a case that it is an unreasonable accumulation. We can not sit here and determine what are the reasonable needs of a business.

The CHAIRMAN. I did not ask you that. I asked you how many cases you had gone into to find out.

Mr. GREGG. I answered that question.

The CHAIRMAN. About 25?

Mr. GREGG. Yes, sir; as far as I know, that is all.

The CHAIRMAN. Well, the fact of the difficulty involved does not preclude, as I see it, the bureau from making an attempt to analyze the different returns.

Mr. GREGG. Of course, when I said 25 I meant that those were the only ones where the question has been raised, considered, and determined one way or the other. The auditor, when he is upon a case auditing it, is supposed, and we have instructions in the bureau from the commissioner to the audit sections, that in every case that is audited it should be examined to determine whether the profits are being accumulated beyond the reasonable needs of the business. If so, it should be immediately sent to the solicitor to determine whether section 220 is applicable.

The CHAIRMAN. Well, does the auditor's report in each case determine the fact, yes or no, whether it is a case for that kind of consideration?

Mr. GREGG. He makes no report to anyone saying that this is not a 220 case, but he is given instructions to send them to the solicitor.

The CHAIRMAN. Yes; but when he is going through these records he must determine, if he is really following out the commissioner's instructions, as I understand them, whether or not that case comes under section 220 or not. If not, he should state it.

Mr. GREGG. To whom should he state it?

The CHAIRMAN. On the record. If it is a case, then he should refer it to the solicitor. In other words, you say the auditor determines it. In what manner does he determine it? Is there a record of his determination?

Mr. GREGG. The fact that he does not send it to the solicitor for an opinion shows that he determines that there is no evidence that 220 applies.

The CHAIRMAN. Then, every auditor may determine for himself, no matter how many there are, whether it is a question for the solicitor to consider, or whether it comes under section 220.

Mr. GREGG. Whether section 220 should be raised.

The CHAIRMAN. That is what I am trying to get at—that each auditor will determine that for himself.

Mr. GREGG. Yes; we can not pass on all of them.

The CHAIRMAN. There is no section in the bureau to assign to consider 220?

Mr. GREGG. No, sir. If the question arises, it comes to the solicitor.

The CHAIRMAN. In other words, it is quite evident that the bureau is not taking section 220 seriously. Otherwise they would have set up the machinery to determine in what cases section 220 should apply.

Mr. GREGG. I just cited the order of the commissioner to show that we had set up machinery.

The CHAIRMAN. No; because the auditor may pass it right by without a record. That is no machinery, to tell a man to do something, and then do not see whether he does it or not.

Mr. GREGG. We can not go over every case and see whether 220 should be raised.

The CHAIRMAN. But, as I understand you, you have not gone over any of the cases to determine this, except to leave it to the individual auditor.

Mr. GREGG. We leave it to the auditor, and he then sends it to the solicitor.

The CHAIRMAN. And out of hundreds of thousands of cases, 25 is all that you have found that come under section 220?

Mr. GREGG. That is all I have found; yes. However, in the 1924 act we attempted to plug up some of the holes in section 220. This dividend matter was taken care of, and then the presumption was raised that any investment companies were subject to the penalty imposed by 220. I do not think myself that 220 was ever designed to apply to an operating company, particularly if the stock of an operating company is widely held, and not held simply by a small group or members of a family. I think it was designed to apply to small corporations, such as we have discussed in this committee

before, where the business of an individual is incorporated, for the purpose of accumulating profits of the corporation, and relieving the stockholders of the surtax.

The CHAIRMAN. Where the ownership is largely diffused, then, as you have said, I can see the force of your argument, but coming back to where it is all held, or a great portion of it is held, by one individual, I can not see the force of your argument at all, that they can not be analyzed. Under the 1924 act, in what respect have you set up machinery to catch it?

Mr. GREGG. No new machinery whatever. It is just like everything else. The determination must be in somebody's hands to raise the question. Suppose the revenue agent in the field thinks that section 220 should be applied. He can raise the question or not. Suppose he determines that a loss of the corporation should be allowed or disallowed? He can put it in his report or not. We can not send somebody around checking somebody else all the time.

The CHAIRMAN. What are your rules and regulations to the collectors and investigators of that question of how to determine whether section 220 should apply?

Mr. GREGG. The regulations are published.

The CHAIRMAN. What are they? I just ask you what the regulations are. Is there any basis by which an auditor——

Mr. GREGG. It is general. We do not lay down any rule of thumb.

The CHAIRMAN. It seems to be ridiculous to put those things in the statute if the bureau pays no attention to them, or if it considers them impracticable. That is one of the difficulties in the administration of all laws. We enact ridiculous statutes, which confuse the citizen and the Government, without any effect.

Mr. GREGG. The department is on record as to the ineffectiveness of section 220 of the old act as far back as the early part of 1923. We have been telling Congress ever since then that it was ineffective. The regulations, if you care to read them, begin on page 117 and run through page 119.

The CHAIRMAN. We will not take the time of the committee on that; I would like to suggest to Mr. Manson that he go over them and make a note of them, and then report at one of our other hearings.

Mr. MANSON. I will do that. I am familiar with it, but I will want to refresh my recollection on it before I discuss it.

Mr. GREGG. Section 220 of the old acts was not effective. It was not drafted in such a way that it could be effective. Of course, the time has not arrived to enforce section 220 of the 1924 act. We are not that far up in our audit, but it has been effective in this respect: The penalty is so high and the prima facie case has been increased to cover a new class of cases so that the section has been strengthened to such an extent that it has frightened these people who organized these small corporations, to the extent that a great many of them have been dissolved for fear of the penalty. The penalty is too high to take a chance on. It is 50 per cent of the entire net income, not of the undistributed net income.

The CHAIRMAN. I would like to ask the bureau to advise us some time this week what new machinery has been put in for this purpose, because it is apparent to me that some machinery needs to be set up to really enforce section 220 in the 1924 act other than has

been exercised before. I admit the difficulties, and perhaps there was a sound reason for not taking it seriously prior to 1924, but the solicitor now says it might be taken more seriously than it has been effective in some respects, and I can see where it might be more effective if the bureau knew that the bureau was going to apply section 220.

Mr. MANSON. I might say at this time that I endeavored to make a rather thorough investigation of the application of section 220 in connection with the statistical work that we are doing, and that I have found a large number of cases which, had the 1924 act been enforced, would have been affected by the 1924 act, but that in practically all the cases that I have found—there may be more that have been discovered since I last looked over the schedules—but all of those that I have examined were cases of the kind described by Mr. Gregg. In other words, the corporation was organized to hold stock, not to hold bonds, and in very few cases to hold real estate, but organized to hold stock, and the former acts specifically exempted dividends as a part of the income upon which the penalty was to be applied. The result was that there was nothing to impose a penalty on.

The CHAIRMAN. Mr. Gregg stated that in his statement.

Mr. MANSON. Yes. There is one thing that I would like to inquire about.

Section 326 of the 1918 act defining invested capital permitted the valuation of tangible property exchanged for stock at a higher value than the par value of the stock, but 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.

I will say that we would like to examine that record, and I would like to know where it is, so we may inspect it.

Mr. NASH. I will try to find it.

The CHAIRMAN. I think you will be a long time finding it. I think that it rather a trick question, because I think you know it is not in existence.

Mr. MANSON. Well, I do not want to make any statement. I will try to locate it. I will say frankly that I have not been able to find it, but I do not want to say it is not in existence until I know.

The CHAIRMAN. Have you anything further now, Mr. Manson?

Mr. MANSON. Nothing further this morning.

Senator KING. Is that all you care to say now, Mr. Gregg?

Mr. GREGG. Yes.

Senator KING. Have you anything further, Mr. Nash?

Mr. NASH. No, sir.

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

(Whereupon, at 1.10 o'clock p. m., the committee adjourned until to-morrow, Wednesday, May 27, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, MAY 27, 1925

UNITED STATES SENATE,
SPECIAL 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 King.

Present also: Mr. L. C. Manson, counsel for the committee.

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. A. G. Gregg, solicitor, Bureau of Internal Revenue; and Mr. C. R. Arundell, assistant solicitor, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson, or do you want to put something in now, Mr. Gregg?

Mr. GREGG. Let me put in my statement on the Atlantic Gulf & West Indies Co. at this point. I will read your letter with reference to it, Mr. Chairman.

This is a letter dated April 25, 1925, and is addressed to Commissioner Blair:

MY DEAR COMMISSIONER: It has just occurred to me that there is a possibility that the case of the Atlantic Gulf & West Indies Corporation, whose taxes were the subject of a hearing before the Senate committee, might be considered in connection with the information given me some time ago by one of the staff of the Department of Justice.

I am inclosing you herewith a memorandum dictated in my office by the Department of Justice representative, who drew my attention to the fact that the Department of Justice was defending a suit brought by the Atlantic Gulf Oil Corporation against the United States Shipping Board. The memorandum is self-explanatory.

I hope that it is not too late to take into consideration the claim referred to, as the Atlantic Gulf Oil Corporation is a subsidiary of the Atlantic Gulf & West Indies Corporation.

That is signed by the chairman.

We had the matter gone into, and here is my memorandum to Mr. Nash in reference to it:

Reference is made to your memorandum dated May 1, 1925, with which you forwarded copy of a letter from Senator Couzens, dated April 25, 1925, addressed to the commissioner, to which was attached copy of a memorandum furnished Senator Couzens by a representative of the Department of Justice, concerning a claim of the Atlantic Gulf Oil Corporation against the United States Shipping Board.

It appears that at the time the question of settlement of the Atlantic Gulf & West Indies Steamship Lines' tax liability for the years 1917 to 1920 was under consideration this office made inquiry at the Shipping Board to ascertain whether the Atlantic Gulf & West Indies Steamship Lines had any claims outstanding against the Shipping Board or the Emergency Fleet Corporation. According to the recollection of Mr. Lewis, of the special adjustment section, he and Mr. Milliken, of this office, were requested by Mr. Hartson about July, 1923, to ascertain from the Shipping Board whether there were any such claims. Mr. Lewis states that he and Mr. Milliken were told that it was roughly estimated by the Shipping Board that the then pending claims of the Atlantic Gulf & West Indies Steamship Lines amounted to approximately $500,000. Mr. Lewis is of the opinion that a verbal report to this effect was made either to Solicitor Hartson or Commissioner Blair. Mr. Milliken's recollection is substantially in agreement with that of Mr. Lewis, although he does not recall definitely what report was made except that no written report was rendered. Mr. Lewis and Mr. Milliken both state that the Shipping Board gave them no information whatever concerning the claim of the Atlantic Gulf Oil Corporation for $5,000,000, which claim was based on an alleged breach of contract by the Shipping Board under the terms of which the Atlantic Gulf Oil Corporation was to furnish and the Shipping Board to accept 15,000,000 barrels of oil during the year 1921. Further investigation has developed the fact that this claim was not one of the matters handled by the claims division of the Shipping Board, but was handled in regular course by the law division of that board. This may account for the fact that no information was given Mr. Milliken or Mr. Lewis concerning this particular claim at the time their inquiry was made.

Now, here is the important point:

Furthermore, this office was not on the lookout for any claims by the Atlantic Gulf Oil Corporation against the Shipping Board, inasmuch as the said corporation and the Atlantic Gulf & West Indies Steamship Lines had previously been held by the bureau to be not affiliated.

Later, in November, 1923, Mr. Hartson directed Mr. Deibert, of this office, to make an inquiry in connection with the claim of a subsidiary of the Atlantic Gulf & West Indies Steamship Lines on account of the loss of the steamship *Carolina*. Mr. Deibert submitted a report of his investigation of that claim to Mr. Hartson on November 13, 1923, to the effect that it was found that the New York & Porto Rico Steamship Co. had obtained a judgment in its favor in the Court of Claims on account of the steamship *Carolina* amounting with interest to approximately $1,351,000.

It should be observed that the compromise settlement made by the department with the Atlantic Gulf & West Indies Steamship Lines and its subsidiary companies provided that the United States should accept the terms proposed, namely, "$1,280,000 in lieu of tax liability for the years 1917 to 1920, inclusive, and ad valorem fraud penalty for the year 1920, the New York & Porto Rico Steamship Co. (of Maine) to release to the United States the judgment in its favor of the Court of Claims on account of the loss of the steamship *Carolina*, amounting with interest to approximately $1,351,000, and any and all claims of any nature whatsoever growing out of the loss of the steamship *Carolina*."

This compromise agreement was approved by the Secretary on January 5, 1924.

In the offer of compromise and the acceptance thereof there are enumerated as parties to the agreement the Atlantic Gulf & West Indies Steamship Lines and certain specifically named subsidiaries thereof, but no mention whatever is made of the Atlantic Gulf Oil Corporation.

It is of interest to note also that in the annual reports for the years 1920 and 1921 of the Atlantic Gulf & West Indies Steamship Lines to its stockholders the statement is made that in presenting to the stockholders the consolidated balance sheet of the parent company and its subsidiary companies, together with the consolidated income account and profit and loss account for each of the respective years, said statements do not include the figures for the Atlantic Gulf Oil Corporation and certain other corporations named "inasmuch as your corporation does not own substantially the entire capital of these enterprises."

Mr. Lewis has again examined the file of the Atlantic Gulf & West Indies Steamship Lines and finds that no mention of the Atlantic Gulf Oil Corporation's claim is made therein or in the balance sheets of the former corporation.

The affiliations section held that for 1919 and 1920 the Atlantic Gulf & West Indies Steamship Lines and the Atlantic Gulf Oil Corporation were not affiliated, for the reason that while the former owned 53.75 per cent of the stock of the latter there remained a minority stock ownership of 46.25 per cent. Consequently, even if the bureau had been aware of the $5,000,000 claim of the Atlantic Gulf Oil Corporation against the Shipping Board, it is obvious that under a ruling that the two corporations were not affiliated the Atlantic Gulf Corporation's claim would not have been taken into account in compromising the tax liability of the Atlantic Gulf & West Indies Steamship Lines and its subsidiaries for the years 1917 to 1920.

Since the receipt of your memorandum the special adjustment section has requested the affiliations section to review the question of affiliation between the Atlantic Gulf & West Indies Steamship Lines and the Atlantic Gulf Oil Corporation. In order to comply with that request the affiliations section has already written to the Atlantic Gulf & West Indies Steamship Lines for certain additional data deemed necessary to reach a proper conclusion, inasmuch as the affiliation was originally denied on the sole ground of large minority stock ownership as above indicated.

In view of the fact that the question of affiliating these two corporations for the year 1921 and subsequent years has not been determined, the question of the tax liability of both corporations for those years may be reviewed and a deficiency tax be proposed for assessment if the facts warrant such action.

Officials of the Shipping Board are of the opinion that the Atlantic Gulf Oil Corporation will not be able to establish its claim in full before the Court of Claims, and are rather sanguine that the claimant may not be able to recover any of the anticipated profits alleged to be due.

The facts are, in other words, that this company that had the $5,000,000 claim against the Shipping Board was not a party to this compromise settlement, so we had no right to consider its claim in settling with the other corporation.

The CHAIRMAN. Even though it owned 53 per cent plus of the stock?

Mr. GREGG. No, sir. If they are different taxpayers and not affiliated, we would have no right to consider it. It is only in cases where they are affiliated that we have a right to consider it.

Mr. MANSON. Is not the real question of the settlement, the compromise of tax liability, the question of the ability of the Government to collect? Then the value of the stock owned by the Atlantic Gulf & West Indies Co. in the Atlantic Gulf Oil Corporation might depend very largely upon the soundness of its claim against the Government. In other words, that claim, as I understand it, of some $5,000,000 would materially affect the value of the stock owned by the Atlantic, Gulf & West Indies Co. in that company, and would have an important bearing at the same time upon the question of the amount of money that could be collected from the Atlantic, Gulf & West Indies Co.

Mr. GREGG. Your case there is rather remote. The parent company owned 53 per cent of the stock of the Atlantic & Gulf Oil Corporation and the oil company had a claim against the Government the validity of which is very questionable. We were not on notice in our compromise settlement about that claim, and that is the explanation of why no account was taken of it.

The CHAIRMAN. Has the bureau anything further that they want to put in this morning?

Mr. GREGG. No.

Mr. MANSON. During the proceedings of yesterday there was some discussion of section 220 of the acts of 1921 and 1924, and the chairman made the statement that before the conclusion of these hearings,

which must conclude this week, he desired to hear me upon that subject.

When I first became connected with this committee it was in the capacity of statistician, and in preparing the questionnaire for information I had section 220 of the acts of 1921 and 1924 under consideration. The questionnaire was prepared with the view to bringing out such information as would throw light upon both the administration of section 220 and the economic questions involved in section 220.

In setting up classifications of corporations for statistical purposes we had the same object in view, and provided for the automatic classification of such corporations as section 220 might apply to.

Before I had had the opportunity to go much deeper into the question than I have just indicated to you I was placed in charge of the tax end of this investigation, and since then I have had no opportunity to give the subject the study which it merits. I have from time to time examined such returns as might come under the application of section 220. I use the word "might" advisedly here, meaning that the corporations which fall within the classification designated are not necessarily corporations which do come within that section.

This section probably delegates to the commissioner more authority, more discretion, which would be of vital consequence to the taxpayers of the country generally than any other section of the income tax law. Among other things, it delegates to the commissioner the right to determine whether or not accumulations of earnings are reasonably necessary for the conduct of the corporate business. That, in effect, gives to the commissioner, if he chooses to exercise that authority to the full extent delegated by Congress, a right to review the financial managements and to act as a sort of an appellate court over the board of directors in determining the financial policy of every corporation in the United States.

I point that out for the reason that I desire to indicate to the committee the fact that before any intelligent judgment can be formed as to the soundness of the regulations or as to the economic policy behind section 220, or as to whether or not that section should be amended, the most careful investigation of the facts should be made.

What I have done is this: We have called for all returns of corporations for 1923 whose net income, including dividends, which are not legally a part of the taxable net income of corporations, exceeds $50,000, and which distributed less than 60 per cent of their net earnings. That classification would, in my judgment, include all corporations to which section 220 might apply.

Therefore the committee has in its possession the data showing the facts and circumstances in every situation to which section 220 might apply, and a proper examination of that data will bring out all of the problems incident to the administration of that section.

I have brought with me a bunch of returns. I do not know exactly how many they are. They were not selected with any other purpose in mind than that they are cases which come somewhere near the application of section 220.

Before citing those specific cases to the committee, I wish to say that for the reasons I have indicated I have formed no conclusions

upon this subject. The discussion of it, for that reason, is somewhat embarrassing to me; but I do believe that a statement of such problems incident to the administration of section 220 and a statement of the economic problems involved at this time would be helpful to the committee, for the reason that it will permit the members of this committee to consider these problems between now and the time that they meet to adopt a report.

In the first place——

Senator WATSON. Does anybody but an expert know what section 220 means?

Mr. MANSON. Well, I am going to state some of the problems that arise out of it. I am not prepared to say now what, in my judgment, it means. My only reason for discussing it at this time is that I believe that if the committee has in mind, between now and the time they get together to adopt a report, some of the problems that arise here, they are going to be able to think about them in the meantime and perhaps exercise a better judgment than they would if the problems were all thrust upon them at the last minute.

Senator WATSON. I am not so much interested in that as I am in knowing how, if at all, section 220 can be simplified. The Committee on Finance had that question up, as Mr. Gregg will remember. We went over it, and after we had wrestled with it time and again, on many occasions, we all came to the conclusion that we did not know what it meant, and let it go in.

Mr. MANSON. Well, I do not blame you.

Senator WATSON. Of course, Mr. Gregg understood it.

Mr. GREGG. I never claimed to.

Senator WATSON. Well, but we thought you did. At least, you gave the only explanation of it that anybody ever did. Doctor Adams went over it and, of course, we had great respect for his knowledge and ability. I talked with him privately about it and we were trying to see if there was not some way in which it could be simplified, so that the wayfaring man, though a fool, need not err therein, but found that it could not be done. The problems with which it dealt were, in their nature, so abstruse and complex that the language dealing with those problems, of necessity, could not be expressed plainly and simply, as was the case with the other tax sections.

I might say in connection with my statement that the members of the Finance Committee did not know what it meant or were not able to come to a conclusion about it—was too drastic and sweeping. We all had our ideas about what it meant, of course.

Mr. MANSON. It was something like section 220 itself.

Senator WATSON. Yes; and while we did not all exactly agree as to some of the conclusions that might be drawn from it, nevertheless, I think we all came to something like a real conclusion as to what it was, at all events, intended to meet.

Mr. MANSON. It is not my purpose to read section 220 and the regulations at this time, but in order that whoever reads this record may get a connected story I suggest that the reporter incorporate section 220 and articles 351, 352, and 353 of regulations 65 into the record at this point.

Senator WATSON. How long is section 220?

Mr. MANSON. The section is not particularly long, and I will read it:

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section, the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

In order that the record may be clear, I will state that the effect of subdivision (d) is to include in income, for purposes of the penalty or the tax imposed by this section, the dividends of corporations upon stock owned by the corporation in question.

Senator WATSON. You say that that is the effect of it or the purpose of it?

Mr. MANSON. Well, that is both the purpose and the effect of it. I think it is very clear.

Under the 1921 act a penalty of 25 per cent of the net income was imposed upon the corporations provided for in section 220. The net income of a corporation does not include dividends received by it from another corporation; that is, the taxable net income.

Senator WATSON. Yes.

Mr. MANSON. Inasmuch as most of the corporations at which section 220 was directed were corporations which derived their principal source of income from dividends received from other corporations, the purpose of the section was nullified by the fact that the penalty did not apply to their principal source of income.

That is overcome by this amendment in the 1924 act.

The 1924 amendment also adds investment companies to those which are prima facie organized or utilized for the purpose of escaping tax.

The object of this section is probably not open to dispute. It was found when taxes were raised on individual incomes that corporations were being utilized for the purpose of accumulating income, and thus preventing their being taxed under the surtax brackets.

The difficulty with the section, in my judgment, both in the framing of the section and in its interpretation by the regulations, is due to the fact that it has a very narrow, if any, economic basis to stand upon.

The determination of whether or not the penalty of this section is to be imposed depends upon the purpose of the taxpayer. The section provides certain prima facie evidence of what that purpose shall be, but it is manifest that whatever the purpose of a taxpayer may be in accumulating earnings the effect upon the taxpayer and upon the Government is exactly the same.

In other words, if a corporation legitimately needs its undivided earnings for the development of its incorporated business, for the payment of its debts, the effect upon the taxpayer and upon the Government is not different- because its purpose there is to serve a legitimate purpose—than would be the effect if it did not need that money and accumulated it for the sole purpose of defeating the tax.

In both instances the money escapes individual income tax.

The CHAIRMAN. How long are the regulations of the department, Mr. Manson?

Mr. MANSON. There are about two pages of them here. Does the Senator desire to have them read?

The CHAIRMAN. I raised the question of the regulations yesterday.

Mr. MANSON. I am going to discuss these regulations, and am going to read them from time to time.

The CHAIRMAN. That will be all right.

(The regulations referred to are as follows:)

ART. 351. Taxation of corporation utilized for evasion of surtax: Section 220 of the statute is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of after January 1, 1924, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 230 of the statute.

ART. 352. Purpose to escape surtax: Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 220 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its stockholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

ART. 353. Unreasonable accumulation of profits: An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to penalize reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for the year in question. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus, and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations, after the effective date of this act, with the purpose of enabling their shareholders to escape surtaxes on such gains and profits, which subject such corporations to the additional tax imposed by section 220. The financial condition of a corporation at the close of the taxable year in question, the manner in which its funds are invested at that time, determines the reasonableness of the accumulations.

For the purpose of section 220 the term "net income" means the net income of the corporation as defined in section 232 increased by the sum of (1) the amounts received as dividends and not allowed as a deduction by section 234 (a) (6), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The commissioner or any collector may require any corporation to furnish a statement of its gains and profits, the names and addresses of and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed.

Mr. MANSON. The first question——

Senator WATSON. Are the regulations intended to illustrate or elucidate the section?

Mr. MANSON. The regulations are intended to elucidate the section.

The CHAIRMAN. And they were written after the 1924 act, or after the 1921 act?

Mr. MANSON. A part of them were written after the 1924 act, and a part of these regulations were carried over from the 1921 act.

Senator WATSON. This same section was not in the 1921 act and in the 1924 act, was it?

Mr. MANSON. There have been some radical changes in the section since 1921.

Senator WATSON. Certainly.

Mr. MANSON. Yes.

Senator WATSON. Therefore, the regulations that were written to elucidate or explain the sections of the 1921 act may not be explanatory of the 1924 act.

Mr. MANSON. The regulations have been radically changed in the same way as the statute has.

Senator WATSON. Oh, yes.

Mr. MANSON. This section makes a holding company or an investment company which accumulates its profits, prima facie evidence; that is, in the case of a holding company or investment company, the fact that it is a holding company or an investment company is

prima facie evidence of an attempt to defeat the surtax, provided the company accumulates its profits.

Right there you have a problem. There are some cases which will come clearly within section 220. There are some cases that come clearly outside of it. The vast number come between these two.

Let me illustrate: A large New York bond house is incorporated. It accumulates very large business profits or earnings. The business of this corporation is the underwriting of bond issues and the sale of those bond issues to the public.

It can not be said that that corporation is a mere holding company, because it is engaged in the very active business of buying and selling bonds. It can not be said, no matter to what extent it accumulates its earnings, that those earnings are not required for the corporate business, because there is no year in which that corporation, notwithstanding the amount that it accumulates, is not required to go to the banks and borrow money for the purpose of financing the underwriting of bonds.

As long as a corporation is doing a business which requires it to borrow money from the banks it is certainly impossible for the department to say that it does not need its own money.

There is a case that comes clearly outside of the operation of this section. That corporation has at times idle capital. That capital has not been permitted to remain in cash. They carry the bonds and stocks to keep that capital working while it is not required for the regular business of the corporation.

We have at the other end of the line, as it were, the case of an individual who owns several million dollars of stock. There is no change in his holdings. He organizes a corporation to hold his stock. The only purpose of that corporation is to collect the dividends and accumulate them.

There is a clear case that comes under the application of this section.

The regulation adopted in construing this section confined the application of the section to the latter class of cases.

Section 220 of the statutes is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon the stockholders, through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of after January 1, 1924, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 230 of the statute.

Article 352 says that where a corporation has practically no business except holding stocks, securities, or other property, and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business, it is prima facie evidence of a purpose to escape the surtax.

I call special attention to the language "where a corporation has practically no other business except holding stocks, securities, or other property and collecting the income therefrom or investing therein."

An examination of the individual income-tax returns of men of large wealth discloses the fact that those men do not have all of their eggs in one basket. They do not carry all of their investments in one stock, and from time to time, as market conditions change, they buy and sell. In other words, their investments are constantly undergoing change. Those men are constantly studying the stock market with respect to the particular class of stock in which they are interested.

Senator WATSON. Is the object of this talk by you, Mr. Manson, to lead us to conclude that we ought to change the phraseology of this section, or that it is not being correctly administered as now stated?

Mr. MANSON. No; the question came up here yesterday, and I was asked to express my views on this section.

The CHAIRMAN. In answer to Senator Watson I might say that at a previous meeting Mr. Gregg was asked to report how many cases had been dealt with under section 220, and he made a very brief statement in connection with it. I then asked Mr. Manson to deal with his observations of it, since he has been on this investigation, for the purpose of bringing before the committee how the rules and regulations were applied and what the effect was. As to what we might do with it afterwards would be a matter for us to decide after he presented the case.

Senator WATSON. Well, but he started out by saying that he has not any conclusion on the subject.

Mr. MANSON. I can not say that I can make a single recommendation at this time.

Senator WATSON. That is the reason I was wondering what the object of the talk was.

The CHAIRMAN. It was to put the facts before the committee, Senator.

Mr. MANSON. There are certain problems presented by this section. I believe it important that the committee should have at least those problems in time so that they may consider them between now and the time you come to make your report.

I have stated two cases here, one of them an investment company, where an investor has an investment which is put into the hands of a corporation to hold, and where there is practically no change in its investments.

There is a clear case that comes under section 220, both as the act is written and as the section is construed by the department.

I have called attention to the fact that investors seldom hold investments without change. There is a constant buying and selling. If a corporation is organized to do exactly what the individual would do if he had that stock in his own hands, it is probably the kind of a corporation that was intended to be met by this statute; but at least in one class of cases it is doubtful whether the statute, at least as defined by the department, does cover it. That is this case.

Mr. GREGG. Let me say this word on that, Mr. Manson: You refer to a case where the incorporated business is changing its investment.

Mr. MANSON. Where it is changing its investment; yes.

Mr. GREGG. And increasing its investments.

Mr. MANSON. Well, not necessarily increasing them; but it does what the individual investor does.

Mr. GREGG. That was the case that we had in mind in putting in the presumption with respect to investment companies. The regulations contain no definition of an investment company.

Mr. MANSON. I intended to call attention to the fact that there is no definition of an investment company here. But here is where the problem becomes a troublesome one: An investment company is owned by one man or by a family. They, for the purpose of evading the tax, have organized this company, and have transferred the stock that they hold in different companies to this company. Now it becomes a question of applying this section to them. They are not keeping the same stock. They are selling the stock as the market conditions make it advisable for them to sell, and they are buying stock whenever they deem it proper to buy.

There is an investment company, and that comes clearly within this section, you say?

Mr. GREGG. I did not say that.

Mr. MANSON. No; I do not mean that you said it. The claim is set up by the department, we will say, that there is an investment, that it is doing just exactly what the individual did before he organized it, in handling his own investments. The individual comes along and says, "This is not an investment company. I am dealing in stocks and bonds. That is my business." Where are you going to set up a line of demarcation between an investor and a dealer?

It is very clear that the dealer that I have first described does not come under this section. It is very clear that the investor who keeps his investment intact and does not change it does come under this section.

Senator WATSON. Now, you have asked a question. How do you answer your own question?

Mr. MANSON. I do not answer it. I frankly stated at the outset here that my investigation of the question is so incomplete that I am not prepared to answer it. I did state that the purpose of my discussion this morning was this: In the first place, I was requested yesterday by the chairman to express my views——

Senator WATSON. I am not making any point about it at all.

Mr. MANSON. And, in the second place, I deemed it to be of benefit to the committee to know what problems were involved here, so that they could think about it during the next few months.

The CHAIRMAN. Let me say in that connection that I think we have a general understanding of those problems that you have enunciated. You might now read a few of the cases which typify the problems.

Mr. MANSON. Permit me to conclude this illustration.

Senator WATSON. I did not aim to interrupt you at all, Mr Manson.

Mr. MANSON. No.

Senator WATSON. I have no objection to your statement, but, as you go along, you state the problems, and then you state that you have not come to any conclusion about them, and I have been wondering whether there was much to be gained by a mere stating of the problems.

Mr. MANSON. I did not state that I am not coming to a conclusion. I have tried to avoid coming to conclusions about anything until I knew I had the facts.

What I want to point out is this: That the bureau has had before it in other cases the question of what constitutes a dealer in securities. The question has been raised with respect to inventories. In other words, a dealer in securities is permitted to value his securities at the beginning and the end of the year, the increase in the value becoming income, and the decrease becoming an offset as against income.

For the purpose of determining who is a dealer in that connection, the bureau took the position that a man must have an office; he must hold himself out to the public as a dealer.

The question arose as to whether or not the fact that such a person, who was not a member of the stock exchange, but who had another broker make all of his sales and purchases, was a dealer. The bureau ruled that he was a dealer, even though he employed another dealer to make his sales and purchases.

Now, applying those same precedents to the application of section 220, we have this situation:

There is no company that has ever been organized for the purpose of evading the surtax by putting its securities into the hands of a corporation organized for the purpose of holding them, which does not from time to time change those securities, selling some and buying some. All that corporation needs to do is to rent a cubby-hole in an obscure building and put a sign on the door "Dealer in securities."

Senator WATSON. A hole in the wall?

Mr. MANSON. Yes; a hole in the wall, and put a sign on the door "Dealer in securities," and under the precedent which has been established, section 220 has no application at all.

Senator WATSON. We have discussed that all over and over again, Mr. Manson. I do not remember whether Senator King was present or not.

Senator JONES of New Mexico. Yes; and I stated at the time that the section would never have any practical effect, and I do not believe it has had. The thing to do is to try to equalize or to do away with the disparity in taxation as between individuals and corporations. That is the only remedy that I know of for the problem.

Mr. MANSON. In my judgment, such judgment as I have, the section is founded upon an economic fallacy, and attempts to treat the symptom of a weakness in the system of taxation. I am not prepared to say that this section is not a good policeman, to use an expression that I heard the chairman use this morning; in other words, that the fear of the application of it may not be a deterrent; but I can see where the section itself is so weak that anyone who is at all clever can get around it, without the least bit of trouble. I want to call attention now to several cases here. Here is the case of the Boma Investment Co. of Denver, Colo. The business stated on this return is investments.

The total income of this corporation for 1923 was $1,545,112.15. Of that total income, $1,320,719.57 consisted of dividends on the stock of domestic corporations.

Mr. GREGG. For what year is this return?

Mr. MANSON. 1923.

The balance of the income consists of interest, rents, and a small amount on the profits of the sale of stock, and that is all.

The net income of the corporation, which was taxed to the corporation, is $200,474.02.

The operating expenses of that corporation, including compensation of officers, taxes, bad debts, depreciation, and sundry office expenses, were about $23,000. The net earnings of the corporation for the year was $1,599,000.

As I have stated, they paid a corporate tax on $200,000. There were no dividends distributed whatever.

The corporation owned no property except stocks, bonds, and buildings, which the income return indicates are rented.

Senator KING. Are what?

Mr. MANSON. The buildings are rented, and that appears to me——

Mr. GREGG. May I ask how the stock of the corporation is held; by whom?

Mr. MANSON. Belle B. Bonfils is vice president, and holds 1,279 shares; Helen Bonfils holds 635 shares; and May V. Berryman holds 635 shares. They each draw a salary of $3,000 a year. There is no further showing on that.

This appears to be a family corporation. I assume that the president of the corporation, who draws no salary and whose stock holdings are not indicated here, probably holds the balance of the stock in this corporation.

The CHAIRMAN. Was he not required to put in a return, under the law?

Mr. MANSON. The return clearly calls for the stock held by the salaried officers.

This is a case—if this is a holding company, as I believe investigation will show it to be—upon which the 25 per cent penalty provided in the 1921 act would produce an additional tax of about $50,000.

The CHAIRMAN. In this connection, let me state that Mr. Gregg yesterday said that the auditors were supposed to draw to the attention of proper officials cases where they thought section 220 might apply. I would like to ask Mr. Gregg if he does not think that this is the kind of case that might be drawn to the attention of the officials.

Mr. GREGG. It certainly should have been; yes, sir. Has that case been audited?

Mr. MANSON. I do not think it has been audited; no.

Mr. GREGG. I am perfectly certain that it has not been audited.

Mr. MANSON. I am merely using it as an illustration of the kind of case that was developed.

Mr. GREGG. Of course, under the 1924 act, the penalty would have been about $750,000.

Mr. MANSON. About three-quarters of a million dollars, except this: That under the 1921 act it was not necessary for those people to camouflage the real nature of this corporation.

Under the 1924 act, all they need to do is to set themselves up as dealers in securities. I know that, under the regulations, they

would not be considered to come within section 220, and I doubt whether that section even could be construed to cover it.

Mr. GREGG. I do not agree with that. It seems to me that section 220 would cover this case, from the facts as stated. There may be other facts, however.

Mr. MANSON. As I say, according to the business done in 1923, when there was no incentive for them to camouflage the corporation——

Senator WATSON. Is that the case of a newspaper?

Mr. MANSON. No, no.

Mr. GREGG. This is an investment company.

Mr. MANSON. It is a sort of investment company.

Senator KING. Is that Mr. Bonfils from Denver?

Mr. MANSON. Yes.

Senator WATSON. He is a newspaper man, and I was wondering whether that was a newspaper case.

Senator JONES of New Mexico. They own a circus, do they not?

Senator WATSON. They tried to have one with section 220.

The CHAIRMAN. This is a man whose name is connected with a Denver newspaper, but this is not a newspaper case.

Senator WATSON. Well, I did not know about that.

Mr. MANSON. This is the case of a corporation, organized for the purpose of holding the stock of other corporations, which actually produced dividends, because the amount of dividends collected by this corporation was $1,320,000.

Mr. GREGG. How much was the profit from the sale of securities?

Mr. MANSON. The profit from the sale of securities was $3,992.63.

Mr. GREGG. Were there any losses?

Mr. MANSON. No losses.

Mr. GREGG. It seems to me that they could not possibly qualify as a trader.

Mr. MANSON. No; but all they need to do is to increase their trading operations to some extent.

Senator KING. I am inclined to think that an investigation will show that this corporation was organized primarily to hold the capital stock of a newspaper, of which Mr. Bonfils is owner.

Mr. GREGG. Of course if that is the case, it could not switch its investments.

Mr. MANSON. No; but this corporation was organized on October 16, 1918.

Senator WATSON. What was it you stated about no return required except from salaried officials?

Mr. MANSON. The return does not call for the names of any stockholders except salaried officials. That is the form of return.

Senator JONES of New Mexico. Is that by reason of express provision in the statute?

Mr. MANSON. No; it is a form of return prescribed by the bureau.

Mr. GREGG. The reason for that is that we want to determine the reasonableness of the salaries in a case where salaries are paid to stockholders.

Senator JONES of New Mexico. Yes.

Senator KING. It might be proper to look into the returns of the newspaper, which is published in Denver, to see if that corporation

which owns the newspaper has not transferred its stock or, rather, the stockholders of that company, to this holding company.

Mr. GREGG. We can find that out direct.

Senator KING. Yes.

Mr. MANSON. Here is another interesting case, that of T. W. Warner Co., of Toledo, Ohio. I ran this case down——

Senator WATSON. Before you go to that case, Mr. Manson, do you think there is something that ought to be done with reference to that that has not been done? That is not a closed case yet. Could any change in the law reach that sort of situation?

The CHAIRMAN. Which case are you talking about?

Senator WATSON. I am talking about this Bonfils case.

Is it a question of law, a question of administration, or a question of the regulations?

Mr. MANSON. I clearly pointed that out in the Bonfils case for the purpose of showing that if they conduct the same operations in 1924 that they had in 1923 they would come under a heavy penalty in 1924, but a very light penalty in 1923.

Mr. GREGG. There was practically no penalty in 1923.

Mr. MANSON. Practically no penalty in 1923; but if it is true that that corporation's principal investment is the stock of a newspaper that they control, they probably would not be in a position to deal very largely in that; but if it was a typical case of the ordinary investor, who has a large line of stocks and who is constantly buying and selling stocks, it would be very easy for them to come under the classification of a dealer, and bring this under the class of dealer, and thereby escape the operation of section 220.

Senator KING. I suggest that the auditors make an investigation of this and other cases, because I think that there are many of these cases. I have heard of many corporations being formed in 1922 and 1923 for the purpose of holding the stock of one or two corporations that were paying large dividends. The holding company was not a dealer at all, but merely a passive, naked trustee, and I think that is so palpably a fraud that they could not avoid the ordinary taxes.

Mr. MANSON. What I have attempted to point out, Senator, before you came in, was that the line of demarcation between a dealer and a holding company is so shadowy, particularly under the precedents which have been established by the department, that it could be crossed with very little trouble. If an investor has a considerable diversity of investments, as most large investors have——

The CHAIRMAN. I take issue with that statement, Mr. Manson. You have repeated that several times this morning, and the first case you develop is the very kind of case that can not change the form of investment, such as you have stated, and many of these corporations which have been formed are identical with the corporations which you have just referred to as existing in Denver, where it is not possible to change the type of investment because they own practically all of it, a well-paying stock in a corporation, and that is the main part, if not their entire wealth.

Mr. MANSON. I base my statement upon the fact that such investigation as I have been able to make shows that about 90 per cent of the large investors do have a diversity of investment, in which they are constantly trading.

The CHAIRMAN. You are probably unfortunate in calling to our attention this as the first case, which is not that kind of a case.

Mr. MANSON. I have not selected these cases. I simply grabbed a bundle of returns, which come somewhere near the subject. I am not trying to make a case one way or the other on this subject. I am simply presenting the facts.

The CHAIRMAN. I think it was indicated, as you started out, that section 220 would catch every kind of a case, such as the one that you have just cited as existing in Denver.

Mr. GREGG. I think section 220 would get that case under the 1924 act, upon the facts as stated.

Mr. MANSON. Referring to this other case, the Warner case. The T. W. Warner Co. were manufacturers of automobile parts. I think they were located at Muncie, Ind. In 1919 they made a deal with the General Motors Co. to sell out their physical assets and their business. At that time, instead of making the sale effective in 1919, they entered into a contract with the General Motors Co. which provided that the General Motors Co. should have an option upon the property of the T. W. Warner Co.; that the General Motors Co. should immediately enter into possession and should operate that property; that the General Motors Co. should deposit with a trustee a certain amount of Government bonds and a certain amount of General Motors stock; that the T. W. Warner Co. should take as the rental of the property, until that option was exercised, the interest upon these Government bonds and the dividends upon this General Motors stock. In 1921 the option was exercised and the title passed. Thereafter, the T. W. Warner Co. had no assets other than the Government bonds and the stock.

In 1921 T. W. Warner's share of the net earnings of the T. W. Warner Co. was $693,600. For that year he reported a deficit of $9,821.41.

In 1922 he received dividends from the T. W. Warner Co. of $102,816, and reported a net income of $97,985.94.

In 1923 the dividends from the T. W. Warner Co. were $14,137, but his share of the undivided profits was $502,945. In that year he reported an income subject to surtax of $25,772.

During all that period of time, as I have stated, the company had no assets other than securities——

The CHAIRMAN. And you say that those securities were not traded in at that time?

Mr. MANSON. Yes; they were traded in to some extent. In 1923 the profits from the sale of stock was $612,799, and the dividends were $112,879.20; so that the trading profits far exceeded the dividends in that year.

Had the earnings of this company been distributed as dividends in 1921, the net taxable income of Warner would have been $683,778.59, instead of a deficit of $9,821.41.

In 1922 it would have been $107,807.35, instead of $97,985.94, and in 1923 his net income would have been $528,717, instead of $25,772.

The CHAIRMAN. Just what percentage of the company did he own? Does the record show that?

Mr. MANSON. Yes. He owned approximately seventeen twenty-fifths. There were 25,200 shares of stock outstanding, of which he owned 17,111.

The CHAIRMAN. Does the record show who owned the balance of the stock?

Mr. MANSON. No; I was unable to find out who owned the rest. I do not think there is a particle of difficulty in that company establishing a status as a trader.

Senator JONES of New Mexico. What difference would it make in the amount of tax there if the earnings of the company had been distributed as dividends?

Mr. MANSON. I have not attempted to compute that; but under the circumstances he would have had an income of nearly $700,000 in 1921, as against a deficit of $9,800.

Senator JONES of New Mexico. How does he get that deficit?

Mr. MANSON. He has deductions of losses on stock. He gets a salary from T. W. Warner Co. of $25,000. He had other salaries of $29,750; interest, $9,465; dividends other than from the T. W. Warner Co., $22,611.75. His total gross income was $76,506.40. He sets up losses on the sale of stock of $80,753.79, and taxes, $5,574.02, which gives him total deductions of $86,327.81, or a deficit of $9,821.41.

Senator KING. What finally became of that enormous sum that was held there as reserves?

The CHAIRMAN. In that connection, let me say this, Senator: This case has not been closed. It is a 1923 case.

Mr. MANSON. In 1923 they distributed a stock dividend of $480,000 and added about $250,000 to their surplus.

The CHAIRMAN. And distributed what per cent of their earnings?

Mr. MANSON. In 1923 there were cash dividends.

Senator KING. And their earnings were what?

Mr. MANSON. $753,730.76.

Senator KING. Do you think a proper interpretation of the statute would permit such a palpable evasion in order to escape taxes?

Mr. MANSON. I believe that this company was subject to the 25 per cent tax in 1923, and that 25 per cent tax would be a very substantial one. The most of their earnings for that year were profits from the sale of stock, instead of dividends.

Senator KING. May I suggest, Mr. Nash, in view of the numerous complaints which have been made to me, and doubtless to other Senators, as well as to the bureau, that many of the corporations were organized or availed of for the purpose of evading taxation in 1923 and 1924, the audit sections should scrutinize pretty carefully these returns?

Mr. NASH. I think, Senator, such instructions have been issued to the audit sections, and also to the lawyers in the solicitor's office who are passing on these cases. The returns that are being presented here were filed for the year 1923 and have gone through a preliminary audit, in which the mathematics has just been verified. The principles upon which the returns have been rendered have not been examined.

Senator JONES of New Mexico. I was just wondering whether any special attention has been given to the constitutionality of the statute against a corporation being availed of.

Take that particular case. There is a corporation which existed and was doing business. It is winding up its affairs. The result is that the taxpayer does not pay much tax, but what right has the

Government, in the exercise of the power to tax income, to force a corporation to distribute its earnings? I do not see how you can question that transaction, or reach it, rather, other than through a tax upon the corporation itself.

Mr. GREGG. Of course, section 220 applies to the corporation itself, Senator.

Senator JONES of New Mexico. But how can you, in the absence of some provision for taxing a corporation, say that that is a fraud upon the Government?

Mr. GREGG. We do not have to say it is fraud, if it is——

Senator JONES of New Mexico. I know; but the intent to avoid taxation is what you reach, and how can you say that that is such an attempt? For aught we know or can tell, they keep the assets of the corporation; they may want to invest them some other way in the name of the corporation.

Mr. GREGG. Under the statute we do not even have to go to intent.

Senator JONES of New Mexico. I wonder, from a constitutional standpoint, how you can apply it to a thing of this sort.

Mr. GREGG. The constitutionality has been questioned. It seems to me that we can go rather far in prohibiting, by attacks on the corporation itself, a tax on the income of the corporation, this attempt to evade taxes. We can go pretty far in preventing such action.

Senator WATSON. You mean a penalty?

Mr. GREGG. Yes, sir; it is called a tax. It does not say it is a penalty. It is a penalty, however.

Senator WATSON. It is a penalty?

Mr. GREGG. Yes.

Senator JONES of New Mexico. Under existing law the only object or any other result that could have been brought about other than that which happened in through requiring that this corporation declare dividends. I do not think you can require a corporation, for taxation purposes, to do anything.

Mr. GREGG. You can not do that.

Senator JONES of New Mexico. You have to meet the situation that the law itself covers and impose a tax. I do not see anything in the present law which would impose a tax under the circumstances here, if it were organized with the intent of doing this thing and using it, and so on, that is one thing.

The CHAIRMAN. Well, it was in this case——

Senator JONES of New Mexico. No; here is a corporation which has been in existence for some time, doing a regular business.

The CHAIRMAN. No; I think the Senator is wrong on that.

Senator JONES of New Mexico. I am talking about the Warner Co. case.

The CHAIRMAN. I think the Senator is wrong about that, too, because this corporation was organized to receive from the General Motors Co. the moneys and the returns for selling the physical property of the Warner Co.

Mr. MANSON. No; the T. W. Warner Co. was an old corporation.

Senator WATSON. They are an old corporation, out in Muncie, Ind.

Mr. MANSON. And it was engaged in the business of manufacturing automobile parts. In 1919 it sold out its business.

The CHAIRMAN. And the company was organized to avoid a sale.

Mr. MANSON. To avoid a profit on the sale until the tax was reduced, or at least until they expected it to be reduced.

The General Motors Co. went into possession of the property, and the Warner Co. collected the dividends on the Motors Co. stock and the interest on the Government bonds which they took as the purchase price. The title did not pass until subsequently, until 1921. From 1921 this old corporation had no property other than these Government bonds and this stock, and from then on it was availed of and kept alive for the sole purpose of carrying those investments.

Senator KING. It seems to me that that is a subterfuge, Senator Jones, which Congress would have a right to deal with, whether you call it a tax upon undistributed profits, or whether you call it a penalty or a tax upon earnings, which they got there, and which, in effect, they distributed, but availed themselves of a corporation for the purpose of holding it. It seems to me the law would strip aside all of that flimsy paraphernalia to get at the intent and purpose.

Senator JONES of New Mexico. That company was doing a legitimate business. It received these stocks and bonds in payment for its property, and of course collected the dividends and coupons on its stocks and bonds. Now, to say that that is availed of would be to force a corporation to a distribution of its dividends.

I quite agree that we can reach the matter, but not through the provisions of section 220. We can reach it by imposing upon the dividends received by that corporation a tax on what is undistributed, and it there becomes a tax upon income.

Senator KING. Senator, what would you do in a transaction like this, where A sells to B. B gets the property; he draws the dividends upon the stock, and he gets the Government bonds which are given to him in part payment, but he does it under the guise of an option.

Senator JONES of New Mexico. I am not going into the option feature of it. That is another matter.

Senator KING. Until the taxes are lowered.

Senator JONES of New Mexico. That option matter is another thing, an independent thing entirely. I am speaking of what happened after the option was exercised.

Mr. MANSON. Suppose that company would come in and show they expected the market on the stock that they held to improve? We will say that you adopted some legislation which was intended to compel them to distribute their assets——

Senator JONES of New Mexico. I do not see how you can compel a distribution of assets under an authority to tax income.

Mr. MANSON. I do not, either; but suppose you attempted to impose a penalty here, because they did not under the income tax law? They might be able to come in and show that they were not holding this property to escape tax, because they expected the market on General Motors stock to go up, and that the market conditions were unfavorable, and that they wanted to hold that stock until the market on General Motors improved. That would be a perfectly legitimate reason.

Senator JONES of New Mexico. And they might want to use this corporate entity here for the purpose of engaging in some other line of business.

Mr. MANSON. Yes.

Senator JONES of New Mexico. And keep these assets for that purpose.

Mr. GREGG. I would like to come back to that question, Senator. In this case, if section 220 were applied, it would be on the theory that this corporation had not distributed its income. The Government has lost the surtax on those undistributed earnings. Therefore we will levy on the corporation a 50 per cent tax on its earnings. Now, from a constitutional point of view, what is the difference between that and a tax which was levied automatically, a graduated tax on undistributed earnings of a corporation?

Senator JONES of New Mexico. What is the difference between that and the case of the Santa Fe Railroad, for instance, which distributes in dividends just about one-half of its net earnings? What is the difference between this case and that, except as a matter of degree?

Mr. GREGG. It is a matter of degree, but I was speaking of the constitutionality of the 50 per cent tax. It seems to me that it is constitutional to levy a graduated tax on the undistributed earnings.

Senator JONES of New Mexico. I know, but that tax is not levied here under section 220. This penalty does not apply to the mere fact of holding dividends and holding earnings undistributed. That is not the law. If that were this law, I think that would be true; but when you are doing it under the guise, when your penalty is based upon "availed of" for the purpose of avoiding tax, that is quite a different thing. Because of the mere fact that a corporation does hold its dividends undistributed, I do not think you can go to the intent of it and say that a penalty should apply, because it has the effect of enabling an individual stockholder to reduce his tax.

Mr. MANSON. The regulations adopted under this section recognize the fact that the mere fact that it is a holding company or an investment company is not conclusive; that still the question of the purpose of the corporation in withholding the dividend is to be a fact to be considered, even though you have established the fact that it is a mere holding company.

Senator JONES of New Mexico. Can not the individual always establish some reason, other than the mere avoidance of taxation, in order to justify holding the earnings undistributed?

Mr. MANSON. Assume that the T. W. Warner Co. would come in and say that it was their intention to go into business again. They have gone out of the business that they were organized for, but they say it is their intention to go back into business, and they need more money than was represented by their capital assets, and that they are therefore accumulating these earnings to increase the fund with which they will engage in business.

Senator JONES of New Mexico. Or they could reasonably say, "We have not decided yet what we are going to do with our funds. We may engage in another manufacturing enterprise or we may close out. We have not decided yet what we are going to do."

The CHAIRMAN. That would be cleared up through a graduated tax on corporations.

Senator KING. You would get the money if they did not distribute it, regardless of the intent.

The CHAIRMAN. In this case we would get it anyway under section 220.

Senator JONES of New Mexico. I do not think so.

Mr. MANSON. No.

Senator JONES of New Mexico. No.

Mr. MANSON. The weakness of section 220 is that it involves the question of intent all the way through.

Senator WATSON. Do I understand, Senator Jones, that you are in favor of a tax on undistributed earnings of a corporation?

Senator JONES of New Mexico. I am in favor of a graduated tax, not on the accumulated surplus——

Senator WATSON. Then, the only question, as I understand it, is that you are not in favor of a tax on the undistributed earnings of a corporation, kept for legitimate purposes.

Senator JONES of New Mexico. Oh, absolutely. On the earnings; yes.

Senator WATSON. You are in favor of that?

Senator JONES of New Mexico. Yes.

Senator WATSON. I am talking about undistributed earnings.

Senator JONES of New Mexico. I am talking about earnings which are earned and not distributed during the year.

Senator WATSON. I am talking about earnings put aside for rainy days or to be used in times of depression.

Senator JONES of New Mexico. I would take it before it is put aside.

Senator WATSON. You would tax it immediately, before it became a reserve?

Senator JONES of New Mexico. Yes.

Mr. GREGG. That is what Section 220 does.

Senator WATSON. That is my understanding of Section 220.

Senator JONES of New Mexico. Hold on now. Section 220 is a wholly different proposition. Section 220 involves this question of intent absolutely, and is in the nature of a penalty.

Senator WATSON. Of course, to a certain extent, that is true, and I though that was what it was intended to do and why it was designed; but the question of intent enters in where a corporation is organized for or availed of to escape taxation. The section 220 applies. Am I right about that?

Mr. GREGG. Yes, sir.

Mr. MANSON. The regulations recognize the fact that even when we have established that it is a mere holding company, the question of intent is still present, because they provide here that:

> The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 220 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its stockholders.

Senator WATSON. That becomes a question of intent.

Mr. MANSON. As I construe that, if you can ascribe any other legitimate reason for the accumulation of earnings, instead of mere distribution, you do not come under section 220.

Senator JONES of New Mexico. Absolutely, and you can not frame a section on that basis which would be broader than the present section of the law, and I think the regulations there do very properly lay down requirements and limitations within the scope of the statute.

Mr. MANSON. Here is another case which, in my judgment, illustrates the same abuse, but I do not believe it comes under section 220 at all. This is a case of the Berkeley Arcade Corporation, of New York City. Their business is the operation of an office building erected on a leasehold, leasing the same from the owners and subletting to various subtenants. Their assets consist entirely of this building upon this leasehold. Their income is derived principally from rentals.

Their gross income is $470,942.86. The expense of operating the building, including the ground rent, is $259,828.17, leaving a net income of $211,114.69, of which they distributed in dividends $15,000.

The CHAIRMAN. How many owners are there in that case, or is it just one owner?

Mr. MANSON. The return does not show. It just gives the name of the president of the corporation and shows that he holds 1,535 shares of the stock. The capital stock is $250,000. There is nothing to indicate how much stock there is outstanding or who holds the balance of the stock, if any.

The CHAIRMAN. Was there anything done with the earnings except to hold them in the corporation? I mean, did they carry in cash those surplus earnings?

Mr. MANSON. The surplus appears to be carried in bonds; that is, the principal part of it.

The CHAIRMAN. It seems to me, then, that that might be a case if the surplus is invested in bonds, where it is almost prima facie evidence that it is done to avoid the tax.

Mr. MANSON. All they had to show is that intent to go out and get another lease and build another building, and they are out of the operation of section 220.

Senator JONES of New Mexico. Or that they are awaiting an opportunity to buy stocks or anything else.

Mr. MANSON. Well, that might not be considered a legitimate reason for an accumulation of income.

Senator JONES of New Mexico. The charters of nearly all of these corporations are just as broad as business industry, and they can engage in almost anything. Take a charter issued under the laws of New Mexico or Arizona. You can organize for any legitimate industry, and you can put them all together. You can make their specifications as broad as you can devise language to cover any kind of an enterprise, and there is no reason why a corporation should not say, "We do not know what we are going to do with these dividends or the profits that we have made this year. We may want to use them; we have not decided as yet what we are going to do with them"; and you can not attribute in that case any intent to evade taxation.

Mr. MANSON. Here is the case of the Halsey Stuart Co. and the Corporation Securities Co., Consolidated, of New York. They are one of the largest bond houses in the country.

The net earnings for the year 1923 were $2,583,018.07. They declared $70,000 dividends. They declared a stock dividend of $2,500,000. Their assets are entirely invested in securities, and it is very clear that they do not come under section 220.

We will suppose that instead of Halsey, Stuart & Co., we had Dillon, Reed & Co. They can show that they required $146,000,000 for the handling of the Dodge property, and certainly it could not be said, when they required that amount of money in one deal, that $2,500,000——

Senator JONES of New Mexico. By the way, have we been furnished with the information which we asked for some days ago, as to how much tax had been collected under section 220?

The CHAIRMAN. No; I would not say that we had been furnished with the information. We had a general statement from Mr. Gregg yesterday, but no figures were mentioned.

Mr. GREGG. I do not have any figures.

The CHAIRMAN. Are we going to get the figures?

Mr. GREGG. I can take up the three cases that I have been able to find and ascertain the amount of tax involved in them, but I told the committee that it was trivial. Section 220 of the 1924 act, of course, has not been in operation; but it is better than the old act, much better.

Senator JONES of New Mexico. Well, I anticipated that the amount of tax will not be much more than under the old acts, and I do not think it should be, because these are legitimate transactions.

Take the case of Halsey, Stuart & Co. that you have mentioned there. That, to my mind, clearly does not come within the provisions of section 220.

Mr. MANSON. It does not come within the provisions of section 220.

Mr. GREGG. There are very few cases where you can apply section 220, although I think section 220 under the new law can be applied to the family corporation.

Senator JONES of New Mexico. I consider the Warner Co. a family corporation, now that it is out of the active business for which it was incorporated, and I certainly think the Bonfils Corporation, of Denver, was a family corporation.

Mr. GREGG. From Mr. Manson's statement of the facts, it certainly would appear to me that section 220 would apply to that case.

Senator JONES of New Mexico. I doubt that it is constitutional. I do not think, under an income tax law and under authority merely to levy income taxes, that you can force a dissolution of a corporation.

Mr. MANSON. Here is another case, the Park Avenue Operating Co. of New York. The business is real estate, operating and maintenance. They apparently own an office building or apartment house in New York .

Their net income for 1923 consisted of rents principally. The rents amounted to $1,456,000 plus. Their profits from the sale of realty were $411,000, and dividends on the stock of domestic corporations, $301,000.

The net earnings for the year 1923 were $1,171,441.99. Their dividends were $80,000.

This company owes upon mortgages $5,994,000. The fact that they owe $5,000,000, in my judgment, would be sufficient to take them out of the operation of section 220. It is very clear that a corporation that owes $5,000,000 can say that they did not reserve their earnings for the purpose of evading taxes, but for the purpose of paying their debts.

Senator JONES of New Mexico. How many stockholders did that company have?

Mr. MANSON. This does not show. Here is another corporation, the New Empire Corporation, of New York. The business is stated as owning, purchasing, and selling investment securities.

Their net income for 1923 was $535,700. Their dividends were $80,000—about $81,000. Their assets consist entirely of stock in domestic corporations.

They do not come within section 220 because they are dealers in stock.

Senator JONES of New Mexico. And they would pay very little tax, if any, because the income of the corporation is derived from dividends of other corporations, and the tax has been paid by the other corporations.

Mr. MANSON. Of course, the penalty under section 220 of the 1924 act includes dividends, but here the principal source of income is profits from the sale of stock. That is the principal single item. There was $353,000 out of $765,000 of income that is due to profits. I do not believe it could be successfully——

Senator JONES of New Mexico. And the other $350,000 would come from dividends?

Mr. MANSON. No.

The CHAIRMAN. They are not exempt under the 1924 act, anyway.

Senator JONES of New Mexico. Yes; they are.

The CHAIRMAN. No.

Mr. GREGG. Not under section 220.

Senator JONES of New Mexico. Not under section 220, no; but under the general operation of the income tax law on corporations.

Mr. GREGG. Yes.

Senator JONES of New Mexico. There is only a normal tax assessed against corporations. The original corporation pays a tax on its income; then the corporation pays only a normal tax, and that has already been paid by the corporation to stock this concern owns. Therefore it would not pay any tax.

The CHAIRMAN. Yes; but under the new section 220, if they applied that law, they would pay just the same thing, no matter what kind of income there is there.

Mr. MANSON. Yes; but it is very clear that that case does not come under section 220.

Senator JONES of New Mexico. It is clear that that case does not come under section 220 at all.

Mr. MANSON. Here is another case where a claim could clearly be maintained that this is a dealer.

This is the case of the Pacific Securities Co., of San Francisco.

They have an income from interest amounting to $120,719.49; dividends of $198,294.05; profits from sales of $189,232.92. They received on a claim against the Government for some purpose or

other $154,381.73. Their total net income is $705,622.46, on which they distributed as dividends, $63,423.

I do not think it could be successfully maintained that they came under section 220.

The CHAIRMAN. Have you looked up the records of the Hyva Corporation, which corporation received considerable publicity during the oil investigation?

Mr. MANSON. Yes. I do not think I have that data here.

The CHAIRMAN. Will you get that?

Mr. MANSON. Yes.

The CHAIRMAN. That might be interesting to the committee.

Mr. MANSON. Yes; I have that.

Senator JONES of New Mexico. Have you got the Ford Motor Co. case there?

Mr. MANSON. Our statistics on that are not complete as yet. Here is the case of the Paramount Realty Co., of Newark, N. J. Their income was derived from interest, $92,000; rents, $233,000; profit on sales, $156,000; dividends on stock of domestic corporations, $114,000. Their net income for the year is $398,000, of which they distributed $87,000.

From the amount of profits involved there it is very clear that that corporation does not come under section 220.

Next is the case of Peabody, Houghtaling & Co., Chicago.

Their income from commissions on the sale of securities is $1,272,825.34. In addition to that, there is $86,555.54 interest, $50,180.87 dividends, and the surrender value of a life insurance policy of $20,571.99. The net income is $470,538.53. The dividends are $126,000. It is clear that they do not come under section 220.

Senator JONES of New Mexico. How many stockholders are there in that Peabody, Houghtaling Co.?

Mr. MANSON. There are eight salaried officers who are stockholders, but the bulk of the stock is held by two of these. Alexander Smith holds 1,339 shares; Augustus S. Peabody, 1,569 shares; C. B. Hibbard, 65 shares; Thomas McLaren, 55 shares; Francis Butler, 400 shares; W. S. Lynn, 50 shares; Burton Townes, 210 shares; and W. C. Gibson, 33 shares.

Senator JONES of New Mexico. Does that represent the total stock?

Mr. MANSON. I think that represents the total stock, although there is no way to tell. It checks up pretty closely with the outstanding capital.

Here is the case of Blair & Co., of New York:

Their gross income is $5,027,176.70, of which $536,476 is from dividends and about $600,000 interest. The balance is profits and commissions on sales. Their net income is $2,667,169.98. The dividends are about $700,000 out of $2,667,000.

Senator JONES of New Mexico. How many stockholders are there in that concern?

Mr. MANSON. That schedule is not filled out here, but I happen to know that Blair Co. is rather closely held. I do not think it was incorporated up until a few years ago. I do not think any of those large bond houses were incorporated until recently. The date of incorporation, as shown here, is 1920.

Those are fair samples. I think it is profitable to go through all of these. All of this data will be presented to the committee in concise, tabular form, and I have picked up this bunch of schedules off the top this morning. I just picked them off the top of a pile of schedules of corporations that had no plant investment, but whose investments were entirely either in real estate or stocks and bonds, and which distributed but a small percentage of their net earnings. Among such corporations you will find those to which section 220 would apply, and, of course, they are corporations which have plant investment that it might apply to; but you are most likely to find it among those that have no plant investment.

It is manifest, as we have gone through these, that section 220 does not reach the evil that it was intended to reach, to the extent that I think Congress anticipated that it would.

Senator JONES of New Mexico. I might say here, as one individual Member of Congress, that I never expected that it would.

The CHAIRMAN. Have you any more cases to take up this morning, Mr. Manson?

Mr. MANSON. There is one further observation that I would like to make on section 220 before I take up something else.

Take the case of a manufacturing concern that has a large amount of surplus, and is reserving, we will say, 90 per cent of its earnings. It goes out into the field of investment to find a place to utilize these earnings. It is a consumer of coal. It buys a coal mine. It can not consume all of the coal that economic operation of that mine produces.

The question presented to the commissioner there is whether or not the fact that they went outside and invested in a coal mine is evidence of the fact that they did not need that money for their business.

It is quite clear to my mind that that corporation might be justified, as an incident to its business, in purchasing the coal mine, even though at the time it purchased it it could not use all of the coal that the mine produced. In the first place, you have the question there of whether or not that is incident to the business of the corporation. In the second place, you then have the question of what percentage of the output of that mine would be necessary for that corporation to consume in its business, so that it could be said that the mine was bought as an incident to the former business of the corporation instead of an independent investment.

Senator JONES of New Mexico. If the charter is broad enough to include the different businesses, how can the Commissioner of Internal Revenue restrict it to one line of industry?

Mr. MANSON. Under such circumstances, of course, as applied to manufacturing companies and things of that sort, there is no force or effect to the statute whatever.

If the statute is to be construed as permitting the commissioner discretion, I point out an illustration of that kind to show the vast amount of discretion, and to show that questions are raised that are far more troublesome than any that we have ever presented to this committee in all the work that we have done from the time that we began to hold hearings.

The regulations provide that if a large surplus has been created, and the company goes out and engages in a new line of business,

that may be considered evidence of the fact that they are accumulating their earnings to evade the surtax.

Take an illustration of this character:

An automobile manufacturer has a surplus, which has been actually accumulated to evade the surtax, and he is looking for a field of investment. His agents are selling cars on credit. Banks are financing him. This corporation makes an arrangement with its agent, whereby it will take over the notes that he receives on these cars, instead of having him discount those notes at the bank. That corporation is embarking in a line of business that it was not doing before. It is virtually doing a banking business all over the United States; but can the commissioner say that that is not a necessary incident or a reasonably necessary incident to its original business?

They could come back at the commissioner and say, "There have been times when the Federal reserve banks have shut down on loans on automobiles; they have restricted them, and in order to know that we have a permanent market and to know that we are not going to be interfered with, and in order that the bankers may not cut off our market we have determined, in order to insure a permanent market for our cars, to finance the sale of these cars on the installment plan."

Once the commissioner attempts to pass on questions of that sort I can see no limit to the discretion this act gives him. I believe that the acts vests him with that discretion. I do not know of any case in which he has attempted to exercise it. I can see many cases. There are some of these cases that I have called to the attention of the committee where it is clear that they come within that.

Senator JONES of New Mexico. If the charter of the corporation authorizes them to do that sort of thing, how can the commissioner be vested with lawful authority to say that that is not within the business of the corporation?

Mr. MANSON. The corporation laws of many States will permit a corporation to be authorized to do anything that is not inherently wrong.

Senator JONES of New Mexico. I have had occasion to investigate the charter of the United States Steel Corporation, and that charter is broad enough to cover every kind of imaginable line of business.

Mr. MANSON. They could not run a national bank, but outside of that I suppose they could do anything.

Senator JONES of New Mexico. They could not run a national bank; that is true; but they could own the stock of a national bank.

Mr. MANSON. Yes.

Senator JONES of New Mexico. I think that is true generally of modern charters of corporations, that they make the charter so that it can engage in any line of legitimate business, and then it is up to the directors and stockholders to determine what line shall be the principal line, or which shall be the side line, or a possible line.

The CHAIRMAN. I would like to ask Mr. Gregg if he will not present one of those three cases, so that we may get the theory on which the bureau applied it in one of those cases.

Mr. GREGG. Yes, sir.

The CHAIRMAN. In other words, we have not a single case before us as to how the bureau has applied it in the few cases that it has applied it.

Senator JONES of New Mexico. And if there are three cases, let us have all three of them. I would like to have every case where that section 220 has been applied.

The CHAIRMAN. The number, of course, makes it sound humorous, but, at the same time, I would like an interpretation of how it should be applied, and whether we get any results from the application.

Mr. GREGG. I rather think that the committee, from the remarks this morning, will think that we applied it where we had no authority to apply it.

Senator JONES of New Mexico. If you have made it work, we want to know that. I assume that among all of the taxpayers of the country there are some of them who are stupid, and it may possibly be that you have found two or three stupid ones, and you have caught them by reason of their stupidity.

Mr. GREGG. And not by reason of our alertness.

Senator JONES of New Mexico. Your alertness in discovering the stupidity may be commendable.

Mr. GREGG. The chairman seems to appreciate the humor of that.

Mr. MANSON. Several days ago I called the committee's attention to the fact that in the case of a pulp and timber company the auditors had seen fit to ignore the recommendation of the engineers fixing depreciation rates. That was the case of the Dill & Collins Co.

In that case the auditors raised the depreciation rate from 6½ per cent to 10 per cent.

In this case, which is the case of the Watab Pulp & Paper Co., Sartell, Minn., the auditors allowed a 2½ depreciation rate during the period from 1907 to 1912, 5 per cent from 1912 to 1917, and 7½ per cent for the years 1917, 1918, and 1919, against the protest of the engineers, and the same principles were involved as were involved in the Dill & Collins case.

At that time I made the suggestion that while the spreading of depreciation, when the rate has once been fixed, was a proper matter for the auditors, that in all cases the determination of depreciation rates is an engineering, not an auditing, question, and I offer this case as another illustration on that same point.

The facts in this case, as set forth by the committee's engineer, are these:

Analysis of this case reveals that the same principle is involved as in the case of the Dill & Collins Co. (see office report No. 41, May 8, 1925), namely, the disregard of the recommendations of the engineer by the audit section in making final determination of the amount of tax liability.

The taxpayer's company was organized in 1905 and reorganized in 1920, engaged in the manufacture of pulp and paper.

The principal issue in the case is in the allowances for depreciation of physical property claimed by the taxpayer and finally allowed by the bureau over the protests of the bureau's engineer. It appears that the taxpayer's policy has been to treat depreciation arbitrarily, writing it off only on recommendation of the board of directors.

The revenue agent, in June, 1920, made an examination of the taxpayer's tax liability for the years 1909 to 1919, inclusive, at which it was found that the taxpayer claimed a flat 5 per cent charge for the years 1917, 1918, and 1919. Investigation by the revenue agent into the depreciable assets, using rates allowed by the department, proved this 5 per cent rate fair to both taxpayer and the Government, at which time Mr. Cole, secretary of the taxpayer's company, raised no objection to the use of that rate; in fact, the revenue agent implies that he assented to it. (See p. 2 of revenue agent's report.)

The revenue agent accordingly used this rate, determining the amount of tax due for the three years in question, resulting in net additional liability of $137,052.95. To this the taxpayer took exception and claimed the right to have his tax determined on the basis of depreciation rates, as follows: 2½ per cent for the period 1907 to 1912, 5 per cent for 1912 to 1917, and 7½ per cent for the years 1917, 1918, and 1919, giving as the reason for the high rate in the high tax years the extra amount of wear and tear on machinery due to the abnormal conditions prevailing during those years.

Two valuation reports dealing almost entirely with the matter of depreciation of the taxpayer's physical property were made by the timber section under dates of November 23, 1921, and April 3, 1922, the first reports having found no justification for the taxpayer's use of the sliding scale. This report is very explanatory and is offered as an exhibit in the case. The valuation report of April 3, 1922, also covers the same subject.

Attention is directed to the second paragraph in which the statement is made that the outstanding feature of the case, irrespective of the provisions A. R. M. 106, on which taxpayer bases his claims, the action taken is in violation of articles 143, 161, 165, 166, and 839 of regulations 45. Both of these valuation reports, you will note, were made by Mr. W. Robertson, the engineer in the timber section, who has charge of all matters relating to the pulp and paper industry and who is regarded in that section as a specialist in that line.

A communication throwing light upon the audit section's attitude toward the recommendations of the engineers in this case in particular is shown by the memorandum dated April 11, 1923, to Mr. Fay, head of the division, by Mr. H. P. May, resident auditor. This memorandum appeared to have for its purpose to supply Mr. Fay with information on the case. In the third paragraph there is the startling statement that the revenue agent's report was not based on fact.

In the fifth and subsequent paragraphs of this same memorandum it will be seen that A. R. M. 106 played a very important part in arriving at the result. Another line of interest is the statement that the case should have been closed in the manufacturing section. The "many conferences" referred to as having been held in the manufacturing section and the natural resources division have nothing to show in the way of record. There is only one conference recorded, and that is the taxpayer's conference held November 26, 1921, in which the issue discussed was the effect the solicitor's memorandum 106 will have on invested capital. The conclusions reached were that Mr. Ronan, the taxpayer's representative, would file a statement in support of his position that depreciation deducted for the years prior to 1917 at low rates and for years subsequent to 1917 at high rates is justified.

In my examination of this case I find throughout the files pencil comments and notations by auditors who probably handled the case which are sufficiently indicative that the auditors did not understand the issue involved. It appears that the taxpayer's statement of increased wear and tear, due to abnormal usage during the three years in question, is accepted by the auditors without any further substantiation, and that engineers' opinions and recommendations derived from an apparent exhaustive and impartial study of the case are given such little weight as to be finally disregarded. The revenue agent's recommendations are treated in the same manner.

The question of jurisdiction over the review of pulp and paper companies and the right to final determination is in this case as in the case of the Dill & Collins Co. The memorandum for Mr. Bright, deputy commissioner, dated May 7, 1923, by the chief of the timber section, I find is an accurate review of the case and contains practically all of the salient matters involved. I do not find in the files, however, any reply to this memorandum or any acknowledgment in any form.

A word in regard to A. R. M. 106. This case is an example of the effect of this memorandum in providing the taxpayer and the audit section with the means of disregarding an engineer's recommendations with respect to depreciable property, but so far as I have been able to study A. R. M. 106, my interpretation is that it is weak in providing a basis for argument in the face of articles 143, 161, 165, 166, and 839 of regulations 45. The attitude of the audit section in this case appears to be one of aloofness, at least lacking in

the cooperation which would ordinarily be necessary in the proper review of such an important matter. The stand that the audit section is as well qualified to pass upon matters of depreciation as the engineering division is unreasonable in this case. There is ample evidence in this case that the taxpayer's policy of doubling and trebling annual depreciation rates so that in the high-tax years there are three times the rates in the early life of the plant should never have been accepted by the unit without affirmative evidence being supplied by the taxpayer, which the files do not disclose and which the engineers proved had not been substantiated by the taxpayer.

That method is exactly contrary to the methods so much in vogue in industry, namely, the reducing balance method which has for its basis a system of computing depreciation with the highest rates in the first few years of the life of the property with gradual annual reductions.

In conclusion I beg to say that the result of my examination of this case sustains the opinions rendered and position taken by the engineer.

(The exhibits in case of Watab Pulp & Paper Co. are as follows:)

EXHIBIT No. 1

OFFICE OF INTERNAL REVENUE AGENT,
DIVISION OF MINNESOTA AND NORTH AND SOUTH DAKOTA,
July 29, 1920.

Watab Pulp & Paper Co., Sartell, Minn.—District of Minnesota

Further tax, $137,052.95.

HEAD, INCOME TAX UNIT,
Washington, D. C.
(Attention, Head, Field Audit Division.)

CHRONOLOGY

June 18. 1920. Date of report.
June 24, 1920. Report received, Minneapolis office. Returned for correction.
July 8, 1920. Corrected report received.
July 29, 1920. Report typed for mailing.

Inclosed is a report under date of July 18, 1920, by Revenue Inspector George J. Abel and Revenue Inspector George Thane, covering their investigation of the income and excess-profits tax liability of the Watab Pulp & Paper Co., Sartell, Minn., for the years 1909 to 1919, inclusive, indicating a further tax of $137,052.95, which I recommend be assessed in accordance with this report, if found correct.

Information as to income received by the officers of the corporation, details of which are required by field order No. 5, was transmitted with the officer's report to this office and is retained in the files here for future use and reference.

A copy of this report has been furnished the collector for the district of Minnesota.

Inclosures: Transcripts of income-tax returns for years 1910, 1911, 1912, 1913, 1914. Corporation income for 1915, 1916. Transcripts of corporation income and excess-profits tax returns for 1917.

C. E. BOULDEN,
Revenue Agent in Charge.
By G. W. KURTZ,
Revenue Agent Temporarily in Charge.

Summary

Year	Additional tax	Refund	Year	Additional tax	Refund
1909		$38.49	1917	$64,861.18	
1910		123.89	1918	49,159.79	
1911		485.45	1919	24,374.57	
1912	None.			138,395.54	$1,342.59
1913	None.			1,342.59	
1914		233.47			
1915		75.81			
1916		385.48	Net additional due	137,052.95	

Examining officers: George J. Abel and George Thane.
Examination commenced June 7, 1920.
Examination completed June 18, 1920.
Internal-revenue agent in charge, St. Paul, Minn.

The following report is submitted as a result of an investigation of the income and excess-profits tax liability of the above-named corporation for years 1909 to 1919, inclusive.

Comparison has been made with its retained copies of returns for the years 1918 and 1919 and with transcripts for years 1910 to 1917, inclusive, which are returned herewith. No retained copy or transcript for year 1909 on hand.

Organized May 10, 1905.

Manufacturers of pulp and print and book paper.

There are no intercorporate relationships.

No stock dividends were received in any year.

Relative to admitting the tax: The only officers at the plant are the manager and auditor. They raised no objections, however. The corporation was reorganized in 1920, and Mr. Cole, the auditor, stated the new owners would probably want an accountant to go over our figures.

Officers	Salaries			
	1916	1917	1918	1919
I. N. Bushing, president	$500.00	$500.00	$500.00	$1,000.00
Jacob Mortenson, vice president	500.00	500.00	500.00	
F. A. Leavens, executive committee	500.00	500.00	500.00	1,000.00
Karl Mathie, executive committee	500.00	500.00	500.00	1,000.00
O. L. E. Weber, general manager	7,500.00	10,000.00	10,000.00	10,000.00
Total	9,500.00	12,000.00	12,000.00	13,000.00

We also inclose herewith a report on the income received by the officers as shown by the corporation books per field order No. 5.

The corporation was furnished a copy of our report.

Relative to depreciation: The corporation has claimed for the years 1917, 1918, and 1919 a flat 5 per cent charge on the whole plant, less the real estate. The American Pulp & Paper Association, who are endeavoring to establish uniform cost systems for paper manufacturers, advocate a 5 per cent charge on the whole plant. Mr. Cole believes this to be as close to being correct as any other method; he, however, admitted that for prior years no depreciation was written off except in prosperous years and then only on recommendation of the board of directors. To satisfy ourselves as to the correctness of this depreciation charged we estimated the amount of different depreciable assets and using the rates allowed by the department came within $1,000 of the 5 per cent method. Therefore it was concluded that the 5 per cent rate was fair both to the mill and Government, and in order to save time and a tremendous amount of work in making a segregation, and, after all, arriving at practically the same result, the flat 5 per cent rate was used. The mill owns practically the whole town of Sartell, Minn. In addition to the mill proper and machinery they own a large dam together with water wheels, flowage right for backing up water on certain farms, a generating and water plant which furnishes

water and light to the village, spur tracks, piers, and ice breakers, and houses which are rented to employees. The logs for the pulp mill are purchased outright and depletion does not enter into the cost of operation.

No transcript furnished, no retained copy preserved. Tax paid, as shown by cash book, $1,073.34. During years 1909 and 1910 the corporation closed its books on a fiscal year ending April 30, and in making amended returns it was necessary to prorate earnings for these years; therefore differences can not be explained.

FISCAL YEAR MAY 1, 1908, TO MAY 1, 1909

1. Paid-up stock			$700,000.00
2. Interest-bearing indebtedness			392,500.00
3. Gross income:			
Pulp sales		$160,340.39	
Paper sales		508,743.62	
			669,084.01
Paper cost	$338,723.99		
Commission	4,674.35		
Inventory May 1, 1908	8,261.70		
	401,660.04		
Inventory May 1, 1909	18,603.03		
Cost of paper sales		383,057.01	
Pulp cost	151,312.85		
Inventory May 1, 1908	7,349.00		
	158,661.85		
Inventory May 1, 1909	8,205.93		
Cost of pulp sales		150,455.92	
			533,512.93
			135,571.08
Other debits:			
Repairs not allocated to manufacturing expense		7,624.91	
Depreciation allowed		42,385.34	
			50,010.25
Amended net income			85,560.83
Net per books			137,310.97
Less:			
Depreciation		42,385.34	
Stock premium, credit to profit and loss		9,364.80	
			51,750.14
Amended net income			85,560.83

	Pulp manufacturing expenses	Paper manufacturing expenses
Labor	$28,447.35	$41,018.68
Raw material	103,296.00	151,793.68
Machinery felts and wires	1,331.46	12,816.12
Supplies and repairs	3,097.02	8,682.07
Electric supplies	585.80	1,171.60
Insurance	1,105.24	2,210.48
Oils and grease	515.90	694.30
General expense	4,565.98	9,131.97
Taxes	1,189.84	2,379.80
Interest	7,178.26	14,356.54
Clay, sulphite, alum, color, etc		116,484.23
Fuel		27,984.52
Total	151,312.85	388,723.99

FISCAL YEAR MAY 1, 1909 TO MAY 1, 1910

1. Capital stock			$674,500.00
2. Indebtedness			340,000.00
3. Gross income:			
Pulp sales		$145,174.54	
Paper sales		570,179.50	
			715,354.04
Cost of pulp	$157,042.34		
Inventory May 1, 1909	8,205.93		
	165,248.27		
Inventory May 1, 1910	23,964.75		
		141,283.52	
Cost of paper	392,983.91		
Inventory June 1, 1909	18,603.03		
	411,586.94		
Inventory May 1, 1910	3,253.37		
		408,333.57	
			549,617.09
			165,736.95
Less:			
Repairs not allocated to manufacturing expense		$2,871.46	
Depreciation allowed		43,649.46	
			46,520.92
			119,216.03
Discount on purchases			731.36
Amended net income			119,947.39
Net income per books			138,807.09
Less:			
Additional depreciation		$4,699.70	
Premium on stock sold		14,610.00	
			19,309.70
			119,497.39
Plus donations disallowed			450.00
Amended net income			119,947.39

	Pulp cost	Paper cost
Labor	$29,767.74	$43,405.40
Raw material	107,431.50	145,174.54
Machinery felts and wires	1,163.93	12,847.40
Supplies and repairs	4,194.63	6,691.70
Insurance	1,015.89	2,031.70
Oils and grease	407.28	814.58
Electric supplies and repairs	473.42	946.85
General expense	4,789.82	9,147.66
Taxes	1,416.55	2,833.11
Interest	5,772.58	11,545.18
Pulp stones	609.00	
Sulphate, clay, color, alum, etc.		124,190.62
Fuel		25,949.24
Commission		7,405.93
Total	157,042.34	392,983.91

COMPUTATION

One-third of income May 1, 1908, to May 1, 1909	$28,520.28
Two-thirds of income May 1, 1909, to May 1, 1910	79,964.92
Net income 1909	108,485.20
Net income reported	112,333.85
	3,848.65

Refund due at 1 per cent on above, $38.49.

FISCAL YEAR MAY 1, 1910, TO MAY 1, 1911

1. Capital stock			$1,050,000.00
2. Indebtedness			484,500.00
3. Gross income:			
Paper sales		$497,544.10	
Pulp sales		138,491.55	
			636,035.65
Paper cost	$423,453.77		
Inventory May 1, 1910	3,253.37		
	426,707.14		
Inventory May 1, 1911	22,631.81		
		404,075.33	
Pulp cost	119,169.22		
Inventory May 1, 1910	23,964.75		
	143,133.97		
Inventory May 1, 1911	4,902.80		
		138,231.17	542,306.50
			93,729.15
Less:			
Depreciation allowed		47,792.80	
Losses charged off		8,108.04	
			55,900.84
			37,828.31
Discount on purchases			957.43
Amended net income			38,785.74
Net per books			47,988.78
Less:			
Additional depreciation allowed		$8,843.04	
Premium on stock sold		360.00	
			9,203.04
Amended net income			38,785.74

	Pulp cost	Paper cost
Labor	$27,546.69	$49,704.24
Raw material	70,903.24	151,784.57
Machinery, felts, and wires	593.48	10,748.45
Supplies and repairs	2,718.76	7,243.10
Insurance	1,164.87	2,329.74
Oils and grease	284.08	568.16
Electric supplies and repairs	388.09	1,026.20
General expense	5,433.07	10,866.14
Taxes	3,314.21	6,628.42
Interest	5,880.37	12,060.75
Pulp stones	942.36	
Sulphite, clay, alum, color, etc		133,767.95
Fuel		31,221.04
Commission		5,505.01
Total	119,169.22	423,453.77

COMPUTATION

One-third income, May 1, 1909, to May 1, 1910	$39,982.47
Two-thirds income, May 1, 1910, to May 1, 1911	25,857.16
Net income, 1910	65,839.63
Net income reported	78,228.87
	12,389.24

Refund due at 1 per cent on above, $123.89.

EIGHT MONTHS, MAY 1, 1911, TO JANUARY 1, 1912

1. Capital stock			$1,050,000.00
2. Indebtedness			759,423.30
3. Gross income:			
Pulp sales		$105,355.89	
Paper sales		371,533.04	
			$476,888.93
Cost of pulp	$94,961.42		
Inventory, May 1, 1911	4,902.80		
		99,864.22	
No closing inventory.			
Paper cost	364,466.58		
Inventory, May 1, 1911	22,631.81		
	387,098.39		
Inventory, January 1, 1912	52,656.83		
		334,441.56	
			434,305.78
			42,583.15
Plus discount on purchases			796.33
			43,379.48
Less depreciation allowed			41,522.26
Amended net income			1,857.22

	Pulp cost	Paper cost
Labor	$21,616.50	$40,870.56
Raw material	61,017.00	155,685.36
Machinery felts and wires	724.43	12,747.60
Supplies and repairs	2,562.91	6,220.00
Insurance	1,217.47	2,434.94
Oils and grease	317.18	634.35
Electrical supplies and repairs	580.89	1,161.78
General expenses	3,728.65	7,457.31
Taxes	320.11	640.23
Interest	2,276.28	9,707.57
Pulp stones	600.00	
Sulphite, alum, color, clay, etc		99,815.47
Fuel		22,227.15
Commission		4,864.26
Total	94,961.42	364,466.58

Net per books:		
Stock dividend charged to profit and loss		$18,859.42
Less additional depreciation allowed		17,002.20
Amended net income		1,857.22

COMPUTATION

One-third income, May 1, 1910, to May 1, 1911	$12,928.58
Net income, May 1, 1911, to January 1, 1912	1,857.22
Year 1911	14,785.80
Net income reported	63,331.16
	48,545.36

Refund due at 1 per cent on above.

YEAR 1912

Transcript furnished shows a net income of $970.54 reported and no tax paid. Examination disclosed no taxable income for this year; details are therefore omitted, but can be furnished if desired.

Profit per books	$970.54
Depreciation allowed	73,343.60

Loss.

YEAR 1913

Transcript furnished shows a loss. Examination discloses a loss and no tax due. Details are therefore omitted, but can be furnished if desired.

Loss per books	$21,669.27
Depreciation allowed	77,062.63

Loss.

YEAR 1914

Transcript furnished for this year shows a net income of $23,346.56 reported. Examination discloses a loss for this year and no tax due. Details are therefore omitted, but can be furnished if desired.

Profit per books	$21,377.83
Depreciation allowed	78,809.96

Loss.

Refund due, $233.47.

YEAR 1915

Transcript furnished shows a net income of $7,580.50 reported and tax paid of $75.81. Our examination disclosed a loss for this year and no tax due. Details are therefore omitted, but can be furnished if desired.

Profit per books	$53,851.34
Depreciation charged to surplus	40,000.00
Additional depreciation allowed	40,311.61
Loss	80,311.61

Refund due, $75.81.

YEAR 1916

Transcript furnished for this year shows a net income of $253,270.61 reported and a tax paid of $5,065.41. Our examination disclosed no differences except in depreciation; other details are therefore omitted, but can be furnished if desired. It might be well to mention that "repairs" on the original return, $66,428.94, is in error; $28,428.94 of the above amount consists of what is known as "machinery, clothing," such as heavy belting, felts, wires, etc.

Profit per books		$302,346.24
Plus recoveries credited to surplus		977.83
		303,324.07
Less bad notes charged to surplus	$2,425.55	
Miscellaneous adjustments	82.48	
Salary of president charged to surplus	416.66	
Depreciation	40,000.00	
Salary charged in January, 1917	2,000.00	
		44,924.69
		258,399.38
Plus dividend charged as expense		16,271.23
		274,670.61
Additional depreciation charged on return		21,400.00
Per original		253,270.61
Less additional depreciation per schedule		19,273.81
Amended net income		233,996.80

COMPUTATION

Depreciation claimed	$61,400.00
Depreciation charged off	80,673.81
Subject to refund	19,273.81

Refund due, at 2 per cent, $385.48.

