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SENATE

REPORT
No. 903

TAX TREATMENT OF CERTAIN CLAYS AND SHALE FOR TAXABLE YEARS BEGINNING PRIOR TO 1961

SEPTEMBER 7, 1961.—Ordered to be printed

Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

together with

MINORITY VIEWS

[To accompany H.R. 7057]

The Committee on Finance, to whom was referred the bill (H.R. 7057) relating to the application of the terms "gross income from mining" and "ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products" to certain clays and shale for taxable years beginning before December 14, 1959, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments strike out all after the enacting clause and substitute the material appearing in italic in the bill as reported by your committee. A summary of the committee amendments appears in the second paragraph below.

I. SUMMARY OF THE BILL

The version of the bill passed by the House provided in the case of brick and tile clay, shale, refractory and fire clay, and ball, sagger, and china clay that insofar as the holding in the *Cannelton Sewer Pipe* case departs from the principles previously enunciated in the *Cherokee Brick and Tile Company* and *Merry Brothers Brick and Tile Company* cases, it is not to be applied retroactively for years beginning before the Supreme Court granted certiorari in the *Cannelton* case on December 14, 1959. Thus, in the case of brick and tile clay and the other clays or shale where the finished product is the first commercially marketable product, percentage depletion for these past years to the extent they

are open would, under the House bill, be based upon the value of the finished or end product.

Your committee has amended the House bill to provide that in the case of brick and tile clay, fire clay and shale used to make certain products, "gross income from the property" for purposes of computing the percentage depletion deduction is to be 50 percent of the gross income from the finished product but not in excess of $12.50 for each ton of this clay or shale used in the finished product. The types of products for which the shale or specified types of clay must be used are building and paving brick, drainage and roofing tile, sewer pipe, flowerpots, or kindred products. This provision is in the form of an election which taxpayers may make for all open years beginning before January 1, 1961.

II. GENERAL STATEMENT

This bill is concerned with the proper base for the application of percentage depletion in the case of various clays and shale for taxable years beginning before January 1, 1961. The question presented here is what the base for percentage depletion should be in the past and not in future, since the basis for taxable years beginning on or after January 1. 1961, was decided quite specifically by Congress in the so-called Gore amendment in the Public Debt and Tax Rate Extension Act of 1960. (That act specified for the future, not only in the case of clay, but in the case of other mineral products as well, the so-called cutoff points at which the various percentage depletion rates are to be applied, or which processes could be applied to the mineral products before determining their value for percentage depletion purposes.)

A. HISTORICAL BACKGROUND

Percentage depletion was provided for ball and sagger clay in 1942 and in 1947 for china clay. In 1951 brick and tile clay, shale and refractory, and fire clay were added to the list of clays eligible for percentage depletion. In that act the rate of depletion for brick and tile clay and shale was set at 5 percent and the rate for ball, sagger, china and refractory and fire clay at 15 percent. In the 1960 amendments, instead of referring to refractory and fire clay as such the code was amended to provide percentage depletion at a 15-percent rate for "clay used or sold for use for purposes dependent on its refractory properties." Also, in the category of clay receiving percentage depletion at the 5-percent rate, instead of referring to brick and tile clay as such, the 1960 legislation provided for percentage depletion for "clay used, or sold for use, in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flowerpots, and kindred products."

The statute provides that the percentage depletion rates referred to above are to be applied to the "gross income from the property." Congress in the Revenue Act of 1943 defined the "gross income from the property" as the "gross income from mining." The term "mining" in turn was considered to include—

> not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally

> applied by the mineowners or operators in order to obtain the commercially marketable mineral product or products.

This definition was made applicable to taxable years beginning after December 31, 1931. Although this definition has recently been changed (by the Gore amendment in 1960) it was fully applicable for the period with which this bill is concerned; namely, taxable years beginning before January 1, 1961. Your committee in its report on the Revenue Act of 1943 stated that—

> The purpose of this provision is to make certain that the ordinary treatment processes which a mineowner would normally apply to obtain a marketable product shall be considered as a part of the mining operation * * *.

The issue presented is what represents the oridinary treatment processes normally applied by the mine owners or operators in order to obtain the commercially marketable mineral product or products. In 1954 a district court, in ruling for the taxpayer in the *Cherokee Brick and Tile Company* case (122 F. Supp. 59), held that in the case of the brick and tile clay involved in that case there was no commercially marketable product prior to the finished product and, therefore, that percentage depletion in this case should be based on the finished product. This case was appealed to the Court of Appeals, Fifth Circuit. In affirming (in 1955) the decision of the lower court, that court held:

> The statutory language is clear and unambiguous, which is that gross income from mining must include the income from ordinary treatment processes which must be applied to the ore or mineral in order to obtain the commercially marketable mineral product; that is, the first product which is marketable in commerce. There is no provision in the statute for excluding any process before such a marketable product is reached. The only restriction is that the processes must be the ordinary treatment processes normally applied by mine owners or operators.
>
> The complaint alleges that, of the brick and tile clay mined in the United States, there is opportunity for the sale of only a negligible quantity before it is put into the form of burned brick and tile. This allegation is admitted in the answer of the appellant. For this and other reasons (but mainly for this one) stated in the opinion of the district court, above cited, the judgment appealed from should be affirmed.