Additional depreciation allowed in this and all subsequent years was written off at the time of making examination.

Income, 1917

	Original	Amended	Difference
1. Capital stock	$1,295,650.00	$1,295,650.00	
2. Indebtedness	480,000.00	480,000.00	
3a. Gross sales	2,340,180.09	2,340,180.09	
3b. Rents	2,377.49	2,377.49	
3c. Interest	926.52	926.52	
3e. Other income	20,116.38	20,116.38	
	2,363,600.48	2,363,600.48	
4a. Cost of goods	1,674,493.99	1,665,153.87	[1] 9,340.12
4b. General expenses	113,610.57	112,372.57	[1] 1,238.00
5a. Losses charged off	120,178.56	46,716.03	[1] 73,462.53
5b. Depreciation	85,000.00	81,170.88	[1] 3,829.12
6a. Interest	39,745.20	39,745.20	
7a. Taxes	18,154.53	18,154.53	
	2,051,182.85	1,963,313.08	
Net income	312,417.63	400,287.40	[2] 87,769.77

[1] Decrease. [2] Increase.

Decrease in cost of goods represents royalties paid for the use of certain equipment. The equipment was installed and the manufacturer was to receive as compensation, or rather for the privilege of using the device, the saving brought about by the use of the new method for the first year, after which the corporation would be entitled to use it without royalty. This was considered a capital expenditure as all subsequent years are also benefited by the use of the new device.

The decrease of $1,238 in expenses represents donations disallowed.

Decrease in losses results from the following:

	Cost	Depreciation allowed
1 water wheel unit installed, 1909	$5,205.00	$2,820.00
8 water-wheel units installed, 1906	39,145.50	21,530.03
1 barker installed, 1907	1,410.00	705.00
1 barker installed, 1909	1,600.00	640.00
1 barker installed, 1911	1,400.00	420.00
	48,760.50	26,115.03
	26,115.03	
	22,645.47	

NOTE.—Salvage value is taken care of in item 3 (a) under "Sale of waste material."

Losses allowed are bad accounts charged off during the year.

Cost of installing new equipment		$79,840.42
Loss claimed old equipment	$16,267.58	
Loss per above	22,645.47	
		6,377.89
Disallowed		73,462.53

Depreciation is as per depreciation schedule.

COST OF GOODS

Inventories Jan. 1, 1917	$16,064.80
Raw material used	1,238,288.38
Productive labor	241,335.92
Fuel	152,775.63
Machine felts, wires, etc	41,801.17
Wrappers and twine	28,930.32
Pulp stones	166.65
	1,719,362.87
Inventories Jan. 1, 1918	54,209.00
Cost of goods	1,665,153.87

OTHER INCOME

Discount on purchases	$1,144.81
Sales waste material	12,968.29
Color sold	5,142.69
Freight charges collected	426.59
Bad accounts recovered	434.00
	20,116.38

Rents are received from houses owned by corporation and rented to employees.

Interest received is on notes receivable.

EXPENSES

Officers' salaries	$12,000.00
Other office salaries	13,280.92
Repairs [1]	40,751.58
Stationery, printing, postage, etc	2,037.66
Insurance	7,929.04
Traveling expense	5,207.14
Transportation of employees	661.32
Miscellaneous adj	272.69
General expense [2]	30,232.22
	112,372.57
Net income per books	$289,764.89
Add bad debts recovered credited to surplus	434.00
Capital expenditures disallowed (charged to losses)	73,462.53
Donations disallowed	1,238.00
Capital expenditures disallowed (charged to manufacturing)	9,340.12
Dividend preferred stock charged to expense	17,500.00
Income tax 1916	5,065.41
Excessive depreciation	3,829.12
	400,634.07
Less bad accounts charged to surplus	346.67
Amended net income	400,287.40

[1] Above are ordinary and incidental repairs made from day to day throughout the year.
[2] General expense consists of legal fees and various trade association dues, the legal expense comprising the greater part of the total, all allowable.

RECONCILIATION OF SURPLUS

Surplus Dec. 31, 1916		$268,019.87
Profits		400,287.40
		668,307.27
Dividend, preferred stock, June 1 and Dec. 1	$17,500.00	
Income tax	5,065.41	
Improvements	82,802.65	
Donations	1,238.00	
Excessive depreciation	3,829.12	
Officers' salary 1916 charged to surplus January, 1917	2,000.00	
		112,435.18
Balance Dec. 31, 1917		555,872.09

1917 EXCESS-PROFITS TAX

The pre-war data is not set up as the percentage of net income to invested capital for this period is much below 7 per cent, and therefore the 7 per cent excess-profits tax deduction applies and is used in the amended return.

SCHEDULE A—ORIGINAL

	Taxable year
1. Preferred stock	$250,000.00
3. Common stock	1,045,065.00
6. Earned surplus	268,019.87
Total	1,563,669.87

The above is correct per books.

SCHEDULE B

Blank, both in original and amended.

SCHEDULE C—ORIGINAL

Blank.

SCHEDULE C—AMENDED

	Taxable year
Insufficient depreciation	$420,773.60
Depreciation per schedule	603,193.18
Depreciation written off	182,419.58
	420,773.60

SCHEDULE H—ORIGINAL

Blank.

SCHEDULE H—AMENDED

Dividend June 1 and Dec. 1, out of current earnings	$17,500.00
Income tax (amended) June 15	4,679.93
Six and one-half months	2,534.96

SCHEDULE I

1. Net income	400,287.40
6. Net income subject to excess-profits tax	400,287.40

SCHEDULE II

1. Capital and surplus	$1,563,669.87
4. Deduct schedule	420,773.00
5. Balance	1,142,896.27
6. Changes	2,534.96
7. Invested capital	1,140,361.31

NOTE.—Invested capital for 1917 was reduced below the par value of stock outstanding on December 31, 1916, as there was a stock dividend of approximately $200,000 paid in prior years, which for excess-profits tax purposes was considered surplus. In fact, the corporation did not provide for depreciation, and therefore there really was no surplus from which to pay such a dividend.

SCHEDULE III

2. Percentage used (7 per cent)	$79,825.29
3. Specific deduction	3,000.00
Total	82,825.29

SCHEDULE IV

	Amount	Deduction	Balance	Rate	Tax
				Per cent	
15 per cent	$171,054.20	$82,825.29	$88,228.91	20	$17,645.78
5 per cent	57,018.06		57,018.06	25	14,254.52
Do	57,018.06		57,018.06	35	19,956.33
8 per cent	91,228.90		91,228.90	45	41,053.00
Balance	23,968.18		23,968.18	60	14,380.91
	400,287.40	82,825.29	317,462.11		107,290.54

COMPUTATION

Net income	$400,287.40
Less excess profits tax	107,290.54
Subject to 2 and 4 per cent	292,996.86
Tax at 2 per cent	5,859.94
Tax at 4 per cent	11,719.88
Excess profits tax	107,290.54
Total due	124,870.36
Total paid	60,009.18
Additional due	64,861.18

Relative to the additional tax for 1917, please note assessment letters IT:IA:M. $\frac{BLC}{V}$-34750285

This letter addressed to the corporation advised them of an additional assessment of $31,912.80. This, however, has never been paid and is therefore reflected in the additional tax recommended in this report.

SCHEDULE A, 1918

	Original	Amended	Difference
1. Gross sales	$2,606,679.70	$2,606,679.70	
2. Cost of goods	2,034,851.28	2,034,851.28	
	571,828.42	571,828.42	
6. Rentals	3,788.20	3,788.20	
10. Other income	13,096.73	13,036.73	[1] $60.00
	588,713.35	588,653.35	
12. Ordinary expense	97,168.29	63,168.29	[1] 34,000.00
13. Compensation officers	12,000.00	12,000.00	
14. Repairs	66,892.93	66,892.93	
15. Interest	33,887.32	33,887.32	
16. Taxes	21,933.82	21,933.82	
18. Depreciation charged off	85,000.00	90,869.10	[2] 5,869.10
	316,882.36	288,751.46	
25. Profit	271,830.99	299,901.89	[2] 28,070.90

[1] Decrease.
[2] Increase.

Explanation: Sixty dollars decrease, item 10, represents Liberty bonds purchased below par.

Decrease in expenses represents additions to buildings and other improvements disallowed.

Depreciation is as per schedule.

COST OF GOODS

Inventories, Dec. 31, 1917	$54,209.00
Labor	281,893.69
Fuel	187,305.80
Machinery, wires, felts, etc	55,788.69
Wrappers and twine	36,564.94
Raw material	1,473,614.66
	2,089,376.78
Inventory, Dec. 31, 1918	54,525.50
Cost of goods	2,034,851.28

SCHEDULE A–10

Discount on purchases	$1,177.56
Scrap materials sold	11,061.30
Freight charges recovered	111.41
Bad account recovered	686.46
	13,036.73

SCHEDULE A–12

Office expense and clerk hire	$16,605.68
Liabilities insurance	7,109.04
Fire and tornado insurance	5,436.30
Selling expense	11,962.43
General expense[1]	21,241.59
Transportation employees[1]	813.25
	63,168.29

SCHEDULE A–14

Ordinary and necessary repairs made from day to day throughout the year	$66,892.93

[1] This represents legal fees and various association dues, all allowable deductions.

SCHEDULE B

1. Net per books	$253,000.11
2. Preferred stock dividend	17,499.96
Improvements	34,000.00
Recoveries credited to surplus	686.46
	306,086.53
5. Tax free interest United States obligations	255.54
Additional depreciation not written off during year	5,869.10
Liberty bonds purchased below par	60.00
8. Taxable income	299,901.89
	306,086.53

RECONCILIATION OF SURPLUS

Surplus Dec. 31, 1917		555,872.09
Liberty bonds purchased below par		60.00
Tax free United States interest		255.54
Depreciation not charged off during year		5,869.10
Profits		299,901.89
		861,958.62
Improvements	$34,000.00	
Cash dividends Feb. 1	19,434.75	
Income tax	60,009.18	
Cash dividends June 29	19,434.75	
Cash dividends Sept. 30	19,434.75	
Cash dividends Dec. 31	19,401.75	
Preferred stock dividends June 1	8,749.98	
Preferred stock dividend Dec. 1	8,749.98	
		189,215.14
Surplus Dec. 31, 1918		672,743.48

INTEREST ON LIBERTY BONDS

All exempt	255.54

SCHEDULE E—ORIGINAL

NOTE.—Pre-war history is not set up as 10 per cent of the invested capital for the taxable year gives a larger war-profits credit than the average pre-war net income plus 10 per cent of the increase in invested capital as between the pre-war years and the taxable year.

	Taxable
1. Preferred stock	$250,000.00
3. Common stock	1,045,650.00
6. Earned surplus	555,872.09
Total	1,851,522.09

Above is correct per books.

SCHEDULE F—ORIGINAL

Blank.

SCHEDULE F—AMENDED

Improvements charged to expense 1917	$82,802.65

SCHEDULE G—ORIGINAL

Blank.

SCHEDULE G—AMENDED

Insufficient depreciation	$416,944.48

SCHEDULE H—ORIGINAL

Dividend Feb. 1, 1918, $19,434.75, 333 days	$17,730.88
Income tax June 14, $00,000.18, 200 days	32,881.74
Treasury stock acquired Oct. 28, $2,200, 64 days	385.76
Total	50,998.38

SCHEDULE H—AMENDED

Dividend Feb. 1, 1918, $19,434.75, 334 days	$17,784.13
Income tax (amended) June 15, $124,870.36, 200 days	68,422.12
Treasury stock acquired Oct. 28, $2,200, 64 days	385.76
Total	86,592.01

NOTE.—Other dividends paid out of current earnings.

SCHEDULE I

Pre-war data not set up. See explanation under Schedule E, 1918.

SCHEDULE II—INVESTED CAPITAL

	Taxable year
1. Capital and surplus	$1,851,522.09
2. Additions	82,802.65
3. Total	1,934,324.74
4. Deductions	416,944.48
5. Balance	1,517,380.26
6. Changes	86,592.01
7. Balance	1,430,788.25
9. Invested capital	1,430,788.25

SCHEDULE III

1. 8 per cent of invested capital	$114,463.06
2. Exemption	3,000.00
3. Excess-profits credit	117,463.06
6. 10 per cent of invested capital	143,078.83
7. Exemption	3,000.00
8. War-profits credit	146,078.83

SCHEDULE IV

	Amount	Exemption	Balance	Rate	Tax
				Per cent	
1. 20 per cent invested capital	$286,157.65	$117,463.06	$168,694.59	30	$50,608.38
2. Over 20 per cent	13,744.24		13,744.24	65	8,933.76
Total	299,901.89	117,463.06	182,438.83		59,542.14

BRACKET 3

4. Net income	$299,901.89
5. War profits credit	146,078.83
6. Difference	153,823.06
7. 80 per cent, item 6	123,058.45
8. Item 3, column 6	59,542.14
9. Tax, bracket 3	63,516.31
Total war profits and excess profits tax under section 301	123,058.45
Total war profits and excess profits tax under section 302	223,921.51

INCOME TAX

12. Net income		$299,901.89
14. Excess profits tax	$123,058.45	
15. Exemption	2,000.00	
		125,058.45
16. Balance		174,843.44
17. Tax 12 per cent, No. 16		20,981.01
18. Total tax		144,039.46
Total tax paid		94,879.87
Additional tax due		49,159.59

SCHEDULE A, 1919

	Original	Amended	Difference
1. Gross sales	$2,870,171.66	$2,870,171.66	
2. Cost of goods	2,170,802.70	2,170,802.70	
Gross	699,368.96	699,368.96	
4. Interest, United States obligations, not exempt	287.69	287.69	
5. Interest, other	464.65	464.65	
6. Rentals	3,469.29	3,469.29	
10. Other income	12,236.24	12,232.74	[1] $3.50
	715,826.83	715,823.33	
12. Ordinary expense	106,835.78	106,835.78	
13. Compensation, officers	13,000.00	13,000.00	
14. Repairs	93,739.87	62,855.61	[1] 30,884.26
15. Interest	33,033.80	33,033.80	
16. Taxes	27,221.44	27,221.44	
17. Fire loss		1,911.03	[2] 1,911.03
18. Depreciation charged off	86,112.00	94,921.86	[2] 8,809.86
	359,942.89	339,779.52	
Profit	355,883.94	376,043.81	
22. Profit, land deed $1,200.00		1,200.00	
23. Fire loss 1,911.03			
	711.03		[1] 1,911.03
Net profit	355,172.91	377,243.81	[2] 22,070.90

[1] Decrease; profit and loss.
[2] Increase.

Explanation: $3.50 decrease, item 10, represents Liberty bond purchased below par and difference credited to profit and loss. Decrease in repairs represents improvements disallowed. Depreciation is as per schedule.

SCHEDULE A–2

Inventory Jan. 1, 1919	$54,525.50
Labor	327,113.45
Fuel	163,125.00
Machinery, felt, wires, etc	62,470.85
Wrappers and twine	39,760.54
Sulphites	386,470.99
Pulp	[1] 701,710.77
Scrap paper	[1] 188,403.20
Spruce wood	[1] 142,833.25
Alum	17,752.38
Color	10,744.98
Clay	63,587.73
Rosin size	29,521.52
Soda ash	14,086.56
Other material	14,779.48
	2,216,895.20
Less inventory, Dec. 31, 1919	46,092.50
Cost of goods	2,170,802.70

SCHEDULE A–5

Interest notes receivable	$464.65

SCHEDULE A–6

Rent of company houses	$1,316.70
Water and light rents, Northern Pacific Railway, etc	2,152.59
	3,469.29

SCHEDULE A–10

Waste material sales	$7,424.84
Discount on purchases	786.33
Freight charges recovered	230.75
Bad accounts collected	3,545.77
Miscellaneous adjustments	245.05
	12,232.74

SCHEDULE A–12

Liability insurance	$8,815.93
Fire and insurance (tornado)	5,218.87
Selling expense	12,503.35
Office expense	10,092.89
Transportation employees	561.75
General expense [2]	69,642.99
	106,835.78
Ordinary and necessary repairs	62,855.61

FIRE LOSS

Cost of material, 1917	$2,666.51
Insurance received	755.48
Loss	1,911.03

PROFIT ON LAND DEED

Cost or market value, Mar. 1, 1913	$2,000.00
Selling price [3]	3,200.00
Gain	1,200.00

[1] Raw material.
[2] This represents legal fees and various association dues and other unclassified expense, all allowable deductions.
[3] This was credited to land account on books.

Liberty-bond interest all exempt except $287.69, which was interest on Victory bonds.

SCHEDULE B

Net profit per books		$309,123.09
Donations		30,330.00
Improvements		30,884.26
Profit on land deed		1,200.00
Preferred dividend		17,500.00
Recoveries credited to surplus		245.05
		389,282.40
6. Tax-free interest, United States		3,225.23
Depreciation not written off during year		8,809.86
Liberty bond purchased below par		3.50
Taxable income		377,243.81
		389,282.40

RECONCILIATION OF SURPLUS

Surplus Jan. 1, 1919		$672,743.48
Tax-free income	$3,225.23	
Depreciation not charged off during year	8,809.86	
Liberty bonds purchased below par	3.50	
Profits	377,243.81	
		389,282.40
		1,062,025.88
Preferred dividends June 1 and Dec. 1	17,500.00	
Donations	30,330.00	
Improvemetns	30,884.26	
Cash dividends June 28 and Sept. 30	38,803.50	
Income tax	94,879.87	
Gain on land deed sold not reflected in profit and loss	1,200.00	
		213,597.63
Balance Dec. 31, 1919		848,428.25

$30,000 of the above donations was a gift to the retiring president. Mr. Cole informed us that the corporation wanted to pay the tax on same.

SCHEDULE E—ORIGINAL

1. Preferred stock	$250,000.00
3. Common stock	1,050,000.00
6. Earned surplus	672,743.48
	1,972,743.48
10. Treasury stock	6,550.00
Total	1,966,193.48

Above is correct per books.

SCHEDULE F—ORIGINAL

Blank.

SCHEDULE F—AMENDED

Improvements, 1917	$82,802.65
Improvements, 1918	34,000.00
	116,802.65

SCHEDULE G—ORIGINAL

Blank.

SCHEDULE G—AMENDED

Liberty bonds purchased below par, carried at par on books	$60.00
Insufficient depreciation	422,813.58
	422,873.58

SCHEDULE H—ORIGINAL

Income tax Mar. 14, $24,000, 291 days	$19,134.25
Income tax June 4, $23,439.94, 200 days	12,843.80
Income tax Sept. 11, $23,719.97, 111 days	7,213.47
Income tax Oct. 31, $23,719.96, 61 days	3,964.16
	43,155.68

AMENDED

No common stock dividend.

Preferred dividend $17,500, paid one-half June 1 and December 1 out of current earnings.

Income tax (amended) $128,626.67, $0.42260273	$60,871.55
Additional income tax 1917, less refund to 1917, $29,738.30, 365 days	63,518.59
	124,390.14

SCHEDULE B

1.	Capital and surplus	$1,966,193.48
2.	Additions	116,802.65
3.	Total	2,082,996.13
4.	Deductions	422,873.58
5.	Balance	1,660,122.55
6.	Charges	124,390.14
7.	Invested capital	1,535,732.41

SCHEDULE C

1.	8 per cent of capital	$122,858.59
2.	Exemption	3,000.00
3.	Total	125,858.59

SCHEDULE D

	Amount	Credit	Balance	Rate	Tax
				Per cent	
1. Not over 20 per cent	$307,146.48	$125,858.59	$181,287.89	20	$36,257.58
2. Over 20 per cent	70,097.33		70,097.33	40	28,038.93
3.	377,243.81	125,858.59	251,385.22		64,296.51
4. Excess profits tax computed under section 302					146,297.52

INCOME TAX

5.	Net income		$377,243.81
6.	Item 4, Schedule A	$287.69	
7.	Excess-profits tax	64,296.51	
9.	Exemption	2,000.00	
			66,584.20
10.	Balance		310,659.61

11. 10 per cent item 10	$31,065.96
12. Total tax	95,362.47
Total paid	70,987.90
Additional due	24,374.57

Attached hereto are balance sheets, depreciation schedule, and reconciliation of surplus, together with other inclosures mentioned on page 1 of this report.

GEO. J. ABEL,
Internal Revenue Inspector.

EXHIBIT No. 2

NOVEMBER 23, 1921.

VALUATION REPORT BY TIMBER SECTION, PHYSICAL PROPERTY EXCLUSIVE OF TIMBERLANDS

Re Watab Pulp & Paper Co., Sartell, Minn.
Returns 1916 to 1919, inclusive.

According to the information contained in the revenue agent's report dated June 18, 1920, the taxpayer organized on date of May 10, 1905, and engaged in the manufacture of pulp, print, and book paper.

According to the affidavit of the general manager, the output of the mills was approximately 32 tons of pulp and 38 tons of paper per day from years 1908 to 1911; 31 tons pulp and 68 tons paper per day from years 1912 to 1915; 41 tons pulp and 89 tons paper per day from years 1916 to 1919.

The earliest record of the company's finances shown in the revenue agent's report is for the fiscal year ended April 30, 1909, when the paid-up stock was $700,000 and the interest-bearing indebtedness $392,500.

These figures agree with those contained in the detailed report made by the taxpayer's accountants under Exhibit A, sheet No. 1, which is a statement of the comparative balance sheets as taken from the taxpayer's books covering the period from April 1, 1907, to April 30, 1911.

Reference is made to last paragraph of page 31, "Exhibit C, journal entries necessary to cover adjustments made for the calendar years 1907 to 1919" in the report of the taxpayer's accountants wherein it appears that the capital invested in fixed assets has been determined on the basis of cash costs with the depreciable portion of the assets depreciated at a flat or combined annual rate of 2½ per cent during the period from April 1, 1907, to December 31, 1911, when the rate was increased to 5 per cent per annum and applied to the end of 1916, when it was again increased to 7½ per cent per annum and applied during the high-tax years 1917, 1918, and 1919.

This sliding depreciation scale apparently is designed to work to the benefit of the taxpayer by maintaining its invested capital at a high figure up to the high-tax years, when heavy depreciation deductions from the gross incomes of such years are indicated by tripling the rate applied during the earlier life of the properties.

The taxpayer's representative has given evidence that a consistent policy was followed in all years with respect to charging all costs of replacements and betterments either directly to the capital account or as a credit to the reserve for depreciation.

Therefore it can not be claimed that the plant account was reduced by improper charges of capital items to operating expense, as was often the case in plants of this character and under which circumstances the taxpayer may reconstruct its capital account as provided by the regulations.

Under the circumstances existing in this case there is not warrant for doubling the depreciation rate in year 1912 and tripling the rate used prior to 1912 for the years 1917, 1918, and 1919.

During the war period the taxpayer increased its production, and, according to the evidence, one of the means whereby this increase was accomplished was in speeding up part of the equipment.

It is known, however, that approximately 50 per cent of the equipment in plants of this character are designed to run at a standard rate of speed that can not be increased to any appreciable extent.

The paper machines, however, can be operated at increased speeds, and some other items in the paper-making equipment, such as beaters and Jordan engines, can be made to do heavier duty, and in consequence the power equipment, such as boilers, steam engines, and electric motors, may be loaded up in excess of their rated capacities.

Under such circumstances there is no doubt that there is a heavier wear and tear on certain parts of such machinery than when operating conditions are normal.

This additional wear and tear generally may be taken care of by the replacements and repairs to such parts as are most affected, so that the actual length of life even of such equipment as receives the hardest usage from increased production should not be greatly reduced, provided the repair policy is an adequate one.

The repair charges of the taxpayer against gross income in the high tax years are sufficiently high to maintain the plant in good operating condition, and the taxpayer's representative has given evidence that the maintenance of the plant has been well taken care of.

It is the opinion of this office that the taxpayer may be given the benefit of uniform depreciation on its classified assets at rates lower on some items than the general average up to and including year 1916 and that the rates on machinery and certain other miscellaneous items of fixed assets for the years 1917, 1918, and 1919 may be slightly increased.

Rates lower than the average during the earlier life of the properties are recommended on account of the evidence submitted as to exceptionally good maintenance, and the increase recommended in rate on machinery and other items is because of evidence submitted as to extra wear and tear from increased production and from the fact that repairs made during the war period were not quite as adequate in arresting depreciation as the more thorough repairing done during other periods when operating conditions were normal.

The taxpayer has submitted evidence on page 38 of the accountant's report tending to show that the depreciation sustained prior to January 1, 1908, which is the earliest date at which classification data were obtainable, was $21,993.18.

The evidence further indicates that the total cost of the fixed assets exclusive of the timberlands as at January 1, 1908, was $915,067.72.

This may be taken as a base for classifying the assets, allocating their proper values, and setting up the proper annual rates of depreciation to be applied thereto and to the additions to assets in the subsequent years in accordance with the following schedule No. 1:

Class of property	Cost of properties to Jan. 1, 1908	Depreciation	
		Rate per cent to Dec. 31, 1916	Rate per cent 1917, 1918, 1919
1. Real estate	$101,475.72		
2. Flowage rights			
3. Wooden dam	240,815.88	3.75	3.80
4. Equipment	305,845.05	4.75	6.50
5. Brick buildings	254,014.01	2.20	2.30
6. Hotel	5,677.63	3.25	
7. Frame buildings	5,322.37	3.75	4.50
8. Spur tracks	1,137.80	5.00	6.00
9. Furniture and fixtures	779.26	8.50	10.00
10. Dwellings		2.40	2.80
11. Miscellaneous plant equipment		8.50	10.00
12. Ventilators		6.00	6.00
13. Wood room equipment			6.50
14. Machine room roof			3.50
Total fixed assets cost	915,067.72		
Depreciation to Jan. 1, 1908	21,993.18		
Sound, Jan. 1, 1908, value of fixed assets	893,074.54		

Hereunder is Schedule No. 2, based upon the application of the foregoing depreciation rates, that will determine by years the capital invested in fixed assets exclusive of timber properties, the depreciation reserve, and depreciation allowances on gross income in the subsequent taxable years.

Year ended Dec. 31, 1908:	
Cost to Jan. 1, 1908	$915,067.72
Depreciation accrued to Jan. 1, 1908	21,993.18
Sound value at Jan. 1, 1908	893,074.54
Depreciation during 1908	29,653.79
Balance	863,420.75
Additions (net amount during year)	36,472.46
Fixed assets at end of year	899,893.21
Year ended Dec. 31, 1909:	
Depreciation	30,926.29
Balance	868,966.92
Additions (net amount)	40,760.07
Fixed assets at end of year	909,726.99
Year ended Dec. 31, 1910:	
Depreciation	32,120.77
Balance	877,606.22
Additions (net amount)	231,399.67
Fixed assets at end of year	1,109,005.89
Year ended Dec. 31, 1911:	
Depreciation	38,938.68
Balance	1,070,067.21
Additions (net amount)	341,636.09
Fixed assets at end of year	1,411,703.30
Year ended Dec. 31, 1912:	
Depreciation	49,856.34
Balance	1,361,846.96
Additions (net amount)	76,821.12
Fixed assets at end of year	1,438,668.08
Year ended Dec. 31, 1913:	
Depreciation	53,646.94
Balance	1,385,021.14
Additions (net amount)	18,313.08
Fixed assets at end of year	1,403,334.22
Year ended Dec. 31, 1914:	
Depreciation	54,556.43
Balance	1,348,777.79
Additions (net amount)	44,433.08
Fixed assets at end of year	1,393,210.87
Year ended Dec. 31, 1915:	
Depreciation	56,505.04
Balance	1,336,705.83
Additions (net amount)	10,156.77
Fixed assets at end of year	1,346,862.60

Year ended Dec. 31, 1916:	
Depreciation	$56,979.54
Balance	1,289,883.06
Additions (net amount)	55,506.09
Fixed assets at end of year	1,345,389.15
Year ended Dec. 31, 1917:	
Depreciation	75,488.55
Balance	1,269,900.60
Additions (net amount)	81,813.62
Fixed assets at end of year	1,351,714.22
Year ended Dec. 31, 1918:	
Depreciation	80,272.44
Balance	1,271,441.78
Additions (net amount)	88,501.05
Fixed assets at end of year	1,359,942.83
Year ended Dec. 31, 1919:	
Depreciation	86,209.00
Balance	1,273,733.83
Additions (net amount)	46,389.90
Fixed assets at end of year	1,320,123.73

The accumulated reserve for depreciation in the foregoing schedule amounts to $667,146.99 as at December 31, 1919, and the net total cost of the fixed assets or the total cost thereof less the value of assets extinguished as at December 31, 1919, amounts to $1,987,270.72.

The depreciation allowances in the foregoing Schedule No. 2 are figured on the assets as at the beginning of the taxable period for all years except 1919, when a half year's depreciation is included in the assets acquired during the year.

This is done for the reason that the value of the assets in year 1920 undergo a change on account of reorganization of the company and it is thought best to determine the actual depreciation sustained on assets acquired during 1919 as near as practicable and include it in the calculations on the assets as at the end of 1919 instead of carrying it into the succeeding year as has been done for all prior taxable periods.

The capital invested in timber properties is dealt with in a separate report by this section.

Recommended by:

W. ROBERTSON,
Forest Valuation Engineer.

Approved.

CARL M. STEVENS,
Chief, Timber Section.

EXHIBIT No. 3

VALUATION REPORT BY TIMBER SECTION

APRIL 3, 1922.

Re Watab Pulp & Paper Co., Sartell, Minn.

Reference is made to the fifth paragraph of page 1 of the report of this office dated November 23, 1921, wherein attention is called to the fact that the taxpayer uses a low rate of depreciation in the earlier life of its properties, then doubles this rate in a later period, and then triples it during the high tax years.

This is the outstanding feature of this case, and irrespective of the provisions of A. R. M. 106, on which the taxpayer bases its claims, the action taken is in violation of articles 143, 161, 165, 166, and 839 of regulations 45.

It violates article 143 inasmuch as the operation of the taxpayer's plant has not up to the present time been terminated on account of the obsolescence, nor

has any substantial portion of the equipment been scrapped before the end of the natural life.

Such anticipated obsolescence as the taxpayer cites as evidence is of a kind applicable to all of its competitors, inasmuch as it pertains to all industry wherein the normal progress of the art makes for a gradual obsolescence that is included in depreciation allowances as provided for in article 161.

The obsolescence cited on page 1 of the affidavit of O. L. E. Weber, dated December 27, 1921, should be distributed in depreciation over the life of the property, for the reason that such obsolescence as is claimed is one that is clearly recognizable at all periods and may be anticipated at the outset of any new enterprise.

The faster machines named by the affiant are installed in but a very small number of mills at the present time, compared with the total in the industry.

In the few mills in which a very high speed machine has been installed the speed for which the machine was designed has almost invariably been reduced in order to effect an economical operation.

These few installations have not been the means of compelling any taxpayer to scrap any good equipment installed in the past 15 years, for the reason that such few machines have been costly and have their attending disadvantages as well as advantages over the general run of modern machines like those owned by this taxpayer.

The consistency of method in writing off depreciation provided for in article 161 is violated, because it is not possible, in the art of paper making, to deteriorate a plant three times as rapidly during one period of its operating existence as at some other period.

Only in case of abandonment of a property or in long periods of nonoperation could such excessive increase in deterioration processes take place.

The taxpayer's action violates article 165, because it is not a recognized trade practice.

Such increase in depreciation as has been claimed by other of the taxpayer's competitors operating under exactly the same conditions, and who increased their production during the war period, has been in a majority of cases along the lines of reasonability, and in such cases the claims have been allowed by this office.

In the case of no pulp and paper property has the taxpayer been permitted an increase of as much as 30 per cent in the combined depreciation rate on account of increase of operations due to war activities.

In order to place the members of this industry on terms of equality with respect to tax liability it is necessary to accord to each one the same just allowance with respect to depreciation deductions.

The statements made in paragraphs 3, 5, and 6, of page 2 of the prior report by this office, are matters of common knowledge in the pulp and paper business.

The increased wear and tear, due to increase in production, is almost wholly sustained on machinery journals, bearings, and other minor parts for which the taxpayer is allowed deductions by way of ordinary and incidental repairs.

This kind of expense if not incurred during the war period would necessarily be incurred in a following period and an allowance therefor would be made against the gross income of some taxable period.

An addition to this sort of allowance against gross income in heavily increased depreciation charges is so far out of reason that the effect of allowing the taxpayer's claims in the instant case would be unfair to all of its competitors.

Any knowledge on the part of other members of the pulp and paper industry that a claim of this sort had been recognized and allowed in this office would immediately result in the filing of credit and refund claims from numerous taxpayers who were in the same position as this taxpayer with respect to war activities.

The provisions of article 166 are violated by the taxpayer's action for the reasons cited in the violation of article 143 and, further, that any modification of the policy of writing off depreciation should apply against a March 1, 1913, value of the property after which the useful life of the property may be reestimated from that date, and then written off in equal annual installments unless obsolescence subsequently becomes a clearly recognized and proven factor in the case.

The provisions of article 839, regulations 45, are violated for the reasons cited in paragraphs 1 and 2, page 2, of the prior report by this office dated November 23, 1921.

The taxpayer's entire argument is built up on the provisions of A. R. M. 106, the intention of which was to give relief to such taxpayers as had been erroneously charging capital-account items into annual operating expense in lieu of setting up depreciation at what would have been necessarily a higher rate if the capital items had been charged to their proper accounts.

The taxpayer's own evidence indicates that it is not entitled to step up its depreciation on account of that ruling and there is nothing in the new evidence that justifies a treatment of the case in accordance with such ruling.

Inconsistency and an attempt to write appreciation into its assets on the part of the taxpayer under cover of A. R. M. 106 is apparent from the fact that whereas a 2½ per cent depreciation rate is claimed for the period from 1907 to 1911, a 5 per cent rate is then used with no reason whatsoever being advanced that could be considered allowable since no let up in the repair policy or overworking of the machines could be in any way claimed or justified in the period from 1912 to 1915, inclusive.

It is hereby recommended that the case be acted upon in accordance with the findings in the prior valuation report which is based on the logical position that the taxpayer can not use a sliding depreciation scale, using very low depreciation in the earlier life of the property and very high depreciation when profits and taxes were high.

If the low rate claimed in the earlier life of the property is to be allowed then a properly consistent rate must be taken in deductions from gross incomes in the high tax years in the ration indicated on page 3 of the valuation report of this office dated November 23, 1921.

Recommended by—

W. ROBERTSON,
Valuation Engineer.

Approved:

CARL M. STEVENS,
Chief Timber Section.

EXHIBIT No. 4

APRIL 11, 1923.

In re Watab Pulp & Paper Co., Sartell, Minn.

Mr. FAY,
Head of Division.

The case of the above-mentioned taxpayer has been reviewed in con. .dion with the inclosed copy of letter from Mr. Condon H. Ronan to the Flambeau Paper Co.

History of this case is somewhat as follows:

A field examination was made and the agent recommended a large amount of additional tax to be assessed for 1917, 1918, and 1919. The 1917 tax was assessed while the 1918 and 1919 additional assessments were never made. The company filed claim for abatement of the 1917 tax. F. A. R. section, where the claim was adjusted, allowed only a small portion of the amount claimed. This action was based on the revenue agent's report, however, and as the report was not based on fact, the action taken on the claim was naturally in error.

The additional tax shown by the revenue agent's report resulted from the agent charging off large amounts of depreciation for years prior to 1917, thereby reducing surplus.

In accordance with A. R. M. 106, such reduction in invested capital was disregarded and that shown by the books of the company accepted.

The report in question was fully sustained by the valuation engineer in reports dated November 23, 1921, and April 3, 1922.

The case was practically closed in manufacturing section, which section had apparently accepted Mr. Ronan's report as submitted when it was requested by the timber valuation section since, however, depletion is in no wise involved (see valuation comment dated November, 1921), the case should have been closed in manufacturing section.

After many conferences held in manufacturing section and in the natural resources division, and viewed in the light of A. R. M. 106 and the other factors peculiar to the case, it was evident that the additional tax recommended

by the revenue agent was excessive. It must be borne in mind that the greater amount of the additional taxes recommended for assessment by the revenue agent were never made by the manufacturing section when the case was first audited by said section.

To sum up, it appears that in the final adjustment of the case Mr. Ronan did succeed in having the additional tax recommended by the revenue agent reduced by the percentage in his letter, although, as stated above, the additional taxes recommended for 1918 and 1919 were never assessed.

H. P. MAY, *Resident Auditor.*

EXHIBIT No. 5

MAY 7, 1923.

Memorandum for Mr. Bright, re Watab Pulp & Paper Co., Sartell, Minn. Data attached: Returns for years 1915 to 1920. R. A. R. for years 1909 to 1919, dated July 29, 1920. Valuation reports for years 1909 to 1920.

The assets of this taxpayer were valued in reports of this office under dates of November 23, 1921, and April 3, 1923, wherein the depreciation reserve and depreciation deductions from gross income in each of the years covered by the attached returns were determined in accordance with facts in the case.

The audit on the case made in audit section F, by H. P. May, under A. J. Barrett, section auditor, and reviewed by C. A. Appel, contains findings on important features of a technical character that are in disregard of the recommendations contained in the revenue agent's report and reports of the valuation engineers. This final audit and assessment for years 1916 to 1919 also disregards the work of the previous auditors on the case who were substantially in agreement with the findings as set forth in the reports of both the revenue agent and the timber section.

The revenue agent recommends an additional tax of $64,861.18 for 1917, and a net additional tax for 1917 to 1919 of $137,052.95.

The auditors who closed the case found an overassessment of the original taxes as reported for 1917 of $17,954.19, and a net additional tax of less than $6,000 for period 1916 to 1919, inclusive, which was chiefly due to the fact that a higher net plant value as at January 1, 1917, was allowed in the closing audit for those years than was properly allowable in accordance with (*a*) revenue agent's report, (*b*) valuation reports by timber section (*c*) prior audit by J. H. Polk, under Section Unit Auditor M. E. Palmer.

The reason for the contention of this office that the amount of capital invested in depreciable assets as allowed by the auditors that closed the case is too high is clearly set forth in the valuation reports of the timber section dated November 23, 1921, and April 3, 1922.

The taxpayer's representative, Mr. Condon H. Ronan, had several conferences with this office shortly after the issue of A. R. M. 106, and it was then clearly indicated that the taxpayer had erroneous conceptions of that memorandum as well as the subsequent O. D. 1104.

During these conferences, the taxpayer brought forth the same arguments that were set forth in the letter to the revenue agent at St. Paul (stamped "Received August 31, 1920"), and on its affidavit of December 27, 1921, by O. L. E. Weber, secretary and general manager.

These arguments were not considered sound by the revenue agents, and when later reviewed in the timber section it was evident that under the circumstances existing in the case they were extreme and unreasonable.

The sum and substance of the taxpayer's exceptions to the findings in the revenue agent's report were that no matter how little depreciation has been written off on its books during the earlier life of its properties, there was nothing in the laws and regulations to prevent it from taking a full measure of depreciation against the gross incomes made in the years in which excess-profits taxes were levied.

Thus during several years after the start of operations in year 1905, the taxpayer wrote off no depreciation whatsoever.

It is fully recognized by this office that a taxpayer's surplus can not be written down by arbitrary reductions or by theoretical formula on account of accrued depreciation in cases where it is evident that the taxpayer maintained the value of its depreciable properties by charging replacements and renewals to operating expense.

But the taxpayer in this case had given testimony to the effect that betterments and renewals were either capitalized or charged against the depreciation reserve and that only the repairs were charged to expense in the earlier life of the property the same as in the later taxable periods.

Therefore the actual costs of all the fixed assets were maintained in their proper account which was the capital or plant account, but the depreciable portions thereof were not depreciated under any consistent method (refer to page 2 of revenue agent's report) since in many years no depreciation was taken on account of slack business periods and the effect of depreciation in reducing earnings during such periods.

When it became evident that, in order to set forth any proper claim to a high rate of depreciation in the high tax years, some degree of consistency would have to be shown in respect to depreciation on prior years, the accountants, Ronan and Herminghouse, employed by the taxpayer, made a reconstruction of the fixed asset account, taking over to the asset side of the balance sheet all of the replacements that had formerly charged against the reserve for depreciation which was constructed on a new basis of 2½ per cent, 1907 to 1911; 5 per cent, 1912 to 1916; and 7½ per cent, 1917 to 1919; for determining net values and depreciation allowances on the plant equipment.

This method was regarded by this office as inconsistent and not in accord with sound practice, particularly with respect to the kind of properties used in the taxpayer's operations.

If the depreciation is calculated on a sliding scale, from a minimum account or nothing in the earlier life of a property to a maximum amount in its later life, it is manifest that the opportunity to return adequate income in the later years would be impossible of accomplishment under ordinary circumstances.

Only under the highly favorable circumstances due to the war could a fair income have been returned under such method of charging off the cost of the depreciable plant assets.

The only sound evidence submitted by the taxpayer as justifying the failure to set up a depreciation reserve covering all years at consistent rates applied to costs of the depreciable property in its earlier life as well as during the war and postwar periods was the claim that repairs made during the war period were not so adequate in maintaining the property as those made in prior years.

In recognition of the validity of that claim this office allowed an increase in the rate on machinery (which is the principal item that would be affected by the change in repair policy) of 4¾ per cent per year for the years prior to 1917 to 6½ per cent for years 1917, 1918, and 1919, and also allowed certain other advances in the rates as warranted by the facts in the case.

It was considered that the taxpayer was entitled to increase the rate and amount of depreciation over a normal rate and amount to such extent, and only to such extent, as the general repair policy in 1917 to 1919 had, on account of such reasons as were cited by the taxpayer, become less adequate in keeping the deterioration of the plant within normal limits.

The extent to which such conditions has become manifest in a certain instance is a matter to be determined through a technical understanding of the composition and operation of the particular kind of industrial activity under investigation.

The Income Tax Unit has in its employ the services of engineers that are required to be competent to fix the value of certain kinds of depletable and depreciable property, which includes pulp and paper plants that manufacture their finished product from timber.

The application of A. R. M. 106 and O. D. 1104 to a specific case is purely a matter of valuation of depreciable physical property, and as such should come strictly under the jurisdiction of the valuation engineers reporting on the case.

Obviously it should not come under the jurisdiction of auditors who are without sufficient knowledge of the particular kind of property under consideration to enable them even to enumerate the machines used in the business and, therefore, have no means of determining whether or not A. R. M. 106 is applicable to a given case.

As a matter of fact, the case in question contains one of the most flagrant abuses of the application of A. R. M. 106 that has come to the attention of this office.

In the closing audit of the case for years 1916 to 1919, inclusive, the taxpayer was allowed to set up an improperly constructed reserve for depreciation

for the years prior to 1917 and then, without consulting the valuation section (timber section), further action favorable to the taxpayer was taken with respect to the depreciation allowances in years 1917, 1918, 1919, by increasing the rates for those years, which had already been increased to an approximate maximum in the timber-section report.

Not only was this action an unwarranted disregard of the valuation reports, but it was also in disregard of the revenue agent's report on invested capital, as shown on pages 13 and 14, under Schedules C and 11, wherein it was found that the taxpayer's reserve for accrued depreciation was inadequate and inconsistent with the depreciation deducted from gross incomes in years 1917 to 1919, inclusive.

The adjustment considered necessary by the examining officers was, therefore, made as shown in their report, and resulted in additional taxes in years 1917 to 1919, inclusive, as above cited.

This adjustment considered necessary by the examining officers was, therefore, made as shown in their report, and resulted in additional taxes in years 1917 to 1919, inclusive, as above cited.

This office hereby enters protest on the auditors' action on the case and considers it useless to report on year 1920 returns as requested until some understanding is had as to the authority of auditors in making changes in valuation reports.

As a cure for the violation and disregard of reports on questions of a strictly technical nature, which should include the use and interpretation of A. R. M. 106 and depreciation of physical properties used in pulp, paper, and timber operations, it is suggested that the audit sections of the natural resources division be given definite written instructions to make no changes in the findings contained in valuation reports without the written consent or a supplemetal memorandum by the valuation section reporting on any case.

The attached exhibits of circular letters, written by the accountants employed by the Watab Pulp & Paper Co., to other taxpayers who have sent copies of such letters to the commissioner asking advice, contain clear indications that the foregoing recommendations are in order.

The committee on enrollment and disbarment have already taken under consideration the disbarment of the Watab Pulp & Paper Co.'s tax representative on account of his using the name and case of this taxpayer for advertising purposes and for stating how much of the additional tax recommended by the revenue agent he has been able to have abated.

_____, *Chief, Timber Section.*

EXHIBIT No. 6

APRIL 16, 1921.

WATAB PULP & PAPER CO.,
Sartell, Minn.

SIRS: An examination of your income-tax returns for 1909 to 1919, inclusive, in connection with the report of internal revenue agent in charge at St. Paul, Minn., dated July 29, 1920, indicates a further tax liability of $51,064.90, a summary of which follows:

	Additional tax	Overpayment
1909	$127.03	
1910	26.73	
1915		$67.27
1916	120.22	
1918	33,746.80	
1919	17,111.39	
	51,132.17	67.27
	67.27	
Net additional tax to be assessed	51,064.90	

Under authority conferred by section 252 of the revenue act of 1918 the overpayment for 1915 has been credited against the additional tax due for 1909.

Due to limitations imposed by law the overpayments for 1911 and 1914 can not be refunded.

Upon careful consideration of the facts submitted in your brief this office is of the opinion that the following rates are fair and reasonable for depreciation sustained:

	Per cent
Machinery and equipment	5
Brick buildings	2
Frame buildings	4
Dwellings	3
Dam	2
Furniture and fixtures	7½
General and miscellaneous equipment	10
Wood room	10
Ventilators	10

In computing depreciation on machinery and equipment a rate of 5 per cent was used from 1907 to 1915, inclusive, and a rate of 7½ per cent was used from 1916 to 1919, inclusive, in view of the fact that the machinery and equipment were subject to extraordinary wear and tear during these years.

Depreciation was computed for a half year on all additions and betterments instead of a full year, as shown in your brief.

Relative to the claim for obsolescence of the dam over the period from April 1, 1907, to December 31, 1921, due to the fact that you are contemplating building a new and modern structure at the end of this period, you are advised that this office holds that obsolescence is a chargeable expense when it is definitely determined and in the extent of the difference between the salvage or residual value and the depreciated value at the date of destruction which shall be apportioned over the remaining life of the asset. Inasmuch as you intend to use the old dam in the construction of the new one, a standard rate of 2 per cent for depreciation is used, as it is thought that the dam will have a life of at least 50 years.

The changes in the additional taxes and overpayments for 1909 to 1916, inclusive, are due to adjusting the deductions for depreciation by using the rates indicated above.

The decrease in the additional tax for 1918 is due to the following adjustments:

(*a*) Repairs are increased from $66,892.93 to $72,788.83, due to allowing $5,895.90 that was charged to the reserve for depreciation in error.

(*b*) Losses are increased by $3,887.73 due to allowing the losses on the old machine roof and the old wood room.

(*c*) Depreciation is changed from $90,869.10 to $84,434.80 to agree with the correct depreciation schedule.

(*d*) Invested capital is increased by $179,732.20, due to using the correct depreciation and prorating the correct Federal income tax in the amount of $89,747.48 instead of $60,009.18.

The decrease in the additional tax for 1919 is due to the following adjustments:

(*a*) Depreciation is changed from $94,921.86 to $89,350.37 to agree with the corrected depreciation schedule.

(*b*) Invested capital is increased by $194,964.97 due to using the correct depreciation reserve and prorating the correct Federal income taxes.

It is noted that you did not execute a waiver or sign an amended return consenting to an assessment of the additional tax for 1909, 1910, and 1916. You are, therefore, requested to make voluntary payment to the collector of internal revenue for your district of the balance due for 1909, $59.76; $26.73 for 1910; and $120.22 for 1916.

Your claim filed February 18, 1920, for the abatement of taxes assessed for 1917 has been considered in determining the additional taxes previously indicated. The final disposition of this claim will be made the subject of a separate communication.

The collector of internal revenue for your district will notify you as to the time and manner of making payment of the tax for 1918 and 1919.

Respectfully,

_____,

Acting Deputy Commissioner.

APRIL 16, 1921.

COLLECTOR OF INTERNAL REVENUE,
St. Paul, Minn.:

Reference is made to the report of internal revenue agent in charge at St. Paul, Minn., dated July 29, 1920, which indicates an additional tax as follows:

	Additional tax	Overpayment
1909	$127.03	
1910	26.73	
1915		867.27
1916	120.22	
1918	33,746.80	
1919	17,111.39	
	51,132.17	67.27
	67.27	
Net additional tax to be assessed	51,064.90	

It is noted that the corporation did not file an amended return or waiver consenting to the assessment of an additional tax due for 1909, 1910, and 1916. You are therefore requested to make informal demand for $59.76 for 1909, $26.73 for 1910, and $120.22 for 1916, and advise this office the result thereof.

_____,
Acting Deputy Commissioner.

EXHIBIT NO. 7

SEPTEMBER 19, 1922.

WATAB PULP & PAPER CO.,
Sartell, Minn.

SIRS: The audit of your income-tax returns filed for the years 1916 to 1919, inclusive, and verified by your books of account and records indicates an additional income-tax liability for 1916, 1918, and 1919, and overassessment for 1917, summarized and explained as follows:

1916

Net income reported on original return		$253,270.61
Depreciation deducted in return	$61,400.00	
Depreciation deducted on books	40,000.00	
Depreciation disallowed		21,400.00
Net income corrected		274,670.00
Tax due at 2 per cent		5,493.41
Tax previously assessed		5,065.41
Additional tax due		426.00

1917

Your net income is increased to $347,637.50 and is subject to tax as follows:

Excess-profits tax		$56,313.88
Income tax at 2 per cent		5,826.47
Income tax at 4 per cent		11,652.94
Total		73,793.29
Tax assessed	$91,921.98	
Less amount abated on Schedule 5594, June, 1921	174.50	
		91,747.48
Overassessment		17,954.19

Following are the adjustments which have been made in your net income:

Net income reported on amended return		$333,471.27
Depreciation deducted	$98,186.35	
Depreciation allowed	84,020.12	
		14,166.23
Net income corrected		347,637.50

Invested capital is computed as follows:

Capital stock outstanding		1,295,650.00
Surplus		[1] 268,010.87
Dividends accrued		1,458.37
Rents credited in error to real estate and plant account		326.50
Invested capital Jan. 1, 1917		1,565,454.74
Less:		
1916 salaries paid in January, 1917, charged to surplus	$2,000.00	
Income tax for 1916 of $5,493.41 prorated for six and sixteen-thirtieths months	2,990.86	
		4,990.86
Corrected invested capital		1,560,463.88

Since representative concerns did not earn in excess of 7 per cent during the pre-war years, your deduction for excess-profits tax purposes has been computed at the rate of 7 per cent.

7 per cent of $1,560,463.88	$109,232.47
Exemption	3,000.00
Excess-profits deductions	112,232.47

1918

Your net income as corrected is $293,592.80 and is subject to tax as follows:

Profits tax	$86,182.88
Income tax at 12 per cent	24,649.19
Total	110,832.07
Tax previously assessed	94,879.87
Additional tax due	15,952.20

The following adjustments have been made in your net income:

Net income reported on amended return		$276,257.15
Depreciation deducted	$104,730.21	
Depreciation allowed	87,394.56	
		17,335.65
Corrected net income		293,592.80

Invested capital is adjusted as follows:

Invested capital Jan. 1, 1917		$1,565,454.74
Net income for 1917	$347,637.50	
Less:		
Accrued salaries	$2,000.00	
1918 income tax	5,493.41	
Dividends paid	17,500.00	
Donations	1,238.00	
	26,231.41	
		321,406.09
Invested capital Jan. 1, 1918		1,886,860.83

[1] Pencil notation on original: The allowance of this surplus is a direct violation of the recommendations in the R. A. R. and valuation report.

Less:		
Dividend of $19,434.75 paid Feb. 1, 1918, prorated for 334 days	$17,784.13	
Income tax for 1917 of $73,793.20, prorated for 200 days	40,434.68	
		$58,218.81
Invested capital as adjusted		1,828,642.02

1919

Your net income as corrected is $382,414.06 and is subject to tax as follows:

Profits tax	$44,480.06
Income tax at 10 per cent	33,564.63
Total	78,044.69
Previously assessed	70,987.90
Additional tax due	7,056.79

Your net income has been adjusted as follows:

Net income reported on amended return		$363,958.76
Depreciation deducted	$108,206.91	
Depreciation allowed	89,751.61	
		18,455.30
Corrected net income		382,414.06

Invested capital is computed as follows:

Invested capital Jan. 1, 1918		$1,886,800.83
Net income for 1918	$203,592.80	
Nontaxable income for 1918	255.54	
		293,848.34
		2,180,709.17
Less:		
Income tax for 1917	73,793.20	
Dividends paid in 1918	95,206.00	
Treasury stock purchased during 1918	2,200.00	
		171,199.20
Invested capital Jan. 1, 1919		2,009,509.88
Less income tax of $110,832.07 for 1918 prorated from the dates when due and payable		46,837.85
Corrected invested capital		1,962,672.03

Schedule showing method of computing depreciation is attached.

The overassessment for 1917, shown herein, will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district and will be applied by that official in accordance with section 252 of the revenue act of 1921.

You will be given 30 days from the date of this letter to present any exception to this proposed assessment and to show cause or reason why the same should not be listed and paid. This may be done either by a sworn statement of facts or exceptions submitted within the above period, or at a conference in this office which may be arranged upon request for a date prior to the expiration of such period.

Payment should not be made until a bill is received from the collector of internal revenue for your district, and remittance should then be made to him.

You are requested to fill out and return to this office the inclosed blank form of waiver consenting to the assessment of the additional tax for 1916 as noted above, or in lieu thereof make voluntary payment to the collector for your district within 30 days from the date of this letter.

Respectfully,

E. H. BATSON,
Deputy Commissioner.

Depreciation schedule, Watab Pulp & Paper Co.

	Asset at beginning of year	Deduction (figured for half year)	Additions figured for—		Net amount	Rate	Depreciation
			Full year	Half year			
1917						P. ct.	
Dam	$314,946.52		$4,673.61		$319,620.13	3.8	$12,145.56
Equipment	747,888.22	$97,528.06	50,978.27	$88,890.72	795,047.82	6.5	51,678.11
Brick buildings	530,923.46	849.02	1,665.31		532,164.26	[1] 3.0	15,964.93
Frame buildings	16,969.65		177.00		17,146.65	4.5	771.60
Furniture and fixtures	4,041.92	16.10		1,298.77	4,683.16	10.0	468.32
Dwellings	5,431.45			10,029.05	10,445.48	2.8	292.47
Miscellaneous plant equipment	12,329.35	1,735.12	4,312.92		15,774.71	10.0	1,577.47
Ventilators	434.85		16,547.21		15,982.06	6.0	958.92
Wood-room equipment			2,503.66		2,503.66	6.5	162.74
Machine-room roof							
Total							84,020.12
1918							
Dam	319,620.13		823.74		320,443.87	3.8	12,176.87
Equipment	791,229.15	2,193.42	5,567.53	23,415.17	807,407.55	6.5	52,481.49
Brick buildings	531,739.75	4,952.65			526,263.42	3.0	15,877.90
Frame buildings	17,146.65		2,410.78		19,557.43	4.5	880.08
Furniture and fixtures	5,324.59		378.73	281.08	5,843.86	10.0	584.39
Dwellings	15,459.80	1,281.35		13,593.75	21,616.70	2.8	605.27
Miscellaneous plant equipment	14,907.15		1,081.81		15,988.96	10.0	1,598.90
Ventilators	15,982.06		7,170.68		23,152.74	6.0	1,389.16
Wood-room equipment	2,503.56		18,576.27		21,079.83	6.5	1,370.19
Machine-room roof			12,294.65		12,294.65	3.5	430.41
Total							87,394.56
1919							
Dam	320,443.87				320,443.87	3.8	12,178.87
Equipment	818,018.43	1,490.00		47,793.03	841,907.50	6.5	54,723.99
Brick buildings	526,787.10				526,787.10	3.0	15,803.61
Frame buildings	19,557.43				19,557.43	4.5	880.08
Furniture and fixtures	5,964.40			32.50	6,000.65	10.0	600.07
Dwellings	27,772.90			54.37	27,801.09	2.8	778.43
Miscellaneous plant equipment	15,988.96				15,988.96	10.0	1,598.90
Ventilators	23,152.74				23,152.74	6.0	1,389.16
Wood-room equipment	21,079.83				21,079.83	6.5	1,370.19
Machine-room roof	12,294.65				12,294.65	3.5	430.51
Total							87,751.61

[1] Pencil note on original: Where does a 3 per cent rate on brick buildings come from? Life is at least 45 years.

MEMORANDUM BY TIMBER SECTION, WATAB PULP & PAPER CO., 1913 TO 1919, INCLUSIVE

NOVEMBER 25, 1921.

This company acquired timberlands prior to 1911 and small additions were made in subsequent years. Purchases are carried on the books at cost. In the revenue agent's report it is stated that its pulp wood is purchased from other owners and that none of the taxpayer's timber has been cut. Depletion of timber is therefore not involved at present.

Recommended by:

D. P. TIERNEY,
Forest Valuation Engineer.

Approved:

CARL M. STEVENS,
Chief, Timber Section.

Mr. GREGG. In that connection I would like to point out that depreciation is involved in every corporation case that arises. It is impossible for us to have that gone into by engineers in every case. The auditors have to do it.

Mr. MANSON. It at least can be gone into by industries.

Mr. GREGG. Well, it varies, of course, in an industry. We do always refuse to set fixed rates for an industry, because it varies on account of the peculiar conditions in each case.

Senator JONES of New Mexico. How do the auditors arrive at a figure of 7½ per cent?

Mr. GREGG. I do not know anything about that case.

Senator JONES of New Mexico. Well, how do they arrive at it ordinarily, if they do not look at it from an engineering standpoint?

Mr. GREGG. Is this the case of a pulp and paper company?

Mr. MANSON. Yes.

Mr. GREGG. I happen to know that the rates set by Great Britain for the composite rates of pulp and paper companies is 7½ per cent, and we use that to a certain extent.

Senator JONES of New Mexico. Is that not wholly inconsistent with your idea that you do not know, and that you do not estimate depreciation by industries?

Mr. GREGG. Yes, sir. I did not say we were following the British, but their rates are known to the department, and they are sometimes considered. We do not apply them flat-footedly to an industry, though.

Senator JONES of New Mexico. How do you determine when to apply it, and not to apply it, unless you consider it from an engineering standpoint?

Mr. GREGG. There may be factors shown in an individual case, such as the question of overtime. I am wondering whether the plant was working overtime in 1917, 1918, and 1919.

Mr. MANSON. Yes; but the engineers pointed out that that machinery was designed to run that fast, that it could not be made to run any faster, that it was designed to operate 24 hours a day, and that the depreciation rate was fixed upon that basis, so that while speeding it up may be a factor, the overtime was not, and that even under those conditions the parts that would wear, such as bearings, etc., were taken care of out of maintenance and not out of depreciation, and there was no possible condition under which depreciation could be doubled, to say nothing about trebling it.

In this case I call attention to the fact that the taxpayer had taken 2.5 per cent when there was no income tax, 5 per cent when it was low, and 7½ per cent in the high years.

The CHAIRMAN. On what theory, I would like to ask Mr. Gregg, could an auditor arrive at a depreciation rate if he is not required to consult engineers? Just assume that I am an auditor going over a case of a paper mill. Just what basis would I use to arrive at the depreciation rate?

Mr. GREGG. As a guidepost or starting point, I do not know what data we have outside of the rates which have been set in Great Britain. Do you know, Mr. Arundell?

Mr. ARUNDELL. No; I do not.

Mr. GREGG. Where they have their ratings on different types of machinery and in the industry they are the starting points. We have never applied them 100 per cent.

The CHAIRMAN. Where there is a dispute, as there was in this case, between the engineers and the auditors, who would you consider the most competent to determine the depreciation rate?

Mr. GREGG. I should say the engineers.

The CHAIRMAN. Then you would not justify the audit section in overriding the engineers on a question of depreciation?

Mr. GREGG. They might do it here, but I would not ordinarily. Here is a case where we have to have the engineers pass upon engineering questions——

The CHAIRMAN. But here is a case where they did pass upon them, and the rate was not used.

Senator JONES of New Mexico. Unless you do it by industries, it seems to me it is an engineering question, not an auditing question.

Mr. GREGG. I assume that properly it is an engineering question. It would be desirable, I suppose, if we had the engineers available, to have them pass on all depreciation questions; but we do not have the engineers available to do that.

Senator JONES of New Mexico. And do you not, as a matter of fact, have a standard for general purposes, based upon an industry?

Mr. GREGG. As a starting point; yes, sir.

Senator JONES of New Mexico. And is not that starting point necessarily an engineering question?

Mr. GREGG. I think that is true.

Mr. MANSON. I have a report here on the case of the Kerr Turbine Co.

The material point in this case is that the officers, the two principal officers of the company, had a contract with the company under which they were to receive as their compensation 4 per cent of the gross sales, to be paid when, in the discretion of the directors, the company was financially able to pay it.

This 4 per cent of gross sales, even though not paid under that contingent arrangement, was permitted as a deduction from the income of the corporation, but upon the ground that they had not actually received it, and the officers of the corporation did not include it in their own income for the purposes of taxation.

The CHAIRMAN. In other words, your contention is that it should not have been set up by the corporation, unless it was paid?

Mr. MANSON. My contention is that it should not have been set up, unless it was at least a fixed liability.

Mr. GREGG. You do not contend, though, do you, Mr. Manson, that the fact it was not included as income by the stockholders necessarily deprives the corporation of the deduction?

Mr. MANSON. No, sir; I do not.

Mr. GREGG. In other words, a corporation may accrue a salary liability which is not income to the official or employee?

Mr. MANSON. Absolutely; I admit that.

The CHAIRMAN. Assuming that as correct, has the bureau any system to follow up, after the corporation has once accrued this liability, to see that it is actually paid?

Mr. GREGG. When it is paid, the corporation is required to make an information return, which is checked against the individual's returns.

The CHAIRMAN. Oh, yes; that is understood. But suppose it is never paid; what then? Does the bureau have any basis for checking up to see whether that may not be a fictitious set-up?

Mr. GREGG. In the subsequent audit of the corporation's accounts that would be determined. For example, every corporation accrues hundreds of items, and in the audit for subsequent years we determine whether they are paid or not.

The CHAIRMAN. That question is asked?

Mr. GREGG. Yes.

The CHAIRMAN. The bureau does check up to see whether the reserves not paid in one year are really paid in subsequent years?

Mr. GREGG. Oh, yes. Of course, we may miss them once in a while.

Mr. MANSON. The report in connection with this case is as follows:

This corporation was organized July 9, 1904, under the laws of the State of New York.

It was engaged in the manufacture of steam turbines and gears.

On November 30, 1921, Henry C. Kelly, revenue agent, submitted a report of his examination of the books of this taxpayer for the fiscal years from April 30, 1917, to April 30, 1921, inclusive. He recommended the assessment of the following additional taxes:

Fiscal year 1917	$736.17
Fiscal year 1919	7,161.03
Fiscal year 1920	29,473.43
Fiscal year 1921	18,684.92
Total additional tax	56,055.55

Among other things in his report, he stated that—

"The taxpayer employed accountants to close his books and prepare return. In general their work was above the average, but in some cases they erred, as mentioned in my report. This business is highly organized and an elaborate cost system is maintained, so that they can tell the cost of each item in their business. This business of determining cost is carried to great detail and elaborate reports to arrive at percentages are prepared. It was necessary to use some of this data for my purpose, but in general I could not hope to go far into the cost system since the results were controlled. The consulting accountants took some two or three months to prepare their audit. I consider the entire affair as too big for one to grasp, unless he were actually here when these audits were prepared."

The minutes of the corporation show that at the annual meeting of the board of directors on July 5, 1917, the following resolution was adopted:

"Whereas, in lieu of any fixed salaries, the compensation allowed the president and treasurer for financing and managing the affairs of this corporation since the reorganization of the company, was fixed at 4 per cent per annum of the gross sales; and

"Whereas this allowance applies on the amount of unfilled orders on the books of this company on May 1, 1917, amounting to the sum of $1,232,956.33; and

"Whereas Mr. F. P. Merrill, president, and Paul B. Hanks, treasurer, have at this meeting offered to relinquish said agreement and compensation at a net saving to the company of $12,329.55 on orders already accrued on the books; and offer to accept 3 per cent allowance of the monthly shipments in lieu thereof: Be it

"*Resolved*, That the offer of Messrs. Merrill & Hanks be accepted, but in view of the present and probable future financial necessities of the company that said compensation be credited to an accrued commission account, to be drawn upon by Messrs. Merrill & Hanks only when in the opinion of the directors the financial condition of the company will permit, except that the treasurer will be permitted to draw a salary of $250 per month."

Under the authority of this resolution the taxpayer set up on its books as commissions accrued to Messrs. Merrill & Hanks the following amounts:

F. P. Merrill, fiscal year 1918, $11,084.39; fiscal year 1919, $19,544.87; fiscal year 1920, $11,457.57; and fiscal year 1921, $8,934.48.

P. B. Hanks, fiscal year 1918, $25,168.79; fiscal year 1919, $29,089.77; fiscal year 1920, $22,915.21; and fiscal year 1921, $38,880.53; making totals as follows: Fiscal year 1918, $36,253.18; fiscal year 1919, $48,634.64; fiscal year 1920, $34,372.69; and for the fiscal year 1921, $47,815.01.

For the fiscal year 1922, F. P. Merrill, blank, and P. B. Hanks, $9,809.31; making a total for that year of $9,809.31.

The taxpayer claimed that as these amounts represented commissions that were actually accrued and set up on their books, they were properly deductible from their gross income for income-tax purposes. These deductions were allowed by the Income Tax Unit.

An examination of the returns of the president and treasurer, above named, for the years from 1917 to 1921, inclusive, shows that they reported the following income as having been received from this taxpayer:

For 1917, F. P. Merrill, $9,351.66; P. B. Hanks, $21,751.95; total, $31,103.61. For 1918, P. B. Hanks, $6,300; 1919, P. B. Hanks, $4,500; 1920, P. B. Hanks, $6,027.50; and for 1921, P. B. Hanks, $9,406.03.

The difference between the amount deducted by the corporation on account of these accrued commissions and the amounts of compensation reported by the officers is $119,547.69, which amount has escaped taxation.

In examining the return of Mr. F. P. Merrill for the year 1918, the revenue agent reported as additional income for the year 1918 the amount of $11,084.39, representing the sum set up by the corporation on its books as accrued commissions to the credit of Mr. Merrill, which, however, he failed to report in his return. Objection by the legal representative of Mr. Merrill, who died in 1920, was made, and a conference was held on January 12, 1923, a report of which is as follows:

"Objection was also made to the inclusion in 1918 of $11,084.39 as having been received from the Kerr Turbine Co. It was contended by the representative that this amount was not set aside or made available to the taxpayer by this corporation, but was merely accrued on the books of the company, as shown by an affidavit from Clyde E. Schultz, secretary of the Kerr Turbine Co. Reference to the affidavit indicates that this amount was credited to an accrued commission account to be drawn upon by the taxpayer only when in the opinion of the board of directors the financial condition of the company would permit, and in view of the representative's statement that the board of directors never authorized the withdrawal of any amount on account of constant losses of the corporation, the amounts could not be legally withdrawn. It is the opinion of the conferee that this amount was not actually received as income for that year in arriving at the taxpayer's tax liability.

"It should be further noted that the representative stated that each year up until the date of the taxpayer's death the 3 per cent allowance on monthly shipments was credited by the corporation to the accrued commission account, but has never been withdrawn or authorized to be withdrawn, even by the estate, on account of the fact that the Kerr Turbine Co. is on the verge of bankruptcy and the collection of this amount would immediately cause the concern to be thrown into the hands of a receiver. In view of the evidence submitted, it is recommended that the amount of $11,084.39 be eliminated from the taxpayer's income for 1918 and that adjustments be made accordingly."

Under date of January 18, 1924, W. F. Mays, internal revenue agent in charge, Buffalo, N. Y. submitted a report of Internal Revenue Agent W. J. Carr on his investigation for estate tax purposes of the estate of Frederick P. Merrill. In this report Mr. Carr includes as an asset an account against the Kerr Turbine Co., Wellsville, N. Y., $51,021.31, representing unpaid commissions due Mr. Merrill at the time of his decease. The estate tax return as submitted by the executors of the decedent reported this asset at the value of $25,000. The agent stated as follows:

"This account was verified at the office of the Kerr Turbine Co. Mr. L. E. Hopkins, treasurer of this company, states that this account is made up of a stipulated percentage basis of profit of the business which decedent was to receive as salary as president of the company for his financial assistance rendered to the company. This percentage of the profits as shown by the books

of the company covers a period from April 30, 1918, to December 14, 1920, when decedent ceased to act as president to the company, and was as follows:

Balance to Apr. 30, 1918	$11,084.39
May 1, 1918, to May 1, 1919	19,544.87
May 1, 1919, to Dec. 14, 1920	8,734.48
Total	51,021.31

"Mr. Hopkins states further that the sum of $51,021.31 had actually accrued to this decedent up to the date of death and was an enforceable obligation of the company and that the company had to pay that sum to the estate by signing and delivering the company's promissory notes for the full amount as recommended herein."

It appears from the record that Mr. Merrill, president of this taxpayer, adopted various means for the purpose of evading income tax. Agent Carr reports on this question as follows:

"Fred A. Robbins, Esq., Hornell, N. Y., states that this decedent was a monomaniac on the subject of tax. Decedent continually pestered Mr. Robbins to assist him in his efforts to eliminate such high taxes, stating that the Government was taking all he made, and would sit in Mr. Robbins's office with a pencil and pad and describe to Mr. Robbins how by a system of pyramiding figures the Government would eventually take a man's entire income and his property.

"Further, that the decedent made business trips to New York City about every other week pertaining to the silk industry, purchasing silk and watching the market, as this decedent, when he made a purchase, would take over 100 bales at one time, being such a heavy buyer that his purchases were felt all over, even in Japan, when the market would jump 3 to 4 points. That the decedent made his purchases through a Japanese firm in New York City; that some time between the fall of 1919 and June, 1920, this decedent acquired in an unknown manner blank shipping bills of the Japanese firm in New York City. That at various times during the aforementioned period this decedent, in his effort to defeat the income taxes, would make out a bill against the Merrill Silk and Merrill Hosiery Cos. upon a typewriter that he had at his home for a fraudulent shipment of silk, and mail it from New York City, and return to Hornell, make out a check in payment thereof to himself, take it to New York City upon his next trip and deposit it to his personal credit at the Liberty National Bank in New York City. The charge for the silk was made upon the books of the two companies but the silk was never delivered. This decedent did not endeavor to defraud his fellow associates in these companies; that on or about June, 1920, the decedent purchased New York City bonds with a greater portion of the money he procured in this manner and went to each of his associates and gave them a proportionate share, telling them as he made the donation, 'These are yours. Don't ask any damn questions.' That when he gave Mr. B. C. De Witt, Hornell, N. Y., his bonds, Mr. De Witt told the decedent he would go to jail if he did not watch out. The decedent told him to mind his own damn business and was very angry.

"That after decedent's death these transactions were discovered upon the books of the companies and brought to the attention of the executors, who made an investigation by procuring a copy of the decedent's deposits and withdrawals at the Liberty Bank aforesaid, and tallied approximately with the amount of bonds distributed by the decedent to his associates in the two companies. A settlement of this matter was had by the companies and the executors and set forth under Schedule I of this report."

The executors, according to Mr. Carr's report, reimbursed the Merrill Silk Co. and the Merrill Hosiery Co. in the sum of $196,566.19 and $131,564.64, respectively, for the purpose of making good the defalcations of Mr. Merrill, who had been president of each of his companies.

Regardless of the fact that the report of Agent Carr in regard to the character of the president of this taxpayer was filed in the Internal Revenue Bureau, the records fail to indicate that any effort was made by the Income Tax Unit to collect the taxes due the Government on the items of commissions which had been accrued on the books of the taxpayer in favor of its president and treasurer but not paid.

The resolution referred to above adopted by the taxpayer providing for the payment of a commission of 3 per cent of the gross sales was not sufficient authority for deducting the accrued commissions from the income of the taxpayer, as it provided for the payment of commissions only upon a certain contingency; that is, "only when in the opinion of the directors the financial condition of the company will permit." If the financial condition of the company was such that it could not pay its officers, the officers could not enforce the payment of the commission, or if the financial condition would permit of such payments, but in the opinion of the directors the financial condition would not permit such payment, the officers could not enforce the company to compensate them, so that no deductions should have been allowed the taxpayer on account of these accrued commissions, from its income, and such deduction should not be allowed until the actual time of payment or at such time as the amount was set up on its books and available to its officers to such an extent that they could have enforced their rights by an action at law.

Mr. MANSON. That is all I have to present this morning.

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

(Whereupon, at 12.30 o'clock p. m., the committee adjourned until to-morrow, Thursday, May 28, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

THURSDAY, MAY 28, 1925

UNITED STATES SENATE,
SPECIAL 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, Ernst, and Jones of New Mexico.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. Raleigh C. Thomas, investigating engineer for the committee.

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, Assistant to the Commissioner of Internal Revenue; and Mr. A. W. Gregg, solicitor, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed now, Mr. Manson.

Mr. MANSON. I want to call the committee's attention to the matter of the taxes of the General Motors Co. and the General Motors Corporation for the year 1917.

On the original return the General Motors Co. paid a tax of $1,278,519.56.

Subsequently there was assessed against the General Motors Co. for 1917—that is, in February, 1923—an additional tax of $7,105,554.91.

The General Motors Corporation paid on their original return a tax of $3,911,016.22.

The CHAIRMAN. For the same year?

Mr. MANSON. For the same year.

Senator WATSON. Is there a difference between the General Motors Co. and the General Motors Corporation?

Mr. MANSON. The one succeeded the other in 1917.

In June, 1920, there was assessed against the General Motors Corporation an additional tax of $10,008,899.94, making a total additional assessment against these two corporations, one of which succeeded the other, of $17,114,454.85.

After these additional assessments were made claims in abatement were filed, which I understand have not been disposed of.

There are two questions that arise with reference to which I desire to have Mr. Gregg give the committee some information.

Senator ERNST. Do I understand that this case has not been finally determined?

Mr. MANSON. No; it has not been; but there are two questions involved here, one of which is the question whether, inasmuch as the statute of limitations has run—and there are no waivers, I understand, in this case—against the assessment, it has not also run against the collection of these taxes; and the other question is as to when interest, if the statute has not run, begins to run on deficiencies found in the 1917 tax.

As to the first question, the statute of limitations as to the collection of taxes was the same—that is, for 1917—as the statute of limitations for the assessment of taxes, and while there have been these extra assessments—the assessments have been levied within the statute—they have not been collected within the statute.

The United States Circuit Court of Appeals has recently held—that is, as I understand the decision—that proceedings by the department by distraint come within the limitations of the statute, the same as proceedings in court do, and yesterday I called Mr. Gregg on the phone and asked him to inform the committee this morning as to the effect of those decisions and as to the present status of this and similar cases, of which there must be a great many.

Mr. GREGG. This whole question goes back pretty far. Under the old acts the practice used to be to assess the tax and fight out the points at issue on the claim in abatement. The policy was afterwards changed to thresh them out first and then make the assessment. The old policy was to make the assessment and have the taxpayer file a claim in abatement, and then fight out the points which are in dispute.

Senator WATSON. When was that policy changed, Mr. Gregg?

Mr. GREGG. The 1924 act changed it.

Senator WATSON. Oh, yes.

Mr. GREGG. And the 1921 act changed it, too.

Mr. MANSON. Under the 1921 act you have a period within which you can make an assessment, and then you have an additional period of time within which you can make the collection; is not that right?

Mr. GREGG. That is right.

The CHAIRMAN. Mr. Nash does not seem to agree with that.

Mr. NASH. There have been some changes as to the time within which to make collection.

Mr. GREGG. There is under the 1921 act. The 1921 act gives four years for the assessment and five years for the collection for taxes due under that act.

The CHAIRMAN. What is the 1924 act? I am not clear on that. Is it the same as the 1921 act?

Mr. GREGG. Yes; it keeps the period of limitations the same, but I was making the point that Mr. Manson raised. The result was that we would make the assessment within the period, and it might be several years before the tax would be collected. We would be fighting out the different points involved in the assessment.

Mr. MANSON. That is, you would make the assessment, the taxpayer would file a claim in abatement, and a period of time would elapse, which would carry the matter over the statute of limitations for the assessment?

Mr. GREGG. Yes. When the 1921 act was in the Senate a provision was put in 250 with reference to the tax under the old act, prior to

the 1921 act. The language is that no suit or proceedings for collection of the tax shall be begun within five years after the time the return was filed. When it was in the Senate the department suggested an amendment, to say that no suit or proceeding in court, so as to clearly except distraint proceedings. Senator Smoot offered the amendment on the floor of the Senate, and Senator Reed of Missouri objected to it. They got into some discussion on the point, and it was dropped and never brought up again.

Immediately after the act was passed the taxpayers contended that if the tax was assessed within the statutory period, but not collected within the period, the department could take no steps to collect it, because distraint was a proceeding which was barred by the statute after a lapse of five years.

We took the position that distraint was not a proceeding of that kind, and that if the tax was assessed within the period, we could collect it by distraint at any time thereafter.

There is an opinion of the solicitor on that point.

The first case brought to test was the Du Pont case, where the tax was assessed within the five-year period, but there was some controversy in connection with the reorganization of the company as to whether it was income, and it was finally settled by the Supreme Court in the Phellis case.

After the lapse of the five-year period, when we attempted to collect the tax, the taxpayer attempted to enjoin us.

Mr. Moss. In the Phellis case?

Mr. Gregg. No; the Du Pont case. It went to the Supreme Court. He contended that we had no right to collect the tax by distraint after the five-year period. The court upheld the action of the department, but on the ground not that we had a right to collect the tax after the five-year period but they put the decision entirely on section 3234 of the Revised Statutes, and stated that the collection of the tax could not be enjoined in any case.

Mr. Manson. And Du Pont paid the tax, did he not?

Mr. Gregg. He paid the tax.

Mr. Manson. Yes.

Mr. Gregg. We compromised the penalties, and he paid the tax.

Mr. Manson. Yes.

Mr. Gregg. That settled the matter of enjoining collection.

Senator Watson. They did not decide it on the point on which it was taken up at all, then?

Mr. Gregg. No, sir.

Mr. Manson. No.

Mr. Gregg. They did not pass on that question at all. Subsequently, the question has gone to court in a good many cases, and I have here one decision passing squarely on the point.

Senator Ernst. Is that a decision of the Supreme Court?

Mr. Gregg. No; it is a district court decision and, of course, we are going up on it. We have not acquiesced in it.

Mr. Manson. Before you come to that district court decision, in the case of Seaman *v.* Bowers, a similar attempt was made to enjoin the collection of taxes. In that case the United States Circuit Court of Appeals, following the Du Pont case, held that an injunction would not lie to restrain the collection of the tax; but they did pass,

perhaps obiter, on the question of whether a distraint was a proceeding within the meaning of the statute of limitations, and held that it was.

Senator WATSON. Was that the question involved?

Mr. MANSON. That was the question involved.

Mr. GREGG. Of course, they did not have that question squarely before them when they decided the case on 3234.

Mr. MANSON. Well, Judge Hand, in the subsequent case, which, as I take it, is the one you are referring to here, holds that they did have the question before them, and that their ruling was not obiter.

Pardon me for interrupting you, but I wanted to make that statement.

Mr. GREGG. Here is the only case that passes squarely on that point.

Senator WATSON. What was this Phellis case, and what was the decision in that case?

Mr. GREGG. The first case, the Phellis case, decided that income was realized by the sales of the Du Pont Co. in connection with the reorganization of that company in 1917.

Senator WATSON. That had nothing to do with this case?

Mr. MANSON. No.

Mr. GREGG. That has nothing to do with this case. Then they attempted to enjoin our collection of the tax, and it went to the Supreme Court, and the Supreme Court held that they could not enjoin the collection, but did not pass on this point. This is the first case in which they passed squarely upon it. It is a decision by Judge Hand, and I can read it if the committee desires me to do so.

The CHAIRMAN. I would like to have you do so.

Mr. GREGG (reading):

This is an action to recover income and excess-profits taxes for the year 1917 collected by distraint. The return was filed by the plaintiff with the collector of internal revenue on March 26, 1918, and at the time of such filing $1,515.92 taxes were paid "which plaintiff believed to be the entire amount for which it was liable for income and excess-profits tax for the year 1917." On or about March 18, 1923, plaintiff received from the defendant as collector of internal revenue a bill and demand for payment of an additional assessment of $1,180.62 claimed to be due from plaintiff for income and excess-profits taxes, which plaintiff refused to pay on the ground that such additional assessment and collection were barred by the provisions of section 250 of the United States internal revenue act of 1921. In October and November, 1923, the defendant filed notices of lien and collected the taxes through warrants of distraint. This case comes up on a motion by the plaintiff for judgment against the defendant on the first cause of action in the complaint, which is to recover taxes paid under duress.

Section 250 (d) of the revenue act of 1921 provides as follows:

"SEC. 250 (d) The amount of income, excess profits, or war profits taxes due under any return made under this act for the taxable year 1921, or succeeding taxable years, shall be determined and assessed by the commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this act for prior taxable years or under prior income, excess profits, or war profits tax acts, or under section 38 of the act entitled 'An act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes,' approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this act or under prior income,

excess profits, or war profits tax acts, or of any taxes due under section 38 of such act of August 5, 1909, shall be begun, after the expiration of five years after the date when such a return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this act."

In the present case the assessment was within five years from the date when the return was filed and the proceedings by distraint were after that time. The Government contends (1) that the assessment itself was a proceeding for the collection of the tax which was taken within the five-year period; (2) that if this is not so, the five-year statute of limitations should not be taken to relate to anything but a court "proceeding." If either contention should be upheld, the right to collect the taxes was not barred when they were received by the defendant through warrants of distraint.

The arguments made by the Government here were urged by it before the circuit court of appeals of this circuit in Seaman *v.* Bowers (297 Fed. 371). The opinion of the court in that case construed the word "proceeding" as embracing distraints. It is argued that such a holding was obiter dictum. It is true that the court denied the injunctive relief sought by the taxpayer by reason of the provisions of section 3224 of the Revised Statutes as construed by the Supreme Court in Graham *v.* Du Pont (262 U. S. 254). But there was a careful brief submitted by the Government to show that the five-year limitation did not apply to warrants of distraint under circumstances where the taxpayer was contending that the right to collect his tax was barred and that if he paid it he had no way of recovering it back under the statutes then applicable. In answer to these various contentions the circuit court of appeals gave its reasons for holding that the Government was wrong in its contention that the five-year limitation did not apply to warrants of distraint, and that the taxpayer was equally wrong in his supposition that his right to sue for recovery of taxes paid under duress would be barred by existing statutes.

It seems a rather forced view to regard as mere obiter dictum the opinion of the court of appeals that in the absence of fraud on the part of the taxpayer proceedings for the collection of taxes, whether by suit or distraint, must be begun within five years after the date when the return was filed. The taxpayer rested his whole prayer for an injunction upon the ground that the right of the Government to collect the tax was outlawed, that his right to recover back the tax, if he should pay it, would be barred, and that he was, therefore, asserting his only remedy. If the Government's contention that distraints were not affected by the five-year statute had been sound this would have been quite as complete an answer to the taxpayer's suit as were the provisions of section 3224 of the Revised Statutes that "No suit for the purpose of restraining the assessment for collection of any tax shall be maintained in any court," because, irrespective of this important regulation of procedure, there would have been no foundation whatever for the claim.

As an original question the position the Government takes is not without some force. Not only is "proceeding" associated in the same clause with the word "suit," but in the report of the Committee on Finance in the Senate relating to section 250(d) of the bill, which afterwards became the revenue act of 1921, it is said that—

"Section 1320 of this bill prevents the bringing of any suit or proceeding by the Government in any court for the collection of internal-revenue taxes after the expiration of five years from the time such tax was due except in the case of fraud. Subdivision (d) of section 250 contains limitations with respect to income and profits taxes similar to those contained in section 1320."

This language indicates that the Senate committee who reported on the bill thought that "proceeding" meant a judicial proceeding, and their opinion, while not controlling, is relevant and important. (U. S. *v.* St. Paul, M. & M. Ry. Co., 247 U. S. 319.)

Moreover, five years are given by the act within which to make the assessment. Under section 3187 of the Revised Statutes, the taxpayer is given 10 days after notice and demand by the collector within which to pay the tax before a warrant of distraint can issue. It is argued by the Government that if the five-year limitation of section 250(d) of the revenue act applies to proceedings by distraint it in effect cuts down the period within which assessments may be made in all cases where collection by distraint is proposed. This is true enough, but it is not a bad answer to say that if the department chooses to wait until the last 10 days of the five-year period before making its assessment, there can be no great hardship if it be found necessary for it to proceed against the taxpayer by an action at law rather than by a warrant of distraint.

I think that irrespective of the original merits, if any, of the arguments presented by the Government as to the meaning of the word "proceeding" I should follow the opinion of the circuit court of appeals in Seaman *v.* Bowers, supra, and I accordingly grant the motion of the plaintiff for judgment.

Senator WATSON. When was that decision handed down?

Mr. GREGG. I have not the date of it.

Senator WATSON. Is it a recent decision?

Mr. GREGG. Yes; about a month ago.

Senator WATSON. Was that handed down by the district court here?

Mr. GREGG. No.

Mr. MANSON. It is the district court in New York.

Mr. GREGG. It is a decision by Judge Hand of the district court in New York.

Mr. MANSON. I call attention to the fact that in this particular case of the General Motors Co. and the General Motors Corporation assessments were made aggregating $17,000,000 or more long prior to the running of the statute; that the only reason those assessments were not enforced by collection was because of the taxpayers' objection, and the delay was to afford the taxpayer an opportunity for further hearing before the department upon a claim in abatement.

If the decision of Judge Hand, which follows the decision of the circuit court of appeals for the second circuit, is to become the law on this subject, to afford the taxpayer an opportunity for further hearing upon his taxes, the Government has lost a substantial portion of $17,000,000, and I have no doubt that there are many more cases that are similar to that.

Mr. GREGG. There are a great many more.

Mr. MANSON. I believe, the circuit court of appeals having taken this position in this case, there is no reason to suppose, at least so far as this circuit is concerned, that is not the law on the subject, and I call attention to the fact that the second circuit comprises an area in which you probably have more large taxpayers and more taxes involved than in any other circuit in the United States.

Mr. GREGG. Of course we will take that case on up to the Supreme Court of the United States.

Mr. MANSON. I have no doubt of that.

Senator WATSON. Is that case on appeal now?

Mr. GREGG. Yes.

Senator WATSON. When was that decision rendered?

Mr. MANSON. This decision was rendered on the 17th of March, 1924.

The CHAIRMAN. If the Supreme Court sustains the decision of the circuit court of the second district, then the Government really loses all of these taxes?

Mr. GREGG. Yes, sir; it would.

Mr. NASH. I would not say that, because a great many of our collectors on these claims for abatement require a bond, and they would have an action on the bond even if the court held against us on the assessment. The bond is a personal transaction between the collector and the taxpayer, a requisite that the collector requires when he accepts a claim for abatement instead of enforcing collection. I would not be surprised if the collector at Detroit has a bond on this General Motors case.

The CHAIRMAN. But you have no record as to whether he has or not?

Mr. NASH. As I say, it is a personal transaction in his office. It is something that was not required under the law before 1924. The 1924 act now requires a bond with a claim in abatement.

Mr. MANSON. I do not believe there are any bonds in this case, for the reason that a collector in Texas attempted to secure a bond from the Texas Buick Corporation, which was one of the subsidiaries here, and apparently under the laws of Texas it was advisable to have a separate corporation there, and he was ordered by the department not to require the bond. There was a considerable controversy about it and even a suggestion that the collector be removed, because the collector was rather insistent upon the point.

I take it that if they were so insistent in that particular case that bond should be required, it is at least reasonable to believe—this is a tremendously big case and we have not had time to go through all of this evidence—we believe from the experience that the Texas collector had that no bond was required of the corporation at all.

In other words, there would not be any reason for entering into this controversy over one subsidiary if it was the general policy with respect to the cases to require a bond.