Substantially similar positions to that described above were taken by three other circuit courts of appeals (the 3d, 4th and 10th), the U.S. Tax Court, and district courts in the 6th and 9th circuits. In fact, with the exception of a district court case (*Dragon Cement Company* v. *United States*, 244 F. 2d 513) which was subsequently reversed by the court of appeals, there were no decisions on this issue in favor of the Government prior to the *Cannelton* case. The Government in 1957 asked the Court of Appeals, Fifth Circuit, to reconsider its decision in the *Cherokee* case as a part of its consideration of *United States* v. *Merry Brothers Brick and Tile Company* (242 F. 2d 708). In the *Merry Brothers* decision, the court of appeals

again upheld its *Cherokee* decision in holding for the taxpayer as follows:

> [B]ecause in their decisions the district court and this court dealt adequately and correctly with the question presented in it and here, we will not undertake to restate or further elaborate upon the reasons they gave but will content ourselves with saying that, upon the plain and simple consideration set down and for the reasons pointed up in the *Cherokee* case, we decline to depart from the decision in it, and, on its authority, affirm the judgments appealed from.

Following the *Merry Brothers* decision, the Government petitioned the Supreme Court to review this case and the *Dragon Cement* case. However, on October 14, 1957, the Supreme Court denied certiorari in both of these cases. Four days later, on October 18, 1957, the Internal Revenue Service issued Technical Information Release No. 62, which is as follows:

> The Internal Revenue Service announced today that in view of the denial by the Supreme Court of the United States on October 14, 1957, of the Government's petitions for certiorari in *United States* v. *Merry Brothers Brick & Tile Co., et al.*, 242 F. (2d) 708 (1957), and in *Dragon Cement Co., Inc.* v. *United States*, 244 F. (2d) 513 (1957), it is taking steps to dispose of pending litigation and claims involving brick and tile clay and cement rock, as required under these decisions, and to conform Treasury regulations and outstanding rulings accordingly. This should permit the expeditious disposition of the great majority of such cases. Consideration is being given as to the applicability of these decisions in cases involving fire clay and limestone.

For 2 years after the issuance of TIR-62, the Internal Revenue Service followed the position expressed in that release and on that basis did in fact settle many depletion claims in prior years in the case of brick and tile clay. As a result, first it can be said that until the Supreme Court decided the *Cannelton* case there is nothing to indicate in the case of clays such as brick and tile clay that percentage depletion would not be allowed on the finished product. Second, this position had been held in an unbroken chain of many court cases dealing with this subject. Third, the Internal Revenue Service had announced that it would follow this policy in an official release and in fact had followed this practice in settling cases.

Following the decision in the *Cannelton* case on June 27, 1960, the Internal Revenue Service announced that it would follow the principles of the *Cannelton* case in the disposition of cases involving the definition of the term "mining" and—

> in view of this decision certain revenue rulings, long in contest by many taxpayers and inconsistent with the position taken administratively and in litigation, will be revoked.

Subsequently, in specific reference to brick and tile clay, the Service ruled that "any process which is not necessary to bringing such mineral to shipping form will not be considered an ordinary treatment process." It has been indicated that such a position would be followed in all open cases despite the fact that section 7805(b) of

the code provides that the Secretary or his delegate may prescribe the extent, if any, to which rulings or regulations may be applied without retroactive effect. Thus hundreds of taxpayers throughout the Nation were, and are, confronted with a completely new policy in this area.

B. REASONS FOR THE BILL

The House Committee on Ways and Means concluded from an examination of the record cited above that taxpayers in the brick and tile industry were justified, at least for this past period, before the Supreme Court granted certiorari in the *Cannelton* case, in basing percentage depletion on the value of the end product. The House was convinced that taxpayers are justified in placing full faith and credit on the long line of court cases upholding percentage depletion on the finished product in the case of brick and tile clay, on the official statement issued by the Internal Revenue Service that it intended to follow the principles laid down in those court cases, and on the fact that the Internal Revenue Service had settled many cases on this basis. The House report also noted that the Government itself apparently assumed that percentage depletion could be taken on the selling price of the end product in the case of brick and tile clay as was evidenced by recommendations in two budget messages for changes in the tax laws and by statements to Congress on this subject. The House report cites as an example of this the statement made by the former Secretary of the Treasury, Robert B. Anderson, in a letter to the Speaker of the House in 1959 requesting legislation in which it is stated:

> Early last year I testified before the Ways and Means Committee on the need to revise the law in order to preclude excessive depletion deductions for the brick and cement industry. My recommendation was made as a result of a series of court cases which permitted manufacturers of brick and cement to compute percentage depletion on the basis of the selling price of the finished manufactured product rather than on the value of the clay or cement rock before it is manufactured.

As a result of the considerations outlined above, the House bill provided how the terms "gross income from mining" and "ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable product or products" (as these terms were used in the tax laws for taxable years beginning before January 1, 1961), are to be interpreted in their application to the terms "clay and shale" as used in the percentage depletion provisions, but only for taxable years beginning before December 14, 1959. For this period the House bill would provide that these terms are to be treated as having a meaning consistent with the principles set forth in the *Cherokee Brick and Tile Company* and *Merry Brothers Brick and Tile Company* cases referred to previously in this report, notwithstanding the decision of the Supreme Court in the *Cannelton* case.

The House committee report also suggests that to apply the Treasury Department's interpretation of the *Cannelton* case to past, open years of taxpayers who are miners of clay and shale would be highly inequitable because of the very large number of cases which the Treas-

ury Department had in the past already settled upon the principles of the *Cherokee* and *Merry Brothers* cases. It points out that a survey made by the industry from a large sample of the taxpayers in the brick, tile, and fire clay industry, for example, suggests that for years prior to 1957, approximately 80 percent of the cases are closed. Since the Service cannot assess deficiencies in those cases, the House committee report suggests that it would be highly discriminatory to assess deficiencies in other cases or to refuse claims for refunds based upon the same principles.