Mr. NASH. I am not familiar with the controversy that the Texas collector had with the department about requiring a bond. I have always understood that it was the privilege of the collector to require a bond, that it was his responsibility, and that the department held the collector's bond for the collection of the tax. He was liable under his own bond. I do know that in the New York office—I spent several months there a few years ago auditing the office—that the present collector and his predecessor made a practice of requiring a bond on every claim for abatement. The collector has been subjected to a great deal of criticism on the part of many taxpayers for requiring the bond, but he has held to this policy very strictly.

The CHAIRMAN. Would the bond be sufficient to cover such a claim as this, of $17,000,000?

Mr. NASH. The bonds usually cover the amount of tax involved plus interest for 18 months or 2 years in advance.

The CHAIRMAN. But in case the collector does not get a bond, does his bond in turn protect the Government?

Mr. NASH. His bond is presumed to protect the Government, especially in an important case. In a case like this the collector's bond is for about $250,000.

The CHAIRMAN. So in the event of his not requiring a bond from a taxpayer making a claim in abatement, the Government would not be protected in any such a claim as this?

Mr. NASH. Not under the previous acts, Senator. Under the 1924 act the collector is required to get a bond.

The CHAIRMAN. At this point may I ask whether the bureau has anything to say as to the delay in a case involving so much as this does?

Mr. NASH. I checked up on this case yesterday afternoon. It is a case that I have known has been pending for a long time. It seems to have been one that has involved a great many changes and reor-

ganizations. It seems that the nature of the companies involved has changed two or three times, and there have been several field examinations. The field examinations alone took over a year. The case has been closed in the Income Tax Unit, and it involves an overassessment of over $50,000; it is now pending in the solicitor's office. The years 1918 and 1919 are also closed in the unit, but have not been definitely adjusted, because there are points under question in the 1917 case that are also involved in the 1918 and 1919 cases. They can not close out 1918 and 1919 until 1917 is closed out. This has been one of the really large cases that have gone through the bureau, and one which has been very difficult to handle. We have had as many men working on it as we could work on it without interfering with each other. I believe it has been handled as rapidly as it could be handled under all of the circumstances.

Mr. MANSON. It is manifest to me that if the Supreme Court of the United States has not passed on this question, when the next revenue act is considered by Congress the act should be amended so that a taxpayer may not escape taxes which have been assessed because the collection of them has been delayed in order to give him a further hearing before the department.

The CHAIRMAN. It would appear to me, from looking over the record in the Sinclair oil case, that the same principle applies there. Does it not? Were there not delays in that case, due to the taxpayer's request for further hearings?

Mr. MANSON. Oh, yes; in all of those cases. Of course, in the Sinclair oil case you have a different situation. There you have the statute with reference to depletion. Where depletion or amortization allowances are involved then the statute of limitations does not apply; so it creates a different situation with respect to cases where the amount of tax depends upon depletion and amortization allowances.

Mr. GREGG. I might say, with reference to your statement about legislation, that the 1924 act covers this question.

Mr. MANSON. Oh, yes; I understand that; but what I am talking about now are assessments for 1917, 1918, and 1919, under the 1917, 1918, and 1919 laws. I believe the 1921 act provides, in case of an assessment under the 1921 act, for a period of time permitted for the collection, which begins to run with the date of the assessment. So that the question really does not arise, and in the case of a claim in abatement, that automatically extends the time. It is only cases that arise under the 1917, 1918, and 1919 acts, and they cover a very substantial portion of the war taxes.

The CHAIRMAN. What is the situation with respect to the question of interest?

Mr. MANSON. The question of interest, I am frank to say that I did not get the report in this case until yesterday afternoon, and these are rather large questions, and in view of the fact that I had a good many other cases to examine I depended upon Mr. Gregg's replies for the information as to what the law on the subject is; but I will say this: That from my hurried examination of the law I do not believe that interest begins to run on a deficiency assessment under the 1917 law until the assessment is made.

Mr. GREGG. That is true. It runs from the date of notice and demand, really.

Mr. MANSON. Yes.

Mr. GREGG. Of course, if these are claims in abatement here, it runs from the date the tax was assessed.

Mr. MANSON. Yes. In the General Motors Co. case there was an extra tax assessed of $7,000,000 in 1923 for 1917 taxes. That would be a period of about five years that the Government would lose the interest on the money, and in the case of the General Motors Corporation there is an extra assessment of $10,000,000, assessed in June, 1920, which would be a period of about two years and a half that the Government would lose the interest.

Mr. GREGG. The 1921 and the 1924 acts both carry interest.

Mr. MANSON. Yes.

Mr. GREGG. On additional assessments for 1921 and subsequent years.

Mr. MANSON. Yes.

Mr. GREGG. None of them provide interest on additional assessments under the 1918 or 1917 acts.

Mr. MANSON. In other words, under the 1921 and 1924 acts, the tax paid by a taxpayer on his original return is subsequently found to be less than the amount due the Government, he is charged with interest from the time when he filed his original return, when he should have paid the full tax. Under the earlier acts he is not charged with interest until the department or until the commissioner determines the deficiency.

The CHAIRMAN. Do you consider that the deficiency has ever been determined in this General Motors case as yet?

Mr. MANSON. They determined the deficiency in February, 1923, in the General Motors Co. case, and in June, 1920, in the General Motors Corporation case. If that tax is affected by subsequent action of the department, it would be to reduce it; it would not be to increase it; so that from those dates, they can collect interest, but they can not collect interest from March, 1917.

Mr. GREGG. March, 1918.

Mr. MANSON. Or March, 1918. They can not collect interest on this $7,000,000 from March, 1918, to February, 1923, nor can they collect interest on the $10,000,000 from March, 1918, to June, 1920. When I say $7,000,000 or $10,000,000 I mean so much thereof as is ultimately to be determined to be properly assessable against those companies.

The CHAIRMAN. So that the Government loses the interest on that money from the time of filing the tax return until the time in which they made these additional assessments?

Mr. MANSON. Yes. That is an important point in connection with oil cases and in connection with all natural resource cases, where a long period of time elapsed between the time when the return is filed and the time when the assessment is made, because the Government loses interest there, just the same as in the other case.

The CHAIRMAN. Has any additional assessment been made in the General Motors case since those assessments which have been referred to, or does your record show that?

Mr. MANSON. The record does not show that these cases have not been finally disposed of, but Mr. Nash has just explained that they have not.

Mr. NASH. The two assessments for 1917 aggregate, as Mr. Manson has stated, about $18,000,000. The case is now pending in the solicitor's office, allowing about $8,800,000 on their claim in abatement, and leaving around $10,000,000 due to be paid, if the solicitor approves the findings of the unit.

The 1918 case has a proposed additional assessment pending of $8,855,000, and the 1919 case has a proposed additional assessment of $9,376,000 pending. Both of those cases have been closed by the Income Tax Unit and are awaiting the ultimate closing of the 1917 cases in the solicitor's office before we proceed with the collection.

The CHAIRMAN. Have the assessments been made?

Mr. NASH. They are proposed assessments.

Mr. GREGG. No; those assessments were made for 1917.

Mr. NASH. The 1917 assessments have been made, and the assessment letter is out on 1918 and 1919.

The CHAIRMAN. Does interest run from those dates, then?

Mr. MANSON. No. It would run back from the date when the original extra assessments were made; that is, it runs on as much of the $7,000,000 as is found——

The CHAIRMAN. Oh, yes; I understand that, but I am trying to get at these proposed assessments that Mr. Nash referred to. As I understand it, they have not really been made.

Mr. NASH. No, sir; they have not.

The CHAIRMAN. And so no interest is running?

Mr. NASH. No interest is running until the assessment is actually made.

The CHAIRMAN. So that the longer they are delayed in the solicitor's office the more the Government loses in the way of interest on that money?

Mr. NASH. I would not call it delay, Senator. It takes time to work these cases. I would say that the longer the case is in process of adjustment, that would be true. I do not think the case is being unnecessarily delayed.

The CHAIRMAN. I did not say it was being unnecessarily delayed. I say as long as there is delay—I did not pass on the necessity of it—the taxpayer is saving interest.

Mr. GREGG. This matter, I may say, was brought to the attention of Congress in connection with the 1924 act, and is was then determined that since the delay on those old years was the department's fault, interest should not be provided for retroactively under the old law.

The CHAIRMAN. Then, I would like to get in my own mind just what is the difference as between a proposed assessment and a real assessment, because Mr. Nash has said that in the 1918 and 1919 cases there are two amounts proposed to be assessed. I would like to know why they could not have been assessed, and have interest running.

Mr. NASH. The assessments were not made because the determination of the unit is not final. It is not final until the solicitor advises on the points that are involved in the 1917 cases.

Mr. GREGG. And since this has arisen after the passage of the 1924 act, it can not be assessed until the taxpayer has had a right to go to the Board of Tax Appeals.

The CHAIRMAN. But, of course, those points are not involved in these proposed assessments for 1918 and 1919; are they? I refer to the questions that you spoke of, Mr. Gregg.

Mr. NASH. The taxpayer has a right, under the 1924 act, to take these proposed assessments for 1918 and 1919 to the Board of Tax Appeals. On the 1917 cases I do not believe the board has jurisdiction.

Mr. MANSON. I will submit the report and exhibits in this case for the record.

(The report and exhibits in the General Motors Corporation case are as follows:)

EXHIBIT A

MAY 26, 1918.

To: L. C. Manson, general counsel.
From: L. H. Parker, chief engineer.
Office Memorandum No. 16.
Taxpayers: General Motors Co. and General Motors Corporation.
Subject: 1917 additional taxes uncollected.

Figures involved for 1917

Company	Tax	Remarks
General Motors Co	$1,278,519.56	Paid on original return.
Do	7,105,554.91	Assessed February, 1923.
General Motors Corporation	3,911,016.22	Paid on original return.
Do	10,008,899.94	Assessed June, 1920.

Total additional taxes not paid, $17,114,454.85.

SYNOPSIS OF CASE

We have studied only a few of the outstanding points in this case in the limited time at our disposal in order to develop the following points:

(*a*) Loss of interest to Government by delay of bureau.

(*b*) Probable loss of entire $17,000,000 in taxes on account running of statute of limitations.

(*c*) Failure to protect interests of Government by requiring bond.

(*d*) Interference with collectors in protecting Government by Deputy Commissioner Callan.

(*e*) Failure to publish ruling containing vital points of interest to other taxpayers.

(*f*) Bureau uses unpublished rulings as precedents for their own actions.

CONDENSED HISTORY OF CASE

The General Motors Corporation purchased practically the entire stock of the General Motors Co. about January 1, 1917. Both companies were, therefore, taxable for the year 1917. The General Motors Co. was assessed an additional $7,000,000 in February, 1923. The General Motors Co. was assessed an additional $10,000,000 in June, 1920. These assessments, while based on travel auditor's reports, might be said to be in the nature of arbitrary assessments. The present status of the case, however, indicates a tax of at least $10,000,000 out of this $17,000,000 should be collected at the minimum.

This $17,000,000 tax may be cut to about $10,000,000 on adjustments which can properly be made by the bureau on a basis fair to both taxpayer and Government. We are attaching herewith ruling of solicitor in the United

Motors Corporation case (for year 1917), A. R. R. 6617 (not published). (See Exhibit B, attached; also grounds for ruling, see Exhibit C, attached.) While this ruling is not on General Motors Co. or Corporation, the United Motors were taken over by them December 31, 1918, and, therefore, any of the points brought out in this ruling will be pertinent to General Motors.

To develop certain points shown in the synopsis we attach certain papers in regard to the Buick Automobile Co. of Texas, a subsidiary of the General Motors Co. at this time and now out of existence.

Exhibit D is a letter from Collector A. S. Walker, of Texas, to the commissioner, dated April 15, 1919, in which he agrees to suspend action on a distraint warrant in collecting $68,000 tax against Buick Co. for five days at previous request of commissioner.

Exhibit E is a telegram of thanks from General Motors Co. to Commissioner Roper, dated April 16, 1919.

Exhibit F is a telegram from Deputy Commissioner Callan to Collector Walker directing action to be suspended until further notice, dated April 17, 1919.

Exhibit G is a telegram from Deputy Commissioner Callan to General Motors advising them that collector has been given peremptory instructions to take no action, dated April 17, 1919.

Exhibit H is a note to Mr. Talbert, signed "C," suggesting probable necessity of getting another collector at Austin, Tex., dated April 17, 1919.

Exhibit I is a letter from Commissioner Roper to Collector Walker, dated April 25, 1919.

Exhibit J is a letter from the bureau to Buick Co., of Texas, disallowing the claim in abatement, dated February 8, 1923.

Exhibit K is a telegram from collector at Austin to commissioner in re claim of abatement, dated March 17, 1923.

Exhibit L is a telegram from bureau to collector advising claim in abatement has been rejected, dated March 19, 1923.

Exhibit M is a letter from collector to commissioner showing no bond had been required on abatement claim which is now rejected, dated March 22, 1923.

Exhibit N is a memorandum showing that assessment originally made can not now be legally collected.

DISCUSSION OF THE CASE

The first point we wish to discuss in this case is interest. By waiting to assess a $7,000,000 additional tax against General Motors Co. until February, 1923, the Government loses interest to that date, or approximately five years' interest, a sum of $2,100,000. On the General Motors Corporation additional assessment of $10,000,000, dated June, 1920, the Government loses two years' interest, or $1,200,000. A total loss of interest of $3,300,000.

We wish to take this opportunity of digressing for the moment from this individual case and drawing the committee's attention to the effect of the 1924 act on interest in the years prior to 1924. This can best be shown by a hypothetical case.

Suppose one of the old 1917 cases, which has been kept open by waivers, be considered. We have a good many of these cases, especially in the natural resource division, where valuations are in question. Suppose a refund of $1,000,000 is now found due the taxpayer for the year 1917, and suppose that an additional tax of $1,000,000 is found for the year 1918. If no assessment has been made on this additional tax in 1918, then the Government will have to pay the taxpayer interest on the 1917 refund and still can collect no interest on the additional tax found for 1918. In other words, instead of the refund of $1,000,000 due for 1917, counterbalancing the $1,000,000 additional tax in 1918, due to the effect of the interest provision in the 1924 act, the Government will owe the taxpayer about 42 per cent interest, or $420,000.

The second point we wish to discuss in this case is the very grave probability of the Government's losing not only the interest we have pointed out above but also the entire $17,000,000 in additional taxes assessed. This point is, of course, a legal matter, but we are taking the libert[y] of presenting our views for your consideration.

Under the 1921 act the taxes were supposed to be collected 10 days after assessment by the collector. It was also provided that the collector could receive claims in abatement against such taxes and might also demand bond if necessary to protect the interests of the Government. We can find nothing

under the 1921 act whereby the mere assessment of the tax prevents the statute of limitations operating on a court proceeding.

Consider now the 1924 act. Under section 277(2) of this act it is provided that "The amount of income, excess profits, and war profit taxes imposed by * * * the revenue act of 1917 * * * shall be assessed within five years after the return was filed, and no proceeding in court for the collection of such taxes shall be begun after the expiration of such period." Further, in section 278 (e) it is provided that "This section shall not (1) authorize the assessment of a tax or the collection thereof by distraint or by a proceeding in court if at the time of the enactment of this act, if such assessment, distraint, or proceeding was barred by the period of limitation then in existence." It appears to your engineers that the statute of limitations had run on the $17,000,000 in additional assessments previously noted at the time when the 1924 act was passed. We believe the sole hope of the bureau in collecting this tax rests on the technicality concerning distraint actions. However, in two cases a circuit court of appeals has held that a distraint action is a proceeding. In one of these cases, Seaman *v.* Bowers, Internal Revenue Collector (Circuit Court of Appeals, Second Circuit, March 17, 1924), No. 254, it was held under (2) that—

"Revenue act, 1921, 250(b), being Comp. St. Ann. Supp. 1923, 6336 1/8 tt, providing that no 'suit' or 'proceeding' for the collection of taxes shall be begun after the expiration of five years' return was filed, except in the case of false or fraudulent return or failure to file any return, applies to an executive action by warrant for distraint, or otherwise 'proceeding' not being limited to an action or suit in court."

The second case was before the United States District Court, Southern District, New York, the New York and Litherage Co. being the plaintiff and the collector of internal revenue the defendant. It appears in this case that the plaintiff paid his taxes for the year 1917 on March 26, 1918. An additional assessment was received by the plaintiff from the collector on March 18, 1923, eight days before the statute of limitations would run. In November, 1923, the collector collected the additional tax through warrants of distraint. Action was taken by the plaintiff to recover the taxes thus paid under duress. Judge Hand found for the plaintiff and granted his claims for the return of taxes illegally collected. Judge Hand states as follows:

"I think that irrespective of the original merits, if any, of the arguments presented by the Government as to the meaning of the word 'proceeding,' I should follow the opinion of the circuit court of appeals in Seaman *v.* Bowers, supra, and I accordingly grant the motion of the plaintiff for judgment."

It is to be noted that in the case of the General Motors Co. an assessment of over $7,000,000 was made less than 30 days before the expiration of the five-year period. No bond was required, and the bureau therefore has put itself again in the same position it found itself in the case quoted above. We do not believe the Government will ever recover 1 cent of this $17,000,000 taxes nor any interest thereon. How many similar cases of this nature exist we do not dare predict; the amount at stake must be enormous.

The third point we wish to raise is the failure of the bureau to protect the interests of the Government by requiring bond when the claims for abatement were accepted for the additional taxes mentioned above. We have been in touch with the office of Deputy Commissioner Mires, of the accounts and collections unit, and he has advised us, after wiring his collector, that claims in abatement were received but no bonds were required. It is therefore extremely doubtful if any part of the $17,000,000 additional tax in this case will be collected.

The fourth point we wish to discuss is the case of a deputy commissioner interfering with the collector in protecting Government interests with disastrous results.

In the history of this case we noted the contents of certain Exhibits C to M, inclusive. These exhibits constitute prima facie evidence that a collector, Walker, at Austin, Tex., wanted to put the taxpayer under bond in a matter of the collecting of $68,000 in additional tax, but that he was interfered with by Deputy Commissioner Callan, with the result that no bond was obtained. The final result is also shown by the exhibits, which demonstrate beyond question that the Government has lost this sum of money through the statute of limitations taking effect. It might also be noted that Collector Walker resigned his position in August, 1920. The credit that Mr. Walker got from trying to protect the interests of the Government was this memorandum which Mr. Callan put in the files (see Exhibit G attached):

"My recollection is that we wired this collector to suspend action until further instructed. If he can not follow our instructions, I shall recommend to the commissioner that we get another collector. This is not the first time, despite specific instructions from the bureau, Collector Walker has proceeded in an absolutely obstinate fashion to carry out his own personal will."

The fifth point we wish to discuss is the failure of the bureau to publish A. R. R. 6617, on the United Motors Corporation case, when there were new points decided in this ruling that were of vital interest to many taxpayers. The ruling itself is shown completely in Exhibit A (attached) and the grounds for the ruling in Exhibit B (attached).

Referring now to the ruling under item (4), it is stated "that the tentative valuation of the good will of each of the corporations involved in this appeal should be computed in accordance with A. R. M. 34, C. B. 2, page 31, based upon the earnings of each corporation for the three years next preceding June 30, 1916."

Under item (5) it is provided "that in the tentative computation of the value of good will it was proper for the unit to consider the average tangible assets for each of the three years."

Under item (6) it is provided "that in the tentative computation of the value of good will the unit should accept the appellant's contention that 8 per cent represents a fair return on the tangible property of each of the companies and that the earning applicable to good will should be capitalized upon the basis of 15 per cent return."

Now, we do not wish to find any fault with reasonableness of the conclusions reached under items (4), (5), (6), quoted above, but we do believe that every taxpayer should have the right to know that a three-year average for tangibles and earnings may be taken on the presentation of proper evidence, instead of the five-year period called for in A. R. M. 34. It can readily be seen that where earnings are rapidly advancing from year to year it is of enormous advantage to the taxpayer to take a three instead of a five year period. We can further see no reason for withholding knowledge from the public in regard to the 8 per cent rate on tangibles and the 15 per cent rate for the capitalization of earnings attributable to good will.

We desire to call your attention also to page 6 of Exhibit B, where reference is made to A. R. R. 3388 (not published), and to page 8 of the same exhibit, where reference is made to A. R. M. 209 (not published), and to A. R. R. 3615 (not published). On page 9 of this same exhibit the following statement is noted: "L. O. 1117, not published, is referred to by both the unit and the appellant."

We have been advised repeatedly by individuals of the bureau that unpublished rulings were not used as a precedent. The above shows conclusively that they are used as a precedent not only by the bureau but by the taxpayer. Just how the taxpayer is in possession of unpublished rulings we do not know.

CONCLUSION

We desire to state in concluding that the files in this case are very voluminous; one part is in Annex No. 2, two other parts are located at different points of the solicitor's office, and another part is with the Board of Tax Appeals. It is obvious that your engineers could only touch on a few interesting features in this case in the time available. The Income Tax Unit, consolidated returns division, has had from one to two auditors at work on this case for the last two years.

As a constructive suggestion, it would appear to the writer that the unit should be allowed to put a sufficient force of auditors on these old cases to bring the work up to a point where it is current. A firm of accountants would probably put at least 20 auditors on a case of this kind in order to get out any reasonable audit of the firm's books. We believe that the Government should proceed along lines found best in ordinary business practice. What does forty or fifty thousand dollars in expense amount to when it means a collection of seventeen millions in tax, now probably lost to the Government through the operation of the statute of limitations in this case?

We submit that economy on personnel of the Income Tax Unit in its present condition, with a vast accumulation of back work, means the loss of perhaps $100 every time $1 is saved on pay roll.

Respectfully submitted.

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

RECOMMENDATION NO. 6617, COMMITTEE ON APPEALS AND REVIEW

In re appeal of United Motors Corporation and affiliated companies, 33 West Forty-second Street (removed to 1764 Broadway), New York, N. Y., fiscal year ended June 30, 1917

NOVEMBER 30, 1923.

Mr. COMMISSIONER
(For Deputy Commissioner, Head Income Tax Unit):

The committee has considered the appeal of the United Motors Corporation from the action of the Income Tax Unit in the proposed assessment of additional taxes for the fiscal year ended June 30, 1917.

After careful consideration of the evidence of record, as well as that presented at oral hearing on September 19, 1923, the committee finds:

(1) That the value of the assets acquired with 942,160 shares of no par stock was at date of acquisition $51,818,800.

(2) That the value of organization services, an intangible asset, was at date of acquisition $55,000.

(3) That the 20 per cent limitation for intangible assets should be based upon the market value of the no par stock outstanding March 3, 1917, as at the date or dates of issue as claimed by the appellant.

(4) That the tentative valuation of the good will of each of the corporations involved in this appeal should be computed in accordance with A. R. M. 34, C. B. 2, page 31, based upon the earnings of each corporation for the three years next preceding June 30, 1916.

(5) That in the tentative computation of the value of good will it was proper for the unit to consider the average tangible assets for each of the three years.

(6) That in the tentative computation of the value of good will the unit should accept the appellant's contention that 8 per cent represents a fair return on the tangible property of each of the companies and that the earnings applicable to good will should be capitalized upon the basis of a 15 per cent return.

(7) That in the computation of the tentative value of good will the unit should first deduct from the average earnings of each company the earnings applicable to patents as determined by the appellant in its tentative valuation of the patents, then deduct an amount equal to 8 per cent of the average tangible assets and multiply the remaining earnings by 6⅔ to arrive at the tentative value of good will.

(8) That for the purpose of computing depreciation the Perlman rim patent should be valued at $2,330,000 (value at date acquired by the Perlman Rim Corporation), and that for the purpose of computing the consolidated invested capital the Perlman rim patent should be valued at $7,792,653.86.

(9) That for the purpose of computing consolidated invested capital the difference between the total value of the assets $51,818,800, acquired with 942,160 shares of stock, and the sum of the value placed upon the tangible assets and the value placed upon the intangible assets (including patents and organization expense), as above set forth, should be added to or subtracted from the value of the good will and the patents (not including the Perlman rim patent), allocation to be based upon the percentage that the tentative valuation of the patents (not including the Perlman patent) and the tentative valuation of the good will bears to the total tentative valuation of both the good will and the patents, other than the Perlman patent.

(10) That depreciation of both tangible assets and patents must be computed upon the basis of cost to the subsidiary companies without regard to the amount paid by the parent company for stock in the subsidiary companies.

(11) That the rates of depreciation used by the unit in the last audit made of the appellant's returns are fair to the taxpayers and to the Government and therefore should not be changed.

(12) That for the taxable year involved no depreciation should be allowed on patents, other than the Perlman rim patent, as the appellants exercised an option in not claiming depreciation in their original returns and in not charging same off on their books.

(13) That that part of the distribution made during the taxable year by the Hyatt Roller Bearing Co. and the Remy Electric Co. to the United Motors Corporation out of earnings accrued since March 1, 1913, should for tax purposes be considered a dividend and taxes at either 2 per cent or 1 per cent

(not 4 per cent) depending upon the years in which the earnings distributed were accumulated by the corporations.

(14) That the appellant admits that the result of the surplus reserve computations set forth in the unit's memorandum is the same as the result of its computations arrived at by a different method.

(15) That the contribution made by the Perlman Rim Corporation in the amount of $25 to the switchmen's union is not deductible in the computation of taxable income.

(16) That with reference to other minor adjustments referred to in the unit's memorandum to the committee, the appellant states in last brief submitted "the committee need not be burdened."

In view of the foregoing the committee recommends that the appeal be allowed in part and denied in part and that the unit revise its audit in accordance with the findings above outlined.

KINGMAN BREWSTER,
Chairman Committee on Appeals and Review.

Approved:

D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT C

COMMITTEE ON APPEALS AND REVIEW, GROUNDS FOR COMMITTEE RECOMMENDATION

In re appeal of United Motors Corporation and affiliated companies, 33 West Forty-second Street (removed to 1764 Broadway), New York, N. Y., fiscal year ended June 30, 1917

NOVEMBER 12, 1923.

Point 1, appellant's brief, page 12.—The United Motors Corporation was incorporated May 11, 1916, with an authorized capital stock of 1,200,000 shares of no par value.

Under date of May 22, 1916, a syndicate composed of W. C. Durant and L. G. Kaufman offered to purchase 1,130,000 shares of the appellant's 1,200,000 shares of authorized capital stock and in consideration thereof to deliver to the United Motors Corporations a specified number of shares of stock in five named corporations. On the same day (May 22, 1916) the minutes of the United Motors Corporation show that the offer was accepted.

Between May 22, 1916, and June 30, 1916, the United Motors Corporation issued to the syndicate or to its order 951,160 shares less 10,000 shares returned, total 941,160 shares, for which it received stock in other corporations, and on June 6, 1917, 1,000 shares were issued to J. T. Smith for services rendered in connection with the organization.

The unit has under the authority of T. D. 2001 considered the acquisition of the stock of the subsidiary corporations as being in effect the acquisition of their assets, to which the appellant does not object, the issue being the value of such assets.

The unit contends that the property acquired with stock should be valued for invested capital purposes and not the stock issued therefor. (A. R. R. 1289 not published.) The taxpayer contends that the only fair way to value the assets acquired is to ascertain the market value of the stock as at the date issued to the syndicate or to the order of the syndicate. (A. R. R. 436, C. B. 4, p. 392, and O. 791, C. B. 1, p. 73.)

The unit calls attention to a claim for abatement of capital stock tax filed by the United Motors Corporation in which it claimed the value of its outstanding stock as at June 30, 1916, was only $20,988,800 ($18.57 a share) and not $76,669,385 ($8.37 a share) as now claimed, and the statements made to the capital stock division as to the reasons why the sales of stock on the curb market did not reflect the value of the assets represented by the stock. (P. 130, unit's memo.)

It is noted on page 19 of the unit's memorandum that the appellant on May 22, 1916, agreed to issue its stock to the syndicate for stock and within the next four days the syndicate sold to Dominick & Dominick 390,000 shares of the United Motors Corporation no-par stock at $50 a share ($19,500,000), and that this stock was issued on May 26, 1916, to Dominick & Dominick in accord-

ance with the direction of the syndicate. On page 116 of the unit's memorandum, it is shown that the United Motors Corporation now claims that the value of the assets acquired with 942,160 shares of its no-par stock was at the date of acquisition $76,069,385 ($81.376 a share), and the unit has valued the assets at $31,797,354.78 ($33.749 a share). In the opinion of the committee the fact that Kaufman & Durant (the syndicate), who were best able to ascertain the value of the assets of the companies involved, sold 390,000 shares of the appellant's stock immediately after acquisition for $19,500,000, or $50 a share, is good evidence as to the value of the assets. The fact that Dominick & Dominick were willing to pay $50 a share with the intention of immediately selling at a profit indicates that in their opinion the stock would sell for more than $50 a share. Assuming that Dominick & Dominick could afford to handle the stock for a 10 per cent commission it might be assumed that $55 a share would correctly reflect the value of the assets.

After careful consideration of all the evidence submitted by the unit and by the taxpayer as to the value of the assets (including organization expenses), acquired with stock the committee is of the opinion that the value of such assets is represented by an amount arrived at by multiplying the number of shares issued therefor by $55 (942,160 shares at $55 equals $51,818,800).

Point 2, appellant's brief, page 27.—The appellant claims the right to include in invested capital $18,983,825 as organization expenses. It is contended that in addition to the 1,000 shares paid to Mr. Smith by the United Motors there were issued to the members of the syndicate, at the direction of the syndicate, 212,000 shares of stock for services rendered.

It appears that the United Motors Corporation never agreed to pay Messrs. Kaufman and Durant anything for organization services, and in the opinion of the committee the stock received by Kaufman and Durant was for services rendered to the syndicate, not for services rendered the appellant—the United Motors Corporation. The appellant entered into an agreement with the syndicate whereby the syndicate would obtain and deliver to the appellant certain stock in five corporations for and in consideration of the appellant's stock. The appellant issued its stock for stock and was in no way concerned with the expenses or the profits of the syndicate.

It appears, however, that 1,000 shares of stock were issued on June 6, 1916, to J. T. Smith, for organization services rendered the United Motors Corporation. The unit admits that there should be included in invested capital the value of these services and, upon the basis of the sale of 390,000 shares by the syndicate at $50 a share, has valued for invested capital purposes the organization expense at $50,000. The unit refuses to accept as a basis for the valuation the curb market quotations on the stock on June 6, 1916, on the ground that the market prices did not reflect the actual value of the assets represented by the stock. (A. R. R. 1289, not published.) To support its valuation of the organization expense the unit calls attention to the fact that the General Motors Corporation, which took over the appellant corporation at a later date, paid Mr. Smith $50,000 in cash for similar services.

In the opinion of the committee the value of the services rendered by J. T. Smith in connection with the organization of the appellant corporation (organization expenses, an intangible asset, T. D. 2499 and A. R. R. 4689 not published) may be ascertained by multiplying 1,000 shares of stock issued to him by $55.

Point 3 (a–b–c–d), appellant's brief, page 30.—Limitation on intangibles acquired with no par stock. Section 207 of the 1917 law defining the term "invested capital" provides that intangible property purchased for and with shares in the capital stock of a corporation having a par value may be included in invested capital, subject to certain limitations; that is, not in excess of 20 per cent of the par value of the total stock outstanding March 3, 1917, or the actual value of the intangible property at the date acquired, or the par value of the stock or shares issued in payment therefor. No provision is made in the law, however, for the inclusion of intangible property acquired with no par value stock. Regulations 41, article 58, however, provides as follows:

"Intangible property bona fide purchased prior to March 3, 1917, with stock having no par value may be included in invested capital at a value not exceeding the actual cash value of such intangible property at the time of the purchase and in an amount not exceeding 20 per cent of the total shares of stock outstanding on March 3, 1917, measured by their value as at the date or dates of issue."

The unit refers to article 58, does not state "market" value, but it appears clear that the 20 per cent limitation should, under the authority of article 58, be based on the value of the stock at the date or dates of issue, and the price such stock could be or was sold on the exchange was the value of the stock at that date. In other words, it appears that the department meant by the word "value" market value. It is noted that article 58 was referred to in T. B. R. 38, C. B. 1, page 280, as a proper interpretation of the law and in A. R. R. 520, C. B. 5, page 156, article 58, is referred to and the 20 per cent limitation is applied to the "cash value of the corporation's capital stock."

It is also noted that section 325 (b) of the 1918 law provides:

"For the purposes of this title the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares."

In the opinion of the committee the taxpayer is given the right under the provisions of article 58, regulations 41, to insist upon the 20 per cent limitation being based upon the market value of the total shares of stock outstanding March 3, 1917, as at the date or dates of issue.

(*a*) In the computation of the value of good will in accordance with the committee's ruling, A. R. M. 34, set forth in C. B. 2, page 31, the unit has for the Hyatt and New Departure Cos. considered earnings for a 5-year period, for Dayton Co. 5½ years, and for Remy Co. 6¾ years. The appellant contends that only three years' earnings should be considered. In A. R. M. 34 the committee computed the value of the good will of liquor companies on the basis of five years and stated that the method used was applicable to other businesses. In this memorandum (A. R. M. 34) it is also stated that "a representative period should be used" and "preferably not less than five years."

The committee recognizes the fact that ordinarily five years is a representative period, but in view of the evidence submitted by the appellant (pp. 32–34 of brief), it concludes that in this case the tentative valuation of the good will of each of the companies involved should be computed in accordance with A. R. M. 34 on the basis of earnings and tangible assets for the three years next preceding June 30, 1916.

(*b*) The unit bases its computation upon average tangible assets for a number of years. The appellant contends, on page 34, that the average tangibles should not be used. The committee is unable to concur in the appellant's contention in this respect. A. R. M. 34 states "a return of 10 per cent upon the average tangible assets for the period," and it appears logical that the average assets should be used, as the earnings for the year depend upon the average investment for that year, not merely the investment as at the beginning of that year.

(*c*) The unit has computed good-will value for the Hyatt and New Departure Cos. on the basis of 8 per cent and 15 per cent, and for the Remey and Dayton Cos. on the basis of 10 per cent and 20 per cent. The appellant contends that each computation should be based upon a return of 8 per cent on tangible assets and 15 per cent on intangible assets, which contention is correct in the opinion of the committee.

(*d*) In the computation of the value of good will the unit has computed the value of intangibles and from this value has deducted the value previously assigned to patents. The appellant states that it "ascribed certain earnings to the patents by a method recognized as proper in case of damages for infringement. This method has the support of numerous Federal court decisions. In its calculation of good will it has first deducted (*a*) an amount representing a return on tangibles and (*b*) an amount representing earnings attributable to patents, and has then capitalized the remainder to ascertain the good-will value." It appears that before the valuation of patents could be ascertained it was necessary to determine the amount of the income each year attributable to patents. The committee therefore finds that the unit should in its computation of the value of good will deduct from the average earnings the average earnings applicable to patents as previously determined in the valuation of the patents, and then deduct 8 per cent of the average tangible assets (not including patents) as representing the earnings applicable to tangible assets, and the remaining earnings should be multiplied by 6⅔ to arrive at the value of the intangible assets other than patents, or, in other words "good will." The appellant's contention in this respect is found to be correct. (Point 3.)

Point 4, appellant's brief, page 37.—The appellant claims a value of the Perlman rim patent of not less than $9,847,755.00. The unit allows for depreciation and for invested capital purposes a value of $2,150,000.

The appellant, as set forth in its brief, computes the value of the Perlman rim patent at amounts ranging from $5,343,000 to $16,000,000.

The unit refuses to accept the curb market quotations on the stock of the Perlman Rim Corporation as proof of the value of the Perlman rim patent, and calls attention to the fact that while the curb market quotation on June 30, 1916, was approximately $134 a share, the Perlman Rim Corporation convinced the capital-stock division that the fair value of its stock was on that date, June 30, 1916, only $34.50 a share, and a refund of capital-stock tax of $2,418 was allowed. It is also noted that in 1918 it was ascertained that the Perlman rim patent was without value.

The unit has computed a value of $2,150,000 for the Perlman rim patent upon the basis that the Perlman Rim Corporation issued 36,000 shares of stock for same and assumed a liability of $350,000, the stock being valued at $50 a share in view of the fact that when stock was issued for the patent 60,000 shares were also issued to Messrs. Durant and Kaufman for $50 a share. It appears, however, that Durant and Kaufman intended to and did sell the stock acquired in the Perlman Rim Corporation, and by allowing a profit of 10 per cent on the sale of such stock the Perlman rim patent may be valued at $2,330,000 as at the date acquired by the Perlman Rim Corporation, upon which valuation the depreciation should be computed (36,000 shares at $55 equals $1,980,000 plus $350,000).

It is noted that the agreement of May 22, 1916, provided that if the syndicate was unable to deliver the stock of the Perlman Rim Corporation at once that the appellant would reserve for future delivery two shares of its stock for each share of Perlman rim stock not delivered. Upon the basis that the stock of the United Motors Corporation was worth $55 a share (corrected book value) and two shares were issued for one share of Perlman rim stock the committee concludes that the Perlman Rim Corporation stock was worth $110 (corrected book value), and upon this basis the Perlman rim patent was worth $7,792,653.86, which value should be accepted for the purpose of the computation of consolidated invested capital.

96,000 shares, at $110 a share	$10,560,000.00
Less tangible assets	2,767,346.14
Value of patent	7,792,653.86

It is assumed that the Perlman Rim Corporation had no good will, as the company was not organized until March, 1916.

Point 5, appellant's brief, page 45.—The appellant contends that the difference between the market value of the stock as at the dates issued, $76,669,385 (average $81.376 a share) and the total value determined for all assets—the value of patents and good will being determined without regard to the value of the General Motors stock issued therefor—should be added to the value of patents and good will as previously determined upon a percentage basis.

In view of the fact that the unit allowed an average of only $33.75 a share on 942,160 shares of stock outstanding as at the beginning of the taxable year ($31,797,354.78) and in view of the fact that the committee has already agreed to value the assets acquired upon the basis of $55 a share for stock issued therefor $51,818,800 it appears there will be a difference of several million dollars, even after the unit makes slight adjustments in the computation of the value of good will.

The committee therefore finds that the unit should add to the value of patents (except the Perlman rim patent, the value of which has been finally determined) and good will, as tentatively computed, an amount equal to the difference in value of all assets acquired on or before the beginning of the taxable year as tentatively computed and the value of the stock (942,160 shares) computed upon the basis of $55 a share. The allocation of the amount between patents and good will should be based upon the percentage that the tentative valuation of the patents and the tentative valuation of the good will bears to the total tentative valuation of both the patents and good will.

Point 6, appellant's brief, page 49.—The appellant claims—"The affiliated group should be allowed, in computing its net income for excess-profits tax, to deduct depreciation upon the values of its property at the date of acquisition of the subsidiaries' stock by the United Motors Corporation."

In reference to this contention, it appears only necessary to state that the unit has in this case followed its consistent practice since the beginning of the audit of consolidated returns, which practice was approved by the solicitor after very thorough consideration in the case of the Mexican Petroleum Co. The unit's practice in this respect was also approved in A. R. R. 3388. (Not published.)

In view of the above, the committee finds that the action of the unit should be sustained in holding that depreciation must be computed upon the basis of cost to the subsidiary company and not on the cost of the stock in the subsidiary held by the parent company.

Point 7, appellant's brief, page 53—Depreciation rates.—The rates of depreciation as claimed by the appellant are set forth on page 58 of the unit's memorandum, and the rates allowed by the unit are set forth on page 60 of the unit's memorandum. The principal difference appears to be that the appellant claims 2½ per cent on buildings and 10 per cent on machinery, and the unit has allowed for practically all the companies 2 per cent on buildings and 8 per cent on machinery.

The unit states that the rates allowed "are based in general on a study of appraisals of taxpayer's properties made in 1916 as of June 30, 1916, by Coats & Burchard, and in 1919 as of January 1, 1919, by Manufacturers' Appraisal Co." It is further stated that the appraisals showed depreciation reserves in the case of every company to be too high and that such reserves were adjusted by the companies to conform with the appraisals.

The appellant does not contend that the unit is in error in stating that the depreciation claimed is excessive in the opinion of the appraisal companies and does not attempt to show from past experience of the several corporations involved that the rates allowed are not sufficient, but apparently rests its case upon the fact that the unit in previous assessment letters allowed the rates claimed, that other taxpayers had been allowed rates as large as the rates claimed, and that rates used by appraisal engineers should not be accepted as conclusive.

The determination of fair rates of depreciation is an engineering problem in the solution of which it is necessary to take into consideration a number of factors peculiar to each corporation, and as the appellant claims that the appraisals were made by approved appraisal companies and that the values of tangible property shown by the appraisals should be accepted for invested capital purposes, and in view of the fact that corporations reduced their depreciation reserves upon the strength of the appraisals, and in the absence of any evidence that the rates allowed by the unit are not sufficient, the committee finds that the action of the unit should be sustained.

Point 8, appellant's brief, page 59.—The taxpayer claims the right to deduct depreciation on patents in amended returns, whether or not any deduction therefor was taken in the original returns.

It appears that the Perlman Rim Corporation was the only corporation involved in this appeal which claimed depreciation either on its books or in its returns.

Under date of August 26, 1922, the unit advised the committee that there were then pending in the special assignment section approximately 400 cases in which the taxpayer claimed the right to depreciation on patents, even though not claimed in the original returns, and an opinion was requested.

After careful consideration of the questions by the commissioner, the solicitor, and the committee it was decided "that the option to charge off depreciation of patents remains open only during the time for filing the original return; that such option, or election, is exercised by not claiming a depreciation allowance with respect to the particular taxable year; and that an option so exercised is therefore binding and conclusive on the taxpayer with respect to the particular taxable year." This decision is covered in A. R. M. 209, not published, and has been followed by the committee in other cases. (See A. R. R. 3615, not published.)

The appellant's brief (pp. 59–77) deals principally with the legality of the ruling in A. R. M. 209, and it is not believed necessary in this brief to refer to any part of its argument, except on page 76 the following statement is made:

"If any member of an affiliated group has elected to take depreciation in its original return, patent depreciation may be deducted in an amended return for the purpose of determining consolidated net income with respect to the patents of all the companies in the group, even though some of such companies may have omitted to take depreciation in their original returns."

The committee is also unable to concur in the appellant's contentions in this respect, first, for the purpose of computing depreciation each corporation stands alone (see committee's ruling as to point 5, p. 49, of the appellant's brief); second, if it can be said that the appellant exercised an option to deduct depreciation by the fact that one of a number of its subsidiaries elected to claim depreciation, why can it not also be said that the appellant elected to not claim depreciation by the fact that several of its subsidiary companies did not claim depreciation on patents owned by them; third, it is clear that no depreciation was claimed on any patents not owned by the Perlman Rim Corporation, and therefore an option was exercised—assume the following facts: Company Y purchases two new patents, No. 1 for $17,000 cash and No. 2 for $34,500 cash. On its books and in its tax return it is clearly shown that depreciation is claimed on only one of the patents, No. 2 (cost, $34,000; life, 17 years; depreciation, $2,000). So far as patent No. 1 is concerned the company has elected to not depreciate the cost of same to the extent as Company X, who owned only one patent and did not claim depreciation on same in its original return.

Point 9, appellant's brief, page 77.—The appellant claims that any profits distributed by the Hyatt & Remy Cos. at the time of their liquidation should not be subjected to the 4 per cent income tax. The entire capital stock of the Hyatt Roller Bearing Co. and the Remy Electric Co. was purchased by the United Motors Corporation on or about June 30, 1916. The unit states that on April 30, 1917, the United Motors surrendered all of the stock of the Hyatt Roller Bearing Co., except 1,500 shares (par $150,000), and took over all of that company's net assets except assets valued at $150,000, and on May 31, 1917, the United Motors surrendered all of the stock of the Remy Electric Co., except 2,000 shares (par $200,000), and took over all of that company's assets except assets valued at $200,000. In conference one of the taxpayer's representatives stated that the stock of the two companies was reduced to $150,000 and $200,000 approximately a year before the distributions were made, but could not give exact information. It appears, however, that information as to this detail is not necessary for a decision of the issue raised.

L. O. 1117, not published, is referred to by both the unit and the appellant. The unit contends, however, that L. O. 1117 does not apply in this case because the two companies were not completely liquidated—that is, the distribution was not "final distribution by a corporation in complete liquidation." It is argued that L. O. 1117 is not applicable to this case "where the transaction involved the exchange of property (portions of the capital stock of subsidiary corporations) for other property (portions of the net tangible and intangible assets of those subsidiary corporations) which had a value in excess of the cost of the property given in exchange. It appears, however, that the income tax law (sec. 31 of the 1917 law) has defined the term "dividend" to be any distribution to shareholders out of earnings accrued since March 1, 1913, whether in cash or other property, and that such amounts distributed "shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation."

As stated in L. O. 1117, the law appears clear and the committee must therefore hold that that part of the distribution made by the Hyatt and Remy corporations to the United Motors Corporation out of earnings since March 1, 1913, should for tax purposes be considered a dividend and taxed at either 2 per cent or 1 per cent (not 4 per cent), depending upon the years in which the earnings distributed were accumulated by the corporations.

Surplus reserves, appellant's brief, page 79.—The appellant states that the effect of the surplus reserve computations set forth in the unit's memorandum is the same as its computations arrived at by a different method. The figures will necessarily be changed by the recomputation of the income and capital as now recommended.

Donations, appellant's brief, page 80.—The appellant claims that a certain contribution made in 1917 by the Perlman Rim Corporation ($25 to the switchmen's union) was not for income-tax purposes a donation, but constituted a deductible and ordinary expense. The unit relies upon article 135, regulations 33.

The appellant contends that contributions, if "made in the exercise of the discretion of the management of the corporation and is intended to benefit the business by building up or retaining good will, general publicity, or the protection of property, should be allowed as a deduction."

In the opinion of the committee, the unit's action is in accordance with the regulations and should be sustained.

Miscellaneous, appellant's brief, page 83.—The appellant discusses a number of minor points under this heading and stated that "the committee need not be burdened." It appears that the appellant unit is willing to waive these points as the differences are negligible and caused principally by the fact that the income and invested capital are in dispute. It is believed that these points will be settled to the satisfaction of both the appellant and the unit when the principal issues have been determined. For instance, the appellant and the unit can not agree upon the amount of accrued taxes until they agree upon the amount of taxable income.

G. E. A.

DECEMBER 1, 1923.

Mr. HAMEL: You will note Mr. Steiner objects to the valuation based upon the Perlman rim patents for the reason that the committee shows the patent increased in value from March 15, 1916, to May 22 of the same year 235 per cent.

In order that you may more easily determine the value of this patent the following facts are set forth:

The appellant contends that the value of the patent for both depreciation and invested capital purposes is not less than $9,847,755.50, and sets forth several computations. One computation the applicant claims shows a value of $16,000,000.

On page 40 of appellant's brief it is stated:

"The decision of the circuit court of appeals in February, 1916, sustaining the Perlman patent gave to Perlman an undisputed monopoly upon demountable rims, which at the time were being used on practically all cars other than Ford cars."

The car manufacturers acting together agreed to pay Perlman a royalty of 50 cents per set. They refused, however, to pay $1.50 a set. Mr. Perlman therefore, acting with Messrs. Kaufman and Durant, formed the Perlman Rim Corporation March 15, 1916, which company issued to Mr. Perlman 36,000 shares of stock for the patent, and Messrs. Kaufman and Durant paid into the corporation $3,000,000 in cash for 60,000 shares of stock. On May 22, 1916, the United Motors Corporation acquired controlling interest in the Perlman Rim Corporation by issuing stock for stock. It was agreed that if all of the Perlman Co. stock could not be delivered at once there would be reserved for future delivery two shares of the United Motors Corporation stock for each share of Perlman Rim Corporation stock not delivered.

The committee having previously determined that the United Motors Corporation stock was worth $55 a share in May, 1918, it was held that the Perlman Rim Co. stock was worth $110 a share in May, 1916, and therefore the patent was accordingly worth $7,792,653.86 for invested capital purposes.

The value of the patent in March, 1916, was found to have been only $2,333,000 on the basis that it was acquired by the Perlman Corporation for 36,000 shares of no par stock plus $350,000 liability assumed, the stock being valued at $55 a share based upon stock issued to Kaufman and Durant upon organization of the corporation.

In order to meet Mr. Steiner's objection that it is not reasonable to assume that the patent increased 235 per cent in two months' time ($2,333,000 to $7,792,653 86), proposed to recommendation might be changed based on the argument that Mr. Perlman was willing for stock to be issued to Messrs. Kaufman and Durant for less than actual value in order that these men might furnish capital which was necessary for the operation of the corporation, and therefore the stock in March as well as in May was worth $110 a share (based on the fact that two shares of United Motors was given for one share of Perlman stock).

If the Perlman stock was worth $110 immediately after organization (which value is supported by the fact that the first sales of its stock on the curb market, so far as the records show, April 13, 1918, were $130 a share), then the value of the patent when acquired by the Perlman corporation, which would be the value for depreciation purposed was $7,910,600.

Some of the other methods of valuing the patent are set forth below:

(1) $2,150,000 on the basis that stock issued for the Perlman patent was worth $50 a share.

(2) $3,126,631.20 on the basis of a royalty of $1 a set and upon the basis of the output of car companies during the previous three years.
(3) $4,870,475.15 on the basis of a royalty of $1 a set and upon the basis of the output of car companies during the previous years.
(4) $7,305,712.82 on the basis of a royalty of $1.50 a set and upon the basis of the output of car companies during the previous years.
(5) $14,344,653.86 on the basis that two shares of the United Motors stock was given for one share of the Perlman stock, and that the United Motors stock was selling on the curb at $89.12½ a share.
(6) $11,920,653.86 on the basis that the Perlman stock sold on the curb market at $153 a share on May 31, 1916.
(7) $9,808,653.86 on the basis that the Perlman stock sold on the curb market at $131 a share on May 22, 1916.
(8) Other methods are set forth in appellant's brief showing values ranging from $5,343,000 to $16,000,000.

G. E. ADAMS.

DECEMBER 5, 1923.

MR. STEINER: Reference is made to your memorandum of November 26, 1923, calling attention to the fact that in the proposed recommendation in the above-named case the value of the Perlman rim patent has been fixed at $2,330,000 in March, 1916, when acquired by the Perlman Rim Corporation and that its value in May, 1916, when the stock of the Perlman Rim Corporation was acquired by the United Motors Corporation was $7,792,653.86, an increase of 235 per cent in a few months' time.

The value placed upon the patents in March, 1916, was for purposes of depreciation. The Perlman Rim Comporation was organized in March, 1916; 60,000 shares of its stock were sold at that time for $50 per share. It was on this basis that the value of the patent was fixed when acquired by the Perlman Rim Corporation. This sale was made to bankers who were interested in the formation of the corporation. This valuation may or may not have reflected the intrinsic value of the patents. The patents were acquired directly from the patentee.

committee, having determined that the United Motors Corporation sto was worth $55 per share in May, 1916, held that the Perlman Rim Co. stock was worth $110 a share in May, 1916, two shares of United Motors being exchanged at that time for one of Perlman Rim Co., and on that basis the patent was valued at $7,792,653.86 for invested capital purposes. The file shows that there were a large number of shares of United Motors stock sold at prices considerably in excess of $55 per share and that immediately after the acquisition of the stock of the Perlman Co. that United Motors stock sold at a still higher figure, in the neighborhood of $140 per share. On its face this appears to be a large increase in the value of the patents. It should be borne in mind that the determination of value for purposes of depreciation is based upon cost to the subsidiary. The transaction in May is an invested capital question which concerns the United Motors Corporation, which purchased the stock of the Perlman Rim Corporation. While it may not necessarily have a bearing on the case, it may be that the patent actually had a greater value in March, 1913, than the cost, which has been determined for depreciation purposes, but that that value had not been determined at that time. The evidence as to the value of the stock exchanged for Perlman stock is so convincing that it can not be ignored. The committee, in fixing the value at $55, was exceedingly conservative. Between the time that the Perlman Co. was organized in March, and May, 1916, it is very probable that the public had been impressed with the value of the patent to the automobile industry. While the case is a very unusual one, the committee believes that there was sufficient evidence to justify the value it has fixed for the stock of the Perlman Co. for invested capital purposes.

CHARLES D. HAMEL, *Chairman.*

JANUARY 10, 1924.

MISS HOWARD: Please hold this case until I can discuss it with the commissioner, as indicated in Mr. Steiner's memorandum of December 20.

C. D. HAMEL.

DECEMBER 20, 1923.

In re United Motors Corporation, New York, N. Y.

CHAIRMAN COMMITTEE ON APPEALS AND REVIEW:

I have taken up the above-named case with Mr. Blair in connection with your memorandum of December 5, 1923. He requests that you give the case your personal attention and then take it up personally with him. The only phase of the case I discussed with him was the matter which is the subject of your memorandum of December 5.

WM. J. STEINER.

NOVEMBER 26, 1923.

In re United Motors Corporation, New York, N. Y.

MR. BREWSTER,
Chairman Committee on Appeals and Review:

Reference is made to point 8 (4 in the memorandum) in the above-named appeal. The committee recommends that the value of the Perlman rim patent upon acquisition by the Perlman Rim Corporation in March, 1916 (?), be fixed at $2,333,000 and the value for the purpose of consolidated invested capital of the affiliated corporations as at date of acquisition by the United Motors Corporation (parent company), presumably on or about June 30, 1916, to be $7,792,653.86. This means that the bureau will be recognizing an increase in value of the patent of about $5,460,000, or about 235 per cent, in less than four months. This is, of course, a most unusual situation, although I do not know whether this phase of the case was considered by the committee. The case will, in all probability, have to be brought to the personal attention of the commissioner, and I feel that there should be a very complete explanation of so unusual a situation.

Will you look into the matter and advise me further? If any change is made in the value, apparently it may affect also point 9 (5 in the memorandum).

WM. J. STEINER.

EXHIBIT D

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
AUSTIN, TEX., *April 15, 1919.*

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

SIR: Receipt is acknowledged of your telegram of April 12 as follows:

"If without risk to yourself or the Government you may suspend action looking to collection of tax against Buick Automobile Co. pending determination by this office whether tax has been paid on consolidated return by General Motors Co. as claimed.

ROPER, *Commissioner.*"

This office has an outstanding assessment of $68,734.28 against that company for income and excess profits taxes for the fiscal year ended July 31, 1917. There is a considerable amount in addition now due on account of penalty and interest. It appears that the Buick Automobile Co. surrendered its charter and was dissolved on June 28, 1917, its business and assets being taken over by the Buick Motor Co., a Michigan corporation having permit to do business in Texas. Correspondence addressed by this office to the Buick Automobile Co. has lately been handled by the Buick Motor Co. J. W. Atwood, formerly manager of the Buick Automobile Co., now of the Buick Motor Co., on October 11, 1918, filed claim in abatement of this assessment, alleging that the taxes due by the Buick Automobile Co. had been paid by the General Motors Co. Mr. Atwood was informed in reply that this claim in abatement would not be accepted by this office unless it could be shown through a statement from the collector of internal revenue at Newark, N. J., where the General Motors Co. paid its taxes, that the payment to him included the taxes due by the Buick Automobile Co. No such statement has been filed with this office. Still later, the Buick Motor Co. was informed that claim in abatement would be accepted, provided indemnity bond covering amount of the assessment was filed. That has not been done. Accordingly, warrant of distraint has

been issued and placed in the hands of a field officer for collection. The Buick Motor Co. now gets very busy.

In view of your telegram above quoted, I have agreed to suspend action in executing warrant of distraint for five days from this date. That period should give your office time to determine whether or not taxes due by the Buick Automobile Co., represented by the assessment above referred to, was included in report of the General Motors Co., filed with Collector Duffey, of New Jersey, and paid to him. I am not willing to assume the risk of permitting this assessment to remain in its present condition. The matter must be definitely disposed of one way or the other.

You will find inclosed copy of my letter of this date to Messrs. Crane, Crane & Umphreys, attorneys for the Buick Motor Co.

Respectfully,

A. S. WALKER, *Collector.*

EXHIBIT E

[Western Union Telegram]

DETROIT, MICH., *April 16, 1919.*

Hon. DANIEL C. ROPER,
Commissioner of Internal Revenue, Washington, D. C.:

Accept our thanks for your wire April twelfth advising that you have authorized collector at Austin to suspend collection of tax against Texas Buick Company pending investigation. He has, however, wired our representative at Dallas that matter must be disposed of within five days. Unless your office can furnish him information asked for in our letter of March fifth will be compelled to file bond for eigthy thousand nine hundred dollars in order to protect our business and property. It seems unjust to put us to the expense of such bond as we included Texas Buick income in General Motors return for 1917 and have paid tax in full. Will you kindly advise him again to desist from all proceedings until further instructions from you? The only information which will satisfy him must come from your office, hence we are powerless in the premises.

GENERAL MOTORS CORPORATION,
T. S. MERRILL, *Secretary.*

EXHIBIT F

[Treasury Department Telegram]

INCOME TAX UNIT,
Washington, April 17, 1919.

COLLECTOR OF INTERNAL REVENUE,
Austin, Tex.:

By office telegram twelfth instant you were authorized to suspend action against Buick Co. pending determination by this office whether tax had been paid on consolidated return by General Motors Co. Motors Co. now advises that you have notified the matter must be disposed of within five days. Not yet able to determine positively but all indications point to full payment of tax by General Motors Co. You are therefore directed to take no further action until further advised.

CALLAN, *Acting Commissioner.*

EXHIBIT G

[Treasury Department Telegram]

INCOME TAX UNIT,
Washington, April 17, 1919.

GENERAL MOTORS CO. (an answer),
Detroit, Mich.:

Your telegram sixteenth. Have wired collector at Austin peremptory instructions to take no action until advised.

CALLAN, *Acting Commissioner.*

EXHIBIT H

APRIL 17, 1919.

MR. TALBERT:

Please give this telegram immediate attention. My recollection is that we wired this collector to suspend action until further instructed. If he can not follow our instructions, I shall recommend to the commissioner that we get another collector. This is not the first time that, despite specific instructions from the bureau, Collector Walker has proceeded in an absolutely obstinate fashion to carry out his own personal will.

Please prepare and send up to me such communications as you think ought to be sent to the General Motors Corporation and to the collector and give me the benefit of any advice you think I may need.

C.

EXHIBIT I

APRIL 25, 1919.

HON. A. S. WALKER,
Collector of Internal Revenue, Austin, Tex.

MY DEAR MR. WALKER: I have noted especially your letter of the 15th instant acknowledging receipt of my telegram of the 12th instant in regard to the tax assessed against the Buick Automobile Co., although I am extremely reluctant to suggest to a collector any course which is likely to jeopardize either the interests of the Government or the personal interests of the collector, I have been hopeful that all collectors would appreciate, as I think I do, the vital importance in administering the present high tax laws, of refraining from drastic and arbitrary action in the enforcement of collection about which there is serious question. The tone of your letter and particularly your statement that the matter must be definitely disposed of one way or the other within the five days you have agreed to suspend distraint proceedings, indicates that you have not the same attitude in matters of this sort as the officers of the bureau have endeavored to maintain throughout the last two years.

There are excellent reasons why it may be impossible to ascertain the facts in this case within the brief period of five days. The question raised here relates to a most complex phase of our work, namely, the consolidated returns. Furthermore, because of the tremendous volume of detailed work connected with the handling of the several million returns filed in 1917, extended research is frequently necessary in locating returns and information relating to them.

Prior to the receipt of your letter on April 15, a second telegram was sent to you requesting that you suspend distraint proceedings until further advised by the bureau. I hope you have seen fit to observe these instructions and that you will continue to hold the distraint warrant in abeyance until the bureau advises you whether the tax assessed against the Buick Automobile Co. was paid on the consolidated return of the General Motors Co.

Yours very truly,

DANIEL C. ROPER, *Commissioner.*

EXHIBIT J

FEBRUARY 8, 1923.

BUICK AUTOMOBILE CO., OF TEXAS,
Care of General Motors Corporation, Detroit, Mich.

Attention Mr. C. A. Souther.

SIRS: Your claim for the abatement of $73,545.67 corporation income and profits taxes for the fiscal year ended July 31, 1917, has been examined and is hereby rejected for the reason that an audit of your returns discloses a tax liability in excess of the amount assessed.

In arriving at the true liability, due consideration was given the statements set forth in your claim. The basis of the additional assessment will be made the subject of a separate communication from this bureau.

The rejection of this claim will officially appear on the next schedule to be approved by the commissioner.

Respectfully,

E. W. CHATTERTON, *Deputy Commissioner.*

EXHIBIT K

[Western Union Telegram]

MARCH 17, 1923.

COMMISSIONER OF INTERNAL REVENUE,
Attention W. A. Preignitz, Internal Revenue Auditor,
Consolidated Returns Subdivision, Washington, D. C.

Refer your letter December eighteenth, nineteen twenty two, re Buick Automobile Company of Texas, also office reply January twenty second nineteen twenty three Commissioner section nineteen twenty three February double naught special eight list indicates additional assessment one hundred twenty seven thousand nine hundred sixty three dollars and fourteen cents, advise status of account so that this office may if proper file suit before April first.

HOPKINS, *Collector.*

EXHIBIT L

[Treasury Department Telegram]

WASHINGTON, D. C., *March 19, 1923.*

COLLECTOR OF INTERNAL REVENUE,
Dallas, Tex.:

Additional taxes Bureau letter to taxpayer February twenty eight is final action on returns fiscal year ended July thirty one nineteen seventeen Buick Automobile Company of Texas. Claim for abatement seventy three thousand five hundred forty five dollars sixty seven cents rejected.

E. W. CHATTERTON, *Deputy.*

EXHIBIT M

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
Dallas, Tex., March 22, 1923.

Second district of Texas.
Re Buick Automobile Co. of Texas, Dallas, Tex.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.:

Reference is made to the outstanding assessment against the above-named corporation appearing on the April, 1918, list, page 862, line 1, of the old third district of Texas and transferred to this office July 1, 1920.

In connection with the above, reference is also made to office letter dated June 14, 1921, in which you were advised that an abatement claim in the amount of $73,545.67 would be forwarded as soon as an appropriate bond was secured, which was requested May 27, 1921.

You are advised that the bond as indicated above was not secured for some reason which the files of this office fail to disclose.

Further reference is made to bureau letter dated December 18, 1922, signed by W. A. Priengnitz, internal revenue auditor, consolidated returns subdivision, which explains in detail the dissolution of the above-named company; also refer to office telegram of March 17, 1923, and bureau reply dated March 19, 1923.

You are advised that the original return in this case was filed August 30, 1917, which, if this office understands correctly, prevents any action by suit at law.

The only former stockholder known to this office is the General Motors Corporation, Detroit, Mich.: J. W. Atwood, Dallas, Tex., and B. R. Webb, San Antonio, Tex.

Please advise this office what disposition should be made of this case.

GEO. C. HOPKINS, *Collector, P. F. J.*

EXHIBIT N

JUNE 14, 1923.

In re Buick Automobile Co. of Texas.

Memorandum of conversation had with Mr. Simpich, of the Office of the Solicitor of Internal Revenue:

Memorandum from solicitor dated May 18, 1923, relative to the above-named company stated that no suit or proceedings for the collection of the amount of the rejected claim of $73,545.67 could be instituted in this case because the statutory five-year period had expired. The impression given to the readers of this memorandum was that collection of any tax must be made within the five-year period as well as the assessment. Mr. Simpich, however, stated that such was not the intention of his memorandum. The opinion of the solicitor in this case referred only to the above-mentioned company, that company having been dissolved and its assets having passed through several hands since, the only recourse left to the Government now would be suit against successors or stockholders. In view of the fact that suit would be necessary, Mr. Simpich stated that the provisions of section 250(d) of the revenue act of 1921 operated as a bar in this case.

He stated that were the Buick Automobile Co. of Texas still in existence there would be no quetsion as to the right of the collector to distrain upon the taxpayer if necessary without proceedings in court as is customary.

Mr. Hammond, of the technical staff, took part in this conversation.

H. B. ROBINSON, *Chief, Audit Section D.*

EXHIBIT O

Seaman *v.* Bowers, Internal Revenue Collector

(Circuit Court of Appeals, Second Circuit. March 17, 1924

No. 254

1. Internal revenue 36. "False," as used in statutes permitting refund of illegally assessed or collected tax, defined.

Under Rev. St. 3220, 3225 (Comp. St. 5944, 5948), authorizing the refund of taxes erroneously or illegally assessed or collected, unless taxpayer's return was false and fraudulent; "false" means incorrect or not true, as distinguished from intentionally fraudulent or erroneous.

(ED. NOTE.—For other definitions, see Words and Phrases, first and second series, False; Falsely.)

2. Internal revenue 28.—Statute limiting time to bring "suit" or "proceeding" for collection of tax held applicable to executive action by warrant for distraint.

Revenue act 1921, 250(b), being Comp. St. Ann. Supp. 1923 6336 1/8 tt, providing that no "suit" or "proceeding" for the collection of taxes shall be begun after the expiration of five years after return was filed, except in the case of false or fraudulent return or failure to file any return, applies to an executive action by warrant for distraint, or otherwise; "proceeding" not being limited to an action or suit in court.

(ED. NOTE.—For other definitions, see Words and Phrases, first and second series, Proceeding; Suit.)

3. Internal revenue 2. Statute permitting taxpayer to recover tax erroneously or illegally assessed or collected held retroactive.

Rev. St. 3220, 3225 (Comp. St. 5944, 5948), as amended by revenue act, 1918 (Comp. St. Ann. Supp. 1919, 5944, 5948), authorizing a taxpayer who made a false return to sue to recover taxes erroneously or illegally assessed or collected, unless taxpayer's return was willfully false or fraudulent, being remedial, is retroactive.

4. Internal revenue 28. Remedy of taxpayer against imposition of additional income tax, stated.

Where Commissioner of Internal Revenue began proceedings to collect an additional income tax and penalty on the ground that taxpayer's return for the year 1916 was erroneous, taxpayer's remedy under act March 4, 1923, amending revenue act, 1921, 252, and Rev. St. 3226, as amended by revenue act, 1921, was to pay the additional tax and sue to recover it, and in such

action present his contention that the right to collect the tax was barred under revenue act, 1921, 250(d), being Comp. St. Ann. Supp. 1923, 6336 1/8 tt. and an injunction pendente lite to restrain the collection of the tax was properly denied under Rev. St. 3224 (Comp. St. 5947).

* * * * * * *

Cadwallader *v.* Sturgis, T. D. 3579; Wetherley *v.* Burree, T. D. 3560; Beshara *v.* Hopkins, T. D. 3552; Graham *v.* Du Pont, T. D. 3486.

Mr. MANSON. There has been considerable discussion before the committee upon the question of the adequacy and efficiency of the organization to review audit determinations—that is, determinations made by auditors.

It appears that in each of the large auditing sections there is a review section, which consists of the higher class or better men in the division, and after a case has been audited it then goes to the review section, where the review auditors check it over, at least as to the principles involved.

Attention has been called to the fact that the review sections are all under the same heads as the audit sections, whose work is subject to their review; and the suggestion has been made that because of the fact that the review sections are under the same head as the audit sections the review is not a check against the head of the division, who may desire to put a case through the division improperly.

We have to present this morning a case which, I believe, illustrates that objection.

This is the case of the Robert Dollar Co. No extended investigation of the merits of the claim has been made. Our attention has been devoted primarily to the procedure followed in this case, having in mind the matter of organization; but in order that the committee may have some appreciation of the question I might state briefly what was involved.

It appears that a syndicate made a contract with the Russian Government to furnish them shells at something like $15 apiece. This syndicate turned the contract over to a Canadian manufacturer, with the provision that the Canadian manufacturer should pay the syndicate 70 cents apiece for the shells that were paid for by the Russian Government.

The syndicate then made a contract with the Robert Dollar Co. under which the Robert Dollar Co. was to act as the agent of the syndicate and was to receive a percentage of the amount collected by the syndicate from the Canadian shell manufacturer.

The shells were manufactured and paid for by the Russian Government in 1916.

The manufacturer refused to pay the commission, until finally a suit was brought and a settlement of that suit was made in 1918. In other words, the syndicate did not collect their commission from the manufacturer until 1918. The Robert Dollar Co., under their contract, had no right to collect their commission from the syndicate until the syndicate collected their commission from the manufacturer, which was in 1918.

The Robert Dollar Co. made no return of the amount, involving something over $100,000, in its 1918 returns, but did return it in 1920.

The CHAIRMAN. When did they actually get the commission?

Mr. MANSON. They got the commissions in 1918. Under their contract they were not entitled to them until 1918.

The CHAIRMAN. Is there anything to show why they did not return them until 1920?

Mr. MANSON. No; that does not appear; but when they found that they could not get these commissions allowed as earned in [illegible] then set up the claim that they kept their books upon an accrual basis, and that the commissions were earned in 1916.

Senator WATSON. Upon what basis?

Mr. MANSON. Upon an accrual basis, and that the commissions were earned in 1916, and that therefore they should be considered as 1916 income, notwithstanding the fact that they were not entitled to the commission, unless the syndicate collected the money from the Canadian manufacturer, and the collection was not made until 1918.

It also appears to be a fact that while they claimed to have kept their books upon an accrual basis, they never entered these commissions on their books in 1916 as having accrued in that year.

I have stated the principal question that was involved here.

I will now come to the matter of procedure, which was really the purpose of our investigating and reporting on this case.

It appears that the 1918 and 1919 taxes of the Robert Dollar Co. were settled without review by the review section in the consolidated returns division, as is required under the regular procedure. This was done under the orders of Mr. Lohman, head of the consolidated returns division.

From verbal and written information the following appears to be the pertinent facts in this case as regards the manner in which it was handled by the Income Tax Unit.

Mr. Bergeron, auditor of the consolidated returns division, originally audited the case, but it was taken away from him and given to another auditor of this division by the name of T. F. Callahan, following a conference held by the division with the Robert Dollar Co., represented by C. T. Haines. You will please note that Mr. B. V. Iobred signed this conference report, subject to exception to points 1 and 5 mentioned therein.

Point 1 is as I have just described it to the committee.

Subsequent to this conference, it appears that Mr. Lohman prepared a memorandum upholding the conference report, and directed just how the case was to be audited. Not only that, but he also instructed the auditor to return the case to him, instead of letting it go to the review section in the ordinary manner.

Before I proceed further I wish to say that this memorandum of Mr. Lohman's, which is attached as an exhibit, sustains the taxpayer's contention that these commissions were 1916 income, even though they were not collectible under their contract until 1918, and even though they were not due until 1918, not earned until 1918, and even though they were not collected until then.

The following facts are brought out in a conference with Mr. Callahan, who made the audit:

There is attached here as an exhibit a stenographic report of the conference between Mr. Parker and various employees of the bureau who were connected with this case.

First. The audit was made as per instructions in Mr. Lohman's written memorandum

Mr. Moss. Is that memorandum there?

Mr. MANSON. Yes; we have it. It is attached here.

Mr. NASH. Would you mind reading it, Mr. Manson?

Mr. Moss. It would seem proper to have it right at this point in the record.

Mr. MANSON. This memorandum is dated August 18, 1924:

I have carefully considered the conferee's findings and conclusions in the above-mentioned case, together with a memorandum written by the auditor on this case and the briefs and data filed by the taxpayer, and it is my conclusion that the decisions as reached by the conferee are correct and should be followed in the closing of this case.

A careful study of all the facts with respect to the contract made with the Russian Government for goods clearly indicates that this should be claimed as income for the year 1916. Their books are kept on an accrual basis. This was income properly chargeable to the year 1916, and the taxpayer has agreed to file a waiver, allowing assessment of such additional tax in that year. The second point raised is the question of the distribution of certain income derived through organizations in Tientsin, China, and Hankow, China. After careful study of the facts, I have reached the conclusion that this association can not be termed a partnership, for general reasons as stated below.

I have taken no exception to the matter of the determination of a partnership, and the balance of the arrangement deals with the partnership arrangement.

The CHAIRMAN. I had the impression that Judge Moss was referring to the memorandum that Mr. Parker wrote.

Mr. Moss. No. I was referring to the memorandum which he has read.

Mr. MANSON. Mr. Loman's memorandum?

Mr. Moss. Yes.

Mr. NASH. I understood Mr. Manson to say that Mr. Lohman's memorandum specifically directed how the case should be closed, and that is why I asked to have it read.

Mr. Moss. Yes.

The CHAIRMAN. I understood from the memorandum that he just read to instruct them to close it on the 1916 basis.

Mr. MANSON. Yes; it says:

I have carefully considered the conferee's findings and conclusions in the above-mentioned case, together with the memorandum written by the auditor on this case, and the briefs and data filed by the taxpayer, and it is my conclusion that the decisions as reached by the conferee are correct and should be followed in the closing of this case.

Senator ERNST. That is the part of it to which you had reference?

Mr. MANSON. Yes. Going back now:

First. The audit was made as per instructions in Mr. Lohman's written memorandum.

Second. It was taken to Mr. Lohman personally instead of being sent through to the review section in the ordinary manner.

Third. The case would not have been audited in this way without instructions from Mr. Lohman.

Fourth. The result of the audit was to wipe out one-half million dollars in tax and refund to the taxpayer for the year 1918 alone over $11,000.

From the testimony of Neely, in the same exhibit, we see that the case went to the administrative section first, instead of going to the review section, and it was turned back to them because it was not signed by the review section. When it did get to the review section, it came there with instructions to sign the certificates of overassessment without the usual review.

A memorandum from Mr. Lohman directing how this case should be audited was missing from the files, as well as a memorandum from Mr. Lobred, which set up the objections of the audit unit to the consideration of this case on any such basis as was finally made.

Fortunately, it later developed that Mr. Neely had kept copies of these two memoranda for the protection of himself and his section. Copies of these two memoranda are therefore appended under Exhibit D, which is Mr. Lohman's instructions to audit, and Exhibit E, which sets up the contentions of the auditors. We believe from examination of Mr. Lobred's memorandum and Mr. Lohman's memorandum, that there is no doubt but what Mr. Lobred was right in the majority of his contentions. We will not, however, go into that phase of the case here, because we do not wish to cloud the issue.

The issue in this case is the establishment of the fact that no matter how perfect may seem the safeguards set up by the bureau for the review of cases, they are of absolutely no avail when the administrative officers of the bureau may cut out such procedure and safeguards at their own personal pleasure.

We have information that Mr. C. T. Haines, representative of the taxpayer, in this case, is a brother-in-law of Mr. Bright, and that Mr. Lohman has now left the department to go into business with Mr. Haines. This latter statement is simply on verbal information, and we have not had time to confirm it.

It appears also from the papers in this case that it was closed under a final determination signed by the commissioner, at least for the year 1918, under section 1006. This means the case can not be opened up unless fraud is shown. A rapid survey of the case makes it appear that an item of about $1,200, deductible from the tax of 1918, was omitted from the audit for that year and a certificate of overassessment and a final determination was signed without this being taken into account. We understand later that this amount of money was deducted from 1919 taxes of the taxpayer. This procedure is absolutely contrary to the statute.

Conclusion: This case would have received a careful and thorough study if time had been available, but we believe that this brief statement will bring out the astounding condition which exists in the department. We contend that if one case is reviewed, all cases should be reviewed, and that no administrative officers of the Government should be allowed to vary procedure at pleasure. It was quite evident from the conferences held by the writer that the individuals in the bureau do not dare protest such cases for fear of losing their positions. It should be stated also, in fairness to these men, that they volunteered no information, but answered the questions in the only way which honest men could do.

Mr. MANSON. This report is signed by Mr. Parker.

Senator ERNST. Is that a single, isolated case, or do you think there are others like it?

Mr. MANSON. Well, I do not know about that.

Senator ERNST. Do you know of any others?

Mr. MANSON. I do not know of any others.

I should like to say this, that our work of endeavoring to get matters of procedure in the bureau was but recently started. I had but one man available to do that, Mr. Parker, who is our chief engineer, and it was not until his work in the engineering division had reached the point where he could be spared from it that he was available to investigate the general procedure of the bureau and, as is known, the investigation in the bureau is now cut short. I have no way of knowing whether this is an isolated case. I do not even know how Mr. Parker got onto the case. There was no complaint that came to us in regard to it, and I do not even know how he got onto it; but there is appended as Exhibit C a stenographic report of Mr. Parker's conferences with the various parties who worked on this case, which sustains fully the statements made by Mr. Parker in the summary report to me which I have just read.

If it is the desire of the committee that I should read the stenographic report of those interviews with the employees of the depart-

ment who worked on this case, I would be glad to do so. It is in the record here.

Mr. Moss. Mr. Manson mentioned some memoranda of Mr. Lobred and of somebody else, which had disappeared from the records, but copies of which had been kept by Lobred. Did you read those?

Mr. MANSON. I read Mr. Lohman's memorandum. Mr. Lobred was the auditor who audited this case, and whose audit was overturned, and his memorandum sets forth the facts very clearly and precisely, which I attempted to summarize at the time I started to state this case, and unless the facts which he sets forth here are not true, there is no question in my mind but what the taxpayer was not entitled to have this income considered as of anything other than the income as of the year 1918.

Senator WATSON. Would this case naturally, in due process, have come finally to Mr. Lohman?

Mr. MANSON. Mr. Lohman was the chief of the consolidated returns division. Under Mr. Lohman was the section in which Lobred, the auditor, worked. Mr. Lobred audited this case. Mr. Lobred was one of the conferees and his report is based upon the conference.

Mr. Bergeron audited the case originally, and the case was then taken from him and given to Mr. T. F. Callahan. Mr. Callahan's statement is in the record here.

He states, in substance, that he audited the case as he was directed to audit it by Mr. Lohman, and not as he would if he were exercising his own judgment.

After Mr. Callahan had audited the case, Mr. Lohman instructed that the case be sent direct to the administrative division, instead of to the review section.

I take it that the administrative division does not review audits, but merely looks the papers over to see that they are all there and in due form.

The administrative division sends the case back to the audit section, for the reason that it had not been reviewed; in other words, it was not signed by a reviewer. Mr. Lohman then directed that the reviewer sign the case, but that no review be made, and the reviewer states that is what he did, that he signed the report in accordance with Mr. Lohman's direction, but that he did not make a review.

Mr. Moss. I would like to ask for a little information here. Was that under verbal instructions?

Mr. MANSON. Under verbal instructions.

Mr. Moss. To sign this, but not to review it?

Mr. MANSON. To sign it, but not to review it.

Mr. Moss. He makes that statement?

Senator ERNST. Do you still want that report read?

Mr. Moss. I think so. I do not know how the chairman feels about it.

The CHAIRMAN. I would also like to hear it read.

Mr. MANSON. The report of the auditor?

The CHAIRMAN. The one which Judge Moss has asked for.

Mr. NASH. May I make a statement first?

I want to say that Mr. Lohman entirely exceeded his authority if he did what he is said to have done in this case. He had no right to direct that that case go through without a review, and he had no

right to dictate the direction of the audit. I can not understand the workings of the mind of this auditor, if he would audit a case as he had been directed to audit it, if he thought that basis was wrong. He should have audited it to the best of his own honest judgment and closed it in that way. But no auditor need take directions from any superior as to how a case should be audited. It should be honestly audited on the basis of the facts before him and in no other way.

The CHAIRMAN. I am sure that that is the intention of the organization, but, as has been pointed out in the previous hearings, these reviewers and these auditors are all subordinates——

Mr. MANSON. Of the same man.

The CHAIRMAN (continuing). Of the same man, of the chief of section, and it requires a man of perhaps more than ordinary nerve to fly in the face of his superior, especially when his livelihood is dependent on that particular job.

Mr. NASH. If a man is honest, I do not see why he would hesitate to fly in the face of anybody, if they told him to do something wrong.

The CHAIRMAN. Well, that is ideal, of course. No one would differ with that conclusion, but, at the same time, the evidence as shown to these heads of divisions or chiefs have dominated their subordinate to such an extent that some of them have become timid about raising issues with their chiefs. That was evidenced by Mr. Greenidge; it was evidenced by the letter he wrote to his subordinates that they must not disagree with their chiefs. That feeling permeates the department, and it is a perfectly natural condition.

This man that you discharged the other day, Mr. Briggs, was unquestionably discharged, notwithstanding any statement that anybody else may make; he was unquestionably discharged because he was irritable and disagreed with the actions of his chief, that he constantly found fault, and he pointed out to the committee's staff errors in the closing of cases. He no doubt irritated many of his superior officers way up the line, and was immediately removed. The pretext on which he was removed was because of a reduction in force, and that, perhaps, is not debatable. I can not tell what was in the minds of the men who removed him, but it is perfectly apparent to every person down there, and is verified by our men, that it is the impression in the bureau that he was removed because of his insistence in having cases properly closed, and when not properly closed, drawing it to the attention of the committee's examiners. It does not matter what anybody says about it, and I do not claim that the heads of the bureau discharged him for any other reason than because of a reduction in force. I do not say that Mr. Nash and Mr. Blair did not remove him for that purpose, but you never can convince the staff down there that that was the true reason, because he was the most vigorous and outstanding opponent of some of these methods of which we have complained.

Mr. NASH. I just want to state that I am familiar with the separation with Mr. Briggs from the service, and that he was not separated for anything that he brought to the attention of this committee, and he was not separated on account of a disagreement with his immediate superior.

The CHAIRMAN. I do not deny that, so far as you are concerned, Mr. Nash. I believe that is so; but I may say that the reflex action

of the psychology of the method upon the staff down there is that it was because he was an outstanding man who fought against this very kind of procedure that we are now complaining of, and this case this morning verifies the conclusions that were reached by our staff—that it was possible to put through any kind of a case that the head of a division wanted to put through. He wanted it put through in this case, and it was put through.

Whether this is an isolated case or not is not important. It shows the weakness of the organization and the weakness of the organization which was manifested in a previous hearing.

Senator WATSON. On the other hand, we sat here the other day and criticized this man Greenidge because he refused to obey the orders of the head, when Commissioner Blair had ordered him to decide a case, and he declined to accept that and stood out against it.

Senator JONES of New Mexico. I think it must be generally understood that subordinates are to obey the orders of their chiefs.

Senator ERNST. It can not be otherwise.

Senator WATSON. I do not see how you are going to do otherwise and have an organization.

Senator JONES of New Mexico. I think it is apparent in this record, time and again, that after engineers or auditors would act and subsequently be overruled they changed their initial settlements in accordance with the directions of their superiors, rather than with their own views. So I think it goes without saying that if this man here directed this thing to be done the underemployee was doped.

Mr. MANSON. My suggestion in regard to the whole thing is that a review section or a review organization, to be effective, must be under a different head than the organization whose work it is reviewing. That is the point that I have in this case.

Senator ERNST. Will you be good enough now to read that report that Judge Moss asked for?

Mr. MANSON. Yes; I will read that.

Mr. MOSS. Before you do that, let me make another point here.

Mr. MANSON. Yes; certainly.

Mr. MOSS. I do not want to delay the proceedings here; but in Mr. Manson's investigation, or the investigation by his staff, how many cases have been discovered which presents facts similar to the unfortunate Greenidge incident and the incident which has been referred to this morning?

Senator ERNST. He has just answered that, that this was the only case of that kind that he had found.

Mr. MANSON. This is the only case we found arising in the audit sections, where the head of the division has directed how an audit was to be made, and then has kept the case away from the review section, which is set up and established there for the purpose of reviewing audits.

I might say that this case involved no refund. There was no possibility of this case going to the solicitor, and the case has gone through as Mr. Lohman directed it to go through, and has been finally closed, under an agreement finally disposing of the case.

Mr. NASH. I would like to emphasize that I can not understand how a conscientious reviewer can be on his job if he is going to put

his initials on the case, indicating that he has reviewed it, if he has not.

Another thing I want to point out is that we have recognized that the review is not 100 per cent efficient, and on next Monday morning we are putting into each review section an attorney from the solicitor's office, to sit with the reviewers in going over these cases. That attorney is from an organization outside of the Income Tax Unit, and is responsible to the solicitor.

Mr. MANSON. The report of the auditor who sat in that conference is as follows——

Mr. MOSS. Is that Lobred?

Mr. MANSON. This is Lobred.

Mr. MOSS. And Lobred is the man who says that he preserved that memorandum for his own protection?

Mr. MANSON. Yes; he said he preserved this for his own protection.

This is headed In Re: Robert Dollar Co., New York, N. Y.:

The following is submitted by section C in support of its action with reference to:

1. Denial of the taxpayer's contention that commissions of $107,919.59 received from the Canadian Car & Foundry Co. (Ltd.) constituted income for 1916 rather than 1918.

2. Denial of the taxpayer's contention that partnership profits amounting to $153,472.29 are nontaxable, which action was reversed by the conferee in report of May 29, 1924.

The facts in connection with point No. 1 are as follows:

During the year 1914 a syndicate composed of five individuals procured a contract from the Russian Government for the delivery of 2,000,000 shrapnel shells at $15.85 each, delivery to be made during the year 1916.

On February 12, 1915, the syndicate assigned the contract to the Canadian Car & Foundry Co. (Ltd.), of Montreal, which agreed to pay the syndicate in consideration thereof 85 cents per shell out of the payments received, part in cash and part in treasury bills of the Russian Imperial Government, in the same proportion as payments were made to it by the Russian Government. Shortly thereafter the Russian Government agreed to the assignment of the contract, and pursuant to its terms deposited one-fourth of the entire contract price, or $7,925,000, in the Bank of Montreal and the National City Bank. The 85 cents per shell, to which the syndicate was entitled, was to be distributed to the individuals in the following proportions:

Knapp, Mindin, Dumbadse, 70 cents per shell.

Mackie, Allison, 15 cents per shell.

On March 5, 1915, Knapp, Mindin & Dumbadse entered into an agreement with the Robert Dollar Co. (taxpayer), constituting the latter as their agent, and agreeing to pay it five-seventieths of the amount collected from the car and foundry company as its remunerations. (At this point attention is directed to the fact that a copy of the agreement mentioned above has never been filed.)

On March 4, 1915, the Canadian Car & Foundry Co. (Ltd.) paid to the Robert Dollar Co. for the account of Knapp, Mindin & Dumbadse the sum of $150,000 as payment on account of commissions from the advance received from the Russian Government in accordance with the terms of the syndicate agreement.

Up to March 8, 1916, the Canadian Car & Foundry Co. (Ltd.) had shipped less than 10,000 shells. The time of delivery was extended and the contract was assigned to a corporation organized by the Car & Foundry Co. under the laws of the State of New York, known as the agency for Canadian Car & Foundry Co. (Ltd.), which company completed the contract in 1916.

On July 27, 1916, the Robert Dollar Co. brought suit against the Car & Foundry Co. and the newly organized company to recover the amounts due Knapp, Mindin & Dumbadse.

On June 24, 1918, an agreement was entered into between the Car & Foundry Co. and the Robert Dollar Co. to suspend the legal proceedings for 90 days. The company represented that it had made settlement with Knapp and Dumbadse

and offered $360,000 in full settlement to be paid by a note in favor of the taxpayer six months after date of acceptance; this offer was accepted.

Accordingly, on November 13, 1918, the taxpayer received a note for $360,000 in full discharge of its claim both individually and as trustee including costs and expenses.

The commissions due the taxpayer amounted to $107,919.59. The taxpayer included this amount in its returns for 1920, but the unit decided that they accrued as income in 1918.

Taxpayer's contention: (1) The taxpayer now contends that the commisisons were earned and accrued as income in 1916, because there was at no time a question of the amount earned and due but only the question of payment of the amounts due. That the corporation kept its books on a strict accrual basis and should have accrued the profit on the contract in 1916.

That it has been consistently held by authorities that if the question at issue is whether or not there is any liability no amount can be accrued and no income reported until the proper tribunal has determined that a liability exists, but if the question is one of enforcing the liability already existing, income has accrued.

Contentions of section C: (1) It is the contention of section C that the conferee is in error, and that his decision is probably based upon a misunderstanding of the true facts in the case.

It should be borne in mind that the taxpayer was merely acting as agent for the syndicate and that its main service most likely consisted of making collection of the amounts due the syndicate. In consideration of the services rendered it was entitled to compensation equivalent to five-seventieths of the amount collected on behalf of the syndicate.

Hence this section is of the opinion that the commisisons accrued as earnings in the year 1918, in which year the taxpayer fulfilled the agency agreement with the syndicate by making collection of the amount due certain of its members.

It could not be correctly asserted that the taxpayer earned the commissions in 1916, the year in which the Canadian Car & Foundry Co. completed its contract with the Russian Government, for the reason that the taxpayer had not at that time fully performed the services it had undertaken. The syndicate was not obligated to the taxpayer for any sum prior to the time of the collection of the amount due from the Car & Foundry Co.

If the question at issue was whether the syndicate should have accrued its share of the contract price in 1916, it is likely that the principle asserted by the taxpayer could apply, even though it is highly probable that the members of the syndicate had considerable doubt that it could enforce payment of the amount agreed upon as its share. But the issue relates to the amount to which the taxpayer was entitled for services rendered "on behalf of the syndicate." Hence it would seem that the taxpayer's compensation accrued when the compromise was effected in 1918; in other words, when it fully performed the services it had undertaken.