The House report further pointed out that the retroactive application of the Treasury interpretation of the *Cannelton* case would work hardships on many clay miners. Many of them made decisions—as to the price of the product, whether to use funds for plant expansion, to use them for dividend distributions, etc.—on the assumption that the court and Internal Revenue Service interpretation of what the base was for their percentage depletion allowance could be relied upon. To retroactively impose a tax in these cases would in the view of the House be especially serious in the brick and tile industry because it is traditionally an industry of many small, independent businesses which do not have large financial resources to fall back on if there is to be a redetermination of their tax liability.

Your committee recognizes the validity of much of the case made in the House report for the enactment of this legislation. However, the Treasury Department has taken strong exception to the House version of the bill and representatives of the industry, in view of this Treasury opposition, have agreed to a modification of the House-passed bill. In addition, the legislation which would be provided if the House-passed bill were enacted presents uncertainties in application. For example, it is not possible to determine with certainty exactly what the "principles" of the *Cherokee Brick and Tile Company* and *Merry Brothers Brick and Tile Company* cases actually are, particularly in their application to different types of clay.

The Treasury Department, in its report to your committee on a companion measure to H.R. 7057 (S. 2289), recognized that the technical information release issued by the Internal Revenue Service in 1957 "justifies some degree of legislative relief because of the reliance which may have been placed on this announcement." The report indicates that the Treasury Department would not object if the brick and tile industry were granted a cutoff point for purposes of determining percentage depletion after crushing and grinding and separation of waste material. In addition, the Treasury report indicates that there is some merit to the contention that merely allowing the process of crushing and grinding would not allow the same proportion of relief in the brick and tile industry as the compromise worked out last year in the case of the cement industry. In this connection the Treasury representative before your committee referred to an alternative proposal which would provide that the gross income per ton would be equal to 25 percent of the amount for which the finished product is sold so long as the gross income per ton of clay used in the finished product is not in excess of a maximum of $6 a ton. However, your committee has concluded that, giving due regard to the tax treatment it previously was thought was applicable in such cases, this proposal would provide too little relief for the miner-producers involved; and, in the case of the small companies, it would be

likely to place many of them in severe financial straits. It is believed that the committee proposal described below, while still causing some hardship, nevertheless will meet the Government's interpretation of the *Cannelton* case halfway without seriously undermining the financial condition of the companies involved.

In view of the factors described above, your committee has concluded that a legislative settlement of the basis for percentage depletion is desirable in the case of certain clays. The legislative settlement, or compromise, provides that the "gross income from the property" in the case of brick and tile clay, fire clay, and shale used for certain specified purposes is to be 50 percent of the amount for which the finished products are sold but not more than $12.50 for each ton of such clay or shale used in the finished product. To be eligible for this provision the clay or shale must be used in manufacturing building or paving brick, drainage and roofing tile, sewer pipe, flowerpots, or kindred products.

This provision, in general, is a compromise which is much closer to the 25 percent of the value of the finished product, which the Treasury would not oppose, than the 100 percent specified by the House bill. Moreover, it is more restrictive than the House bill in that it is limited to brick and tile clay, fire clay, and shale, and available only for these products when they are used in manufacturing building or paving brick, drainage and roofing tile, sewer pipe, flowerpots, or kindred products. This category of products is the same as that specified in present law where percentage depletion at the rate of 5 percent is allowable. (This is not in any way intended, however, to reduce the allowable percentage rate of depletion in those cases in prior years where the 15-percent rate was applicable.)

The limitation of $12.50 for each ton of the specified type of clay or shale used in the finished product is designed to restrict the allowance of depletion to the amount which would be available if the clay or shale had been used to make standard common brick. (It has been found that such brick generally sells for approximately $25 per ton of clay used in the brick.) This limitation is to be applied separately with respect to each of the clay and shale products covered by this bill which are sold by a miner-producer during his taxable year. Under the bill there are five "products" for purposes of applying this limitation; namely, (1) all building and paving brick, (2) all drainage and roofing tile, (3) all sewer pipe, (4) all flowerpots, and (5) all kindred products.

Your committee's amendment also provides a means of computing the provision which limits the depletion deduction allowable to 50 percent of the taxable income from the property (computed without allowance for depletion).

Your committee has provided that the treatment specified in this bill is to be in the form of an election with respect to all open years (in the aggregate) in the period from January 1951 through any taxable years beginning before January 1, 1961. Thus, your committee's amendment also covers the year 1960 to which the House provision would not have been applicable. Thus, under your committee's action (if the election is made under this provision) only two sets of rules, namely, the rules provided by this bill for taxable years beginning before January 1, 1960, and the rules provided by the Gore amendment with respect to taxable years beginning on or after

January 1, 1961, will be applicable in the case of these clays and shale. The House bill would have made the treatment provided in that version of the bill available only for years beginning before December 14, 1959, which meant that for taxable years beginning after that time and before January 1, 1961, the "principles" of the *Cannelton* case would have applied and that after 1960 the Gore amendment would be applicable. Your committee's amendment makes it unnecessary for taxpayers to apply the "principles" of the *Cannelton* case for what usually is merely a 1-year interval.

The election if made applies with respect to all assessments of deficiencies and refunds or credits of overpayments where the statute of limitations has not run on the date of enactment of this bill. Under the bill the taxpayer has until 60 days after date of the publishing of the final regulations to make this election. Any such election once made may not be revoked. The bill also provides that for any deficiency or overpayment arising from the exercise of the election specified in this bill, the statute of limitations is not to close until 1 year after the last day for making the election.

C. REVENUE EFFECT

It is estimated that this bill will decrease revenues by about $20 million if the Treasury interpretation of the *Cannelton* case is correct. This is the aggregate loss anticipated for the years 1951 through 1960. It includes both losses expected from deficiencies which might otherwise be assessed and collected and also losses occurring from making refunds required under the bill.