Attention is directed to the fact that the taxpayer did not accrue the commissions on its books in 1916, which is prima facie evidence that it did not consider the amount as earnings for that year. In view of the above, it would seem that this method of treatment was entirely correct from an accounting viewpoint. The taxpayer was not entitled to compensation until it fully performed the service agreed upon, and there is no question that collection of the amount due the syndicate constituted an important part of such services. Hence it would have violated good accounting principles to have accrued the commissions as income prior to the year 1918.

There is no doubt whatsoever that the taxpayer did not have an enforcible claim against the syndicate prior to the year 1918, and this would seem to be the final test preventing accrual of the item in 1916.

It should be noted that an important part of the evidence has not been furnished, viz, the agency agreement between the syndicate and the taxpayer, and it would seem to be contrary to good policy to allow the taxpayer's contentions without requiring the submission of a copy of the agreement.

The facts in connection with point No. 2 are as follows:

That deals with something entirely outside of the question that I have raised here.

The CHAIRMAN. Do you want that last part read, too, Judge Moss?

Mr. Moss. No; I do not care for that.

Mr. MANSON. I believe it would——

Mr. Moss. From what source did that memorandum emanate?

Mr. MANSON. That memorandum was written by Mr. Lobred, who was one of the conferees and who signed the conference report, and specifically stated on the conference report that he signed this, subject to acceptance of points 1 and 5.

Senator WATSON. Did this particular report go up to Mr. Lohman?

Mr. MANSON. Yes; that went to Mr. Lohman, but at the time we examined the files in the case both the memorandum and Lohman's memorandum had disappeared from the files.

Senator ERNST. That is, when you got it?

Mr. MANSON. When we got the file; yes; and it was not until Mr. Parker had the conference with Mr. Lobred that Mr. Lobred produced from his own papers a copy, which he stated that he had written for the reason that he believed that those memoranda would at some time disappear from the files.

Senator JONES of New Mexico. From whose custody did they disappear? Who was the last person in charge of them?

Senator ERNST. Who had them last?

Senator JONES of New Mexico. Yes; who handled those original files?

Mr. MANSON. There is nothing here stating that. They go into the files, and any auditor, or particularly the chief of the section or anybody who has any apparent business with those files, can get the file.

Senator JONES of New Mexico. Without those two memoranda, in what condition would that have left the case?

Mr. MANSON. Without those two memoranda, there would be nothing to indicate what are the merits of this question here. There would be nothing to show Lohman was upon notice of the fact that exception had been taken to the conference.

Mr. Moss. To points 1 and 5.

Mr. MANSON. To points 1 and 5, other than the mere note that exception was taken to it, but the ground upon which it had been taken would not appear.

Senator WATSON. Was any appeal ever taken from Lohman to anybody else above him?

Mr. Moss. No; there was no reason to take an appeal.

Mr. MANSON. The taxpayer had been satisfied.

Mr. Moss. The taxpayer was satisfied.

Senator WATSON. Oh, he was satisfied, and nobody else knew about it?

Mr. MANSON. Nobody else knew about it. I believe, inasmuch as we have gone thus far into this matter, I should read the report of the conferences between Mr. Parker and the employees of the bureau, who handled this matter. They are short.

Mr. Thomas F. Callahan is the auditor who made the audit in the case.

Mr. Moss. He started that audit.

Mr. NASH. His audit was subsequent to this other man's audit, who prepared the memorandum.

Mr. MANSON. Yes; he made the audit of the case pursuant to Mr. Lohman's memorandum.

Mr. MOSS. Lobred started the audit; is that it?

Mr. MANSON. Lobred was the conferee.

Mr. MOSS. Somebody started that audit and was taken off of it.

Mr. MANSON. A man by the name of Mr. J. Lewis Bergeron.

Mr. Callahan's statement is as follows:

Q. Did you audit the case of the Robert Dollar Co.?—A. I audited it after Mr. D. Louis Bergeron.

Q. Did you have a memorandum in this case from Mr. Lohman telling you how to audit this case?—A. I did.

Q. Was there a written memorandum to that effect in the file?—A. Yes.

Q. You looked those files over to-day and you can not find that memorandum?—A. That is right.

Q. When you finished auditing this case did you transmit it to review in the usual manner?—A. No.

Q. What did you do with it?—A. Took it to Mr. Lohman, in accordance with instructions from Mr. Lohman.

Q. If you had been allowed to audit this case without instructions, would you have reached the results you did?—A. I don't believe I would.

Q. The additional tax involved for 1918 involved something over one-half million dollars, according to the revenue agent's report. Your audit showed how much overassessment, instead of this additional tax?—A. $11,189.97.

Q. Do you believe that this case for the year 1918 ever went to review?—A. I do not think it did.

Q. At least, if they made a review, they did not consult you about it?—A. That is right.

Q. I have here the overassessment certificate of 1919. This is signed by you, dated October 17, 1924; signed by Section Unit Auditor H. S. Jones, October 17, 1924; reviewed by J. H. Neely, review section, October 18, 1924; approved by Lohman, October 20, 1924. You admit that there was extraordinary speed in the handling of this case?—A. Yes; it was special.

Mr. PARKER. For your information you are informed that Mr. Neely just told me over the telephone that he did not really review this case, but signed it under instructions.

Q. Can you find a 1918 overassessment certificate in this file?—A. No; I can not find it.

Q. Do you know whether the C. T. Haines, agent for the taxpayer in this case, is the brother-in-law of Deputy Commissioner Bright or not?—A. I do not know.

Mr. Christopher Ray was examined before Mr. Parker, and was questioned by Mr. Callahan as follows:

Q. Was there ever a memorandum in this case (Robert Dollar Co.) that you have seen signed by Mr. Lohman?—A. I will not say that I saw it, but I do know that you did what they told you to do.

Mr. James Hill was examined by Mr. Parker, as follows:

Q. What is your full name and title?—A. James Hill, assistant chief section C consolidated audit.

Q. In this Robert Dollar Co. case, I want to show you a copy of a conference report dated May 29, 1924. Do you remember ever seeing it?—A. I don't know that I can remember it.

Q. Did you ever get any instructions from Mr. Lohman?—A. There was a memorandum prepared taking exception to points 1 and 5 of the conference by Mr. Lobred, and Mr. Lohman then prepared a memorandum sustaining this conference.

Q. You saw that memorandum of Mr. Lohman?—A. Yes.

Q. The memorandum is missing?—A. I saw it and Mr. Lobred and Mr. Bergeron and Mr. Callahan.

Q. Mr. Callahan, did you transmit to Mr. Neely certain verbal instructions from Mr. Lohman?—A. I told him that the case was an expedite case; I was told to tell him that.

Q. Did that mean that the case was to be given a perfunctory review?—A. This just meant to hurry the case.

Q. Was there a memorandum in this case, Mr. Callahan, containing the opinion of Mr. Lobred?—A. I believe there was.

Q. Can you find that memorandum in the files?—A. No; I can't seem to find it. It is not here.

Mr. J. H. Neely was examined by Mr. Parker, as follows:

Q. Did you sign the overassessment certificate as the reviewer for the review section in the case of Robert Dollar Co.—A. Yes.

Q. For what years?—A. 1918 and 1919.

Q. You did not make a review of the case?—A. No; I was instructed not to make a review as there was a memorandum in the case covering the points signed by Mr. Lohman.

Q. This case was handled altogether different from the other cases going through the bureau?—A. Yes.

Q. Do you know whether this case went to the review section in the ordinary way?—A. No. It was returned from the administrative section to section C, because it was not signed by the review section.

Q. How did you get your instructions to sign these certificates of overassessment without the usual review?—A. Mr. Hill stated that the case was not intended to come through review, that all the disputed items were threshed out by Mr. Lohman and his memorandum covering the items in the case was signed by Mr. Lohman.

Q. Did you keep a copy of these memoranda in your desk in the bureau in order to protect yourself and the section?—A. Yes. I was afraid the memoranda would disappear from the files, as is often the case.

This is signed by Mr. Parker.

Senator WATSON. How long after that did Lohman leave the department?

Mr. MOSS. He left just a few days ago.

Mr. NASH. Mr. Lohman resigned this month; somewhere around the 1st of May.

Senator WATSON. When did this transaction take place?

The CHAIRMAN. In 1924, as I recall it, Senator.

Mr. MANSON. Yes; in 1924. The conference was in May.

Mr. NASH. I want to say right here that I think that reviewer ought to be disciplined for signing a certificate of overassessment without looking into the files.

The CHAIRMAN. Do you not think the system ought to be changed whereby anything like that can take place, so as to prevent it in the future?

Mr. NASH. I do not believe that any change in a system would cure a situation of this kind.

Senator WATSON. No; because no matter what the situation is, you will have to have a head of the department.

Mr. NASH. You must have administrative officers, and you must have subordinates, and if the subordinates are going to do wrong because their administrative officers tell them to do it, I do not know what organization change will correct it.

The CHAIRMAN. Do you think that an administrative officer would be able to tell an independent reviewer and get away with it?

Mr. NASH. Senator, if you had a reviewing section outside of the audit division, you would still have to have an administrative officer at the head of it, and he would have just as much chance to tell one of his subordinates how to review a case as Mr. Lohman had.

Mr. MANSON. You would at least have to have the cooperation of two heads of two sections, and I believe that this case demonstrates

what I have felt for a long time, and that is that a review section under the same head as the section that does the work being reviewed loses a large part of its efficiency, because both of those sections are under the same head. I believe that any review section ought to report directly to the deputy commissioner.

Senator JONES of New Mexico. After getting Lohman's direction, to whom should the auditor have appealed, if he did not want to obey Mr. Lohman?

Mr. NASH. That auditor comes under the immediate direction of the head of the section. I have heard mentioned here section C, and I do not see the head of section C in the controversy at all. The reviewer is also responsible to the head of the review section, Mr. Akers, and I do not see Mr. Akers in this case.

I do not understand how a case can go through without going through the head of the auditing section, and also through the head of the review section, before it gets to Mr. Lohman.

Senator JONES of New Mexico. That has not answered my question. Assuming that Mr. Lohman made this order, which the record indicates that he did make, to whom should that auditor have appealed if he thought that Mr. Lohman was not doing right?

Mr. NASH. That auditor should have appealed to the commissioner or to the deputy commissioner or to me.

Senator JONES of New Mexico. Well, I do not understand that that has been the attitude of the bureau generally at all. On the other hand, I think it appears all through this record that people are, perhaps, not disciplined, to use that word in the ordinary sense, but they are not expected to go over the heads of their chiefs.

Mr. NASH. They are expected to go over the heads of their chiefs, as far as they can go, if they have knowledge of anything that is going on that is not right.

Senator WATSON. As far as I can see, this is the only instance of this kind.

Mr. MOSS. I understand that there are only two instances—this and the Greenidge matter—that have been discovered.

The CHAIRMAN. I might say in response to that, Judge Moss, that there is a trail of that all through the oil and gas section. While it has not been reduced to writing, and there is not as clear-cut a case as this, the record would indicate that there is that sort of atmosphere, and that that trail predominates in the oil and gas section, even though it has not been reduced to writing, as it has been in this case.

Mr. MANSON. Take the William Boyce Thompson case. There an engineer in the mine section discovered the transaction out of which a partner of Thompson's had made $600,000 profit on the sale of mineral lands. When the tax was assessed against his partner the partner defended, or he asked a deduction on the ground that Thompson was his partner and got half the profit, and that therefore he should not pay the tax upon the whole profit. In that way the fact that Thompson was involved came to the attention of the bureau.

The engineer was very diligent in following that thing up, and he found that Mr. Alexander, the head of an audit section, had had a conference with the taxpayer and had determined upon a basis of

settlement, and this engineer went to his chief, Mr. Grimes, and Mr Grimes advised him to go to the solicitor.

He went up and saw the assistant solicitor, or the employee of the solicitor's office to whom mining matters are referred, and he was advised there to write a memorandum setting up these facts, so that the solicitor could get jurisdiction over the case.

That memorandum was prepared. It was forwarded through the regular channels and went to Mr. Greenidge. It never reached the solicitor's office, where it was addressed, but went from Mr. Greenidge to Alexander, the very man whose conduct was being complained of, and there it rested until we dug the case up.

The CHAIRMAN. And as yet no punishment has been administered to Mr. Greenidge or to Mr. Alexander for that very reprehensible act, as I see it.

Senator WATSON. Of course, nobody defends this wrong. I do not see anybody defending it, anyway.

The CHAIRMAN. I do not think it can be defended, and this, Senator, is brought out for the purpose of trying to strengthen the administration, so that these things can not happen again.

Senator WATSON. Well, where the human element enters into such a jumble as they had down there during the war, with 52,000,000 cases to settle, it was a mighty hard thing to get any kind of a system in which somebody would not be in a position to do something that was wrong.

The CHAIRMAN. But when wrong is discovered it ought to be punished.

Senator WATSON. That is quite true.

The CHAIRMAN. But it does not appear that anybody has ever been punished for this wrong.

Senator WATSON. Well, I did not know that you had ever heard of it before.

The CHAIRMAN. Oh, that William Boyce Thompson case was up.

Senator WATSON. I am talking about this case.

Mr. NASH. In this particular division, I think we now have a head of division who will correct a few of these situations.

The CHAIRMAN. Who is that, Mr. Nash?

Mr. NASH. Mr. Robinson.

The CHAIRMAN. Has Mr. Robinson been in the bureau very long?

Mr. NASH. Mr. Robinson came into the bureau in 1919 out of the Army. He was a major in the Army, and has been an auditor, and was head of section D in the consolidated division. We promoted him to succeed Mr. Lohman on the 1st of the month.

The CHAIRMAN. You feel that he will do better?

Mr. NASH. He is a strong administrative man, and one in whom we have a hundred per cent confidence.

Mr. MOSS. Nobody knew anything about this Lohman transaction until it was presented here this morning?

Mr. NASH. No, sir.

Mr. MOSS. And nobody wants to defend it.

The CHAIRMAN. Have you another case, Mr. Manson?

Mr. MANSON. Yes.

I will submit the report covering this transaction for the record.

(Exhibits in the Robert Dollar Co. case are as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE, INCOME TAX UNIT,
May 27, 1925.

To: L. C. Manson, General Counsel.
From: L. H. Parker, Chief Engineer.
Special memorandum:
Taxpayer: Robert Dollar Co.
Subject: Case settled without review.

SYNOPSIS

It appears that the 1918 and 1919 taxes of the Robert Dollar Co. was settled without review by the review section in the consolidated returns division, as is required under the regular procedure. This was done under the orders of Mr. Lohman, head of the consolidated returns division.

HISTORY OF THE CASE

From verbal and written information the following appears to be the pertinent facts in this case as regards the manner in which it was handled by the Income Tax Unit.

Mr. Bergeron, auditor of the consolidated returns division, originally audited the case, but it was taken away from him and given to another auditor of this division by the name of T. F. Callahan, following a conference held by the division with the Robert Dollar Co., represented by C. T. Haines. (See Exhibit B attached.) Please note that Mr. B. V. Lobred signed this conference report subject to exception to points 1 and 5 mentioned therein. Subsequent to this conference it appears that Mr. Lohman prepared a memorandum upholding the conference report and directing just how the case was to be audited.

Not only that; but he also instructed the auditor to return the case to him instead of letting it go to the review section in the ordinary manner. (Stenographic report of a conference held in my office May 27, 1925.) The following facts are brought out in this conference by Mr. Callahan, who made the audit:

First. The audit was made as per instructions in Mr. Lohman's written memorandum.

Second. It was taken to Mr. Lohman personally instead of being sent through to the review section in the ordinary manner.

Third. The case would not have been audited in this way without instructions from Mr. Lohman.

Fourth. The result of the audit was to wipe out one-half million dollars in tax and refund to the taxpayer for the year 1918 alone over $11,000.

From the testimony of Neely in the same exhibit, we see that the case went to the administrative section first instead of going to the review section, and it was turned back by them because it was not signed by the review section. When it did get to the review section, it came there with instructions to sign the certificates of overassessment without the usual review.

A memorandum from Mr. Lohman directing how this case should be audited was missing from the files, as well as a memorandum from Mr. Lobred, which set up the objections of the audit unit to the consideration of this case on any such basis as was finally made.

Fortunately, it later developed that Mr. Neely had kept copies of these two memoranda for the protection of himself and his section. Copies of these two memoranda are therefore appended under Exhibit D, which is Mr. Lohman's instructions to audit, and Exhibit E, which sets up the contentions of the auditors. We believe from examination of Mr. Lobred's memorandum and Mr. Lohman's memorandum, that there is no doubt but what Mr. Lobred was right in the majority of his contentions. We will not, however, go into that phase of the case here, because we do not wish to cloud the issue.

The issue in this case is the establishment of the fact that no matter how perfect may seem the safeguards set up by the bureau for the review of cases, they are of absolutely no avail when the administrative officers of the bureau may cut out such procedure and safeguards at their own personal pleasure.

We have information that Mr. C. T. Haines, representative of the taxpayer in this case, is a brother in-law of Mr. Bright, and that Mr. Lohman has now left the department to go into business with Mr. Haines. This latter statement is simply on verbal information and we have not had time to confirm it.

It appears also from the papers in this case that it was closed under a final determination signed by the commissioner, at least for the year 1918, under section 1006. This means the case can not be opened up unless fraud is shown. A rapid survey of the case makes it appear that an item of about $1,200, deductible from the tax of 1918, was omitted from the audit for that year and a certificate of overassessment and a final determination was signed without this being taken into account. We understand later that this amount of money was deducted from 1919 taxes of the taxpayer. This procedure is absolutely contrary to the statute.

CONCLUSION

This case would have received a careful and thorough study if time had been available, but we believe that this brief statement will bring out the astounding condition which exists in the department. We contend that if one case is reviewed, all cases should be reviewed, and that no administrative officers of the Government should be allowed to vary procedure at pleasure. It was quite evident from the conferences held by the writer that the individuals in the bureau do not dare protest such cases for fear of losing their positions. It should be stated also in fairness to these men that they volunteered no information, but answered the questions in the only way which honest men could do.

Respectfully submitted.

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

CONSOLIDATED RETURNS, AUDIT DIVISION—TAXPAYER'S CONFERENCE

Taxpayer: The Robert Dollar Co.
Address: New York, N. Y.
Represented by: C. T. Haines, agent.
Credentials: Power of attorney; credentials verified.
Years involved: 1917 and 1918.
Matter presented: Brief sworn to May 8, 1924, formed the basis for the following discussions and decisions:

1. Contention: The taxpayer states that the amount of $108,787.40 represents income (commission) earned during the year 1916 from a contract made with the Canadian Car & Foundry Co., but the actual receipt of the money earned was not received until the year 1918. It was admitted by the taxpayer that they did not accrue on their books nor report the above amount in the 1916 tax return, but it was simply an error made by them, as their books were kept on an accrual basis. A suit was entered by the taxpayer against the Canadian Car & Foundry Co. for the payment of the commissions; the amount of the commission earned, however, was not in dispute.

Decision: The amount claimed by the taxpayer was allowed, provided they file a waiver for the year 1916 and pay the additional tax on same.

2. Contention: The taxpayer claims that the unit was in error in increasing taxable income by the amount of $21,378.99, representing profit on sale of logs; however, they furnish a statement showing unreported income on the transaction in the amount of $10,517.20.

Decision: Contention allowed, subject to check of the schedule (8) presented.

3. Contention: The taxpayer contends that the amount of $16,111.91 represents the profit on sale of "Bear Creek logs," instead of the amount of $30,018 added to taxable income by the unit.

Decision: Subject to verification of the schedule presented, the contention is allowed.

4. Contention: The taxpayer contends that the unit was in error in disallowing as a deduction from gross income the amount of $300,000, representing bonus paid officers of the corporation. In support of their contention the

taxpayer shows that the bonus was not based on stock holdings but simply based on earnings.

Decision: The salaries and bonus combined do not seem excessive, and further, in view of the fact that a normal and a high surtax would be paid by the recipient, the amount is conceded by the unit.

5. Contention: The taxpayer contends that the amount of $153,472.29, distributive share of profits, is nontaxable income, inasmuch as the income is derived from a foreign quasi corporation and therefore nontaxable.

Decision: Contention allowed.

Taxpayer has withdrawn his request for 327 and 328.

Interviewed by:

T. C. HAMMOND,
Chairman Technical Staff.
F. L. WARFIELD,
Conferee, Technical Staff.
B. V. LOBRED,
Auditor, Audit Section C.

Date: May 29, 1924.

L. T. LOHMAN,
Head of Division.

EXHIBIT C

TESTIMONY OF MR. THOMAS F. CALLAHAN

Q. Did you audit the case of the Robert Dollar Co.—A. I audited it after Mr. D. Louis Bergeron.

Q. Did you have a memorandum in this case from Mr. Lohman telling you how to audit this case?—A. I did.

Q. Was there a written memorandum to that effect in the file?—A. Yes.

Q. You looked those files over to-day and you can not find that memorandum?—A. That is right.

Q. When you finished auditing this case did you transmit it to review in the usual manner?—A. No.

Q. What did you do with it?—A. Took it to Mr. Lohman in accordance with instructions from Mr. Lohman.

Q. If you had been allowed to audit this case without instructions, would you have reached the results you did?—A. I don't believe I would.

Q. The additional tax involved for 1918 involved something over one-half million dollars, according to the revenue agent's report. Your audit showed how much overassessment instead of this additional tax?—A. $11,189.97.

Q. Do you believe that this case for the year 1918 ever went to review?—A. I do not think it did.

Q. At least if they made a review they did not consult you about it?—A. That is right.

Q. I have here the overassessment certificate of 1919. This is signed by you, dated 10-17-24, signed by section unit auditor, H. S. Jones, 10-17-24, reviewed by J. H. Neely, review section, 10-18-24, approved by Lohman, 10-20-24. You admit that there was extraordinary speed in the handling of this case?—A. Yes; it was special.

Q. Mr. Callahan, did you transmit to Mr. Neely certain verbal instructions from Mr. Lohman?—A. I told him that the case was an expedite case, and I was told to tell him that.

Q. Did that mean that the case was to be given a perfunctory review?—A. This just meant to hurry the case.

Q. Was there a memorandum in this case, Mr. Callahan, containing the opinion of Mr. Lobred?—A. I believe there was.

Q. Can you find that memorandum in the files?—A. No; I can't seem to find it. It is not here.

Mr. PARKER. For your information, you are informed that Mr. Neely just told me over the telephone that he did not really review this case, but signed it under instructions.

Q. Can you find a 1918 overassessment certificate in this file?—A. No; I can not find it.

Q. Do you know whether the C. T. Haines, agent for the taxpayer in this case, is the brother-in-law of Deputy Commissioner Bright or not?—A. I do not know.

TESTIMONY OF MR. CHRISTOPHER RAY

Question by Mr. Callahan to Mr. Ray:

Q. Was there ever a memorandum in this case (Robert Dollar Co.) that you have seen signed by Mr. Lohman?—A. I will not say that I saw it, but I do know that you did what they told you to do.

TESTIMONY OF MR. JAMES HILL

Q. What is your full name and title?—A. James Hill, assistant chief, section C, consolidated audit.

Q. In this Robert Dollar Co. case I want to show you a copy of a conference report dated May 29, 1924. Do you remember ever seeing it?—A. I don't know that I can remember it.

Q. Did you ever get any instructions from Mr. Lohman?—A. There was a memorandum prepared taking exception to points 1 and 5 of the conference by Mr. Lobred, and Mr. Lohman then prepared a memorandum sustaining this conference.

Q. You saw that memorandum of Mr. Lohman?—A. Yes.

Q. The memorandum is missing.—A. I saw it, and Mr. Lobred and Mr. Bergeron and Mr. Callahan.

TESTIMONY OF MR. J. H. NEELY

Q. Did you sign the overassessment certificate as the reviewer for the review section in the case of Robert Dollar Co.?—A. Yes.

Q. For what years?—A. 1918 and 1919.

Q. You did not make a review of the case?—A. No; I was instructed not to make a review, as there was a memorandum in the case covering the points signed by Mr. Lohman.

Q. This case was handled altogether different from the other cases going through the bureau?—A. Yes.

Q. Do you know whether this case went to the review section in the ordinary way?—A. No. It was returned from the administrative section to section C because it was not signed by the review section.

Q. How did you get your instructions to sign these certificates of overassessment without the usual review?—A. Mr. Hill stated that the case was not intended to come through review, that all the disputed items were threshed out by Mr. Lohman, and his memorandum covering the items in the case was signed by Mr. Lohman.

Q. Did you keep a copy of these memoranda in your desk in the bureau in order to protect yourself and the section?—A. Yes. I was afraid the memoranda would disappear from the files, as is often the case.

Interviewed by L. H. Parker, chief engineer.

MAY 27, 1925.

EXHIBIT D

AUGUST 18, 1924.

Memorandum in re Robert Dollar Co.

MR. HAMMOND:

I have carefully considered the conferee's findings and conclusions in the above-mentioned case, together with the memorandum written by the auditor on this case and the briefs and data filed by the taxpayer, and it is my conclusions that the decisions as reached by the conferee are correct and should be followed in the closing of this case.

A careful study of all the facts with respect to the contract made with the Russian Government for goods clearly indicates that this should be claimed as income for the year 1916. Their books are kept on an accural basis. This was income properly chargeable to the year 1916 and the taxpayer has agreed to file a waiver, allowing assessment of such additional tax in that year. The

second point raised is the question of the distribution of certain income derived through organizations in Tientsin and Hankow, China.

After careful study of the facts, I have reached the conclusion that this association can not be termed a partnership for general reasons as stated below:

The conclusions reached by best authorities is that whether an association constituted a partnership depends on the intention of the members at the time when the association was formed. The question is whether they intend to enter into the relation of partnership, i. e., to form an association for the purpose of carrying on a business together as joint principals and dividing the profits. The rule is that in determining whether the association or relationship is a partnership, the test whether a man is a partner is not whether he actually receives a share of the profits but whether he has entered into an association formed for the purpose of carrying on a business and dividing the profits. (See Parsons on Partnerships, fourth edition, also Burdick, second edition.) In the case in question it should be noted that 80 per cent of the money used by the so-called partnerships was advanced by the California corporation; 20 per cent was contributed by four Chinese partners. At this point it is well to bring out that these four partners were special partners. An agreement was entered into by the California corporation and the individuals in the so-called partnership, whereby it was agreed that the individuals agreed to pay and deliver any profits over to the taxpayer derived from the partnership. Attention should be called to the fact that the corporation could not, under its charter or under any circumstances, be a party to a partnership interest. Therefore, from a legal standpoint, it is clearly evident that the corporation could not obtain any profit from the so-called partnership by its operations. Another fact, certain Chinese in the so-called partnership were special partners. According to certain well-known authorities and partnership law, where anyone of the partners in an organization is constituted a special partner, the partnership partakes of the nature of a limited partnership. The authorities as quoted above are unanimous in the agreement that the determining factor should be the intent in the minds of the organizers of the partnership or association, as the case might be. In the case under discussion the intention is clearly shown by the briefs submitted by the taxpayer, and also the affidavits of the attorney who drew up the papers creating the so-called partnerships. From the facts presented in these documents it is clearly seen that the intention was to form at first a corporation. On account of the difficulties encountered in the foreign laws with respect to the China trade act it was discovered that a straight out and out corporation could not be formed. Therefore, an organization was completed which partook of the nature of a corporation in so far as it was possible to do under the restrictions as mentioned.

It is quite evident from the facts in this case that the two so-called partnerships can not be called partnerships, neither association nor corporation, but in effect contain the elements of all three, and, to my mind, are nothing more than quasi corporations. As such the profits derived from the operations of these foreign organizations can not be taxed as income, and I agree and concur with the conferee in his decision on this case.

L. T. LOHMAN, *Head.*

EXHIBIT E

Memorandum in re Robert Dollar Co., New York, N. Y.

The following is submitted by section C in support of its action with reference to—

1. Denial of the taxpayer's contention that commissions of $107,019.59 received from the Canadian Car & Foundry Co. (Ltd.) constituted income for 1916 rather than 1918.

2. Denial of the taxpayer's contention that partnership profits amounting to $153,472.29 are nontaxable, which action was reversed by the conferee in report of May 29, 1924.

The facts in connection with point No. 1 are as follows:

During the year 1914 a syndicate composed of five individuals procured a contract frfom the Russian Government for the delivery of 2,000,000 shrapnel shells at $15.85 each, delivery to be made during the year 1916.

On February 12, 1915, the syndicate assigned the contract to the Canadian Car & Foundry Co. (Ltd.), of Montreal, which agreed to pay the syndicate, in consideration thereof, 85 cents per shell out of the payments received, part in cash and part in treasury bills of the Russian Imperial Government, in the same proportion as payments were made to it by the Russian Government. Shortly thereafter the Russian Government agreed to the assignment of the contract, and pursuant to its terms deposited one-fourth of the entire contract price, or $7,925,000, in the Bank of Montreal and the National City Bank. The 85 cents per shell to which the syndicate was entitled was to be distributed to the individuals in the following proportions: Knapp, Mindin, and Dumbadse, 70 cents per shell; Mackie and Allison, 15 cents per shell.

On March 5, 1915, Knapp, Mindin, and Dumbadse entered into an agreement with the Robert Dollar Co. (taxpayer) constituting the latter as their agent and agreeing to pay it five-seventieths of the amount collected from the Car & Foundry Co. as its remunerations. (At this point attention is directed to the fact that a copy of the agreement mentioned above has never been filed.)

On March 24, 1915, the Canadian Car & Foundry Co. (Ltd.) paid to the Robert Dollar Co. for the account of Knapp, Mindin, and Dumbadse the sum of $150,000 as payment on account of commissions from the advance received from the Russian Government in accordance with the terms of the syndicate agreement.

Up to March 8, 1916, the Canadian Car & Foundry Co. (Ltd.) had shipped less than 10,000 shells. The time of delivery was extended and the contract was assigned to a corporation organized by the Car & Foundry Co. under the laws of the State of New York, known as the agency of Canadian Car & Foundry Co. (Ltd.), which company completed the contract in 1916.

On July 27, 1916, the Robert Dollar Co. brought suit against the Car & Foundry Co. and the newly organized company to recover the amounts due Knapp, Mindin, and Dumbadse.

On June 24, 1918, an agreement was entered into between the Car & Foundry Co. and the Robert Dollar Co. to suspend the legal proceedings for 90 days. The company represented that it had made settlement with Knapp and Dumbadse and offered $360,000 in full settlement to be paid by a note in favor of the taxpayer six months after date of acceptance. This offer was accepted.

Accordingly, on November 13, 1918, the taxpayer received a note for $360,000 in full discharge of its claim, both individually and as trustee, including costs and expenses.

The commissions due the taxpayer amounted to $107,[illegible]59. The taxpayer included this amount in its returns for 1920, but the unit decided that they accrued as income in 1918.

TAXPAYER'S CONTENTION (1)

The taxpayer now contends that the commissions were earned and accrued as income in 1916, because there was at no time a question of the amount earned and due, but only the question of payment of the amounts due. That the corporation kept its books on a strict accrual basis and should have accrued the profit on the contract in 1916.

That it has been consistently held by authorities that if the question at issue is whether or not there is any liability no amount can be accrued and no income reported until the proper tribunal has determined that a liability exists, but if the question is one of enforcing the liability already existing, income has accrued.

CONTENTIONS OF SECTION C (1)

It is the contention of section C that the conferee is in error, and that his decision is probably based upon a misunderstanding of the true facts in the case.

It should be borne in mind that the taxpayer was merely acting as agent for the syndicate and that its main service most likely consisted of making collection of the amounts due the syndicate. In consideration of the services rendered it was entitled to compensation equivalent to five-seventieths of the amount collected on behalf of the syndicate. Hence this section is of the opinion that the commissions accrued as earnings in the year 1918, in which year the taxpayer fulfilled the agency agreement with the syndicate by making collection of the amount due certain of its members.

It could not be correctly asserted that the taxpayer earned the commissions in 1916, the year in which the Canadian Car & Foundry Co. completed its contract with the Russian Government, for the reason that the taxpayer had not at that time fully performed the service it had undertaken. The syndicate was not obligated to the taxpayer for any sum prior to the time of the collection of the amount due from the car and foundry company.

If the question at issue was whether the syndicate should have accrued its share of the contract price in 1916, it is likely that the principle asserted by the taxpayer could apply, even though it is highly probable that the members of the syndicate had considerable doubt that it could enforce payment of the amount agreed upon as its share. But the issue relates to the amount to which the taxpayer was entitled for services rendered on behalf of the syndicate.

Hence it would seem that the taxpayer's compensation accrued when the compromise was effected in 1918; in other words, when it fully performed the services it had undertaken.

Attention is directed to the fact that the taxpayer did not accrue the commissions on its books in 1916, which is prima facie evidence that it did not consider the amount as earnings for that year. In view of the above it would seem that this method of treatment was entirely correct from an accounting viewpoint. The taxpayer was not entitled to compensation until it fully performed the service agreed upon, and there is no question that collection of the amount due the syndicate constituted an important part of such services. Hence it would have violated good accounting principles to have accrued the commissions as income prior to the year 1918.

There is no doubt whatsoever that the taxpayer did not have an enforceable claim against the syndicate prior to the year 1918, and this would seem to be the final test preventing accrual of the item in 1916.

It should be noted that an important part of the evidence has not been furnished, viz, the agency agreement between the syndicate and the taxpayer, and it would seem to be contrary to good policy to allow the taxpayer's contentions without requiring the submission of an copy of the agreement.

The facts in connection with point No. 2 are as follows:

On May 1, 1915, the taxpayer organized a lumber yard to be operated at Hankow, China, as a copartnership under the name of Dollar Lumber Co. (Ltd.), and contributed 80 per cent of the paid-in capital, the remaining 20 per cent being divided between four Chinese partners. On February 24, 1916, it organized a lumber yard to be operated at Tientsin, China, as a copartnership under the name of Dollar Lumber Co. (Ltd.), and contributed 90 per cent of the paid-in capital, the remaining 10 per cent being paid in by N. K. Howe, of Shanghai, an employee of the taxpayer.

These investments were carried on the books of the company as "Hankow yard investment" and "Tientsin yard investment." The income of the copartnerships for 1916 was credited to the investment account of the taxpayer and reported as taxable income. The amount of income for 1918, $153,472.29, was not reported.

The articles of agreement under which the above-named companies were formed are in the names of nominees of the taxpayer, since it was prevented by law from enduring into a partnership; however, a separate agreement was made between the taxpayer and its nominees under which the latter agreed to pay and deliver any profits due to the taxpayer derived from the partnerships. In other words, the taxpayer was really the beneficial owner of 80 per cent and 90 per cent of the partnerships, respectively.

The status of the copartnerships may be better understood by reference to amended articles of copartnership attached to taxpayer's brief.

The articles provide for six general and one special partners. Each of the general partners were to contribute 15 per cent of the capital and the special partner 10 per cent. No salaries were to be paid. Profits were to be divided in proportion to capital contributed when desired by a majority. Provision was made for voting by proxy.

It was also provided that in the event of death of one of the copartners the surviving partners would have an option of purchasing the interest of the deceased partner.

During the year 1918 the profits of the partnerships amounted to $153,472.29. This amount, which is in question, was added by the revenue agent to the income reported by the taxpayer corporation on account of the collateral agreement which it had with the partnership.

TAXPAYER'S CONTENTION (2)

The taxpayer contends that the so-called copartnership agreement resulted in the formation of a true association or quasi corporation as contemplated by article 1502, Regulations 45, and each corporation or association being foreign, is nontaxable.

It is stated that the parties to the agreement did not desire to incorporate under the laws of China due to the chaotic conditions existing in that country. That the form of organization decided upon was an association that would function as nearly like a corporation as would be possible under agreements between the parties, incorporating such features of a corporation that would insure an agreeable continuance of the business without the existing disadvantages and further possible disadvantages that might be imposed by the Government of China upon corporations.

The conferee in report of May 29, 1924, allows the taxpayer's contention that the amount of $163,472.29 profits is nontaxable income because it is derived from a foreign quasi corporation or association.

CONTENTIONS OF SECTION C (2)

This section is forced to disagree with the conferee's decision and submits the following to show that it is contrary to the principles of the income tax law:

The commissioner has already ruled (letter of April 25, 1919) that the companies in question are foreign partnerships. This of itself should be sufficient to warrant the denial of the taxpayer's claim. However, the conferee has apparently ignored the ruling, without stating any reason therefor.

There is no question but that if the companies are partnerships, whether domestic or foreign, their income is taxable as income of the taxpayer. This proposition has been admitted by all concerned. There is nothing whatsoever in the income tax law which would warrant a differentiation as between a foreign and a domestic partnership in so far as the taxability of the distributive share of the members thereof is concerned.

Therefore, the only device by which the taxpayer could escape reporting the income from the companies in question would be to have them classified as corporations, as defined by section 2 of the revenue act of 1921 which provides that—

"The term 'corporation' includes associations, joint-stock companies, and insurance companies."

The question, therefore, is whether the companies come within the above classifications.

It is readily apparent that the companies are not joint-stock companies for the reason that no stock was ever issued. Furthermore, the interests of the respective partners are not transferable.

It is the impression of this section that the companies are neither corporations nor quasi corporations. There is no question whatsoever but that they are not corporations for the reason that there was no sovereign grant of corporate powers, an essential element to the formation of a valid corporation.

A quasi corporation is one which exercises all the functions of a true corporation but without legal authority.

A study of the articles of agreement reveals certain features of the companies which are common to corporations. However, these features are unimportant, and, as a matter of fact, are more or less common to many partnerships. For instance, the provision that no salaries should be paid the members, the provision that no profits should be divided except by a majority vote of the partners, no distribution should be made of the assets until dissolution of the partnership, and voting by proxy.

As a matter of fact, these provisions could have been excluded from the articles and would have been embodied therein by legal implications. The only feature which is distinctly corporate in its nature is the provision in the articles for maintaining the companies intact in case of death of one of the members. This provision was made for the purpose of preventing parties not controlled by the taxpayer from acquiring an interest in the companies. It is insufficient to hold that the presence of this corporate feature placed the companies in the catagory of corporations.

As contrasted to this, the following features which are essential to corporate existence are absent:

1. The companies are not chartered.
2. The companies have no corporate seal.
3. The companies are not entities.
4. The members' liability is only limited as to one person of a total seven.
5. There is no directorate.
6. There are no shares of stock.
7. The interest of the respective members are not transferable; that is, not transferable without effecting dissolution of the companies.

This section contends further that the companies are not associations, and cites in support of this contention O. D. 590, U. B. 3–1084, wherein it is held that a certain company having general and limited partners differed from an ordinary partnership in that it was not dissolved by death of one or more of the partners, but that it resembled a partnership and differed from a joint-stock association or corporation in that it did not provide for the free transferability of the interest of a member; therefore it was held that the company was a partnership. (See also O. D. 800, O. B. 4–1440, and I. T. 1150, O. B. C–1–1.)

From the above it is apparent that the principle element going to establish a company in the classification of an association, viz, transferability of shares, is absent in this case. This, coupled with the fact that there never were any certificates of stock provided for, would seem to definitely exclude the classification of the companies as associations.

On the other hand, this section contends that the companies are partnerships for the following reasons:

A partnership is defined by the United States Supreme Court in the case of Meehan *v.* Valentine (145 U. D. 611) as follows:

"In the present state of the law upon this subject it may perhaps be doubted whether any more precise general rule can be laid down than that those persons are partners who contribute their property or money to carry on a joint business for their common benefit and who own and share the profits thereof in certain proportions."

The companies in question meet the test laid down in the above definition.

Furthermore, the presence of the features listed below would seem to clearly establish the companies as partnerships:

1. The articles of agreement consistently mention the organization as a copartnership, which shows the intention to form a partnership. In this connection it is admitted that the companies may have desired to incorporate, but nevertheless their intention was to form a copartnership.
2. The members are personally liable for losses.
3. Existence of the delectus personarum. This is the most important feature of a partnership. It embodies the principle that if a member of a partnership transfers his interest it automatically effects a dissolution; in other words, a stranger can not be brought into a partnership by transfer of one of the partner's shares. In the articles of agreement in this case there is no prohibition against transfer of a partner's interest; hence it must be assumed that it could be freely transferred, in which event a dissolution of the partnership would take place.

Contrary to the ruling of the commissioner in letter of April 25, 1919, attention is called to U. D. 3267, which provides that a partnership created by articles entered into in San Francisco between residents of the United States and residents of China is a domestic partnership.

It would seem that since the articles in question were entered into in San Francisco the companies should be classified as domestic partnerships.

B. V. LOBRED,
Section Unit Auditor Section C.

Mr. MANSON. The next matter is one involving an estate tax, the estate of Charles Warren Fairbanks.

The question involved here is the valuation of a very large farm. It appears that Mr. Fairbanks died on June 4, 1918.

The valuation placed on this farm by the field agent was $960,265.31. The value of the farm was returned by the estate at $691,000.

It seems that in September, 1917, just a few months before the death of Mr. Fairbanks, a value had been placed on this farm by

the Mississippi Valley Trust Co. for the purpose of making a loan upon it, which was approximately the same as the value placed by the agent of the unit.

The unit could not agree with the estate, and finally the commissioner authorized the determination of a value by a board of arbitration consisting of one man appointed by the estate, one to be appointed by the bureau, and the third to be selected by the other two.

Senator ERNST. Pardon me there. Is that the Mississippi Valley Trust Co., of St. Louis?

The CHAIRMAN. I think it is, Senator. Yes; I know it is.

Mr. MANSON. Yes; of St. Louis.

Senator ERNST. They did place a value on it?

Mr. MANSON. They placed a value on it.

Senator ERNST. What is that valuation?

Mr. MANSON. Their valuation is $950,400.

Mr. MOSS. And the agent found a valuation of $960,000.

Mr. MANSON. $960,000. There was a difference of about $300,000 between the valuation contended for by the estate and the valuation made by the agent, and the difference between the valuation fixed by the Mississippi Valley Trust Co. and the agent is about $10,000.

As I have stated, there was subsequently an agreement to submit the matter to arbitrators, who fixed the value at $647,000. I do not know anything about the actual value——

Senator JONES of New Mexico. That is the matter of contention in the case?

Mr. MANSON. Yes, sir.

Mr. MOSS. May I ask you to repeat who those arbitrators were? One from the bureau——

Mr. MANSON. One from the bureau.

Mr. MOSS. And one from the estate?

Mr. MANSON. One from the estate, and a third to be selected by the other two. The arbitrators, Mr. Rainey, former Congressman; Mr. Lowenstein, president of the People's Bank, Whitehall, Ill.; and Mr. Lawrence Y. Sherman, an ex-senator of the State of Illinois.

The CHAIRMAN. Who was it that asked the bureau to do that? As I remember, from reading over the case, there was some political influence brought to bear to get that arbitration board appointed.

Mr. MANSON. Representation was made to the bureau by Assistant Secretary of the Treasury Clifford that Mr. Hays, the then Postmaster General, was very much interested in the matter and had spoken to Secretary Mellon about it, requesting a rehearing. There is nothing in the record to indicate that he requested this arbitration. This arbitration was agreed upon subsequently.

My point is this——

Senator JONES of New Mexico. When was the arbitration had?

Mr. MANSON. On December 19, 1921.

My point in connection with this case is this, that the law does not contemplate the submission of matters of valuation by the commissioner to arbitration. The law contemplates that the commissioner must delegate his discretion to his subordinates. Those subordinates are sworn employees of the Government; they are supposed to be uninfluenced by any improper considerations. I do not

say that these arbitrators were influenced by improper considerations, but an employee of the department, if influenced by any improper consideration, is subject to punishment. Arbitrators appointed in this manner are not. They are not officers of the Government: they are not responsible to anybody. The law does not contemplate any such method of arriving at valuation.

The commissioner recognized that in this case, for the reason that when he ordered the submission of these matters to these appraisers or arbitrators he stated specifically that the procedure to be followed in this case was not to be considered as a precedent in other cases.

Mr. Moss. I suppose this is the only one in which it ever was followed.

Mr. MANSON. For all I know, it was the only one in which that was done.

The CHAIRMAN. But that was done as the result of great political influence.

Senator WATSON. That was Senator Sherman?

Mr. MANSON. Yes.

Senator WATSON. And Congressman Henry T. Rainey, of Illinois?

Mr. MANSON. Yes. My point is that the whole method of arriving at that valuation is absolutely illegal. It is a general rule of law that the rights of the public can not be submitted to arbitration, in the absence of express authority to do so.

Senator ERNST. Was there any agreement to be found by it, or was that a method which the commissioner took upon himself?

Mr. MANSON. That is the method which the commissioner took of determining the value.

Senator ERNST. I mean, was there any agreement that he would follow their determination? I understand, under the law, he need not have followed that, unless he desired to do so.

Mr. MANSON. No; I do not think he did.

Senator JONES of New Mexico. May I inquire as to the reason for appointing the third arbitrator? Ordinarily, in arbitration matters, if the two appointed can agree, they report without the appointment or selection of the third.

Mr. MANSON. The record does not disclose any reason.

Mr. Moss. I do not recognize in the names mentioned there any representative from the bureau. They were Senator Sherman and Congressman Rainey, and the other was——

The CHAIRMAN. A banker.

Mr. Moss. A banker.

Mr. GREGG. He was selected by the bureau.

Mr. Moss. What is that?

Mr. GREGG. He was the bureau's man.

Mr. Moss. He was the bureau's man, was he?

Mr. GREGG. Yes.

Senator WATSON. Did that close the case, Mr. Manson?

Mr. MANSON. Yes: the tax has been determined.

Senator WATSON. I say that is all closed, then?

Mr. MANSON. Yes.

(The report submitted by Mr. Manson in the case of the estate of Charles Warren Fairbanks is as follows:)

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE, INCOME TAX UNIT,
May 26, 1925.

To: Mr. Manson, counsel.
From: Mr. Box, chief auditor.
In re estate of Charles Warren Fairbanks.

Transmitted herewith is an original and copy of report on the estate tax return of Charles Warren Fairbanks, deceased.

The record showed that Revenue Agent Carroll made a very complete examination, and in my opinion his report should have carried great weight in arriving at the valuation of the property which my report deals with.

You will note from his report that all of the persons who made the appraisal of the property for the Mississippi Valley Trust Co. at the time a loan was secured from it appear to have been experienced and qualified for that duty. Note also that Mr. Carroll states that he interviewed every real estate man in Carrollton in regard to this valuation. All of the facts indicate that he took every possible means to arrive at the valuation which he reported before recommending the figure of $950,400.

After this valuation was questioned by C. W. Fairbanks, Revenue Agent Beck held a hearing, at which Mr. Fairbanks appeared, as a result of which Mr. Beck recommended that the valuation be cut down $43,400. It must be assumed that Mr. Beck made all possible concessions in making this recommendation, but I doubt whether he had either the information at hand or made as thorough an investigation of the matter as did Revenue Agent Carroll when making the original valuation.

Notwithstanding the fact that the revenue agents made a thorough investigation as to this valuation, the taxpayer, through political influence, was given an opportunity to have the property assessed by a committee which was composed of two politicians and another man, who was the owner of property in close proximity and who could hardly be expected to give as unprejudiced an opinion as the revenue agents who worked on the case.

You will note from the report that Commissioner Blair consented to the appointment of this committee in this case only, and did not agree that it should be used as a precedent.

GEO. G. BOX, *Chief Auditor.*

MAY 26, 1925.

In re: Estate of Charles Warren Fairbanks.

Decedent died June 4, 1918. His estate tax return was filed by the executors on June 3, 1919, indicating a net estate of $960,265.31. An amended return was filed on September 3, 1919, returning real estate valued at $246,250 and a three-fourths interest in the Indianapolis News, valued at $1,500,000, which was not returned originally as the executors had no knowledge of the decedent's ownership thereof.

The original return contained an item of an asset set forth as 9,883.3 acres of farm land in Green County, Ill., valued at $691,831. In regard to this item the report of Revenue Agent William J. Carroll, dated November 29, 1920, stated that—

"Opinions were requested of all real estate dealers and agents in Carrollton, the county seat of Green County, Ill., as well as opinions of many other parties believed to have knowledge of the value of said real estate. All values recommended and all opinions as to values quoted herein are upon the basis of the fair market value as of the date of the death of the decedent.

"The tract is known as 'Fairbanks valley farm,' title to same on August 25, 1917, being in Warren C. Fairbanks, a son of the decedent. On August 25, 1917, Warren C. Fairbanks conveyed the premises by special warranty deed to his father, the decedent. On August 30, 1917, the decedent conveyed the same premises to W. J. Long (who was superintendent of the farm) by deed. On September 1, 1917, W. J. Long mortgaged these premises to William M. Fitch (who at that time was, and now is, vice president of the Mississippi Valley Trust Co., St. Louis, Mo.) to secure payment of 350 notes for $1,000 each, dated September 1, 1917, payable after five years from date thereof, with interest from date at the rate of 5½ per cent per annum, payable semiannually. These notes bore the signature of Long and were given upon the making of a loan of $350,000 by the Mississippi Valley Trust Co. to the de-

cedent. On the same day, September 1, 1917, Long conveyed to Charles W. Fairbanks by deed and the record title was in the decedent at date of his death.

"A short time before the placing of the above-described mortgage, the Mississippi Valley Trust Co. had a very careful and thorough examination with reference to title, area, character of sales, improvements, and value, made by Mr. D. H. Doane, formerly farm expert under the joint supervision of State and Federal agricultural departments; Mr. Eugene H. Benoist, a director of the Mississippi Valley Trust Co., a real estate man of 40 years experience; Mr. A. M. Dunn, for 15 years in bank and real estate and farm loan business; and William M. Fitch, vice president and farm-loan officer of the Mississippi Valley Trust Co."

The appraisal made by this committee of the property in question was $950.400, which value was recommended by the agent in his report for Federal estate tax purposes. The agent states that—

"Said appraisal was made less than 10 months prior to the death of the decedent by competent experts, was very thorough, and it is believed can be relied upon as based upon sound data. While there was some increase in the value of farm lands in the period between the date of appraisal and the date of death, it would not be very great on the class of land in question, the greater increase in land value having been after the date of death.

"Mr. Benoist, one of the appraisers stated that in arriving at the values they aimed to be conservative and not to place the highest possible values on the property. Mr. Walter W. Steel, chief of the farm-loan department of the Mississippi Valley Trust Co., who has had wide experience in farm loans and appraisals stated that he believed that the valuation was very close to the actual market value at that time and that in his opinion there would be no material difference in the value of the farm as actually at the date of the decedent's death."

The revenue agent states that he consulted every real estate man in Carrollton and found but three who would express any opinion as to value, the others stating that they were unfamiliar with the property. He states further:

"Charles P. Casey, of the firm of Casey & Johnson, realtors, is commissioner of the drainage district in which the farm is located and he stated that he knew of the value placed upon the premises at the time of the appraisal and that he considered it absolutely reliable and the best indication of the value obtainable.

"Mr. O. P. Reynolds and Mr. O. H. Vivell, realtor and mayor of Carrollton, gave similar opinions. There had been no sales of similar land upon which to base their opinions.

"Gus Lowenstein, cashier of Peoples' Bank, Whitehall, Ill., who, with his father, owns considerable bottom land a few miles north of the Fairbanks farm, said that he had been on the Fairbanks farm and that as a general proposition such land inside the levee and under cultivation at date of death would be worth $150 per acre.

"In view of the above facts, it is believed that the value as shown by the appraisals of the Mississippi Valley Trust Co. must accurately represent the market value at date of death and I recommend that the same be taken, to wit, $950,400."

As the result of a protest to placing the valuation of this property at $950,400, a conference was arranged and a hearing granted Warren C. Fairbanks, executor for the estate of Charles W. Fairbanks, which hearing was held at Carrollton, Ill. William J. Carroll, the revenue agent who made the former examination, was present at this hearing.

The revenue agent, T. G. Beck, reports that the executor submitted evidence in the nature of affidavits which he desired to have considered in making final review of the valuation of the land. He states that the question of determining the true value of property such as that in controversy is an extremely difficult one and that—

"It is apparent that all the valuations shown in the affidavits submitted and later testified to at this hearing have been dictated by one and the same person. That such uniform opinions in connection with property of such a varied character would not be possible otherwise. As proof conclusive of the above assertion attention is invited to the affidavit submitted by Arthur Robly, which is almost identical with the remaining affidavits submitted herewith. In direct evidence the said Arthur Robly makes no denial of having placed the value of land inside the levee district, but under cultivation, at $150

per acre; the timberland within said drainage district at $65 per acre; and he further admits that he placed the value of the land outside of said drainage district, which is subject to overflow, at $25 per acre, when interviewed by Revenue Agent Carroll at the time the original report was being prepared."

He states in conclusion that—

"From interviews with the various parties competent to express an opinion as to the value of the land under consideration it is believed that the value of said land within levee district can be sustained at the values reported; that the 1,660 acres outside the levee has no specific value; and that it would be difficult to sustain an increased valuation on the land within said levee district to the extent of the valuation placed on said waste land, and as a result it is recommended that the value attributed to said 1,660 acres be eliminated. It is also recommended that the 330 acres of hill land be included at $50 per acre instead of $80 per acre."

Report of Revenue Agent T. G. Beck is attached as Exhibit A.

Under date of May 17, 1921, the committee on review, following the recommendation of Revenue Agent Beck, reduced the value of the property in question, as reported by Revenue Agent Carroll, viz, $950,400, by $43,400 (Exhibit B), thereby making the new valuation $907,000. The executor, Mr. Warren C. Fairbanks, was notified of this action by the bureau by letter dated May 18, 1921.

Under date of June 18, 1921, Warren C. Fairbanks wrote to Assistant Secretary of the Treasury Clifford (Exhibit C) advising him that he had written to the Postmaster General requesting that he cooperate with him in the matter of gaining a rehearing of the inheritance tax matter on his father's estate, as well as a hearing on their back income tax which was in controversy.

Under date of June 23, 1921, Assistant Secretary Clifford wrote the Commissioner of Internal Revenue (Exhibit D) transmitting the last above-mentioned letter in which he states that "Postmaster-General Hays is very much interested in this matter and has spoken to Secretary Mellon about it, requesting that the rehearing be granted."

Under date of June 30, 1921, Assistant Commissioner C. P. Smith wrote a memorandum for the solicitor (Exhibit E) advising him that he had looked into the claim of the estate of Charles Warren Fairbanks superficially and was of the opinion that there was some doubt as to the correctness of the valuation placed on the land in Greene County, Ill., and suggested that the representatives of the estate be given a hearing in the solicitor's office. By memorandum for Assistant Secretary of the Treasury Clifford, written July 11, 1921, by the Commissioner of Internal Revenue (Exhibit F), the former was advised that as soon as the claim for refund in the matter of the estate of Charles W. Fairbank's estate tax matter reached his office the latter matter would be handled as expeditiously as possible.

Under date of July 15, 1921, Solicitor Mapes notified Mr. Warren C. Fairbanks (Exhibit G) that "An examination of the record discloses a difference between the values placed upon this land by the witnesses for the estate and the Government of approximately $300,000. The valuations upon which the Government has been relying were made by men who were experts in valuing farm lands. The valuations relied upon by the estate appear to have been made principally by farmers who lived on lands adjoining and near to the Fairbanks farm. In view of the fact that the witnesses used by the estate apparently can not qualify as experts in the valuation of farm land, the department has not felt that it could accept the valuation made by the witnesses for the estate."

Under date of September 26, 1921, Solicitor Mapes advised the internal revenue agent in charge, Springfield, Ill., that his office had had under consideration for some time the valuation of the farm lands belonging to the estate of Charles W. Fairbanks for the purpose of fixing the amount of estate tax and requested him to furnish the names of at least six real estate men who were competent to make a fair valuation of the land in question as at the date of the death of Charles W. Fairbanks. (See Exhibit H.)

Under date of October 11, 1921, the solicitor, in a memorandum to the commissioner advised him that a plan was tentatively agreed upon, subject to approval of the commissioner, for a revaluation of the property located in Greene County, Ill., whereby the Fairbanks estate was to appoint one expert appraiser, the Government appoint one, and these two select a third man for the purpose of making an independent valuation of the land according

to their own methods, without suggestions or assistance from either of the interested parties. (Exhibit I.)

Under date of October 14, 1921, Assistant Commissioner C. P. Smith advised the solicitor in a memorandum (Exhibit J) that "Mr. Blair agreed to the proposition outlined in this memorandum for this case only. Mr. Blair was not favorable to making this a rule for similar cases."

On December 14, 1921, a report (Exhibit K) finding the value of the property in question as at June 4, 1918 to be the sum of $647,362.20 was submitted by the special appraisers appointed under the plan mentioned in the solicitor's memorandum of October 11, 1921, above referred to. This appraisal was by Henry T. Rainey, United States Representative in Congress; Louis Lowenstein, president Peoples' Bank, Whitehall, Ill.; and Lawrence Y. Sherman, an ex-Senator of the State of Illinois. Mr. Lowenstein was the appraiser representing the Government, Mr. Rainey was chosen by the representatives of the taxpayer, and Mr. Sherman was chosen by Messrs. Rainey and Lowenstein as the third member of the committee. Mr. Lowenstein is the father of Gus Lowenstein, referred to above in commenting on the report of Revenue Agent Carroll, and who advised Carroll that in his opinion the part of the Fairbank's farm under cultivation at date of death of the decedent was around $150 per acre. (The valuation of $950,400 was based on $120 per acre.)

Under date of December 20, 1921, the review committee acted upon the last above-mentioned report and recommended that action be taken for abatement of claim filed by Warren C. Fairbanks, and under date of January 26, 1922, the claim for abatement in full was allowed. The amount of tax lost to the Government on account of this revaluation was approximately $35,000.

GEO. G. BOX, *Chief Auditor.*

EXHIBIT A

(Estate of Charles W. Fairbanks, district of Indiana; date of death, June 4, 1918)

SUPPLEMENTAL REPORT—COLLATERAL INVESTIGATION

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
Springfield, Ill., March 23, 1921.

INTERNAL REVENUE AGENT IN CHARGE,
Springfield, Ill.:

In compliance with department letter ET-763-LLH, dated February 4, 1921, a conference was arranged and a hearing accorded Warren C. Fairbanks, executor for the estate of the late Charles W. Fairbanks, which hearing was held at Carrollton, Ill., William J. Carroll, the officer who made the former examination, being present.

Considerable delay has been occasioned in submitting this report due to there being only one stenographer available at Carrollton, she being also employed by the circuit court of that place, which convened immediately following the taking of testimony in this case. As a result, the evidence submitted was not made available until March 28, 1921.

The executor preferred to submit evidence touching on all parts of the property situated in Greene County, Ill., and there is being transmitted herewith a copy of the evidence introduced at said hearing, together with a number of affidavits which the executor desires to have considered in making final review of the value of said land.

The question of determining the true value of property, such as that in controversy, is an extremely difficult one. The vast different character of land in the tract involved, and the fact that no sales similar land are available for comparison, render the question of determining the true value largely one of speculation.

No lengthy comment will be made as to the evidence or affidavits herewith submitted, but it is desired to call attention to a few of the more pertinent and outstanding features of both.

It is apparent that all the valuations shown in the affidavits submitted and later testified to at this hearing have been dictated by one and the same

person; that such uniform opinions in connection with property of such a varied character would not be possible otherwise. As proof conclusive of the above assertion, attention is invited to the affidavit submitted by Arthur Robley, which is almost identical with the remaining affidavits submitted herewith. In direct evidence the said Arthur Robley makes no denial of having placed the value of the land inside the levee district, which, under cultivation, at $150 per acre; the timberland within said drainage district at $65 per acre; and he further admits that he placed the value of the land outside of said drainage district, which is subject to overflow, at $25 per acre, when interviewed by Revenue Agent Carroll at the time the original report was being prepared.

With the exception of Alfred H. Johnson, who is an abstractor and real-estate dealer at Carrollton, Ill., neither of the witnesses introduced are qualified to give expert testimony as to land values; said parties being principally local farmers, having no knowledge of any sales of land similar to that under consideration, with the exception of the 330 acres referred to as hill land. It will be noted on pages 23 and 24 of the evidence submitted, that Alfred H. Johnson terms the appraisement made by the Mississippi Valley Trust Co. as rather strong—"not so much too high, but plenty high enough." Mr. Johnson is perhaps as well qualified as any local person to express an opinion as to the true value of said property, and after our hearing had been concluded he admitted that when interviewed by Revenue Agent Carroll at a previous date he was of the opinion that the Mississippi Valley Trust Co.'s appraisal was not unfair; but on reconsideration his views had been somewhat changed. Such is, no doubt, due to the recent decrease in land values.

Among the exhibits submitted will be found one marked "Exhibit 2," showing several sales of land made at public auction by the master in chancery during the years 1917 and 1918. It will be noted that James McNabb states on page 64 of the evidence submitted that the best of the land included in said sales is regarded by him as being a little better than the average Fairbanks land—this refers to the land under cultivation—and it will be noted that the two pieces referred to on said Exhibit 2, being the second and third items thereon, was sold at $130 per acre, which would indicate the value of $120 per acre placed on the Fairbanks land under cultivation and within the drainage district is not unfair.

The only other sale which was disclosed at this hearing which could fairly be used as a comparison with the Fairbanks land that is under cultivation is the 170 acres purchased by Elmer Robley from Mrs. Casey in the year 1917 at approximately $118 per acre. While Elmer Robley states (see p. 74) that this land is better than that of the Fairbanks estate which is under cultivation, the fact that about one-half of this 170-acre tract is subject to overflow and can not be successfully cultivated would, it is believed, render it somewhat less valuable than the land within the drainage district, which was included at $120 per acre.

The 120-acre tract referred to by Arthur Robley (see p. 57) for which he received an offer and refused $135 per acre in 1917 is land very similar in character to that of the Fairbanks land, which was valued by the Mississippi Valley Trust Co. at $120 per acre.

The 330 acres of hill land appears to have been included at a figure somewhat in excess of its true value, and from the evidence submitted it is believed that same should be reduced to $50 per acre.

The 1,660 acres located outside of the drainage district has no commercial value in itself; can not be reclaimed; and, taken alone, it is very doubtful if it could be disposed of at any figure. That it affords a material protection to the levee is indisputable, and the question of determining its actual worth in this respect is one that could be more readily determined by engineers who were familiar with the conditions, which, presumably, was the case when the Mississippi Valley Trust Co. made their appraisal. While the 1,660 acres in question is not such as could ever be self-supporting, it serves to lessen the cost of levee maintenance, and is regarded as almost inseparable from the land within the drainage district for which it serves as a protection.

The Mississippi Valley Trust Co., in their appraisal of this property, no doubt took this fact into consideration and distributed the value of the entire tract in the manner reported, and any lessening of value with respect to this 1,660 acres would result in a like increase on the land within the levee. If we are to assume that the land within the levee district was placed at its full market value, then it appears that the valuation placed on the 1,660 acres might properly be eliminated.

In conclusion, I will say that from interviews with the various parties competent to express opinions as to the value of the land under consideration it is believed that the valuation on said land within the levee district can be sustained at the values reported; that the 1,660 acres outside the levee has no specific value; and that it would be difficult to sustain an increased valuation on the land within the said levee district to the extent of the valuation placed on said waste land; and as a result it is recommended that the value attributed to said 1,660 acres be eliminated. It is also recommended that the 330 acres of hill land be included at $50 per acre instead of $80 per acre.

T. D. BECK, *Revenue Agent.*

EXHIBIT B

(District of Indiana, estate of Charles W. Fairbanks. Submitted on appeal)

MAY 17, 1921.

Memorandum for the head of the estate tax division (attention Mr. Roman).

IN RE VALUATION OF REAL ESTATE

The estate has filed a claim for abatement of $51,315.04 of the tax assessed by the bureau in its letter of December 8, 1920, wherein there was determined to be due an additional tax of $130,171.74. The claim arises through alleged excessive valuation by the bureau of a tract of land consisting of 9,960 acres in Greene County, Ill., which was returned at $691,831 and which was determined by the bureau at a valuation of $950,400, plus an additional amount for the value of machinery of $62,150.

A hearing was granted counsel for the estate, and subsequently thereto the estate was permitted to submit to the revenue agent in charge of the Springfield division both documentary and oral evidence as to the value of the property in question. In accordance therewith the estate submitted numerous affidavits, each being to the same effect, and produced before the revenue agent in charge of the Springfield division several witnesses who testified orally and whose testimony was reduced to writing and transmitted with a supplemental collateral report from the Springfield division.

After a careful consideration of all the evidence submitted with the original report, together with that adduced by the estate, it appears that the recommendations made by the supplementary report, dated March 23, 1921, transmitted in a letter from the agent in charge of the Springfield division, dated March 24, 1921, fairly represent the value of the property with the exception of the machinery, to which no reference was made or intended.

Accordingly, the following adjustments should be made in acting upon the claim for abatement:

Three hundred and forty acres of hill land, forming a part of a large tract, should be valued at $50 per acre in lieu of $80 per acre as originally determined. This results in a reduction of $10,200.

One thousand six hundred and sixty acres of land outside the levee, subject to overflow, should be valued at no unit value, as it has no inherent value and its existence and location is responsible for the value determined for the land inside the levee, which it protects. It is conceded that these 1,660 acres can not be reclaimed and have no commercial value; that this land could not be sold for any value; and that it is for no other purpose than for protection of the adjacent land. To place a valuation upon this land would be similar to placing a valuation upon a dike, which serves merely to give value to the land which it protects and without which the land it protects would have no value, or, at least, a much reduced value. This will accordingly result in reducing the valuation of the whole tract by $33,200, due to the fact that the bureau has determined the value of these 1,660 acres at the rate of $20 per acre.

As a separate item on page 5 of the letter of the bureau of December 8, 1920, under the heading "Mortgages, notes, and miscellaneous," there were included in the gross estate pumping plants and other machinery on the Greene County tract, which were not returned, but were valued by the bureau at $62,150. This item was valued by the bureau because it was alleged to have been upon the farm of 9,960 acres. It appears, however, that the pumping plant and machinery did not belong to the decedent, but was the property of

the Keach levee and drainage district of Illinois. Even if this pumping plant did belong to the decedent, it would be treated in a manner similar to a dike, because its existence and use is responsible for the high valuation of the land and without it the land would have a much reduced value, considerably in excess of the value of the pumping plant. Accordingly, this item as determined by the bureau should be stricken out.

The result of the foregoing is to reduce the gross and net estates as determined by the bureau by the aggregate sum of $105,550. Thus the net estate would be reduced from $3,493,559.24 to $3,388,049.24, and the tax would be reduced from $120,975.88 to $404,087.88, resulting in an abatement of $16,888. The additional tax of $130,171.74 should be reduced $16,888, which leaves as the correct additional tax $113,283.74, with interest thereon at the rate of 10 per cent per annum from the expiration of 30 days after receipt of the bureau's letter of December 8, 1920, unless some part thereof has since been paid.

L. L. HAMBY,
Chairman Committee on Review.

EXHIBIT C

CORN EXCHANGE NATIONAL BANK BUILDING,
Chicago, June 18, 1921.

MY DEAR COLONEL: I have to-day written a letter to the Postmaster General requesting that he cooperate with you in the matter of gaining a rehearing of the inheritance tax matter on my father's estate, as well as a hearing on our back income tax, which is in controversy. The Postmaster General is conversant with the subject.

I feel that the Revenue Department has not thoroughly grasped the matters in question. They have raised the valuation which was made by the attorney general of Illinois some $300,000, this valuation having been made by a specially appointed commission, composed of landowners holding lands contiguous to this property, and presided over by the attorney general.

The property in question, which is a reclaimed project in Greene County on the Illinois River, can not maintain a productivity that would warrant such an appraisal as the Government has made. The undertaking is in some degree a hazardous one, depending upon the downfall of water.

In our very best years the most we have been able to derive from the property is approximately 35,000 bushels of corn, about 14,000 bushels of wheat, from 1,800 to 3,000 bushels of oats, and about 100 tons of hay, a part of which is necessary to use for our part of the farm upkeep. The crop, however, is divided on a half-and-half basis between the tenants and ourselves, and this represents our share in record years. In most years the property has lost money rather than made it.

You can very readily see that even on a top production such a property can not maintain a valuation of anything approximating $900,000, which the Government is exacting.

In addition to the ordinary operations it is necessary for us to maintain two pumping stations from which we draw the water off the property. This is a fixed charge which must be met at all times. Our expense in operating the pumping station alone last year was in the neighborhood of $13,000.

In addition we have managerial expense, the maintenance of an engineering staff, and levee expense, from which ordinary farm land is immune.

Any assistance that you can render me in gaining a rehearing in the matters detailed above will be more than appreciated by me.

Sincerely,

WARREN C. FAIRBANKS.

Col. EDWARD CLIFFORD,
Assistant Secretary of the Treasury, Washington, D. C.

EXHIBIT D

TREASURY DEPARTMENT,
Washington, June 25, 1921.

Hon. DAVID H. BLAIR,
Commissioner of Internal Revenue.

DEAR MR. BLAIR: I am inclosing you herewith a letter from Mr. Warren C. Fairbanks, who desires rehearing of the inheritance-tax case of his father's estate, and also a hearing on the back income tax of that estate.

Pastmaster General Hays is very much interested in this matter and has spoken to Secretary Mellon about it, requesting that the rehearing be granted. Mr. Hays told Mr. Mellon that Mr. Fairbanks had written me about the matter. Accordingly, Mr. Mellon has asked me to take it up with you.

Mr. Fairbanks is an intimate friend of mine and has often spoken to me about this case; he thinks the Government has appraised this property too high on account of the high figures given in the newspapers at the time there was litigation in the courts of Indiana over the estate. May I therefore suggest that you look into the matter, and I believe you will then grant a rehearing.

Sincerely yours,

EDWARD CLIFFORD,
Assistant Secretary.

EXHIBIT E

JUNE 30, 1921.

Memorandum for the solicitor:

Please note the atrached file in the case of the estate of Charles Warren Fairbanks.

I have looked into the claim superficially and am now of the opinion that there is some doubt as to the correctness of the valuation placed on the lands in Green County, Ill.

I would suggest that you get all the papers from the estate tax division and give the representatives of the estate a hearing in your office, and that the estate tax division be advised with respect to the adjudication of the claim.

C. P. SMITH,
Assistant Commissioner.

EXHIBIT F

JULY 11, 1921.

Memorandum for Mr. Clifford, Assistant Secretary of the Treasury.

Reference is made to the claim in the estate of Charles W. Fairbanks and to the telegram from Warren C. Fairbanks, dated July 9, 1921, addressed to you.

You are advised that on May 18, 1921, the estate tax unit rejected the claim for abatement filed by this estate, but later I ordered the claim reopened. The question in dispute is the valuation of 9,960 acres of land in Greene County, Ill. The file in the case has been transferred to the office of the Solicitor of Internal Revenue and is now being given very careful consideration in that office. As soon as the claim for refund referred to in Mr. Fairbank's telegram reaches this office, it will be delivered to the office of the Solicitor of Internal Revenue and the whole matter will be handled as expeditiously as possible.

D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT G

JULY 15, 1921.

MR. WARREN C. FAIRBANKS,
Corn Exchange National Bank Building, Chicago, Ill.

DEAR SIR: Reference is made to the claims filed by the estate of Charles W. Fairbanks, deceased, in connection with additional estate tax against said estate.

The file in connection with the above claims has recently been referred to this office for further consideration in connection with the value of the farm lands belonging to the estate. The land, the value of which is in dispute, is located in Green County, Ill. An examination of the record discloses a difference between the values placed upon this land by the witnesses for the estate and the Government of approximately $300,000. The valuations upon which the Government has been relying were made by men who were experts in valuing farm lands. The valuations relied upon by the estate appear to have been made principally by farmers who live on lands adjoining and near to the Fairbanks farm. In view of the fact that the witnesses used by the estate apparently can not qualify as experts in the valuation of farm land, the department has not felt that it could accept the valuations made by the witnesses for the estate.

However, this office will be glad to confer with you or your attorneys at any time convenient to you with a view of arranging for the submission of additional evidence bearing upon the question at issue.

Respectfully,

CARL A. MAPES, *Solicitor*

EXHIBIT H

SEPTEMBER 26, 1921.

INTERNAL REVENUE AGENT IN CHARGE,
Springfield, Ill.:

This office has had under consideration for some time the valuation of the farm lands belonging to the estate of Charles W. Fairbanks, deceased, for the purpose of fixing the amount of the estate tax. The valuations in the record are not entirely satisfactory, and an agreement has been reached with the representatives of the estate to have another valuation made of these lands. The lands are situated inside the drainage districts in Greene County, Ill., and it is desired to obtain the names of several experts in the valuation of such land. It is, therefore, requested that you furnish this office, with as little delay as possible, the names of at least six real-estate men who are competent to make a fair valuation of the land in question as of June 4, 1918, the date of the death of Charles W. Fairbanks. It is desired to have the names of men who are familiar with local conditions, and who were familiar with local conditions in 1918. A brief statement of the qualifications of each person whose name is submitted should accompany the list of names furnished.

In view of the fact that there have been several affidavits filed by real-estate men in the vicinity of the land, it is thought best that the men selected to make another valuation of the land not be told the valuation heretofore placed upon the land by witnesses who testified either for the Government or for Mr. Fairbanks.

Charles T. Casey, D. P. Reynolds, E. A. Eldred, and William A. Hubbard have already filed affidavits in this case, and their names should not be included in the list which is furnished. The experts for the Mississippi Valley Trust Co. have also made a valuation of the land, and they should not be included.

CARL A. MAPES,
Solicitor of Internal Revenue.

EXHIBIT I

OCTOBER 11, 1921.

Memorandum for the Commissioner:

On June 30, 1921, there was transmitted to this office, with a memorandum from the assistant commissioner, the file in the matter of the estate of Charles Warren Fairbanks. The memorandum from the assistant commissioner suggested that this office give the representatives of the estate a hearing in the matter and adjudicate the question involved and notify the estate tax division of the adjudication made.

The question involved in the case is the value of certain lands located in Greene County, Ill. The evidence submitted by the estate tends to establish a value of approximately $600,000 and the evidence gathered by the estate tax division tends to establish a value of approximately $900,000. The difference in the two values mades a difference in the tax of approximately $35,000. Upon examination of the file in this office, the evidence was found to be unsatisfactory, and the office was unable to reach a conclusion as to the correct value of the lands in question. The executor of the estate was notified to this effect and the suggestion made to him that he confer with this office with a view of making arrangements to obtain expert testimony as to the value of the land. After some delay, Mr. Fairbanks did confer with this office, and, subject to your approval, a plan was tentatively agreed upon. The plan is to let the Fairbanks estate appoint one expert appraiser, the Government appoint one expert appraiser, and these two select a third man, the three to make an independent valuation of the land according to their own methods without suggestions or assistance from either of the interested parties. It is understood that men who have not heretofore expressed any opinion in the matter and who are thoroughly competent to value a tract of land as large as the one in question will be selected by each of the interested parties. The understanding further is that, if the valuation made by this board of experts is less than the value at which the land was returned by the estate, both the interested parties will accept the returned value. If the valuation made by the board of experts is greater than the value heretofore placed upon the land by the estate tax division, both parties will accept the value heretofore placed upon the land by the estate tax division. Within these limitations both parties will accept the valuation made by the experts so appointed. It is believed by the estate and this office that the true value of the land is between the returned value and the value as found by the estate tax division.

It is realized that this plan is a departure from the usual method of arriving at the value of property for estate tax purposes, but the number of experts near the land, who are qualified to make the valuation are few, and most of them have already committed themselves on one side or the other in the case. For these reasons it is believed that a departure from the usual methods may be justified in order to obtain a valuation which will be fair and satisfactory to both the Government and the representatives of the estate.

In view of the special nature of the case and the possibility of establishing a precedent in such cases, before proceeding further with the matter I should like to know if the proposed action meets with your approval.

CARL A. MAPES,
Solicitor of Internal Revenue.

(In pencil:) It might be wise to consult the estate tax division before acting.

C. M.

EXHIBIT J

OFFICE OF THE COMMISSIONER OF INTERNAL REVENUE,
October 14, 1921.

Memorandum for the solicitor.

Relative to the attached file in the matter of the estate of Charles Warren Fairbanks, you are informed that Miss Ruddick took this matter up personally with the commissioner and Mr. Blair agreed to the proposition outlined in this memorandum for this case only. Mr. Blair was not favorable to making this a rule for similar cases.

C. P. SMITH,
Assistant Commissioner.

EXHIBIT K

We, Henry T. Rainey, Lewis Lowenstein, and Lawrence Y. Sherman, heretofore appointed special appraisers to make an appraisement of a certain parcel or tract of land, containing 9,960 acres, situated in Greene County, in the State of Illinois, together with all improvements thereon, or in any wise thereto appertaining, being property belonging to Charles W. Fairbanks at the time of his death, do hereby certify that we have fairly and impartially, without any suggestions whatsoever as to value from any person whomsoever, completed our appraisement of the whole of such property, and we do hereby certify that we find the value of the whole of said property, as of June 4, 1918, to be the sum of $647,362.20.

In witness whereof we have hereunto set our hands and seals this 14th day of December, 1921.

HENRY T. RAINEY. [SEAL.]
LEWIS LOWENSTEIN. [SEAL.]
LAWRENCE Y. SHERMAN. [SEAL.]

Subscribed and sworn to before me this 14th day of December, 1921.

CLYDE LINDER, *Notary Public.*

Mr. MANSON. A complaint has reached us with reference to the estate of Celestine Eustis, of North Carolina.

The facts in regard to this matter are that Celestine Eustis is a very old woman, past 80. She had given a mortgage to the same person, who was the sole legatee under her will, for $80,000.

The agent of the Income Tax Unit contended that that mortgage was given without consideration. He cited, in support of that contention, a lot of circumstances tending to indicate that Mrs. Eustis was not in need of money at the time when the mortgage was given; that she had no use for the money; and that there was no apparent result; in other words, she did not acquire any property, and there was nothing to show for the money.

The fact, however, is that the mortgage and note were in due form and were duly filed.

My personal view is that the department did the only thing it could do under the conditions by allowing the amount of the mortgage to be deducted from the estate for the purpose of determining the tax. Whatever I may think about the actual facts, as a matter of law, the mortgage was an instrument in writing; it was under seal, and it imported a consideration and the burden was upon the Government to show that it was without consideration. In my judgment, the circumstantial evidence adduced by the agent in support of his position was not sufficient to overcome the presumption of the consideration.

The CHAIRMAN. Why do you bring it before the committee, then?

Mr. MANSON. Because I was told to last night.

The CHAIRMAN. You were only told, if there was anything wrong with the decision there.

Mr. MANSON. Well, I understood——

The CHAIRMAN. I think there is no necessity of taking up the time of the committee on cases you agree

Mr. MANSON. I got the memorandum from the Senator last evening directing me to bring this case to the attention of the committee, and I did so.

The CHAIRMAN. I did not see the case myself, and I asked to have it presented here on the assumption that there was something wrong with it. Of course, if there was nothing wrong with it, it was like

every other case. There are dozens of cases we did not bring here, because we found there was nothing wrong with them.

Senator JONES of New Mexico. I am not prepared to take Mr. Manson's stated view of the case. It seems to me from what he said that there was plenty appearing to put the department on inquiry at least.

Mr. MANSON. Well, they were upon inquiry. A thorough investigation was made by the estate tax officers.

Senator JONES of New Mexico. It seems to me that nothing resulted. There was no statement made here as to whether or not the money was actually paid, nor that the deceased ever received it.

Senator ERNST. We have not heard the other side of it, Senator.

Senator JONES of New Mexico. That is what I say. On the statement made here thus far, I am not prepared to say that that is a case that ought to be put to one side.

Mr. MANSON. I, perhaps, omitted to say that the legatee claimed that she had advanced a large amount of money for the building of houses and also set up a claim that there was an agreement between her and the deceased under which she agreed to take care of the deceased for the remainder of her life and that the mortgage was in consideration of both of these.

Of course, the deceased was dead; the transaction was not in writing; the only person who could deny the fact had passed out of existence, and the only evidence of the transaction was the note and mortgage.

Senator JONES of New Mexico. There was no attempt made to trace the payments?

Mr. MANSON. Yes; the agent made an attempt to trace the payments and came to the conclusion, and I think very soundly, that there was nothing to show; there was no property of the old lady; she had passed that stage of life when she could have possibly spent all the money; she was living with the residuary legatee; she had no use for the money, and there was no property to show for the money.

The CHAIRMAN. Is there any evidence of the legatee paying the decedent?

Mr. MANSON. No; except the note and mortgage.

The CHAIRMAN. I mean that there is no evidence that when the note and mortgage were made the legatee turned over anything of value to the decedent.

Mr. MANSON. Oh, yes; the legatee stated she did turn it over.

The CHAIRMAN. Have you any other evidence than her mere say-so?

Mr. MANSON. No; no other evidence than that.

The CHAIRMAN. No checks or cash transferrance or any records of it?

Mr. MANSON. No. Both of them were wealthy parties. The residuary legatee was a wealthy woman.

Senator JONES of New Mexico. Did the deceased have other properties than this mortgage?

Mr. MANSON. Other than the property that was covered by the mortgage?

Senator JONES of New Mexico. No; of course, that which was covered by the mortgage was not hers, I take it.

Mr. MANSON. You mean the residuary legatee?

Senator JONES of New Mexico. No; I mean the deceased. Did she have other property than this note and mortgage?

Mr. MANSON. The deceased did not own the note and mortgage. The Senator has a wrong impression of the facts. The deceased owned a lot of real estate. The deceased, several years before death, gave a mortgage to the same person to whom she willed this property for $80,000. When the property passed to the legatee under the will, the legatee took the position that the taxable transfer under the will was $80,000 less than the value of the property, because she already had an $80,000 mortgage on it.

Senator JONES of New Mexico. I did get confused in my question.

Mr. MANSON. Yes.

Senator JONES of New Mexico. But the real point I had in mind was this: You stated awhile ago that a part of the consideration for this note was an agreement to pay the expenses of board and all that sort of thing of the old lady.

Mr. MANSON. The old lady lived with her.

Senator JONES of New Mexico. Did she have any property outside of that which she had mortgaged to the legatee?

Mr. MANSON. I am not sure about that.

Senator JONES of New Mexico. As I understood it, you stated awhile ago that they were wealthy people.

Mr. MANSON. Yes.

Senator JONES of New Mexico. Both of them?

Mr. MANSON. This involved a large amount of property, and she had a very substantial income.

Senator JONES of New Mexico. Then, what was the occasion for her giving a mortgage to the legatee in consideration of her giving her board and lodging?

Mr. MANSON. That is one of the circumstances that the agent pointed out as indicating that this mortgage was without consideration. My own view is this: That the mortgage to be a valid instrument does not necessarily need to carry with it the full consideration of the note.

Senator JONES of New Mexico. I think that is quite true, and perhaps in a court of justice it would not be set aside for want of consideration, because the seal imported consideration.

Mr. MANSON. It imports consideration.

Senator JONES of New Mexico. I think that is quite true, but when you come to the question of considering fraud in connection with the settlement of an estate for taxation purposes, that is quite a different question.

Mr. MANSON. There is another fact to be considered, and that is that this mortgage was not secreted; it was not something that was just brought forth.

Mr. MOSS. How many years before the death was it?

Mr. MANSON. It was several years before the death of the testator, and it was not something that was just dug up.

Senator JONES of New Mexico. I think that is a very important fact.

Mr. MANSON. It was in due form and properly recorded several years before the death of the testator.

There was another thing that influenced my mind in saying that I could not take exception to the action of the bureau here, and that was this: There was a very close relationship between these parties, the old lady leaving her entire estate to this legatee, and assuming that there was no consideration for that mortgage, other than just a desire to make a gift, it would have constituted a valid gift.

Mr. GREGG. I would like to call the Senator's attention to this point:

What was the date of the decision of this case? What act did it arise under?

Senator JONES of New Mexico. I am not so sure as to the date.

Mr. MANSON. The decedent died February 11, 1921.

Mr. GREGG. So it comes under the 1921 act. The point that I wanted to bring out is that the 1921 act, in covering this situation, provides for a deduction from the gross income of claims against the estate, unpaid mortgages upon, or any indebtedness in respect to, property.

In the 1924 act we put in the additional qualification, "to the extent that such claims, mortgages, or indebtedness, were incurred or contracted bona fide and for a fair consideration in money or money's worth."

Senator JONES of New Mexico. Yes.

Mr. GREGG. We did not have, until the 1924 act, any authority for going back to see whether there was a consideration.

Mr. MANSON. This mortgage was made and recorded more than two years prior to the death of the testator.

The CHAIRMAN. So that the legatee might have contended that it was a gift, if she wanted to.

Mr. MANSON. Yes; although there is nothing set up in the record to indicate that she did make any such contention.

Mr. GREGG. But, under the old act, it would have been deductible, even if it had been a gift.

Mr. MANSON. Yes.

Mr. GREGG. Even if there had been no consideration.

Mr. MANSON. Even if it was a gift it would have been deductible.

Senator JONES of New Mexico. That statement settles the whole question.

Mr. GREGG. Yes; the law settles the whole thing.

Mr. MANSON. While that was not in the record before me, the thought occurred to me that there was no consideration for it at all, but it was just a gift which was made more than two years prior to death. There was a close relationship here, and the entire estate was left to this same woman.

The CHAIRMAN. Let us proceed with the next case, then, Mr. Manson.

Mr. MANSON. I will submit the report in this case for the record.

(The report submitted by Mr. Manson in the case of the estate of Celestine Eustis is as follows:)

MAY 27, 1925.

In re Estate of Celestine Eustis, Aiken, S. C.

The decedent died on February 11, 1921. An estate-tax return was filed by the executrix, Mrs. Louise Eustis Hitchcock, a niece and adopted daughter of

the decedent. This return showed a total gross estate of $127,870.05, against which were deductions totaling $139,463.76, so that there was no net estate subject to Federal estate tax.

Among the deductions claimed in the return was one of $80,000, representing an unpaid mortgage on nine parcels of real estate owned by the decedent and located at Aiken, S. C., the value of which was returned at $64,000. Revenue Inspector J. W. Wilson made a report under date of January 24, 1924, and his examination of the return in question in relation to this mortgage stated as follows:

"Mortgage on real estate in Aiken County, S. C., described in Schedule A, made in favor of Mrs. L. E. Hitchcock, Aiken, S. C., dated February 3, 1919, recorded in Aiken County, February 7, 1919, mortgage book 33, folio 236, $80,000. Interest to run from demand; no demand made.

"Found this mortgage duly made and recorded as described in the amount of $80,000. Mortgage dated February 3, 1919, recorded February 7, 1919, which is just a few days over two years prior to death of decedent. No record or anything to show for what this mortgage was given. Attorney states decedent gave it in payment for her support and maintenance in her old age. Decedent lived with her niece, the mortgagee, and was about 83 years of age when mortgage given. Upon inquiry and review of Form 706, it is noted that the decedent had ample means of her own for her support; in fact, could indulge in luxuries; she received in rentals from the various items enumerated under Schedule A about $6,000 per annum and had a good income from other sources, such as her stocks and bonds (see Schedule B), and being then 83 years old, her wants could not have been great and am advised that she was not an extravagant liver.

"There is no evidence whatever that decedent owed any money at time the mortgage was given or that her estate was in any way involved. The houses (Schedule A) had been built many years and there was no debt on them. At her age it could not have been presumed that she would live for such a length of time as to require an expenditure of $80,000 for her support, even had she no income of her own. By her will the mortgagee, her niece, Mrs. Hitchcock, received all of her real estate, and it is reasonable to suppose that Mrs. Hitchcock knew she was to receive the real estate upon the death of the decedent, so could really be no reason for exacting a mortgage from decedent when 83 years old. Decedent had lived for many years prior to her death with her niece, Mrs. Hitchcock, and am informed Mrs. Hitchcock collected her rents for her and looked after her finances. From a very careful investigation and inquiries from all sources am convinced that while decedent may not have given this mortgage in anticipation of death that she was induced to make the mortgage, and the party so persuading her did it knowing she could not live long. Not owing anything, no apparent need of money, and no result obtained by the making of this mortgage except to reduce the amount of her gross estate, it would appear that this was the object in view.

"From a careful investigation and all the facts obtained, am convinced this is not a just deduction, so recommend its disallowance, and have informed the attorney of their privileges in the premises.

"Would also add that mortgagee, Mrs. Hitchcock, is herself a very wealthy lady, and in no way dependent on proceeds from this estate for her support and maintenance.

"It should also be noted that mortgage is for $80,000 while entire real estate is returned under Schedule A at total value of $64,000.

"Decedent was a resident and entitled to the specific exemption."