MINORITY VIEWS OF SENATORS PAUL H. DOUGLAS AND ALBERT GORE

The granting of percentage depletion to a variety of minerals has been one of the most controversial provisions of our tax code. But whatever may be said against the excesses of percentage depletion for raw materials, these excesses, pale in principle when compared with the attempt of this bill to provide percentage depletion on a retroactive basis on the greatly enhanced value of the final manufactured product of brick and tile clay, fire clay, and shale.

Even those who may support percentage depletion for certain minerals could hardly justify such an allowance for the final product.

In 1951, when percentage depletion was extended to brick and tile clay, shale, fire clay, and a number of other nonmetallic minerals, no one foresaw where we would find ourselves 10 years later. Prior to 1951 the various persons entitled to percentage depletion had computed their depletion allowances on the basis of the value of the raw materials or the mineral concentrates. No one appearing before the committees of Congress requesting percentage depletion benefits for his mineral had ever asked that depletion be based on the value of his manufactured product. There is no evidence that the brick and tile industry requested Congress to allow percentage depletion on finished bricks, sewer pipe, and other such products. The various industry representatives who appeared before the congressional committees generally stated that they were mining a certain mineral, such as clay, which became exhausted or depleted over a period of time, and that they felt they were entitled to a greater deduction for depletion of the mineral. No one suggested that he was mining a brick or a flowerpot and that he was entitled to a depletion deduction based on its value.

Yet, shortly after percentage depletion was extended to the brick and tile industry, the members of the industry began for the first time to express the view that Congress had granted them depletion of their finished products. Naturally, the Internal Revenue Service opposed this effort to extend depletion to manufacturing. The industry then embarked on a well-organized and carefully planned litigation campaign which was designed to secure, through the courts, depletion on the manufactured products.

Nine years later, this litigation effort ended in failure for the industry. The Supreme Court declared unanimously in the case of *U.S. v. Cannelton Sewer Pipe Company* the obvious answer that Congress had never intended that depletion be based on manufactured products, and that depletion was not intended as a subsidy to manufacturers. Since the brick and tile industry did not attain its objective through the courts, the forum which it originally selected, it then turned its gaze back toward Congress and said, "Give us for the past 10 years that which the courts have denied us—depletion on the manufactured product."

This request was ostensibly based on two factors. First, the industry pointed out that it had obtained a number of favorable lower court decisions before the Supreme Court decision was handed down, and second, at one stage of the litigation the Internal Revenue Service had issued a press release indicating that pending claims involving brick and tile clay would be settled as required by certain of these lower court decisions.

What the brick and tile industry failed to point out is that producers of a number of other minerals followed the lead of the brick and tile producers so that the lower court decisions involved a substantial number of minerals in addition to brick and tile clay. Thus, if these lower court decisions are used as a basis for granting legislative relief to brick and tile clay, producers of a number of other minerals may press similar claims. It is a novel theory that a decision in favor of a taxpayer in a lower court followed by a reversal by the Supreme Court produces grounds for legislative relief. As far as the press release is concerned, it was merely one event in the course of extended litigation, and the brick and tile industry itself knew that the issuance of the press release did not finally resolve the question. Thus, the brick and tile industry was aware that it alone could not obtain depletion on the manufactured product, and that the litigation would continue until either all mineral producers or none obtained depletion on the finished product.

However, on the bases of the lower court decisions and the press release, the House of Representatives passed a bill granting finished product depletion to producers of all clay and shale for all open years back to 1951. The Senate Finance Committee has amended this bill to grant producers of brick and tile clay, fire clay, and shale 50 percent of the value of the manufactured product limited to $12.50 per ton of clay or shale. Even this measure is far too generous in distributing money that belongs to all taxpayers to one industry which interpreted the law incorrectly, and which, we suspect, knew it was interpreting the law in a manner contrary to accepted depletion concepts.

The passage of this bill would truly reward the contentious. All the taxpayers in the various mineral industries who did not seek to take depletion on their manufactured products, who conscientiously adhered to the rulings and practices long followed by the Internal Revenue Service and taxpayers alike, would not obtain depletion on 50 percent of the value of the manufactured products. Only those who sought to extend depletion beyond its normal meaning, who were instrumental in creating a 10-year period of uncertainty and turmoil in the entire depletion area, would obtain this substantial benefit. The passage of such legislation is an invitation for taxpayers to "shoot for the moon" knowing that if they do not succeed, there is a good chance that Congress will grant them 50 percent of what they aspired to.

In addition to these fundamental objections to the bill reported by the committee, it is defective for another reason. Although the bill has as one of its primary reasons for existence the aforementioned press release, it applies to fire clay which was specifically excepted from the terms of the press release. Thus, those who favor this bill base their advocacy primarily on the fact that persons mining brick and tile clay may have relied on the press release, and are entitled because

of this reliance to some tax forgiveness for past years. Miners of fire clay, however, cannot claim reliance on the press release. They may say that they relied on the lower court decisions and are entitled to relief on that ground; but this same claim can be asserted by miners of many different minerals. On this count, the bill is not only objectionable but is also dangerous since many other segments of the mining industry will attempt to use it as a precedent. The extension of this type of unjustified retroactive relief to the mining industry as a whole would involve a revenue loss to the Government of several hundred million dollars.

We are appending the letter of the Treasury opposing the enactment of H.R. 7057 as it passed the House.

The Senate should reject this bill.

PAUL H. DOUGLAS.
ALBERT GORE.

TREASURY DEPARTMENT,
Washington, August 29, 1961.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Old Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request dated July 29, 1961, for the views of the Treasury Department with respect to S. 2289, a bill relating to the application of the terms "gross income from mining" and "ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products" to certain clays and shale for taxable years beginning before December 14, 1959. The purpose of S. 2289, which was introduced by Senator Ervin, is to permit taxpayers who mine certain clays and shale to compute the percentage depletion allowance on the basis of gross income from the sale of finished manufactured products for taxable years beginning before December 14, 1959. This bill is the same as H.R. 7057 which was passed by the House of Representatives on August 21, 1961.

The Treasury Department is opposed to the enactment of S. 2289 for reasons which will be discussed hereinafter.

BACKGROUND

Congress has provided the percentage depletion allowance to permit recovery of the investment in a wasting asset and to provide an incentive for the discovery and development of additional mineral deposits. The amount of the percentage depletion allowance is computed by applying the percentage rate for the particular mineral, as determined by Congress, against the gross income attributable to mining the mineral. The allowance may not, however, exceed 50 percent of the taxable income from the property. To determine the gross income from mining, it is necessary to define the point at which mining ends and manufacturing begins. This point is often referred to as the "cutoff point."

In the 1951 Revenue Act, percentage depletion was first extended to brick and tile clay, shale, refractory and fire clay, limestone, and a number of other nonmetallic minerals. Shortly thereafter, the question arose with respect to a number of these minerals as to where the "cutoff point" occurs.

In November of 1951, the Brick and Clay Record, a leading trade journal in the brick and tile industry, stated that "the depletion allowances apply to the market value of the *raw minerals* * * *." [Emphasis supplied.] This statement indicated that many in the industry were of the opinion that mining ended in the brick and tile industry when the clay was extracted from the ground. However, by January of 1952 the same trade journal stated the opinion that the cutoff point was not reached for brick and tile clay until the finished brick was obtained. Under this view, "mining" included crushing, grinding, elimination of any waste material, mixing in the pugmill, the shaping and cutting of bricks, drying, and burning. At this point some producers of brick and tile clay and cement rock (a low-grade limestone suitable for making cement) began to apply the percentage rate granted by Congress against the gross income from the sale of finished brick and finished bagged cement, respectively. This approach was based on an interpretation of statutory language which provided that the cutoff point occurs after the mine owner or operator has applied "the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products." These brick and tile clay and cement rock producers contended that, in their industries, the finished manufactured products were the commercially marketable mineral products, and that all the processes necessary to obtain these products were normally applied by miners of brick and tile clay and cement rock.

The Internal Revenue Service took the view that Congress had never intended "mining" to include manufacturing processes, and that it was known generally in the mining industries that depletion was not to be based on gross income from the sale of finished manufactured products. Because of this dispute, it was necessary for the Revenue Service to determine precisely where the cutoff points fell in the brick and tile and cement industries. In 1953 the Revenue Service published a revenue ruling providing that the cutoff point for minerals used in making cement occurs after the materials are crushed and ground but before they are burned in the kiln; and in 1954 the Service published a similar revenue ruling providing that the cutoff point for brick and tile clay and shale used in making brick and tile products occurs after crushing, grinding, and the elimination of any waste material associated with the clay or shale. It was the view of the Revenue Service that after crushing and grinding, the taxpayer had obtained the commercially marketable mineral product, and that subsequent processing converted the mineral product into a manufactured product.

In 1955 the Court of Appeals for the Fifth Circuit decided in the case of *U.S.* v. *Cherokee Brick & Tile Co.* (218 F. 2d 424) that percentage depletion should properly be based on the gross income from the sale of finished brick. In 1956 and 1957 other cases involving brick and tile clay and cement rock were decided against the Government. In these cases the Government had stipulated that there was an opportunity for the sale of only negligible amounts of the minerals involved before obtaining the finished products, but had contended that, in spite of this fact, the taxpayers were not entitled to obtain depletion for the manufacturing part of their business. In holding for the taxpayer in the *Cherokee* case, the Court stated that the "gross income from mining must include the ordinary treatment

processes which must be applied to the ore or mineral in order to obtain the commercially marketable mineral product; that is, the first product which is marketable in commerce."

Two of the cases lost by the Government in 1957 were *U.S.* v. *Merry Brothers Brick and Tile Co.* (242 F. 2d 708) and *Dragon Cement Co., Inc.* v. *United States* (244 F. 2d 513). The Government requested the Supreme Court to review these decisions, but the Supreme Court denied the request. Shortly thereafter, the Internal Revenue Service issued Technical Information Release 62 stating that it would take steps to dispose of pending litigation and claims involving brick and tile clay and cement rock as required under the *Merry Brothers* and *Dragon Cement* decisions. This release read as follows:

"The Internal Revenue Service announced today that in view of the denial by the Supreme Court of the United States on October 14, 1957, of the Government's petitions for certiorari in *United States* v. *Merry Brothers Brick & Tile Co., et al.* (242 Fed. (2d) 708 (1957)) and in *Dragon Cement Co., Inc.*, v. *United States* (244 Fed. (2d) 513 (1957)), it is taking steps to dispose of pending litigation and claims involving 'brick and tile clay' and 'cement rock,' as required under these decisions, and to conform Treasury regulations and outstanding rulings accordingly. This should permit the expeditious disposition of the great majority of such cases. Consideration is being given as to the applicability of these decisions in cases involving fire clay and limestone."

This release was applicable to no minerals except brick and tile clay and cement rock, and even in the case of these two minerals it was considered by the Revenue Service to be applicable only to the extent it could be shown in the particular case that the finished product was "the first product which is marketable in commerce."