As a result of the agent's report, in which he recommended, among other things, increasing the value of the real estate mentioned above from $64,000, the amount at which it was returned, to $92,000, and disallowing as a deduction from the gross estate the mortgage of $80,000, an A–2 letter was mailed under date of March 1, 1924, proposing the assessment of an additional tax of $1,294.43. Claim in abatement was filed by the executrix protesting that the valuation placed on the real estate by the bureau was excessive and against the disallowance of the $80,000 representing the mortgage, for the reason that same was a bona fide debt of the decedent at the time of her death, as it had been given as repayment for moneys previously advanced.

The bureau requested that a reinvestigation be made by the revenue inspector, and under date of April 30, 1923, Inspector James W. Wilson submitted his report.

The protest of the executrix in regard to the increased values placed on the various parcels of real estate by the revenue inspector did not prevail, as the bureau accepted the inspector's recommendations. However, to indicate the unreliability of the amounts shown in the return, the agent's report on the values of the real estate is interesting. He states in the supplemental report as follows:

"Values returned by executrix were values placed by Messrs. J. W. Ashurst, David W. Gaston, and Nelson Johnson, appointed to appraise the property, which was merely a perfunctory act, as the entire real estate was willed by decedent to Mrs. Hitchcock and no division required. Mr. J. W. Ashurst is an insurance agent and wrote all insurance policies for decedent and executrix. Mr. D. W. Gaston is president of bank where all deposits and business of executrix is carried. Mr. Johnson is closely associated with Mr. Gaston. It is not meant to infer that these parties would intentionally place an erroneous value, but they were certainly not disinterested parties. On my former investigation I consulted Mr. Ashurst, and he stated to me then that the values were too low, and revised his estimates in accord with Messrs. E. H. Wyman and E. H. Hutson. A further incident has just developed. Insurance laws do not permit a building to be insured for over 75 per cent of its real value, and in writing the policies it must be so stated. A few nights ago, April 24, 1924, buildings in item 5, Schedule A, known as "Live Oak Cottage," was destroyed by fire, and it now develops Mr. J. W. Ashurst had written a policy on these buildings for $9,000, which is 75 per cent of $12,000, the amount recommended by me in my former report, so must appear as inconsistent, to say the least, for Mr. Ashurst to appraise these buildings at $12,000 for purpose of insurance and then to appraise it at $8,500 for purposes of taxation, and value of land is not taken into consideration in valuations for insurance purposes."

In regard to the mortgage, he states as follows:

"This mortgage was found duly recorded and described as stated in claim and is a legal claim against the estate if found to have been given by decedent in good faith for a real debt.

"This property was bought and houses built between years 1886 and 1912, and will of decedent, dated January 4, 1911, reads in article 10, 'I devise and bequeath to Louise Eustis Hitchcock all real estate and improvements thereon,' so under this will executrix would at death of decedent come into possession of the entire real estate. It was noted that this land was bought during years 1886 and 1912 and the houses built during that period and that the mortgage was not made until in the year 1919, so claimant admits no security required for seven years and then would soon have actual ownership under the will, it was then deemed advisable to procure a mortgage, or that decedent thought it wise and prudent, when knew claimant was well protected by the will.

"There is abundant evidence that decedent was possessed of considerable fortune at time she bought this property and built the houses and that same were built as an investment so does not appear reasonable that she would borrow such a considerable amount for the purpose of investment. It would not appear reasonable to suppose that decedent wished at her advanced age to borrow $80,000 to simply gratify a desire or whim of hers to own property and build houses in Aiken.

"While this note and mortgage is perfectly legal and bears every evidence of being a just claim under ordinary circumstances, still under the attending circumstances it does not appear to be reasonable. It should be considered that this mortgage was given many years after the houses built for which claimant contends the money was advanced and after decedent had attained to old age when her end must have been expected to come in very few years and that then claimant would own the property under her will, also that decedent had considerable wealth and seems would have been perfectly satisfied with investing her own funds without borrowing."

When the revenue inspector appeared for the purpose of checking up the return, Mrs. Hitchcock refused to see him. He was advised, however, by her attorney that the mortgage for $80,000 was executed in favor of Mrs. Hitchcock by Miss Eustis in payment of the latter's support and maintenance during her old age. Subsequently Mrs. Hitchcock's attorney presented her affidavit, in which she stated that she gave the decedent the money to purchase land in Aiken, S. C., in the years from 1886 to 1912; that the decedent had

kept a record of this money and in 1919 insisted upon executing the mortgage and that the records which the decedent made relative to the loans were lost in the fire.

Article 6 of the decedent's will sets out a bequest of all diamonds and jewelry to the same Mrs. Louise Eustis Hitchcock. The return failed to show any item covering these assets. On February 1, 1924, subsequent to the date of the first report made by Inspector Wilson, Mrs. Hitchcock's attorney submitted a memorandum showing jewelry belonging to the estate of Celestine Eustis valued at $2,050 at the date of her death. It does not appear from the records that the bureau has assessed a tax on this additional asset.

A summary of the case shows that an $80,000 mortgage was executed by an 83-year-old woman in favor of a person, her executrix, who already was fully protected by a devise of all the property covered by the mortgage; that the property was perfunctorily appraised by three interested parties and returned at a value of $64,000, when its real value was at least $92,000; and that the value of the jewelry left by the decedent was wholly omitted from the return.

The revenue agent recommended that the deduction of the $80,000 mortgage be disallowed. This recommendation was approved by the bureau, and subsequently, on July 15, 1924, allowed as a valid and outstanding lien on the real estate.

The final result, after increasing the value of the real estate from $64,000 to $92,000 and allowing the deduction of the $80,000 mortgage, left a net estate subject to taxation of $7,128.03, upon which a tax of $71.28 has been paid.

The tax saved the estate by allowing as a deduction the $80,000 mortgage is $1,223.15.

GEO. G. BOX.

Mr. MANSON. Another case which has been brought to our attention is the matter of the affiliation of the Mellon National Bank, Union Trust Co., and the Union Savings Bank for the year 1917. This case was called to our attention by a complaint addressed to the chairman.

It appears that over 99 per cent——

Senator ERNST. Pardon me. Was the complaint that called your attention to this case signed?

Mr. MANSON. Yes; it was in writing.

Senator ERNST. Whose complaint is it?

Mr. MANSON. A man by the name of Hickey.

Mr. NASH. An employee of the bureau?

Mr. MANSON. Yes; he is at the present time an employee of the bureau, unless he resigned in the last day or two.

The Union Trust Co., one of these corporations, owned over 99 per cent of the stock of the Mellon National Bank and over 98 per cent of the stock of the Union Savings Bank.

In the 1917 law there was no provision for the filing of consolidated returns.

I might say here that the bureau held that these corporations were not affiliated. In 1917 there was no provision for the consolidation of returns of affiliated corporations, but the revenue act of 1921 provided:

That Title II of the revenue act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

It then provides that:

For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all of the stock of the other or

others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital.

The amount of stock owned by the Union Trust Co. in these two other corporations would bring this case within the provisions of this act, if these corporations were engaged in the same or a closely related business.

It is manifest that they were not engaged in the same business.

The only question is whether the business of conducting a national bank, the business of conducting a savings bank, and the business of conducting a trust company is a closely related business within the meaning of that act.

The claim that the corporations were not affiliated was predicated very largely upon the proposition that the charters of these corporations were such that they could not all do the same business.

The bureau, I may say, has, in at least one similar instance, held that a national bank and trust company, which also did a savings bank business, were affiliated.

Senator JONES of New Mexico. Is it not a very frequent occurrence throughout the business world for a national bank to have a savings bank or a trust company as a subsidiary?

Mr. MANSON. Yes; it is; and I have always understood it was upon the ground that a national bank lost a very substantial part of the profit to be derived from the banking business, unless it could also do, through a subsidiary, the business incident to a savings bank and a trust company. It is frequently a combination.

Senator ERNST. Senator Jones, a great many of the banks of the country have organized trust companies, and they are controlled by one certificate of stock, reciting that so many shares and so many shares in the trust company are owned, and one certificate of stock carries an interest in both concerns.

Senator JONES of New Mexico. That has been my observation.

Senator ERNST. That was done just recently in the case of a bank that I am largely interested in.

Mr. MANSON. I asked the auditor, in examining this case, to also look up the First National Bank of Chicago and the First Trust & Savings Bank, because I happen to know that the very thing was done there that Senator Ernst has just mentioned, namely, you bought a share of stock, or several shares of stock in the First National Bank, and you had to buy the same proportionate amount in the First Trust & Savings Bank.

Senator ERNST. May I add that that is the case with the Third National Bank of Cincinnati and the First National Bank of Cincinnati.

Mr. MANSON. And while, of course, the stock is a separate instrument, it is printed upon the same piece of paper, and they can not buy one without the other.

For that reason, it is my view that the business of conducting a trust company, the business of conducting a savings bank, and the

business of conducting a national bank, is a closely related business, and that it should have been so held in this case, which would have made a difference in the amount of tax involved of $91,472.37 for the year 1917.

Senator JONES of New Mexico. That is for the year 1917?

Mr. MANSON. For the year 1917.

Senator JONES of New Mexico. When was that case closed?

Mr. MANSON. It was pending during the summer of 1922. The final ruling on the question of affiliation was made on August 18, 1922, and on August 17, 1923, an agreement, under section 1312 of the 1921 act, was signed, disposing of the case.

Senator JONES of New Mexico. What do you mean by "agreement under section 1312"?

Mr. MANSON. That is a final agreement between the commissioner and the taxapayer, which the act provides, definitely and finally disposing of a case. It can not be reopened thereafter.

The CHAIRMAN. Unless there is fraud.

Mr. MANSON. In the absence of fraud.

Senator JONES of New Mexico. Who reported on that affiliation point?

Mr. MANSON. A man by the name of Rusch seems to have handled the matter of affiliation all the way through—L. E. Rusch, assistant chief of consolidation section.

Senator JONES of New Mexico. Who reviewed him?

Mr. MANSON. I can not say as to that. I would say this, that Mr. Risley, the assistant chief of the affiliations section, ruled that these corporations were not affiliated, and recommended that the case be audited in the consolidated returns subdivision.

Senator JONES of New Mexico. What was the cause of that ruling? Have you got it there?

Mr. MANSON. What was the basis of it?

Senator JONES of New Mexico. Yes; the basis of the ruling.

Mr. MANSON. I determined that from the taxpayer's brief. That is the only place in the record where the contentions made by the taxpayer are set up.

Senator JONES of New Mexico. Then, are they set up in the final decision or ruling upon it?

Mr. MANSON. I do not find any such final ruling made, other than just a ruling that they are not affiliated.

As I stated before, the contention in support of the theory that they were not affiliated was based upon the fact that the charters of these different corporations were different; that is, for instance, a national bank can not do a trust company business; but I call attention to the fact that the statute here does not require that they do the same business, but it provides that in case they do a closely related business. For instance, the different subsidiary corporations of the United States Steel Corporation do not all do the same thing. Some may be steamboat lines, and some may be railroads.

Senator JONES of New Mexico. Was that holding generally enforced in the case of national banks, savings banks, and trust companies?

Mr. MANSON. I called attention to the fact that, in connection with the investigation of this case, I desired to know whether the ruling here applied generally, and, for that reason, I asked that the matter be looked into in connection with the First National Bank of Chicago and the First Trust & Savings Bank of Chicago, because I happen to know that that same situation existed there. The report is that, as a matter of information, it is observed that the First National Bank and the First Trust & Savings Bank of Chicago were ruled affiliated for the year 1917.

Senator JONES of New Mexico. There are hundreds and hundreds of such cases throughout the country.

Mr. MANSON. I know there are, Senator, but I did not have personal knowledge of any other cases, except the First National Bank and the First Savings Bank in Chicago and, for that reason, I could not extend the investigation any further than that.

Senator JONES of New Mexico. Is it practicable for us to find out whether or not that is the situation? You have cited one case where they ruled otherwise.

Mr. MANSON. Yes.

Senator JONES of New Mexico. Here we have two opposed decisions, and I would like to know what the general practice is.

The CHAIRMAN. Perhaps Mr. Gregg can tell us.

Mr. GREGG. I know of three or four other cases where they were held not to be affiliated.

Senator ERNST. I should think it would depend upon the facts of the case. That is the reason I asked what were the facts set out in this particular case.

Mr. MANSON. The contention was made that because they were not authorized by their charters to do the same business——

Senator JONES of New Mexico. They never are authorized by their charters to do the same business. That is the reason why they have separate charters.

The CHAIRMAN. Mr. Gregg has stated that there were three or four cases where they had been ruled as not affiliated. Do you know of any cases where they ruled that they were affiliated?

Mr. GREGG. I do not know.

The CHAIRMAN. Can Mr. Nash point out what the practice has been in that connection?

Mr. NASH. In that connection I would like to say that evidently this case was handled by the bureau before we made a change in the organization creating an affiliation section directly under the deputy commissioner. Under the plan in use at the time this case was handled, evidently the question of affiliation was determined at the same time that the case was audited. The auditor handling the case determined whether or not there was an affiliation and then went ahead and closed the case. Under our present plan of procedure the case is first referred to the affiliation section, which passes on that question only. If they determine that there is an affiliation, then it goes to the consolidated returns division for audit. If they determine that there has been no affiliation, it goes to the corporation division for audit. We have found that the same auditor that audits the case ought not to pass on this other question. The affiliation ques-

tion is determined outside the audit, just the same as an engineering question is determined outside the audit.

The CHAIRMAN. Has the solicitor's office ruled on that question, Mr. Gregg?

Mr. GREGG. No, sir.

The CHAIRMAN. Not at any time?

Mr. GREGG. No, sir.

The CHAIRMAN. They never had a case of affiliation to rule on, so far as you know?

Mr. GREGG. Not this particular question; no, sir.

The CHAIRMAN. In any of the solicitor's rulings has the question of the charter entered into the discussion as to whether it is an affiliated company or otherwise?

Mr. GREGG. Not that I know of; no, sir. I can think of very few cases that have been over there on the question of what constitutes a closely related trade or business. You see, that question just arises under the 1917 act. It does not arise under the subsequent acts, and I know of very few rulings in the office on the point. I know that we were very strict at one time in ruling them not affiliated—so strict that at one time we held that where the parent company owns all of the stock of subsidiaries, which are in the same trade or business—these were public utilities, I think electric-lighting companies—that the holding company is in a different trade or business from the subsidiaries and therefore not affiliated.

The CHAIRMAN. Does the stock ownership have a controlling effect when they are not in a related business?

Mr. GREGG. No, sir. The act says that two things must be present. There must be this control and ownership of the stock, and the same or closely related trade or business, or an intercompany shifting of profits, or something of that sort.

The CHAIRMAN. Well, you say "control or ownership." What constitutes control?

Mr. GREGG. I think the statute means what it says when it says "control."

The CHAIRMAN. Have you any more cases, Mr. Manson?

Senator JONES of New Mexico. When did that question first arise, Mr. Manson?

Mr. MANSON. You mean in connection with this——

Senator JONES of New Mexico. It seems that it related to conditions back in 1917, but that we did nothing further about it until 1922.

Mr. MANSON. The income and excess-profits tax returns of these companies for the year 1917 were filed on a consolidated basis. Under date of March 9, 1921, the Income Tax Unit advised the attorneys of the said companies that the returns for that year would be audited as a consolidated case.

The CHAIRMAN. If they are a consolidated case, is not that the same as an affiliated case?

Mr. MANSON. Yes.

The CHAIRMAN. Do I understand you to say, then, that they considered them to be consolidated?

Mr. MANSON. The taxpayer, in filing the original returns, filed them as consolidated returns, as an affiliated corporation, and, as I have stated, under date of March 9, 1921, the Income Tax Unit ad-

vised the attorneys of the companies that the returns for that year would be audited as a consolidated case. That means that the affiliation would be accepted.

Under date of February 23, 1922, William A. Seifert, on behalf of the corporation in question, mailed to the attention of L. E. Rusch, assistant chief of consolidated section, a brief, in which he questioned the right of the Government to require a consolidation of the returns of these corporations for the year 1917.

The CHAIRMAN. Did the Government require it? I understood you to say that that had already been done, had it not?

Mr. MANSON. Yes; but they came in after that was done, and asked to be considered as separate corporations, as nonaffiliated.

Then, as I have stated, in his brief he sets up as a reason for his position the fact that their corporate charters are different.

The CHAIRMAN. This man Rusch who passed on this case, I understand, is now working in the Seifert firm, is not that right, according to the records?

Mr. MANSON. We have some information to that effect, although I can not place my hands on it right at this minute.

Senator ERNST. Working where?

The CHAIRMAN. With the Seifert firm.

Mr. GREGG. I understand that Mr. Rusch is practicing on his own account in Washington. I do not know.

The CHAIRMAN. It may be that I have the wrong information, but that is the way I understood it.

Senator JONES of New Mexico. Then, we have this state of affairs, that in about 1918 the returns for the 1917 taxes were made?

Mr. MANSON. Yes.

Senator JONES of New Mexico. And that return treated the transaction as a consolidated return.

Mr. MANSON. As a consolidated return.

Senator JONES of New Mexico. When do we find the first action in the bureau?

Mr. MANSON. When they got around to auditing that return, apparently on March 9, 1921, because, as of that date, the unit advised the attorney for the companies that the returns would be audited as consolidated returns.

Senator JONES of New Mexico. What was the cause for that notice? If the returns themselves treated them as affiliated concerns and the bureau agreed with them, why should there have been any notice to counsel?

Mr. MANSON. I do not know, I am sure.

Senator JONES of New Mexico. When was that notice given?

Mr. MANSON. That notice was dated March 9, 1921.

Senator JONES of New Mexico. Who gave that notice?

Mr. MANSON. That does not appear here.

Senator JONES of New Mexico. March 9, 1921. Then, nothing was done further with the case until when?

Mr. MANSON. I have not the chronological history of this case before me. The auditor has set out the dates of these transactions, which are pertinent to this one question of affiliation. On February 23, 1922, Mr. Seifert sent a brief to the department.

Senator JONES of New Mexico. To whom in the department?

Mr. MANSON. To Mr. L. E. Rusch, assistant chief of the consolidation section.

Senator JONES of New Mexico. Was Mr. Rusch the man who notified Seifert that they were going to close the case?

Mr. MANSON. I can not answer that question. I do not know.

Mr. NASH. Senator Jones, I might state that, as I understand it, under the 1917 act there was a question as to whether or not a return could be filed on a consolidated basis. There were many returns that had been filed on a consolidated basis that were set aside in the bureau and no audit made of them at that time. When it was proposed to put in the 1921 act the amendment to the 1917 act authorizing the filing of consolidated returns the bureau went ahead on those returns, and that is probably why there is a lapse in here between 1918 and 1921 during which little work was done on these returns.

Mr. MANSON. Under the 1917 act the bureau set up regulations, which required substantially what was afterwards enacted in the 1921 law with respect to 1917 affiliations.

Senator JONES of New Mexico. I was going to ask what the regulation was regarding that law.

Mr. MANSON. I have read the 1921 law and the regulations. They provide substantially the same thing as is indicated with respect to 1917. I might say this, that the revenue act of 1921 was approved on November 23, 1921, which was just about three months prior to the time that taxpayer filed this brief protesting against affiliations.

Senator JONES of New Mexico. There is nothing in the act which would give him a clue on which he could found the kind of a brief which he sent in, it seems to me, and inasmuch as the act of 1921 put into the law what the bureau had previously decided in its regulations, I do not see the connection or what there would be in the passage of the act to cause the attorney to file the kind of a brief he did. It seems to me to be just the contrary.

Mr. MANSON. Well, it may be—this does not appear in this record here, that is, in the report that I have—it may be that they hired a new lawyer, about that time, who threw some new light on the subject. I do not know about that.

The CHAIRMAN. Have you any further cases this morning, Mr. Manson?

Mr. MANSON. No.

Senator JONES of New Mexico. When was that closed under section 1312?

Mr. MANSON. August 17, 1923.

The CHAIRMAN. Is that all you have, Mr. Manson?

Mr. MANSON. That is all I have to-day.

The CHAIRMAN. I want to say to the Senators that after the meeting to-morrow I would like to hold an executive session of the committee.

Mr. MANSON. I will submit this report in this case.

(The report submitted by Mr. Manson is as follows:)

In re Mellon National Bank, Union Trust Co., Union Savings Bank, of Pittsburgh, Pa., represented by W. A. Seifert, Esq., of the law firm of Reed, Smith, Shaw & McClay, of Pittsburgh, Pa.

The income and excess-profits tax returns of these companies for the year 1917 were filed on a consolidated basis. Under date of March 9, 1921, the Income Tax Unit advised the attorneys of the said companies that the returns for that year would be audited as a consolidated case.

At the beginning of 1917 the Union Trust Co. owned 59,708 shares of the stock of the Mellon National Bank out of a total of 60,000 shares issued and outstanding, and 9,817 shares of the stock of the Union Savings Bank out of a total of 10,000 issued and outstanding, percentages of 99.5133 and 98.17, respectively. At the end of 1917 the holdings were 59,713 and 9,807 shares, respectively.

Under date of February 23, 1922, William A. Seifert, Esq., on behalf of the corporations in question, mailed to the attention of L. E. Rusch, assistant chief of consolidation section, a brief in which he questioned the right of the Government to require a consolidation of the returns of these corporations for the year 1917, stating as follows:

"The revenue act of 1917 is silent as to the consolidation of returns for either income or excess-profits tax purposes.

"Regulation No. 41 purports to require consolidated returns where corporations are affiliated.

"Article 77 of Regulations 41 provides as follows:

"'ART. 77. When affiliated corporations must furnish information as to intercorporate relations. For the purpose of the excess-profits tax every corporation will describe in its return all its intercorporate relationships with other corporations with which it is affiliated, and will furnish such information in relation thereto as will enable the Commissioner of Internal Revenue to compute the amount of the tax properly due from each corporation on the basis of an equitable and lawful accounting.

"'For the purpose of this regulation two or more corporations will be deemed to be affiliated (1) when one such corporation owns directly or controls through closely affiliated interests or by nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all the stock of two or more corporations is owned by the same individual or partnership, and both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (*a*) buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or (*b*) in any way so arranges its financial relationships with another corporation as to assign to it a disproportionate share of net income or invested capital.'

"The department has held in the incident case that the Mellon National Bank of Pittsburgh and the Union Savings Bank of Pittsburgh are affiliated with the Union Trust Co. of Pittsburgh, notwithstanding the fact that the three institutions are conducted as separate organizations, separately officered, and dealing at arm's length as though the Union Trust Co. did not own one share of stock in either the national bank or the savings bank.

"We understand that the bureau relies upon the revenue act[1] of 1921 in support of its alleged right to require a consolidated return for profits tax purposes for the year 1917. Section 1331 provides as follows:

"'SEC. 1331. (*a*) That Title II of the revenue act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

"'(*b*) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all of the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purpose of this section public-service corporations which (1) were operated independently, (2) were not physically connected or merged, and (3) did not receive special permission to make a consolidated return shall not be construed to have been affiliated; but a railroad or other public utility which was owned

[1] The revenue act of 1921 was approved November 23, 1921, three months prior to date of taxpayer's brief.

by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return shall be construed to have been affiliated.

"'(c) The provisions of this section are declaratory of the provisions of Title II of the revenue act of 1917.'

"It is admitted that retroactive taxation as to income tax laws has been approved by the Supreme Court of the United States; however, the Supreme Court in the La Belle Iron Works case held that the excess profits tax was a tax upon trade or business. The effect of the decision in this case is to make excess profits tax act a tax upon the privilege of doing business and not a direct tax upon income.

"Retroactive taxation is always objectionable, more particularly legislation postponed for a period of four years beyond that in which the business was actually transacted. The right of Congress to legislate as to business already transacted is questioned.

"The consolidation of the returns of the three banks above referred to for the year 1917 results in an additional assessment of approximately $83,898.76. This is in effect a confiscation of the companies' property and it is not fair for the Government to make such legislation nor can the taxpayer submit to such without the express authorization of the courts of last resort.

"It is respectfully submitted that the Commissioner of Internal Revenue was without the legal right to require the consolidation of the returns for the year 1917 for excess profits tax purposes."

Under date of August 12, 1922, W. A. Seifert, attorney for the taxpayers wrote the unit (attention of L. E. Rusch) submitting a brief, sworn to by the said Seifert, in support of his contention that the corporations under consideration were not engaged in the same line of business during the year 1917, and therefore were not consolidated. The following is an excerpt from the brief.

"Each of the corporations is engaged in a different line of business.

"The Union Savings Bank of Pittsburgh is located in the Frick Building on the corner of Grant Street and Fifth Avenue, in the city of Pittsburgh, Pa.; The Union Trust Co., of Pittsburgh, is located at 337 Fourth Avenue, Pittsburgh, Pa.; While the Mellon National Bank, of Pittsburgh, is located at the corner of Fifth Avenue and Smithfield Street, Pittsburgh, Pa.

"The charter of the Mellon National Bank of Pittsburgh was issued on the —— day of ———, 19—; under the laws of the United States it can endure for 20 years.

"The charter of the Union Savings Bank of Pittsburgh was reissued by the Commonwealth of Pennsylvania on the —— day of ———, 19—, and under the law under which it was incorporated will endure for 20 years.

"The charter of the Union Trust Co. of Pittsburgh, unlike either of the two other institutions, is perpetual.

"The Mellon National Bank of Pittsburgh is a bank of issue. The power to issue circulatory notes is prohibited to the Union Trust Co. of Pittsburgh and to the Union Savings Bank of Pittsburgh.

"The Mellon National Bank of Pittsburgh and the Union Savings Bank of Pittsburgh are authorized to do a banking business in the manner and subject to the restrictions in the statutes under which they are respectively incorporated. The Union Trust Co. of Pittsburgh is specifically forbidden to engage in a banking business. Primarily, the capital stock of the Mellon National Bank of Pittsburgh is invested in Government securities. There is no such restriction on the power of either of the other two institutions. As a commercial banking institution, the capital stock of the Union Savings Bank of Pittsburgh is invested in short-term obligations representing commercial transactions. On the other hand the capital stock of the Union Trust Co. of Pittsburgh is permanently invested. As previously stated, the main purpose to which the capital stock of the Union Savings Bank of Pittsburgh is devoted is the creation of new wealth, while as opposed to this, the main purpose of the Union Trust Co. of Pittsburgh is conservation of wealth already created. The capital of the Union Trust Co. of Pittsburgh is by law pledged as security for its faithful performance of the fiduciary obligations, obligations utterly foreign to the corporate purpose of either the Union Savings Bank of Pittsburgh or the Mellon National Bank of Pittsburgh.

"The sovereignties under which these corporations are formed—in the case of the Mellon National Bank, the Federal Government, and in the cases of the other two institutions, the Commonwealth of Pennsylvania—recognising

the distinction in fact between the enterprises in which they were to engage, embodied and emphasized that distinction in the law. The formalities relative to the incorporation, advertisement of application, the requirements as to capital the corporate powers and the limitations therein are in each instance distinct and different.

"The Mellon National Bank of Pittsburgh can not act in a fiduciary capacity. The Union Savings Bank of Pittsburgh may, under the act of June 17, 1919 (P. L. 1032), by special application, obtain a permit to act in a fiduciary capacity. No such application has ever been made by it and no such powers are vested in it. To act in a fiduciary capacity is one of the main purposes of the Union Trust Co., of Pittsburgh.

"The Mellon National Bank of Pittsburgh and the Union Savings Bank of Pittsburgh are specifically prohibited to hold real estate other than that necessary for their banking houses and that taken as security for debts. They are commercial banks, the former, being primarily a bank of issue. The Union Trust Co. of Pittsburgh, on the other hand, is not a commercial bank and there is no limitation as to the amount of real estate which it may hold.

"It will, therefore, be readily observed that the capital stock of these three institutions is devoted to entirely different purposes; their charters endure for different periods and they can not be said to be in a 'single business enterprise' nor can they be said to be engaged in 'the same line of business.'"

Mr. Risley, assistant chief of affiliations section, on August 18, 1922, ruled that these corporations were not affiliated during the year 1917, and recommended that the case be audited in the consolidated returns subdivision.

It is disclosed in an examination of the case, that a field investigation was made, in the report of which the following appears:

"This consolidated group carries on all branches of the banking and trust company business. In addition to its regular banking functions, the Mellon National Bank conducts an investment department for the purchase and sale of securities. The Union Trust Co. conducts an extensive trust department for the handling of trust estates; acts as registrars and trustees for corporations issuing securities, and purchases and sells issues of securities, as well as carrying on a general banking business. The Union Savings Bank carries on an extensive safe deposit business in addition to the banking business."

A saving of $91,472.37 was effected in ruling the companies nonaffiliated for the year 1917, shown as follows:

Tax liability computed on consolidated basis	$495,655.07
Tax paid computed on the basis of three separate entities	404,182.70
Difference saved	91,472.37

The following shows the number of shares of stock of the Union Trust Co. out of total issued and outstanding in 1917 of 15,000 shares, owned by members of the Mellon family:

	Shares
Andrew W. Mellon	2,875
Richard B. Mellon (brother)	815
James R. Mellon (brother)	4
W. L. Mellon (son of James R.)	365
Jennie K. Mellon (wife of Richard B.)	1,000
Total, or 33.88 per cent	5,041

Under date of August 17, 1923, agreements were signed by the taxpayers and C. R. Nash, as acting commissioner, that the determination and assessment of the taxes paid as mentioned above "shall be final and conclusive."

As a matter of information it is observed that the First National Bank and the First Trust and Savings Bank of Chicago were ruled affiliated for the year 1917.

Respectfully submitted.

GEO. G. BOX,
Chief Auditor.

SENATE COMMITTEE INVESTIGATING
THE BUREAU OF INTERNAL REVENUE.

Mr. MANSON. On May 14, 1925, a letter was addressed in my name to Mr. Bright requesting information as to further cases handled

by this production committee of the engineering division, which letter I will read:

We understand that certain cases have been handled by the engineering production committee, Mr. C. J. Rashleigh, chairman, without the consideration of the engineering section involved. Will you kindly furnish us with a list of all such cases involving "Amortization," "Obsolescence," "Loss of useful value," "Valuation," and "Depletion," in which action was taken together with the following:

1. Whether taxpayers' claim was allowed or disallowed.
2. If allowed, amount of allowance.
3. Date of final action by the committee.
4. Whether case was previously reported on by one of the unit's engineers.
5. Recommendation of engineers.

Will you also furnish us with either a duplicate copy or photostat copy of engineers' reports on all cases involved?

NOTE.—It may be that some of these cases have already been requested of the bureau, but owing to the fact that we do not know just which cases have been acted upon by the committee, we are unable to state whether or not they have been requested. This question can be determined as soon as we are in possession of the list above referred to, when we will be glad to check same and eliminate all those cases which have already been asked for.

Mr. MANSON. I would like to know whether the information requested is being prepared.

Mr. NASH. I have asked Mr. Bright to give me a complete report on that situation. I talked to Mr. Bright about it the other day, and he personally had no recollection of having authorized such a committee to function.

The CHAIRMAN. So that you probably will not have that information in time to file to-morrow, but you expect to file it later?

Mr. NASH. I am to see Mr. Bright this afternoon. He may have it prepared by to-morrow.

Mr. CHAIRMAN. I would like to be furnished with an additional copy of the memorandum on the Dollar case so that we can refer it to the intelligence unit for investigation.

The CHAIRMAN. Yes.

Mr. MANSON. I have not one with me, but I think I have one in my office, and if I have not, I will have one made for you.

Mr. NASH. You asked me the other day if we had any regular procedure on the application of section 220 in the bureau, and I have brought here two memoranda and a copy of a letter which deal with that subject.

The first memorandum bears date of January 22, 1923, is addressed to Mr. Chatterton and is signed by Mr. Blair, commissioner, giving some instructions as to the audit of cases where section 220 is involved.

Then there is a memorandum dated February 2, 1923, addressed to Mr. Kimbrell, Mr. Clute, Mr. Fay, and Mr. Alexander, heads of audit divisions.

Mr. Moss. That is signed also by the commissioner?

Mr. NASH. That is signed deputy commissioner, transmitting the commissioner's instructions.

Then there is a form letter, which the auditor is supposed to send to the taxpayer, asking for information on the return, wherever he suspects there should be action taken under section 220.

I offer these for the record, if you want to have them incorporated.

Mr. MANSON. I would like to have them.

Senator JONES of New Mexico. I think it would be a good idea to insert, just following that, the amount of money which has been collected as tax under section 220.

The CHAIRMAN. Mr. Gregg has promised a statement in that connection.

Mr. GREGG. I have two section 220 cases here.

The memoranda and the letter referred to are as follows:

JANUARY 22, 1923.

Memorandum for Mr. Chatterton:

In order to insure the prompt and uniform determination by the bureau of the liability of corporations for the penalty imposed by section 220 of the revenue act of 1918 and the revenue act of 1921 you will in the future, in the place of the existing practice with reference to the determination of the liability for the penalty imposed by these sections, be guided by the following:

Immediately upon the examination of the income-tax returns filed by a corporation for any of the years from 1918 to 1922, inclusive, the official examining the return shall determine from the data contained in the return and the schedules attached thereto whether there is any reasonable probability of a liability of the corporation to the penalty imposed by section 220 of the revenue act of 1918 or the revenue act of 1921. If there is any indication from this return or the schedules attached that the corporation may be liable to such penalty the questionnaire form now being prepared shall be sent to the corporation for immediate execution by it and submission of all data necessary to determine whether the penalty provided by section 220 should be imposed.

Upon receipt of this information from the corporation the case shall be referred to the Solicitor of Internal Revenue for his opinion upon the facts and evidence presented as to the liability of the corporation for the penalty imposed by section 220. The opinion of the solicitor, which shall be rendered promptly, shall be transmitted to the commissioner for his consideration and determination.

This change in the method of handling cases under the provisions of section 220 is to be effective immediately.

D. H. BLAIR,
Commissioner.

FEBRUARY 2, 1923.

Mr. KIMBRELL: In order to insure the prompt and uniform determination by the bureau of the liability of corporations for the penalty imposed by section 220, you will follow the practice next outlined:

Immediately upon the examination of the income-tax returns filed by a corporation for any of the years from 1918 to 1922, inclusive, the official examining the return shall determine from the data contained in the return and the schedules attached thereto whether there is any reasonable probability of a liability of the corporation to the penalty imposed by section 220 of the revenue act of 1918 or the revenue act of 1921. If there is any indication from this return or the schedules attached that the corporation may be liable to such penalty the questionnaire form now being prepared shall be sent to the corporation for immediate execution by it and submission of all data necessary to determine whether the penalty provided by section 220 should be imposed.

Upon receipt of this information from the corporation the case shall be referred to the Solicitor of Internal Revenue for his opinion upon the facts and evidence presented as to the liability of the corporation for the penalty imposed by section 220. The opinion of the solicitor, which shall be rendered promptly, shall be transmitted to the commissioner for his consideration and determination.

For the time being, in order to insure uniformity in consideration of cases which may come within the provisions of this memorandum, I desire that you submit each one to me before the questionnaire is sent out.

———, *Deputy Commissioner.*

(Same memorandum sent to Mr. Clute, Mr. Fay, Mr. Alexander.)

SIRS: By virtue of the authority granted in section 220 of the revenue acts of 1918 and 1921, it is requested that you submit at the earliest practicable date the following information:

1. Date and place of incorporation.
2. Nature of business.
3. Balance sheets at the beginning and ending of the taxable years 1918, 1919, 1920, 1921, and 1922, if not already furnished to the bureau.
(*a*) Book value of no par value stock at date of issue.
(*b*) Are the assets shown on your books at cost; if not, explain in detail.
4. Analysis of surplus account for the above taxable years, if not already furnished to the bureau.
5. Number of stockholders at close of each of the above years.
6. Is your corporation a holding company?

You are requested to advise as to the amount of the undistributed earnings of the above periods, which the corporation considers necessary to be withheld from distribution, in the interest of the reasonable requirements of the business, and the reason for which such undistributed profits are withheld from distribution.

Respectfully,

D. H. BLAIR,
Commissioner.

Mr. NASH. Mr. Chairman, the committee requested the other day some information as to the amount of money that had been refunded by the Bureau of Internal Revenue and the amount that was refunded on the 25 per cent reduction order by Congress, together with an estimate of the cost of making that refund. They also asked for the amount that has been refunded as the result of court decisions.

The total estimated amount of money spent from the various refunding appropriations for refunds made pursuant to Federal court decisions and Attorney General's opinions is $148,278,828.

The total amount of money spent for refunding of taxes pursuant to the act of Congress approved June 2, 1924, reducing the taxes 25 per cent, is $17,694,232.99.

The total amount of money spent for the refunding of all taxes, including those refunded as a result of court order and as a result of the 25 per cent reduction in taxes, is $459,090,825.49.

That also includes interest, which runs to a very considerable item. I notice that the interest is not segregated here.

The above figures cover the period beginning with the fiscal year 1921, or the first fiscal year definite annual appropriations were granted to the bureau for refunding taxes, and ended with April 30, 1925, or the first eight months of the present fiscal year.

Senator JONES of New Mexico. What period did those refunds cover?

Mr. NASH. The figures I have given cover the fiscal year 1921 down to April 30, 1925. Before 1921, Congress did not make a definite annual appropriation for refunding, but they refunded under indefinite appropriations.

The best estimate that can be made by the bureau of the cost of refunding the 25 per cent reduction is $110,151.80. Of that it is estimated that $92,375 was spent in the offices of collectors of internal revenue, and about $17,775 was spent in the bureau.

The CHAIRMAN. No estimate was made as to the amount of refund for items due to court decisions, was there?

Mr. NASH. Yes; $148,278,828.

The CHAIRMAN. No; I mean the cost of it.

Mr. NASH. No, sir.

The CHAIRMAN. That was just in the regular routine.

Mr. MANSON. Yes; going through the regular routine with the other cases.

Mr. GREGG. Here is a statement prepared on March 15, 1924—we have not had one prepared since then—giving a list of the cases where the question of section 220 was raised in the audit, and giving the disposition and status as of that time as of those cases.

If the committee wants me to, I can read it. It probably is not complete. I happen to know one case where that was considered which is not on here; so I know it is not complete. No accurate records have been kept of the section 220 cases.

The CHAIRMAN. You, then, have no information as to the amount of tax collected under section 220?

Mr. GREGG. No. I can give you a list of the ones that we have been able to find, where section 220 was raised, and what action was taken on it.

The CHAIRMAN. I would like to have that in the record.

Senator JONES of New Mexico. Yes; I think that ought to be read.

Mr. GREGG. Do you want me to read it?

The CHAIRMAN. Please.

Mr. GREGG. The question was raised in the case of the Bermont Oil Co. for the years 1918, 1919, and 1920.

As to the disposition of the case, it was returned to audit on November 2, 1923. Section 220 not applied.

Senator JONES of New Mexico. Section 220 not applied?

Mr. GREGG. Yes, sir. Bronx Iron & Steel Co. The question was raised for 1918, 1919, and 1920. Section 220 not applied.

Crescent Bed Co. (Ltd.), New Orleans, La. The question was raised for the years 1918, 1919, and 1920. Section 220 applied for all years involved. The case is now in the solicitor's office on appeal.

Senator JONES of New Mexico. You have not gotten your money yet?

Mr. GREGG. No, sir. Dodge Bros. (Inc.), Detroit, Mich. The question was raised for 1918, 1919, 1920, and 1921. Section 220 applied for 1918, 1919, and 1920. This was prepared as of March 15, 1924. The case went to the solicitor's office, and it is indicated here that it is in the solicitor's office on appeal. I know that the case has been disposed of and section 220 was not applied.

Dodge Bros. Realty Co., Detroit, Mich. The same question was raised there, and it is indicated as being in the solicitor's office for a decision on appeal. Section 220 was not applied.

Hamtramck Heating & Plumbing Co. The question was raised for 1918, 1919, and 1920 and 1921. Section 220 was not applied.

Kent Iron & Steel Corporation. The question was raised for 1918, 1919, and 1920. Section 220 was applied for 1918, but not for 1919 or 1920.

Senator JONES of New Mexico. It was applied for the year 1918?

Mr. GREGG. Yes, sir.

Senator JONES of New Mexico. Has the money been collected?

Mr. GREGG. I do not know what the status of it is. Has it, Mr. Nash?

Mr. NASH. I do not think so.

The Murlyn Corporation. The question was raised for 1918, 1919, and 1920. Section 220 was applied for 1918 and 1919. The case is marked "In the solicitor's office on appeal." I do not know what action was taken on the appeal. I do not remember it, but I do not think it has been acted on.

Rockaway Rolling Mill. The question was raised for 1918, 1919, and 1920. Section 220 was applied for 1918; sent to audit March 11, 1924, for assessment, since no waivers were filed in the case. The appeal in that case will be taken after the assessment is made.

Shermar Investing Corporation. Section 220 was applied for 1918 and 1919. It is in the solicitor's office on appeal.

Theodore Smith & Sons Co. (Inc.). Returned to audit June 22, 1920. Section 220 was applied for all the years involved.

Senator JONES of New Mexico. What became of that case? Have you gotten the money in that case?

Mr. NASH. That would have to pass through the collector's office to see whether or not the collections have actually been made. I assume from what Mr. Gregg has read that the assessments have been made.

Mr. GREGG. Storz Beverage & Ice Co. Section 220 applied for all the years involved, the question being raised for 1918, 1919, and 1920. The case is in the solicitor's office on appeal.

Talbot Commercial Co. The question was raised for 1918, 1919, and 1920. Section 220 was applied for all years involved, and that case is in the solicitor's office on appeal.

The CHAIRMAN. When will those appeals be decided, Mr. Gregg?

Mr. GREGG. I do not know, sir. It is quite possible that some of them have been decided. I did not have an opportunity to check them very carefully, because I did not get this report——

Senator JONES of New Mexico. There are not many of them. Suppose you have them checked over and see whether any money has been collected on any of them.

The CHAIRMAN. In view of the fact that the bureau is going to file some statement with the committee later, they might file a statement with respect to that inquiry of Senator Jones.

Mr. GREGG. I have gone through the cases on appeal, where the solicitor, on appeal, held that section 220 applied. I can read the opinions in those cases, if the committee desires.

The CHAIRMAN. I would like to have them, because I think that is important.

Mr. MANSON. Are those opinions published, Mr. Gregg?

Mr. GREGG. I do not think so. I am very sure that they are not:

MAY 21, 1923.

Mr. COMMISSIONER:

This office has, at your request, given careful consideration to the committee's recommendations in re F. W. Bradley and the San Francisco Commercial Co.

Several questions were raised on the appeal, but none of these will be discussed at length except that dealing with the application of section 220 of the revenue act of 1918. It may be remarked, however, in passing, that the other questions have been considered and are concurred in.

The facts pertinent to the application of section 220 are as follows: Mr. F. W. Bradley, of San Francisco, Calif., is and has been a mining engineer since 1884. He was in the year 1915 an officer and employee of several mining companies. In December of that year he caused the San Francisco Commercial Co. to be incorporated under the laws of the State of California. The

articles of incorporation give to the organization authority to engage in a very wide range of activities, including mining, public utilities, borrowing and loaning of money, purchasing of real estate, etc. At the time of incorporation the authorized capital stock was $100,000, divided into 100,000 shares of the par value of $1. The articles of incorporation recite that $5 were paid in at the time. The remainder of the assets consisted almost solely of various mining securities which Mr. Bradley had received as a liquidating dividend on the dissolution of the San Francisco Exploration Co. and which had by him been paid in to the San Francisco Commercial Co. These securties had an estimated fair market value at the time of approximately $641,000.

Mr. Bradley states in an affidavit that the purpose of formation of the corporation was to furnish an avenue of employment for his four sons when they should become able to engage in business activities and to make proper provision for the maintenance of his wife and care and education of his children during minority.

At the time of incorporation there was issued one certificate for 50,995 shares in the name of Mr. Bradley, one for 25,000 shares in the name of his wife, and four others of 6,000 shares each in the name of each of his four sons. The other five shares were qualifying shares. These certificates were immediately deposited in the Crocker National Bank of San Francisco under the order of the corporation commissioner of the State of California in order that he might satisfy himself of the value of the assets represented thereby. The instruction given to the bank by Mr. Bradley states that the shares are deposited in the bank to keep and preserve for the owners thereof and are not to be released except upon demand of Mr. Bradley and the owner of the certificate, jointly, or upon his death, upon the order of his executor and the owner thereof jointly. It further provides that the instruction is irrevocable.

The securities which were turned over to the corporation were principally nondividend paying. Soon after incorporation and during the succeeding years the corporation proceeded to sell these nondividend-paying securities to Mr. Bradley and to purchase from him dividend-paying securities. From these and other securities which the corporation purchased it received income in the years 1916, 1917, and 1918 of $100,032.80, $166,165.73, and $167,587.43, respectively, which sums were not distributed but were allowed to accumulate in the surplus of the corporation. Under these circumstances the revenue agent recommended that section 220 of the revenue act of 1918 should be applied and that the tax should be levied on Mr. Bradley accordingly, it being considered that he was owner of all the shares of stock. The unit adopted the revenue agent's recommendation and the case was carried to the committee on appeals and review, which reversed the decision finding that the corporation was not formed or availed of for the purpose of avoiding surtax and that the accumulations were not unreasonable for the needs of the business.

Section 220 of the revenue act of 1918 provides:

"That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distr buted, such corporation shall not be subject to the tax imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this tilte in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation."

In this case, after the committee on appeals and review had acted on it, the commissioner sent it to the solicitor for consideration before he accepted the committee's conclusions, and this is the opinion that was written then:

"The statute also provides that the fact that any corporation is a mere holding company or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

"Two elements are essential to the application of section 220, (*a*) a purpose to escape the surtax, and (*b*) an unreasonable accumulation of gains and profits. (Art. 352, regulations 45.) Prima facie evidence of the purpose to escape the surtax exists where the company is a mere holding company or where profits are allowed to accumulate beyond the reasonable needs of the business.

"It can scarcely be said that this company is a mere holding company. Aside from its dealings with Mr. Bradley, activities for the years 1916 and

1917 show considerable dealing in bonds and stocks, loans on collateral and commercial paper, as well as loans on real estate. The corporation regularly paid the capital stock tax for the years 1917 to 1922, inclusive.

"However, in the opinion of this office the corporation was availed of for the purpose of avoiding the imposition of the surtax through the medium of allowing its profits to accumulate beyond the reasonable needs of the business. It is a closely held corporation, all the stock being held by Mr. Bradley and his immediate family. At the outset it had assets which were admittedly worth approximately $641,000, principally nondividend paying. It proceeded at once to dispose of this nondividend-paying stock to its principal stockholder, Mr. Bradley, and to buy from him stock in other mining companies which were paying large dividends. Its income was, in round numbers, $100,000 in 1916 and $166,000 in 1917. No distribution in the form of a dividend was made during these years. At the beginning of the year 1918 the corporation, therefore, had assets valued at approximately $900,000, $226,000 of which represented earned surplus. In 1918 it proceeded to add $167,000 more to this surplus, though the files indicate that it engaged in less business activities in that year than in any previous year of its existence. It is claimed that this accumulation was not unreasonable, considering the purpose of the organization to engage in mining ventures which require large sums of money. The fact is, however, that other than comparatively small dealings in securities and loans the corporation did not engage in any business ventures, mining or otherwise, during the years 1916, 1917, 1918, and so far as the record shows has not done so up to the present time. Surely it seems that the accumulations made were not reasonably necessary for the business done. In the opinion of this office the facts establish a prima facie case under the statute.

"In addition to this the explanations of certain facts by the taxpayer are not very satisfactory. It is claimed that the corporation was formed to take over any mining ventures which might be offered and to furnish employment for the sons when they become able to assume business responsibilities. The facts are that the corporation engaged in no mining venture at least up to the year 1919 and so far as the record shows has never engaged in any since that time. Furthermore, in 1915, the oldest of the four sons was only 11 years of age, and the statement is made in the file that he was just entering the university in 1922 or 1923. The prospect of his or his younger brothers entering into business were therefore very remote in 1915, to say the least. Furthermore, the statement that the corporation was formed for the maintenance of the wife and children is not very satisfactory when it is realized that not a dollar of the surplus of the corporation was distributed to the stockholders until the year 1920."

And that distribution in 1920 was made long after the revenue agent had recommended section 220.

"Another explanation given as to why the corporation did not pay dividends in 1918 is that Mr. Bradley had pledged his shares of stock as collateral to the Crocker National Bank for a loan of $500,000, and the bank imposed as condition of the loan that the corporation should not declare dividends in that year. The evidence in the file does not disclose as to what time of the year the loan was made or when the condition was released. So far as this office can find there is no statement by the bank in the file or any copy of the loan agreement, if there was such.

"For the foregoing reasons this office concludes that this is a proper case for the application of section 220.

"The entire sum should not, however, be taxed to Mr. Bradley individually. The facts seem to establish a valid gift of 25,000 shares of San Francisco Commercial Co. stock to Mrs. Bradley and 6,000 shares to each of the four sons. They were owners of the stock and the fact that the certificates were for the time being in the custody of the bank does not alter the ownership of the stock. Any income earned by such stock is taxable therefore to the owners of the stock. The husband has no interest in his wife's separate property (sec. 157, Civil Code of California) or any control over his children's property (sec. 202, Civil Code)."

Senator JONES of New Mexico. What is the date of that?

Mr. GREGG. May 21, 1923.

Senator JONES of New Mexico. What has become of the case since then?

Mr. GREGG. I do not know, sir. I can have it looked up.

Senator JONES of New Mexico. Yes; I wish you would.

Mr. GREGG. I do not think there is any other delay possible in this case. I feel sure that that tax must have been collected, because he had his appeal, rehearing, and everything else.

The CHAIRMAN. Is that the only opinion that has been written by the solicitor on that subject?

Mr. GREGG. No, sir; there are some more that have been written by him. I have one right here.

Mr. MANSON. Are any of them published?

Mr. GREGG. I do not think so. Do you want me to read this or just put it in the record?

Senator JONES of New Mexico. I would like to have you read it, so that we can see the facts.

Mr. GREGG. All right, sir.

This is dated March 11, 1924, and it relates to the case of the Crescent Bed Co. (Ltd.):

Mr. COMMISSIONER: This office has had under consideration the appeal of the stockholders of the Crescent Bed Co. (Ltd.) from the proposed assessment of additional taxes arising because the corporation had been availed of for the purpose of permitting its gains and profits for the years 1918, 1919, and 1920, to accumulate beyond the reasonable needs of its business in violation of section 220 of the revenue act of 1918.

The Crescent Bed Co. (Ltd.) was incorporated under the laws of the State of Lou siana on November 2, 1900, with an authorized capital of $10,000, which was increased on February 19, 1907, to $100,000. Its capital stock has always been owned by Peter Jung, sr., and his two sons, Peter Jung, jr., and A. L. Jung. No dividends have been paid by the corporation since the incidence of the income tax law, and, so far as the evidence shows, none have ever been paid. For the taxable years 1918, 1919, and 1920 the increase in the earned surplus of the corporation amounted to $83,312.15, $210,311.21, and $187,867.94, respectively.

It has always been the policy of the corporation to make short loans and investments in real estate and securities with the earned and paid-in surplus, which was not required for the immediate needs of the bed bus ness. The acts of the corporation in making these loans and investments were ultra vires, as its charter stated that it is organized for the purpose of "manufacture and sale of iron beds, iron castings, hardware specialties, and other articles."

At the close of 1918 the loans and investments of the corporation amounted to approximately $125,000, the amount of such loans and investments at the end of 1919 was approximately $312,600, and at the close of 1920 approximately $565,000. The paid-in surplus of the corporation at the beginning of 1918 amounted to only $90,466.11, and at the end of 1920 to only $201,390.53, all of which shows that the greater part of the loans and investments cons sted of earned surplus. The earned surplus at the end of 1917 amounted to approximately $416,800.

The existence of such a large surplus at the beginning of 1918 and the use to which it was put would, in the opinion of this office, make the accumulations of earnings and profits during the years 1918, 1919, and 1920 unreasonable within the meaning of section 220 of the revenue act of 1918. Indeed, the fact that the corporat on was able to engage in these ultra vires pursuits with the profits not needed in the bed business precludes any other conclusion. Evidence was submitted to show that it had always been the policy of the corporation to utilize its spare earnings and profits in making loans and investments. This fact, however, can not prevent the application of sect on 220.

It may be true that the acts of the corporation in accumulating its profits and earnings and retaining them, when not needed in the business, were not illegal until the statute made them so. However, one of the sources of the Government's revenue has been the corporate earnings received by stockholders. The statute was enacted not only to prevent the drying up of this source, but to compel all corporate earnings, rightfully belonging to stock-

holders, to bear their fair burden of taxation. When a corporation retains profits that it could prudently and legitimately distribute to its stockholders the provisions of section 220 have been violated. The facts in this case show that the corporation could have prudently and legitimately paid dividends.

It was also contended by the taxpayers that the corporation was used to accumulate a family fortune and provide a living for its members, and that there was no intent to escape the surtaxes. This argument loses its force when it is considered that the corporation was a close family corporation. An unreasonable accumulation of earnings and profits by such a close corporation as the Crescent Bed Co. in itself proves a violation of the section. This is especially true in view of its provisions making an unreasonable accumulation of profits prima facie evidence of a purpose to escape the surtax. The intent to escape the surtaxes must be ascertained from the acts and conduct of the taxpayers, and not from the hidden recesses of their minds. No dividends having been declared by the corporation during the best business years of its existence, and the large earnings for those years having been added to a large surplus, not needed nor used in the business, it is apparent that the corporation was "availed of for the purpose of preventing the imposition of the surtax upon its stockholders" in violation of section 220.

It is therefore recommended that the appeal be denied and that the taxes be assessed as proposed.

That is signed by Nelson T. Hartson, solicitor.

Senator JONES of New Mexico. That is addressed to whom?

Mr. GREGG. To the commissioner.

Senator JONES of New Mexico. Was the other opinion addressed to the commissioner, too?

Mr. GREGG. Yes, sir.

Senator JONES of New Mexico. Have you the decision of the commissioner in those cases?

Mr. GREGG. He followed the opinion in both cases as written by the solicitor. At least, I know that he did on the other one, and his approval of these recommendations was pretty much a pro forma matter. He can not go into them himself.

Mr. NASH. He followed this opinion, Senator Jones, because the assessments of the amounts was made against Peter Jung and A. L. Jung in the same month that the opinion was written in March, 1924.

Mr. NASH. Not without checking it in the collector's office. The

The CHAIRMAN. Do you know whether they ever collected it?

assessments were sent to New Orleans in March, 1924, and I assume that they were collected.

The CHAIRMAN. What was the amount of the assessment?

Mr. NASH (reading):

Peter Jung, jr., for 1918, $4,196.77.
Peter Jung, sr., for 1918, $12,720.95.
A. L. Jung, for 1918, $3,554.92.
Peter Jung, jr., for 1919, $12,708.55, and for 1920, $16,090.27.
Peter Jung, sr., for 1919, $44,226.10, and for 1920, $57,111.24.
A. L. Jung, for 1919, $7,531.29, and for 1920, $9,305.52.

The CHAIRMAN. So that had this policy in this case been followed out quite generally through the bureau, the taxes might have been considerable?

Mr. GREGG. You do not have many cases like these cases. I am not sure that the decision in the last case is correct. I think it is in the first case, but I am not sure it is in the last one.

Senator JONES of New Mexico. I am inclined to just reverse that order, because, in the last case, where they were holding this money, and were investing it ultra vires——

Mr. GREGG. Of course, all they had to do was to amend the charter.

Senator JONES of New Mexico. All they had to do was to amend the charter and fix it up.

Mr. GREGG. In the last case, though, they were just continuing the old policy of accumulating the profits.

Senator JONES of New Mexico. Yes.

Mr. GREGG. Using their earnings in this investment business.

Senator JONES of New Mexico. I think that does raise a question.

Mr. GREGG. I think that makes it very doubtful.

Senator JONES of New Mexico. Yes.

The CHAIRMAN. Have you anything further that you want to put in now, Mr. Nash?

Mr. NASH. Not anything further to-day, Senator.

The CHAIRMAN. Mr. Gregg?

Mr. GREGG. No, sir. Is the committee meeting to-morrow, Senator?

The CHAIRMAN. Yes. I would like to ask Mr. Manson if he is going to take up any of these questions dealing with the question of control of affiliated companies, whether on the theory of actual or legal control. That question has been involved very much in the matter of affiliations.

Mr. MANSON. Up to the present time I have not had an opportunity to study that question with the care that should be devoted to it. It is a very complicated question, and one that, in my judgment, requires considerable study to form an intelligent opinion.

The CHAIRMAN. Personally, I was not so much concerned about the opinion, Mr. Manson, but I would like to have something presented, if you can do so, to show how it works, and then, if we could determine how it works, we could probably form an opinion, in collaboration with you later on.

Mr. GREGG. I think you can probably get that out of the board of tax appeals decisions. They have handed down several decisions on affiliation, giving the specific cases where they have applied it.

The CHAIRMAN. In those cases, have they sustained the bureau?

Mr. GREGG. They reversed the bureau, taking the position that control means actual control.

The CHAIRMAN. And not legal control?

Mr. GREGG. Not legal control.

The CHAIRMAN. In that event, it seems to me that Congress ought to change the statute.

Mr. GREGG. Of course, Congress has changed the statute.

The CHAIRMAN. In 1924?

Mr. GREGG. They knock out control entirely.

The CHAIRMAN. What is it now?

Mr. GREGG. Straight ownership. It is made definite in the statute, 85 per cent. It is a kind of a fool-proof rule now.

The CHAIRMAN. So the real effect of this whole matter now will be to deal with unclosed cases?

Mr. GREGG. Under the old acts; yes, sir.

The CHAIRMAN. If it is agreeable, then, we will adjourn until 10 o'clock to-morrow.

Senator JONES of New Mexico. You say that the present statute practically makes the situation foolproof. That may be true as far as administration under it is concerned, but, after all, is not that open to evasion through the putting of the title of the shares of stock into the names of dummies?

Mr. GREGG. You see, the taxpayer does not have to evade it. Since the 1921 act it has meen made optional with him, even if it were affiliated, as to whether it would file a consolidated return. He does not have to if he does not want to. He has the option of filing a consolidated return or a separate return. There was not very much reason for the consolidated returns after the repeal of the excess profits act. The real reason for it has gone. The only thing is that if they have two affiliated corporations, and one has lost money, they can file a consolidated return, which permits them to charge the losses of that company against the income of the other. But it is not particularly important there.

Mr. MANSON. It is only where they do business over a series of years with losses?

Mr. GREGG. Yes.

Senator JONES of New Mexico. I think that is very important. We hear of the organization of a new newspaper to enable one concern to continue to do business at a loss for a series of years, and I am not so certain that it is advisable to let the taxpayer have an option.

The CHAIRMAN. I think the option that the law gives in many of these cases is very stupid, because the taxpayer uses the option to suit his own purposes, as to whether he makes a gain in his tax by it.

Mr. GREGG. Of course, we have a provision to take care of any artificial shifting of profits.

Senator JONES of New Mexico. I have contended, as a matter of fairness all around, that as long as we have this disparity of taxation on a business, whether it is done as an individual or a partnership or a corporation, that there the taxpayer ought to be given an option to make a return in either form. That, of course, was suggested largely to direct attention to the disparity, but it seems to me that to leave some option to the taxpayers solely for the purpose of enabling them to get an advantage may not be advisable.

Mr. MANSON. Here is the situation. Suppose you have two corporations, and you have the conditions under which you can affiliate. You have practically the same conditions under which those two corporations could be affiliated into one——

Senator JONES of New Mexico. Yes.

Mr. MANSON. Except in certain States. For instance, the laws of certain States may prohibit the holding of property by a corporation, unless that corporation is incorporated under the laws of that State. That is about the only case where you would have a situation where you could not affiliate and where you could not consolidate.

Do I make myself clear there?

Senator JONES of New Mexico. Oh, yes; that is quite clear.

Mr. MANSON. Under any other situation, if you had a series of losses, or, in other words, if you had a business that was doing business at a continued loss, and you wanted to continue that business, and you could not affiliate under the tax law, of course you could just dissolve that corporation and have the other corporation take its business over, because the percentage of stock required by the statute to be held in common is so high—85 per cent—that the minority interests do not amount to very much.

Senator JONES of New Mexico. Since we have repealed the excess-profits tax, why not require them all to make consolidated returns?

Mr. MANSON. That is, all corporations, where the 85 per cent——

Senator JONES of New Mexico. Yes.

Mr. GREGG. You will have the same effect as you have now. The consolidated returns section can not now operate other than to the advantage of the taxpayer.

Senator JONES of New Mexico. That seems so to me. Why have such a section, except to deal with past transactions?

Mr. GREGG. It seems to me it is perfectly fair, if a corporation is operating a subsidiary at a loss, owning 100 per cent of its stock, to allow it to offset the loss.

Senator JONES of New Mexico. The taxpayer is allowed by the statute to make consolidated returns; so what is the use of having this transaction reviewed any more on that question?

The CHAIRMAN. There is one feature of that, Senator, that occurs to me, and that is if a taxpayer does not file a consolidated return, there is no way for the bureau to know that there are any affiliated companies. I mean that that information is in the possession of the taxpayer, and if he does not disclose the fact that he has affiliated companies or subsidiaries, there is no way for the bureau as I see it to know that.

Senator JONES of New Mexico. No; if he does not want the bureau to know what affiliated companies he has, he does not make a consolidated return.

The CHAIRMAN. No.

Senator JONES of New Mexico. Would it not be advisable to require him to make a consolidated return?

The CHAIRMAN. From my point, I would rather see the whole consolidated question abolished, and have none of them make consolidated returns.

Senator JONES of New Mexico. Well, one or the other, it seems to me.

The CHAIRMAN. Yes; I think it should be one or the other, because now the bureau can not tell in one case if the taxpayer does not want him to know. The taxpayer only wants him to know if it is to his financial advantage. He will let them know if it is in his favor; but even taking your angle, Senator, and require consolidated returns, then the bureau will not know whether he has filed a consolidated return. If he evades doing it, or if he just forgets, the bureau has no information whereby they can determine what the affiliated companies are. In other words, if the consolidated section was abolished, these companies that are running subsidiaries at a loss would just combine, and they would then have only one report to deal with. It seems to me that the simple way is to abolish the whole question of consolidated returns.

Mr. GREGG. There are some companies whose business affairs are so intermingled that it is practically impossible to segregate their accounts and make a separate return.

The CHAIRMAN. Then, require them to combine under one corporation. The taxpayer now makes a consolidated return if it is to his advantage.

Mr. GREGG. Yes.

The CHAIRMAN. And it is always, since the repeal of the excess profits tax, to his advantage to make a consolidated return.

Mr. MANSON. He can make it one way or the other.

Mr. GREGG. It is always to his advantage—it can not be otherwise—since the repeal of the excess profits tax; so the only thing that would keep him from making a consolidated return is that it would be of no advantage to him to make it, and it might cause additional work in the preparation of the return. For that reason, he would not make it, and that is the only reason.

The CHAIRMAN. I would like to ask Mr. Manson, before I forget it, whether you have something to tell us about this British tax that Mr. Gregg drew to our attention some time ago? You were going to present a case whereby, in effect, the American Government was paying the income tax of its citizens who had paid an income tax in Great Britain.

Mr. MANSON. Yes; I can present that situation to-morrow.

The CHAIRMAN. I wish you would please do it.

Senator JONES of New Mexico. I think this question of international taxation ought to be gone into at some time, but I assume that that can be done by an examination of the law upon the subject.

The CHAIRMAN. I thought it would be well to get an example of just how it works, to show what the practical application of it is.

Senator JONES of New Mexico. Yes.

Mr. GREGG. It seems to me that that situation should be acted upon by Congress.

Senator JONES of New Mexico. Something should be done about it.

Mr. GREGG. It is very unsatisfactory.

Senator JONES of New Mexico. That must be so.

The CHAIRMAN. I thought if we could get one example of how it worked, plus a study of the law, it would be advantageous.

Mr. MANSON. In that Edison case it seems to me that the principal point there is the fact that the disparity arises out of the difference between the basis upon which the tax is paid in England and the basis upon which it is paid here. In other words, the taxpayer is permitted to deduct or to take credit for taxes here that he has not actually paid over there. For that reason he takes his credit upon an accrual basis. In case he had a royalty contract he takes his credit upon an accrual basis. In other words, as his royalties accrue while over there, he pays his tax.

Mr. GREGG. After he has had his credit?

Mr. MANSON. After he has had his credit.

Mr. GREGG. Of course, we safeguard that very carefully.

Mr. MANSON. In the course of years it would seem to me that the thing straightens itself out.

Mr. GREGG. Yes.

Mr. MANSON. It is only a matter of reaching over from one year into the next.

Mr. GREGG. The thing that impressed me with the situation boils down to this, that in the case of an American deriving income from a source within Great Britain, which is taxed by the British Government, in effect the American Government pays his tax to Great Britain.

The CHAIRMAN. Because he deducts it from his income tax here?

Mr. GREGG. Because he deducts the tax he pays to Great Britain from the taxes that he pays to this country.

Mr. MANSON. If the British rate is higher than our rate, he would deduct more than he would pay us here.

Mr. GREGG. That was under the old act. We have corrected that in the 1924 act. Under the old acts that was true. He might be taxed at a 30 per cent rate in Great Britain and at a 20 per cent rate here, and under the old acts he would get credit for the full tax paid, with the result that we would not only get no tax on his British income, but would apply that part of his tax on his American income.

The CHAIRMAN. Before I forget it, I would like to ask Mr. Nash what effect on the simplification of the bureau's work would it have if you had one form of return, say, for the calendar year, without the fiscal year? It occurs to me that there is delay in getting statistics and information as a result of the two methods of filing returns, one on the fiscal-year basis and one on the calendar-year basis.

Mr. NASH. There is a delay in statistics on account of the returns being filed and accepted on the fiscal-year basis. I do not know that it would help any in our administrative problem, whether they come in on the calendar year or the fiscal year basis. The problem of auditing is not any more intricate because of the fact that the return is on a fiscal-year basis, except in those years in which there was a change of tax law within the year, and that is over with now.

The CHAIRMAN. Have you any idea of the percentage of those that come in on the fiscal-year basis as compared with those that come in on the calendar-year basis?

Mr. NASH. The law now permits either a corporation or an individual to file on a fiscal-year basis, but there are very few individuals filing on a fiscal-year basis.

The CHAIRMAN. Most of them file on the calendar-year basis?

Mr. NASH. Most of them file on the calendar-year basis. As I recall it, there are something over 300,000 corporations. I do not know just the percentage of those that file on a fiscal-year basis, but I should imagine it would not be one-fifth of them.

Senator JONES of New Mexico. It seems to me that we should remedy the situation in that way, requiring the calendar-year basis for the returns, or the statistics could be made up on the calendar-year basis, taking the actual returns filed within the calendar year.

Mr. NASH. We have directed that that be done for the calendar year 1924; so that the statistics for all returns that were filed in 1924 would be available for the Finance Committee and the Ways and Means Committee next fall.

Senator JONES of New Mexico. That is splendid.

The CHAIRMAN. What injury would there be, if any, to the taxpayers, if the law required them to file a return on the calendar-year basis?

Mr. NASH. It would upset their accounting system. A great many corporations keep their accounts on the fiscal-year basis, and usually date it from the month in which they began their organization.

The CHAIRMAN. You say that is about one-fifth of the corporations?

Mr. NASH. That is just a guess.

The CHAIRMAN. Yes. I wonder if that one-fifth would be materially harmed by making it mandatory to file their returns on a calendar basis?

Mr. GREGG. I think you will find that it would, Senator.

Mr. MANSON. It changes the time of taking the inventory.

Mr. GREGG. Yes; they would have to completely change their accounting system. A corporation has to make its return on the same basis that it keeps its books, on account of the inventory at the close of the year, and to put them on a calendar-year basis would require a change in the entire system of accounting.

Senator JONES of New Mexico. Take concerns that are using cotton. I think the cotton year ends along in October—maybe in September—I forget just the time, but it is fixed in the trade with respect to the crop, and so is the sugar industry.

Mr. NASH. That is also true of grain. Most of the flour mills and elevator companies take their inventory in June or July. That is when the elevators are empty and the bins are low and before the new crop of grain comes in. Out in the Northwest practically every elevator company and flour mill will file a fiscal-year return for June or July.

The CHAIRMAN. If agreeable we will adjourn here until 10 o'clock to-morrow morning.

(Whereupon, at 1.30 o'clock p. m., the committee adjourned until to-morrow, Friday, May 29, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

FRIDAY, MAY 29, 1925

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

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

Present: Senators Couzens (presiding), Watson, Ernst, Jones of New Mexico, and King.

Present also: Mr. L. C. Manson, counsel for the committee.

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; and Mr. A. W. Gregg, Solicitor, Bureau of Internal Revenue.

Mr. MANSON. I have here a matter of the compromise of a fraud penalty and the subsequent refund of tax in the case of the J. H. Hillman & Sons (parent company), Hillman Transportation Co. (subsidiary), Pilgrim Coal Co. (subsidiary), Unity Supply Co. (subsidiary), and Isabella Supply Co. (subsidiary).

We have been compelled to make a very rapid survey of this case on account of the lack of time. The fact of the matter is that it did not come to our attention until yesterday morning, but we shall attempt to develop the following points:

First. That the taxpayer has been properly assessed a fraud penalty amounting to $1,888,828.29, but that this penalty has been compromised at the very low figure of $100,000, although the assets of the taxpayer were very large.

Second. That the formal offer of compromise was preceded by an informal offer in compromise tentatively approved by the commissioner which acted as instructions for the penal division. This procedure, as far as we can determine, is unique in the history of the department.

Third. That the informal offer in compromise and the formal one following it were both illegal with respect to the statutes existing at that time.

Fourth. That since the offer in compromise was accepted a letter of overassessment has been approved by the Income Tax Unit amounting to $487,310.83 in favor of the taxpayer, relief having been granted under section 210, revenue act of 1917 (special assessment).

Fifth. That in addition to the above overassessment letter, which was for the year 1917, an overassessment of about $800,000 for 1918 is contemplated in favor of the taxpayer.

The CHAIRMAN. The settlement in compromise did not settle the whole case, then?

Mr. MANSON. No; it was unique in that respect. In the first place, as I will point out, the statute in existence at the time prohibited compromise if the case was tainted with fraud.

In this case, the fraud penalty alone was compromised before the tax had been determined; that is, a final determination; and, as I will point out, the settlement specifically exempted and reserved to the taxpayer the right to prosecute his objections to the tax.

I do not think there is a precedent for that practice in the department. I think it is the uniform practice of the department to refuse to compromise a fraud penalty, unless the whole matter is compromised.

In 1917 the income and excess-profit tax return of J. H. Hillman Co. was subjected to a field audit which was concluded about August, 1918. On November 16, 1921, revised A-2 letter was sent to the taxpayer, in which an additional tax for 1917 was found amounting to $1,172,093.10 and also a 100 per cent penalty for fraud amounting to $1,880,838.18. This amount was assessed.

The fraud feature of this case is best set out in Exhibit B attached, which is a letter dated March 25, 1921, from the Solicitor of Internal Revenue to Acting Deputy Commissioner Matson. We shall quote briefly from this exhibit in order to set forth the nature of the fraud in this case:

Bonus to employees, $130,305: In the original return this amount was claimed as a deduction for bonuses paid to officers and employees. Investigation disclosed that this item was taken up on the books in 1918 instead of 1917, and that $30,305 was actually paid to employees on February 28, 1918, but no part of the total sum claimed as a deduction was paid in 1917. There is no evidence presented which shows that any part of this item was made available in the year under consideration.

Taxpayer claims that $100,000 of this item was intended as a bonus to the three principal officers of the corporation.

There can be only one interpretation to put on the above transaction, and that is that the deduction claimed in the original return which was not paid or even entered on the books during the year was false and fraudulent for the sole and specific purpose of diminishing tax liability.

Depreciation of stocks, $671,377.64: During 1917 the corporation, seeking control of certain companies engaged in business similar to its own, bought stock in the United Coal Corporation, paying therefor an amount considerably above its par value. At the close of 1917 this stock was inventoried in block A under cost of goods sold and the excess of the price paid above par was written off and consequently claimed as a deduction.

While the charter of taxpayer gives it the right to buy and sell securities, there is a complete absence of evidence that prior to this year taxpayer ever dealt in stocks and securities as a business (and this year only buying and no sales are shown). Revenue agent reports that this company can not show any buying and selling of securities either for customers or itself. This one isolated deal in securities, in which no sale follows, clearly does not class taxpayer as a merchant of securities but brings it specifically under paragraph 459, regulations 33, and therefore the deduction claimed as a shrinkage in the inventory value of these stocks is not only not allowable but has all the ear marks of fraud when there is no evidence indicating the belief that this taxpayer considered itself a dealer in securities within the purview of Treasury Decision 2609, dated December 19, 1917.

Inflation of invested capital, $1,573,941: The revenue agent states that the president, vice president, and treasurer "loaned" the company as of December

31, 1916, stocks, the aggregate value of which amounted to the above figure. Instead of the books of the taxpayer showing this amount as a liability, it was added to surplus. According to the vice president, the three individual owners intend to either have this stock returned them or have capital stock issued in payment of it. At the time of the investigation in August, 1918, neither of the above had been done.

The agent is emphatic in his statement that the above transaction was a false and fraudulent method of increasing invested capital for the purpose of evading excess profits tax, and believes that such manipulation would justify assertion of the 100 per cent penalty. It appears that the agent has ascribed the correct motive to taxpayer in inflating its invested capital.

The CHAIRMAN. What is the solicitor's name?

Mr. MANSON. This is signed by Carl A. Mapes.

Senator KING. Mr. Manson, is there anything to indicate that the price paid, which the solicitor states was above par, was more than the stock was worth in the market, and is there anything to indicate that there was a shrinkage in the market value of the stock between the date of the purchase and the date of the return of the taxpayer?

Mr. MANSON. There is nothing here to show that. The point involved here is this——

Senator KING. One other question, and perhaps you can answer them both at once: Does the record show that they tried to buy out a competitor's business?

Mr. MANSON. Yes; that is what they were trying to do, and offered a high price, but the point is this, that it is only a dealer in securities——

Senator KING. Yes; I know the statute, but for my own satisfaction, I was trying to get the correct perspective of the situation.

Mr. MANSON. It is only a dealer in securities who can take a shrinkage in value in his inventory.

Senator KING. I was just trying to see whether there was more immorality in that transaction than was indicated by the discussion.

Mr. MANSON. The recommendation of the solicitor is:

The revenue agent in his report states: "It would appear that the tactics used were to keep the tax down to a minimum by either fair or foul means." Thorough examination of the file leads to a concurrence with the finding of the agent. This corporation has flagrantly attempted to reduce its tax liability by methods which would appear difficult to explain. It is, therefore, recommended that the 100 per cent penalty for filing a false and fraudulent return for 1917 be assessed.

In substantiation of the above statement we append to our report Exhibit C, which is a letter from the solicitor to Deputy Commissioner Batson, dated October 18, 1921. This exhibit shows that a reconsideration of the assessment of a 100 per cent penalty for fraud for the year 1917 was made. It confirms, however, the first finding, excepting a few unimportant details.

As already stated, an A-2 letter was sent to the taxpayer, dated November 17, 1921, and the additional tax and fraud penalty was shortly thereafter assessed.

The taxpayer then filed a claim for abatement. This claim for abatement was rejected in a very carefully prepared memorandum to Mr. Batson, signed by D. H. Blair, commissioner, and dated March 8, 1922. In this memorandum Commissioner Blair sustains the ruling of the solicitor for fraud.

Up to this point in the case the handling of the matter by the bureau seems beyond criticism. The taxpayer had been represented by Attorney Burling, whose letters and claims seemed also to have been strictly ethical. As near as we can determine, it was at about this time that Mr. Wayne Johnson, former solicitor, took active charge of the case for the taxpayer.

On March 16, 1922, the taxpayer addressed a letter to the Commissioner of Internal Revenue, making a definite offer in compromise as to the fraud

penalty. As this offer was not made on the regular form, and as it refers to a formal offer to be made on the approval of this letter, we will refer to this offer of the taxpayer as an informal offer. This informal offer is tentatively approved by Commissioner Blair under date of March 17, 1922. (See Exhibit E, attached.) As it is the invariable custom of the bureau to first fix the tax liability before entertaining an offer in compromise, we quote in full the following statement contained in the informal offer, which is directly contradictory to this established custom:

"It is understood in making this offer that all questions of tax liability shall remain open, to be decided by the Income Tax Unit at the same time it disposes of questions which have not heretofore been settled by the bureau, and upon which no hearings have been held. Specifically, this paragraph has reference to the question of the right of this taxpayer to inventory its securities for the purpose of ascertaining the true net income subject to tax. The questions upon which the Income Tax Unit have held no hearings are: Consolidation, invested capital, depletion, and perhaps other questions of lesser importance.

"The officers of the taxpayer are present in Washington to-day and are prepared to enter into a final adjustment of this matter with you, the formal offer to be made as quickly as you have decided upon the acceptability of this offer, and the other formalities connected with it to be carried out with the greatest expedition."

That is signed by J. H. Hillman & Sons Co., by J. H. Hillman, jr., president, on which the following notation appears March 17, 1921 (22), signed D. H. Blair, commissioner.

On June 4, 1924, the unit having apparently fixed a new tax liability for the taxpayer, considerably over $400,000 less than the amount assessed, the solicitor advised Deputy Commissioner Bright that it was now possible to abate this amount of tax inasmuch as section 3225 of the Revised Statutes had been repealed by section 1015 of the revenue act of 1924, signed by the President on the preceding day. (See Exhibit F attached.)

Senator KING. Were they holding up that in order to get some legislation that would help that condition, where they wanted to save $400,000?

Mr. MANSON. It just happened the day after the act was approved.

Senator KING. But that act did not, ipso facto, compel that reduction, did it?

Mr. MANSON. Oh, no.

Senator KING. It required a settlement upon the basis of the statute.

Mr. MANSON. Here is the solicitor's letter (Exhibit F), dated June 4, 1924.

Senator KING. You say that is Mr. Bright's statement?

Mr. MANSON. No; that is the solicitor's letter, signed by Mr. Hartson.

Senator KING. Oh, yes.

Mr. MANSON. That shows that at the time the compromise of the fraud was made the act under which such a compromise was prohibited was still in force.

Mr. GREGG. Oh, Mr. Manson, that is a conclusion which I differ with.

Mr. MANSON. This taxpayer makes an offer. That offer is accepted by the commissioner. Subsequent to the making of that offer, and subsequent to its acceptance, which I maintain closed the deal, then an offer was made on the proper form on a prescribed piece of printed paper, and it was accepted on the proper form; but the real gist of the transaction—the real transaction, the transaction of agreeing to the compromise of this fraud penalty of

$1,800,000 for $100,000, took place before the repeal of the statute which forbade such a compromise, and I maintain that the subsequent action was a mere confirmation of what had already been done at a time when the statute prohibited its being done. It was a confirmation after the revenue act of 1924 repealed section 3225 of the Revised Statutes.

Senator KING. They made the compromise in effect and received $100,000, or at least agreed to receive it, before the repeal of this statute?

Mr. MANSON. It was not long before. It was the day before.

Senator KING. When the $100,000 was paid?

Mr. MANSON. When the agreement was approved by the commissioner.

Senator KING. And when was the $100,000 paid?

Mr. MANSON. I do not know that that is set out here. I assume that it was deposited with the formal offer. That is the usual practice.

Senator KING. Why was it that the case was so delayed, from 1917 or 1918, when that return was made, down to——

Mr. MANSON. It was the 1917 tax.

Senator KING. Yes.

Mr. MANSON. The return would be made in 1918.

Senator KING. In 1918, and that fraud assessment was levied against them in what year; the fraud was discovered, and the assessment made, in what year?

Mr. MANSON. The A–2 letter is dated November 16, 1921.

Senator KING. Then the matter hung fire until just the day before; do I understand you to say that this statute was repealed in the 1924 act?

Mr. MANSON. This is dated 1921, March 17, but it was actually 1922, as I note in parenthesis. They made a mistake in doing that. The A–2 letter is November, 1921. The compromise was accepted in March, 1922.

Senator KING. But the whole transaction was not completed, as I understand you now, until 1924, the day after——

Mr. MANSON. Oh, no; subsequently, after this fraud was compromised, then they abated part of the tax. That was in 1924.

The CHAIRMAN. When the fraud was abated, do I understand that that was two years or a year and a half prior to the settlement of the case in 1924?

Mr. MANSON. It was about two years.

Senator KING. Then they deducted from the assessment—not the fraud assessment but the tax assessment—approximately $400,000?

Mr. MANSON. Something over $400,000.

At the present time there is a certificate of overassessment, amounting to over $480,000, in the solicitor's office, pending approval, same having been audited and reviewed in the Income Tax Unit.

Senator KING. You say "at the present time." When do you mean?

Mr. MANSON. At the present time—right now.

Senator KING. Right now?

Mr. MANSON. Yes.

Although this certificate of overassessment has not yet been approved, it is evident that the taxpayer is fully informed concerning

it. In this connection see Exhibit G, which appears to be an agreement signed by the taxpayer, stating that he agrees to the tax as determined in overassessment certificate No. 281607 in the amount of $487,310.23, as determined at the rate of 37.005 per cent, determined under the provisions of section 210 of the revenue act of 1917.

Mr. GREGG. May I ask, just before you get to that point, has the case gone through the solicitor's office?

Mr. MANSON. The tax liability has not; that is, the certificate of overassessment has not been approved as yet by the solicitor's office. It is now in the solicitor's office.

Senator KING. Let me inquire right there, has no part of the tax of 1917 been paid, except the fraud assessment of $100,000? Is all of that still unpaid?

Senator JONES of New Mexico. Up to the present time, there has been no statement made that the $100,000 has been paid.

Senator KING. No; that is true. There is no statement that that has been paid.

Mr. MANSON. I have not cited you to the particular document here, but I have read this report, and I know that this record shows that the $100,000 has been paid.

We submit Exhibit H, which is a memorandum for Mr. Charest, assistant solicitor, from the penal division. This memorandum advises the "most careful consideration" of the right of the taxpayer to relief under section 210, and also advises the careful consideration of the comparatives used in recomputing the tax liability.

From the above history we can find nothing to criticize in this case up to March 17, 1922, which was the date on which the commissioner approved the informal offer in compromise. Up to this time the case appears to have been carefully handled, the fraud features sustained on the three most important points and even the taxpayer's attorney appeared to have been governed by proper ethical considerations.

Our information is that Mr. Wayne Johnson took charge of the case about this time. We entirely disagree with the propriety of this tentative approval by the commissioner of the taxpayer's informal offer in compromise. We do not wish to have this statement construed as reflecting upon the intention of Commissioner Blair, but we do think, at least, some improper advice must have been given him at this time, which is not in the file. Our objections to the approval of such offer in compromise are as follows:

First. The tentative approval of a definite offer in compromise signed by the commissioner acted from all practical standpoints as instructions to the solicitor to compromise the case for $100,000.

It is my understanding that in the regular course of events, the investigation of offers of compromise and the investigation of these cases is made in the solicitor's office, and a recommendation goes from the solicitor's office to the commissioner.

The CHAIRMAN. Is that correct, Mr. Gregg; is that the usual practice?

Mr. GREGG. That is correct.

Mr. MANSON. That is the usual practice. As I understand it, the commissioner acts upon the solicitor's recommendation.

In this instance, the tentative offer was accepted before the matter was referred to the solicitor's office, and we take the position that, for all practical purposes, that was tantamount to a definite instruction to the solicitor's office as to how to proceed.

Second. It contains a clause which allows the compromise of the fraud penalty before the question of tax liability is determined. We have been definitely informed that this is the only case in which such a procedure has been allowed.

Third. It provides for a refund of taxes at a time when such refund was contrary to section 3225 of the Revised Statutes.

In other words, the reservation of the right there to have these taxes abated under conditions which were not permitted under that section, for the reason that the transaction was tainted with fraud, is another feature of the settlement itself which is contrary, at least to the spirit of the statute, if not the express language of it.

On May 26, 1922, this informal offer in compromise was followed by the acceptance of a formal offer in compromise, which included the exact provisions provided in the informal offer. This was also approved. We believe that the acceptance of this formal offer in compromise was illegal, because it contains the provision allowing for the refund of taxes of an additional assessment of taxes in which the element of fraud exists. It would appear to us that no officer of the Government has the right to enter into any form of agreement which contains provisions contrary to law. We again point out that with the multitude of papers requiring the signature of the commissioner, we do not wish to lay stress upon his personal action, but rather on the system which permits of his receiving bad advice.

It appears from the exhibits in this case that on June 4, 1924, one day after the revenue act of 1924 was signed by the President, which repealed section 3225 of the Revised Statutes, the solicitor approved the abatement of over $400,000 due from this taxpayer. It is evident from the exhibits, therefore, that the computation of this deduction in tax had already been made, at least in a form which permitted of a very close approximate of the exact amount.

In other words, at the time the formal offer of compromise was accepted, it was apparent that the bureau knew that when they took $100,000 in compromise of that fraud penalty they were going to pay this man $400,000.

Your engineers do not agree with the bureau in the principle in allowing the taxpayer relief in securing this overassessment by the use of section 210 of the revenue act of 1917. This section provides the right of special assessment only in case the Secretary of the Treasury is unable satisfactorily to determine the invested capital of the taxpayer. The wording of this section is entirely different from that of sections 327 and 328 of the revenue act of 1918, which give the right of special assessment in cases of abnormal conditions affecting the capital or income of the corporation. This case is being determined under the revenue act of 1917, and the invested capital of the taxpayer could be, and in fact was, determined by the unit, and we see nothing in the act of 1917 that would permit of the special assessment on the basis that the taxpayer would undergo a hardship on account of abnormal conditions.

That right was not granted to the taxpayer until 1918.

Yet in this case the taxpayer has been given relief under section 210. We believe there is nothing retroactive in sections 327 and 328 of the revenue act of 1918.

We have information that the 1918 taxes of this taxpayer have been recomputed and that an overassessment letter amounting to about $800,000 is on its way to the solicitor. We also understand that the auditors have instructions how to audit this case and that the files contain a protest from the auditor who audited same. We are making this statement on our own responsibility, although we have had it from two sources. In any event we think that the case for 1917 is sufficiently clear evidence of the improper handling of this case.

It might also be mentioned that there is a solicitor's or appeals and review ruling in this case providing that taxpayer is not a dealer in securities in 1917; and another ruling providing that taxpayer is a dealer in securities in 1918. We believe this second ruling should be reviewed. They are both unpublished. If this second ruling was published there should be a considerable number of taxpayers getting relief by inventorying stocks at the end of each year.

I say "stocks"; I mean securities.

Senator KING. Everybody would be a dealer that had a few stocks.

Mr. MANSON. Pretty near.

We are at a loss to account for the action of the bureau in this case from March 16, 1922, to date. It appears that special procedure has been set up, which in our opinion is illegal. It would appea. that even though three distinct points of fraud were found, this very taxpayer, guilty of these fraudulent acts, has been granted special consideration and special assessment under section 210, which we contend was not applicable. The only conclusion we can come to, to account for the above, is that undue influence was used somewhere along the line in handling this case.

The CHAIRMAN. I would like to ask Mr. Carson if it is true that he got the impression from some of the staff down there that this case was so rotten that a former employee by the name of Claude Kitchen resigned, after protesting to the commissioner about it?

Mr. MANSON. Mills Kitchen.

The CHAIRMAN. Mills Kitchen?

Mr. MANSON. Mills Kitchen, the son of Claude Kitchen.

The CHAIRMAN. Is that correct, Mr. Carson, that this is the case that Mr. Kitchen resigned because of its rottenness?

Mr. CARSON. The information we got, and we could not confirm it by letter, was that Mills Kitchen had fought this case constantly while he was in the office there. We found his name on there protesting against the handling of that fraud penalty, in the way it was being handled, and that the word was passed around the office that Mr. Johnson was coming into the case. He took that information in to the commissioner, and shortly thereafter Wayne Johnson come into the case, and Mr. Kitchen resigned in protest, or he resigned as a protest against the way in which the case was handled. I do not know whether I should say it for the record or not, but my experience has been that every place I have gone into in the unit there is the highest respect and commendation of Mr. Kitchen's ability and integrity all the way through.

Mr. GREGG. I would like to have in the record the information on which Mr. Carson's conclusions are based.

The CHAIRMAN. You would like to have what?

Mr. GREGG. I would like to have in the record the information on which Mr. Carson's conclusions are based.

Senator KING. About the integrity of Mr. Kitchen?

Mr. GREGG. No; about Mr. Kitchen resigning as a protest against the settlement of this case.

Mr. MOSS. As I understand Mr. Carson's statement, he was unable to get a confirmation of it.