This was not the end of the litigation, however. It was now necessary under the court decision to determine with respect to each mineral what was the "first commercially marketable product," and whether this determination was to be made on an individual, a regional, or an industrywide basis. The Government took the position that the first marketable product must be determined on an industrywide basis. Otherwise, there would be no uniformity of treatment throughout the country. Taxpayers in one area might base the depletion allowance upon the gross income from finished products because there was no market in the area at an earlier stage, and taxpayers mining similar minerals in other areas where there were markets might be cut off after obtaining the crude mineral product. However, taxpayers mining numerous different minerals took the position that the first marketable product should be determined on an individual basis and that depletion should be based on the gross income from the first product that the particular taxpayer could sell at a profit. Under this approach, the depletion allowance could vary widely for the same mineral depending upon whether it was used by the particular taxpayer in making cheap or expensive finished products and upon whether the taxpayer had a low-cost mining operation so that he could profitably sell the crude mineral at prevailing prices or a high-cost mining operation which did not permit the sale of the crude product at a profit.

This question of the determination of the first commercially marketable product was before the courts in 1958 and 1959. Taxpayers

prevailed in this litigation in cases involving limestone used in making lime, cement, pulverized material for agricultural purposes, and other products; refractory clay used in making expensive ceramic title and sewer pipe; shale used in making lightweight aggregate; slate used in making roofing tiles; and several other minerals such as perlite, gilsonite, and dimension stone.

This problem was considered by the Government to be so serious from the standpoint of equity as between taxpayers, the theory of the depletion allowance, and revenue considerations, that the Government in 1959 again requested the Supreme Court to review a lower court decision involving the cutoff point question. The case in which the Government requested Supreme Court review was *U.S.* v. *Cannelton Sewer Pipe Company* (C.A. 7th 1959) 268 F. 2d 334, a case involving a taxpayer which mined fire clay and shale and used them in the manufacture of sewer pipe and other finished products. The taxpayer contended that its depletion allowance should be based on the gross income from the sale of its finished products since it could not profitably sell its clay or shale at any earlier stage. The Government contended that fire clay and shale are marketable in crude form and are in fact marketed by many miners in crude form, and that it is immaterial whether or not the taxpayer could sell its crude clay and shale at a profit since a uniform cutoff point for all miners of these minerals is applicable under a correct interpretation of the statute.

On December 14, 1959, the Supreme Court granted certiorari; and in June of 1960 the Supreme Court handed down a unanimous opinion in favor of the Government (364 U.S. 76). The Court held that raw clay and shale were the marketable mineral products and that the fact that the taxpayer could not sell its raw clay and shale at a profit was immaterial. The Court distinguished the *Cannelton* case from the *Cherokee* and *Merry Brothers* cases. However, it stated that it did not express approval of these earlier decisions. In fact, although the Court did not overrule these earlier decisions, the language used by the Court indicates that depletion should not be taken with respect to value added by manufacturing processes in any case. Thus the Court stated that depletion "is not a subsidy to manufacturers or the high-cost mine operator," and that in the case of an integrated operation "the miner-manufacturer is but selling to himself the crude mineral that he mines, insofar as the depletion allowance is concerned."

A recent District Court case in Kansas, *Great Bend Brick and Tile Co.* v. *U.S.* (61-1 U.S.T.C. par. 9394), held that the principles of the *Cannelton* decision apply to brick and tile clay as well as to fire clay and shale.

At approximately the same time that the Supreme Court handed down the *Cannelton* decision, Congress amended the cutoff point provisions of the code for 1961 and future years. This amendment made it clear that taxpayers could not base depletion on the gross income from the finished manufactured products. It also provided cutoff points at crushing and grinding for clay used in making brick and tile products and for minerals used in making cement. These cutoff points are in accord with the above-mentioned revenue rulings published by the Internal Revenue Service in 1953 and 1954 with respect to these industries.

In 1960 the Internal Revenue Service announced that cases involving the years 1951–60 would be settled in accordance with the principles of the *Cannelton* decision. This meant that, for these years, the cutoff point for clay used in making brick and title products would occur when the raw clay was obtained, and the cutoff point for limestone and cement rock would occur after crushing since these are the points at which the minerals would be sold by the nonintegrated miner.

Because the cutoff points for the cement and brick and title industries would occur at an earlier stage of processing under the *Cannelton* decision than under the rulings published by the Internal Revenue Service in 1953 and 1954 and the statutory amendment adopted by Congress in 1960, and because of the technical information release issued by the Revenue Service in 1957 indicating that some cases involving brick and tile clay and cement rock would be settled on the basis of finished brick and cement, the Treasury Department indicated that it would not oppose legislation granting producers of brick and tile products and cement an election to utilize for past years the provision adopted by Congress for future years. Under such an election, the affected taxpayers would be assured that crushing and grinding would be treated as mining. The Congress adopted such an elective provision for the cement industry, and it has been used by the great bulk of the taxpayers in the industry. This election did not grant cement producers the right to base depletion on the gross income from finished cement for the past years. It merely assured these taxpayers that crushing and grinding, the processes necessary to ready the minerals for the kiln, would be treated as mining. The net effect of this elective provision was generally that taxpayers relinquished their claims for refund based on finished cement for the years 1951–56, and the Government relinquished its right to assess approximately 15 percent of the deficiencies that could be assessed for the years 1957–60 under the *Cannelton* decision.

The Treasury Department indicated to industry representatives and to the House Ways and Means Committee last year and again during this session of Congress that it would not object to comparable legislation for the brick and tile industry. The equities of this industry are similar to those of the cement industry since both were the subject of published rulings by the Revenue Service and since the technical information release issued in 1957 was partially applicable to both industries.

DISCUSSION OF THE BILL

S. 2289 would provide that, notwithstanding the decision of the Supreme Court in the *Cannelton* case, the percentage depletion allowance with respect to various clays and shale shall be determined under the principles of the *Cherokee* and *Merry Brothers* cases for all years beginning before December 14, 1959 (the date that the Supreme Court granted certiorari in the *Cannelton* case). The Treasury Department has two fundamental objections to the bill. The primary objection is that the granting of depletion for manufacturing operations with respect to any mineral for any period of time violates the basic concepts and theories underlying the congressional grant of depletion allowances. The secondary, but also important, objection to the bill relates to the uncertainty of its effect. Any bill which provides that cases are to be settled on the principles of court decisions which are

subject to various interpretations can only result in continued and extensive litigation which will be costly and burdensome both to the taxpayers and to the Government. Furthermore, the eventual results of this litigation are likely to be unsatisfactory to many of the parties involved.

The only justification for granting finished product treatment to producers of brick and tile clay stems from the technical information release issued by the Internal Revenue Service in 1957. It is admitted that this justifies some degree of legislative relief because of the reliance which may have been placed on this announcement. However, there are a number of factors on the other side of the ledger which must be weighed in the balance to determine the extent to which special relief is justified.

First, mineral producers, including brick and tile clay producers, were no doubt aware that it was a distortion of percentage depletion principles to base depletion on value added by manufacturing. Percentage depletion has been a part of our revenue system since 1926 in the case of oil and gas and since 1932 in the case of metals, sulfur, and coal. During this long period of time, it has been widely understood that the cutoff point occurs when the mineral has been obtained, not when it has been converted into a manufactured product. For example, a preliminary report on depletion in 1930 by the staff of the Joint Committee on Internal Revenue Taxation stated, with respect to iron ore, that "probably 95 percent of the entire production is owned or contract-controlled by the smelting companies." In spite of the fact that this industry was integrated (as much as the brick and tile industry is integrated), there was no thought in Congress of extending percentage depletion for iron ore through the smelting process and there was no thought on the part of the industry of claiming depletion on such a basis. Many other industries were integrated to a greater or lesser degree when percentage depletion was extended to them, but they did not seek to base depletion on income from finished products. Many representatives of various mining industries, including representatives of integrated miner-manufacturers, have appeared before congressional committees to request the extension of percentage depletion to their minerals, but not one of them has asked that depletion be allowed with respect to a finished manufactured product. As mentioned previously, the trade journal of the brick and tile industry itself first indicated that depletion was to be based on the value of the raw product. In addition, many brick and tile clay producers did not base their depletion allowances on the gross income from the finished products when they filed their 1951 tax returns; these producers subsequently adopted the finished product argument and then filed claims for refund. A representative of the American Mining Congress, in appearing before the House Ways and Means Committee in 1959, indicated that the interpretation of the cutoff point provisions by the courts "not only allows results which go beyond the original concept of the percentage depletion deduction, but also can produce unintentional discrimination between taxpayers employing the same treatment processes to produce the same end product [because of different marketing practices in different areas]." Thus, the allowance of finished product treatment is not only inconsistent with the basic theory of the depletion allowance but is also contrary to the understanding of the mining industry itself.

Second, the technical information release was issued in response to a series of court decisions. All told, the Government lost upward of 50 cases relating to the cutoff point question prior to the *Cannelton* decision. Less than half of these cases involved brick and tile clay. The balance involved talc, cement rock, refractory and fire clay, shale, gilsonite, limestone, perlite, slate, granite, and dolomite. Either the *Merry Brothers* or *Cherokee* decision, or both, have been cited by courts as authority for allowing depletion to be based on gross income from the sale of such diverse products as talc crayons in packages, hydrated hydraulic lime in bags, ceramic tile, and finished dimension stone. In addition, by 1959 there were approximately 380 cases, involving more than 25 different minerals, pending either administratively or in litigation in which taxpayers were seeking to use the finished product cutoff point. These cases involved some $300 million in revenue. These figures relate only to the cases which had come to the attention of the Internal Revenue Service by 1959 so that both the number of cases involved and the potential revenue loss were actually much greater.

Producers of all of these other minerals thought they were entitled to rely on the principles of the *Merry Brothers* case, and they did so rely in filing their returns. Thus, they too could make a claim for legislative relief for past years similar to that being made by the brick and tile industry, stressing reliance on the court decisions rather than the information release. Mineral producers did not expect, and indeed brick and tile clay producers themselves did not expect, that producers of one mineral would obtain a cutoff point at the finished product and that producers of all other minerals would be held to earlier cutoff points. Thus, in the Brick and Clay Record of December 1957 after the technical information release had been issued, a summary of a statement made by Douglas Whitlock, chairman of the Structural Clay Products Institute, contained the following paragraph:

"As another key point, it is believed that depletion [on the finished product] must be granted to all mineral industries and that the clay industry must help to keep depletion allowances for all. He's sure that no situation can exist wherein only the brick and tile people are allowed depletion [on the finished product]. For this reason, the question of the fire clay allowance as a means of protecting the brick and tile clay allowance needs attention."

In view of the entire background and the complex of factors involved, it is difficult to justify the selection of one factor, an information release which happened because of the course of litigation to apply to two minerals, as a basis for granting finished product treatment to brick and tile clay for a 9-year period. Such treatment differentiates too sharply between brick and tile clay producers and the other mineral producers who also claimed reliance on the court decisions.