The CHAIRMAN. I do not think that is pertinent, to involve statements of other people down there. It is not necessary to do that.

Mr. CARSON. The only way that I think you can confirm it, if at all, would be to subpœna Mr. Kitchen, if he is still in town, and I think I can get the names of two others who are still in the employ there. I will give them to the chairman later. You might be able to subpœna them and let them testify.

Mr. GREGG. Let me say just a few words about the case. I know nothing about this particular case, but I wish to say a few words on the general matter of assessing the fraud penalty.

The 1917 act levied a fraud penalty of a hundred per cent of the tax—not of the deficiency, but of the entire tax. It was a carry over from section 3176 of the Revised Statutes, which had been en-

acted about the Civil War days, and had never been changed. It was not intended to apply to income taxes, because they were not in existence then. The penalty was so high that the department very early took a very liberal attitude in compromising them. We thought we had authority to compromise them, and I still think we have.

Senator JONES of New Mexico. Under what statute?

Mr. GREGG. The provisions of section 3229 of the Revised Statutes.

The CHAIRMAN. And what date was that statute passed?

Mr. GREGG. Which one?

The CHAIRMAN. The one that you have just referred to.

Mr. GREGG. Section 3229?

The CHAIRMAN. Yes.

Mr. GREGG. I think it was about the same time that 3176 was passed.

The CHAIRMAN. I understand that you exercised your authority under one statute, and you liberalized it under another statute, passed about the same time.

Mr. GREGG. It seems to me, on its face, that a penalty of a hundred per cent of the entire tax is too high. As soon as it was called——

Senator JONES of New Mexico. Is not that a matter for the discretion of Congress?

Mr. GREGG. Yes, sir. As soon as it was called to the attention of Congress, it was modified materially. It was reduced to 50 per cent of the deficiency.

The CHAIRMAN. Yes; but in the meantime you took the law into your own hands, and compromised it, because you did not agree with the act of Congress.

Mr. GREGG. We did not have to do that. Congress had given us the power to compromise it. I am not defending my action or the action of anybody else in the department. That policy was adopted about 1918 or 1919.

Senator KING. Do you think, Mr. Gregg, that when that statute was liberalized. the penalty was intended to be retroactive?

Mr. GREGG. No, sir; it was not, by its terms, made retroactive.

Senator KING. And yet they made it retroactive here.

Mr. GREGG. No, sir. Under our authority to compromise, we compromised the penalty in this case, and in 90 per cent of the fraud cases——

Mr. MANSON. It is my judgment—I have not section 3225 before me—but it is my judgment that your authority to compromise under the compromise statute was limited by section 3225, until the act of 1924 went into effect.

Mr. GREGG. I was coming to section 3225.

Mr. MANSON. And section 3225 deprived you of the right to compromise where there was fraud in the case.

Mr. GREGG. I was coming to section 3225.

Senator ERNST. You said that this policy was adopted at what time and by whom?

Mr. GREGG. About 1918 or 1919. Mr. Arthur Balentyne was solicitor at the time, and Mr. Roper, as I remember it, was commissioner. A very liberal attitude was taken toward the compromising of these fraud penalties, which everyone considered to be excessive.

Senator JONES of New Mexico. I want to express my opinion here, and that is that I do not think that anyone should be very punctilious when it comes to a case of fraud. If it is fraud, I think it should be punished not only with respect to making them pay a large penalty but I think perhaps it should go further than that.

Mr. GREGG. Where we feel that the evidence justifies it we bring criminal action; we prosecute criminally.

Senator JONES of New Mexico. Well, either it is fraud or it is not, it seems to me, and if you conclude that it is a case of fraud, and that is established, I do not see why anyone should be tender-hearted in a case of that kind.

The CHAIRMAN. I do not see under what authority they had a right to be tender-hearted, and to say that they thought the act of Congress was too strict and should be liberalized.

Mr. GREGG. Congress, in the same act, had given us authority to compromise taxes in certain instances. The Attorney General has ruled that that applies to penalties—that they can be compromised. I will answer your point on section 3225 that way, that the Attorney General has ruled that under the old act we could compromise penalties, and, as I say, we adopted this policy away back in 1919. In the enactment of the next revenue act we called the attention of Congress to the fraud penalty, and they reduced the penalty from 100 per cent of the entire tax to 50 per cent of the deficiency.

Senator KING. As a minimum or a maximum?

Mr. GREGG. That is the penalty, and we still have authority to compromise it.

Mr. MANSON. It would appear that if the commissioner has the power to compromise penalties, and if he exercises that discretion in such a way as to compromise a penalty of $1,880,000 for $100,000, it does not make very much difference what sort of a penalty Congress imposes. In other words, the determination of Congress that the penalty should be 50 per cent or 100 per cent does not seem to have any effect when the penalty that is actually imposed as the result of the compromise is about 5 per cent.

Mr. GREGG. The question of whether anyone in the department should have authority to compromise a tax or penalty is one that should be determined by Congress. I can see many reasons why Congress might want to consider the repeal of that statute giving anyone authority to compromise. There is nothing that gives so much trouble as these compromise cases; there is nothing in which the discretion of the department is so great. This policy of compromising the fraud penalty at less than 100 per cent of the tax was adopted back in 1918 and 1919, and was consistently followed in reference to the 1917 penalties. We are doing it to-day. If Congress wants to stop us, of course it can be done by legislative act; but we are compromising fraud penalties to-day, under the 1917 act, for amounts much less than the penalty imposes of 100 per cent of the tax.

I do not think the compromise of that penalty for $100,000 was at all unusual, in view of those circumstances. I am sure that I can dig up other cases where the same thing was done, or where the amount accepted in compromise bore a smaller relation to the amount of the penalty than in this case, and I can find some where it has been done in the last month.

The CHAIRMAN. Is not influence sometimes brought to bear to get those compromises?

Mr. GREGG. No, sir; I have never seen any evidence of it.

The CHAIRMAN. The charge in this case was that there was considerable influence used.

Mr. GREGG. Yes, sir; but if I may point out, that was a conclusion, and there were no facts to support it.

The CHAIRMAN. Well, it is pretty difficult to get private conversations as a matter of evidence, is it not? I mean that it is difficult, when a man goes into an office, and, through influence, fixes things up, to get that as a matter of evidence.

Mr. GREGG. Yes, sir; but do you think the charge should be made if there is no evidence to support it?

The CHAIRMAN. Well, it is a matter of inference, and of course the records can be so manipulated as to enable anyone to draw any inference he pleases from them.

Senator KING. The record does show that an attorney who was entirely ethical conducted those negotiations up to 1921 or 1922, at which time a man who had been in the department for a long time, in a responsible position, who had left the department, and who the record shows was doing considerable business with the department, is employed, and his activity seems to have centered around the efforts to secure a compromise of that tax—a very successful effort, too.

Mr. GREGG. Is there anything unethical in an attempt to compromise a penalty, when it was known by everybody that the policy of the department was to compromise these penalties for amounts much less than the actual penalty imposed?

The CHAIRMAN. Was it the policy of the department, Mr. Gregg, to compromise the penalties before the amount of the tax was fixed?

Mr. GREGG. Not usually. I do not know why it was done in this case.

The CHAIRMAN. Is it the policy of the department, when the amount of the tax has been computed, but not officially acted upon, and it is known that it is proposed to refund $400,000, to compromise a penalty for $100,000, before that has been fixed?

Mr. GREGG. I see no objection in the world to that. The reduction of the tax automatically would reduce the penalty. In other words, the penalty is based upon the tax. If you reduce the tax, that, in itself, reduces the penalty, the statutory penalty. If the understatement due to the fraud was less than it was first supposed that it was, that certainly is no reason for increasing the penalty. It seems to me a very good reason for decreasing it; but the point I wanted to bring out in this case is this: I see nothing irregular in it, and if Congress does not approve our compromising those penalties for much less than the amount of the penalty, by legislative action it can stop it immediately. It is being done every day, and it is being done in the solicitor's office to-day.

The CHAIRMAN. You said a while ago that everybody knew that those penalties were being compromised. Was everybody informed by rulings or publications, or how did everybody know it?

Mr. GREGG. I do not know how they knew it, but everyone seems to have.

Senator JONES of New Mexico. Did you have any regulation on the subject?

Mr. GREGG. Yes, sir. I can read them if the committee desires. It does not say what amount will be accepted in compromise. It just says what the taxpayer is to do; he has to submit his offer on such and such a form in a compromise case.

Now, with reference to section 3225. That is another section of the Revised Statutes which had no application to income taxes. I would like to read that to the committee. It is on page 266 of regulations 62, section 3225 of the Revised Statutes.

Senator KING. Before you read that, may I ask whether it should not be construed with another section of the statute passed before, which authorizes the penalizing up to 100 per cent in excess of the fraud?

Mr. GREGG. No, sir. Let me read the section there. I think that will clear it up:

When a second assessment is made in case of any list, statement, or return, which, in the opinion of the collector or deputy collector, was false or fraudulent, or contained any understatement or undervaluation—

Just think of that language—"any understatement or undervaluation"—

* * * such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation.

Immediately when that section was called to the attention of Congress they repealed it—not only repealed it, but they repealed it retroactively and explicitly stated in the 1924 act that the repeal of that section was retroactive. That certainly shows what Congress thought of it. They thought is had no application to income taxes.

Senator KING. Mr. Gregg, do you think that is putting that fairly; that it had no application to income taxes?

Mr. GREGG. That it should not have.

Senator KING. Did they not think it was safer, rather than to modify it, to repeal that section and enact another in its place?

Mr. GREGG. That section was not followed by the department for years. I do not think anybody in the department knew that it was in the Revised Statutes for years. By its terms I do not think it applies to an income-tax case, because it says if the collector or deputy collector determines that the return was false or fraudulent. In our procedure the collector or deputy collector has nothing to do with the determination of fraud.

Mr. MANSON. Is not the same true of the section which authorized you to compromise at all? In other words, both the one which authorizes you to compromise and the section which limited the right to compromise were passed long before the income tax law was even contemplated?

Mr. GREGG. I do not think that section limits the rights to compromise. The Attorney General has ruled that we can compromise penalties under the old act. As I say, section 3225—and I am stating facts; I am not defending—was not followed for years. I do not think anybody in the department knew it was in the Revised Statutes.

The CHAIRMAN. Was the compromise statute followed in all of those years?

Mr. GREGG. Yes, sir.

The CHAIRMAN. What was the number of the compromise statute?

Mr. GREGG. Three thousand two hundred and twenty-nine. When this section 3225 was adopted and put into operation it produced some very harsh situations, and the Treasury Department recommended to Congress that it be repealed immediately. I handled it for the Treasury Department up here, and I know that everyone agreed heartily with our recommendation that it should be repealed. I do not think, by its terms, it has any application to this case. No collector or deputy collector makes a determination of fraud any more. That is done by the revenue agent; it was done in this case by the revenue agent, who recommended the assessing of the fraud penalty, and that is an entirely different matter. That is a penal statute and has to be strictly construed.

Senator KING. Pardon the interruption, Mr. Gregg, but frequently a statute may contain dual provisions, and the execution of the statute may devolve upon A. The statute may be modified, a part of it continued in force, but the execution of it transferred to another agency or department of the Government, which we will call B. Obviously that statute would not be repealed in toto, because of the transference of the duties and responsibilities which A performed to some other agency of the Government. So I do not quite agree with you.

Mr. GREGG. This is a penal statute. It says that if the deputy collector or the collector determines the fraud. Well, the deputy collector or the collector made no such determination in this case. It was determined by the revenue agent and then by the solicitor.

Senator ERNST. Furthermore, Senator, I do not think the case that you have imagined is the case here.

Mr. GREGG. I do not think so, either.

The CHAIRMAN. Who executes section 3229, and who determines the compromise according to that section?

Mr. GREGG. That specifically says the solicitor, with the approval of the commissioner, may compromise, and that is the way it is done.

The CHAIRMAN. Was there a Commissioner of Internal Revenue when that section was passed?

Mr. GREGG. Yes.

The CHAIRMAN. But there was no income tax?

Mr. GREGG. No, sir. The income tax laws have been passed since then.

The CHAIRMAN. Yes; but there were none at the time that that was passed?

Mr. GREGG. I do not think so. The department, as I say, never followed section 3225 until about 1922 or 1923. Then, when we started to employ it, it worked so harshly that we recommended to Congress that it be repealed, and that it be repealed retroactively.

I do not see a thing that is peculiar in this case. I see nothing strange in Mr. Johnson attempting to compromise the penalty. It was in accordance with the policy of the bureau. In accordance with the policy of the bureau it was accepted, and if the committee desires I can dig up other cases of the same sort.

The CHAIRMAN. Were they accepted before the tax was determined?

Mr. GREGG. I do not know, but I do not see that that is an important point.

The CHAIRMAN. Well, if the penalty has a relation to the tax—and it must be 100 per cent of the tax—how can you determine the penalty before you determine the tax?

Mr. GREGG. Well, the penalty was determined on the basis of an excessive tax, a tax which the department has since held was excessive.

The CHAIRMAN. But you had not held at that time that it was excessive.

Mr. GREGG. No, sir.

The CHAIRMAN. It seems to me that you are simply putting the cart before the horse.

Mr. GREGG. It does not seem so to me. The penalty was compromised before the tax was determined; that is true; but I see nothing wrong about that.

Senator KING. But does not the new law under which you operate and which you say is retroactive provide that where a compromise is effected it shall be 50 per cent of the tax which has been proven to be erroneous or——

Mr. GREGG. No, sir.

Senator KING (continuing). Excessive?

Mr. GREGG. No, sir. That is not retroactive. The provisions of the 1918, 1921, and 1924 acts are not retroactive on the matter of the penalty. They impose a penalty of 50 per cent of the amount of the deficiency for 1918 and subsequent years but do not affect 1917. Our power of compromise still exists. We are to-day compromising cases where the penalty is only 50 per cent of the deficiency.

Senator KING. For 1917 what law are you now operating under in compromising these fraud cases?

Mr. GREGG. The law in reference to 1917 remains the same, except that section 3225 is repealed. The 100 per cent penalty is repealed but the compromise section is the same.

The CHAIRMAN. You said you had compromised a case where the penalty assessment was only 50 per cent of the deficiency?

Mr. GREGG. Yes, sir.

The CHAIRMAN. On what grounds did you compromise a fraud case where the penalty was only 50 per cent of the deficiency?

Mr. GREGG. We look to the degree of fraud. It sounds strange to say "degrees of fraud," but in income-tax cases there are.

Senator JONES of New Mexico. What is the efficacy, then, in Congress fixing the amount of the penalty?

Mr. GREGG. I should say myself that Congress should consider very carefully whether it should settle the amount of the penalty and then take away from the department the power to compromise that.

Senator JONES of New Mexico. What force and effect do you give to that provision of the statute fixing the amount of the penalty?

Mr. GREGG. Well, that is the maximum amount. Very often we compromise it at the present time.

The CHAIRMAN. You do not have to compromise, do you?

Mr. GREGG. No, sir; it is entirely discretionary.

The CHAIRMAN. Then why do you assume the responsibility of compromising, when, by your own statement, you think Congress ought to fix it and take away the power of compromise?

Mr. GREGG. It has always been done. The penalty has been compromised ever since we have had an income tax.

The CHAIRMAN. There is nothing mandatory about your compromising now, is there?

Mr. GREGG. That is perfectly true, but Congress gives us the power, and because we dislike to assume the responsibility is no reason why we should refuse to exercise this power which Congress gave us.

Senator ERNST. Do you not think that in most cases where you have exercised that power, it has been the equitable and just thing to do?

Mr. GREGG. Yes, sir; I do.

Mr. NASH. I have in mind a case about three years ago, where large tax and fraud penalties were assessed against a manufacturing concern in the Middle West. The fraud was also prosecuted in the courts. The judge sentenced the president of the concern to two years in Leavenworth, and fined the president, the treasurer, the secretary, and one other officer of the concern $10,000 each, which is the maximum fine that could be imposed upon them. They paid all of the additional taxes that had been disclosed, and in that case, I think, the judge and the United States attorney and the collector all recommended that the fraud penalties be compromised. I think they were compromised, and the compromise was accepted, but the initial action started in the district in which the case had occurred.

Mr. GREGG. I will give you another case of the same sort.

Mr. NASH. Pardon me a minute. And one of the reasons that was given for considering the compromise was that this was a going business, and that the fraud case had put it on the ragged edge, but if the penalties could be relieved to some extent, it would give them a chance to recuperate and continue as a potential taxpayer. I know that case was discussed at some length in the bureau. I heard some of the discussions and, as I have said before, I think the fraud penalty was compromised in that case. I also believe that the department did the right thing in compromising it.

Mr. GREGG. Take the case of the Crucible Steel Co. We alleged fraud there. Indictments were brought against the officials of the company whom we deemed responsible for the fraud. We did everything we could to punish them. After the time that the fraud was committed the corporation had come into the control of different people. The people who had committed the fraud were with the corporation before these people came in. These later people came in and said:

> The penalty applies to us, that is true, because the corporation is a continuing one, but you are penalizing innocent people, as these new officeholders had nothing to do witth the old company.

Senator JONES of New Mexico. Did they not know that the company was liable for the penalty when they assumed control?

Mr. GREGG. I do not think so. I think the fact of the penalty was disclosed after they assumed control. We compromised that case.

Mr. MANSON. In that case, the officers were prosecuted. What was the outcome of the prosecution?

Mr. GREGG. They were cleared. We brought action against them.

Senator KING. Of course, it would be a dangerous thing to lay it down as a rule in cases of the transfer of property after a fraud order has been made, to relieve the corporation of the payment of taxes imposed because of the fraud, as new parties, not participating in the fraud, have stepped into their shoes. That would be a very dangerous rule to announce.

Mr. GREGG. That would be, and we have never announced any such rule. But it has been done.

The chairman brought out a minute ago the fact that we did not have to exercise this power of compromise. Well, it is a power that exists under the law. It is a power that everyone dislikes to exercise, because it involves the assuming of too great a responsibility for anyone to care to shoulder; but that is no reason why we should not go ahead and do what Congress told us to do or authorized us to do.

Senator JONES of New Mexico. I have not seen any evidences of timidity about your exercising authority under this statute.

Mr. GREGG. Well, I do not mind telling you that it worries me.

The CHAIRMAN. If you did not exercise it, they could go to court for relief.

Mr. GREGG. You can not force a compromise in court.

The CHAIRMAN. Yes; but I mean they could go to court if you do not compromise it.

Senator JONES of New Mexico. When we see in the Fleishmann Yeast Co. case, where, on the face of things, at least, there was a tax due of nearly $3,000,000 and it was compromised for $75,000, I do not see any evidence of timidity there when the department comes in and undertakes to justify it; and when I see, as in this case, where a penalty is assessed, if it amounted to anything at all, of over a million dollars, and then you compromise it for a hundred thousand dollars, I do not think there is any evidence of timidity there.

The CHAIRMAN. That is just where political influence comes in, Senator. There is not any question about it. It is difficult to get conversations on the record, and in the Fleishmann case there was not any question about political influence. There is no question in my mind about political influence in this particular case, and that is just the kind of thing that causes distrust in Government, and that is the reason why the power to compromise should be taken away from the bureau.

Mr. GREGG. I do not see any evidence of influence in this case.

The CHAIRMAN. Of course, there are none so blind as those who will not see.

And when they get a reversal of the usual procedure and get a compromise before the tax is determined, which you state is unusual, and which you admit is unusual, but yet say there is nothing unusual about this case.

Mr. GREGG. No, sir; I see no objection to compromising the penalty before the tax is determined. I do not see how that jeopardizes the interests of the Government. It seems to me that this case was compromised as hundreds of other cases were compromised.

Senator JONES of New Mexico. Then, may I ask you whether there is any basis or factors considered when the question of a compromise of fraud cases comes up for consideration? What is the basis of compromise. What is the basis of the degree of the fraud?

Mr. GREGG. That is, as I say, a matter of judgment in each case.

Senator JONES of New Mexico What kind of judgment? The judgment is based upon what?

Mr. GREGG. Principally upon the degree of fraud and the ability of the taxpayer to pay. It really comes down to what we think he should pay as a fraud penalty.

The CHAIRMAN. In most cases the solicitor recommends it to the commissioner, but in this case the commissioner took the action first, and yet there is nothing unusual about the case?

Mr. GREGG. Quite likely the solicitor was present at the conference that the commissioner had. There is no doubt about that.

Senator JONES of New Mexico. What evidence is there that that is so?

The CHAIRMAN. There is nothing in the evidence of it.

Mr. NASH. I will say this, that I have never known of a conference in a tax case being held in Mr. Blair's office that either Mr. Bright or the solicitor or some expert on taxes was not present.

Senator JONES of New Mexico. Have we any evidence that there was such a conference held in Mr. Blair's office?

Senator ERNST. But there is not any evidence to the contrary in this case. Mr. Manson has been giving us the facts in this case, and he has said that he has had but little time to examine them, and we do not not know whether that was the case or not, and have we any right to assume that it was not done?

Senator JONES of New Mexico. May I state that the solicitor just told us that he assumed it was done; I have inquired the reason why. He was making the assumption.

Senator ERNST. Because that is the regular practice in the department, and he would have the right to make that assumption.

Mr. GREGG. I think Mr. Nash answered that. There have been plenty of compromise cases where the hearings have been held in the commissioner's office, and the amount there tentatively agreed upon. I have done the same thing myself. I have held conferences on compromise cases, and have tentatively agreed to an amount, and have advised the taxpayer that if he submitted an offer of that amount, I would recommend its acceptance. I did that not a week ago. I was trying to think of some case where the conference was held in the commissioner's office and the amount tentatively agreed on, and then the case sent back to the solicitor for his preparation of the formal papers of acceptance. I think that was done in some of the cases which have been taken up here before the committee. I remember that in the Slim Jim Oil Co. case a conference was held in the commissioner's office.

Mr. MANSON. In all of the cases that have come to my attention, the matter was taken up by the solicitor, and a recommendation made to the commissioner, before there was any action by the commissioner. The commissioner then acted upon it.

Mr. GREGG. That was his formal act; yes.

Mr. MANSON. The commissioner then acted upon the solicitor's recommendation, and after he had signified tentatively what he would do, then the formal offer of compromise would be made and accepted.

Mr. GREGG. You will unquestionably find in this case that a recommendation was made by the solicitor that this offer in compromise

be accepted, and its subsequent approval by the commissioner. That is done in all cases.

Mr. MANSON. Yes; but the first step in this case was the acceptance of the tentative offer, and the recommendation of the solicitor followed that.

Mr. GREGG. That is not unusual in any sense.

Senator JONES of New Mexico. Why should there have been a recommendation by the solicitor following that?

Mr. MANSON. Our contention in this matter is that after the commissioner has accepted the tentative offer in writing, as he did in this case, that all subsequent acts are mere formalities, which have no force and effect whatever.

Mr. GREGG. That is not unusual. It is the commissioner who acts in the premises. He can follow the solicitor if he wants to, but he does not have to if he does not want to. In the Slim Jim Oil case the commissioner held a conference, at which, of course, the solicitor was present, and they agreed tentatively on an amount.

Senator KING. As I understand this case, it seems to me that the procedure was peculiar, and was very unfortunate and was not for the best interests of the Government. I think it was peculiar in that they accepted the offer of compromise before they had determined the amount of the tax they should legally have paid, and which should have been legally assessed. I can not understand how they could have properly accepted an offer of compromise for fraud when they had not determined what would be the valid and proper tax. So I concur absolutely with Mr. Manson in this. I do not quite agree, however, with our chairman and Senator Jones in their view—and that is not very material, because my opinion does not determine this question—that there should be no discretion in determining fraud case, or, rather, in assessing a penalty for fraud. If you will take, for instance, all of the penal statutes you will find that there is a discretion lodged in the courts.

The CHAIRMAN. Oh, yes; but, Senator, I think where it is done in secret it is entirely different from what it is when it is done in the open. I have no objection to settling the cases in the open, but I do object to their being settled behind closed doors.

Senator KING. Let me finish what I have to say on that.

The CHAIRMAN. Yes; Senator.

Senator KING. I think there has to be a discretion lodged somewhere in the penal statutes. It is pretty hard to try a man and say that "this act is more fraudulent than the other." They are both fraudulent, and yet the law does recognize different degrees of perfidy, wrongfulness, or criminality. I have been a judge, and when I sentenced a man for wrongdoing, I inquired into his motives and the circumstances attending the alleged violation of the law, and I tried to pronounce a sentence that would be commensurate with the inherent wickedness and wilfulness and criminality of the act. You have to grade them, and, of course, you may make a mistake, and our judges, in pronouncing sentences, make many mistakes. Some sentences are absolutely irreconcilible with the facts of the case; and yet we have to lodge somewhere the discretion, legitimate discretion. However, I think where a compromise is made in a fraud case, it should be done only after the most searching investigation, and it ought to be done, as the chairman says, in the open.

These things when they are done secretly and behind closed doors are provocative of distrust in government and distrust in our tax system, and I think there should be more care than the record thus far shows in the settlement of these fraud cases.

I think the department has been a little too lenient to persons who have committed frauds in the settlement of these fraud cases, and yet I would not want to pronounce a general judgment. However, I do think that the department has been too lenient and too generous to those who have flagrantly and wilfully, as the evidence shows in many of these cases, apparently set about deliberately to cheat the Government.

Mr. GREGG. The point I wanted to bring out was that the only thing unusual in the handling of this case was the fact that the fraud penalty was compromised before the tax was finally determined, and, as I said before, I do not see anything in that to prejudice the interests of the Government. The acceptance of the compromise was in accordance with the established practice, and, as I have said, I see nothing unusual in it.

Senator JONES of New Mexico. I would like to add that I am very much impressed with the latter statement of the solicitor, that as long as you have this unlimited right to compromise fraud cases and are not required to have any basis for the compromise it depends upon the sweet will, the discretion, the tender-heartedness, or some other factor of the individual in the department dealing with it. I do not think it makes any difference whether it occurs before you assess the tax or afterwards, or when it occurs. If you are going to compromise it without any definite factors entering into the compromise, I do not see that it is material whether it is done before or after the tax is fixed, as long as you are going to settle it for a certain amount, anyhow.

Mr. GREGG. I think that is perfectly true, Senator.

Senator JONES of New Mexico. But I think it shows a weak spot in the law somewhere which will enable such things to be done lawfully that appear from the record of the hearings here to have been done on the subject of compromise.

Mr. GREGG. On the general subject I have said that I think it deserves the very careful consideration of Congress. It is something that the department worries about.

Senator JONES of New Mexico. I understand, and I want to refer to a remark that Senator King has just made for the record. I realize the force of what he has said, but he, in his statement, emphasizes the fact that extenuating circumstances were taken into consideration. We do not find anything in the records showing any extenuating circumstances in these compromise cases. No one can go to the records and find out why they were compromised for the amounts which were fixed. I think that is quite a different situation from the case presented by Senator king. I know that judges do often suspend sentences because of extenuating circumstances, and so forth; but here, apparently, these things are done without the disclosure of any extenuating circumstances. Nothing appears in the record to indicate the extenuating circumstances.

Mr. GREGG. Well, I am not sure of that. I imagine that the record shows all the facts with reference to the case.

Mr. MANSON. The only extended discussion, in which the merits of it are discussed, is contained in the recommendation of the solicitor that the penalties be imposed, and the material parts of that recommendation were read by me to the committee. If I have overlooked anything in there, of course, I want to stand corrected, but I read such portions of the solicitor's opinion as appear to me to be pertinent.

The CHAIRMAN. Even if there are extenuating circumstances, there is no evidence taken to substantiate it. Nobody is placed under oath to give evidence as to the existence of extenuating circumstances, and there is nothing in the record to show that anybody who examined it can find what the extenuating circumstances were.

Mr. MANSON. I will say this, that there is nothing in the record to indicate why the penalty was made $100,000 instead of $10,000 or $1,000,000. The amount involved in the penalty was $1,880,000—nearly $2,000,000. The settlement that was made was for approximately 6 per cent of that amount. There is nothing in the record to indicate why it was not 4 per cent or 10 per cent or 20 per cent or 50 per cent.

Mr. GREGG. Could you give any reason yourself?

Mr. MANSON. Not from that record, I could not.

Mr. GREGG. But could you, if you had handled that case, say why you selected 6 per cent or 10 per cent?

Mr. MANSON. I will say that I never heard a judge pronounce sentence in a criminal case in which he did not state his reasons for doing it.

Mr. GREGG. That is possibly true; but does he state why he gives a man five years or seven years or six years instead of any other number of years?

Mr. MANSON. I do not recall a single instance in which the judge did not state the reasons for fixing the sentence at the time that he did fix it.

Senator JONES of New Mexico. And I do not recall that a judge ever suspended sentence or failed to impose the penalty absolutely, unless he did state some extenuating circumstances.

Mr. GREGG. I want to emphasize again to the committee what I have said before, that the same thing that was done in that case is being done daily in the department. We have our very able men on penal cases, and we compromise penalties almost daily.

Senator JONES of New Mexico. In that case, should not the taxpayer have the right to select the individual who shall pass upon his compromise? In other words, is it right to have hard-boiled men in there and tender-hearted men in there and deal with one taxpayer one way and with another taxpayer another way?

Mr. GREGG. I do not think we do. They all go through the division. One man reviews every compromise that comes out of there.

Senator JONES of New Mexico. Then why do you refer to the fact that you have some hard-boiled men there?

Mr. MANSON. Mr. Cannon is the head of the penal division of the solicitor's office, and I do not think he is either tender hearted or hard boiled.

I believe he is a man that would be competent to sit on a criminal bench anywhere, and it is apparent from the record in this case that Mr. Cannon had no opportunity to use any discretion because of

the fact that the amount of the settlement had been fixed before it reached him.

Senator JONES of New Mexico. It seems to me that that is wholly immaterial, whether a man happens to get his case heard by Mr. Cannon or by Mr. Blair. I think, from what I know of Mr. Blair, if I wanted to compromise a case, I would be perfectly willing to have him pass on it, just the same as this man Cannon, whom I do not know, but, apparently, there is something wrong with the whole system there, when, without giving any definite reason therefor, and, as Mr. Gregg just said a moment ago, where he could not give a reason why these cases were compromised for a given amount, these cases are compromised; but it is a confession that, to a very material extent, it depends upon whether the man that passes upon it is tender-hearted or hard-boiled.

The CHAIRMAN. Oh yes; it rests on more than that. I think it rests on the influence back of it. It rests upon the influence of the attorney, his acquaintance and things that come from behind, that are not apparent in the record. They enter into the decision of those compromise cases more than the tender-heartedness or the hard-boiledness, or anything else there.

Senator JONES of New Mexico. Apparently, if you have a representative there who has the ability or the faculty of appealing to the tender-heartedness of the person who is considering the case, you get one sort of a compromise, but if you have a blunt plain advocate, presenting, in a cold way, the facts of the case, and the circumstances, you get a different result, depending upon the effect that you can make on the man that is dealing with the case.

Mr. GREGG. Do not court decisions——

Senator ERNST. Senator, do you think that statement is justified by the evidence?

Senator JONES of New Mexico. I certainly do, by what Mr. Gregg stated a while ago, that there is no basis at all, that it depends upon how you happen to feel about it at the time you settle the case.

Mr. GREGG. Is not the ability of the lawyer handling a case a factor in any case?

Senator JONES of New Mexico. I think so.

Mr. GREGG. We can not iron out that matter.

I will say, in answer to the chairman's question, with reference to influence, that I have been in the bureau for five years, and have been very closely connected with it, and I have never seen anything of that sort.

The CHAIRMAN. Oh, well, the records show it.

Mr. GREGG. Well, I have never seen it.

The CHAIRMAN. Take, for instance, the case of this man Rusch. The investigation of him covers dozens and dozens of sheets, which I have not been able to complete reading as yet, concerning his hearings before your Intelligence Unit and your committee on enrollment and disbarment. There is affidavit after affidavit in there. That record shows influence and instructions and the "good soldier attitude" toward specific cases.

The fact of the matter is that this investigation has been closed too soon to get the best results as to the methods existing in the bureau. I do not charge that Mr. Blair or Mr. Nash know about these things, but Mr. Nash now knows things have come up before

this committee that were never known to him before. I contend that if the records that we have gotten out of the bureau up to date had been presented to this committee before this time, they would have known much more about conditions than they now know.

Mr. Moss. Mr. Chairman, the wrongdoing, whatever it was, in the case under discussion, however, refers to Mr. Blair and no one else, and you now say that you do not charge Mr. Blair——

The Chairman. With knowing all of the conditions. I was not speaking with reference to this particular case; I say now that I do not think he knows all of these things that are going on down there, nor do I think that he knows all of the influences that come into the handling of oil and gas cases in the oil and gas section. I do not think it is humanly possible for any commissioner to know all of those things, but I do contend that it is the responsibility of the commissioner to see that those things do not exist, and he has not done his duty.

Mr. Gregg. The statement of the chairman with reference to these cases was made with specific reference to compromise cases.

Let us see just what happens to a fraud compromise. There are probably six men, at least, who consider the case at one time or another.

Senator Jones of New Mexico. What is the purpose of having six men do such a thing?

Senator Ernst. I would like to get the process, if you will permit him to state it.

Senator Jones of New Mexico. That is what I am getting at myself.

Mr. Gregg. The man in the penal division who handles a case, actively handles it, reviews it. The head of the penal division reviews it, and so does the solicitor in examining the case. He generally has one or two reviews of it.

Senator Jones of New Mexico. What do they review?

Mr. Gregg. You mean in a compromise case?

Senator Jones of New Mexico. Yes.

Mr. Gregg. To see if our judgment is in accordance with the judgment of the man who is making the recommendation. Let me go ahead. That case then goes to the commissioner and he considers it. I think Mr. Nash has adopted the policy lately of calling either me or Captain Rogers over on every compromise case that comes there before he signs it. What possibility is there of influence all along that line?

The Chairman. You do not need any influence all the way down the line, because there is only one that has the authority.

Mr. Gregg. One man has the final say, but you can not possibly avoid that.

The Chairman. Oh, no; I never said that you could avoid that, except by act of Congress.

Mr. Gregg. Coming to your point, Senator Jones, when I said I could not give reasons——

Mr. Manson. This compromise case did not take that route.

Mr. Gregg. It began with the recommendation of the man in the penal division; it went to the head of the penal division and then to the solicitor, and then to the commission.

Mr. MANSON. Yes; but that was all done after the compromise had been accepted.

Mr. GREGG. Well, if there was anything peculiar in it those men certainly would have brought it out.

Senator ERNST. Will you continue your answer to Senator Jones, Mr. Gregg?

Mr. GREGG. I wanted to bring out this point: I think you drew the wrong conclusion from my statement that I could not give the reasons for this amount of a compromise. If an offer in compromise, say, of $100,000 of a penalty of $500,000 comes through, I can not say why we set it at $100,000 instead of $110,000 or instead of $90,000, but I can say why we set it at $100,000 instead of the full penalty of $500,000. I have the evidence before me to enable me to pass on that, just as the judge has the evidence before him in pronouncing a criminal sentence. If Congress does not want us to do it, that, of course, is another question; but the point I am trying to bring out is that we are doing the best we can with what Congress has told us to do.

Senator KING. Does each one of those six men through which these applications for compromise pass make an independent investigation?

Mr. GREGG. Yes.

Senator KING. Or do they not, more in a pro forma way, take the papers that come to them?

Mr. GREGG. The extent of their investigation, of course, is determined by the importance of the case.

Senator KING. Do they have hearings?

Mr. GREGG. The head of the penal division probably sits in on a hearing with the attorney who actively handles it.

Senator KING. They do not sit en banc, the five or six of them?

Mr. GREGG. No; that is impossible.

Senator KING. I just wondered whether they did.

Senator ERNST. You do not mean to say that in making these settlements you just guess at the amount, but that you do take all the facts into consideration and then arrive at the figure which you consider to be correct and fair?

Mr. GREGG. Yes, sir. I can not say why, as Mr. Manson pointed out, it was 6 per cent in this case. I can not say why it was six instead of five or seven; but I can say, after I pass on a compromise case, why it was 6 instead of 50.

Senator JONES of New Mexico. Let us come back to what you said a moment ago, that there were a half dozen reviewers here that these cases would pass through.

Do I understand that the first man who reviews it makes a memorandum, setting out the facts as to why he believes it should be compromised at all, and why it should be the amount which he recommends?

Mr. GREGG. The man who actively handles it does; yes, sir. The man who handles the case holds the hearings. He makes a written recommendation, giving all of his reasons for his recommendations. It goes through the head of the penal division, who probably sits in at the hearing. It then goes to the solicitor and then to the commissioner.

Senator KING. Who is the man that first holds the hearings that you have just referred to?

Mr. GREGG. Well, there are about 15 men in the penal division.

(Exhibits submitted by Mr. Manson in case of J. H. Hillman & Sons Co. are as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT,
May 28, 1925.

To: Mr. L. C. Manson, General Counsel, Senate Committee Investigating Bureau of Internal Revenue.

Office Memorandum No. 19.

Taxpayer: J. H. Hillman & Sons (parent company), Hillman Transportation Co. (subsidiary), Pilgrim Coal Co. (subsidiary), Unity Supply Co. (subsidiary), and Isabella Supply Co. (subsidiary).

Subject: Compromise of fraud penalty and subsequent refund of taxes.

SYNOPSIS OF CASE

We have been compelled to make a very rapid survey of this case on account of the lack of time, but we shall attempt to develop the following points:

First, that the taxpayer has been properly assessed a fraud penalty amounting to $1,888,828.29, but that this penalty has been compromised at the very low figure of $100,000, although the assets of the taxpayer were very large. Second, that the formal offer of compromise was preceded by an informal offer in compromise tentatively approved by the commissioner which acted as instructions for the penal division. This procedure, as far as we can determine, is unique in the history of the department. Third, that the informal offer in compromise and the formal one following it were both illegal with respect to the statutes existing at that time. Fourth, that since the offer in compromise was accepted a letter of overassessment has been approved by the Income Tax Unit amounting to $487,310.83 in favor of the taxpayer, relief having been granted under section 210, revenue act of 1917 (special assessment). Fifth, that in addition to the above overassessment letter, which was for the year 1917, an overassessment of about $800,000 for 1918 is contemplated in favor of the taxpayer.

HISTORY OF CASE

In 1917 the income and excess-profit tax return of J. H. Hillman Co. was subjected to a field audit, which was concluded about August, 1918. On November 16, 1921, revised A-2 letter was sent to the taxpayer, in which an additional tax for 1917 was found, amounting to $1,172,093.10, and also a 100 per cent penalty for fraud amounting to $1,880,888.18. This amount was assessed.

The fraud feature of this case is best set out in Exhibit B, attached, which is a letter dated March 25, 1921, from the Solicitor of Internal Revenue to Acting Deputy Commissioner Matson. We shall quote briefly from this exhibit in order to set forth the nature of the fraud in this case:

"*Bonus to employees, $130,305.*—In the original return this amount was claimed as a deduction for bonuses paid to officers and employees. Investigation disclosed that this item was taken up on the books in 1918 instead of 1917, and that $30,305 was actually paid to employees on February 28, 1918, but no part of the total sum claimed as a deduction was paid in 1917. There is no evidence presented which shows that any part of this item was made available in the year under consideration.

"Taxpayer claims that $100,000 of this item was "intended" as a bonus to the three principal officers of the corporation.

"There can be only one interpretation to put on the above transaction, and that is that the deduction claimed in the original return, which was not paid or even entered on the books during the year, was false and fraudulent for the sole and specific purpose of diminishing tax liability.

"*Depreciation of stocks, $671,377.64.*—During 1917 the corporation, seeking control of certain companies engaged in business similar to its own, bought stock in the United Coal Corporation, paying therefor an amount considerably

above its par value. At the close of 1917 this stock was inventoried in block A under "Cost of goods sold," and the excess of the price paid above par was written off and consequently claimed as a deduction.

"While the charter of taxpayer gives it the right to buy and sell securities, there is a complete absence of evidence that prior to this year taxpayer ever dealt in stocks and securities as a business (and this year only buying and no sales are shown). Revenue agent reports that this company can not show any buying and selling of securities either for customers or itself. This one isolated deal in securities, in which no sale follows, clearly does not class taxpayer as a merchant of securities but brings it specifically under paragraph 459, Regulations 33, and therefore the deduction claimed as a shrinkage in the inventory value of these stocks is not only not allowable but has all the earmarks of fraud when there is no evidence indicating the belief that this taxpayer considered itself "a dealer in securities" within the purview of Treasury Decision 2609, dated December 19, 1917.

"*Inflation of invested capital, $1,573,941.*—The revenue agents state that the president, vice president, and treasurer 'loaned' the company as of December 31, 1917, stocks the aggregate value of which amounted to the above figure. Instead of the books of the taxpayer showing this amount as a liability, it was added to surplus. According to the vice president, the three individual owners intend to either have this stock returned them or have capital stock issued in payment of it. At the time of the investigation in August, 1918, neither of the above had been done.

"The agent is emphatic in his statement that the above transaction was a false and fraudulent method of increasing invested capital for the purpose of evading excess-profits tax, and believes that such manipulation would justify assertion of the 100 per cent penalty. It appears that the agent has ascribed the correct motive to taxpayer in inflating its invested capital."

RECOMMENDATION

The revenue agent in his report states "it would appear that the tactics used were to keep the tax down to a minimum by either fair or foul means." Thorough examination of the file leads to a concurrence with the finding of the agent. This corporation has flagrantly attempted to reduce its tax liability by methods which would appear difficult to explain. It is therefore recommended that the 100 per cent penalty for filing a false and fraudulent return for 1917 be assessed.

In substantiation of the above statement, we append to our report Exhibit C, which is a letter from the solicitor to Deputy Commissioner Batson dated October 18, 1921. This exhibit shows that a reconsideration of the assessment of a 100 per cent penalty for fraud for the year 1917 was made. It confirms, however, the first finding excepting a few unimportant details.

As already stated, an A-2 letter was sent to the taxpayer dated November 17, 1921, and the additional tax and fraud penalty were shortly thereafter assessed.

The taxpayer then filed a claim for abatement. This claim for abatement was rejected in a very carefully prepared memorandum to Mr. Batson signed by D. H. Blair, commissioner, and dated March 8, 1922. In this memorandum Commissioner Blair sustains the ruling of the solicitor for fraud.

Up to this point in the case the handling of the matter by the bureau seems beyond criticism. The taxpayer had been represented by Attorney Burling, whose letters and claims seemed also to have been strictly ethical. As near as we can determine, it was at about this time that Mr. Wayne Johnson, former solicitor, took active charge of the case for the taxpayer.

On March 16, 1922, the taxpayer addressed a letter to the Commissioner of Internal Revenue, making a definite offer in compromise as to the fraud penalty. As this offer was not made on the regular form, and as it refers to a formal offer to be made on the approval of this letter, we will refer to this offer of the taxpayer as an informal offer. This informal offer is tentatively approved by Commissioner Blair under date of March 17, 1922. (See Exhibit E attached.) As it is the invariable custom of the bureau to first fix the tax liability before entertaining an offer in compromise, we quote in full the following statement contained in the informal offer, which is directly contradictory to this established custom:

"It is understood in making this offer that all questions of tax liability shall remain open, to be decided by the Income Tax Unit at the same time

it disposes of questions which have not heretofore been settled by the bureau and upon which no hearings have been held. Specifically, this paragraph has reference to the question of the right of this taxpayer to inventory its securities for the purpose of ascertaining the true net income subject to tax. The questions upon which the Income Tax Unit have held no hearings are consolidation, invested capital, depletion, and perhaps other questions of lesser importance.

"The officers of the taxpayer are present in Washington to-day and are prepared to enter into a final adjustment of this matter with you, the formal offer to be made as quickly as you have decided upon the acceptability of this offer, and the other formalities connected with it to be carried out with the greatest expedition."

Respectfully yours,

J. H. HILLMAN & SONS CO.,
By J. H. HILLMAN, jr., *President.*

The foregoing tentative offer is approved.

D. H. BLAIR, *Commissioner.*

MARCH 17, 1921 (22).

On June 4, 1924, the unit having apparently fixed a new tax liability for the taxpayer, considerably over $400,000 less than the amount assessed, the solicitor advised Deputy Commissioner Bright that it was now possible to abate this amount of tax inasmuch as section 3225 of the Revised Statutes had been repealed by section 1015 of the revenue act of 1924, signed by the President on the preceding day. (See Exhibit F attached.)

At the present time there is a certificate of overassessment amounting to over $480,000 in the solicitor's office pending approval, same having been audited and reviewed in the Income Tax Unit.

Although this certificate of overassessment has not yet been approved, it is evident that the taxpayer is fully informed concerning it. In this connection see Exhibit G attached, which appears to be an agreement signed by the taxpayer stating that he agrees to the tax as determined in overassessment certificate No. 281607 in the amount of $487,310.23, as determined at a rate of 37.005 per cent, determined under the provisions of section 210 of the revenue act of 1917.

We also append Exhibit H, which is a memorandum for Mr. Charest, assistant solicitor, from the penal division. This memorandum advises the "most careful consideration" of the right of the taxpayer to relief under section 210, and also advises the careful consideration of the comparatives used in recomputing the tax liability.

DISCUSSION OF CASE

From the above history we can find nothing to criticize in this case up to March 17, 1922, which was the date on which the commissioner approved the informal offer in compromise. Up to this time the case appears to have been carefully handled, the fraud features sustained on the three most important points, and even the taxpayer's attorney appeared to have been governed by proper ethical considerations.

Our information is that Mr. Wayne Johnson took charge of the case about this time. We entirely disagree with the propriety of this tentative approval by the commissioner of the taxpayer's informal offer in compromise. We do not wish to have this statement construed as reflecting upon the intention of Commissioner Blair, but we do think at least some improper advice must have been given him at this time, which is not in the file. Our objections to the approval of such offer in compromise are as follows:

First, the tentative approval of a definite offer in compromise signed by the commissioner acted from all practical standpoints as instructions to the solicitor to compromise the case for $100,000. Second, it contains a clause which allows the compromise of the fraud penalty before the question of tax liability is determined. We have been definitely informed that this is the only case in which such a procedure has been allowed. Third, it provides for a refund of taxes at a time when such refund was contrary to section 3225 of the revised statutes.

On May 26, 1922, this informal offer in compromise was followed by the acceptance of a formal offer in compromise, which included the exact provisions provided in the informal offer. This was also approved. We believe that the acceptance of this formal offer in compromise was illegal, because

it contains the provision allowing for the refund of taxes of an additional assessment of taxes in which the element of fraud exists. It would appear to us that no officer of the Government has the right to enter into any form of agreement which contains provisions contrary to law. We again point out that with the multitude of papers requiring the signature of the commissioner, we do not wish to lay stress upon his personal action but rather on the system which permits of his receiving bad advice.

It appears from the exhibits attached that on June 4, 1924, one day after the revenue act of 1924 was signed by the President, which repealed section 3225 of the revised statutes, the solicitor approved the abatement of over $400,000 due from this taxpayer. It is evident from the exhibits, therefore, that the computation of this deduction in tax had already been made, at least in a form which permitted of a very close approximate of the exact amount.

Your engineers do not agree with the bureau in the principle in allowing the taxpayer relief in securing this overassessment by the use of section 210 of the revenue act of 1917. This section provides the right of special assessment only in case the Secretary of the Treasury is unable satisfactorily to determine the invested capital of the taxpayer. The wording of this section is entirely different from that of sections 327 and 328 of the revenue act of 1918, which give the right of special assessment in cases of abnormal conditions affecting the capital or income of the corporation. This case is being determined under the revenue act of 1917, and the invested capital of the taxpayer could be, and in fact was, determined by the unit, and we see nothing in the act of 1917 that would permit of the special assessment on the basis that the taxpayer would undergo a hardship on account of abnormal conditions. Yet in this case the taxpayer has been given relief under section 210. We believe there is nothing retroactive in sections 327 and 328 of the revenue act of 1918.

We have information that the 1918 taxes of this taxpayer have been recomputed, and that an overassessment letter amounting to about $800,000 is on its way to the solicitor. We also understand that the auditors have instructions how to audit this case and that the files contain a protest from the auditor who audited same. We are making this statement on our own responsibility, although we have had it from two sources. In any event we think that the case for 1917 is sufficiently clear evidence of the improper handling of this case.

It might also be mentioned that there is a solicitor's or appeals and review ruling in this case providing that taxpayer is not a dealer in securities in 1917, and another ruling providing that taxpayer is a dealer in securities in 1918. We believe this second ruling should be reviewed. They are both unpublished. If this second ruling was published, there should be a considerable number of taxpayers getting relief by inventorying stocks at the end of each year.

CONCLUSION

We are at a loss to account for the action of the bureau in this case from March 16, 1922, to date. It appears that special procedure has been set up which, in our opinion, is illegal. It would appear that even though three distinct points of fraud were found, this very taxpayer, guilty of these fraudulent acts, has been granted special consideration and special assessment under section 210, which we contend was not applicable. The only conclusion that we can come to to account for the above is that undue influence was used somewhere along the line in handling this case.

Respectfully submitted.

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

IN RE J. H. HILLMAN & SONS, PARENT COMPANY; HILLMAN TRANSPORTATION CO., SUBSIDIARY; PILGRIM COAL CO., SUBSIDIARY; UNITED SUPPLY CO., SUBSIDIARY; ISABELLA SUPPLY CO., SUBSIDIARY

MARCH 25, 1921.

Acting Deputy Commissioner MATSON
(Attention of Mr. Alexander, head special audit division):

By your memorandum of March 8, 1921, there was transmitted file in the case of above-named taxpayers with request for advice as to assertion of the 100 per cent penalty for filing a false and fraudulent return for 1917.

Taxpayer is a corporation organized under the laws of Pennsylvania in 1913 to take over the business of the partnership of J. H. Hillman & Sons, which was entirely owned by J. H. Hillman, jr., Ernest Hillman, and A. B. Sheets, and who are now the president, treasurer, and vice president, respectively, of the corporation. The business of the company is the buying, selling, and dealing in coal, coke, pig iron, and other materials used in the smelting or manufacture of metals and metallic products.

For 1917 the parent company, without permission from the Commissioner of Internal Revenue, filed a consolidated return and included therein the operations of the following companies: Bessemer Coke Co., Hecla Coal & Coke Co., Hillman-Neff Coke Co., United-Connellsville Coke Co., Luzerne Coal & Coke Co., Bell Vernon Coal Co., Pilgrim Coal Co., Hillman Transportation Co.

It appears that this consolidation for tax purposes found no authority under the act of regulations, and revenue agent accordingly grouped the five companies shown at the outset of this memorandum and investigated the tax liability of such consolidation for 1917. This investigation disclosed an additional tax liability for 1917 of $1,063,006.89, which was based on the following:

Bonus to employees, $130,305.—In the original return this amount was claimed as a deduction for bonuses paid to officers and employees. Investigation disclosed that this item was taken up on the books in 1918 instead of 1917, and that $30,305 was actually paid to employees on February 28, 1918, but no part of the total sum claimed as a deduction was paid in 1917. There is no evidence presented which shows that any part of this item was made available in the year under consideration.

Taxpayer claims that $100,000 of this item was "intended" as a bonus to the three principal officers of the corporation.

There can be only one interpretation to put on the above transaction and that is that the deduction claimed in the original return which was not paid, or, even entered on the books during the year, was false and fraudulent for the sole and specific purpose of diminishing tax liability.

Depreciation of stocks, $671,377.64.—During 1917 the corporation, seeking control of certain companies engaged in business similar to its own, bought stock in the United Coal Corporation, paying therefor an amount considerably above its par value. At the close of 1917 this stock was inventoried in block A under "Cost of goods sold" and the excess of the price paid above par was written off and consequently claimed as a deduction.

While the charter of taxpayer gives it the right to buy and sell securities, there is a complete absence of evidence that prior to this year taxpayer ever dealt in stocks and securities as a business (and this year only buying and no sales are shown). Revenue agent reports that this company can not show any buying and selling of securities either for customers or itself. This one isolated deal in securities, in which no sale follows, clearly does not class taxpayer as a merchant of securities, but brings it specifically under paragraph 459, regulations 33, and therefore the deduction claimed as a shrinkage in the inventory value of these stocks is not only not allowable but has all the earmarks of fraud when there is no evidence indicating the belief that this taxpayer considered itself "a dealer in securities" within the purview of Treasury Decision 2600, dated December 19, 1917.

Unexplained expenses, $14,325.—Taxpayer claimed that this amount was paid to secure good car service. As he refused to divulge to whom this amount was paid and intimated that such payment was in the nature of bribes, the revenue agent disallowed same. This item does not necessarily indicate fraud, but it is believed that it was properly disallowed.

Commissions received but unreported, $36,821.32.—Revenue agent's report does not clearly explain these commissions, nor is there explanation by taxpayer of the noninclusion of this item in its original return.

Inflation of invested capital, $1,573,941.—The revenue agents state that the president, vice president, and treasurer "loaned" the company as of December 31, 1916, stocks the aggregate value of which amounted to the above figure. Instead of the books of the taxpayer showing this amount as a liability, it was added to the surplus. According to the vice president, the three individual owners intend to either have this stock returned to them or have capital stock issued in payment of it. At the time of the investigation in August, 1918, neither of the above had been done.

The agent is emphatic in his statement that the above transaction was a false and fraudulent method of increasing invested capital for the purpose of evading excess-profits tax and believes that such manipulation would justify assertion

of the 100 per cent penalty. It appears that the agent has ascribed the correct motive to taxpayer in inflating its invested capital.

Contracts and agreements, $336,224.05.—This amount represents contracts, agreements, etc., acquired with stock and is treated by the office audit as an amount paid for good will. All of the above contracts, agreements, etc., is included by taxpayer in his computation of invested capital. Particular attention is directed to the fact that $320,000 of these contracts and agreements were reported by the corporation on the balance sheet submitted with its original 1917 returns as accounts receivable.

RECOMMENDATION

The revenue agent in his report states "it would appear that the tactics used were to keep the tax down to a minimum by either fair or foul means." Thorough examination of the file leads to a concurrence with the finding of the agent. This corporation has flagrantly attempted to reduce its tax liability by methods which would appear difficult to explain. It is therefore recommended that the 100 per cent penalty for filing a false and fraudulent return for 1917 be assessed.

Your entire file is being returned without contemplation of criminal proceedings.

CARL A. MAPES,
Solicitor of Internal Revenue.

EXHIBIT C

IN RE J. H. HILLMAN & SONS, PARENT COMPANY; HILLMAN TRANSPORTATION CO., SUBSIDIARY; PILGRIM COAL CO., SUBSIDIARY; UNITY SUPPLY CO. SUBSIDIARY; ISABELLA SUPPLY CO., SUBSIDIARY

OCTOBER 18, 1921.

Deputy Commissioner BATSON
(Attention Mr. S. Alexander, head special audit division.)

Reconsideration of assessment of the 100 per cent penalty for filing a false and fraudulent return for 1917.—Under date of March 25, 1921, the solicitor forwarded a memorandum to the Income Tax Unit and recommended the assessment of additional taxes and the 100 per cent penalty for filing a false and fraudulent income and excess-profits tax return for 1917.

Upon taxpayer's request for a bill of particulars setting forth the items on which fraud was predicated, he was furnished with same and a hearing granted before Mr. Angevine, assistant solicitor in charge of the penal division, on May 27, 1921.

Representing taxpayer.—J. H. Hillman, president of J. H. Hillman & Sons Co.; A. B. Sheets, vice president and treasurer of J. H. Hillman & Sons Co.; Messrs. Covington and Burling, attorneys at law, Washington, D. C.; Messrs. Watson and Smith, attorneys at law, Pittsburgh; Ernest Crowther, of Crowther & Shepard, certified public accountants, Pittsburgh; S. H. Boyd, of the Federal Tax Service Corporation, Washington, D. C.

Representing the Government.—Fred R. Angevine and Mills Kitchin, of the solicitor's office; W. H. Robinson, Income Tax Unit.

The different items on which fraud was predicated were each made the subject of a separate brief by taxpayer's counsel, and will be treated here in that order.

$30,305 bonus to employees.—Taxpayer, at the hearing and in his brief, contends that this entire amount represents an accrued expense for the year 1917. The corporate records do not substantiate this contention. The only record made of this transaction was a resolution by the board of directors at a meeting on December 22, 1917, which authorized the payment of a bonus to the employees of the company in an amount not to exceed a total of $30,305. This amount was not charged to operating expense, however, during 1917, but was charged off and distributed on February 28, 1918. A portion of this bonus was paid in stock of a subsidiary but retained by the company in trust for the payee until January 1, 1920, with the following proviso: "If you remain continuously in the employ of the company during the intervening period and render services satisfactory to the company." Thus, it appears that that portion of the bonus paid the employees in stock remained in the custody and control of the taxpayer until January 1, 1920, and then title would not pass unless the payee had (1) remained continuously in the employ of the company.

and (2) had rendered satisfactory services. It then follows that the stock portion of the bonus did not constitute an expense chargeable to operations for 1917 but merely attached a contingent liability to the company, which was clothed with the arbitrary power of wiping out its liability at or before the end of the "intervening" period if the employee's services were either discontinued or unsatisfactory.

$100,000 bonus to officers.—This item, which is urged by the taxpayer as a deductible expense for 1917, represents additional compensation for extraordinary services to the corporation performed in 1917 by three officers who owned over 80 per cent of the entire stock. The allowance of this deduction is urged because (1) the amount is moderate when the value to the corporation of these officers' services are considered. (2) The bonus was not a subterfuge for the payment of dividends. (3) It (the bonus) was "actually approved by the directors" in 1917, and was "actually credited to bonus account in the year 1917." The first two contentions are admitted. The third contention, if admitted, does not justify the deduction for the following reasons: (*a*) There was no resolution passed by the board of directors during 1917 authorizing the payment of $100,000 to officers of the corporation although an entry was made as of December 31, 1917, charging undivided profits with this amount. This was a bookkeeping transaction, pure and simple, and subject to nullification at the will of the directors. No actual or legal liability accrued thereby. (*b*) The charge to undivided profits was credited to bonus account December 31, 1917, and the latter account not charged with the $100,000 until December 31, 1918, when this amount was credited to and made available to the three officers of the corporation, and up until March 13, 1920, at least, one of the officers alleged to have received $33,333.33 of this bonus had not returned this amount in his individual return. (See letter of A. B. Sheets to the commissioner dated March 13, 1920.)

Notwithstanding the above, which is admitted by the taxpayer, it is vigorously contended that (1) at the time of the resolutions of the board of directors on December 22, 1917, authorizing a bonus for the employees of an amount not to exceed $30,305, it was also informally "agreed" and "authorized" by the directors that the three officers were entitled to added compensation of the aggregate amount of $100,000; (2) that a formal resolution effecting such an agreement was deferred pending the approval of such action by the minority stockholders; (3) that such approval was not obtained until the summer of 1918.

Admitting the foregoing contentions of taxpayer as absolutely accurate, the conclusion is then inescapable that for 1917 (1) the $100,000 was not an accrued liability of collectible character, but a creature of bookkeeping and subject to revocation by the same authority which caused its entry; (2) no part of this bonus being available or even credited to the account of either of the three officers, it was nothing more than a contingency of remote realization.

Recommendation.—Only that portion of the $130,305 bonus as was actually distributed to the employees in cash should be allowed as an expense for 1917; and the original recommendation of this office is amended accordingly.

Depreciation of stock, $650,377.64.—This amount represents the difference between the purchase price of United Coal Co. stock in 1917 and the market value at the close of the taxable year. The stock was not sold but inventoried at the end of the year and the loss written off.

A voluminous amount of data was submitted by taxpayer to substantiate his claim as a dealer or merchant of securities within the purview of T. D. 2609. Subsequent to the hearing taxpayer was invited to submit additional evidence supporting his qualifications as a dealer in securities. An examination of gross income for 1917 and purchases and sales of securities as presented by taxpayer for both 1916 and 1917 revealed the following:

1917 gross income

Coke sales	$12,522,655.28
Coal sales	8,110,719.36
Commission on pig-iron sales	557.00
Profit on sale of West Pennsylvania Coke Co. stock	25,000.00
Commission on sale of coal land	8,400.00
Profit on sale of real estate	9,460.86
Total	20,676,792.50

The foregoing analysis of the corporation's gross income for this year indicates that profits or commissions received from the purchase and sale of securities constituted an almost negligible percentage of its aggregate gross income.

1916 purchases and sales of securities.—The corporation claimed to have purchased $2,095,861 in securities for this year: $1,573,941 of this amount represents the value of securities loaned to the company in 1918 as of December 31, 1916, by the three officers of the company who owned over 80 per cent of the capital stock. This amount was so loaned in an attempt to increase the invested capital for the taxable year 1917. These securities were later returned by the corporation to its owners. The balance of its purchases ($321,920) and sales of $457,526 resulted in not a dollar's gain or loss to the company, but represents mainly the reorganization, merger, or attempted control of companies dealing in coal and coke for investment. The correctness of this conclusion is substantiated by the fact that no income was reported from profits or commissions received on these transactions.

1917 purchases and sales of securities.—What was true of the 1916 dealing in securities is also true for 1917 with one exception, when taxpayer sold 250 shares of West Pennsylvania Coke Co. stock for $200 a share it had bought several years before at $100 per share. Analysis of its alleged purchases of $4,441,260 and sales of $2,209,979.84 resulted in—with the exception above noted—not a dollar of gain or loss to the company. Nor was any gain or loss reflected in its return other than the one transaction mentioned above and the depreciation of United Coal Co.'s stock written down to market value in its closing inventory.

Recommendation.—From the above it is concluded that the evidence submitted by taxpayer represents the reorganization and merger of subsidiaries, which it then controlled or sought to control for purposes of investment. The facts submitted, therefore, do not bring this taxpayer within the purview of that part of T. D. 2909 which permits the inventorying of securities. And since it has not qualified as a dealer or merchant of securities, as a dealer or merchant is defined by T. D. 2649, it can not claim any advantages under T. D. 2909. The deduction, therefore, of $650,377.64 taken as a loss in its closing inventory for 1917 is denied.

Unreported commissions of $36,821.32.—Omission of the above item from the 1917 return is explained by taxpayer as follows: The company obtained an option on a tract of coal land at a price of $130 per acre. It then promoted the organization of the Lincoln Gas Coal Co., and this land was sold to the latter company at $175 an acre. The difference between the purchase and sales price was the above item of $36,821.32. It is vigorously contended that the consummation of this sale was contingent upon taxpayer's agreeing to take 20 per cent of the stock and its (taxpayer) pro rata share of the bonds of the vendee company. That under this agreement taxpayer purchased at par $143,000 of 5 per cent bonds; that these bonds were worth considerably less than par; that it did not consider that there was, in fact, any commission paid on the transaction, but considered the entire transaction a promotion whereby taxpayer paid $14,895 in cash and an option on coal land for securities.

The examining officer treated the foregoing as two separate and distinct transactions whereby taxpayer (1) made a net profit of $36,821.32 on the coal land options and (2) then invested in stocks and bonds of the vendee company.

Recommendation.—The evidence submitted by taxpayer in substantiation of its claim that the sale of the coal-land option could not have been effected unless the vendor company agreed to buy a certain percentage of the stocks and bonds of the vendee company is convincing that the sale of the option and the purchase of stocks and bonds were each the component parts of a single transaction. It is therefore concluded that the taxable profit arising from this transaction was the difference between the sum of $14,895 plus the purchase price of the coal-land option and the fair market value of the stocks and bonds of the vendee company issued to the vendor corporation. The original recommendation of this office respecting this item is therefore amended in accordance with the above.

Amounts paid to undisclosed persons, $14,325.—The evidence submitted at the hearing and in taxpayer's brief sets out the names of individuals and the amounts each received of this item. It further shows that this expenditure was a necessary expense in obtaining and moving coal sold by the company.

Recommendation.—In the light of the above, this item is held to have been a necessary business expense and deductible as such in computing net income. The original recommendation respecting this item is therefore revoked and the deduction of $14,325 allowed.

Inflation of invested capital, $489,697.23.—This item represents an increase in invested capital which was the difference between $1,573,941 of stock owned by three officers of the company and $1,084,243.77 in line 8, Schedule C, Form 1103. The foregoing item of $1,573,941 was entered on the company's books as of December 31, 1916, as paid in surplus.

The contentions of taxpayer respecting the above are as follows: That during 1916 and 1917, J. H. Hillman, jr., H. B. Sheets, and Ernest Hillman, who owned over 80 per cent of the stock of taxpayer, were also the owners of shares of stock having a value of $1,573,941; that the interest of the partnership became intermingled with that of the corporation and the ownership status of the stock was uncertain and confused during the spring of 1918 when the income and excess-profits tax return was being prepared for 1917; that advice of its attorney was sought as to the treatment of these shares in its return for 1917 and its legal effect therein; that the attorney, after consideration of the facts, advised that the transaction could be construed one of three ways, to wit: (*a*) As a purchase of the shares by the corporation directly from the former owners; (*b*) as a loan of the shares to the corporation by the three individuals; (*c*) as a payment of the shares over to the corporation at a total valuation of $1,573,941 on the understanding that the corporation would subsequently issue its own shares in payment therefor. The attorney then advised that the third interpretation above was the one taxpayer should follow; and in accordance therewith entries were made on the books as of December 31, 1916, by which $1,573,941 was added to paid-in surplus.

It is further very vigorously contended that of the three constructions to which these shares were susceptible, the company employed the one which resulted in a tax greater than would have resulted had either of the rejected constructions been followed.

Discussion.—The taxpayer erroneously takes the position that (1) in making up its return for 1917, these shares were necessarily included in its return; and (2) that in so including them they were accorded the treatment which resulted in the most favorable result to the Government. The individuals who owned these shares were separate and distinct entities from the corporation. No record ever appeared on the books of the corporation before or during the taxable year intimating the slightest vestige of ownership in these shares by the corporation; and why in 1918 the corporation felt the necessity of including these shares of stock which belonged to three of its individual stockholders in its balance sheets, is difficult to understand. And the belief that the corporation never intended to own these shares is confirmed by its subsequent action in "returning" them to the owners.

Disposition of the first contention obviates the necessity for discussion of the second contention, which amounts to no more than a comparison of the results of three erroneous and unnecessary constructions of stock which the corporation never had any right, title, or interest in.

Fraud.—Thorough examination of all the evidence submitted by taxpayer respecting the items on which the fraud penalty was predicated has not convinced this office that it should recede from its recommendation of March 25, 1921. Taxpayer's claim for abatement of the fraud penalty is, therefore, rejected.

Your file is being returned.

Solicitor of Internal Revenue.

EXHIBIT D

MARCH 8, 1922.

Memorandum for Mr. Batson in re J. H. Hillman & Sons Co.

The 1917 income and excess profits tax return of J. H. Hillman & Sons Co. was subjected to a field audit which was concluded about August 15, 1918. On or about May 2, 1921, the taxpayer received an A–2 letter assessing additional taxes for the years 1913, 1914, 1915, 1916, and 1917, and a 100 per cent penalty in the amount of $1,906,709.19 for the year 1917, making a total of additional taxes and penalty due of $3,104,886.88.

Upon receipt of the A–2 letter the taxpayer appeared by counsel and after a hearing, a second A–2 letter was sent to the taxpayer, dated November 16, 1921, in which the additional tax for 1917 was reduced $1,172,093.10 and the 100 per cent penalty (based upon the total tax found to be legally due) to

$1,880,838.18, making a total additional tax for the years 1913 to 1917, inclusive, with penalty for 1917 amounting to $3,053,125.07. This amount has been assessed. The taxpayer has paid $210,299.72 of it and has protested the balance and filed a claim for abatement thereof.

The charge of fraud in connection with the 1917 return is predicated upon the three following grounds:

(1) Deduction claimed by the taxpayer on account of a bonus paid to the president, vice president, and treasurer by the taxpayer.

(2) Deduction claimed on write down of inventory of securities.

(3) Taxpayer's inclusion in invested capital of securities purchased by officers of the taxpayer for the benefit of the taxpayer and afterwards delivered to the taxpayer denominated "Contributed capital" on the return.

$100,000 BONUS TO OFFICERS

The facts with regard to the bonuses paid to J. H. Hillman, jr., president of the company, A. B. Sheets, vice president of the company, and Ernest Hillman, treasurer of the company, are as follows:

The bonus amounted to $100,000 and was divided equally among the three individuals; that is, $33,333.33 to each. The salaries of these officials were $12,000 a year each. The facts regarding the payment of this bonus were not set forth on the return or on any paper accompanying it. There was no resolution passed by the board of directors during the year 1917 authorizing the payment of the bonus. An entry was made on the books of account of the taxpayer as of December 31, 1917, charging undivided profits with the bonus. The bonus account was not charged with the $100,000 until December 31, 1918, when this amount was credited to and made available to the three officers of the corporation. Up until March 13, 1920, at least one of the officers alleged to have received $33,333.33 of this bonus had not returned this amount in his individual return.

At the time of the resolution of the board of directors on December 22, 1917, authorizing a bonus for the employees of an amount not to exceed $30,305, it was also informally "agreed" and "authorized" by the directors that the three officers were entitled to added compensation of the aggregate amount of $100,000. The formal resolution effecting such an agreement was deferred pending the approval of such action by the majority of the stockholders. Such approval was not obtained until the summer or fall of 1918.

INVENTORY OF SECURITIES

In the taxpayer's return for 1916 stocks and bonds were not included in the inventories in determining the gross profits on sales. No claim was made at the time the return for 1916 was prepared that the taxpayer was a dealer in securities. Upon its return it states its business as dealing in "Coal, coke, iron, and steel." It its 1917 return purchases and sales of securities were reported under the caption of "merchandise" and were thus merged with its regular purchases and sales of coal, coke, etc.

Its closing inventory for 1916 was reported as $5,875.37 (coal and coke only), but its opening inventory for 1917 (as shown by its 1917 return) was $2,438,630.21, and its closing inventory on December 31, 1917, was $4,039,389.54, which amount was obtained by deducting from the cost of securities carried in the inventory, $650,377.64, which represented the amount of depreciation in the value of the shares of the stock of the United Coal Corporation. This stock was acquired by the taxpayer at a price of approximately $75 per share. The purchase was made in July, 1917. It was expected that the price of the stock would go to even higher levels, but within four weeks after the stock had been purchased the President of the United States fixed the price of coal at $2 per ton, whereas it had been selling in the open market at $5 and $6 a ton, thereby causing a disastrous and precipitous slump in the price of coal stocks. The price of the United Coal Corporation's stock on the Pittsburgh Stock Exchange went down to $30 per share, at which price it continued until after December 31, 1917.

The partnership of J. H. Hillman & Sons Co. wrote their letters on a letterhead showing the different divisions of their business. Under "Investment department" were shown the words "Coal lands, coal mines, coal plants, ore lands, stocks and bonds, coal and coke companies." This same letterhead was used by J. H. Hillman & Sons Co. after its incorporation until that supply

of letterheads was exhausted. The letterhead which was afterwards used contained the following description of the company's business: "Gas coals, steam coal, by-product coking coal, coal securities."

In order to bring more directly to the notice of the members of the Pittsburgh Stock Exchange and for the purpose of securing the interchange of business with those members, the corporation decided in 1918 to qualify itself to do business on the Pittsburgh Stock Exchange by purchasing a seat upon it. This seat was taken in the name of J. H. Hillman, jr. Payment therefor was made by the company's check, and all subsequent expenses, dues, and assessments of the membership were paid by the company. Mr. Hillman was elected a member of the exchange on December 17, 1918.

The company has submitted numerous letters from bankers and stock-brokerage concerns certifying to the fact that the taxpayer is an extensive dealer in coal and coke securities and has been for a number of years.

During the year 1917 the company had only one transaction in dealing in securities which resulted in a profit or loss. It sold 250 shares of stock at a profit of $25,000. The only other transactions which it had in stocks and bonds consisted of a number of purchases of stocks and bonds and the sale or exchange of stocks and bonds at cost. The company habitually purchases many shares of stock and bonds and usually exchanges them for properties. These exchanges result in no income to the corporation so far as its books of account show.

For 1918 and subsequent years the dealings in securities by the taxpayer were on a much greater scale than during the year 1917.

INFLATION OF INVESTED CAPITAL $489,697.23

This item represents an increase in invested capital which was a result of including in the invested capital $1,573,941 of stock owned by the three officers of the company and the deduction therefrom of $1,084,243.77 in line 8, Schedule C, of Form 1103.

The contentions of the taxpayer regarding the above are as follows:

That during 1917 and 1918 J. H. Hillman, jr., A. F. Sheets, and Ernest Hillman, who owned over 80 per cent of the stock of the taxpayer, were also owners of shares of stock having a value of $1,573,941; that the interests of the partnership composed of the three above-mentioned officers became intermingled with that of the corporation and the ownership status of the stock was uncertain and confused during the spring of 1918, when the income and excess-profits tax return was being prepared for 1918; that advice of its attorney was sought as to the treatment of these shares in the return for 1917 and its legal effect therein; that the attorney, after consideration of the facts, advised that the transaction could be viewed in one of three ways, to wit:

(*a*) As a purchase of the shares by the corporation directly from the former owners.

(*b*) As a loan of the shares to the corporation by the three individuals.

(*c*) As a payment of the shares over to the corporation at a total valuation of $1,573,941 on the understanding that the corporation would subsequently issue its own shares in payment therefor.

The attorney then advised that the third interpretation above was the one that the taxpayer should follow, and in accordance therewith entries were made on the books as of December 31, 1916, by which $1,573,941 was added to paid-in surplus.

The cost of the $1,573,941 of loaned securities was less than the last stated amount by $168,275, which represented appreciation in value of the securities. The partnership owned a small part of the loaned securities prior to October, 1916. In October it acquired a portion of the contributed securities, and in December the officers of the company had an opportunity to buy large blocks of the stock of the Hecla Coal & Coke Co. and of the United Coal Corporation at a cost of approximately $650,000. At that time they discussed how the purchase should be financed and how it should be carried. They discussed whether it would not be better to enlarge the partnership operations, but it was finally decided that all shares termed "loaned securities" should be turned over to the corporation. The corporation was not financially able, however, to purchase all the shares. The shares were all purchased in the name of J. H. Hillman, jr. The money therefor was obtained from four different sources. A large part of it was loaned to Mr. Hillman by the corporation upon his personal note, which bore interest. No entries were made on the books at the time, and no formal

agreement was entered into, the reason being partly that the partnership desired to keep the transaction secret until it should be able to acquire such additional stock as would give it the controlling interest in the Hecla Coal & Coke Co., partly because they were very busy and partly because it was a close corporation and partly because they had not at that time clearly made up their minds as to the exact form the transaction ultimately would take.

All the loaned securities were shares of stock.

The dividends received upon the loaned securities during the year 1917 went partly to the corporation and partly to the partnership, the exact amounts being $25,880 to the corporation and $9,192 to the partnership.

Apparently in the latter part of 1917 all thought of increasing the capital stock of the company for the purpose of purchasing the securities which had been contributed to it was abandoned (p. 29 of brief of January, 1922) $934,750 of the contributed securities were purchased by the corporation for cash. The rest of the securities were returned to the individuals who had contributed them, the amount thereof being $639,191. The interest which Mr. J. H. Hillman, jr., owed to the corporation in respect of moneys which had been advanced to him for the purchase of the securities, and amounting to $22,399.20, was deducted from the dividends which had accrued upon them during the year 1917. This interest should have been included in the gross income of the corporation for 1917 and would then have been subject to excess-profits tax. It was not so included.

It is uncertain just when the securities were returned to the partnership. In March, 1918, a journal entry was made bringing the contributed securities on the books of the corporation as of December 31, 1916. The legend with respect to the transaction is "to be paid for in stock of J. H. H. & S. Co. when issued."

Apparently the securities were returned to the individuals by journal entry dated January 1, 1918, but made at a later date.

The net effect of including the loaned securities as invested capital was to increase the invested capital of the corporation approximately $500,000 and to reduce the tax to the amount of between $50,000 and $60,000.

ARGUMENT

The fact that there was no formal action by the board of directors in 1917 with respect to the payment of this bonus and the further fact that the board of directors did not feel free to credit this bonus to the stockholders until after they had had the consent of the majority of the stockholders, which consent was not obtained until late in the year 1918, clearly indicates that the company is not entitled to deduct the $100,000 bonus paid in 1918 from the gross income for 1917. The company was not entitled to deduct this bonus from its gross income in its return for 1917.

With respect to the inventory of securities it is to be noted that the return for 1917 was made under the provisions of the revenue act of 1917 as construed by regulations 33. Article 148 of regulations 33 reads as follows:

"A corporation possessing securities such as stocks and bonds can not allowably deduct from gross income any amount claimed as a loss on account of the shrinkage in value of such securities through fluctuations of the market or otherwise; the only loss to be allowed in such cases is that actually suffered when the securities mature or are disposed of.

"In the case of banks or other corporations which are subject to supervision by State or Federal authorities, and which, in obedience to the orders of such supervisory officers, charge off as losses amounts representing an alleged shrinkage in the value of property, real, personal, or mixed, the amounts so charged off do not constitute allowable deductions. Deductible losses are those only which are determined upon the basis of a closed or complete transaction. (T. D. 2005, 2130, 2152.) The foregoing applies only to owners and investors and not dealers in securities, as to which see T. D. 2609."

The above article makes specific reference to T. D. 2609, which was promulgated on December 19, 1917, and which reads as follows:

"(1) For the purposes of income and excess-profits tax returns, inventories of merchandise, etc., and of securities will be subject to the following rules:

"A. Inventories of supplies, raw materials, work in process of production, and unsold merchandise must be taken either (*a*) at cost or (*b*) at cost or market price, whichever is lower, provided that the method adopted must be adhered to in subsequent years, unless another be authorized by the Commissioner of Internal Revenue.

"B. A dealer in securities who, in his books of account, regularly inventories unsold securities on hand either (*a*) at cost or (*b*) at cost or market price, whichever is lower, may, for purposes of income and excess-profits taxes, make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the Commissioner of Internal Revenue.

"C. Gain or loss resulting from the sale or disposition of assets inventoried as above must be computed as the difference between the inventory value and the price or value at which sold or disposed of.

"(2) In all other cases inventories must be taken at cost or at value as of March 1, 1913, as the case may be."

On January 30, 1918, and before the taxpayer in question had made its return, the following T. D., to wit, 2649, was promulgated:

"T. D. 2609, issued under date of December 19, 1917, authorizes dealers in merchandise and dealers in securities to make their income-tax and excess-profits tax returns upon the basis of inventories taken 'at cost or at market price, whichever is lower.'

"The legality of this authorization having been questioned, the matter was referred to the Attorney General, who advises that the general principle at issue is involved in cases pending in the Supreme Court of the United States and that an early decision may be reasonably expected. Pending this decision, returns made upon the basis of T. D. 2609 will be tentatively accepted.

"If the ruling of the Attorney General should be adverse to the principle enunciated in the Treasury decision referred to, dealers in merchandise or in securities who shall have made returns on the basis of inventories taken at a value other than cost will be required to make amended returns upon the basis of inventories taken at cost. In making their return in the first instance for the taxable year 1917 dealers in merchandise or in securities will be required to indorse upon or attach to such returns a statement specifying the basis upon which the inventories were taken, whether at cost or market price.

"For the purposes of T. D. 2609 and this decision, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business and whose principal business is the purchase of securities and their resale to customers; that is, one who, as a merchant, buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, officers of corporations, or members of partnerships who in their individual capacities buy and sell securities are not 'dealers in securities' within the meaning and purpose of T. D. 2609 or this decision, and in all such latter cases inventories, if taken, must be taken at cost and the gain or loss will be determined and taken into account as the securities are sold and the transactions closed."

In T. D. 2649 a dealer in securities is defined. The significant language is "a dealer in securities is a merchant of securities * * * with an established place of business and whose principal business is the purchase of securities and their resale to customers; that is, one who, as a merchant, buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."

The taxpayer was not a dealer in securities within the meaning of the regulations prescribed under the revenue act of 1917. It must be held, therefore, that the taxpayer is not entitled to deduct from its gross income the shrinkage in the value of the securities which it held.

The action taken by the taxpayer with respect to the third item is far more questionable than that taken by him with respect to items 1 and 2. The title in the securities was apparently never beneficial in the corporation. It apparently was never the intention of the actual owners of the securities to contribute these securities to the capital of the corporation. The action of the taxpayer with respect to the securities argues against such proposition. The securities which were not actually purchased by the corporation had actually been turned back to the owners prior to the date that the return for 1917 was made up. The entries made by the corporation with respect to these securities were unnecessary.

There is no material evidence before this office which was not before the solicitor at the time he ruled that the return which was filed by the corporation

for 1917 was false or fraudulent. The claim for the abatement of the 100 per cent penalty should be rejected.

D. H. BLAIR, *Commissioner.*

EXHIBIT E

WASHINGTON, D. C.,
March 16, 1922.

THE COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

SIR: The undersigned, the J. H. Hillman & Sons Co., filed with you on February 24, 1922, a memorandum in connection with the matter of the ad valorem penalties assessed against it under section 16 of the revenue act of 1917, amending section 3176, R. S., on its 1917 income and excess profits tax return. At that time the taxpayer had a number of extremely important and pressing business matters pending which could not be disposed of until the penalties assessed against it had been acted upon by you. Since that time these matters have become of the most extreme urgency, and this letter is to make definite and to enlarge the suggestions made in the latter part of the said memorandum of February 24 concerning the compromise of the penalties.

The suggestion of compromise contained in the memorandum of February 24 was based upon the proposition that the true basis of compromise should be the admitted additional tax liability. Therefore, the taxpayer suggested that 10 per cent of the amount which it had tentatively paid under the A-2 letter should be acceptable. On that basis the offer of compromise would have amounted to a little over $21,000. After conference and further consideration and consultation, it is thought that the amount offered in compromise of the penalties should not be based upon either the admitted tentative additional tax liability of the taxpayer or the full amount claimed by the Bureau of Internal Revenue, but that a flat amount not based upon either sum would be more acceptable.

In view of the foregoing, the following offer is made:

J. H. Hillman & Sons Co., a corporation organized and existing under the laws of Pennsylvania, hereby offers in compromise of all penalties assessed against it on its return for the year 1917 and for all other penalties, civil and penal, for said year the sum of $100,000.

This taxpayer will at the same time that it pays the said sum of $100,000 in compromise of penalties also pay to the collector of internal revenue at Pittsburgh, Pa., the further sum of $250,000 on account of taxes claimed to be due by the Bureau of Internal Revenue, and heretofore assessed against it for the year 1917 but not admitted by this taxpayer: *Provided, however*, That should the final determination of tax liability result in no additional taxes being due from this taxpayer or that additional taxes in an amount less than $250,000 shall be found due from this taxpayer, then the Commissioner of Internal Revenue will refund to this taxpayer the said sum of $250,000 in full or any part thereof not found to be due upon such final determination.

It is further understood that should the Commissioner of Internal Revenue, upon such final determination of tax liability, find that an amount in excess of $250,000 is due from this taxpayer, then and in that event such amount in excess of $250,000 will be promptly paid by this taxpayer.

This offer is made without admission on the part of J. H. Hillman & Sons Co. of any delinquency of any kind whatsoever and without prejudice in any manner to its rights in the premises.

It is understood in making this offer that all questions of tax liability shall remain open, to be decided by the Income Tax Unit at the same time it disposes of questions which have not heretofore been settled by the bureau, and upon which no hearings have been held. Specifically this paragraph has reference to the question of the right of this taxpayer to inventory its securities for the purpose of ascertaining the true net income subject to tax. The questions upon which the Income Tax Unit have held no hearings are: Consolidation, invested capital, depletion, and perhaps other questions of lesser importance.

The officers of the taxpayer are present in Washington to-day and are prepared to enter into a final adjustment of this matter with you, the formal offer to be made as quickly as you have decided upon the acceptability of this offer,

and the other formalities connected with it to be carried out with the greatest expedition.

Respectfully yours,

J. H. HILLMAN & SONS CO.,
By J. H. HILLMAN, JR., *President.*

The foregoing tentative offer is approved.

D. H. BLAIR, *Commissioner.*

MARCH 17, 1921 (22).

EXHIBIT F

JUNE 4, 1924.

IN RE J. H. HILLMAN & SONS CO., PITTSBURGH, PA.

DEPUTY COMMISSIONER BRIGHT
(For special adjustment section):

Reference is made to your memorandum of the 23d ultimo, IT:E:Aj:RBC-1319, concerning the tax liability of J. H. Hillman & Sons Co., of Pittsburgh, Pa.

You state that additional taxes against the company amounting to $1,172,093.18 were assessed for the year 1917 and fraud penalties for the same year amounting to $1,880,828.29 were also assessed at the same time. You state that a recomputation of the corporation's tax liability under section 210 shows that the additional tax liability is $730,485.22 instead of the amount that was assessed, namely, $1,172,093.18. In view of the provisions of section 3225 of the Revised Statutes, you ask whether the commissioner may abate the difference between the two amounts. You are advised that in lieu of the assessed penalty of $1,880,828.29, $100,000 has been accepted as an offer in compromise. This acceptance took place May 26, 1922. Attached is a copy of the letter of acceptance. Of course, therefore, the difference between the assessed penalty and the amount compromised should be abated. This offer in compromise of the penalties was made and accepted with the distanct understanding and stipulation that all questions of tax liability shall remain open for final determination by the bureau.

So long as section 3225 of the Revised Statutes was in effect, there was no authority for abating any part of the tax liability, since there was fraud in the case and since the additional assessment was a second assessment within the meaning of said section. Section 3225 of the Revised Statutes was repealed by section 1015 of the revenue act of 1924, signed by the President yesterday. There is, therefore, now no legal objection to abating any part of the assessed tax which the bureau determines was improperly assessed.

The complete file submitted with your memorandum of the 23d ultimo is returned herewith.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT G

SEPTEMBER 23, 1924.

In re J. H. Hillman & Sons Co. (and related companies), Pittsburgh, Pa.

AGREEMENT

The undersigned taxpayer hereby consents and agrees to the adjustment of its income and profits tax liability for the year 1917 upon the basis of a certificate of overassessment No. 281607 in the amount of $487,310.23. The tax for 1917 as determined in this certificate is $1,392,496.24 based upon a net income of $3,411,197.08, an invested capital of $1,349,560.43 and a rate of tax of 37.005 per cent determined under the provisions of section 210 of the revenue act of 1917.

The taxpayer further consents and agrees that it will not at any future time contest the said net income of $3,411,197.08; invested capital of $1,349,560.43; or the rate of tax of 37.0057 per cent determined under the provisions of sec-

tion 210 of the revenue act of 1917; nor will it at any future date attempt to reopen the case by appeal, claim, petition for reopening, or in any other manner.

J. H. HILLMAN & SONS CO.,
By THOS. WATSON,
Secretary and Attorney.

EXHIBIT H

Memorandum for Mr. Charest, assistant solicitor, in re J. H. Hillman & Sons Co., Pittsburgh, Pa.

The above case was transmitted to the penal division by your memorandum of March 9, 1925, as follows:

"Please note the memorandum of Mr. Riggles, of this division, with respect to the attached file and let me have your advice in the premises."

The memorandum of Mr. Riggles, to which you refer, suggested that the case be referred to this division for consideration of the compromise settlement effected in this case on May 26, 1922, with particular reference to the question whether or not the taxpayer's right to a refund at this time has been barred by the above-mentioned compromise settlement.

The record of assessments and payments for the year 1917 is as follows:

Original assessment against J. H. Hillman & Sons Co. and affiliated companies	$707,713.29
Additional assessment	1,172,093.18
Total assessed tax liability	1,879,806.47
Fraud penalty	1,880,828.29
Payment on account of tax liability	1,373,659.85
In settlement of fraud penalties	100,000.00

On March 14, 1924, the taxpayer and affiliated companies filed a claim for refund of the amount paid on account of tax liability—$1,373,659.85.

It is now proposed to grant the taxpayer relief under section 210 of the revenue act of 1917, and the correct tax liability computed under section 210 has been reported by the special assessment section to be $1,392,496.24. The difference between this figure and the total assessed tax liability, exclusive of the fraud penalties, is the sum of $487,310.83, which is the figure contained in the proposed certificate of overassessment now under consideration.

It is noted that a ruling by the solicitor, dated August 27, 1923, held the taxpayer not to be entitled to be classified as a merchant of securities within the meaning of T. D. 2649 for the year 1917; because of the invested capital situation resulting from this ruling section 210 was invoked on behalf of the taxpayer. Although the year 1918 is not before the solicitor for review at this time, it is pertinent to note that an opinion by the solicitor, dated October 16, 1923, held the taxpayer to be classed as a dealer in securities within the meaning of T. D. 2649 for 1918, and thus entitled to the benefit of inventory loss for that year, which presumably will result in a large certificate of overassessment for 1918. It may be that certain of the securities were not purchased as a dealer, but rather as a permanent investment.