Third, the allowance of a finished product cutoff point for brick and tile clay would grant a depletion allowance with respect to this mineral which is out of proportion to the allowance granted to many other more valuable minerals. Brick and tile clay is a low-cost and plentiful mineral which Congress granted only a 5-percent depletion rate. Yet, if depletion is based on finished product values, the depletion allowed with respect to this mineral will exceed that allowed to minerals to which Congress has extended higher rates. For example,

statistics of the Internal Revenue Service and the U.S. Bureau of Mines show that the depletion allowance for coal for the years 1951–58 averaged from 10 cents per ton in 1954 to 17 cents per ton in 1957. Coal enjoys a 10-percent depletion rate and was first granted percentage depletion in 1932. Percentage depletion on finished brick values for 1951–59 would, at a 5-percent rate, be as high as $1.25 per ton since some types of brick sold for as much as $25 per ton of clay during this period. If the principles of the *Merry Brothers* decision extend to finished sewer pipe, which sells for as much as $50 per ton of clay, the depletion allowance could equal $2.50 per ton; and if the principles of *Merry Brothers* are applicable to clay enjoying a 15-percent depletion rate, the allowance on sewer pipe could equal $7.50 per ton of clay. It has been pointed out that when depletion reaches this level, it would be more advantageous from a revenue standpoint for the Government to mine the clay and give it to the taxpayer.

Fourth, to the extent the bill applies to clay other than brick and tile clay (which is uncertain), it applies to clay to which the information release issued by the Revenue Service did not apply.

Fifth, the information release applied to cement rock as well as to brick and tile clay. Yet the special legislation enacted by Congress with respect to the cement industry did not grant finished product treatment to producers of cement rock. It is estimated that the legislative relief granted to the cement industry resulted in forgiving 15 percent of the deficiencies which could be assessed against this industry under the *Cannelton* decision. It is difficult to justify eliminating all potential deficiencies with respect to brick and tile clay and only 15 percent of the deficiencies of cement rock producers since producers of both minerals were in identical positions so far as reliance on the information release is concerned.

In view of these factors, it is our view that, although some legislative relief may be justified, no taxpayer should be permitted to base his depletion allowance on the gross income from the sale of the finished manufactured product.

In addition, by providing that the percentage depletion allowance is to be determined under the principles of the *Cherokee* and *Merry Brothers* cases, S. 2289 would result in widespread litigation. The entire course of litigation from 1957 to 1959 related to differences of opinion as to the proper interpretation of these cases. Thus, if the bill were passed, it would not be clear whether it granted a finished product cutoff point to all brick and tile clay or only to that brick and tile clay in areas where the industry was wholly integrated so that there was no market for the crude clay; it would not be clear whether a finished product cutoff point was extended to fire clay and other clays since they are sold in larger amounts in crude form; and with respect to the clay to which the bill finally applied, it would not be clear whether the finished product cutoff point extended only to finished brick or also to other products manufactured by the taxpayer such as sewer pipe, flowerpots, ceramic tile, etc., some of which sell for many times the value of finished brick. All of these questions would have to be settled by further litigation, and what would purport to be a legislative settlement for past years would settle very few cases. Moreover, after the conclusion of this litigation, it is possible that the court decisions would reach results which are not uniform as

to taxpayers mining similar minerals. Such results would be unsatisfactory to many taxpayers as well as to the Government.

The Treasury Department has indicated to industry representatives and to the House Committee on Ways and Means last year and again this year that it would not object to a bill providing legislative relief for the brick and tile industry comparable to that provided for the cement industry. Because of the rulings and the information release that applied to brick and tile clay and cement rock, these two industries have some basis for relief which is not available to other mineral industries. At the time the legislative relief for the cement industry was considered, the Treasury Department indicated that it would not object if the brick and tile industry was granted a cutoff point after crushing and grinding and separation of waste material. Subsequently it was pointed out by industry representatives that although this cutoff point would allow similar processes as were allowed to the cement industry, it would not relieve an equivalent amount of the deficiencies resulting from the *Cannelton* decision. We recognize that there is some merit to this contention if this proposal is viewed largely as a matter of measuring equities, as respects situations in these two industries in which returns were filed on the basis of the finished product, rather than of identifying mining processes. If your committee feels that legislation would be appropriate which will eliminate approximately the same proportion of deficiencies for the brick and tile industry as the Congress eliminated in the case of the cement industry, we will be happy to cooperate with your committee and your staff in devising a proposal to achieve this objective.

It has been suggested that the brick and tile industry would suffer a severe hardship if it was required to pay any portion of the deficiencies resulting from *Cannelton*. In this regard, it is to be noted that these companies must be profitable in order to obtain any significant percentage depletion allowance since the allowance is limited to 50 percent of the taxable income from the property. A company which had little income during the past years would have little depletion and thus would not be the subject of a large deficiency assessment. In addition, the financial statements of some of the companies involved indicate that they have set up reserves for the payment of any deficiencies which may arise from the depletion issue. Further, the future prospects of the industry appear to be bright. The Brick and Clay Record stated in its June 1961 issue that "there are indications that production of structural clay products will hit capacity levels before the end of 1961." The Internal Revenue Service has already stated that it will cooperate in every reasonable way with taxpayers who cannot make immediate full payment of deficiencies without undue financial hardship. Under this program, taxpayers for whom immediate payment would result in hardship would be permitted to pay the deficiencies in installments.

REVENUE LOSS

If S. 2289 would grant finished product treatment to brick and tile clay and shale used in brick and tile products, the revenue loss from its enactment is estimated at $24 million. If the bill extends to fire clay used in making brick and tile products, the revenue loss is esti-

mated at $33 million. If it applies to clays used in other finished products outside the structural clay products industry, the revenue loss could rise to $80 million. If the bill becomes a precedent for other minerals the producers of which filed their returns, or filed claims for refund, on a finished product basis, the revenue loss could be in excess of $400 million.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

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