The foregoing facts have been mentioned for the purpose of presenting the major issues in the case. Turning, however, to the particular question which was referred to this division, viz, the effect of the compromise settlement of May 26, 1922, on the proposed certificate of overassessment for 1917, your attention is invited to the memorandum of this division dated June 4, 1924, which concluded as follows: "There is, therefore, now no legal objection to abating any part of the assessed tax which the bureau determines was improperly assessed." This conclusion was based on the exact language of the accepted compromise offer, which limited the offer specifically to the fraud penalty, leaving for future determination all questions with respect to correct tax liability. The memorandum of June 4, 1924, also called attention to the fact that section 1015 of the revenue act of 1924 repealed section 3225 of the Revised Statutes, thus making it possible for the bureau to reconsider questions of tax liability which had been foreclosed by section 3225. The record does not contain any information which would cause the solicitor to reverse the position taken in the memorandum of June 4, 1924.

Since the certificate of overassessment under consideration is based principally upon the relief provisions of section 210 of the revenue act of 1917, and

since it does not appear that the solicitor has passed upon the applicability of the provisions of said section to such a case as this or upon the comparatives which have been used in recomputing tax liability for 1917, under that section, it is my opinion that most careful consideration should be given, particularly to these two points.

The entire file is returned herewith.

Assistant Solicitor.

Senator ERNST. Mr. Gregg, I asked you a day or so ago about the number of cases which had been submitted by the department to this committee. I told you I was curious to know how many cases this committee had received from the department. Have you any statement on that?

Mr. GREGG. I have not the figures; no, sir.

Senator ERNST. Could you get them for me?

Mr. GREGG. I think we have kept a record of every case.

Senator ERNST. If you do not have them now, I would like you to furnish that statement and put it in the record.

Mr. MANSON. I wish to say that we have been able to report on a very small percentage of the cases that we have called for. For instance, we are taking photostats out of the department of in the neighborhood of 400 cases for examination. Then, of course, there are a very large number of cases we desire merely for statistical information and called for the returns for the purpose of taking off statistical information.

Senator ERNST. Mr. Nash, will you get me that statement?

Mr. NASH. I think we can probably secure some record of the number of cases that have been furnished the committee, Senator.

Senator ERNST. That is what I want. If that is not ready by the time our sessions end, I would like to have you file it, so that it may be made a part of the record.

Mr. NASH. I will submit a statement.

Senator WATSON. Mr. Chairman, are we going on with anything further? I want to leave at 6 o'clock, and I must get through with this hearing as soon as I can.

The CHAIRMAN. We have some other matters for presentation to-day; but if you would like to get to the executive end of it first, we can do that.

Senator WATSON. I would like to do that very much if we can.

The CHAIRMAN. I think we will excuse the officials of the bureau, then.

Senator WATSON. I am very anxious to get away as soon as I can, because I have a number of engagements that I must meet and which will keep me busy until I leave at 6 o'clock.

The CHAIRMAN. How long will you take after we are through with the executive meeting, Mr. Manson?

Mr. MANSON. The chairman indicated yesterday that he would like to have some discussion of the matter of the control provision of the affiliation statute. As I stated yesterday, I have not had the opportunity to make a study of that provision, the study that must be made before I can arrive at any definite conclusion with reference to it, but I can state the questions that appear to arise out of it. It is a very important matter, and a matter that should be considered. It is a matter that I expect to submit a report to the committee on, but that is the only additional matter that I have to present.

The CHAIRMAN. Have you the Edison British case?

Mr. MANSON. I have not had an opportunity to look into that.

Senator JONES of New Mexico. I imagine that after these formal hearings are closed there will be many questions of law that we will want to discuss.

Senator WATSON. That is true.

Senator JONES of New Mexico. And perhaps make recommendations regarding them.

Senator WATSON. On the subject to which you now refer, as I take it, there is nothing in the bureau that would aid us in that connection?

Mr. MANSON. In other words, I have no criticism whatever of the bureau's policy in that connection. The bureau has adhered to a definite policy, I think, in most cases at least. The Board of Tax Appeals, however, has put a construction upon the law which I believe Congress should consider.

Senator JONES of New Mexico. We can consider that at any time.

Mr. MANSON. That was my judgment in deferring the consideration of the matter, myself.

The CHAIRMAN. I think we will be ready for you [addressing a representative of the bureau], in about 10 or 15 minutes. I do not think it ought to take very much longer than that.

(The committee thereupon went into executive session and the representatives of the bureau withdrew from the hearing room.)

(The proceedings were then resumed, with representatives of the bureau present, as follows:)

The CHAIRMAN. I think Senator Jones might state to Mr. Nash his proposal to the committee and the conclusions of the committee on it.

Senator JONES of New Mexico. I have just brought up before the committee in executive session the case of the discharge of Engineer Briggs from the Bureau of Internal Revenue.

When these hearings were begun, it was distinctly understood, and my recollection is that it was distinctly stated in the record, that no employee of the bureau should be penalized for giving information to this committee.

Mr. NASH. That is true.

Senator KING. And the circumstances surrounding the separation of Mr. Briggs from the service of the bureau have not been made clear to me, at least, as to why it took place, and my impression is, which is subject to removal, however, that his connection with this committee has had a great bearing upon his separation from the service. I am advised that the effect of his discharge has been such as to practically close the doors of the bureau to the committee.

I have thought that this matter ought to be reviewed, and the committee has decided that it will hear anything on the subject that any member of the department may have to present to-morrow morning, at which time Mr. Briggs will also be invited to appear and make any statement which he may have to make.

In this connection I should like a full statement of who has been separated from the service in the department by reason of the claim that it was necessary to separate them in order to curtail the expenses of the department, what grades of people have been dis-

charged, what changes in salary have taken place, and especially how much reduction there has been made in the cost of maintaining the personnel of the engineering section of the bureau.

Senator KING. And we also want the service record of Mr. Briggs.

Senator JONES of New Mexico. Yes; we also want the service record of Mr. Briggs.

Mr. MANSON. That is technically called the personnel record.

Senator JONES of New Mexico. Well, whatever it is called, we would like to have that complete.

The CHAIRMAN. I think it might be well to bring the personnel record of the other engineers here for comparative purposes, if the committee agrees with me on that.

Mr. NASH. Senator, do you mean throughout all of the engineering section, or just the engineers in the nonmetals division where Mr. Briggs worked?

The CHAIRMAN. The latter will be sufficient, so far as I am concerned; at least, that group that Mr. Blair sent to me the other day and which I went over with you and Mr. Gregg.

Mr. NASH. That was the efficiency record of all of the engineers in the engineering division.

Mr. MANSON. Those were Mr. Greenidge's ratings of the engineers.

The CHAIRMAN. I understand that; but those were interchanged between the nonmetals and the oil and gas section.

Mr. NASH. Yes; that covers timber, oil and gas, coal, nonmetals, and appraisal.

The CHAIRMAN. I think we ought to have the personnel record of that same group.

Mr. NASH. Very well.

The CHAIRMAN. Because in going over these efficiency ratings I made some comments, as you will remember, about one man being 100 per cent and somebody else being 100 per cent, and you yourself agreed that it was not sound.

Mr. NASH. That is true.

The CHAIRMAN. I think we ought to have the personnel records of those men. We may not need them, but you ought to bring them up here anyhow, because we may need them.

Mr. NASH. In reply to Senator Jones's statement, I want to say that when this committee first began its sessions, some auditor was testifying before the committee and expressed the fear that if he testified he might be removed. I was asked at that time whether if this man testified he would be disciplined in any way and I said emphatically no. I have personally attempted in every way to adhere to that policy. So far as I personally know, no man has been disciplined or hurt in any way for any information that he has furnished this committee or for any contact that he might have had with this committee. I have advised everybody that has questioned me on it to be perfectly open and frank with the committee and with the staff of the committee.

Senator JONES of New Mexico. I think, in order to get a picture of the whole situation, we ought to cover the whole engineering division, because, in the case of a man like Mr. Briggs, if I am correctly informed, while you might want to have made some change in this particular division, you might have found some place for

him in the engineering division, and I should like to know which of the engineers in the engineering division have been separated from the service, and how much the saving has been in each branch or in each section of the engineering division.

The CHAIRMAN. I think we also ought to have statements made by Mr. Briggs and his associates, that they may appear in the record. Those appear in the personnel record, do they not, those statements made by his superior?

Mr. NASH. I do not recall what statements you refer to.

The CHAIRMAN. I mean the statement as to the kind of an employee he has been. I understand the superior officer of an engineer makes a certain comment upon the work of his subordinates.

Mr. NASH. They make an efficiency report every six months, and last November was the first time that that has been in effect in the bureau. That efficiency rating is in the files.

The CHAIRMAN. Yes; but does not the personnel record show statements as to what the superior officer thinks of his subordinates? I understand that, for instance, when you are considering promotion——

Mr. NASH. Oh, that is true.

The CHAIRMAN. Or removals or demotions, the practice is to place a memorandum in the record showing what the superior officer thinks of this particular official.

Mr. NASH. That is so.

The CHAIRMAN. That is what I mean we ought to have down here, because I believe that some influence, unknown to Mr. Nash or Mr. Blair, was exercised to get Briggs removed, as the whole policy of having removed him seems so absurd, in view of the work that Mr. Briggs did to help the committee. In other words, no matter how earnest your desire may be to have cut expenses or to reorganize your bureau, I can not conceive of a man of Briggs's experience and long standing in the service, with his good efficiency rating, being removed at this particular time, when he was still helping the committee.

Senator JONES of New Mexico. If we do not have it in the record, I would like to have information obtained and put into the record as to the status of the work of the engineering division, as to the necessity for closing up those cases that have been pending for so many years, and why it was necessary to have separated anybody from the service in the engineering section, with all of that work there.

Senator KING. In view of the accumulation there.

Senator JONES of New Mexico. In view of the accumulation of work and the importance of the work which was pending, and why it was necessary to curtail the work in this particular branch of the bureau.

Senator KING. Does Mr. Greenidge still have the same power as he did when we began these hearings?

Mr. NASH. Mr. Greenidge is still the head of the engineering division.

Senator KING. Will the bureau be ready to-morrow with these records?

Mr. NASH. I will be glad to get all the records that have been asked for that I can, and bring them here to-morrow morning, Senator.

The CHAIRMAN. Have you any information for the committee concerning this Harrington Horse and Mule Co. matter?

Mr. NASH. I asked Mr. Rogers, who is in Mr. Gregg's office, and who is familiar with the case, to prepare a statement on that, Senator. I came away very hurriedly this morning, and I forgot to ask about it before I left. It had not reached my desk when I left this morning.

The CHAIRMAN. Will you bring that with you to-morrow?

Mr. NASH. If it is available, I will be glad to do it.

The CHAIRMAN. Have you anything else to take up now, Mr. Manson?

Mr. MANSON. No, I have not.

The CHAIRMAN. Has the bureau any statement to make?

Mr. NASH. I wish to present a statement from the committee on enrollment and disbarment in reply to the question that the Senator asked the other day.

The CHAIRMAN. We would be glad to have that.

Mr. NASH (reading):

In reply to your memorandum of May 26, 1925, requesting certain information for use of the special investigating committee of the Senate appointed to investigate the Bureau of Internal Revenue, I transmit the following:

(1) Three copies of Department Circular No. 230 (1923), containing laws and regulations governing the recognition of attorneys, agents, and other persons representing claimants and others before the Treasury Department. You will find in paragraphs 1, 2, and 5 an outline of the procedure of the committee on enrollment and disbarment of the Treasury in investigating the character and responsibility of persons applying for admission to practice. The committee has no funds at its disposal with which to carry on independent investigations; but utilizes the services of the Special Intelligence Unit of the Bureau of Internal Revenue in the effort to make a thorough and fair investigation of any applicant regarding whose qualifications the committee is not entirely satisfied. In cases where the application has been rejected and the applicant requests permission to appear before the committee, he is given an opportunity to convince the committee of his fitness to practice.

The procedure followed by the committee in investigating alleged unethical practices on the part of tax experts who have been admitted to practice may be found in paragraphs 6 and 7. Formal complaints are drawn up by the attorney for the committee, on information furnished by the Special Intelligence Unit as well as by persons not in the Government employ; and in a large number of cases such complaints are based on reports of auditors and agents in the Bureau of Internal Revenue. The committee has, in some instances, received charges direct from employees of the Bureau of Internal Revenue and, so far as the regulations of the committee are concerned, there is no prohibition against such a procedure at the present time. The question of how information shall be transmitted to the committee by employees of the Bureau of Internal Revenue is a matter which is regulated by the bureau. The committee tries to make a careful and impartial investigation of all charges preferred against practitioners and to expedite as much as possible the trial of such cases. There are at the present time 63 complaints pending before the committee, and hearings are being held on two days each week in order to dispose of all cases as rapidly as possible. This is done in order that both the taxpayer and the Government may suffer as little as possible at the hands of practitioners engaged in questionable practices. At the same time the committee feels it to be of great importance that all practitioners should have a full and impartial hearing and that in no case should their means of livelihood be taken away except on justifiable grounds and after a fair and impartial hearing.

(2) The total number of persons who have been admitted to practice before the Treasury Department by the committee on enrollment and disbarment is

13,887. The number of applications which have been disapproved by the committee is 214. In addition to the above, there were also enrolled 8,000 practitioners by the division of bookkeeping and warrants of the Treasury Department prior to the organization of the committee on enrollment and disbarment on March 1, 1921. The committee has disbarred from practice 18 persons and has suspended 37 practitioners for varying periods of time. These sentences of disbarment and suspension are published in the Internal Revenue Bulletin, and the publicity to which the offending practitioner is thus subjected has proved a most salutary influence in discouraging unethical practices. The committee has also given 24 reprimands in cases of minor importance and has dismissed 53 cases after due investigation of the facts.

(3) The committee has been trying for some time to assemble the evidence on which to base its case against the firm of Ernst & Ernst, of Cleveland, Ohio. The following cases in which they have been charged with malpractice have been investigated and findings of facts have been written up preparatory to filing charges: Ernst & Ernst, Cleveland, Ohio; Reams, Jones & Blankenship, Roanoke, Va.; Consolidated Iron & Steel Manufacturing Co., Cleveland, Ohio.

There are several other tax cases in connection with which the above-named accountants have been charged with unethical practices. These are now in process of audit or investigation and will be incorporated in the charges to be filed against this firm in the event that final disposition of the cases pending shall justify such action.

You will recall that in that case of Ernst & Ernst they handled their own case personally.

The committee also has evidence showing solicitation of income-tax business by this firm, and under date of May 22, 1925, the committee received data clearly indicating that Ernst & Ernst are soliciting business by circularizing taxpayers. This charge will also be made a part of the case now being prepared against this firm of practitioners. There has been no disposition on the part of the committee to delay the trial of this case. On the contrary, various members of the committee have repeatedly urged that the committee counsel expedite the assembling of necessary evidence; and it is believed that such evidence will shortly be in hand, so that the Government can make an effective presentation of its case when the matter comes up for hearing before the committee. With reference to the Osborne matter, which will be included in charges now being prepared against Seidman & Seidman, this incident was unofficially discovered by an agent of the Detroit office and reported to the committee on enrollment and disbarment. In order to secure the information officially an examination of the taxpayer's records was authorized for the year in question and a report should be received within a very short time.

That is signed by S. M. Jacobs, chairman committee on enrollment and disbarment.

The CHAIRMAN. How long has that Ernst & Ernst case been pending before the committee; do you know?

Senator KING. Or does anybody know?

Mr. NASH. This does not state. It states that the committee has been trying for some time to assemble the evidence on which to base a case against Ernst & Ernst.

The CHAIRMAN. So the case no doubt has been there for some time, then?

Mr. NASH. This statement that the committee also has evidence showing the solicitation of income-tax business by this firm, and under date of May 22 they say the committee received additional evidence in this case.

The CHAIRMAN. In the case of L. E. Rusch, was that matter before the committee on enrollment and disbarment, Mr. Manson?

Mr. MANSON. It went to the committee on enrollment and disbarment. What action do those papers show that they took?

Mr. NASH. We have no record on that case. The question came up at that time as to whether we had authority to call for the testimony

of the committee on enrollment and disbarment in that case, and you expressed a doubt.

Mr. MANSON. I was the one that expressed a doubt.

Mr. NASH. I subsequently furnished the committee with a full file of the——

Mr. MANSON. We have the intelligence agent's report on it.

The CHAIRMAN. Yes; but we have not the action of the committee on enrollment and disbarment.

Mr. MANSON. No; we have no transcript of the hearing.

The CHAIRMAN. And neither have we the evidence, the affidavits and statements contained in the papers that were prepared in the intelligence unit, and which I assume the committee on enrollment and disbarment had. I can not possibly conceive how that man Rusch can continue to practice before the bureau.

Mr. NASH. I might say that the intelligence unit investigated that case for the committee on enrollment and disbarment, and I presume their original report is with the committee. I furnished this committee with a duplicate of that report.

The CHAIRMAN. From reading that over I can not understand how they continue to permit him to practice, because the intelligence unit severely criticized him, and the affidavits and evidence contained in the papers there show a most reprehensible conduct, it seems to me, and yet he still continues to practice there. I bring this up because the same situation is shown with respect to Ernst & Ernst; and if there is no check against these men, they keep on doing these things. It takes a long time to get a case through this committee, and then when it is passed on there is so much judicial consideration given to the matter before the committee reaches any decision, and the man continues to practice.

Senator KING I think Mr. Nash might ask the committee on enrollment and disbarment to hand to him for the committee a brief reference to that Rusch case and its present status.

Mr. NASH. I will be glad to, Senator. Here are three copies of the regulations 230 that accompany this report.

(The regulations referred to are as follows:)

LAWS AND REGULATIONS GOVERNING THE RECOGNITION OF ATTORNEYS, AGENTS, AND OTHER PERSONS REPRESENTING CLAIMANTS AND OTHERS BEFORE THE TREASURY DEPARTMENT AND OFFICES THEREOF

(Department Circular No. 230[1] with Supplements 1, 2, and 3)

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY,
Washington, August 15, 1923.

The statutes regulating the recognition of attorneys and agents and their practice before the Treasury Department appear at the end of these regulations.

Pursuant to statutory provisions, the following rules and regulations are prescribed:

1. *Practice.*—Any individual taxpayer or member of a firm or officer or authorized regular employee of a corporation may appear for himself or such firm or corporation solely upon adequate identification to the Treasury officials. Where, however, the attorney or agent appears before the department representing a taxpayer, he must be enrolled, and, to be enrolled, must satisfy the requirements of the statute. The statute requires that applicants for

[1] Effective August 15, 1923. This circular supersedes Treasury Department Circular No. 230, dated February 15, 1920, and its several supplements.

enrollment must "show that they are of good character and in good repute, possessed of the necessary qualifications to enable them to render * * * claimants valuable service, and otherwise competent to advise and assist such claimants in the presentation of their cases." (Act of July 7, 1884.) In order better to protect the taxpayer's interests and to expedite practice before the department, applicants should clearly establish their right to enrollment by showing that they possess (1) a good character and reputation; (2) a sound education; and (3) a familiarity with the laws and regulations covering taxes or other subjects which they will present to the department. Practice before the Treasury Department is not restricted to duly licensed attorneys at law and certified public accountants; but an agent who is not an attorney or accountant, and attorneys and accountants licensed in States where, in the opinion of the committee on enrollment and disbarment, the license requirements are not adequate, must show satisfactory educational qualifications and evidence of an ability to understand tax questions or such other matters as will be presented to the Treasury by the applicants. An applicant's character and reputation can only be established by inquiry among those who have had the opportunity of knowing the applicant in the community in which he has lived. A bad reputation as to integrity or any previous conduct of applicant which is unethical, as viewed by the standards of the American Bar Association or the American Institute of Accountants, or such conduct as would be considered unfair in commercial transactions, will be regarded as sufficient to justify the rejection of the application. References as to the applicant's character should be given, and in addition the applicant should furnish the names of those with whom he has come in contact in his business and of whom inquiry may be made. The committee on enrollment and disbarment will endeavor to ascertain all facts deemed necessary by it to pass on any applicant without expense or undue inconvenience to the applicant, but the committee may require, where it is not satisfied with the information received, that the applicant appear in person before the committee or its duly authorized representative.

2. *Applications for enrollment.*— Applicants for enrollment pursuant to these regulations shall submit to the Secretary of the Treasury an application, in duplicate, properly executed on Form 23 attached hereto. Applications in any other form will not be considered, and all statements contained in the application must be verified by the applicant. The application must be accompanied by an affidavit regarding contingent fees, in compliance with the order of the Secretary of the Treasury dated March 21, 1923, as amended April 7 1923. The applicant must also take the oath of allegiance and to support the Constitution of the United States as required by section 3478, Revised Statutes. A person who can not take the oath of allegiance and to support the Constitution of the United States can not be enrolled. Members of the bar of a court of record will apply for enrollment as attorneys; all others will apply for enrollment as agents. Applicants will be notified of the approval or disapproval of their applications. All applications for enrollment must be individual, and individuals who practice as partners should apply for enrollment as individuals and not in the partnership name. An individual who has been enrolled may, however, represent claimants and others before the Treasury Department in the name of a partnership of which he is a member or with which he is otherwise regularly connected. Except as hereinafter provided in paragraph 3, a corporation can not be enrolled and attorneys or agents will not be permitted to practice before the Treasury Department for account of a corporation which represents claimants and others in the prosecution of business before the Treasury Department. Persons applying for enrollment who propose to act for such a corporation in the prosecution of claims and other business before the Treasury Department will be subject to rejection, and enrolled attorneys or agents who act for a corporation in representing claimants and others in the prosecution of claims and other business will be subject to suspension from practice as to such claims or business.

3. *Customhouse brokers.*—The act of June 10, 1910, (36 Stat., 464, T. D. 30789), provides in part that persons, copartnerships, associations, joint-stock associations, and corporations may be licensed as customhouse brokers by the collector or chief officer of customs at any port of entry or delivery to transact business as such customhouse broker in the collection district in which such license is issued. Customhouse brokers so licensed require no further enrollment under these regulations for the transaction of business within their respective collection districts, but for the representation of a

claimant before the Treasury Department in the city of Washington, application for enrollment as attorney or agent must be made in conformity with the requirements of paragraph 2, and otherwise in accordance with these regulations, except that if a customhouse broker, so licensed in a collection district, is a copartnership, association, joint-stock association, or corporation, its claims or other business may be prosecuted in its name before the department in the city of Washington by an accredited member or representative, who must, however, be first duly enrolled in accordance herewith.

4. *List of attorneys and agents.*—A list of all attorneys and agents who make application for enrollment or who are enrolled or whose applications have been rejected or who have been suspended or disbarred, will be kept in the office of the chief clerk of the Treasury Department, and a copy of such list will be furnished the bureaus, offices, and divisions of the Treasury Department. Information as to whether or not any person is enrolled as an attorney or agent may be had by application to the chief clerk. All bureaus, offices, and divisions of the Treasury Department are prohibited from recognizing or dealing with any attorney or agent unless enrolled, provided that an attorney or agent, by application to the chief clerk and at the discretion of the committee on enrollment and disbarment, may be recognized temporarily, pending action upon his application for enrollment.

5. *Knowledge through connection with the Treasury Department.*—No attorney or agent shall be permitted to appear before the Treasury Department in connection with any matter to which such attorney or agent gave personal consideration or as to the facts of which he had actual personal knowledge while in the service of the Treasury Department, and likewise no such attorney or agent shall aid or assist another in any such matter and no attorney or agent shall receive assistance from one formerly in the service of the Treasury Department and having such personal knowledge.

6. *Suspension and disbarment proceedings.*—If information is received by the Treasury Department of conduct of any enrolled attorney or agent in violation of any of the statutory provisions or regulations governing practice before the department, the information shall be referred to the committee on enrollment and disbarment.

The committee may, on the basis of any such complaint, upon its own motion or otherwise upon reasonable cause, institute proceedings for suspension or disbarment against any enrolled attorney or agent. Notice thereof, signed by the Secretary or Undersecretary of the Treasury, shall be sent by mail to such attorney or agent at the address under which he is enrolled, and such notice shall state the charge or charges made and give the place and time within which the respondent shall file, in duplicate, his verified answer, which time shall be not less than 20 nor more than 30 days from the date of mailing the notice. Such answer shall state specifically every ground of defense relied upon by the respondent to answer the charge or charges against him. The committee may, in its discretion, extend the time for filing such answer. The complainant may, in the discretion of the committee, be furnished with a duplicate copy of such answer. If the respondent fails to file such answer within such time he shall be declared to be in default and the charge or charges against him shall be deemed to be true without further proof by the complainant. When the answer has been filed the committee shall pass upon the sufficiency of the same, and in case an issue of fact is raised by said answer then the committee shall set a time and place for the hearing of such case. Notice of the time and place of such hearing, signed by the chairman of the committee, shall be sent by mail to the respondent, which hearing shall not be less than 20 nor more than 30 days from the date of mailing such notice. The committee may, in its discretion, postpone the date of hearing or adjourn any hearing from time to time as may be necessary. An enrolled attorney or agent against whom proceedings for suspension or disbarment have been instituted as herein provided may, pending the conclusion of the proceedings and subject to the approval of the Secretary of the Treasury, be suspended for the time being from practice before the Treasury Department.

The committee shall conduct hearings according to such rules of procedure as it shall determine, and may receive evidence in such form as it may deem proper. The respondent may be represented by counsel. The testimony of witnesses may, in the discretion of the committee, be required to be under oath, and may be stenographically reported and transcribed. Depositions for use at a hearing may, with the approval of the committee, be taken by either party upon oral or written interrogatories before any officer duly

authorized to administer an oath for general purposes upon 10 days' written notice if the deposition is to be taken within the District of Columbia and upon 20 days' written notice if it is to be taken elsewhere. When a deposition is taken upon written interrogatories, any cross-examination shall be upon written interrogatories. Copies of such written interrogatories shall be served with the notice, and copies of any written cross-interrogatories shall be mailed to the opposing party or his counsel at least five days before the time of taking the deposition.

The committee shall, promptly after the conclusion of the hearing, or, if the respondent does not appear in person for the hearing, promptly after the date set therefor, submit to the Secretary of the Treasury a copy of the notice of hearing, the complaint, answer (if any), the record of the hearing (if any), and any written findings of fact by a majority of the committee, together with a recommendation either that the charges be dismissed or that the respondent be reprimanded, suspended for a given period of time or disbarred. The findings and recommendation shall be signed by all members of the committee agreeing thereto. Members of the committee dissenting therefrom shall submit statements of their reasons therefor. If any members of the committee were not present at the hearing, the fact shall be stated.

Upon the suspension or disbarment of an attorney or agent, notice thereof shall be given by the committee to the heads of all bureaus, offices, and divisions of the Treasury Department and to the other branches of the Government, and, unless duly reinstated, such person shall not thereafter be recognized as an attorney or agent in any claim or other matter before the Treasury Department or any office thereof.

7. *Causes for rejection, suspension, or disbarment.*—In general, any conduct which would preclude an applicant from enrollment will be sufficient to justify his suspension or disbarment. Specially, the following matters, among others, will be considered grounds for suspension or disbarment:

(*a*) Violation of the statutes or rules governing practice before the Treasury Department.

(*b*) Conduct contrary to the canons of ethics as adopted by the American Bar Association, or the rules of professional conduct approved by the American Institute of Accountants, or their equivalent.

(*c*) False or misleading statements or promises made by the attorney or agent to a taxpayer or misrepresentation to the Treasury Department.

(*d*) Solicitation of business by the attorney or agent. This includes letters, circulars, and interviews not warranted by previous association; printed matter appearing on the letterheads or cards of the attorney or agent indicating previous connection with the Treasury Department or enrollment as attorney or agent; or representation of acquaintance with Treasury officials or employees. It includes also the use by attorneys and agents of any titles which might imply official status or connection with the Government, such as "Federal tax expert" or "Federal tax consultant." It is not considered a violation of this regulation for Treasury employees, on severing their connection with the department, to send out announcement cards, briefly stating their former official status and announcing their new association, provided the cards are addressed only to personal or business acquaintances, and provided further that such cards are distributed only at the time of severance of the official connection with the Government. These cards are regarded by the committee not as advertising but as the customary announcement cards issued for the express purpose of identifying the sender with his new association or business.

(*e*) Negligence in furnishing evidence required in matters pending before the Treasury Department, and the use of any means whereby the final settlement of the matter is unjustifiably delayed.

(*f*) The employment by an enrolled attorney or agent as correspondent or subagent in any matter pending before the Treasury Department, or the acceptance by such enrolled attorney or agent of employment as correspondent or subagent of or from any person who has been denied enrollment or who has been suspended or disbarred from practice. It is in violation of the regulations for an enrolled attorney or agent to assist in any way or be assisted by an attorney or agent who has been denied enrollment or has been suspended or disbarred.

(*g*) Any other matter which, in the opinion of the committee on enrollment and disbarment, is unfair to the taxpayer or to the Treasury Department or interferes unduly with the orderly disposition of matters pending before the department.

8. *Contingent fees.*—(*a*) While contingent fees may be proper in some cases before the department, they are not generally looked upon with favor and may be made the ground of suspension or disbarment. Both their reasonableness in view of the services rendered and all the attendant circumstances are a proper subject of inquiry by the department. The Commissioner of Internal Revenue or the head of any other Treasury bureau or division of the Secretary's office may, at any stage of a pending proceeding, require an attorney or agent to make full disclosure as to what inducements, if any, were held out by him to procure his employment and whether the business is being handled on a contingent basis, and, if so, the arrangement regarding compensation. The Treasury Department will also make such independent inquiry in regard to the circumstances connected with the employment of attorneys or agents on a contingent basis as it deems advisable.

(*b*) All attorneys and agents and others practicing before the Treasury Department or any of its bureaus or offices are required to file with the chief clerk of the Treasury Department an affidavit, in duplicate, stating whether or not the business in which the attorney or agent appears before the department is being handled on a contingent basis, and if so, on what basis and under what arrangements regarding compensation. Specific information, giving the names and descriptions of cases handled on a contingent basis, must be filed covering all such cases pending before the Treasury Department; and, whenever an additional case is taken on the basis of a contingent interest or fee, a further affidavit regarding such case must be filed with the department, provided, however, that any attorney or agent not practicing before the department on a contingent basis may file with the chief clerk of the Treasury Department, in lieu of these specific affidavits, a general affidavit, in duplicate, stating that he is not handling any business before the Treasury Department on a contingent basis and that he will not handle any business before the Treasury Department on a contingent basis without first giving specific notice to the department and filing an affidavit, in duplicate, as above required. Every such affidavit must state the Treasury offices before which the attorney or agent proposes to practice.

(*c*) The chief clerk of the Treasury Department will retain in his confidential files the originals and duplicates or copies of all such affidavits regarding contingent fees for use of the committee on enrollment and disbarment and of heads of bureaus and divisions. While discouraging contingent fees and requiring their disclosure, the Treasury does not bar such fees in practice before the Treasury Department; nor is the information which is submitted in connection with such cases used to prejudice the fair consideration of any case, provided the attorney or agent is guilty of no unfair practice or violation of the Treasury's requirements.

(*d*) All attorneys and agents practicing before the Treasury Department, who have filed specific or general affidavits regarding contingent fees, will be furnished with cards showing that they have done so, and officers of the department will recognize only those presenting such cards, which will be accepted in lieu of all cards previously issued to them as evidence of their authority to practice before the department. These cards are issued on condition that prior to appearing before the department in any case handled on the basis of a contingent interest or fee, the said case shall be reported to the department as hereinbefore provided.

9. *Constitution of committee.*—The committee on enrollment and disbarment shall consist of the chief clerk of the Treasury Department, ex officio, and five other members appointed by the Secretary of the Treasury, of whom two shall be detailed from the office of the Secretary, two from the office of the Commissioner of Internal Revenue, and one from the Division of Customs. The Secretary shall designate the chairman and vice chairman from members detailed from his office. The committee shall make such rules for its own government as it considers advisable. Subject to these regulations, the committee shall have jurisdiction over all matters relating to enrollment, suspension, or disbarment of attorneys and agents practicing before the Treasury Department, and shall submit its recommendations to the Secretary of the Treasury for approval.

10. *Authority to prosecute claims; delivery of checks, drafts, and warrants.*—(*a*) A power of attorney from the principal in proper form may be required of attorneys or agents by heads of bureaus, offices, and divisions, in any case. In the prosecution of claims involving payments to be made by the United States, proper powers of attorney shall always be filed before an attorney or

agent is recognized. No power of attorney shall be recognized which is filed after settlement made by the accounting officers, even though the settlement certificate may not yet have issued, unless such power of attorney recites that the principal is fully cognizant of such settlement and of the balance found due.

(*b*) In all cases originally filed in the Treasury Department and audited and allowed by the accounting officers, payable from appropriations thereafter to be made by Congress, the drafts, warrants, or checks issued for the proceeds of such claims shall be made to the order of the claimant, and may be delivered to the attorney or agent legally authorized to prosecute the same, upon his filing in the department, after the allowance of the claim, the ascertainment of the amount due, and its submission to Congress for an appropriation, written authority executed in proper legal form for delivery of such draft, warrant, or check. The authority so filed shall describe the claim by the number of certificate of settlement, the amount allowed, the title of appropriation from which to be paid, the date when submitted to Congress, and the number of the executive document in which it is contained. Drafts, warrants, or checks issued for the proceeds of other like cases audited and allowed by the accounting officers but which are to be paid from appropriations available at the time of allowance shall also be made to the order of the claimant and may be delivered to the attorney or agent filing written authority, executed in proper legal form, to receive them. The Secretary of the Treasury reserves the right, however, in any case to send any draft, warrant, or check to the claimant direct. (See also paragraph 11 hereof.)

(*c*) Drafts, warrants, or checks issued in payment of amounts allowed by Congress in favor of corporations and individuals and appropriated for in private or special acts, and for the payment of all other claims presented directly to Congress and prosecuted before its committees, shall be made to the order of claimants and delivered to them in person or mailed to their actual post-office addresses.

(*d*) Drafts, warrants, or checks issued in payment of judgments rendered by the Court of Claims, United States courts, or other courts shall be made to the order of the judgment creditor and delivered to or sent in care of the attorney certified by the court to be the attorney of record upon his filing in the department written authority, executed in proper legal form, after the date of the rendition of the judgment, for such disposition of such draft, warrant, or check.

(*e*) When judgments of the Court of Claims, United States courts, or other courts are paid by the United States, a notice of such payment, giving number, class, and date of the draft, warrant or check, and amount paid, will be sent by the Treasury Department to the clerk of the court in which the judgment was entered in order that payment may be entered on the docket of the court.

11. *Substitution of attorneys or agents and revocation of authority.*—(*a*) Substitution of attorneys or agents may be effected only on the written consent of the attorney or agent of record, his principal, and the attorney or agent whom it is desired to substitute, and in all cases only with the assent of the head of the bureau, office, or division concerned; provided that where the power of attorney under which an attorney or agent of record is acting expressly confers the power of substitution, such attorney or agent, if in good standing before the department, may, by a duly executed instrument, substitute another in his stead, such other, however, to be recognized as the attorney or agent only with the assent of the head of the bureau, office, or division concerned.

(*b*) If a firm dissolve, or those associated as attorneys or agents by virtue of a power of attorney contest the right of either to receive a draft, warrant, or check, the principal only shall thereafter be recognized, unless the members or survivors of such firm, or the associates in such power of attorney, file a proper agreement showing which of such members, survivors, or associates may continue to prosecute the matter and may receive a draft, warrant, or check; and in no case shall a final settlement of the matter or action toward the transmission of a draft, warrant, or check to the principal be delayed more than 60 days by reason of the failure to file such agreement.

(*c*) The revocation by a principal or his legal representatives of authority to prosecute a matter will not be effective, so far as the Treasury Department is concerned, without the assent of the head of the bureau, office, or division before which the matter is pending. Where a matter has been suspended pending the furnishing of evidence for which a call has been made on an attorney or agent, failure to take action thereon within three months from

the date of suspension may be deemed by the administrative officer before whom the case is pending cause for revocation of the authority of such attorney or agent without further notice to him.

(*d*) In the settlement of claims of officers, soldiers, sailors, and marines, or their representatives, and all other like claims for pay and allowances within the jurisdiction of the General Accounting Office, the draft, warrant, or check for the full amount found due shall be delivered to the payee in person or sent to his bona fide post-office address (residence or place of business) in accordance with the provisions of the act of June 6, 1900 (31 Stat. 637).

12. *Acknowledgment of affidavit.*—A declaration, affidavit, or any paper requiring execution or acknowledgment in connection with any claim, application for reaudit, or other matter before the Treasury Department, must be executed or acknowledged before an officer duly authorized to administer oaths for general purposes who is not interested in the prosecution of the claim or other matter to which the said declaration, affidavit, or paper pertains.

13. *Application and effective date of circular.*—This circular supersedes the regulations promulgated by Treasury Department Circular No. 230, of February 15, 1921, as heretofore amended and supplemented, relating to the recognition of attorneys, agents, and others. The regulations contained in this circular shall apply to attorneys, agents, and others representing claimants and others before the Treasury Department in the city of Washington or elsewhere, with the exception as to customhouse brokers, as set forth in paragraph 3, and shall be effective from and after the 15th day of August, 1923. This circular shall apply to all unsettled matters then pending in this department, or which may hereafter be presented or referred to the department or offices thereof for adjudication, and shall be applicable to all those now enrolled to practice before the Treasury Department as attorney or agent, provided that nothing herein contained shall be construed to abrogate any rules or orders of the General Accounting Office relating to the fees of attorneys, agents, or others, or to require those now enrolled to apply again to be enrolled.

14. *Circular may be withdrawn or amended.*—The Secretary of the Treasury may withdraw or amend at any time or from time to time all or any of the foregoing rules and regulations, with or without previous notice, and may make such special orders as he may deem proper in any case.

A. W. MELLON,
Secretary of the Treasury.

STATUTES

The following statutes relate to the recognition of attorneys, agents, and other persons representing claimants and others before the Treasury Department and offices thereof:

"That the Secretary of the Treasury may prescribe rules and regulations governing the recognition of agents, attorneys, or other persons representing claimants before his department, and may require of such persons, agents, and attorneys, before being recognized as representatives of claimants, that they shall show that they are of good character and in good repute, possessed of the necessary qualifications to enable them to render such claimants valuable service, and otherwise competent to advise and assist such claimants in the presentation of their cases. And such Secretary may, after due notice and opportunity for hearing, suspend and disbar from further practice before his department any such person, agent, or attorney shown to be incompetent, disreputable, or who refuses to comply with the said rules and regulations, or who shall with intent to defraud, in any manner willfully and knowingly deceive, mislead, or threaten any claimant or prospective claimant, by word, circular, letter, or by advertisement." (Act of July 7, 1884, 23 Stat. 258.)

"Whoever, being an officer of the United States, or a person holding any place of trust or profit, or discharging any official function under or in connection with any executive department of the Government of the United States, or under the Senate or House of Representatives of the United States, shall act as an agent or attorney for prosecuting any claim against the United States, or in any manner or by any means otherwise than in discharge of his proper official duties shall aid or assist in the prosecution or support of any such claim, or receive any gratuity, or any share of or interest in any claim from any claimant against the United States, with intent to aid or assist, or

in consideration of having aided or assisted, in the prosecution of such claim, shall be fined not more than five thousand dollars, or imprisoned not more than one year, or both." (Act of March 4, 1909, sec. 109, 35 Stat. 1107.)

"It shall not be lawful for any person appointed after the first day of June, one thousand eight hundred and seventy-two, as an officer, clerk, or employé in any of the departments, to act as counsel, attorney, or agent for prosecuting any claim against the United States which was pending in either of said departments while he was such officer, clerk, or employé, nor in any manner nor by any means to aid in the prosecution of any such claim, within two years next after he shall have ceased to be such officer, clerk, or employé." (Sec. 190, Revised Statutes.)

"That it shall be unlawful for any person who, as a commissioned officer of the Army, or officer or employee of the United States, has at any time since April 6, 1917, been employed in any bureau of the Government and in such employment been engaged on behalf of the United States in procuring or assisting to procure supplies for the Military Establishment, or who has been engaged in the settlement or adjustment of contracts or agreements for the procurement of supplies for the Military Establishment, within two years next after his discharge or other separation from the service of the Government, to solicit employment in the presentation or to aid or assist for compensation in the prosecution of claims against the United States arising out of any contracts or agreements for the procurement of supplies for said bureau, which were pending or entered into while the said officer or employee was associated therewith. A violation of this provision of this chapter shall be punished by a fine of not more than $10,000 or imprisonment for not more than one year, or both." (Act of July 11, 1919, 41 Stat. 131.)

"That section five hundred and fifty-eight of the Code of Law for the District of Columbia, relating to notaries public, be amended by adding at the end of said section the following: '*Provided*, That the appointment of any person as such notary public, or the acceptance of his commission as such, or the performance of the duties thereunder, shall not disqualify or prevent such person from representing clients before any of the departments of the United States Government in the District of Columbia or elsewhere, provided such person so appointed as a notary public who appears to practice or represent clients before any such department is not otherwise engaged in Government employ, and shall be admitted by the heads of such departments to practice therein in accordance with the rules and regulations prescribed for other persons or attorneys who are admitted to practice therein: *And provided further*, That no notary public shall be authorized to take acknowledgments, administer oaths, certify papers, or perform any official acts in connection with matters in which he is employed as counsel, attorney, or agent, or in which he may be in any way interested before any of the departments aforesaid.'" (Act of June 29, 1906, 34 Stat. 622. Held by 26 Opinions of Attorney General, 236, to apply to all notaries who may practice before the departments.)

"The head of each department is authorized to prescribe regulations, not inconsistent with law, for the government of his department, the conduct of its officers and clerks, the distribution and performance of its business, and the custody, use, and preservation of the records, papers, and property appertaining to it." (Sec. 161, Revised Statutes.)

APPLICATION FOR ADMISSION TO PRACTICE BEFORE THE TREASURY DEPARTMENT

The honorable the SECRETARY OF THE TREASURY.

SIR: I,_____
residing at_____
with my office at_____
hereby apply for admission to practice as_____
(Attorney or agent)[1]
to represent others before the Treasury Department, and submit the following information for the purpose of determining my eligibility and fitness for such practice, in compliance with Treasury regulations as set forth in Department Circular No. 230, revised August 15, 1923:

1. (*a*) Are you a citizen of the United States?_____ (*b*) Natural born?_____ (*c*) Naturalized?_____ (*d*) Where and when naturalized?_____ (*e*) Date of birth?_____

[1] Members of the bar of a court of record will apply as attorneys; all others as agents.

2. (*a*) Are you a member of the bar?_____ (*b*) If so, of what court? _____ (*c*) Attach a recent certificate, under seal, to that effect from said court.

3. (*a*) Are you engaged in business?_____ (*b*) If so, under what name?_____ (*c*) If not, by whom are you employed?_____ (*d*) Is your business or the business of your employer a sole proprietorship?_____ a partnership?_____ a corporation?_____ (*e*) What is the nature of your business?_____

4. (*a*) Are you familiar with the laws, rules, and regulations of the Treasury Department?_____

(*b*) What class of cases do you expect to handle before the Treasury Department?_____

(*c*) Where and when did you receive your preliminary education, and of what did it consist?_____

(*d*) Where and when did you receive your professional or technical education, and in what lines?_____

(*e*) Where and when did you receive your practical business experience, in what lines and with whom?_____

(*f*) Where and when did you receive your professional or technical experience?_____

(*g*) What are your particular qualifications rendering you competent to advise and assist claimants in presentation of their cases before the Treasury Department?_____

(*h*) Submit the names and addresses of three business references_____

5. (*a*) Have you ever been rejected, suspended, or disbarred from appearing as attorney or agent or in any other representative capacity before any branch of the Federal Government, or of any State government, or of any municipality, or any court?_____(*b*) If so, state details of such rejection, suspension, or disbarment_____

6. Are you under indictment or have you ever been convicted of any felony?_____

7. (*a*) Have you ever been an officer or employee of the United States? _____(*b*) If so, state the office or employment, with dates of appointment to and separation from the service_____

8. (*a*) Have you read and noted Treasury Department Circular No. 230, dated August 15, 1923?_____(*b*) If so, have you read and noted particularly paragraphs 7 and 8 thereof?_____

9. Have you filed an affidavit, in duplicate, with reference to contingent fees, in compliance with the order of the Secretary of the Treasury, dated March 21, 1923, as amended April 7, 1923?_____

10. (*a*) Have you made previous application to be recognized as attorney or agent before the Treasury Department?_____(*b*) If so, state details of such previous application and why you are now making another application_____

I,[1]_____, do solemnly swear (or affirm) that the statements contained in the foregoing application are true and correct; that I will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same; that I take this obligation freely without any mental reservation or pur-

[1] NOTE.—This oath may be taken before any justice of the peace, notary public, or other person who is legally authorized to administer an oath in the State, Territory, or District where the application is executed. The seal of the officer administering the oath must be affixed; or if he has no seal, his official character must be duly certified under seal.

pose of evasion; and that, if authorized to represent others before the Treasury Department, I will at all times conduct myself strictly in compliance with the laws and regulations governing practice before the department. So help me God.

(Name)_____.
(Address)_____.

Subscribed and sworn to before me this _____ day of _____, 192_.
(Signature of officer)_____.
(Official title)_____.

[Impress seal here.]

INDORSEMENT

WASHINGTON, _____, 192_.

The attached application of _____ for enrollment to be recognized as _____ to represent others before the Treasury Department has been examined, and after consideration it is recommended that the application be_____

_____, *Chairman.*
_____
_____
_____
_____
_____

Committee on Enrollment and Disbarment, Treasury Department.

Approved by the Secretary.
(See Schedule No. _____.)

SPECIMEN AFFIDAVIT TO BE FILED IN COMPLIANCE WITH ORDER OF THE SECRETARY OF THE TREASURY, DATED MARCH 21, 1923, AS AMENDED APRIL 7, 1923

I, John Doe, being duly sworn, depose and say that I am an attorney (or agent) with offices at (street)_____ (city)_____ (State)_____.

That I have made application (and am duly authorized)[1] to practice before the Treasury Department as an attorney (or agent) in accordance with the provisions of Treasury Department Circular No. 230, revised August 15, 1923.

That, with the exception of the following-named cases,[2] I am not handling any business before the Treasury Department on a contingent basis, and will not handle any business before the Treasury Department on a contingent basis, without first giving specific notice to the said department and filing an affidavit, in duplicate, as required by order of the Secretary of the Treasury dated March 21, 1923, as amended April 7, 1923:

Name of taxpayer	Office before which case is pending	Description of case and year	Fee arrangement	Amount of tax involved
Richard Roe..	Income Tax Unit..	Claim for refund, 1918.	Retainer: $1,000 and 15 per cent of amount refunded.	$30,000

That none of the business handled by me before the said department was obtained by any solicitation on my part in violation of paragraph 7 of Treasury Department Circular No. 230, revised August 15, 1923.

JOHN DOE.

Subscribed and sworn to before me this _____ day of _____, 192_.
Name_____,
Notary Public.

[1] If applicant has not been admitted to practice before the Treasury Department, strike out the words inclosed in parentheses.
[2] If no cases are being handled on a contingent basis, strike out preceding words in this sentence

LAWS AND REGULATIONS GOVERNING THE RECOGNITION OF ATTORNEYS, AGENTS, AND OTHER PERSONS REPRESENTING CLAIMANTS AND OTHERS BEFORE THE TREASURY DEPARTMENT AND OFFICES THEREOF

(First supplement to Department Circular No. 230, dated August 15, 1923)

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY,
Washington, January 4, 1924.

The regulations governing the recognition of attorneys, agents, and other persons representing claimants and others before the Treasury Department and offices thereof are hereby amended and supplemented, effective January 1, 1924, as follows:

1. The committee on enrollment and disbarment shall consist of six members appointed by the Secretary of the Treasury, of whom two shall be detailed from the office of the Secretary, three from the office of the Commissioner of Internal Revenue, and one from the Division of Customs. The Secretary shall designate the chairman and vice chairman from members detailed from his office. The Secretary shall also designate a secretary of the committee.

2. The duties assigned to the chief clerk of the Treasury Department by paragraphs 4 and 8 of Department Circular No. 230, dated August 15, 1923, shall be performed by the committee on enrollment and disbarment or by its secretary under the direction of the committee.

Any provision in Department Circular No. 230, dated August 15, 1923, in conflict with the foregoing is hereby amended accordingly.

A. W. MELLON,
Secretary of the Treasury.

LAWS AND REGULATIONS GOVERNING THE RECOGNITION OF ATTORNEYS, AGENTS, AND OTHER PERSONS REPRESENTING CLAIMANTS AND OTHERS BEFORE THE TREASURY DEPARTMENT AND OFFICES THEREOF

(Second supplement to Department Circular No. 230, dated August 15, 1923)

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY,
Washington, February 15, 1924.

Treasury Department Circular No. 230, dated August 15, 1923, as supplemented January 4, 1924, is hereby amended by striking out paragraph 5 and subparagraph (*b*) of paragraph 7 of said circular and inserting in lieu thereof a new paragraph and subparagraph to read as follows:

5. *Former connection with the Treasury Department or personal knowledge of matter in controversy.*—(*a*) No attorney or agent shall be permitted to appear before the Treasury Department in connection with any matter to which such attorney or agent gave personal consideration or as to the facts of which he had actual personal knowledge while in the service of the Treasury Department, and likewise no such attorney or agent shall aid or assist another in any such matter, and no attorney or agent shall receive assistance from one formerly in the service of the Treasury Department and having such personal knowledge.

(*b*) No former officer, clerk, or employee of the Treasury Department shall act as attorney or agent in any matter or controversy pending in such department during his employment therein within two years after he has ceased to be such officer, clerk, or employee without first having obtained the consent thereto of the Secretary of the Treasury or his duly authorized representative; and no enrolled attorney or agent shall, without first having obtained the consent of the Secretary of the Treasury or his duly authorized representative, employ or retain any such former officer, clerk, or employee directly or indirectly in any such matter or controversy, within such two-year period. Such consent may only be granted when it appears (1) that such employment is not prohibited by law or by the regulations of the Treasury Department; (2) that the matter or controversy, to handle which such consent is sought, was not pending in the particular office or division (departmental or field) in which the applicant was formerly employed. Applications for consent should be directed to the secretary of the committee on enrollment and disbarment, stating the former connection of the employee and the matter or controversy in which the applicant desires to appear. The applicant shall

thereupon be promptly advised as to his right to appear in the particular matter or controversy, and a copy of such advice shall be filed in the record of the case.

(*c*) Subparagraph (*b*) shall not affect existing contracts of employment, entered into prior to the date of this supplement to Circular No. 230, to handle any specific matter or controversy now pending.

7. *Causes for rejection, suspension, or disbarment*—

(*b*) Conduct contrary to the canons of ethics as adopted by the American Bar Association.

A. W. MELLON,
Secretary of the Treasury.

LAWS AND REGULATIONS GOVERNING THE RECOGNITION OF ATTORNEYS, AGENTS, AND OTHER PERSONS REPRESENTING CLAIMANTS AND OTHERS BEFORE THE TREASURY DEPARTMENT AND OFFICES THEREOF

(Third supplement to Department Circular No. 230, dated August 15, 1923)

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY,
Washington, April 15, 1924.

Paragraph 7 of Treasury Department Circular No. 230, dated August 15, 1923, as amended by the second supplement to said circular, dated February 15, 1924, is hereby further amended by striking out the words "or enrollment as attorney or agent," in the fourth line of subparagraph (*d*), and inserting in lieu thereof the following: "but an enrolled attorney or agent may use on his letterheads or cards the words 'enrolled to practice before the Treasury Department,' or words of similar import," and by adding a new subparagraph (*h*), so that the paragraph will read as follows:

"7. *Causes for rejection, suspension, or disbarment.*—In general, any conduct which would preclude an applicant from enrollment will be sufficient to justify his suspension or disbarment. Specifically, the following matters, among others, will be considered grounds for suspension or disbarment:

"(*a*) Violation of the statutes or rules governing practice before the Treasury Department.

"(*b*) Conduct contrary to the canons of ethics as adopted by the American Bar Association.

"(*c*) False or misleading statements or promises made by the attorney or agent to a taxpayer or misrepresentation to the Treasury Department.

"(*d*) Solicitation of business by the attorney or agent. This includes letters, circulars, and interviews not warranted by previous association; printed matter appearing on the letterheads or cards of the attorney or agent indicating previous connection with the Treasury Department (but an enrolled attorney or agent may use on his letterheads or cards the words "enrolled to practice before the Treasury Department," or words of similar import); or representation of acquaintance with Treasury officials or employees. It includes also the use by attorneys and agents of any titles which might imply official status or connection with the Government, such as "Federal tax expert" or "Federal tax consultant." It is not considered a violation of this regulation for Treasury employees, on severing their connection with the Department, to send out announcement cards, briefly stating their former official status and announcing their new association, provided the cards are addressed only to personal or business acquaintances, and provided further that such cards are distributed only at the time of severance of the official connection with the Government. These cards are regarded by the committee not as advertising but as the customary announcement cards issued for the express purpose of identifying the sender with his new association or business.

"(*e*) Negligence in furnishing evidence required in matters pending before the Treasury Department, and in the use of any means whereby the final settlement of the matter is unjustifiably delayed.

"(*f*) The employment by an enrolled attorney or agent as correspondent or subagent in any matter pending before the Treasury Department, or the acceptance by such enrolled attorney or agent of employment as correspondent or subagent of or from any person who has been denied enrollment or who has been suspended or disbarred from practice. It is in violation of the regulations for an enrolled attorney or agent to assist in any way or be assisted by

an attorney or agent who has been denied enrollment or has been suspended or disbared.

"(g) Any other matter which, in the opinion of the committee of enrollment and disbarment, is unfair to the taxpayer or to the Treasury Department or interferes unduly with the orderly disposition of matters pending before the department.

"(h) No former employee of the Bureau of Internal Revenue who violated his agreement to stay at least a year in the bureau shall be admitted to practice until after two years from his severance of connection with the bureau."

A. W. MELLON,
Secretary of the Treasury.

Mr. NASH. Senator King asked me something about the personnel of the intelligence unit.

There are 92 intelligence agents. Some of them are in Washington and the rest of them are distributed quite generally around the country. Of course, their function is to investigate fraud cases and cases involving our own personnel. One of their incidental functions is to make investigations for the committee on enrollment and disbarment. That is a very minor part of their work.

Senator KING. How many are usually employed in Washington?

Mr. NASH. I think we probably have ten or a dozen in Washington; that is, we have some men at large here. We may have a big case break in some section of the country where we do not have a man, and we will send a man directly out of Washington on that case.

Mr. MANSON. Do you use those men for the preparation of the kind of cases as illustrated by these recent indictments? I have seen in the papers recently several indictments of employees.

Mr. NASH. Yes; in cases of collusion between employees and tax experts on the outside. All of such cases are worked up by these men.

The CHAIRMAN. Do you use them in fraud cases like that discussed this morning—the Hillman case—and in ascertaining the degree of fraud?

Mr. NASH. The agent might be used to make a field examination in a case of that kind and bring in the facts, and he might make a recommendation on it. He might sit in the conference where the case was being considered. I think that was brought out in the Atlantic, Gulf & West Indies cases, where the two agents who had made the examination in New York were brought to Washington and took part in the conference where the ultimate settlement was arrived at.

Mr. MANSON. In the Kerr Steamship Co. case, where the owners of the company sold out and tried to get out of the country with the money, if I remember rightly, the agents were used.

Mr. NASH. Yes. Many of our intelligence agents are expert income-tax men, who have worked up through the Income Tax Unit. I might also say that probably half of their efforts are devoted to prohibition cases. Practically all of the big prohibition cases are worked up by the intelligence agents.

Mr. MANSON. You mean the intelligence agents of your service?

Mr. NASH. Yes. You see, they are the intelligence agents of the Bureau of Internal Revenue, and the Prohibition Unit is a section of the Bureau of Internal Revenue.

Senator KING. Would they be subject to the jurisdiction and control and direction of the Prohibition Unit?

Mr. NASH. No, indeed. They are subject to the direct control of the commissioner.

The CHAIRMAN. Have you anything else to put in this morning, Mr. Nash?

Mr. NASH. Mr. Manson asks us for our record under section 326 of the 1918 act, and I have found this—I do not know that it is all of the record, but it is at least a part of it. It is as much as I could find. It is a card record; the alphabetical arrangement is complete from A to Z.

Mr. MANSON. How many cards are there, Mr. Nash?

Mr. NASH. I should guess around 200.

Mr. MANSON. It is not your judgment that those 200 cases represent all of the cases in which paid-in surplus was allowed under the 1918 act and subsequent acts, is it?

Mr. NASH. It is not my judgment that this is a complete record.

The CHAIRMAN. That is all you have, anyway?

Mr. NASH. That is all I could find, Senator. I did find an order dated October 18, 1919, signed by George Newton, head of the audit and administration division, and approved by Mr. Callan, assistant to the commissioner, which reads as follows:

HEAD OF TECHNICAL DIVISION.
HEAD OF AUDIT SUBDIVISION.
CHIEF OF RETURN CONTROL SECTION.

Section 326 (a) (2) provides:

"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."

In order that this record required by law may be maintained, in the audit of any return coming under this classification the attached form must be prepared and immediately sent to the head of the division or subdivision. The head of the division or subdivision will immediately send the form to the chief of the return control section who will file the same in the manner designated.

In view of the fact that this information may be called for by either the Senate or House of Representatives, it is absolutely essential that every such case be recorded.

That is signed by Newton, head audit and administration division.

As I explained the other day, these cases were handled for a long time in the old special assignment section. About two years ago, that section was abolished, and the work which they were doing was distributed to the regular audit divisions.

There seems to have been a tendency, years ago, in organizing the Income Tax Unit, that every time a peculiar sort of case would come up they would organize a special section to handle that kind of case. The income-tax organization of a few years ago was composed of many sections, each handling a peculiar kind of case. Our job for the last two or three years has been to break down all of these old sections and try to get a machine that would function in all cases, with big divisions instead of little sections.

This section, as I stated, was abolished about two years ago, in accordance with our program, and the work that that section did was distributed into our three big auditing divisions. As I understand it, the records that were kept up to that time became lost in the shuffle, and this is all I have been able to find. After the abolishment of this section I find that no records were kept, and this order evidently was lost sight of, until some of these cases came up before the committee last fall. It was called to my attention that it was necessary to keep such a record under the old law, and since that time we have kept a current record of all such cases.

Senator KING. Mr. Nash, is it not a fact—and this is not germane to what we have been discussing—that there are many cases in which the records show that in the consideration of invested capital as of March 1, 1913, for the purpose of depletion or for the purpose of depreciation, where the invested capital consisted solely of patents, or of something intangible, some intangible property, they have allowed and are still allowing depreciation?

Mr. GREGG. It is done.

Senator KING. Can that be justified, Mr. Gregg?

Mr. GREGG. It is absolutely required, I think, by the statute. You do not differ with that, do you, Mr. Manson?

Mr. MANSON. That depends upon whether it refers to tangible or intangible assets.

The CHAIRMAN. Senator King is speaking of intangible assets.

Senator KING. Intangibles—a mere patent or some other intangible asset. I do not see how you can allow depreciation under those circumstances.

Mr. MANSON. I think the statute absolutely requires the allowance of depreciation on the cost or the 1913 value of a patent. I do not see how, under the statute, you can avoid it. As to other intangibles I have a great deal of doubt about the legality of the allowance of depreciation.

Mr. GREGG. Your question also is whether there is any exhaustion or depreciation?

Mr. MANSON. Yes.

Mr. GREGG. But where there clearly is, in the case of a patent, I do not think we have anything to do under the statute but allow it.

Mr. MANSON. I have not presented the question yet, but I do intend to present a report on the matter of what might be considered the depreciation of good will. The whole subject appeared to be rather involved. In other words, what is considered depreciation in one case, or what is handled as depreciation in one case, appears to be handled as the loss of useful value in another case or as obsolescence in still a third case. The line of demarkation does not appear to be clear in the application of the principle to specific cases. We have a whole lot of information on that subject, but I have not as yet assembled it into form for presentation.

Senator KING. You are going to present that, Mr. Manson, are you?

Mr. MANSON. Yes.

Senator KING. Then I will not ask you to incumber the record with it now.

The CHAIRMAN. If you have an opportunity to-morrow, Mr. Manson, I wish you would take up this question of actual or legal control on affiliation. I think that is important, even if we do not get anywhere with it except to present the problem to the committee, so that we may think about it until we meet again, because, as I understand it, the Board of Tax Appeals is reversing the acts of the bureau right along on these cases. Is not that right, Mr. Gregg?

Mr. GREGG. Yes.

The CHAIRMAN. I not being a lawyer, it may appear presumptuous for me to say so, but it seems to me that the Board of Tax Appeals has been taking a very absurd position.

Mr. MANSON. I think I can state all I know on that in a very few minutes. It will only take me about five minutes.

One of the elements to be considered in the determination of affiliations of corporations is the matter of the control of the stock. The bureau has taken the position that the control intended by Congress in that act was a legal control, an enforceable control, such control as arises out of the ownership of stock, such control as arises out of the power of assignment, and such control as arises out of a proxy.

The Board of Tax Appeals has taken the position that the control intended by Congress includes what you might call moral control. In other words, a control of this character:

A has a majority of the stock of a manufacturing company. B owns a minority. B is an officer of the company. He is employed by the company, but A at any time could vote B out of his job with the company.

A comes in and claims that he has control of a hundred per cent of the stock, because he can fire B if B does not vote his stock as A desires him to vote it.

My objection to that theory is that it leaves it entirely up to the taxpayer to determine whether or not he controls it, and the bureau has absolutely no check on it whatever.

For instance, if A does not desire to be affiliated, he comes in and takes the position that there is a big minority interest which he does not control. He says, "I can not control B's vote, even though B has a job here; I can not control how he will vote his stock." If, on the other hand, A desires to be affiliated and desires to show that he controls that stock, he comes in and represents that because B's job is dependent upon him he controls that stock.

I do not believe that Congress ever anticipated any such control as that where the question of control must necessarily be determined by examining a man's mental operations rather than by an examination of tangible facts.

The CHAIRMAN. I understand that that question of option, though, has been corrected in the 1924 act.

Mr. MANSON. Oh, yes; the matter of the option has been corrected under the 1924 law. I believe, however, that the effect of the ruling of the Board of Tax Appeals, so far as undetermined cases in the bureau are concerned, is going to mean a tremendous loss of money to the Government. I think there are going to be many cases following these recent rulings where taxpayers are going to take advantage of these rulings.

Senator KING. May you not, Mr. Gregg, appeal from that?

Mr. GREGG. Yes, sir; we may.

Senator KING. And is not the department going to appeal?

Mr. GREGG. I do not know. It has not been finally determined. I shall not recommend it.

Mr. MANSON. I do not know as I have stated the situation plainly on that angle of it.

Mr. GREGG. Yes; you stated it very plainly. Your argument was not a legal argument, though.

The CHAIRMAN. Mr. Gregg said that he was not going to recommend an appeal. On what theory?

Mr. GREGG. Because I think the board is right.

The CHAIRMAN. Do you think that it is right for a man to come in here and say that he controls a vote morally?

Mr. GREGG. Yes; if he can prove it. I do not think that is a proper rule, but I think that is a rule that Congress laid down.

Senator KING. Do you think Congress had in mind a moral control?

Mr. GREGG. I do not think Congress thought one way or the other about it, but I think that the language that they adopted means that.

Senator KING. I do not think, on a question of voting, for instance, a court would construe that because A worked for me and I might, and possibly would, assert some authority over his vote, it was contemplated that in some contingency he should be exonerated from voting a proper way——

Mr. GREGG. I do not think the board has ever passed on such a case as Mr. Manson has raised.

Mr. MANSON. No; I used that as an illustration of the principle. I do not mean to say that that is a specific case.

Mr. GREGG. I do not think they have gone quite that far.

Mr. MANSON. But I can see where the rulings which they have made, and which I do intend to discuss in a very carefully prepared report on that subject, involve that principle.

Another illustration is a case where a father controls the majority interest in a corporation and his son controls a minority. It is possible for him to come in and say, "I can not control my son's vote," if he does not desire that corporation to be affiliated; but if he desires it to be affiliated, he comes in and says, "Why, I control my son's vote."

The CHAIRMAN. It applies to a wife.

Mr. MANSON. Oh, yes; it applies to any imaginable number.

Senator KING. We have passed a law now that the wife is not a part of the husband. A woman may be married to an Englishman, but she is still an American citizen, if in her domicile she does not follow her husband.

The CHAIRMAN. I would like to ask Mr. Gregg what there is in the statute that makes him follow the conclusion that it was the intent of Congress to have actual control rather than legal control?

Mr. GREGG. Because it says "control," and when it says "control" it means "control," whether legally enforcible or not. When you read into it that it is legally enforcible control, you are restricting the language of the act.

Senator JONES of New Mexico. I recall an instance of that character—it was the case of an oil company—that came to me once.

They wanted to get a lease, which could only be given on the theory that they had been running an independent concern It appeared that this man had sold all of his stock to the Standard Oil Co., but he said that as long as he was president of that company he proposed to run it to suit himself, and that he was holding an independent company. In that case it would appear hard to define control, except by a blind rule of legal control.

Mr. GREGG. Well, the rule of actual control is a very difficult rule to apply.

Senator JONES of New Mexico. I think so.

Mr. GREGG. It is very difficult.

Senator JONES of New Mexico. Yes.

Mr. GREGG. And we recommended to Congress that control test should be taken entirely out of the statute, which was done in the 1924 act.

Senator KING. I think before you decide as to whether you are going to appeal or not, you ought to have a very serious conference with the officials of the bureau.

Mr. GREGG. It has been most carefully considered by about a hundred people, I should say, by now.

The CHAIRMAN. What was your intention, Senator Jones, when you voted for that?

Senator JONES of New Mexico. I remember that that was discussed. As to the expression, "actual control," nobody went into an investigation of its ramifications to see where it would land; but accepting it on the face, that if there is actual control, it would not seem to be necessary to draw any distinction between that and legal control. If there was actual control, as to how it should be administered, was never really carefully thought out, I am sure.

Mr. MANSON. I think the fact is that if the act referred to a contract, it would necessarily construe it to mean a legal and enforceable contract.

Senator KING. I move that we adjourn until 10 o'clock to-morrow morning, Mr. Chairman.

Senator JONES of New Mexico. You might have various situations to deal with there.

Mr. MANSON. Yes.

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

(Whereupon, at 1.30 o'clock p. m., the committee adjourned until to-morrow, Saturday, May 30, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

SATURDAY, MAY 30, 1925

UNITED STATES SENATE,
SPECIAL 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), Ernst, Jones of New Mexico, and King.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. L. H. Parker, chief engineer for the committee.

Present on behalf of Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. James C. Rogers, Assistant Solicitor, Bureau of Internal Revenue; and Mr. C. B. Allen, assistant deputy commissioner, Income Tax Unit, Bureau of Internal Revenue.

The CHAIRMAN. Mr. Nash, you wish to make a report on some of the matters that the committee asked you to tell us about?

Mr. NASH. This is a memorandum concerning the additional taxes assessed against Guyton & Harrington Mule Co., dissolved, the Stockyards Horse & Mule Co., dissolved, John D. Guyton, William R. Harrington, and Herman N. Beers, and the subsequent reduction of the assessment.

In February, 1923, summary assessments for the year 1917 of additional taxes and penalties were made against these taxpayers as follows:

Guyton & Harrington Mule Co	$4,700,390.99
Stockyards Horse & Mule Co	100,861.41
John D. Guyton	11,936,623.87
William R. Harrington	2,582,759.98
Herman M. Beers	727,445.45

Agents had been investigating these taxpayers' liability for 1917 for a long period of time. The taxpayers rendered them no assistance and presented only fragmentary records, claiming that practically all their records were lost or destroyed. The agents proceeded as directed in section 3176 of the Revised Statutes and made up the returns from the best evidence obtainable, which evidence was gleaned from the fragmentary records presented to them and a number of enormous bank deposits. John D. Guyton was the president of the Guyton & Harrington Mule Co., and enormous deposits were entered in his name which were not reflected in the fragmentary records which had been presented to the agents. The conclusion was reached by the agents that these large deposits were gross income to

the corporation and had been diverted by Mr. Guyton into his own account. They concluded that these deposits should be entered up as gross income to the corporation and should be considered as distributions in the nature of dividends to Mr. Guyton. In addition to this income it also appeared on the first investigation that Mr. Guyton, Mr. Harrington, and Mr. Beers had attempted to set up as gifts to their families certain stock which was later entitled to large liquidating dividends, and that the income from such dividends was income to the individuals rather than to the members of the families to whom they had attempted to give the stock.

This accounting for the original summary assessment in February, 1923, is general in character. In the absence of the Income Tax Unit files which contain the full details and are now in part before the Senate investigating committee it would seem that this general statement of how the original assessment was arrived at is probably all that is necessary for the purposes of this memorandum.

I will say that I did not know until I received this memorandum that the committee had the files in this case.

The CHAIRMAN. I want to say that I did not know we had them, either.

Mr. MANSON. What is the case?

Mr. NASH. Guyton & Harrington Mule Co., the Stockyards Horse & Mule Co., John D. Guyton, William R. Harrington, and Herman M. Beers.

Mr. MANSON. I did not know that we had them.

The CHAIRMAN. Who called for them, do you know?

Mr. MANSON. I do not know that.

The CHAIRMAN. Does Mr. Parker know?

Mr. PARKER. I do not recall.

The CHAIRMAN. They were called for, possibly, at the suggestion of Senator Reed of Missouri, because I remember his speaking to me about the case before the Finance Committee last February. You may finish your statement, Mr. Nash.

Mr. NASH. These summary assessments and equity suits which were brought against the dissolved corporations forced these taxpayers to eventually produce all records, the majority of which they had claimed, when the agents were investigating the case, had been lost or destroyed. After the books were presented to the Government the taxpayers then presented voluminous evidence on the many points in issue and were given about a week's hearing in the solicitor's office, at which they convinced the Government's representatives who sat in the hearing that the summary assessments were entirely too large, and as a result of the evidence then presented, together with their books, it was concluded deliberately by the Government representatives who conducted the hearing that certificates of overassessment for the year 1917 should issue as follows:

Guyton & Harrington Mule Co	$4,790,019.07
The Stockyards Horse & Mule Co	100,861.41
John D. Guyton	11,384,076.13
William R. Harrington	2,582,759.98
Herman M. Beers	879,396.40

Each item going to make up the reduction was given careful consideration and a memorandum was then prepared showing how each item should be treated. The original of this memorandum is

with the unit files to which the Senate investigating committee has full access.

Even though the Government's representatives concluded, after the hearing, that these certificates of overassessment should issue, nevertheless, rather than make a mistake, the bureau sent one of its representatives to Great Britain to check over, in the war office of the British Government, amounts that had been paid to these various taxpayers for horses and mules, etc., aggregating millions. The bureau's representative, after several months' work in London, rendered his report which was checked carefully against the findings of the conferees at the hearing in the solicitor's office, and it was then found that the returns as filed were not far from wrong and that the assessments summarily made should be reduced. It was after this investigation in London that the commissioner approved the reduction of the large assessments and sent out the certificates of overassessment.

The attitude and misrepresentations concerning the loss and destruction of the books on the part of the taxpayer were the real cause of the agents proceeding as they did to make up returns from the best evidence obtainable which resulted in the large amounts involved in the summary assessment.

The CHAIRMAN. You have no intimation, then, as to the actual amount of taxes paid?

Mr. NASH. According to this memorandum, the additional assessments were practically all abated. There was very little difference between the certificates of overassessment and the amount of the original assessment.

The CHAIRMAN. Is the case closed?

Mr. MANSON. It is a 1917 case and I assume that the statute of limitations has run on it.

The CHAIRMAN. Mr. Manson, I assume that you will go over those files——

Mr. MANSON. Oh, yes.

The CHAIRMAN. That have not already been returned?

Mr. MANSON. Yes; if we have the files. I did not know that we had the files. I remember one conversation in which Senator Reed of Missouri was talking about a horse and mule company or a mule company, but he did not give the names at that time. That is why nothing was done about it then. He did not say who it was.

The CHAIRMAN. I think he did to me, but I did not take note of it, as a matter of fact.

Mr. MANSON. At the time that we had the conversation he did not give the name and this letter just came to my attention a few days ago.

Mr. NASH. Of course, the committee has asked for a great many cases for statistical purposes, and it may be that this is among those.

Mr. MANSON. I do not know.

Mr. NASH. Mr. Box has called for a great many cases that may not have come to your attention at all.

Mr. MANSON. Yes.

The CHAIRMAN. I suppose all of those cases that we have asked for for statistical purposes will be included in the list of cases that Senator Ernst has asked for.

Mr. NASH. I do not know, Senator, whether any segregation was made of the cases that were sent for statistical purposes and the cases that were sent for other reasons. I do not believe any record has been kept of those photostats of the 1924 corporation returns that have come up to the committee.

Mr. MANSON. 1923.

Mr. NASH. Or the 1923 returns that have come up to the committee.

Mr. MANSON. We have a record of all of the cases that we have called for and of the use that we made of them.

Mr. NASH. I did ask Mr. Bright's office to keep a record of the files that were turned over to the committee, in order to check them back as they were turned back, so that we could keep control of the files. That is the only record, so far as I know, that was kept.

The CHAIRMAN. Have you received the 1924 returns yet, Mr. Manson?

Mr. MANSON. No; not yet. The chairman will recall that at about the time those returns were asked for, the commission wrote a letter to the chairman explaining why they could not be furnished until about the 1st of June, or soon thereafter.

The CHAIRMAN. You have something else that you want to put in the record, Mr. Nash?

Mr. NASH. I want to say that these 1924 returns for individuals, which were asked for, have been coming in during the month of May, and they are now going through our proving section. They have been recorded, and will be made available for statistical purposes immediately after that work is completed.

The chairman asked the other day for a statement as to the position of the bureau on certain cases that have been called to our attention by this investigating committee.

Mr. Gregg and I went over the list of cases that have been presented to this committee and prepared this statement showing the position of the bureau on such of these cases as are being reinvestigated or reopened.

George Bros., being reinvestigated for years not closed.

William Boyce Thompson, being reinvestigated for all years from 1917 to date.

Witherbee, Sherman Co., being reinvestigated for years not closed.

The Los Angeles Shipbuilding Co. cases is being held until we get data from the collector at Los Angeles as to the collection of this tax.

Houston Coal & Coke Co., being revalued for years not closed.

The J. I. Case Threshing Machine Co. and the United States Steel Co. cases are still in the solicitor's office. The solicitor is now going into the whole subject of amortization, and has informed the committee that he will report to them as soon as they come to a definite conclusion on that subject.

The United Verde Extension Co. case is in the solicitor's office, where they are going into it to see if we can reopen this case. It is a case in which there has been a 1312 contract and we have to show fraud or gross error before we can reopen it.

There are eight cases on amortization on land: The Todd Shipyards Corporation, Todd Drydock Construction Co., Trojan Powder Co., J. H. Williams Co., Guantanamo Sugar Co., Federal Ship-

building Co., South Porto Rico Sugar Co., and the Pacific Coast Shipbuilding Co. The solicitor's office is going into the question of amortization on land and will make a report to the committee on the subject.

The cases of the Union Sulphur Co., Freeport Sulphur Co., and the Texas Gulf Sulphur Co. are being reinvestigated for the years reported to the committee and subsequent years.

In the case of the Standifer Construction Co. the 60-day letter is out and it is on its way to the board of tax appeals. In the case of the United States Graphite Co. the commissioner has signed an order to reinvestigate this case for all years involved.

The Climax Fire Brick Co. case is being reinvestigated for unclosed years.

The Penn Sand & Gravel Co. is being reworked on the basis, I believe, of the field engineer's report, and in which the ruling of Mr. Shepherd has been reversed.

The case of the Houston Colleries Co. is being reinvestigated for unclosed years.

On the Dill & Collins Co. case we are checking up in the Income Tax Unit. That is a case in which the engineers and auditors differed on the rates of depreciation, and to date I have not had any report from the Income Tax Unit on it.

In the case of the Westinghouse Air Brake Co. the commissioner has ordered that case to be reworked. That is the one in which amortization was granted on the basis of the rent that might have been collected had all of the houses been occupied.

The Anne O. Haight, Perlman Rim Co., Standard Parts Co., and the Western Spring & Axle Co. cases are all cases in which the transfer of stock of one party was not reported by the other parties involved in the same transaction, and I have referred those cases to the intelligence unit for an investigation, because there is a possibility of fraud in them.

Senator KING. And at the same time you have asked them to try to ascertain whether there are other stockholders in the same situation?

Mr. NASH. The intelligence unit will investigate everything that is involved in these cases when they go into them.

The cases of the Foster Oil Co. and seven others—the Shell Co. the Union Oil Co., the California Petroleum Co., Mascot Oil Co., the Union Natural Gas Co., Kennedy & Springer Co., and E. F. Connelly—have been referred to the oil section for an explanation, and I have received no reply as yet.

The case of Louis J. Kauffmann, of New York, has also been referred to the intelligence unit for investigation, as there seems to be a possibility of fraud in that case.

The Skelly Oil Co. case is being reinvestigated.

The Kerr Turbine Co. and the remaining cases that were reported during the last few days here, the Watab Pulp & Paper Co., Robert Dollar, General Motors, estate of Charles Warren Fairbanks, the Mellon National Bank, Union Trust Co., and the Union Savings Bank, have all been referred to the Income Tax Unit for explanation, and as yet nothing has been received on them. I will submit

a written report on each of them as soon as I get replies from the unit.

Senator KING. In view of what I conceive to be the unsatisfactory condition in the minerals division, particularly with respect to certain mines, and certain oil and gas cases, have you limited your request to an examination or a consideration of only those cases to which your attention has been challenged by our counsel?

Mr. NASH. No, sir. We are constantly going into other conditions. I am now reporting to the committee the disposition of such cases as have been reported to this committee, and which Mr. Gregg and I felt, after going over the files, ought to be looked into further.

Senator KING. It is apparent from the nature of the work to be performed by this committee and by counsel that it was impossible for them to examine all of the cases in the minerals division, but so many cases have been brought to the attention of the committee that it would seem to me that the heads of the Income Tax Unit could, with very great propriety, ask for closer work upon the part of that part of the bureau and a reexamination of many of these oil and gas cases.

Mr. NASH. We are placing on Monday morning, in the review section of the engineering division, one of the best lawyers that we have in the solicitor's office on engineering cases to assist in the review of such cases as come to that division. It would be physically impossible for him to go into all of them.

The CHAIRMAN. In your statement of cases, Mr. Nash, you mentioned the George Bros. case. That is one of the cases that I think were handled by Mr. Rusch within 12 days from the time that he left the bureau.

Mr. NASH. I think that is one of the cases that was mentioned in the disbarment proceedings against Mr. Rusch. As I recall it, the case was transferred from the corporation audit division to the consolidated audit division. There was some question at that time as to why that case should have been transferred. After going into the case we found that the reason it was transferred for consideration in the consolidated division was that there was a corporation and a partnership, and, under some provision of either the law or the regulations, it was possible, under certain conditions, to affiliate a corporation and a partnership. I am also told that at that time if a case did get into the consolidated division, whether it was a consolidated case or not, they went ahead and completed the audit. It seems that the corporation division at that time was behind in its work, and there were not so many cases pending in the consolidated division. It was thought, therefore, in order to expedite the settlement of cases, that once they were referred to the consolidated section, they would finish the cases in that section.

Th technical question involved in that case, as I recall it, was the allowance of excessive salaries to certain members of the corporation, and that question is now being gone into.

The CHAIRMAN. When you make your report to the committee, will you include your observations as to Mr. Rusch's dealing with this case within 12 days from the time he left the bureau, please?

Mr. NASH. Yes, indeed.

Mr. MANSON. While we are waiting for Senator Jones, there is a matter that I would like to make a statement in regard to.

The question has been frequently raised as to whether the cases which have been presented to the committee were not exceptional cases, freak cases. There were some instances in which such cases have been presented, because they were exceptional and freak cases. In other words, the very criticism of them was predicated on the fact that special favors had been allowed to this particular taxpayer, or that a special procedure had been followed to the advantage of a particular taxpayer, which was not generally followed. In such instances, the criticism was specifically directed to that point; special attention was called to it.

There were other classes of cases in which that was not true; but going back to the beginning of our proceedings, the first class of cases that we began to deal with were amortization cases. We offered a great number of amortization cases. We have now reviewed all of the amortization work in the bureau, in large cases. We started from the top, and from the standpoint of amount involved, and went down the list, and the cases which have been presented to the committee are typical of the conditions with respect to the handling of amortization.

I have had one engineer working constantly on amortization cases, even though but few have been recently presented to the committee, and although he has worked on them right up to date, for the purpose of determining whether the cases which were not presented to the committee were properly determined, or whether they were determined in accordance with the solicitor's ruling, or whether they were not. A summary report dealing with all of those cases, by name and the amount involved, together with a brief statement of how they were handled, will be submitted to the committee. In other words, if I had attempted to present all of the amortization cases to the committee, I could have devoted this whole investigation to amortization and have done nothing else.

Now, with reference to copper mines——

The CHAIRMAN. Just before you go into that, Mr. Manson, in making your report to the committee, I would like, if you can, from the records that you have, tell us to what extent this seven hundred millions of amortization has affected taxes?

Mr. MANSON. We will do that.

The CHAIRMAN. Because we all realize that a mere statement of an allowance of $700,000,000 for amortization does not mean that that much taxes were lost to the Government.

Mr. MANSON. We will do that as near as we can.

Coming now to mines, after the most searching investigation of the mines section, that is, the metals section, under the administration of Mr. Grimes, we were unable——

Senator KING. Now under his administration, you mean?

Mr. MANSON. Yes; now under his administration—we were unable to find anything in his work, or the work done under his direction, which could be criticized.

We presented the copper situation to the committee. There was nothing isolated or peculiar about that, because we presented the data in 70 cases. It was presented at one time and in one report, but it covered specifically and in detail 70 cases.

As to the nonmetals, we were unable to find anything to criticize in the work of the nonmetals section of the bureau. We found an abundance of cases to criticize where the nonmetals section had been overruled by special conferees, and I think, as the result of the disclosures before this committee, the special conferee system was abolished.

I will call attention to a few of the cases: The Climax Fire Brick Co., Penn Sand & Gravel Co., the United States Graphite Co., Border Island Co., New Jersey Calcite Co., and the three sulphur cases. The three sulphur cases which we criticized were not handled under the administration of Mr. Briggs, who was the chief of the nonmetals section at the time our investigation of that section was made. Those cases were handled under the administration of Mr. Griggs, who was the chief of this section before Mr. Briggs, and who is the assistant chief of the engineering division.

The CHAIRMAN. That means that he is Mr. Greenidge's right-hand man?

Mr. MANSON. Yes. He also acted as special conferee in some of these cases which we have criticized.

So that, as far as the administration of the nonmetals section under Mr. Briggs's administration was concerned, which was the administration we were investigating, we found nothing to criticize. We found a great deal to criticize where he had been overruled by special conferees, particularly Mr. Griggs and Mr. Shepherd.

I am informed that Mr. Shepherd was removed from the service, and I am informed that Mr. Griggs is still the assistant chief of the nonmetals section, although the work of one does not seem to be markedly different from that of the other.

The timber section was investigated thoroughly. We found nothing to criticize in the work of the timber section. We found, however, that, particularly with reference to depreciation, while the timber section was required to determine depreciation rates the auditors were not required to abide by the determination of the timber section, and some ridiculous results followed from that.

I want to state here generally now that where cases were isolated cases and criticized for the reason that special consideration had been given to them we called attention to that fact in connection with the case. Other cases were criticized because we believed them to be typical.

At the time that we presented amortization, for instance, we were unable to say that those cases were typical. We know now that they were, because we have gone ahead with that work right up to the present time for the purpose of determining that fact, although we have not brought anything before the committee. It was deemed unnecessary, because it is being incorporated in a report to be made to the committee.

The CHAIRMAN. Have you any further statement to make this morning, Mr. Manson?

Mr. MANSON. No, sir; that is all I care to add.

The CHAIRMAN. Senator Jones, Mr. Briggs is here now. Do you care to interrogate him?

Senator JONES of New Mexico. I would like to ask Mr. Nash if he has any information at hand to tell us about this reduction in

force in the Bureau of Internal Revenue; first, what was the necessity for any reduction in the force?

Mr. NASH. Senator Jones, if I might I would like to read just an extract from the address of the President to the Government business organization in January of this year.

Senator ERNST. Mr. Nash, we want you to make your statement in your own way.

Mr. NASH. The President commented specifically on the personnel situation in Washington. A portion of his address reads as follows:

> At our meeting last June I called your attention to the necessity of reducing the Government pay roll. The matter of personnel should be kept constantly in mind. It is the heaviest single item of our expenditures. * * * We can not look to a reduction in pay to effect a reduction in the Government pay roll. What we are looking for is a reduction in the number of employees. Let me remind you that the Government pay roll for 1924 reached the staggering total of $1,680,000,000. * * * This staggering total should cause concern—not only to us but to every thinking citizen. * * * We have superfluous employees. It is an unpleasant and difficult task to separate people from the Federal service. But it can be done. It will be done. I advise Federal administrators to plan to operate with a smaller personnel than is now employed.

I attended that meeting, and it was my impression that the President meant what he said.

I have charge of the appropriations and the finances for the operation of the Bureau of Internal Revenue. One of my duties is to appear before the Budget Bureau and before the Appropriation Committees of Congress, to explain appropriation estimates as well as to furnish information concerning our expenditures to these committees.

Our appropriations have been reduced consistently for the last three years. In 1924 our administrative appropriations were $34,249,000.

Senator KING. You mean that that is for the entire Bureau of Internal Revenue, the taxation end of it?

Mr. NASH. Just for the tax end of the bureau, not including prohibition.

In 1925 our appropriation was $33,381,600.

In 1926—that is, for the fiscal year beginning July 1—our appropriation has been cut to $31,750,000. We have also been limited to not more than $10,750,000 for personnel cost in the District of Columbia.

On March 10, 1925, I addressed this memorandum to Deputy Commissioner Bright, with reference to his allotments for the fiscal year beginning July 1, and a similar memorandum went to each of the other deputy commissioners. This memorandum is dated March 10, 1925, over my signature, addressed to Deputy Commissioner Bright:

> "The allotments which will be granted to you to meet the needs of the field forces under your supervision (internal revenue agents' divisions) and the Income Tax Unit of the bureau for the fiscal year 1926 beginning July 1 next from administrative appropriations which have been granted to the bureau for that fiscal year are shown in the following statement:
>
> Field organization: Appropriation "Collecting the internal revenue, 1926," $31,750,000.
>
> Allotment No. 21: Salaries of permanent employees, internal revenue agents' divisions, $7,325,000.

Allotment No. 22: Salaries of temporary employees, internal revenue agents' divisions, $20,000.

Allotment No. 23: Traveling expense of internal revenue agents' divisions, $800,000.

Allotment No. 24: Miscellaneous expenses of internal revenue agents' divisions (exclusive of purchases made by Bureau of Supply), $110,000.

Unit organization: Thirty-six salaries, bureau (Income Tax Unit), $8,056,320; 74 salaries, bureau (Income Tax Unit), $785,500.

The administrative appropriations which have been granted by the session of Congress recently closed to the bureau to meet its needs during the coming fiscal year, exclusive of the amount appropriated for the enforcement of the narcotic and national prohibition acts, have been reduced $1,680,606 under the amounts appropriated for the current fiscal year. As a result of this large reduction which has been made on our appropriations and in order to comply with a restrictive clause which has been inserted in the appropriation "Collecting the Internal Revenue" to the effect that not more than $10,750,000 shall be expended under this appropriation title for personal services in the District of Columbia during the coming fiscal year it will be necessary for you to have the bureau and field organizations under your supervision within the limits of the allotments outlined herein on July 1 next and that they be kept within such limits during the ensuing fiscal year.

After Mr. Bright received this memorandum, he came to my office and said that he wanted to discuss some plans of reorganization in order to cut down the size of his organization, so that they could operate within their next year's allotments. We discussed a reorganization of the staff division of the Income Tax Unit, which had to do with the keeping of the personnel records, appointment files, etc., and we have worked out a plan by which the functions of that division will be eliminated by about 50 per cent.

Senator ERNST. By about how much?

Mr. NASH. About 50 per cent.

Senator JONES of New Mexico. What particular unit is that?

Mr. NASH. This is in the Income Tax Unit. As I say, we have worked out plans for reorganization of what we call the staff division.

We also discussed the organization of the engineering division, and I asked Mr. Bright to formulate some definite plan and bring it to me in writing.

On April 18, 1925, Mr. Bright brought this plan to my office. It deals with the engineering division, and it says that the following suggestions are submitted for consideration in connection with contemplated changes in the engineering division:

There are attached two sheets. One shows the entire personnel of the division as of April 15, 1925, the name of each employee, the salary received, the date entered the division, and the group to which assigned. The other shows what the division would be if the suggested changes are made.

The change suggested in the personnel attached to the head office is not to replace Miss J. Gehrman, comptometer operator, who I have been informed will resign, effective June 1, 1925. If Miss Gehrman does not resign, it is suggested that Miss Prendergast, comptometer operator, be transferred out of the division. This change is suggested, because the amount of work for which comptometer operators are needed is decreasing. The work of the two girls mentioned has been satisfactory.

The change suggested in the production committee, that of reducing the permanent personnel from five to two, is a temporary one. The work of the committee is important and has been well done, but is now less than heretofore because of the large number of small cases which are acted upon in the records division by engineers who are periodically assigned to such work.

Mr. MANSON. What was that—the production committee?

Mr. NASH. Yes; that paragraph dealt with the production committee.

Mr. Hanson was reassigned to the nonmetals section to-day.

Combining the present coal, metals, and nonmetals sections into one, to be known as the mining section, is the most important suggestion for consideration. The combined personnel of the three sections is 43 at present. The personnel of the suggested section would be 41, and this may be reduced to 40 by placing one from this section on the production committee. The suggested combination of the present three sections is of such importance that a discussion of it in writing would be lengthy, and is therefore deferred for conference.

There is no change suggested in the oil and gas section.

In the timber section the only change suggested at this time is the elimination of the position of assistant chief of section, thereby adding one engineer to valuation work.

In the appraisal section no change is suggested at this time.

The suggested changes would result in the pay roll being reduced approximately $18,000.

About 1,000 to 1,500 square feet of space now occupied by this division could also be made available for other uses.

At the time that this memorandum came before me the operating allotment of the Income Tax Unit in the bureau for this fiscal year was overdrawn to the extent of $32,395.01; that is, it was necessary for us to effect a reduction equivalent to that amount before June 30 in order not to overdraw our appropriation.

After Mr. Bright brought this memorandum to me I studied it carefully and discussed it with the commissioner. As far as it pertained to the creation of a mining section, combining coal, metals, and nonmetals, I thought it was an inadvisable thing to do at this time. I do believe that ultimately we should have such a section in our engineering division. It is a logical way to divide our work.

My suggestion at the time this was discussed was that if we created a mining section I thought it might be advisable to place Mr. Grimes at the head of it, and to put Mr. Davis, who is now at the head of the coal section, as the assistant to Mr. Grimes, heading this mining division.

The commissioner at the time agreed with me that it would be better to make this reorganization in two bites rather than in one, and it was then agreed to combine the metals and the nonmetals into one section and to put Mr. Grimes at the head of that section.

We called Mr. Grimes in and talked it over with him. I asked Mr. Grimes if he could function as the head of the combined section so that we could eliminate the administrative cost of one section. There were 10 men in the nonmetals section and 13 men, I believe, in the metals section. The new section would have about 23 men.

Mr. Grimes informed the commissioner and myself that he could operate as head of that section without any difficulty, and that it would not entail any additional administrative cost.

The commissioner then signed the order bringing about that consolidation.

Senator KING. I thought the consolidation was for the purpose of reducing cost, and yet you say that Mr. Grimes said that it would not add any additional cost.

Mr. NASH. Mr. Grimes stated that he could take over the work of the nonmetals section into the metals section.

Senator KING. Oh, yes.

Mr. NASH. Without any additional cost to the metals section. That eliminated the administrative cost of the nonmetals section.

Senator KING. Did that mean, then, the elimination of some individuals?

Mr. NASH. It eliminated Mr. Briggs and Mr. Briggs's secretary, I believe; and, as I have stated, at that time the allotment for the Income Tax Unit was overdrawn to the extent of about $32,000. It was necessary for us to get that overdraft out of the way before the 30th of June.

Senator KING. Then, the consolidation of those two sections—the metals and the nonmetals—merely meant the elimination of Mr. Briggs and his secretary?

Mr. NASH. It meant the elimination of the administrative cost of the nonmetals section, without respect to individuals.

Senator KING. But the way it has worked out it only eliminated Mr. Briggs and his secretary; is that right?

Mr. NASH. That would be the administrative cost there; yes sir.

This chart shows the relative position of the work in the engineering division with respect to these years between July, 1923, and April 30, 1924. I had the chart prepared at that time to show what the condition of the work would be in the engineering division. From this chart it is apparent how the work for 1917, 1918, 1919, and 1920 has decreased from the wide margin down to the very narrow margin at the bottom of the chart.

The CHAIRMAN. What division is that where it has increased?

Mr. NASH. Those are the newer years. In 1921 and 1922 the cases are coming in. The cases on hand in this nonmetals section, which we abolished, has been decreased as follows:

On May 1, 1924, we had thirty-two 1917 cases; on May 1, 1925, we had ten. That is just one-third of what we had a year ago.

Of the 1918 cases, a year ago we had 47, and on May 1 of this year we had 10. That is almost one-fifth of what we had about a year ago.

Of the 1919 cases, a year ago we had 330, and on May 1 of this year we had 29.

The CHAIRMAN. You left out 1918.

Mr. NASH. No; in 1918 we had 47, and came down to 10.

The CHAIRMAN. Oh, I see.

Mr. NASH. In 1920 we had 558, and that number has been reduced to 88.

Senator KING. You mean that those are cases still unsettled?

Mr. NASH. Those are cases still unsettled, but I just want to bring out that that is the number of pending cases in the division as of May 1, this year, as compared with May 1 a year ago.

Mr. MANSON. That indicates that Mr. Briggs did a pretty good job of cleaning up the work, does it not?

Mr. NASH. And it indicates that there was not sufficient work; that is, it indicates, to my mind at least, that there not not sufficient work in that division to justify the placing of another valuation engineer in the organization. The work on hand was rapidly diminishing, and we were also confronted with an overdraft in our appropriation which had to be overcome.

The CHAIRMAN. You have not stated the number of cases for the subsequent years.

Mr. NASH. There were 78 cases for the year 1921—that is, as far as this chart shows—a year ago, and 117 for 1921 this year. The

total here is shown as 1,045 cases pending as of May 1, 1924, and 254 cases pending as of May 1, 1925. That is about one-fourth the number of cases pending this year as compared with the number a year ago.

Senator KING. Mr. Briggs has been settling those cases, as I understand it.

Mr. NASH. Mr. Briggs was the head of the section through which these cases were passing.

Senator KING. Yes. The expedition with which they were settled would depend largely on the manner in which he performed his work, would it not?

Mr. NASH. It would, to my notion, depend more on the engineers who were handling these cases, or just as much as it would on Mr. Briggs.

Senator KING. Well, the head of the division has something to do with it.

Mr. NASH. Certainly; it is his job to see that the engineers immediately beneath him are working.

Senator KING. And he is the one who passes upon the result of their work.

Mr. NASH. I am not reflecting——

Senator KING. No; pardon me. He passes upon the result of their work, does he not?

Mr. NASH. I think he reviews it.

Senator KING. That is what he is for, is it not?

Mr. NASH. That certainly is.

Senator KING. He is familiar with that work, is he not, as much so or more so than anybody else in the nonmetals section?

Mr. NASH. He should be.

Senator KING. Then, he would know the method by which those cases should be settled?

Mr. NASH. That is true.

Senator KING. Then, why should you remove a man who was there and whose work was so effectual there because of the celerity with which those cases were disposed of, when you still had this large number of cases undisposed of—a man who knew the ropes and the technique of the organization and the rules to be applied for the settlement of those cases?

Mr. NASH. I think Mr. Grimes is a better man than Mr. Briggs, and Mr. Grimes can do everything that Mr. Briggs could do. Mr. Grimes told the commissioner and me that he could do it without much additional effort on his part or without interfering with important work of his division. It thereby enabled us to eliminate one administrative officer, who, I think, came under what the President termed "superfluous employees."

Senator KING. Why did you not eliminate some from the metals section rather than from the nonmetals section, with which this consolidation was effected?

Mr. NASH. I just want to point out, Senator, that it is necessary for us to make further eliminations.

Senator KING. I agree with you.

Mr. NASH. We have not stopped.

Senator KING. I think you have entirely too many in the Income Tax Unit.

Mr. NASH. There has been separated from the Bureau of Internal Revenue in Washington since January 1 of this year 348 employees.

Mr. MANSON. Did Mr. Grimes ever indicate——

Senator KING. Just let him finish that.

Mr. NASH. The aggregate salaries for those employees was $633,890.

The CHAIRMAN. Per year?

Mr. NASH. Yes, sir; the annual rate.

Included in that list are seven engineers, the salaries of the engineers involving an aggregate of $34,000. Mr. Briggs and Mr. Shepherd are included in that list. That shows the separations from the bureau between January and May 15.

Senator KING. Just the income tax alone?

Mr. NASH. No; the Bureau of Internal Revenue. There is no segregation as to the Income Tax Unit.

Senator KING. Have you any idea what that is?

Mr. NASH. The largest part of this—I presume 80 or 90 per cent—would be in the Income Tax Unit.

Mr. MANSON. Did Mr. Grimes ever indicate to you that he desired Mr. Briggs as his subordinate in the consolidated section?

Mr. NASH. I do not recall that such a question was put up to Mr. Grimes, or that Mr. Grimes commented on it.

Mr. MANSON. I will state that Mr. Grimes told one of the engineers for the committee that he would have been delighted to have had Mr. Briggs brought over to his force in the consolidated section.

Mr. NASH. I do not doubt that. I do not question it. Mr. Grimes might have been delighted. The problem which confronted me, and which confronted the commissioner, was to get rid of this overdraft. We eliminated what we thought were two surplus employees in the engineering division, Mr. Briggs and Mr. Shepherd, and thereby saved $10,000.

Mr. MANSON. You still have a man by the name of Seward, who is employed in the consolidated section, and who was on nonmetals work, have you not?

Mr. NASH. I believe there is a Mr. Seward in that section. I have talked to Mr. Grimes about Mr. Seward. Mr. Briggs criticized the reviewing officer in the engineering section, I believe it was, because he had raised Mr. Seward's rating over the rating that Mr. Briggs had given him.

I had Mr. Seward's rating investigated by a member of the intelligence unit. That officer recommended that Mr. Seward's rating be reduced. I think Mr. Briggs had rated Mr. Seward around 78 or 79. The reviewing officer had rated him about 90, and the intelligence officer recommended that it be reduced to about 84.

I discussed this Seward situation with Mr. Grimes, and I told Mr. Grimes, when he was taking over this section, that if Seward was of no value to him, I wanted to know it, and we would drop him as quickly as we would any other man who was not producing.

Mr. Grimes will make up an efficiency rating for Mr. Seward as of May 15, and if Mr. Grimes's estimate of Mr. Seward is such that he should not be continued in the service, he will not be continued in the service.

Mr. MANSON. I have examined this personnel record of Mr. Briggs which you have produced this morning, and it appears from this

personnel record that this man Seward was employed in the nonmetals section at a salary of $4,800 a year. It appears from the statement signed by Mr. Briggs and all of the engineers employed in his section that Seward was a loafer; that he would not work; that he had no production; and that he was absent from his desk most of the time. Mr. Briggs took that fact into consideration and gave him a low rating. Seward protested. Mr. Griggs, the assistant chief engineer, raised his rating. The effect was to demoralize Mr. Briggs's section, whose excellent record has been laid before the committee by Mr. Nash.

As a result of that situation, and in order that your engineers might know whether a man who had no production was to be rated over them, they signed a written statement. One thing in that statement was that the work of that section had been upon a uniformly sound foundation, except where affected by outside interference.

Mr. Greenidge called in every engineer who signed that statement and questioned each one of them with particular reference to that latter statement, that the work was upon a sound foundation except where affected by outside interference. Those men adhered to their position. They all stated that they signed this statement voluntarily.

The matter went up to Mr. Allen, the assistant to the deputy commissioner, and Mr. Allen has a memorandum on Mr. Briggs's efficiency record here, which I will read.

Senator ERNST. How does that affect the question that we are considering here now?

Senator KING. I think it is very material.

Mr. MANSON. It affects it in this way: It is claimed here—and there is an attempt to show—that this man was removed in order to save expense. The efficiency of his section has been demonstrated by the figures produced by Mr. Nash. No criticism has been made of his work by either the bureau or by the agents of the committee. We found it to be uniformly sound. The agents of the committee are of the same opinion, and, as far as I am concerned, I have reiterated the very statement here that is made in this memorandum, that the work of that section has been uniformly sound, except where affected by outside interference.

I have no criticism of the consolidation of that section, in putting the work under Mr. Grimes, who is an excellent man, but I do say that as long as you are holding a man who, according to a statement signed by every engineer in the section, is a loafer, it is manifest that Mr. Briggs was not summarily removed from the service for the sole reason that it would save expense.

Senator ERNST. Mr. Manson might show that might not have happened, but that would not show that Mr. Briggs under the circumstances which have been outlined here, should not have been dropped.

Mr. MANSON. The situation is this:

Mr. Briggs was getting $5,200 a year. I understand that on the reorganization he would have been satisfied with a subordinate position. There is no criticism of his work nor of the production of his section.

Senator ERNST. Nobody is making that point. You are putting up a straw man and knocking him down.

Mr. MANSON. This record shows——

Senator ERNST. Nobody is complaining of the character of his work, and personally I would like you to confine yourself to the issue; but if you want this in, I have no objection to it.

Mr. MANSON. This record shows conclusively that Briggs was removed because of the circulation and signing of a statement that the work of his section was on a sound foundation except where affected by outside interference. I was about to read this memorandum of Mr. Allen for the purpose of verifying the statement that I have just made.

Senator KING. By the way, did Mr. Greenidge attempt to intimidate or punish those men?

Mr. MANSON. There is no indication of that, but he called in each one of them and took their statement before a stenographer, with particular reference as to who prepared this statement, who had circulated the statement, and the foundation for the statement that the work was on a sound foundation except where it was affected by outside interference.

Senator KING. I think if the bureau wanted to reduce expense it could have gotten rid of Mr. Greenidge with very great advantage to the service.

Mr. MANSON. And they would have saved $7,500.

The CHAIRMAN. More than that. It would have saved a good many millions.

Mr. MANSON. This is Mr. Allen's memorandum:

It appears from the information given by engineers questioned by Mr. Greenidge, head of the engineering division, that a memorandum of April 15, 1925, addressed to Mr. J. H. Briggs, chief of nonmetals section, and signed by eight engineers of the nonmetals section, was circulated in that section by Mr. Briggs himself.

Mr. NASH. Mr. Manson, at that point may I ask you to read the memorandum that was circulated?

Mr. MANSON. Yes.

Mr. NASH. I think if Mr. Allen's comment goes into the record the memorandum ought to go in.

Mr. MANSON. Yes; I will be glad to do that.

The CHAIRMAN. I think that is proper.

Mr. MANSON. This is headed "Engineering Division, Income Tax Unit," and is dated April 15, 1925:

Memorandum for Mr. J. H. Briggs, chief nonmetals valuation section.

We, the undersigned engineers of the nonmetals valuation section, have read your memorandum dated April 14, 1925, and attached statements, addressed to the deputy commissioner.

Senator KING. Was this addressed to Briggs or Griggs?

Mr. MANSON. This is addressed to Briggs. [Reading:]

We indorse the statement made therein to the effect that "it would appear that a section chief should be consulted as an act of common courtesy, if not as a sound business policy, by a reviewing officer before changing his rating marks." This would appear to be axiomatic.

This refers back to Mr. Briggs's memorandum protesting against increasing the rating of this man Seward. [Reading:]

Referring to the memorandum of Engineer Seward—

Senator JONES of New Mexico. Just let me ask you this, Mr. Manson: Tell me about that system of ratings there. It seems that

this controversy relates to the question of ratings. How is that done?

Mr. MANSON. I understand that in the first instance——

The CHAIRMAN. Just a minute, Senator. I would get a better picture of it if he reads Mr. Briggs's memorandum of April 14, which started the controversy. I think that will indicate how it is done.

Mr. MANSON. All right.

The CHAIRMAN. That will bring it out in chronological order.

Senator ERNST. Yes; that will be better.

Mr. MANSON. All right. This is headed "Engineering Division, Income Tax Unit," and is dated April 14, 1925:

Memorandum for Mr. J. G. Bright, Deputy Commissioner (through Mr. S. M. Greenidge, head engineering division):

Reference is made to my conversation with you on April 10, 1925, in the matter of the rating of Engineer John Seward. You will recall that at that time I stated that Seward was rated much higher than the marks that I gave him should indicate. I further stated that the rating given him was unfair to the other men in the section and would have a bad effect upon the morale.

The morning of April 11, 1925, I was called to the office of Mr. C. B. Allen and shown the rating sheet of Seward. Corrections by check mark in red ink had been made thereon and the sheet had been signed by Mr. C. C. Griggs as reviewing officer. Upon my remarking that I had not been consulted in this matter, I was advised that it was not necessary that I should be consulted. However, it would appear that a section chief should be consulted as an act of common courtesy, if not as a sound business policy, by a reviewing officer before changing his rating marks. I would hesitate to contend for the position that I take, did I not feel that I have the support of my engineers.

I will first state how the position of subsection chief happened to be created. At the time that the subject of reclassification was up and reasons were being advanced for salaries to which engineers should be entitled, the nonmetals section had two engineers with salaries of $4,800, which was $800 higher than the next highest salary. It was thought that reclassification might endanger those salaries and as a possible aid to saving them it was decided to create two positions designated as subsection chief, to which Messrs. Seward and Shontz, the $4,800 men, were appointed, salary, not merit, controlling. In this connection reference may be made to Engineers Burdick, Cook, Madison, Nevius, and Hanson, the last named now with the production committee. I may add that I attempted to make the position of subsection chief a position of merit by appointing Engineer Boalich (recently resigned) to the first vacancy in that position where he did valuable work in reviewing and consultation with engineers assigned to him.

Engineers Cook, Madison, and Nevius were assigned to Seward. Engineer Cook has stated that so far as he knows, Seward never reviewed his work, merely signing his name; that he considered the reference of his work to Seward as nothing more than a joke.

Engineer Madison states that reference of his work to Seward he always considered as purely perfunctory. So far as he knows, Seward merely signed his name without reviewing. Seward never consulted him.

Engineer Nevius has on several occasions objected to referring his work to Seward, stating as a reason that he objected to his work being reviewed by one who did not know more than he did, and with whom it would be useless to consult.

Mr. Seward has never consulted about the work of the engineers assigned to him and in no other way has he given me assistance in connection with their work.

The position of subsection chief has been abolished and two engineers have been appointed to review the work. Attached hereto are carbon copies of memoranda relating to the changes. No doubt the discontinuance of the position of subsection chief brought out the memorandum of Mr. Seward, dated April 11, 1925, addressed to the head, staff division. Copy of this memorandum and my memorandum forwarding same are attached.

Inclosed find copy of memorandum of Mr. Greenidge, head, engineering division, dated August 8, 1924, and copy of my reply dated August 11, 1924—the part referring to Engineer Seward—from which it will appear that Engineer Seward did not rate high at that time.

When the engineering division was stationed at Twentieth and C Streets NW., Engineers Cook and Nevius had desks near Seward. Upon removal to the present location Cook and Nevius located their desks at the opposite end of the room from Seward, giving as a reason for so doing that instead of being of assistance they rated Seward as a nuisance. It should not be difficult to get the opinion of other engineers of this section in this matter.

It would hardly appear necessary to add anything further in support of my contention that the rating given Seward was unsound and that there was no justification in improving the rating given him as indicated by check marks made by me.

Taking everything into consideration, the fact that Mr. Seward is out of touch with the other engineers in the nonmetals section and out of harmony with the chief of the section, it is recommended that Engineer Seward be transferred.

That is signed by J. H. Briggs, chief, nonmetals valuation section.

Senator KING. I would like to add right here what has appeared in many instances before various committees, that when this reclassification act was passed, in many departments of the Government some men had their salaries increased, new positions were created, or they were transferred at an advance, so as not to bring them into a higher classification, and I think great wrongs have been done to the Government by reason of that fact, and it appears to have been done here.

Mr. NASH. Senator, I want to say that the Commissioner of Internal Revenue and I did not approve any such practice in the organization as was carried out in this case. It never came to our attention until this case was brought up. I do not understand why Mr. Briggs did not bring it to the attention of somebody outside of his division before April of this year, when this action took place last July.

The CHAIRMAN. Was Mr. Greenidge responsible for this thing that you did not know about?

Mr. NASH. I presume he had knowledge of it. It was within his division.

Senator JONES of New Mexico. Was he not the one to have brought it up?

Mr. NASH. Well, he should have done it. I hold no brief for Mr. Greenidge.

Mr. BRIGGS. May I make a statement here?

The CHAIRMAN. Just a moment, until we get through with this first.

Mr. MANSON. Coming to this memorandum signed by these engineers, I will start again at the beginning of that, in order to have it straight in the record. It is headed "Engineering Division, Income Tax Unit," and it is dated April 15, 1925:

We, the undersigned engineers of the nonmetals valuation section, have read your memorandum dated April 15, 1925, and attached statements, addressed to the deputy commissioner.

We indorse the statement made therein to the effect that "it would appear that a section chief should be consulted as an act of common courtesy, if not as a sound business policy, by a reviewing officer before changing his rating marks." This would appear to be axiomatic.

Referring to the memorandum of Engineer Seward, dated April 11, 1925, addressed to "Head, Staff Division," we will state that in our opinion you have been uniformly fair and impartial in your treatment of your engineers, always courteous and ready to cooperate in the work.

For days and weeks and months it has been very noticeable that Mr. Seward absented himself from his desk much of the time. It appeared that he was doing very little work. It was a common remark, "How does Seward get by?" Under the circumstances it is difficult to see how Mr. Seward could be given any other than a low rating. To give him any other than a low rating would be unfair to the other engineers of the nonmetals section and to Government workers in general—in fact, would be placing a premium upon idleness.

We, who have served some considerable time in the nonmetals section, assure you that since you took charge as chief of section the work as a whole has been more nearly sound and of a much higher quality than it had been previously. Nearly every exception to this statement can be traced to outside interference.

At the present time a condition of hesitation and uncertainty exists in which we in no way hold you responsible. However, some step should be taken to change this condition in order that you and your engineers may continue to maintain the high standard of efficiency which we have built up together.

Frank H. Madison; H. L. Parris (excepting paragraph 5, as not conversant with conditions at that time); C. A. Burdick; W. L. Scanlon (as to first four paragraphs; not conversant with No. 3); R. J. Borhek; J. Nelson Nevius; W. Lorrin Cook; W. W. Hanson, former member of section (not conversant with paragraph 4).

As I have stated, in reference to this memorandum, each of these engineers was called in by Mr. Greenidge and questioned in regard to the last paragraph particularly.

Senator KING. About outside interference?

Mr. MANSON. Yes.

I will now read Mr. Allen's memorandum.

Senator KING. Who is Allen?

Mr. MANSON. Mr. Allen is assistant deputy commissioner. He is assistant to Mr. Bright.

The CHAIRMAN. He is present, is he not?

Mr. NASH. Mr. Allen is present.

Mr. MANSON (reading):

It appears from the information given by engineers questioned by Mr. Greenidge, head of the engineering division, that a memorandum of April 15, 1925, addressed to Mr. J. H. Briggs, chief of nonmetals section, and signed by eight engineers of the nonmetals section, was circulated in that section by Mr. Briggs himself. This action of Mr. Briggs in circulating a memorandum containing serious criticisms of his superiors is grossly improper. If the memorandum had consisted of the third and fourth paragraphs only, which contained an indorsement of his administration of the section and of his adverse comment on John Seward, his action might be pardoned, but the second, fifth, and sixth paragraphs contained very serious criticism of his predecessor, who is now the assistant head of the engineering division, and general criticism of others not specifically pointed out, but indicated as those responsible for the policies of the division. Such criticism might be made by Mr. Briggs direct to the individuals criticized or even under certain circumstances to the deputy commissioner, but the bringing of this criticism to the attention of his subordinates in his section and securing their indorsement of it can not be justified in any way.

It is not of any moment, in this case, whether Mr. Seward is or is not an efficient engineer. The phase of the matter which is important is Mr. Briggs's attitude toward those in charge of his work. It is clearly indicated that he is of the opinion that his decisions should not be questioned and that his recommendations, ratings, etc., should be approved without review. This lack of respect for his superiors and entire unwillingness to accept their decisions must detract from his usefulness and this attitude communicated to his subordinates must have the same effect upon them.

It is a serious question whether Mr. Briggs is qualified to hold a supervisory position, in view of the manner in which he has taken his subordinates into his

confidence and fomented dissatisfaction among them. He would only be justified in securing the indorsement of his subordinates if he were personally under attack, which was not the case. A supervisory official should aim at all times to foster a loyal and cooperative spirit in subordinate employees, and this will certainly not be accomplished by displaying to subordinates for their approval a lack of respect for the higher officials and their policies.

That is signed by C. B. Allen, assistant deputy commissioner.

That is dated April 21, 1925, and on April 22, 1925, appears the following. This is a memorandum from Mr. J. G. Bright, deputy commissioner, to the commissioner.

Senator KING. It looks to me as though Mr. Allen shows a lamentable lack of appreciation of proper discipline, and he condones the irregularities and bad conduct of Seward.

Mr. MANSON. Even the department itself acknowledges that Briggs was right.

Senator KING. It looks to me as though Briggs was being punished because he was faithful and did not bow and cringe to Allen and some of his superiors because he was independent and faithful.

Mr. MANSON. He did the very thing that the department itself has criticized other men for doing—for not protesting.

Mr. Briggs is here, and I am informed that about a year ago he saw how his cases were being overturned on an unsound foundation, and he went to Mr. Allen, the same assistant to the deputy commissioner, and took the matter up with him, and Mr. Allen told him that in the Government service men did not get very far by protesting, and that the proper thing for him to do was to see that his record was straight, so that he could not be held responsible for anything that went wrong.

The CHAIRMAN. Senator Jones, would you like to hear Mr. Briggs now?

Mr. NASH. Senator, I want to state something at this point with reference to Seward. I have been looking for Seward's file here, but I do not find it. The intelligence officer, Mr. Paul, reported, as I recall it, that there was considerable bad feeling between Mr. Briggs and Mr. Seward, and he did not believe that Mr. Briggs could fairly rate Mr. Seward, due to his intense feeling. It was his suggestion that Seward be continued for a time under Mr. Grimes until we could get Mr. Grimes's judgment in the matter.

I want to say again before this committee that if Mr. Grimes substantiates in any way the charges that Mr. Briggs has made against Mr. Seward, Mr. Seward will be dropped. We could not drop Mr. Seward on the rating that Mr. Briggs gave him. I can not understand how Mr. Briggs rated Seward 78 if he is as bad as this file indicates. He certainly ought not to have a rating of 78 if that is the situation. I think 82 is the rating for an average employee; and if Seward is guilty of the things set forth in this file, he is not anywhere near an average employee.

Senator JONES of New Mexico. Mr. Nash, do you not think that Mr. Briggs was quite right in getting the support of the other men in his unit on a matter of this sort, when he knew it was controverted by those above him?

Mr. NASH. I am not criticizing Mr. Briggs for anything that is in this file.

Senator JONES of New Mexico. Well, it seems that Mr. Allen did so very strongly.

Mr. NASH. I would like to also point out that this reorganization which was under consideration antedated this memorandum that is in this file.

Senator ERNST. All of this controversy, you mean?

Mr. NASH. Yes, sir.

Senator JONES of New Mexico. When was it actually decided that Mr. Briggs should be dropped from the rolls?

Mr. NASH The final approval of the commissioner is dated April 22, but this reorganization that we are discussing, the condition of the allotments, etc., was taken up first on March 10, 1925, and continued from that point. I might say that it was the subject of a great deal of discussion during the month of April, when the committee was not holding hearings. During that period I was taking up not only with Mr. Bright, but with the other administrative officers in the bureau, the problem of getting within our appropriation for this fiscal year.

Senator KING. Let me ask you one question right there:

Wherever you have effected reorganizations—and I do not complain about them; I think you ought to have more of them—but where you do reorganize and consolidate two or more sections, and you place at the head of the one section, is it not the aim to keep all of those men in the service, rather than to bring in some persons into the consolidated section whose records are not as good as Mr. Briggs's record has been and place them in a subordinate position in the consolidated section?

Mr. NASH. Senator, when we abolish a specific position we eliminate the man who occupies that position. If the Secretary or commissioner would decide to-morrow to abolish my position, I would not look for them to find a berth for me in some subordinate position and to eliminate somebody else.

Mr. MANSON. Are you not automatically eliminating then, some of your more experienced men at the same time that you are presenting to this committee the difficulty of keeping good men in the service?

Mr. NASH. I do not believe I have stated before this committee that it was difficult at this time for us to get engineers for nonmetals work. I have stated before this committee that during the war years 1919, 1920, and 1921 it was difficult for us to get technical men to build up our organization. I have not complained of our organization as it stands to-day with respect to engineers. We do need lawyers. It is difficult for us to get lawyers. I have made the statement that we do not have enough lawyers. We need a hundred more lawyers, if we could get them. I do not think we have hired any engineers for nearly a year, and we do not contemplate employing any more engineers.

Mr. MANSON. The statement was made to me by Mr. Greenidge that it took him at least six months to break a new engineer in, and that a man did not reach his maximum efficiency as an engineer in any capacity in the Income Tax Unit until he had been there for a couple of years.

Mr. NASH. That may be.

Mr. MANSON. By your system of automatically dropping from the service the head of a section, when the section is abolished or consolidated with another section, does not that automatically eliminate

from the service the men that you yourself have determined are the best men you have when you put them into administrative positions?

Senator ERNST. If the committee wants to continue that controversy I do not object to it, but it seems to me that we are getting a little off of the question that has brought us here in reference to Mr. Briggs. You are now finding fault with the system followed in the department.

Mr. NASH. I am not concerned with Mr. Briggs as an individual. The problem as it came before me was the elimination of an administrative office and the combining of two sections in the organization. This combination could be administered by one head of a division, by a man who was competent and who could handle the problems that would come before him in this consolidation, just as well as he did in the small section that he had in the first place. The Government's interests are not jeopardized. The cases will go through as well as, if not better than, before. It will cut the administrative cost and there will be a saving to the Government.

Mr. MANSON. Then it is a mere coincidence that this all happened on the day following Mr. Allen's memorandum in reference to Mr. Briggs?

Senator ERNST. That is not a fair statement.

Mr. NASH. I knew nothing at that time of this controversy over Mr. Seward's rating.

Senator KING. May I ask you a question, Mr. Nash? What is the fact as to whether Mr. Greenidge, with others who are superior to Mr. Briggs, have been to you some time before this memorandum recommending the dropping of Mr. Briggs with a view to having Mr. Briggs removed?

Mr. NASH. Mr. Greenidge has never discussed with me in any way, shape, or form the dropping of Mr. Briggs. I did not discuss this reorganization with Mr. Greenidge. My discussion was Mr. Bright.

Senator KING. Well, has Mr. Bright been to you with reference to the dropping of Mr. Briggs before this thing happened?

Mr. NASH. Nothing, except that in our discussion on this reorganization it was mentioned that Briggs was in the administrative position that could be eliminated.

The CHAIRMAN. I would like to ask if there is anything in the record before you, Mr. Manson, from Mr. Greenidge concerning Mr. Briggs.

Mr. MANSON. Nothing, except a stenographic report of the conferences that Mr. Greenidge had with these several engineers with respect to this memorandum.

The CHAIRMAN. What conclusion did Mr. Greenidge reach after interviewing all of these engineers?

Mr. MANSON. In a memorandum dated April 16, 1925, to Mr. Bright, deputy commissioner, Mr. Greenidge says:

There is attached memorandum dated April 15, 1925, addressed to Mr. J. H. Briggs, chief nonmetals valuation section, and signed by the following engineers in the nonmetals section: Frank H. Madison, H. L. Parrish, C. A. Burdick, W. L. Scanlan, R. J. Borhek, J. Nelson Nevius, W. Lorrain Cook, and W. W. Hanson.

There is also attached memorandum dated April 15, 1925, addressed to you and signed by Mr. Briggs, chief of the nonmetals valuation section.

I have to-day called each engineer who signed the memorandum to my office and asked him questions concerning it. There is attached a copy of the

questions asked each engineer and the answers thereto as taken by two stenographers.

That is signed S. M. Greenidge, head engineering division.

The CHAIRMAN. He made no comment himself?

Mr. MANSON. He made no comment himself.

Senator JONES of New Mexico. You stated, Mr. Nash, that on April 21, I believe, the order was signed by the commissioner.

Mr. NASH. I believe that was the date read by Mr. Manson. I do not recall definitely, Senator.

Senator JONES of New Mexico. How soon thereafter was Mr. Briggs dropped from the rolls?

Mr. NASH. He was given his accrued annual leave from that date. It brought the date of separation up to some time around the 1st or 2d of May.

Mr. PARKER. The 2d of May.

Senator JONES of New Mexico. Has Mr. Briggs's secretary been removed also?

Mr. NASH. She is out of that division. I do not know whether she has been dropped or reassigned to other work. We are in need of stenographers. Stenographers leave us very rapidly, and we have a big turnover in that class of employees. It is possible that she may have been assigned to stenographic work somewhere else in the bureau.

Senator JONES of New Mexico. What other changes have been made in the engineering division by reason of your reduction of force?

Mr. NASH. We have the resignation of Mr. Woody and Mr. Crockett. Mr. Woody received $3,800 and Mr. Crockett received $4,600. Mr. DeButts received $3,800.

Senator JONES of New Mexico. You mean they resigned?

Mr. NASH. They either resigned or were dropped. The records do not show which, but they were separated from the service; also Leo Perrin, $3,800; T. R. Rothrock, $3,800; Edwin Bolick, $4,200——

Senator JONES of New Mexico. When were they separated?

Mr. NASH. These separations occurred since about the 15th of January. They are separations by resignations or otherwise, and no replacements have been made. They aggregate $34,000. That is a cut in the engineering section, which, in proportion to the size of that section is as great a cut as has been made in the other divisions of the bureau. I think there are about 125 engineers, and 8 of them have been eliminated in the last four months. Mr. Allen tells me that we have just received another resignation, that of Mr. Corning, in the coal section. This place will not be filled.

Senator JONES of New Mexico. Then, if you have those resignations in that considerable number, would you not have made up this $30,000 deficiency?

Mr. NASH. It would not, Senator. We still have some deficiency to make up.

Senator JONES of New Mexico. To make up in what division, now?

Mr. NASH. In the income tax division.

Senator JONES of New Mexico. In the income tax division?

Mr. NASH. Yes, sir.

Senator JONES of New Mexico. The whole division?

Mr. NASH. Yes, sir; the whole division.

Senator JONES of New Mexico. And you have made up how much of that in this engineering division?

Mr. NASH. We have made up $34,000 since January.

Senator JONES of New Mexico. And you still have a deficit?

Mr. NASH. We still have a deficiency to make up; yes, sir.

Senator JONES of New Mexico. Of how much?

Mr. NASH. Our total deficiency on both the field and the bureau end of it is now $69,000. The figures that I quoted before were just for the bureau end. At the time we had the $34,000 deficiency in the bureau we also had a $46,000 deficiency in the field. There has been a little switching in those allotments. We have been transferring a great many auditors from the bureau to the field, and that changes the overdraft from one allotment to the other.

The CHAIRMAN. May I ask, Mr. Nash, if it has been the policy of the bureau at any time to reduce the heads of the divisions by demotion, or to remove them, in line with the policy that you have just stated?

Mr. NASH. So far as I know, Senator, our policy is to eliminate the man whose job is abolished, and not to demote him. We have always felt that if you reduce a man in the ranks, he is not as good an officer. He is not as good a man in the subordinate position when he is demoted and kept among his former associates.

The CHAIRMAN. I entirely concur with that. I asked if there are exceptions to that rule.

Mr. NASH. Not that I know of, Senator.

The CHAIRMAN. I know from our own experience that no organization is sound or can continue to be sound where men are demoted. It simply takes the heart out of a man and he does not do effective work.

Mr. NASH. That has been our experience, and it has been our policy, when we have to make changes, not to demote a man and keep him in the organization.

I would like to say with reference to Mr. Briggs's case that the Civil Service Commission wrote us and asked if we had any objection to his being put on the reemployment register. We replied that Mr. Briggs's record with the bureau was good and that we had no objection to his reemployment in any other department.

The CHAIRMAN. Would you consider it a demotion to go from a deputy commissionership to a revenue agent in charge?

Mr. NASH. It might be a demotion in rank. It would not necessarily be so in salary.

The CHAIRMAN. He would not be in the same environment, would he?

Mr. NASH. No, sir; he would not be in the same environment, because a man in the position of a revenue agent in charge would be located outside of Washington, apart from the bureau organization. He might be in San Francisco or Tacoma or two or three thousand miles away.

Mr. MANSON. And he has a lot of individual responsibility, too?

Mr. NASH. Yes; he is on his own responsibility. I have often considered that very thing myself. I sometimes think I would like to get out of Washington, to be in San Francisco or Honolulu.

The CHAIRMAN. After going through these hearings, I do not display any surprise at that statement at all.

Senator JONES of New Mexico. Mr. Nash, do you know what work Mr. Briggs was engaged on at the time of his separation?

Mr. NASH. I do not.

Senator JONES of New Mexico. It appears that you have a few cases pending in that division for the year 1917.

Mr. NASH. Yes, sir.

Senator JONES of New Mexico. That is eight years. What are those cases that are pending for 1917?

Mr. NASH. I do not know what cases they are, Senator, but I think I am safe in saying that I do not think that any of them would have received the personal consideration of Mr. Briggs. They would be assigned to engineers within his division. When the engineers close their cases they would come up to Mr. Briggs for review and approval. The same cases will now go to Mr. Grimes for review and approval and will receive just as good technical consideration and will be acted on just as expeditiously as if Mr. Briggs was there.

Senator JONES of New Mexico. In that connection, do you not think it was reasonable to assume that Mr. Briggs was familiar with those cases, and it would take Mr. Grimes a considerable length of time to become familiar with them?

Mr. NASH. I do not think that there are any such involved cases pending in that section that Mr. Grimes could not familiarize himself with them as much as is necessary within a very short period of time.

Senator JONES of New Mexico. Is it not reasonable to suppose that any cases which have been pending six or eight years, the head of the unit would necessarily be familiar with them, and that he had gone over them from time to time?

Mr. NASH. I do not think the head of the division would be as familiar with the details of the cases as the immediate engineer who was handling them, and that is where the time would be lost. If the valuation engineer who had a case immediately under his direction was removed, then somebody else would have to study again all of the details of his pending cases.

Senator JONES of New Mexico. What is this chief of the unit supposed to do there?

Mr. NASH. He is an administrative officer. He is an administrative officer. He assigns the work to the engineers under his direction. He takes part in conferences and reviews the work of the engineers after they have completed their jobs and written up their reports.

Senator JONES of New Mexico. Is it not reasonable to suppose, then, that he had reviewed these old cases at one time or another?

The CHAIRMAN. Senator Jones, may I suggest that Mr. Briggs is here, and, for my part, I would like to know just what he knows about the condition of the work in the bureau and the cases therein. I have gathered the impression from these hearings that the chief of the section does not come in contact with the cases to any great extent, if at all, prior to the completion of the work of his subordinates.

Mr. NASH. That is my impression.

The CHAIRMAN. And if that is so, the head of the section would not necessarily know the detail of the cases still in the section.

Mr. MANSON. He does assign the work, though.

Mr. NASH. Yes.

The CHAIRMAN. I mean that he does not know anything about the work on them until they are brought up to the head of the section. At least, that is my understanding of it, but, as I say, Mr. Briggs is here, and we can let him tell us.

Senator JONES of New Mexico. In view of what appears in the record that these cases have been traveling around from one section of the bureau to another, from the commissioner to the officer or employee dealing with the details, covering a period of six or eight years, I think everybody who has been connected with that work ought to be familiar with them. That is my assumption, and I assume that the head of this unit would have known something about the age of these cases and the reason why they had grown so gray in the bureau there, so that he would necessarily be more or less familiar with the details of each one of these old cases. I had assumed that situation, and if I am wrong about it, I would like to know.

Mr. NASH. Senator, I think Mr. Briggs probably has a knowledge of these old cases. At the same time, I think the engineers working immediately under Mr. Briggs have a better detailed knowledge of these cases than Mr. Briggs has. They are in the position to have it. That is not any criticism of Mr. Briggs. To keep in touch with the detail of these cases was not his work.

Senator JONES of New Mexico. I understand that the chief of the section has to review them.

Mr. NASH. After the valuation engineer has completed his work.

Senator JONES of New Mexico. Yes; but is it not reasonable to suppose that there has been work on valuation and reviews in these cases for eight years? If not, why should you, under any circumstances, permit anybody in that unit to separate himself from the service?

Mr. NASH. I do not know what is holding back these ten 1917 cases in the nonmetals section. They probably have had examinations and reexaminations and one conference after another.

Senator JONES of New Mexico. Yes.

Mr. NASH. They are cases in which the taxpayer and the valuation section have not yet come to an agreement. They are probably cases that are under waiver. There may be cases there that were reopened on claims.

Senator JONES of New Mexico. And in the removal of Mr. Briggs, was that situation entered into or investigated, or was there any inquiry made about it?

Mr. NASH. Senator, it is one of the elements that were considered, and it is one of the elements we discussed with Mr. Grimes when he was called up to the commissioner's office. Mr. Grimes assured both the commissioner and myself that he knew of no reason why he could not take over the administrative work that Mr. Briggs formerly had and conduct that work efficiently in connection with the work that he had in his own section.

Senator JONES of New Mexico. Now, on that point, was Mr. Grimes a busy busy man before this thing happened?

Mr. NASH. I think our chart will show, Senator, that the work is gradually falling off in this section. It is in better shape in the metals section—and I think the engineers present will bear me out in that—than it is in other sections of the engineering division now.

Senator JONES of New Mexico. But you are not simply trying to retain a relationship of work. Are you not trying to finish up the work?

Mr. NASH. We certainly are.

Senator JONES of New Mexico. And as long as there is any unfinished work, why should there be any letting up in the work?

Mr. NASH. I do not believe the separation of Mr. Briggs is going to retard the finishing up of these cases one bit. That is my belief.

Senator JONES of New Mexico. Well, of course, if you believe that, that is the end of it. If you can dispense with a man and have the work go on just the same, that would either indicate that the man who takes over Mr. Briggs's job did not have much to do before he took it over or else Mr. Briggs was not doing much when he quit.

Mr. NASH. It means, Senator, that the work in both of these sections is gradually being reduced, and has got to the point where one section could handle that part of the job that remained to be completed. Of the two men that were at the head of those sections, I think that Mr. Grimes was the better man to be retained.

Senator JONES of New Mexico. Do you not think it would have been better to have absolutely closed out the years 1917, 1918, and 1919 in that division and to have made the work more current than it is? I can not for the life of me appreciate the policy which would want to let any case hang in the department for eight years.

Mr. NASH. Senator, there is nobody in the bureau that wants a case to hang for eight years. There is nothing here to show that these 10 cases are not cases that have been reopened within the last year or two on claims. They may have been reopened by the filing of a claim for a refund by the taxpayer. No person in the department wants to take any administrative move that is going to delay the settlement of a case. I do not think any administrative move has been taken in this instance that is going to delay the settlement of any old case.

The CHAIRMAN. I would like to state this for the record: I do I understand that the statement that so many cases remain in any particular unit, whether for 1917, 1918, or 1919, does not mean that they have been in the bureau constantly on the same question for that period of time?

Mr. NASH. Not at all, Senator.

The CHAIRMAN. It may mean that the case was closed at one time, and the taxpayer put in a claim, and then it was sent back to the unit because of that claim.

Mr. NASH. That is very true. We receive claims to-day at the rate of 20,000 a month.

The CHAIRMAN. Then I ask you, Mr. Nash, if you have any information as to the division between the claims that have recently been opened and the ones that have been unsettled there for a great period of time?

Mr. NASH. Not at all; no. The figures I have show the number of cases involved and the years, without any segregation of the claims as between the cases that have not been closed——

The CHAIRMAN. Well, in justice to the bureau there should be a segregation, because I think the testimony that has been given here would leave the impression with Congress that when the statement is made that there are a great many 1917, 1918, or 1919 cases in the bureau, that these cases have been in the bureau constantly from

that [illegible]on. I have had that impression up to this morning, and I think ... is a perfectly logical impression to have gained. Now, it seems that it is not a 1917 case if the taxpayer did not make a claim until 1921.

Mr. NASH. Senator, I believe there are conditions to-day—and Captain Rogers can bear me out if I am wrong—under which a claim can be filed reopening 1917.

The CHAIRMAN. Oh, yes; I am not complaining about that. I am saying that when you make the statement that there are these cases there, it is an injustice to the bureau, because it gives the public and Congress the impression that these cases have been pending in the bureau for all this length of time. I got such an impression and it has only been cleared up this morning by this discussion that we have been having, that these cases have not been pending continuously since this period for all of this length of time. I think it is a grave injustice to the bureau for you to make the statement that these cases are 1917 cases, 1918 cases, and so on, when, as a matter of fact, they may have only been pending in the bureau a few months or for a year.

Mr. NASH. I wish to submit this chart for the record.

(The chart referred to faces this page.)

Senator JONES of New Mexico. Mr. Chairman, Mr. Briggs is here and I believe he ought to be permitted to make any statement that he cares to.

The CHAIRMAN. Mr. Briggs will come up here where we can hear him and be sworn, please.

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

Mr. BRIGGS. In the first place, I wish to make a statement in regard to my hostility to Mr. Seward.

No such thing existed. My men will bear me out in that, that I have no personal hostility.

In the next place, the question raised was why I did not report this to the people higher up, in regard to Mr. Seward's inefficiency. If you will permit me, I will read a memorandum, dated August 8, 1924, from Mr. Greenidge to me in regard to the two most inefficient or the least efficient men in my section, and my reply:

Memorandum to Mr. Briggs, chief nonmetals section.

You are directed to furnish me in writing before noon, August 13, the names of the two least efficient men in your section and the reasons why these men are the least efficient in your section.

I did not wait until the 13th. I replied on August 11, 1924. This has a notation on here, "Copy of part relating to Engineer Seward."

Memorandum for Mr. S. M. Greenidge, head engineering division.

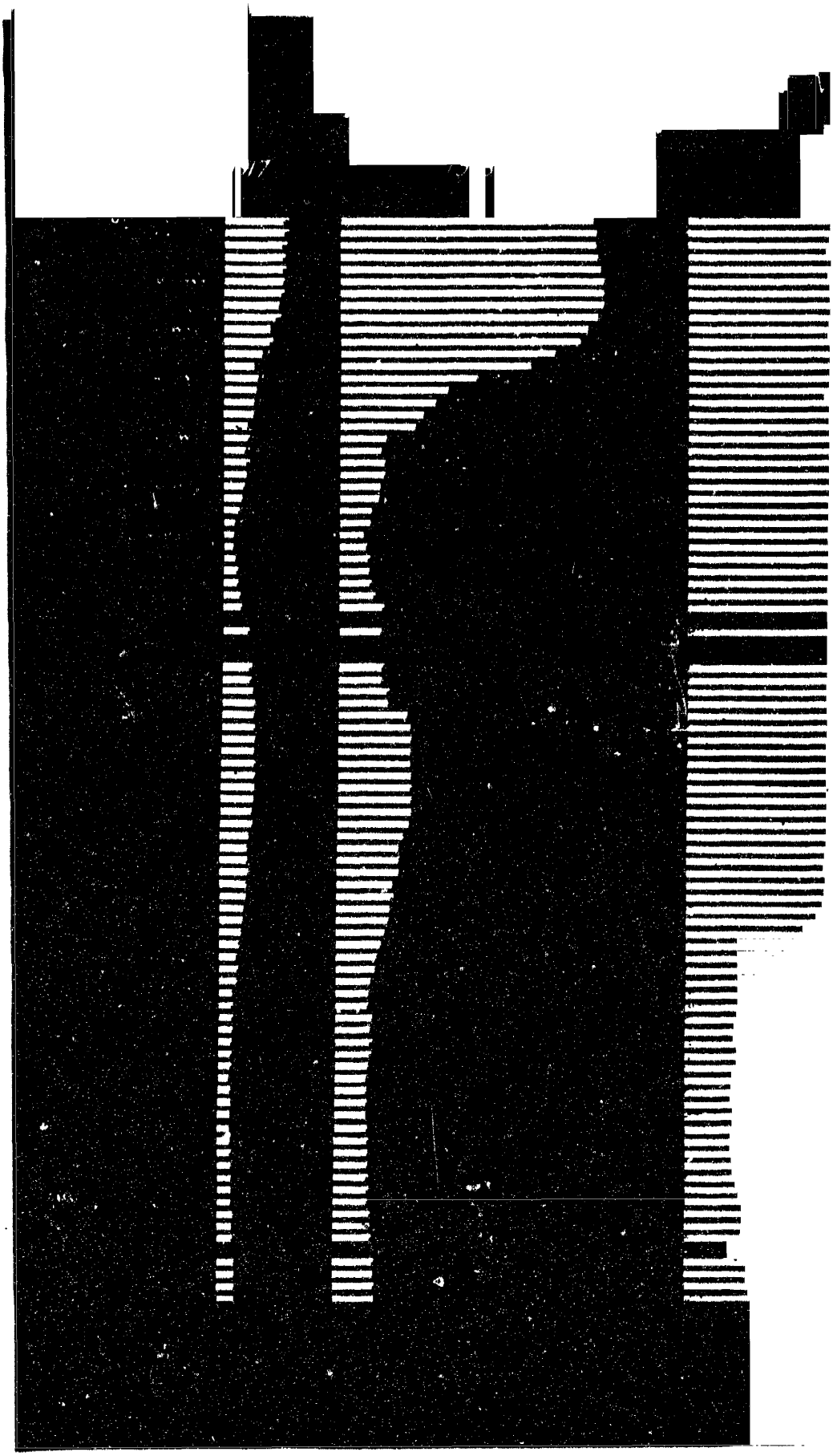
Reference is made to your memorandum, dated August 8, 1924, requesting the names of the two least efficient men in this section and the reasons why these men are the least efficient in the section.

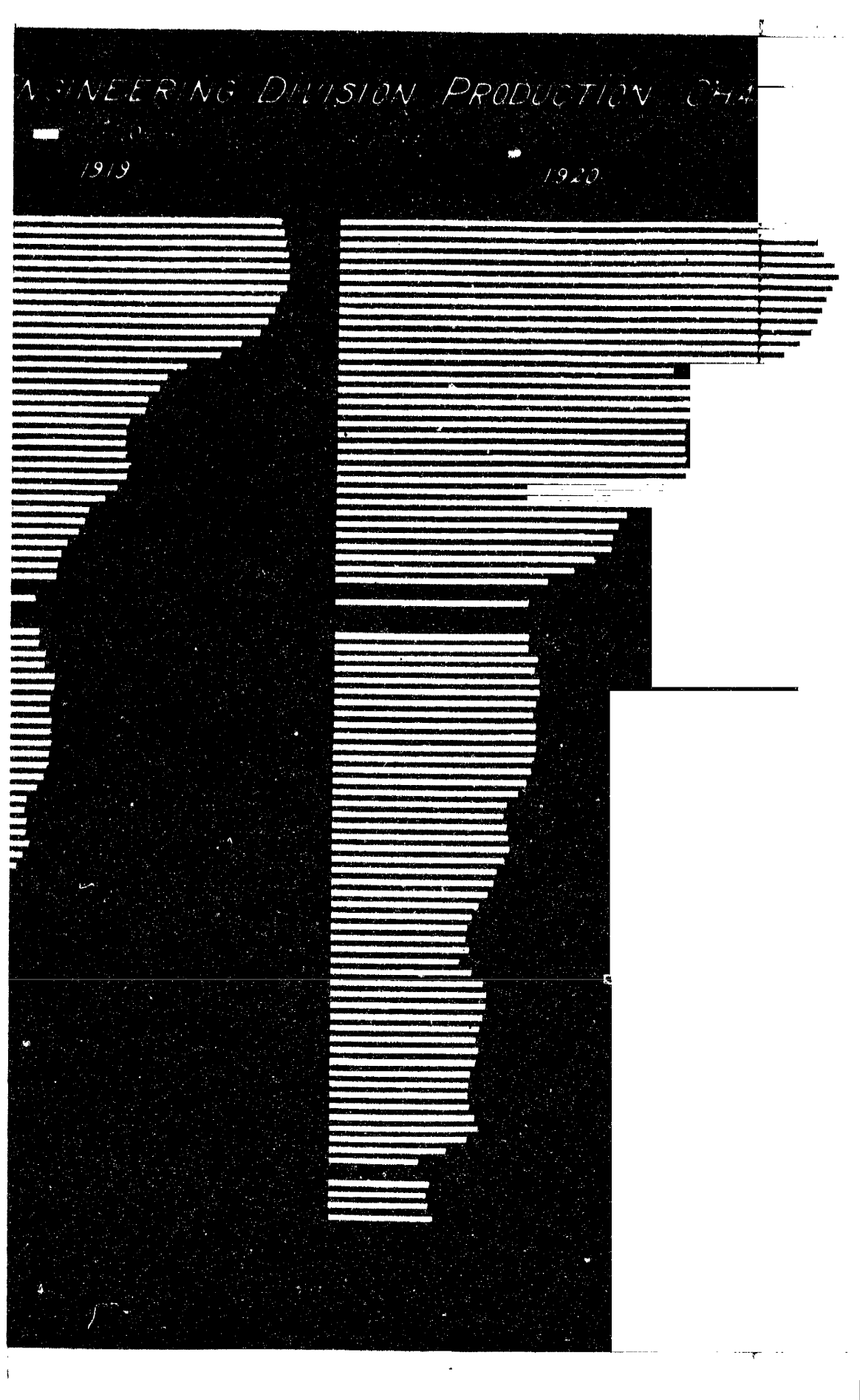
In reply, you are advised that Messrs. John Seward and—

I leave out the other man's name in this, because it only had reference to Seward—

are the two least efficient men in this section, the reasons for this opinion being as stated below:

Mr. Seward is capable of good work and the greater part of the work turned out by him is entirely satisfactory. However, the amount of work




NEERING DIVISION PRODUCTION CHA
1919
1920


1921

turned out by him falls far short of what it should be. There is only one explanation for this, viz, the use of a slang expression—"loafing on the job."

Mr. Seward is away from his desk a great deal, sometimes for a considerable length of time. At times he is away for a short period, but at frequent intervals. Mr. Seward receives a great many more telephone calls than any other man in the section, and in the majority of cases he is not at his desk and the party calling is advised to leave number or call again.

His time report on cases is excessive and the explanation often given has been, "Very difficult case."

The fact of his absenting himself from his desk is often remarked by other men in the section. It has a demoralizing effect. This can readily be understood when consideration is given to the fact that he is the highest-paid man in the section.

The remark has been dropped more than a few times in connection with work that needed to be gotten out without delay, "Let Seward do it; he has plenty of time and besides he is getting the salary."

It was at your request that Mr. Seward was advised several months ago to keep at his desk and get to work.

Those are remarks dropped by men in the section.

The CHAIRMAN. These are the methods which were in effect before the reorganization plan was considered?

Mr. BRIGGS. August, 1924; yes, sir.

I might add also, which I did not put in there, that Mr. Greenidge had made the remark, when we were at Twentieth and C Streets, that any time that Mr. Seward was absent and he wanted to locate him, he could go outside and look in his automobile, and he would find him out there smoking cigarettes.

I am perfect willing to leave it to my men, most of whom are here, in regard to my attitude to Mr. Seward and their attitude to Mr. Seward, too.

In regard to the turnover of the work in 1917 and 1918 and 1919, in connection with those cases, Mr. Nash has stated that the same are in hand now. I think, for instance, we have ten 1917 cases now. Those 10 could be gotten out of the way, and perhaps in three months from now there would be 10 more there. They keep going around in a circle. Sometimes we have a chance at them. Sometimes, we went at them four or five years ago, and they went over to audit and were audited, and they were protested, and they came back to us. They kept going around in a circle. Sometimes we will find that there are 30 or 40 different operations in the same case. Sometimes they travel back and forth between the taxpayer and the man handling the case; there will be 10 or 15 or 20 letters passing, trying to get information and trying to get somewhere.

In regard to the question of whether there are any important cases on hand at the present time in the section I would say that we did have one very important case. There were several others which were very important, but we had one which, if I may be allowed to give the history of it——

Senator ERNST. We do not want to go into any cases now. We are looking into your matter now, and I think we ought to confine ourselves to that. I would like very much to get away as soon as I can.

The CHAIRMAN. I would like to know the name of that case.

Mr. BRIGGS. Harbison & Walker Refractories Co.

The CHAIRMAN. Is that a case that has been before this committee?

Mr. MANSON. No. Complaint was made in regard to it, but we found that the case was not closed.

The CHAIRMAN. Will you tell us why it is not closed, because, as I understand it, that is a case where there is considerable influence back of it.

Mr. BRIGGS. There is enough involved in that case, if it is handled properly, to defray the expenses of the engineering section for several years—the whole engineering section, in that or case.

The CHAIRMAN. The amount involved is not the question. The question is whether the Government is justly entitled to it. It is not a question of covering the expenses of the engineering division.

Mr. BRIGGS. No; the only question——

The CHAIRMAN. Just confine yourself to such statement as will interest the committee. What is the point involved in the case which has delayed it to such an extent?

Mr. BRIGGS. Impossible to get data out of the taxpayer of a satisfactory nature; always giving irrelevant information when he gives any; giving excuses for not giving it, even in the case of field trips.

Senator JONES of New Mexico. I would like to ask Mr. Briggs to tell us some of the detail and the history of that case.

Mr. BRIGGS. Well, my first recollection of that case was about three years ago.

The representative—I think he is the vice president of the company, an engineer—came in on that case and presented what they considered the value of their property. They did not give us any facts. The coal section had a part of the case, and the nonmetals section had a part of the case. While the oil and gas section was represented, I understand there was nothing of an oil and gas nature in it.

They were allowed an amount between nineteen and twenty million dollars, if I remember correctly, covering all of their physical assets, coal, ganister, and clay.

Senator JONES of New Mexico. That was the valuation of the property?

Mr. BRIGGS. That was the valuation of the property.

Senator JONES of New Mexico. And it was being valued for the purpose of depreciation or depletion?

Mr. BRIGGS. Both; yes, sir. They asked of the coal section something over a million dollars for their coal assets. The coal section, if I remember correctly, cut them down to between two and three hundred thousand dollars. The nonmetals section added that to the value of the nonmetal assets and, as I have been informed, increased the tonnage of clay and ganister, so that at the rate of 10 cents a ton it gave them the value that they were asking for.

That covered the physical assets, both fee and leasehold.

Some time after that a letter came in from the taxpayer saying that he wanted a large value for his leaseholds—something like eight or nine million dollars. A reply was made that the amount that was allowed previously covered the leaseholds.

He came in for a conference. I was at that conference, and I had some knowledge of what had been done previously, although I had not been on the case previously. I advised the taxpayer that the value of the leaseholds was covered in the valuation that had been made and that I so stated, and I said, "Your engineer will recollect that." The engineer admitted it.

Then he said, "If I can not get that additional value involved in that way, I want that additional value for good will."

I said, "The engineering section has nothing to do with the value of good will. That is an auditing matter."

Then the auditing section was called in, and they did not give any value for good will.

The next I heard of the case it was appealed to the board of appeals and review, asking for a valuation of eight or nine million dollars for good will.

I was called up by the man in the board of appeals and review——

Mr. MANSON. When you say "the board of appeals and review," you mean the committee on appeals and review?

Mr. BRIGGS. Yes, sir; the old committee on appeals and review.

I was called up by the man who had the case in the committee on appeals and review, saying that there would be a conference on that case at a certain time, and that they desired my presence. I replied that all of the engineering questions had been settled; there was nothing involved in them, as far as I knew. He said, "No; it is a matter of good will." I said, "That does not concern us." He said, "Well, we want you there."

I went up in the morning and put in the forenoon there. The vice president of the company was there, a mining engineer and several tax experts, and they talked a great deal at random, a great deal along the line that the United States Steel Co., when it was formed, brought together a great many organizations, and talked about the potential possibilities of an organization of that kind, and that their company had been composed of several companies, and was brought together, and there were the same possibilities there that there were in the case of the United States Steel Co.

They were finally advised that they could not get good will. Then they said they wanted——

Senator ERNST. Is this what you want to hear, Senator?

Senator JONES of New Mexico. Yes.

Mr. BRIGGS. Then they said if they could not get good will they wanted the case sent back to the nonmetals section, to get that additional value in their physical assets, covering the coal, ganister, machinery, plant, etc.

Then I called Engineer Boalich to come up for the afternoon session. He was up there with me at the afternoon session, and we argued against sending the case back, and said that they had been allowed just what they had asked for and we could not see any reason why it should be sent back. But they insisted on it, and finally the board of appeals and review told them they could send it back to us for review.

At that time I advised them that if that case was sent back, we should want data upon which to base the valuation, that their case had been closed without any substantiating data, but simply upon the value that they placed there, and that if we found they were entitled to more we would give them more and if they were entitled to less we would cut them down.

That was a year ago in September, if I remember correctly.

The CHAIRMAN. Just proceed. That is near enough.

Mr. BRIGGS. Yes, sir; I think it was about a year ago in September.

We have never been able to get any information from them at all.

It is an important case, and knowing that they were on the New York Exchange and had been on the Pittsburgh Exchange, I sug-

gested that the library be visited for an examination. I had three men working on it, off and on, for two or three months. One man visited the Library of Congress and got valuable data. He found statements that they had submitted to the exchanges. I had another man go down to the library of the Interior Department, and another man looking up statistics.

Finally a brief was drawn up, which covers nearly 60 pages, and I think seven different points of view were taken up on which to base a valuation. The highest valuation that I understand that could possibly be given them for everything was a little less than $11,000,000, and the lowest value on another basis was $6,000,000.

We asked them at various times for information, but they did not give it to us. They made excuses. They said their engineer was in Europe, and we set a date for the final submitting of the information.

The representatives of the company finally called up the deputy commissioner's office from Pittsburgh asking for an extension of time. The deputy commissioner asked me about it, and I told him that we should give him an extension of time, that it would not make any difference whether he gave them a month or a year, they would not get any better results.

The CHAIRMAN. How much tax was involved?

Mr. BRIGGS. I figure, covering the high tax years, that there is, probably, giving the proper valuation, at least $2,000,000 in taxes more than what they had been taxed, which is involved in the case.

The CHAIRMAN. Then, the delays, or the extensions, rather, of time would materially affect the case, would they not?

Mr. BRIGGS. I would think so.

Mr. NASH. Mr. Briggs, at this point I would like to know who is responsible for these continuations or the extensions of time?

Mr. BRIGGS. On the last extension of time I was requested by the deputy commissioner to write a very emphatic letter, stating that they would have to submit their data not later than the 1st of May, and if it was not in by that time, the case would be closed.

The CHAIRMAN. The 1st of May of what year?

Mr. BRIGG. This year.

Mr. NASH. As I understand it, you made a valuation of about $11,000,000 in this case several years ago?

Mr. BRIGGS. No; the valuation of several years ago was between nineteen and twenty million dollars.

Mr. NASH. Then it went on to the committee on appeals and review?

Mr. BRIGGS. Yes.

Mr. NASH. What brought it back to you again?

Mr. BRIGGS. The committee on appeals and review allowed them to send it back to us to get an additional valuation.

Mr. NASH. Allowed who to send it back?

Mr. BRIGGS. Allowed the taxpayer to send it back. They sent it back on the taxpayer's request.

Mr. NASH. And you started over on it again?

Mr. BRIGGS. Yes.

Mr. NASH. In September of 1923?

Mr. BRIGGS. Yes.

Mr. NASH. And it has been pending in your unit since 1923?

Mr. BRIGGS. It has.

Mr. NASH. Who has been granting all of the extensions since September, 1923?

Mr. BRIGGS. The extensions have been granted—of course I have written the letters; they have been signed by me, but they have invariably objected to the head of the division in regard to giving the extensions, and the final extension which was given was ordered by Mr. Bright and signed by Mr. Bright.

Mr. NASH. That is, this last one, but were you directed at any time between September, 1923, and the time that you brought this to the attention of Mr. Bright to grant these extensions to these people?

Mr. BRIGGS. Yes, sir.

Mr. NASH. By whom?

Mr. BRIGGS. By Greenidge.

Mr. NASH. By Mr. Greenidge?

Mr. BRIGGS. Yes, sir.

Mr. NASH. Every time?

Mr. BRIGGS. I am satisfied that we never would have given them any further extension until they went in and asked Mr. Greenidge and he said so.

Mr. NASH. How much time would be involved in a case such as this if you went right through with it?

Mr. BRIGGS. It would depend very largely upon——

Mr. NASH. I want to know, in a specific case of this kind, how long it would take.

Mr. MANSON. You say the case has been pending since September, 1923; that is two years ago. Was it not September, 1924? The engineer has just told me that that is so.

The CHAIRMAN. Previously he said a year ago last September, and then he said last September.

Mr. NASH. I am following Mr. Briggs's statement. What I am trying to do is to determine who was responsible for the various extensions of time since this case has been pending in Mr. Briggs's section since 1923.

The CHAIRMAN. He said Mr. Greenidge was responsible for it.

Mr. NASH. He said he was responsible for some of the exceptions, as I understood him.

Mr. BRIGGS. I have not granted any extensions, in this case, and I was ready to close up that case at any time as soon as we could get the data together.

Mr. NASH. Did you recommend that any extensions be made in this case?

Mr. BRIGGS. I did not.

Mr. NASH. Did you object to any extensions being made?

Mr. BRIGGS. I did.

Mr. NASH. To whom?

Mr. BRIGGS. I objected to the extensions being given to Mr. Greenidge, and I objected to the extensions being given to Mr. Bright.

Mr. NASH. You have just stated that you said to Mr. Bright that you had no objection to the extension being given.

Mr. BRIGGS. I said it would not make any difference whether an extension was given for a month or two, that they would not get any more out of it.

Mr. NASH. If that was your conclusion, what was there to stop you from closing up the case?

Mr. BRIGGS. Simply because Mr. Bright told me to write a very strong letter, giving them until the 1st of May in which to submit the information, and if it was not in by that time to close the case up.

Mr. NASH. But I understood you to say you had the case a year and a half before you came to Mr. Bright with it.

Mr. BRIGGS. Do you remember, Mr. Parrish, when the case came down from the board of appeals to us?

Mr. PARRISH. September, 1924.

Mr. BRIGGS. September, 1924.

Mr. NASH. You said that you had the case first about three years ago.

Mr. BRIGGS. Yes.

Mr. NASH. How long was it pending before the committee on appeals and review?

Mr. BRIGGS. It must have been there several months, because they wrote them two or three times, as I understand it, telling them that they could not have any longer time.

The CHAIRMAN. At this point I would like to state that when you grant these taxpayers these extensions, I think it is a more serious granting than most people believe. It involves in the aggregate millions of dollars of interest lost to the Government, yet these extensions seem to be granted, according to the testimony of Mr. Briggs, on the oral statement of the head of a division, such as Mr. Greenidge.

Mr. NASH. Senator, the granting of this extension was for the purpose of obtaining additional information, and, as Mr. Briggs has stated here, he has waited for the taxpayer to furnish the information, and the taxpayer is delaying the case. That is one of the most serious problems that we have to deal with in these old cases. We have been trying from time to time to get the auditors, the engineers, and the heads of divisions to stop granting additional time to the taxpayers to bring in additional information. Every time they hold one of these conferences, and the taxpayer is not satisfied with the conclusion, he asks for further delay, so that he can supply some additional information to gain his point.

The CHAIRMAN. And during all of that time the Government is losing millions of dollars in interest.

Mr. NASH. From what Mr. Briggs has stated in this case, I can not see why it should have hung fire in his section for three years, except the time that it has been before the committee.

The CHAIRMAN. Do you not think that there should be somebody really responsible for these extensions, so that every auditor and every engineer at his sweet will will not be in a position to grant taxpayers extensions, involving a loss to the Government of millions of dollars' interest? Do you not think that is rather more or less of an administrative matter?

Mr. NASH. The auditors are instructed—and they are under rigid instructions—not to grant extensions.

The CHAIRMAN. Oh, but they do grant them, and you know it.

Mr. NASH. Our supervision has not been as good in the past as it is right now. I think we are getting better control of the situation. What I am trying to determine is who was responsible for the repeated extensions in this particular case.

Senator JONES of New Mexico. It seems to me that it is perfectly clear from what Mr. Briggs has said that the committee on appeals and review were responsible here, because Mr. Briggs told that committee that there was no use to send it back to the engineering division; that they had gone over it all that they cared to; but it was sent back notwithstanding that, with directions for Mr. Briggs's section to review the case without any additional testimony, and it appears that instead of being furnished any of the testimony by the taxpayer they went around digging in the library and other places and trying to get up some information, and on hunting that up they found that the previous estimate of value had been too great. Still the taxpayer furnishes no information whatever. I think the difficulty is in listening to a taxpayer who will not do his part and do it promptly.

Mr. NASH. I know of nothing in our procedure, Senator, that would have prevented Mr. Briggs from closing that case out as soon as he was satisfied with the situation.

Senator JONES. But the committee on appeals and review told him not to do it.

Mr. NASH. Well, the committee on appeals and review had not been in existence for nearly a year.

Mr. MANSON. It seems to me that this case was closed, but now, on the taxpayer's initiative, they are trying to get a higher value, taking the position that the tax was not finally determined. Mr. Briggs discovered that the value they fixed is too high. Therefore it is to the interest of the Government that a revaluation may be made, but a revaluation can not be made on this information that is procured from the taxpayer. That seems to be the status of the case.

Mr. NASH. When Mr. Briggs was head of this section, if he could not have obtained the full information from the taxpayer he should have sent an engineer out to get it.

Mr. BRIGGS. There is one man going out on that case, and I venture to say that he will have a fine summer vacation. He will be told what a lovely man he is, because that is the palaver that that taxpayer has given from start to finish.

Mr. NASH. I just want to say that if that is the way that engineer will conduct the investigation, he is not a good engineer.

Mr. BRIGGS. There is hardly a man in the Government service that is a better man than the engineer going out on that case.

The CHAIRMAN. Who is he?

Mr. BRIGGS. Mr. Parrish, sitting over there.

Mr. NASH. I see no reason why this case can not be just as effectively closed by Mr. Grimes.

Mr. BRIGGS. I will tell you what the auditor who went out on the field trip in this case did. He came back, case uncompleted, that the taxpayer would not give him the information so that he could close it. The taxpayer would not give him what he asked for. The taxpayer said, "It is none of your business, and we have that stuff in there uncompleted." They are now sending out another man, an entirely different man, to go and audit it.

The CHAIRMAN. In a side conversation with the Senator here it was suggested that the bureau ought to soak that taxpayer and make

him come to court. I do not see why, when a taxpayer deliberately delays the case, the bureau should not go the limit and make them settle it.

Mr. NASH. There are statutes that will compel a taxpayer to disclose all of his records and any information pertaining to his tax return. There are lawyers in the solicitor's office for the purpose of enforcing those statutes, and I see no reason why any taxpayer can defy us for a year and a half and not furnish anything that we need.

Senator JONES of New Mexico. Something has been going on in this case since 1917, apparently?

The CHAIRMAN. That is where the favoritism comes in. For instance, take the Sinclair case. The chronological order of proceedings in the Sinclair Oil case is one of the most disgraceful things that I have ever seen, and yet it has been consented to for years and years by the bureau. Now, where are all of your statutes, and where are all of your lawyers in the solicitor's office, if they consent to these delays for years and years, which are costing the Government millions of dollars; where is the supervision; where is the system; where is the organization; where is the boss? I think it is outrageous. This case that Mr. Briggs is talking about is typical of lots of others.

It is not sufficient for Congress to say that the responsibility is on a subordinate. Congress does not know Briggs. There is nothing in the statute that places responsibility anywhere except upon the commissioner. You can not come here and say that this condition is due to Briggs or to the committee of appeals and review, or that this condition is due to the taxpayer. The condition is solely and wholly up to the Commissioner of Internal Revenue.

Senator JONES. It appears from the testimony in this case that Mr. Briggs has been censured for making a protest about the action of his superiors in these matters, and from this memorandum of Mr. Allen's, I think, which was read into the record just a moment ago, he is complaining about that very thing. So it seems to me that that puts the responsibility for such things on the head of the bureau, when you will not permit your subordinates to come along the line with protests, when you reprimand them for doing that sort of thing, and they to try to say, "We have lawyers, we have auditors, and we have other men in here to do these things," that will not do, because we find that the protests are not honored, and I do not think the blame can be shifted to the employees under those circumstances.

The CHAIRMAN. The evidence in these hearings up to date has indicated to me absolute incompetence on the part of the commissioner. There is not any leadership; there are not terminal facilities. I never heard of any investigation of an organization anywhere that I found so little leadership and so much lack of ability to do a job as has been shown in this investigation of the Bureau of Internal Revenue.

Mr. BRIGGS. I would like to state, if I may, in regard to the last letter that was sent to the taxpayer as to furnishing information. That was a letter that was written under the direction of the deputy commissioner to me over the phone, that I write a very strong letter that he could have until the 1st of May to furnish the information, but that that would be final. That letter would have gone out under my signature, but to make it a little bit more emphatic, the letter was drawn up, covering about three pages, and it was made very

emphatic, so emphatic that I thought there would be no objection to signing it, and I had it made out for the commissioner's signature. He signed it and it was sent out that way, and it told the taxpayer very emphatically——

Senator JONES of New Mexico. And still they paid no attention to it.

Mr. BRIGGS. And still they paid no attention to it.

Just after I left the office—I have not mentioned this because I am on the outside—I was told that they came in in force in the same way, without any information.

The CHAIRMAN. What is the influence back of the delay in this case? You have intimated to some of our investigators that there is some influence back of this case.

Mr. BRIGGS. Well, they are big, powerful concerns, and big, powerful concerns seemingly get away with a good deal of that. I will say that there has been an unusual statement made. I do not place any credit in the man who stated it; he never stated it to me, but I know he has stated it to others, because I have heard it repeated. He has come in and said, "Mr. Mellon and I are directors in several companies together; we are great friends. Any time I come to Washington, or almost any time I come, I go over and call on Mr. Mellon for a half an hour or so. He often asked about you boys, and I tell him 'You are a damned fine set of boys.' He says, 'I am very glad to hear it.'" That has a great effect on some of the men that he talks to.

Senator ERNST. I think this is a fine time to adjourn.

Mr. BRIGGS. I do not pay any attention to that kind of stuff myself. In fact, I never had it given to me. I did state that if it were given to me—I would probably have been reprimanded for doing it—I would have asked him, "What is your next best story?"

The CHAIRMAN. We are about to close these hearings, but I would like to ask just one question, and I am not trying to foreclose any other questions that the other Senators may want to ask.

Mr. Briggs has been here during all of this discussion. He has heard the history of the bureau's management so far as the combination of these two sections is concerned. He has heard the necessity for cutting down the expenditures. He has heard the amount of deficit. He has heard about the discussions that took place between Mr. Nash and the commissioner, and Mr. Grimes and Mr. Nash and the commissioner, and he knows the general procedure. In view of his having heard all of this, I would like to know what he thinks about the conclusions reached by the bureau and what else it could have done. I say that because the committee wants to be fair. You have heard both sides of it, Mr. Briggs, as we have heard it.

Mr. BRIGGS. Yes.

The CHAIRMAN. What are your conclusions about it?

Mr. BRIGGS. In regard to my discharge?

The CHAIRMAN. Yes.

Mr. BRIGGS. I have not had any doubt at all but that I was discharged on account of this investigation, and I want to say that the men who worked for me have the same feeling, too, that I was discharged on account of this investigation.

If I might be able to make a little statement—it will not take very long, but will give you the history of my connection as chief of the

section—I would like to do so. It will only take me a very few minutes.

In October, 1923, I was appointed chief of this section to succeed Mr. Griggs. Before being appointed Mr. Greenidge called me to his office and asked me if I were appointed chief whom would I appoint as my assistant chief. I told him that I had not given the matter any thought, and he remarked, "You would not think of appointing Seward, would you?" "No," I said, "I would not." "Well, what about Keenan?" I said, "Well, Keenan has done very good work; he has done good work in the field, I think, from what I have seen of it." "Well," he said, "I would like to do something for Jack. Would you have any objection to appointing him your assistant?" I said, "No; I don't think I would. I feel perfectly willing."

So as a result of that I appointed him my assistant.

I think it was almost on the following day after I was appointed chief of the section that Mr. Greenidge came to me and said he wanted to borrow Keenan for about a month. That was before he really got started as assistant to me. He said they were going to take over the appraisal—sometimes called the appraisal, sometimes called the amortization, section—and he wanted to send Mr. Keenan over there to straighten it out. "Well," I said, "when will he be back?" He said, "He will be back in a month." "Well," I said, "wherever the Government needs a man most, I can't put in any objection."

I think it was the next day that Mr. Griggs said, "Whom are you going to appoint assistant chief?" I said, "Keenan is my assistant chief." "Why," he said, "he won't be back." I said, "Greenidge tells me that he is coming back in a month." He said, "He will not be back."

So I spoke to Mr. Greenidge, and Mr. Greenidge apparently did not like the fact that Mr. Griggs had told me that. He said, "Everybody seems to know a damned sight more about it than I do."

Some time about the 1st of September the appraisal section was made a subsection of my section, and Mr. Keenan was returned to me as my assistant chief. There was nothing said in regard to what his duties should be at all in the memorandum returning him.

As soon as we got organized one of the men from the amortization section came up and was starting to ask me some question. Mr. Keenan was out of the room. It seems that he was going to look after that kind of work immediately, and Mr. Keenan saw him speaking to me, and he left the room and went down to Mr. Greenidge and made complaint that I was talking to some of his men.

The CHAIRMAN. Mr. Briggs, just what has that to do with your connection with the committee?

Mr. BRIGGS. I want to show the prejudice that has existed against me from the very beginning.

The CHAIRMAN. That is not the point. You made the statement awhile ago that you were dismissed because of your connection with this committee, and you said you were going ahead to tell us of your connection with this committee.

Mr. BRIGGS. Yes.

The CHAIRMAN. Now, please go on and do so.

Mr. BRIGGS. I want to show that there was an attitude of prejudice, and that is the reason I am stating this.

I want to state that for seven months this appraisal work was work to which my name had to be signed. It was under me, I was supposed to be responsible for it. During that seven months I never was allowed to sign my name to it. Not only that; but I was told that I could not look at the cases there or any of the papers.

Senator ERNST. How long ago was this?

Mr. BRIGGS. From December, 1923, to July, 1924, when the appraisal section was separated from the nonmetals section and, in fact, when the separation took place the first notice I got of it was from my secretary.

Mr. MANSON. Do you mean to say that for that period of time you were responsible for this work and were not permitted to examine it?

Mr. BRIGG. I suppose so. I suppose I was responsible, as chief of section, and my name had to be signed to all of the papers, but I was not allowed to examine them, and not even allowed to sign my name.

Mr. MANSON. Did somebody else sign your name?

Mr. BRIGG. Mr. Keenan signed them.

The CHAIRMAN. Who refused you permission to examine your own cases?

Mr. BRIGGS. Well, I was going into a discussion of that by showing just what happened between Mr. Keenan, Mr. Greenidge, and myself.

Mr. MANSON. Mr. Greenidge is the one that directed you to leave that entirely to Keenan; is not that so?

Mr. BRIGGS. Practically; yes, sir.

Mr. ROGERS. And whenever you attempted to look into it, Keenan complained to Greenidge, and Greenidge reprimanded you; is not that true?

Mr. MANSON. Did you ever make any complaint to anybody above Greenidge about not being permitted to examine these cases?

Mr. BRIGGS. I spoke to Mr. Allen about it.

Mr. MANSON. What did Mr. Allen say?

Mr. BRIGGS. Mr. Allen said that I was responsible, but he said the best way out of it was to keep still and leave things run along as smoothly as possible, and I held that course from that time on. At the time I took that matter up I made this memorandum in which I made a protest, and Greenidge replied to me in the Penn Sand & Gravel Co. and the Climax Fire Brick cases.

The CHAIRMAN. In other words, you were told to be a good soldier?

Mr. BRIGGS. I was told to be a good soldier, and from that time on I was, because, if you will remember in my testimony, we had up the United States Graphite Co. case, and in that case Mr. Burdick said that he had made a written protest to me against Mr. Shepherd's ruling, and I advised him to go ahead and sign it, and if Mr. Shepherd signed it that he was not responsible; that we were told not to criticize our superiors.

The CHAIRMAN. Tell us about your connection with this committee. You stated that you were discharged because of your relation with this committee. Now, just what has been your relation to the committee?

Mr. BRIGGS. My relation to the committee is that I was called on to furnish them certain cases and testify before the committee, and as a result of that there has been a very hostile attitude toward me.

The CHAIRMAN. But that was not on account of your coming down here and testifying; it was not on account of your connection with this committee, was it?

Mr. BRIGGS. The Senate committee?

The CHAIRMAN. Yes; we are talking about this committee right here.

Mr. BRIGGS. Well, that was after I was asked to furnish data.

The CHAIRMAN. Who asked you to furnish data, and what was it?

Mr. BRIGGS. Mr. Parker. Oh, first, I was told on my return from a field trip last September that a man by the name of Parker was here, an engineer acting for the Senate investigating committee, and I was to give him any information that he would ask for.

The CHAIRMAN. Who told you that?

Mr. BRIGGS. Mr. Greenidge.

The CHAIRMAN. Yes.

Mr. BRIGGS. But they made remarks afterwards which indicated that they wanted me to be very careful what I did furnish.

The CHAIRMAN. When did they say that, and what were their remarks?

Mr. BRIGGS. Well, I went to Mr. Griggs and asked him the name of the Calcite case in New Jersey which we had sent to the board of appeals and review, and he asked me what I wanted it for. I said, "To send to the committee investigating it." He says, "Hell, you know those fellows are here just simply to raise the devil with us, and if we are not careful a lot of us will lose our positions." I went to see Greenidge first, but he opened the door and went into Greenidge's room to see whether he wanted that case sent up. Greenidge was not there. He said, "I can't send that down." I said, "They have asked for that kind of a case." I said, "That is as good a case as any."

Mr. Greenidge also met me in the hallway one day, laughing as he went out—apparently he started to laugh as he saw me coming. "Well," I said, "you are happy." He said, "If you will come to my office, I will let you read something that will make you laugh like a horse. If you don't, I miss my guess." So I went up there, and he showed me a note reading that Mr. Parker had made an application with the Civil Service Commission for a position as valuation engineer.

Mr. MANSON. When was that application made?

Mr. BRIGGS. Mr. Parker's application?

Mr. MANSON. Yes. It was not since he has been connected with this committee?

Mr. BRIGGS. Oh, no.

The CHAIRMAN. When was it made?

Mr. BRIGGS. I do not know when Mr. Parker made his application.

Mr. PARKER. Three or four years ago.

The CHAIRMAN. What was the joke about that?

Mr. BRIGGS. Well, he just simply said "Ain't it ridiculous that they send a man here to investigate us that has made an application like that in here? Why," he says, "I thought when this investigation was started they would have some big man like Winchell"; and he mentioned one or two other men. He says "It is absolute nonsense to give him any information."

A very small trick which they played, which showed their hands, was sending Miss Pearce out of Mr. Greenidge's office down to my

secretary and whisper in her ear that she should watch and see who went in to talk to these investigating engineers, and report to the head office every afternoon at half past 4 o'clock who went in there.

Now, apparently, it was given to her with a view that—well, it was given apparently as if it was intended that she should not let me know, but I think it was intended that she should let me know, and see if they could not frighten me about giving this information, because she told me about it, and I said "You just tell them every afternoon at half past 4 that you were too busy to watch out for that."

The CHAIRMAN. Just tell what information you gave this committee.

Mr. BRIGGS. Mr. Parker asked me to give him a memorandum showing a list of cases in which my work in the section had been reversed by the board of appeals and review. I can't remember just exactly the work, the special conferee, or another matter, and I picked up six little cases and gave them to him. I think most of those cases have come up here.

Then, later on, he asked me for some other cases, and I gave them to him. In fact, I made a memorandum to Mr. Greenidge, a typewritten memorandum every day at half past 4, showing what was given your committee.

The CHAIRMAN. Is that a matter of record in the bureau?

Mr. BRIGGS. It should be a matter of record; yes, sir.

The CHAIRMAN. So that you did not give anything to this committee surreptitiously or under the hat; you just openly told us what you thought was wrong, and notified them to that effect?

Mr. BRIGGS. I think that is so. I think Mr. Parker will bear me out that I have been very fearless in giving him information; that I have not done it as a sneak or a horse thief, or anything of that sort.

Mr. MANSON. In all instances, did you notify Mr. Greenidge of the information that you gave to the engineers?

Mr. BRIGGS. Maybe some engineer came in and wanted to discuss some general principle—not a particular case—and wanted to ask what the law was in regard to that. For instance, I remember having one or two discussions where the engineer came in and wanted to know about paid-in surplus, and under what circumstances it could be gotten, and I explained to him the circumstances.

The CHAIRMAN. Of course, that was not information from the bureau at all, but it was a matter of record.

Mr. BRIGGS. It was something that there was a great deal of discussion about.

Mr. MANSON. He wanted to get your views on the subject.

Mr. PARKER. Mr. Briggs had auditing experience as well as engineering experience in the bureau, and we asked him general questions not relating to particular cases.

Mr. BRIGGS. I came into the engineering section from the audit section. I came in at the request of Mr. Hamilton, who was at the head of the metals section. They needed some one in the audit for valuation purposes and for depletion purposes, and Mr. Hamilton found that the work that I was doing there was valuable, and after he had found it was valuable, and after he found out that I had had 16 years' experience in mining, he said, "We want you in this section; you can easily get a rating as a valuation engineer, and I will make a request for you."

He said, "You write Mr. Winchell and get a statement from him."

The CHAIRMAN. To get back to what we started on, you made the statement that you were dismissed because of information that you had given to this committee. Do you still adhere to that statement, in view of what Mr. Nash has stated?

Mr. BRIGGS. Well, I can say that, in view of the way that I was dismissed, I can not have any other feeling in the matter when the notice was stuck on my desk, I think on the 23d—I couldn't say for sure, but I think on the 23d of April, was it?

Mr. MANSON. Yes.

Mr. BRIGGS. The 23d of April, which I opened, and which said "Your services, I am sorry to say, are no longer needed, and you will be given your accrued annual leave," a certain small amount, it seemed to me to be absolutely absurd.

Mr. MANSON. Was it customary to give a 30-day notice when a man was removed other than for cause?

Mr. BRIGGS. I can not say, but I know that—is that right, Mr. Nash?

Mr. NASH. We usually give employees their accrued annual leave, but in some cases I believe the Secretary has the power to give the full 30 days' leave to an employee who is leaving the service. That is done in exceptional or meritorious cases.

Mr. BRIGGS. It is done practically in all cases. My wife got that when she resigned after being three years in the service.

Mr. NASH. There are some cases in which no leave is given.

The CHAIRMAN. I think the committee is about through with the hearings. This is the last day that we can hold a hearing, according to the terms of the resolution, unless we sit to-morrow. I think we had better adjourn.

Mr. NASH. Senator, I would like to make this statement:

Mr. Briggs has stated that he believes he was separated from the service because of his contact with the committee. I have said this before, and I want to repeat it, he was not separated from the service for that reason, nor has any other employee been disciplined in any way for contact with this committee. Mr. Grimes, I think, has been closer to this committee than Mr. Briggs has, yet Mr. Grimes has been promoted. Mr. Davis, who has also furnished information to this committee, has not been molested in any way. Our instructions to those men were to cooperate with this committee, and I am glad that they have done so.

The CHAIRMAN. Mr. Briggs has certified to that, so far as Greenidge is concerned.

Mr. BRIGGS. I think all of the engineers who have worked under me over there, if you will ask them, will tell you that they have the same feeling, that it has been their feeling, and it has had a demoralizing effect upon them, too. Mr. Grimes stated that I could easily have been demoted and retained there as an engineer under him, that he would have been glad to have me.

Senator ERNST. Mr. Chairman, I move we adjourn.

The CHAIRMAN. I hear no objection. The committee is adjourned subject to the call of the Chair.

(Whereupon, at 12.50 o'clock p. m., the committee adjourned subject to the call of the Chair.)